Bank of Albania

FINANCIAL STABILITY REPORT 2013 H1

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PREFACE

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

In producing this Report, we have used data available at the Bank of Albania, and information has been exchanged with other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the developments over 2013 H1. Unless otherwise stated, the expectations for the economic and financial outlook extend until mid-2014.

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. In order to assess the risks arising from its interaction with the surrounding environment, the Report provides an overview of 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. Concerning the domestic indicators, this Report assesses the overall developments and expectations for economic growth, balance of trade, overall price level, exchange rate and fiscal indicators. By analysing employment and income performance, it also evaluates businesses and households' financial situation, and the impact on banking sector borrower's solvency.

NOTES

As of the end of June 2013, banks operating in Albania were divided into the following groups by their share:

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

b) Banks Peer Group 2 (each sharing 2-7% of total banking sector assets): ProCredit Bank, 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 assets): Raiffeisen Bank, National Commercial Bank, Intesa Sanpaolo Bank - Albania, Credins Bank, Tirana Bank.

As of the end of June 2013, by capital origin, banks operating in Albania were grouped as follows:

d) 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 Albania, 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).

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

As of the end of June 2013, the National Commercial Bank had expanded its branches network to Kosovo.

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

FINANCIAL STABILITY STATEMENT FOR 2013 H1

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

The Albanian banking sector and financial system saw stable performance in 2013 H1. Bank capital and liquidity indicators were adequate despite the lower profit figures. Banks' activity volume continued to decelerate due to the lower deposit growth and poor credit growth. Loan portfolio quality continued to deteriorate and a considerable portion of banks' operating income was channelled into reserve funds providing for protection against credit risk. Despite the low growth rates, Albania saw stable macroeconomic framework. It was characterised by low exchange rate volatility and weak inflationary pressures, despite the accommodative monetary policy. Government borrowing cost decreased considerably, notwithstanding the higher budget deficit and public debt. The trading volume and number of transactions in the financial markets were stable. Credit risk remains major risk to the banking sector. The impact of some legal and operating measures taken with a view to ensuring better credit risk management by banks is expected to become more evident in the near future. In the meantime, there is limited banking sector exposure to market and liquidity risks.

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

Global economy continued to grow in 2013 H1, although the growth rates were uneven across regions. Economic developments in advanced economies were more stable and showed relative improvement in 2013 Q2. The U.S. economy continued to grow, driven by the accommodative monetary policies, positive labour market developments and improved real estate market. Euro area's economy grew in Q2, hence reducing the annual contraction rate. Monetary policies remained deeply accommodative, contributing to stabilising the financial market operations. There was, however, elevated tension in the markets following the U.S. Federal Reserve's announcement of possible monetary stimulus tapering next year. As a result, interest rates on longer-term public and private debt securities increased, raising concerns about their impact on economic growth. Developing economies continued to make dominant, albeit downward, contribution to global economic growth. The lower contribution was also attributable to the government support policies winding down. Central and Eastern European countries did not perform alike, with the countries with more developed exports displaying better performance. The lending conditions in this region remained tight also due to the lower euro area banks' exposure. South-East European countries showed relative improvement of their economic performance, driven primarily by the improved external trade balances. They, however, continued to face increasing difficulties in the labour market, further fall in financial sector lending and deteriorated loan quality. At a global level, the inflationary pressures remained weak, despite the slightly higher pressures in advanced economies, reflected in the rise in food and fuel prices. The persistent output gap, the high unemployment and the performance of primary commodity and food prices are expected to keep the inflationary pressures weak in the foreseeable future.

At a global level, economic growth is expected to remain modest in 2013 H2, and recover slightly in 2014. Fiscal policies will continue to make negative contribution to aggregate demand due to the need for fiscal consolidation in many countries. Private consumption is expected to remain subdued, driven by the still weak labour market conditions, unstable real estate market and tight lending standards. The downtrend in some large emerging economies will affect global economic growth adversely. Against this setting, the inflationary pressures are expected to remain weak.

The Albanian economy continued to grow at rates similar to the previous period, driven primarily by the fiscal stimulus and external demand. In 2013 Q1, Albania's GDP grew by 1.7% on average. Similar to the previous period, industry, agriculture and services made positive contribution to economic growth. Construction continued to impact negatively, albeit at a more moderate pace. Transportation and trade also made negative contribution to growth. External demand contributed positively and lowered the current account and trade deficit. Exports performed positively driven by the energy and mineral products. Consumption and private investment remained weak, whereas the unemployment rate was relatively stable. The Albanian Government pursued an expansionary fiscal policy as a result of the increase in fiscal expenditure beyond the plan, and the decrease in revenues. The high budget deficit was mainly financed through domestic resources and at a lower financing cost. The average maturity of debt continued to extend due to the faster increase in debt issues with a maturity of longer than 12 months. Given the weak inflationary pressures, the Bank of Albania pursued an accommodative monetary policy by cutting the interest rate on one-week repurchase agreements. This monetary policy stance aimed at creating better conditions for boosting consumption and private investments by lowering the funding costs in the domestic currency. Concerning non-financial assets, the house and rental price index posted simultaneous and similar decrease during the period. This performance was followed by the increase in the relative cost of real estate loan re-payment, despite the downward interest rate on this type of loan. This combined information suggests that house prices will continue to maintain a steadier downward trend in the period ahead.

Households and businesses' financial position and sensitivity to risks moderated at a low pace. Households' creditor position deepened at a slower pace given the lower difference between deposit and credit growth. The increase in lending in the Albanian lek provided major contribution in this performance. The quality of household lending deteriorated for almost all types of loans. Households' exposure to unfavourable exchange rate changes was lower than at end-2012 but, however, higher y-o-y. In the meantime, households' exposure to unfavourable interest rate changes did not show significant changes to the previous period. Businesses' debtor position remained high; however, it maintained the downtrend begun in the previous period due to the increased business deposits and absent growth in lending. The debtor position is mainly affected by foreign currency operations. Despite the continued downtrend in business non-performing loans, the business non-performing loan ratio increased due to the sluggish lending, the latter being driven by the shrinkage in foreign currency lending. Businesses' exposure to unfavourable exchange rate and interest rate changes, albeit high, was lowered further during the period under review.

The trading volume in financial markets increased, whereas interest rates sharpened the downward trend. Concerning the Government debt security market, there was a higher preference for debt issues with a maturity of longer than 12 months. Interest rates decreased further across all debt issues as a reflection of the key interest rate cut by the Bank of Albania and the ample liquidity available at banks for this kind of investments, given the considerable slowdown in lending to the private sector. In the secondary market for debt securities, the trading volume increased slightly from the previous period. It, however, remained low and concentrated only in Treasury bills. The trading volume in the interbank market improved markedly, almost doubling y-o-y. Overnight transactions have major share in the number of total transactions. Interest rates on interbank transactions reflected the key interest rate performance, settling below it. In the foreign exchange market, the Albanian lek was relatively stable, depreciating slightly against the euro and appreciating against the U.S. dollar.

The technical infrastructure supporting banking sector operations continued to operate smoothly and the legal basis regulating its activity improved. AIPS and AECH payment systems operated in compliance with the technical conditions to meet the banking sector needs for settling lek payment transactions. The volume and value of transactions in the AIPS increased, alongside with the increase in the value per transaction. By contrast, the number and value of transactions in the AECH system decreased over the same period. In both systems, transactions on behalf of bank customers have the main share in the number and value of total transactions. By banks, the operations carried out by the four largest banks in these systems accounted for about 2/3 of the number and value of processed transactions. The first half of 2013 saw the approval and entry into force of the new Law "On the payment systems", which sets higher standards for the safety, stability and efficiency of the national payment system. These standards shall be applied to the licensing, regulation and oversight of participants in the national payment system, and the regulation and oversight of payment instruments. The Law establishes the actions to be followed to limit the impact of situations when a system participant falls insolvent on payment systems and further on financial stability. In this spirit, the law increases the room for using different forms of financial collateral and establishes the rights of the collateral taker to hold/ execute it immediately in case the other party to the transaction falls insolvent.

The financial system increased its share in Albania's economic activity further in 2013 H1. Financial intermediation in Albania, as measured by the ratio of financial system assets to Gross Domestic Product (GDP), was estimated at 95.4% at end-June 2013, from 93.9% at end-2012 and 92.8% at end-June 2012. The volume of financial institutions' assets grew 2.1% from end-2012 and around 5.1% from end-June 2012. The banking sector remained the dominant segment of financial intermediation in Albania. Its assets accounted for about 92.6% of total financial system assets and around 88.9% of GDP.

In face of the further slowdown in banking activity, the banking sector saw adequate capital and liquidity levels. Bank profit, however, was lower on a year earlier. Total banking sector assets rose to ALL 1,204 billion, up 1.4% from end-2012 and 3.4% y-o-y. On the asset side, interbank and security transactions registered major increase, reflecting primarily the higher participation in Government debt security auctions. Banking activity was financed through the increase in public deposits, albeit at a lower pace. Banking sector exposure to non-resident institutions was similar to the previous period, reflecting low banking sector reliance on foreign financing sources. The annual growth rate of lending slowed down markedly to 1.3%, despite the better performance of mortgage and consumer loans. Due to the ongoing annual contraction in foreign currency lending, only lek-denominated lending contributed to the annual growth in total lending, which grew 9.2%. Credit stock grew ALL 0.8 billion in 2013 H1, from ALL 5.1 billion in 2012 H1. New loans extended by the banking sector were 16% lower than in 2012 H1. As of the end of June 2013, the ratio of non-performing loans to total loans rose to 24.2%, from 22.5% at end-2012 and 21.1% at end-June 2012. The non-performing loan ratio for lek loans was 20.1%, up 2.1 percentage points from June 2012. The same ratio for foreign currency loans was 26.5%, up 3.9 percentage points from June 2012. Deposits totalled ALL 991.4 billion, up 4.9% y-o-y. Lek and foreign currency deposits grew 7.2% and 2.3%, respectively, annually.

At a sector level, banks recorded positive profit, with an accumulated net profit of ALL 1.5 billion, from ALL 2.4 billion at end-June 2012. Net interest income totalled ALL 19 billion, or 3.9% lower y-o-y. Loan-loss provisions increased by around ALL 7.9 billion, or 11.5% lower y-o-y. Paid-in capital rose by around ALL 6.3 billion in 2013 H1. Regulatory capital rose to ALL 105.8 billion, up 1.6%, whereas risk-weighted assets dropped to ALL 622.3 billion, down 3.3%. As a result, the capital adequacy ratio rose to 17.0%.

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

Concerning the impact of macroeconomic developments on banking sector performance, fiscal policy will continue to provide major impact over the period ahead, despite the largest portion of the annual planned deficit being realised and financed. Assuming that the Government will stick to the budget plan for 2013, the need/room for lower borrowing for the remaining of the year may enhance banking sector incentives to lend more to the private sector. On the other hand, the limited room for fiscal policy to take a more active position in relation to settling public liabilities to the private sector during this financial year will restrain businesses' necessary financial resources to pay off their liabilities to the banking sector. In any case, it seems like fiscal policy will provide higher impact next year when there will be greater opportunities to address this concern. From this viewpoint, the primary objective of fiscal policy will be to restore economic agents' confidence in the stability of fiscal policy and related indicators. In this context, it is important to adopt a stable fiscal rule in the short-term period, which will establish the public debt ceiling for the medium term and enable its return to stable downtrend. In addition, extending the average maturity of public debt should remain a primary objective, despite the short-term operations aiming at maximising profit and lowering the borrowing cost. As in the previous statement, we note that fiscal policy should cautiously monitor the performance of foreign currency-denominated liabilities. Establishing the actions and the way the foreign currency resources will be provided to deal with these liabilities, at the proper time and at an acceptable cost, contributes to preventing uncertainties in the market and safeguarding financial stability.

Credit risk represents major challenge for the banking system activity. The high non-performing loan stock in banks' balance sheets increases banks' costs, impairs their ability to engage in financial intermediation and requires added and inefficient use of their capacities. In this respect, the Bank of Albania has maintained a clear position in relation to the banking industry and other public authorities that may contribute to resolving this issue. In any case, the Bank has underlined the key role the banking sector plays with regard to the policies it implements to know the client, extend and monitor the loans. On the other hand, identifying the needs for amendments to the relevant legal and regulatory framework, the Bank of Albania, in cooperation with the Ministry of Finance and Ministry of Justice, drafted some legal amendments that improve the collateral execution process. These amendments are expected to enter into force in September 2013. On the other hand, communication with the banking sector shows that the impact of measures approved by the Bank of Albania in May this year will be more evident in 2013 H2. Lastly, the first transactions that allow the transfer of non-performing loans from banks to non-bank financial institutions have emerged in the market. The Bank of Albania will undertake all the necessary actions to strengthen this instrument further. The banking sector is, therefore, expected to have greater opportunities to manage credit risk in 2013 H2 and beyond. The Bank of Albania will, in the period ahead, assess the need for additional actions that encourage banking industry toward a stable solution to this issue.

The banking sector appeared hedged against direct risk associated with unfavourable exchange rate and interest rate movements; however, the sensitivity is higher. The banking sector's open foreign exchange position was within the historical levels and the values of interest rate-sensitive assets and liabilities were comparable. The banking sector, however, appeared sensitive to the impact of exchange rate and interest rate movements on banking customers. A significant depreciation of the exchange rate or a similar increase in the interest rate may impair the solvency of borrowers, particularly of the business sector. The main transmission channel of this risk is represented by foreign currency loans, when the main source for its settlement is the domestic currency, and variable-rate loans.

Liquidity risk in the banking sector was also moderate. Similar to the previous periods, deposits represent the main financing source for the banking sector. They recorded positive growth, albeit lower than in the previous period. Borrowing from non-residents remained at controlled levels. Banking sector's liquid assets, in lek and major currencies, were above the minimum requirement, and the negative difference between liquid assets and current liabilities with a maturity of up to one year fell over the period. Loan-to-deposit ratio was at an optimal level, driven also by the lower lending.

Capital indicators were at adequate levels; however, banks should cautiously monitor the possible scenarios for the future and their needs for additional capital. The lower growth of risk-weighted assets made major contribution to banks' capitalisation during this period. Concerns relating to loan quality and the lower market rates reduced the banking sector's positive profit further. There is, therefore, less room for the banking sector to generate sufficient income that would support the increase in capital and conduct operations through domestic resources. On the other hand, net non-performing loan coverage ratio fell during 2013 H1. It is, therefore, imperative for banks to continue to make cautious and proactive assessment of needs for additional capital in line with their risk profile. When required, banks should take actions to strengthen their capital position, initially by limiting the profit allocation and, later, by injecting additional capital.

The stress test exercise should serve banks as a tool to support the assessment of possible needs for additional capital. The Bank of Albania carries our regular stress test exercises to assess the sensitivity of the main banking sector capital figures to changes in macroeconomic indicators. Baseline and risk scenarios, which extend through the end of 2014, include assumptions relating to changes in GDP growth rate, exchange rate and interest rate, and lending. The stress test results reveal that the banking sector was generally resilient to assumed shocks. The banking sector capitalisation level remained above the minimum requirement in the event of the baseline scenario. In the event of the adverse scenarios, which include the corresponding assumptions of the decline in GDP growth rate, lower lending and exchange rate depreciation, individual banks may need additional capital. The regulatory and supervisory framework, and the international best practices, require similar exercises to be carried out by banks themselves on a regular basis, in order to assist their decision-making process.

1. GLOBAL DEVELOPMENTS

The financial markets saw positive developments despite the remaining structural concerns in the euro area. The expansionary monetary policy pursued by many central banks worldwide contributed to easing the financial systems' situation. However, there is no clear evidence of global economic recovery yet. In consideration of the current uncertainties, there is wide consensus that the monetary policy measures will not suffice and there will be need for major structural reforms. Once the reforms start to be implemented, the recovery of global economy will extend further, which will translate into lower demand for national exports.

Global economy continued to recover gradually in 2013 H1, although the growth rates were broadly uneven across regions. The pace of economic growth in developing countries slowed slightly, whereas advanced economies showed positive signs of recovery. Against a still subdued macroeconomic setting, policy actions in most countries continued to support economic growth.

Global economic activity recorded positive growth in 2013 H1, albeit lower than expected.[2] Growth in advanced economies was disappointing in 2013 Q1, particularly in the euro area where the recovery was sluggish and uneven. Balance sheet adjustment process, fiscal tightening and deteriorating lending conditions continued to condition euro area's economic performance. Some advanced economies, including the euro area, showed positive signs of stabilisation in Q2, and economic activity is expected to pick up at end-2013 and 2014. Growth in developing economies decelerated in Q2, driven by the weak external demand, lower commodity prices and, in several cases, weak policy support. These regions, however, continued to make major contribution to global growth. The inflationary pressures showed an upward tendency in advanced economies in the recent months, due to the higher food and fuel prices. In the meantime, data on inflation in developing economies show uneven performance across the countries. The generally subdued global demand kept the inflationary pressures contained in 2013 H1. Against a still weak macroeconomic setting, most countries continued to pursue accommodative monetary policies, whereas the European Central Bank eased it further.[3]

2 *According to IMF calculations, in July 2013, global economy grew 2.5% in 2013 H1, from 2.75% in 2012 H2, hence lower than the forecast in April 2013.*

3 *On 2 May 2013, the European Central Bank decreased the interest rate on the main refinancing operations by 25 basis to 0.50%.*

Unlike the sluggish performance of the real sector, the global financial markets continued to stabilise in the first months of 2013, due to the effect of policy actions taken by the European and U.S. authorities last year. The trading conditions eased in 2013 H1, particularly in the euro area sovereign debt markets, mitigating the geographical fragmentation of ask rates and enabling new issues. This stability that dated back to last summer was shocked in May-June 2013, following Federal Reserve's statements for a possible tapering of quantitative easing programmes. This increased the uncertainty across the market participants about a possible change in the monetary policy stance of advanced economies, which triggered mounting volatility in financial markets at a global level and partial change in trends. This shock was, however, temporary and the markets gradually recovered to stable rates in July and August.

Based on the latest macroeconomic indicators, global economic growth is expected to remain modest in 2013 H2 and recover mildly in 2014. However, a number of factors are expected to curb growth. First, in most advanced economies, fiscal tightening will continue to have negative impact on demand. Second, private consumption will remain sluggish, due to the still poor labour and real estate market conditions in most countries. Lastly, economic slowdown in some major emerging economies is expected to make significant effect on global economic growth.

The U.S. economy grew in the first two quarters of 2013, driven primarily by the increase in consumer spending and private investment. On the other hand, the decrease in government spending, albeit at a slower pace in Q2, and the faster increase in imports relative to exports, made negative contribution. Economic data suggest that the U.S. economy will continue to grow at moderate rates through the rest of the year, driven also by the positive labour market performance and continued improvement in the real estate market. Relative to 2013 Q1, the inflationary pressures were subdued in Q2 and are expected to remain weak due to the high level of spare capacity in the economy. Federal Reserve's monetary policy continued to support economic growth by holding the federal funds rate at 0-0.25% and continuing with the quantitative easing programme. The Fed has announced it will gradually wind down it quantitative easing programme by 2014 should the economy continue to grow as expected.

After a long period of recession, euro area's economy showed signs of improvement in aggregate terms in 2013 Q2, registering modest quarterly growth of 0.3%.[4] Euro area's economy continued to contract annually but at a slower pace (see Table 1.1). There were, however, notable differences across the euro area countries. Large countries like Germany and France recorded positive modest growth in Q2, whereas southern euro area countries like Italy and Greece continued to remain in negative territory (see Table 1.1). The fall in domestic demand, combined with the weak external demand, and the continuing balance sheet adjustment process, hampered the recovery of euro area's economic activity. Labour market conditions remained difficult

[4] *According to most recent Eurostat calculations, 14 August 2013.*

particularly for the young people and unskilled workers. Unemployment rate at a regional level increased, albeit at a slower pace and with sharp differences across the countries. The inflationary pressures were generally weak, standing below 2%. Bank lending remained subdued in most euro area countries, due to the weak credit demand and supply, elevated uncertainty and sluggish economic activity.

For the rest of 2013 and 2014, euro area's economy is expected to stabilise at low rates. European exports are expected to be positively affected by the gradual improvement in global demand, whereas domestic demand will be supported by the accommodative monetary policy and low inflation. The easier financial market conditions are also expected to be reflected in the real economy.

Nevertheless, there are a number of downside risks surrounding the economic outlook for the euro area. Financial markets stress in May and June evidenced the risk of negative consequences that may arise from tightening the conditions in these markets. In the meantime, other risks include: possibility of weaker-than-expected external demand and slow or insufficient implementation of structural reforms.

Table 1.1 Selected macroeconomic indicators for the U.S. and euro area

	GDP change (annual percentage)			Inflation (annual percentage)			Unemployment (annual percentage)			Gross government debt (% of GDP)	
	2012	2013 Q1	2013 Q2	Average 2012	March 2013/ March 2012	June 2013/ June 2012	2012	March 2013	June 2013	2012	2013 Q1
U.S.	2.8	1.3	1.4	2.1	1.5	1.8	8.1	7.6	7.6	100.2	101.6
Euro area	-0.6	-1.1	-0.7	2.5	1.7	1.6	11.4	12.1	12.1	90.7	92.3
Germany	0.7	-0.3	0.5	2.1	1.8	1.9	5.5	5.4	5.4	81.9	81.2
France	0.0	-0.5	0.3	2.2	1.1	1.0	10.3	11.0	11.0	90.2	91.9
Italy	-2.4	-2.3	-2.0	3.3	1.8	1.4	10.7	11.9	12.1	120.7	130.3
Greece	-6.4	-5.6	-4.6	1.0	-0.2	-0.3	24.3	26.8	:	156.9	160.5

Source: European Central Bank, Eurostat, IMF.

The economic performance of Central and Eastern European countries was generally subdued, but, however, with notable differences across the region. Major exporting countries like Poland and Hungary recorded positive growth, driven by the improved conditions in some euro area countries in 2013 Q2. In the meantime, the lending conditions in this region remained tight due to the lower exposure of euro area banks.

After the sluggish performance in 2012, economic activity in South East Europe improved in 2013 Q1 and is expected to remain positive in Q2. There were, however, notable differences across the countries, with Montenegro and Turkey leading the growth (4.3% and 3%, respectively, at an annualised rate). Labour market conditions remained problematic. The unemployment rate was high and in countries like Bosnia and Herzegovina and Turkey they maintained a rising trend. The inflationary pressures were generally stable or downward over 2013 H1, except for FYROM and Serbia. All the countries in this region, except for Turkey, saw narrower external sector imbalances, mainly due to the lower imports, while exports increased slightly. On the other hand, fiscal sector imbalances remained sharp and in some countries (Serbia, Albania and FYROM) the budget deficit exceeded the projection in Q1. Bank lending in all countries, except for Turkey, continued to contract during Q1 and the loan portfolio quality deteriorated further.

Table 1.2 Selected macroeconomic indicators for Central and South East European countries

Central and South East Europe	Annual GDP growth, in %			Annual inflation, in %			Unemployment (annual percentage)			Sovereign debt (as a percentage of GDP)	
	2012	2013 Q1	2013 Q2	Average 2012	March 2013	June 2013	2012	March 2013	June 2013	2012	2013 Q1
Hungary	-1.7	-0.5	0.2	3.4	2.3	2.0	10.9	10.6	:	79.2	82.4
Poland	1.9	0.7	1.1	3.7	1.0	0.2	10.1	10.7	10.6	55.6	57.3
South East Europe (the Balkans)											
Turkey	2.2	3.0	:	8.9	7.3	8.3	9.2	10.5	:	37.9	:
Serbia	-1.7	2.1	0.7	12.2	11.4*	9.9**	23.9	24.1	:	59.3	63.9
Kosovo	2.1p	:	:	2.5	2.4*	2.2**	35.1	:	:	8.4	7.9
FYROM	-0.2	2.9	:	3.3	3.1	3.4**	31.0	29.9	:	32.1	:
Montenegro	-0.5	4.3	:	4.1	3.2*	3**	13.5	14.2	:	51.1	50.3

Source: European Central Bank, Eurostat, IMF, European Commission, respective central banks.
**data for April 2013.*
**data for May 2013.*
P – IMF projection.

1.1 MAIN HIGHLIGHTS IN FINANCIAL AND COMMODITY MARKETS

Under the positive effect of measures taken by the euro area authorities, the trading conditions in the financial markets continued to improve in the first months of 2013. They remained generally stable even after the negative events following the negotiations over the Cypriot banking crisis[5], reflecting as such market participants' confidence in the commitment of authorities.

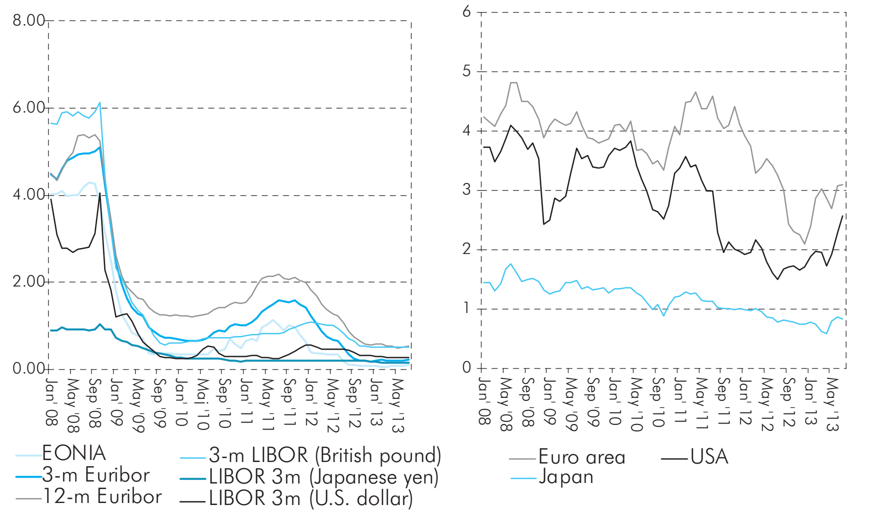
Developments in the European and U.S. money markets reflected the accommodative monetary policies and the buoyant liquidity in the interbank markets. As a result, interest rates hit record low in 2013 Q1, while banks of countries facing sovereign debt issues had easier access to funds in the European markets. In the sovereign debt markets in the euro area, the perceived risk lowered and trading conditions continued to improve. As a result, spreads between yields on long-term euro area periphery government bonds and German Bunds narrowed considerably. Taking advantage of this situation, some of these countries managed to successfully issue new debt. The capital markets also saw positive developments. Despite the global economic downturn, the stock prices rose considerably, particularly in the U.S. markets, while the trading conditions in the credit markets eased and the issued volume increased.

[5] *The Cypriot banking sector faced deep capital deficit in the beginning of 2013. In the negotiations between the Cypriot Government and the ECB and IMF to support the restructuring of the banking sector with a EUR 10 billion bailout package, one of the terms of the deal that attracted particular attention was that uninsured depositors of poorly performing loans and government bondholders would be imposed a levy on their investment. Guaranteed deposits were not affected by these measures.*

In May and June, the financial markets were impacted by the Federal Reserve announcement on a possible tapering of its quantitative easing programme, purchase of mortgage-backed securities, in a near future. This raised the concerns over the shift in advanced economies' monetary policy stance, which was reflected in higher volatility and partial change in market tendencies. While interest rates in the money markets remained generally stable, they rose at a rapid pace in the government bond markets. The rise was sharper in the U.S. versus the European markets, driven partly by the positive results in the U.S. economy indicators for 2013 Q2, which pushed investment flows toward more profitable markets. Over the same period, stock markets saw volatile performance and falling prices, with the European markets experiencing sharper fall.

This shock proved, however, temporary and after the most recent ECB and Fed statements over the future monetary policy stance amid an accommodative setting, market stability seems to gradually restore.

Chart 1.1.1 Interest rates in major money and 10-year government bond markets



Source: European Central Bank, Eurostat.

In the foreign exchange markets, the euro initially appreciated against major currencies, such as the U.S. dollar and the Japanese yen, in Q1. This tendency shifted in Q2 when the euro depreciated slightly, reflecting the change in inflation expectations and interest rates performance.

In the commodity markets, crude oil price has been falling since mid-February 2013 onward and fluctuating between USD 100-105 per barrel. (Brent Crude Oil). This falling tendency was a combination of the weaker-than-expected demand and high supply. Oil price rose slightly at end-Q2 and this tendency is expected to extend through 2013 Q3. This was attributable to the increase in demand for oil over the recent months, whereas supply from oil-producing countries was insufficient due to the elevated geopolitical tensions. Prices of other major commodities were also downward after February and March, and showed signs of stabilisation in the recent months.

Large and Complex Banking Groups operating in the euro area continue to face the challenges arising from the weak macroeconomic environment they are operating in. Their profitability remained subdued in 2013 Q1, attributable mainly to the higher provisioning costs as a result of the deteriorating loan portfolio quality. In annual terms, interest income remained almost unchanged in 2013 Q1, whereas commission and operating income improved. Asset quality remained major concern, particularly in countries with weak economic growth and/or difficult real estate market conditions. While in average terms the non-performing loan ratio was slightly more stable, on an individual level, there were sharp differences across euro area institutions. Most banks improved the capital ratios due to the higher capitalisation and lower risk-weighted assets. In spite of this, there was higher credit risk in the euro area banking sector, which is expected to remain high in the period ahead, due to the weak real sector and difficult labour market conditions in a number of countries.

Box 1 Developments in banking groups operating in Albania

Table 1 shows some of the main indicators obtained from the financial statements of the banking groups operating in Albania. The annual performance of these indicators does not only reflect the impact of macroeconomic developments, but also the decisions of these banking groups during 2013 H1, or the regulatory requirements. These changes, however, varied across the banking groups as shown by the financial analysis below. The changes related to the group's assets, profit, loan quality or capital ratios. Banks appeared adequate as far as capital ratios are concerned. By contrast, the loan portfolio quality deteriorated, interest income decreased and operating expenses saw general increase. The share of banks operating in Albania in total assets of foreign banking groups remained low.

Table 3 Financial data on foreign banking groups operating in Albania, in EUR billion

	Raiffeisen Bank International[I]	Intesa Sanpaolo[II]	Alpha Bank[III]	Piraeus Bank[IV]	National Bank of Greece[V]	Société Générale[VI]	Credit Agricole[VII]
Total assets	130.3	647.8	74.2	95.0	110.4	1254.1	1944.2
Annual change[VIII]	-4.3%	-3.8%	27.1%	35.0%	6%	0%	-3.2%
Volume of customer loans	81.9	358.4	53.5	63.3	69.4	341.2	722.7
Annual change	-1.7%	-4.8%		41.9%	1.0%	3.0%	-1.7%
Volume of customer deposits	66.5	368.4	42.0	54.7	60.8	350	645.8
Annual change	0.4%	-2.4%		48.0%	1.0%	4.0%	1.1%
Non-performing loan ratio	9.9%		31.8%	33%			9.6%
Loan-loss provisions	0.47	2.6	1.0	1.0	0.9		
Net profit	0.28	0.4	2.73	3.50	0.34	1.32	2.41
Annual change	-60.5%	-66.9%				12.6%	44.2%
Operating income	2.7	8.2	1.2	0.96	1.9	1.4	3.7
Annual change	2.7%	-8.3%	81.7%	35.3%	-7%	-43.8%	-19.2%
Net interest income, annual change	4.2%	-17.6%	-5.6%	79.7%	-9.0%		
Net commission income, annual change	9.0%	15.2%	26.6%	36.5%	14.0%		
Operating expenses, annual change	6.5%	-7.7%	26.1%	74.6%	3.0%	-4.0%	1.3%
Personnel cost, annual change	6.2%	-10.6%	36.6%	104.5%	-4.0%		
Net operating profit, annual change	-2.6%	-8.9%					-14.9%
Net interest margin	3.06%		2.0%		3.64%		
Capital adequacy ratio	10.9%	12.6%	13.9%	12.6%	9.2%	11.1%	10.0%
Total banks assets in Albania to total group assets	1.64%	0.14%	0.68%	0.67%	0.26%	0.04%	0.01%

*Data for 2013 Q1.

I *Semi-Annual Financial Report as of 30 June 2013, URL: http://investor.rbinternational.com/fileadmin/ir/2013_Q2/2013-08-22_Q2_Report_RBI.pdf*

II *Consolidated Results at June 30th 2013, press release, URL: http://www.group.intesasanpaolo.com/scriptIsir0/si09/contentData/view/20130802_1H13Resuts_uk.pdf?id=CNT-04-000000014EF0D&ct=application/pdf*

III *First Half 2013 results: Press release, URL: http://www.alpha.gr/files/investorrelations/Alpha_Bank_H1_2013_Presentation.pdf*

IV *First Half 2013 results, URL: http://www.piraeusbankgroup.com/en/investors/financials/financial-results-categories?category=1ou-6minou*

V *Group and Bank Interim Financial Report, 30 June 2013, URL: http://www.nbg.gr/wps/wcm/connect/4cffa091-4f47-4adf-8c74-3ecb17c04b69/Financial+Report+NBG+GROUP-BANK+30+06+2013_EN+FINAL.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=4cffa091-4f47-4adf-8c74-3ecb17c04b69*

VI *First Half 2013 results, URL: http://www.investor.socgen.com/phoenix.zhtml?c=69575&p=irol-results*

VII *First Half 2013 financial results, URL: http://www.credit-agricole.com/en/Investor-and-shareholder/Financial-reporting/Credit-Agricole-S.A.-financial-results*

VIII *Change from end-2012 for balance sheet data.*

2. MACROECONOMIC DEVELOPMENTS IN ALBANIA

2.1 REAL ECONOMY

The Albanian economy expanded at a 1.7% annual rate in 2013 Q1. The industry sector grew 14.8%, providing major contribution to economic growth during this period. Agriculture grew 2.1%, whereas services grew only 0.9%. Construction continued to contract, albeit at a slower pace, and fell 4.8% during the period. In the services sector, post and telecommunication continued to contribute positively, up by 15.4%, whereas trade and transportation contracted 2.1% and 2.9%, respectively.

Aggregate demand saw weak performance during 2013 H1. Fiscal stimulus and external demand were major contributors to economic growth, whereas consumption and private investments remained low. The performance of lending reflected the low private sector demand and the still tight supply-side conditions. In addition to its macro prudential incentives, the Bank of Albania continued to pursue a stimulating monetary policy, aiming at supporting consumption and investment plans, and boosting bank lending.

The inflation rate was within the target in 2013 H1, while the inflationary pressures were weak. Inflation averaged 2.4%, down 0.23 percentage points from 2012 H2.

Based on indirect data[6], households' situation improved in 2013 Q2, with the Consumer Confidence Index increasing by 5.7 percentage points. On the other hand, the lending standards eased and demand for household loans showed the first signs of recovery.

Unemployment rate in the labour market was 12.8% at end-Q2, down by 0.27 percentage points in annual terms. Average real wage rose after a 2-year period of decline. The number of employed persons increased 1.5% in annual terms, reflecting the improvement in the private non-agricultural sector, whose number of employed rose 7.6% in annual terms. The number of employed persons in the public sector continued to drop by 0.5% in annual terms. Employment in the private agricultural sector also dropped 0.9%. Employment expectations[7] for the period ahead appear more optimistic for the industry sector, positive for the services sector and slightly more positive for the construction sector.

[6] *According to the Business and Consumer Confidence Surveys, and Bank Lending Survey.*
[7] *According to the Business Confidence Index for 2013 Q2, expectations index for employment in industry stood at 7.8, in services at 1.0, and in construction at 0.5.*

Fiscal indicators available at end-2013 H1 pointed to an expansionary fiscal policy. Total revenues fell by 2.9% in annual terms and amounted to ALL 156.8 billion. Expenditures maintained an increasing trend and totalled ALL 205.1 billion, up 12.2% y-o-y. Taking into account the share of tax revenues in total revenues, their decrease had an impact on the fall of total revenues, despite the good performance of non-tax revenues. Expenditures were impacted by the concurrent increase in capital and current expenditures, which registered high growth rates during 2013 H1. Budget deficit reflected the higher fiscal stimulus, particularly in Q2, and reached ALL 48.2 billion at end-2013 H1, or 3.55% of GDP.[8] Around 79.1% of the deficit was financed through domestic resources, a considerable portion of which were privatisation receipts. The rest of the deficit, 20.9%, was financed through foreign resources. Public debt stock amounted to ALL 871.5 billion at end-2013 H1. Average maturity of debt continued to increase at fast rates to 457 days. Domestic debt stock accounted for 57.4% of total public debt.

As of the end of June 2013, the current account deficit narrowed by 4.2% in annual terms, and amounted to EUR 519.4 million. Remittances totalled EUR 226.8 million, down 32.9% from 2012 H1. The current account deficit was financed through the capital and financial account, which amounted to EUR 534.3 million, down 20.4% in annual terms. Investments decreased by 12.6% in annual terms and totalled EUR 446.4 million. Portfolio investments improved for the period, whereas other investments continued to fall.

Trade deficit narrowed from a year earlier due to the increase in exports and decrease in imports. The higher exports reflected the positive contribution of 'Minerals, fuels and electrical energy'. Export-to-import coverage ratio stood at 50.2%, or 11.9 percentage points higher, y-o-y.

The economic situation of Albania's main trading partners is expected to exert pressures over external demand and workers' remittances. Fiscal stimulus is expected to be highly limited, whereas inflationary pressures will remain weak. Consumption and private investments will reflect the uncertainties about the economic outlook, hence impacting the economic growth rate.

2.2 HOUSING MARKET

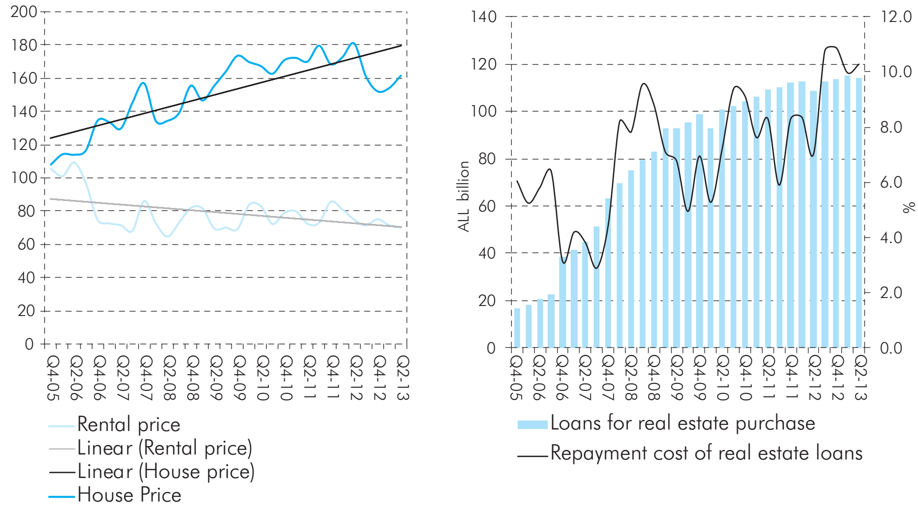
The real estate market improved slightly during 2013 H1. The house and rental price indices continued to fall, with the former showing sharper decline than rental prices. Real estate loans increased, driven by the higher demand and easier lending standards applied to this type of loans. The quality of real estate loans did not improve, whereas the relative cost of real estate purchase continued to increase.

[8] *Preliminary estimates of GDP.*

2.2.1 HOUSING MARKET DEVELOPMENTS

House and Rental Price Indices[9] continued to fall in annual terms, recording an average annual decline of 10.8% and 9%, respectively. Price-to-rent ratio stood at 2.3 at end-2013 H1, remaining at an almost similar level to end-2012 H1, at 2.4.

Chart 2.2.1.1 Housing market developments



Source: Bank of Albania.

As of the end of June 2013, outstanding loans for real estate purchase increased by 4.89% on a year earlier, after expanding by 2.07% in Q1. The weighted interest rate on real estate loans maintained the downward trend of 2013 Q1 and decreased by 1.02 percentage points in annual terms. Relative repayment cost[10] of real estate loans increased by 3.26 percentage points in annual terms at end-Q2. In relative terms, the cost of house loans increased as the house price dropped to a greater extent than the interest rate applied to house loans. This change makes the repayment cost higher in relative terms. A similar tendency was also shown in 2012 H2 following the stable price correction process in the housing market.

Lending for real estate purposes improved in Q1 and Q2, driven by the easier bank lending standards over H1 and the higher household demand for the first time since 2011 Q2.[11]

The real estate loan portfolio quality deteriorated in 2013 H1. The ratio of non-performing real estate loans to outstanding real estate loans stood at 13.57% at end-H1, or 0.69 percentage points higher from 12.88% at end-2012. This ratio, however, was lower than a year earlier, when it stood at 13.9%. Nevertheless, the real estate loan portfolio quality remained under control and better than total loan portfolio's due to the collateral that imposes cautious banking sector and borrower's behaviour.

[9] *House and Rental Price Indices refer only to Tirana.*

[10] *The relative repayment cost of real estate purchase is measured as the difference between the interest rate on real estate loans 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.*

[11] *Based on Bank Lending Survey for 2013 Q2.*

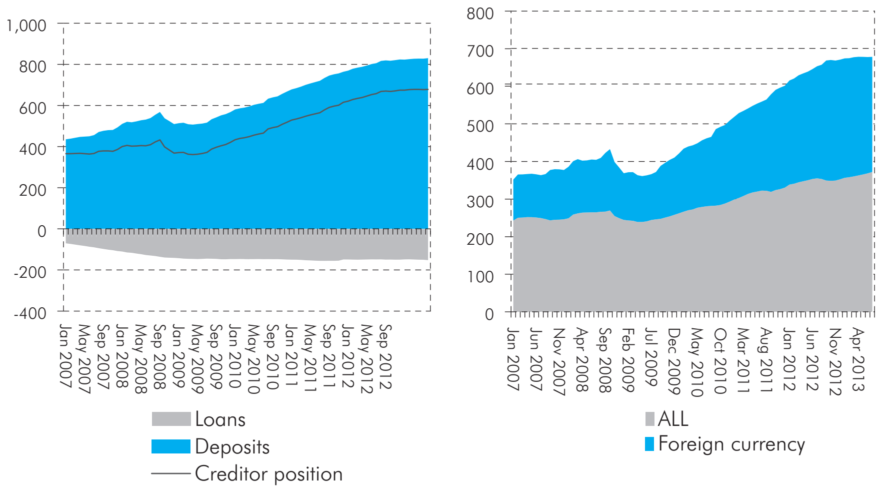
2.3 FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

The financial position of individuals/households maintained a similar trend to the previous period, albeit at a different pace. Households' inclination to save persisted in 2013 H1, though at a slower pace. Lending, albeit positive, grew at weak rates. Consequently, households' creditor position widened further. Businesses' debtor position narrowed during the period under review due to business deposits growing faster than loans. Both household and business loan quality continued to deteriorate in 2013 H1. Though differently, households and businesses remain exposed to indirect credit risk arising from unfavourable exchange rate or interest rate movements.

HOUSEHOLDS

As of the end of June 2013, households' creditor position[12] amounted to ALL 678.32 billion, growing by ALL 4.09 billion during the period and ALL 25.02 billion on a year earlier. In annual terms, the widening of households' creditor position slowed, mainly due to the lower growth in system deposits, whereas lending grew. Household deposits in the system grew ALL 6.47 billion in 2013 H1 and ALL 28.69 billion on a year earlier. The annual growth of household deposits slowed to 3.6% in June 2013, from 7.8% in December 2012 and 12.3% in June 2012. Lending to households grew ALL 2.38 billion in H1 and ALL 3.67 billion on a year earlier. The annual growth of lending to households accelerated to 2.5% in June 2013, from 0.6% in December 2012 and -4% in June 2012, with lek lending providing major contribution.

Chart 2.3.1 Households' financial position to the financial system, in ALL billion



Source: Bank of Albania.

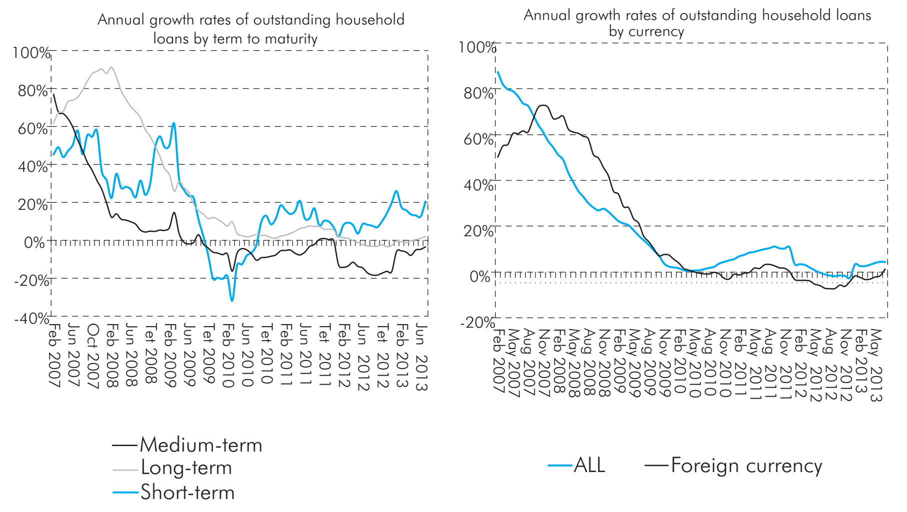
[12] *Households' financial position is measured as the difference between deposits and loans of resident households in the Albanian financial system (which includes all bank and non-bank financial institutions in Albania). If this difference is positive, households are creditors to the system, and if negative, they are debtors to the system. In June 2013, household deposits in the system totalled ALL 830.3 billion, whereas total loans amounted to ALL 151.87 billion.*

By currency, household loans in lek amounted to ALL 372.22 billion and those in foreign currency to ALL 306.09 billion. In June 2013, creditor position in lek increased by around ALL 16.96 billion from a year earlier. This growth rate, however, slowed considerably due to the lower growth of household deposits in lek. For the same period, creditor position in foreign currency increased by only ALL 8.06 billion, from the ALL 61.29 billion growth in 2012. This reflected the increase in foreign currency lending to households compared to the very low levels a year earlier, whereas foreign currency deposits shrank.

2.3.1 CREDIT RISK

As of the end of June 2013, outstanding household loans[13] in the banking sector increased 2.67% in annual terms, and 1.65% from end-2012. Lending to households in lek increased 4.36%, and that in foreign currency 1.32% in annual terms, after some consecutive periods of decrease. By maturity, short-term loans to households grew 20.43%; medium-term loans shrank 3.38%, whereas long-term loans grew 2.16% in annual terms. Short-term loans accounted for 8.2% of outstanding household loans, medium-term loans for 12.9% and long-term loans for 78.9% of household loan portfolio. The share of short-term loans increased slightly from the previous period, despite the loan structure by maturity remaining the same. The loan structure by currency remained almost unchanged, with foreign currency loans accounting for 54.8% and lek loans for 45.2%. However, the share of lek loans continued to show a slight increasing tendency, hence narrowing the difference between the share of foreign currency and lek loans.

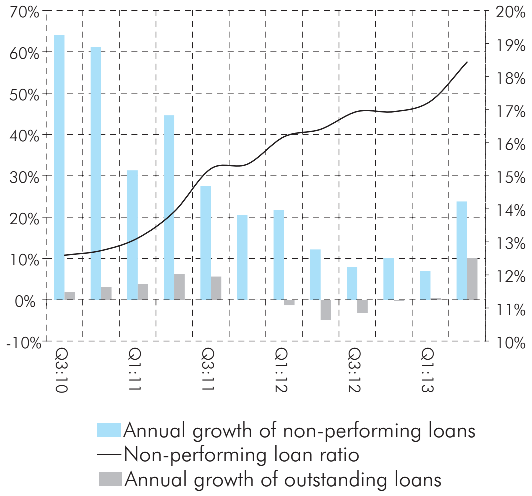
Chart 2.3.1.1 Lending to households



Source: Bank of Albania.

13 *The calculations include only residents.*

Chart 2.3.1.2 Household loan portfolio quality



Source: Bank of Albania.

Household loan portfolio quality continued to deteriorate, due to the increase in non-performing loans at a faster pace than that of outstanding household loans.

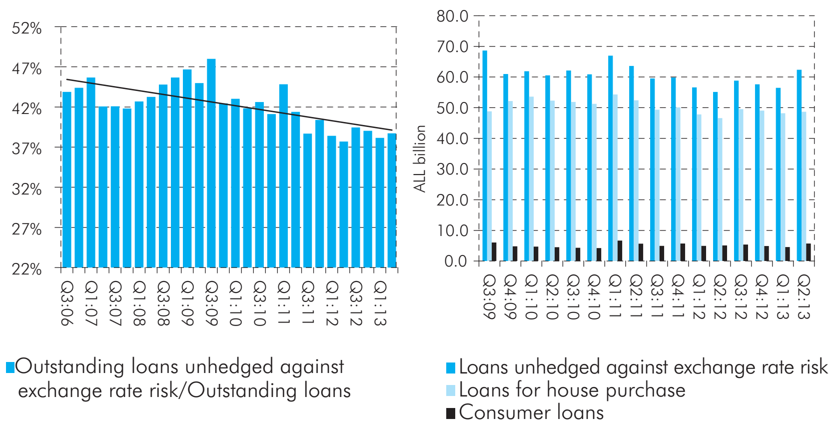
As of the end of June 2013, the ratio of household non-performing loans to total household loans was 18.44%, up 1.5 percentage points from end-2012 and 2 percentage points from end-2012 H1.

2.3.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

As of the end of June 2013, household outstanding loans in foreign currency unhedged against exchange rate risk accounted for around 38.7% of total household outstanding loans. Their share decreased slightly from end-2012 but remained, however, higher on a year earlier.

House purchase loans and consumer loans accounted for around 78% and 9.1%, respectively, of loans unhedged against exchange rate risk. The share of house purchase loans in total loans unhedged against exchange rate risk decreased from 85.1% at end-2012 and 84.5% at end-June 2012. This decrease was attributable to the lower share of foreign currency loans extended for house purchase purposes, whereas outstanding loans unhedged against exchange rate risk grew over the period under review. On the other hand, the share of consumer loans increased from 8.5% at end-June 2012.

Chart 2.3.2.1 Household exposure to indirect credit risk arising from the exchange rate

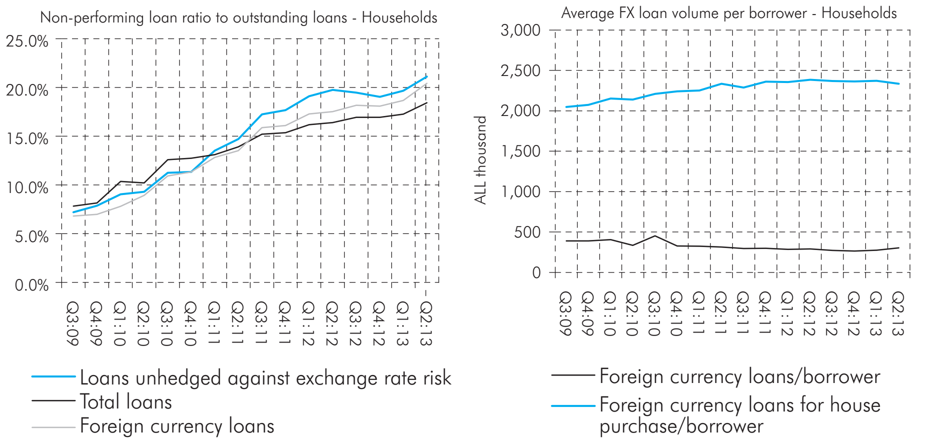


Source: Bank of Albania.

After the slight improvement in 2012 H2, the quality of household foreign currency loans unhedged against exchange rate risk deteriorated at a faster pace in 2013 H1. At end-June 2013, the share of non-performing loans reached 21.1%, from 19.04% in December 2012 and 19.74% in June 2012. The quality ratios of household foreign currency loans and total household loan portfolio (lek + foreign currency) maintained similar tendency, reaching 20.41% and 18.44%, respectively, in June 2013.

Foreign currency house purchase loans per borrower averaged ALL 2.34 million in June 2013, down from ALL 2.38 million in June 2012. The share of non-performing house loans unhedged against exchange rate risk decreased to 18.7% in June 2013, from 19.9% a year earlier.

Chart 2.3.2.2 Household loan quality and average loan volume per borrower



Source: Bank of Albania.

2.3.3 INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

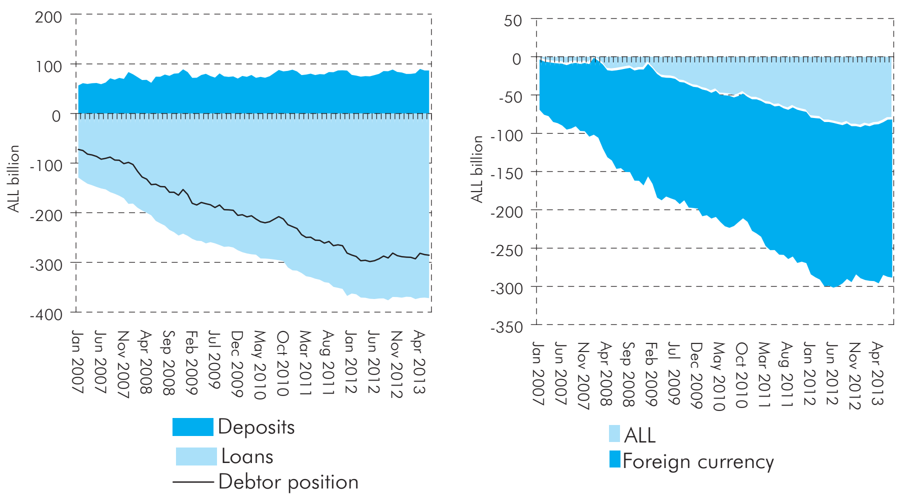
At end-June 2013, household exposure to indirect credit risk arising from unfavourable interest rate movements remained almost similar to end-June 2012 and end-2012. The ratio of variable-interest rate loans to total household outstanding loans was 23.5%, up only 0.1 percentage points from the previous periods. During the period under review, and particularly in 2013 Q2, the interest rates on household loans in lek and foreign currency showed slight changes from end-2012. Interest rates on new household loans increased 0.54 percentage points for lek loans and 0.28 percentage points for U.S. dollar loans, while decreasing 0.53 percentage points for Euro loans from end-2012.

The current changes reflect the fluctuations in demand and supply, and correspond to the period when the lending standards eased and household demand for loans grew.[14]

BUSINESSES

In June 2013, businesses' debtor position[15] amounted to ALL 285.35 billion, shrinking ALL 3.1 billion from December 2012 and ALL 11.15 billion from a year earlier. The developments in businesses' debtor position during 2013 H1 were attributable to the increase in business deposits by ALL 4.09 billion, whereas business loans grew only ALL 0.99 billion. In annual terms, business loans fell 0.5% in June 2013, relative to the 11.6% growth in June 2012. Business deposits showed opposite trend, growing 12.2% in annual terms in June 2013, relative to the 2.6% fall in June 2012.

Chart 2.3.3.2 Businesses' financial position



Source: Bank of Albania.

By currency, business loans in lek amounted to ALL 78.74 billion and those in foreign currency to ALL 206.61 billion. Debtor's position in lek shrank ALL 7.39 billion from December 2012 and ALL 5.97 billion from June 2012, due to the growth of business lek deposits at a faster pace than that of lek loans. Debtor's position in foreign currency increased ALL 4.29 billion in 2013 H1, due to the decrease in foreign currency loans, while business loans saw growth. However, in annual terms, debtor's position shrank ALL 5.18 billion due to the fall in foreign currency loans at a faster pace than that in foreign currency deposits.

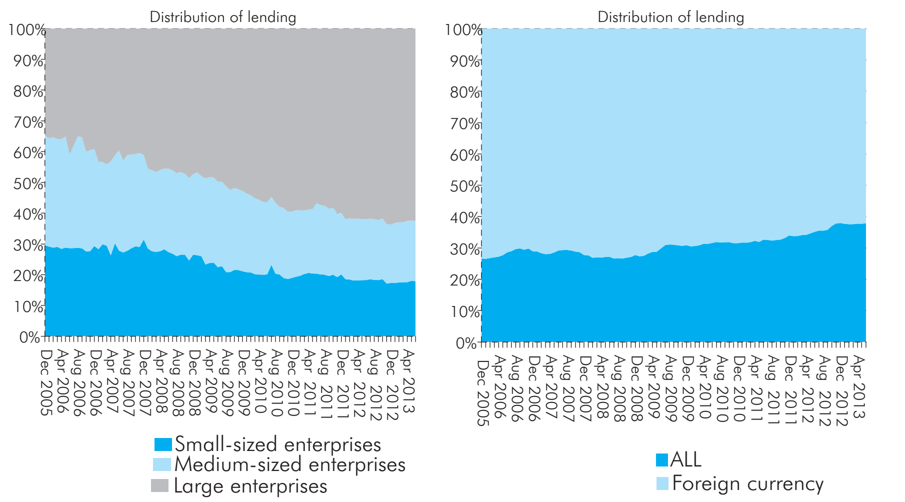
[14] *Bank Lending Survey, 2013 Q2.*

[15] *Businesses' financial position is measured as the difference between business deposits and loans in the Albanian financial system (which includes all bank and non-bank financial institutions in Albania). If the difference is negative, businesses are debtors to the system. In June 2013, business deposits in the system totalled ALL 86.63 billion, whereas total loans amounted to ALL 371.98 billion.*

2.3.4 CREDIT RISK

Lending to businesses began to show the first signs of contraction in 2013 Q2, shrinking 0.63% in June 2013, in annual terms. Business loans in lek grew 4.29%, whereas those in foreign currency fell 2.84% in annual terms, maintaining this trend since 2012 Q4. The structure of lending by business size remained almost similar to the previous period, with minor changes in the share of lending to large enterprises, which fell slightly. At end-H1, lending to small-sized enterprises accounted for 17.9% of the business loan portfolio, whereas lending to medium-sized and large enterprises accounted for 19.6% and 62.5%, respectively. Regardless of the size, businesses lowered the share of short and medium-term loans, while increasing that of long-term loans relative to the previous periods. Concerning the currency, lending in lek increased for both small-sized and large enterprises, whereas that for medium-sized enterprises fell.

Chart 2.3.4.1 Distribution of lending to businesses

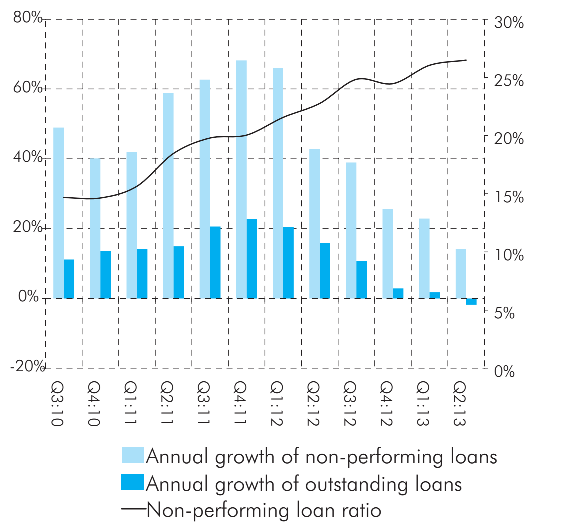


Source: Bank of Albania.

Business loan portfolio quality continued to deteriorate in 2013 H1. However, the growth rate of business non-performing loans slowed during 2013 H1, maintaining this trend since end-2011.

Nevertheless, due to the shrinking lending, the non-performing loan ratio reached 26.49% at end-2013 H1, from 24.46% at end-2012 and 22.77% in June 2012.

Chart 2.3.4.2 Business loan portfolio quality

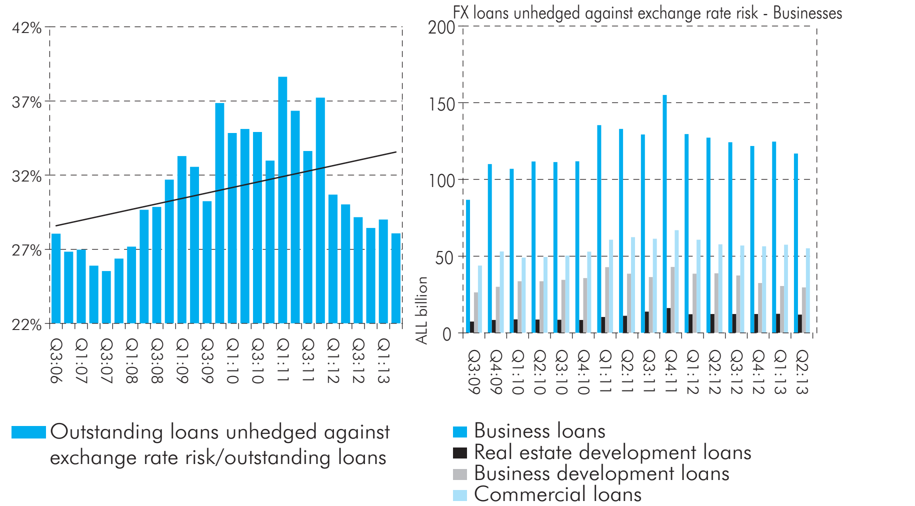


Source: Bank of Albania.

2.3.5 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

After increasing slightly in 2013 Q1, business exposure to exchange rate movements moderated again in Q2, hence maintaining the trend begun last year. In June 2013, business outstanding foreign currency loans unhedged against exchange rate risk accounted for around 28.1% of total business loans, from 28.4% in December 2012 and 30% in June 2012 (see Chart 2.3.5.1 - left). The share of foreign currency loans in total business outstanding loans also fell to 66.6% in June 2013, from 67% at end-2012 and 70.4% in June 2012.

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



Source: Bank of Albania.

After increasing slightly in 2013 Q1, business outstanding loans unhedged against exchange rate risk shrank again in Q2 and, in June 2013, they were around 8.2% lower y-o-y.[16] (see Chart 2.3.5.1 - right). Around 47% of this portfolio consists of commercial loans, 25.4% of business development loans and 10% of real estate development loans. The share of business development loans has been decreasing since June 2012 and it seems to have been offset by the slight increase in the other two items' share.

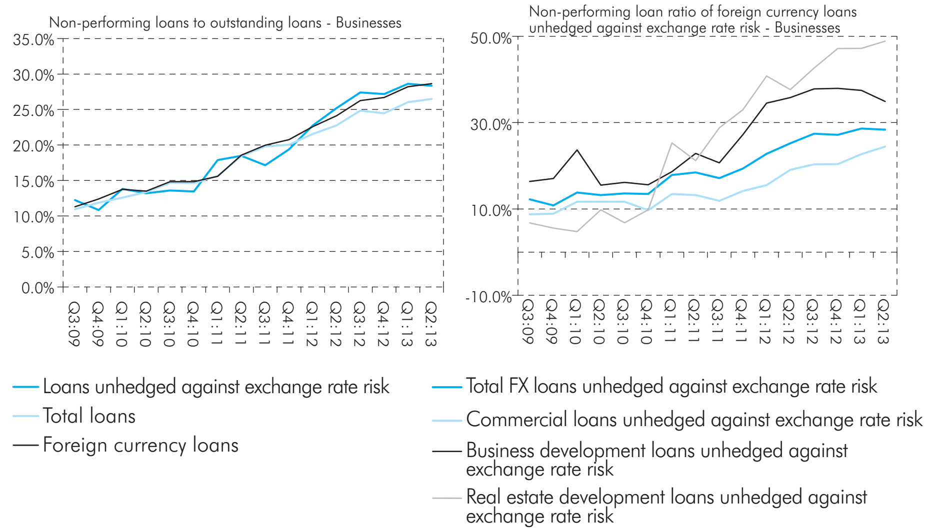
The quality of business loans unhedged against exchange rate movements deteriorated at a faster pace than total business loan portfolio's, and almost at a similar pace to business loan portfolio in foreign currency[17] (see Chart 2.3.5.2 - left). The share of non-performing loans in business foreign currency loans unhedged against exchange rate risk increased to 28.4% in June 2013, from 27.2% in December 2012 and 25.2% in June 2012, mainly due to the considerable shrinkage in foreign currency lending in 2013 Q2. The deterioration of quality in this portfolio remained sharper for real estate development loans, whose non-performing loans increased to 48.9% in June

[16] *In June 2013, business outstanding loans unhedged against exchange rate risk amounted to ALL 116.8 million, down from ALL 124.7 million in March 2013 and ALL 127.2 million in June 2012.*

[17] *In June 2013, the ratio of non-performing loans to total business loans stood at 26.5%, whereas that of non-performing loans to total business foreign currency loans was 28.6%.*

2013, from 47.1% in December 2012 and 37.6% in June 2012. Loans for commercial purposes also deteriorated during the period under review to 24.4% in June 2013, from 20.4% in December 2012 and 19.1% in June 2012. Business development loans were an exception to this trend. The share of their non-performing loans fell to 34.9% in June 2013, from 37.9% in December 2012 and 35.8% in June 2012 (see Chart 2.3.5.2 - right).

Chart 2.3.5.2 Business loan portfolio quality

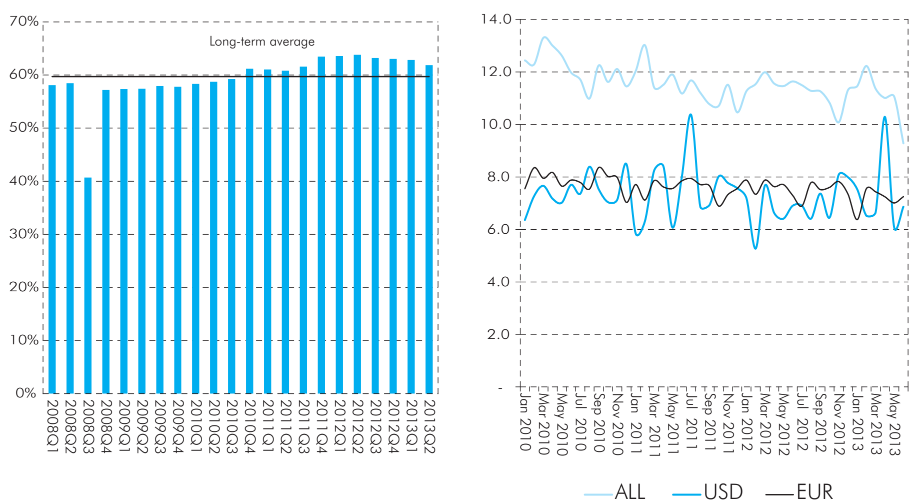


Source: Bank of Albania.

2.3.6 INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

Business exposure to indirect credit risk arising from the interest rate continued to lower in 2013 H1. The ratio of variable-rate loans to business outstanding loans was 61.9%, from 63% at end-2012 and 63.8% at end-2012 H1. This ratio, albeit downward, remained above the long-term average.

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



Source: Bank of Albania.

Interest rates on new business loans dropped on both lek and foreign currency loans. More specifically, interest rates on lek loans dropped 2.03 percentage points, whereas those on U.S. dollar and Euro loans dropped 1.12 and 0.1 percentage points, respectively, from end-2012.

The performance of key rates in Albania and abroad, the lower business demand for loans and the still tight lending standards are expected to keep the interest rates on loans around these levels.

Box 2 Survey on Households and Businesses' Financial Situation

In order to assess households and businesses' financial situation, the Bank of Albania conducts a semi-annual survey. The last survey was conducted during May-June 2013 and focused on developments during 2013 H1.*

2.1 SURVEY ON HOUSEHOLDS' FINANCIAL SITUATION AND BORROWING**

- *FINANCIAL SITUATION*

According to the survey results, the main source of income for the surveyed households remained: self-employment, retirement and labour in the private sector, accounting respectively for 28%, 28% and 24% of total income-earning persons. The share of 'remittances' and 'labour in the private sector' as sources of income decreased during 2013 H1, whereas that of 'self-employment' continued to increase. Around 52% of respondent households stated that their monthly income (lek and foreign currency) amounted to the "ALL 17 thousand - 50 thousand" range and 22% stated that it amounted to the "ALL 50 thousand - 100 thousand" range. There was lower euroisation of income, with only 11% of respondent households declaring that their income is in foreign currency.

- *BORROWING*

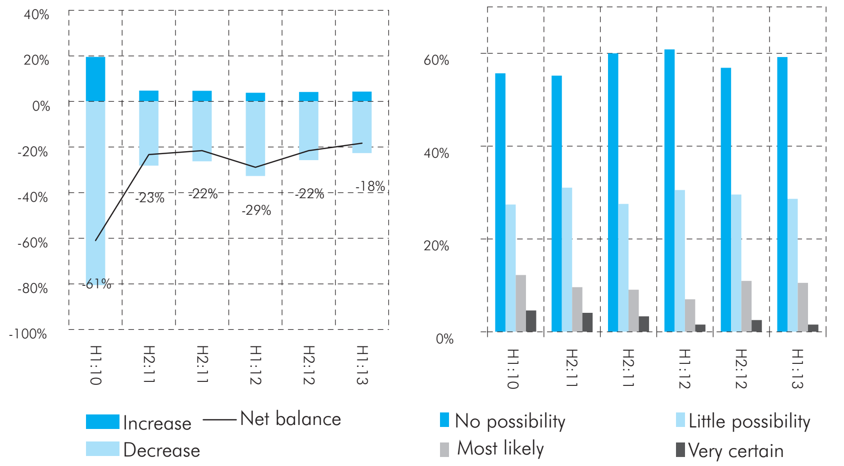
The number of households stating that they have at least one loan to repay, despite its characteristics, was 321 or 28% of respondents, down 6 percentage points from 2012 H2. Around 44% of the borrowing households stated that they had borrowed from formal sources, such as 'banks' (39%) and 'other non-bank financial institutions' (4%), down 2 percentage points from 2012 H2. The fall was sharper in borrowing from other non-bank financial institutions. Around 54% of borrowing households stated that they had resorted to informal sources of funding, such as 'natural persons' (40%) and shops (16%). The main purposes for borrowing remained: 'purchase/renovation of immovable property' (32%), 'consumption' (35%) and 'business development' (14%). Borrowing for purchase/renovation of immovable property and business development maintained the downward trend noted in the previous two periods. Euroisation of household borrowing remained low, with only 4% reporting that their loan was denominated in foreign currency, down 2 percentage points from 2012 H2.

- *HOUSEHOLD DEBT BURDEN*

Around 73% of borrowing households stated that their solvency had not undergone any changes during the reference period, 23% stated that their solvency had deteriorated, whereas 5% stated that it had improved. The net balance of responses was negative, implying the deterioration of households' solvency. However, the *deterioration pace seems to have slowed relative to the previous periods (see Chart 2.1.1). To cope with the financial difficulties, around 51 of borrowing households with worsened solvency stated that they reduced their expenses, whereas 22% sought for a second job.*

For the next half of the year (2013 H2), 78% of borrowing households stated that they did not expect any changes in their solvency, 14% expect it to improve and 8% to deteriorate. As regards the possibility to obtain a new loan in the next period, about 59% of respondent households stated that they excluded this possibility.

Chart 2.1.1 Households' answers on: solvency during the reference period (left) and expectations for obtaining a new loan in the next six months (right)



Source: Bank of Albania, Financial Stability Department.

2.2 SURVEY ON BUSINESSES' FINANCIAL SITUATION AND BORROWING

- *FINANCIAL SITUATION*

In order to analyse Albanian businesses' financial situation and borrowing, a sample of 708 enterprises was interviewed across the entire country.

In 2013 H1, business activity expanded and investments grew relative to 2012 H2, albeit at low rates. The net balance of enterprises declaring expansion/growth was 3.2%, or 1.5 percentage points higher from 2012 H2. Out of active enterprises in this survey, 53.7% (or 45.5% of the total sample, 322 enterprises) stated that they currently have a loan to repay, remaining almost similar to the percentage of borrowing enterprises in 2012 H2.

- *BORROWING*

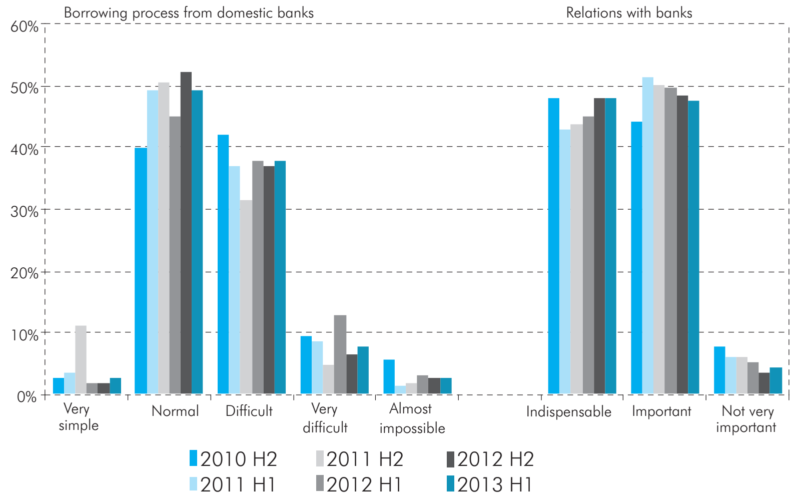
Some 58.4% of respondent enterprises (188 enterprises) stated that they had resorted to borrowing, as a separate or combined source, to fund their activity, down 7.6 percentage points from 2012 H2. Sales funded business operations only in 36.6% of enterprises, which is higher than in the previous period. Around 73% of enterprises stated that they sell more than 80% of their products within the country. The net balance of enterprises stating a change in their profit remained negative at 30.7%, hence reporting again a high number of businesses with worsened profit for the period. Business activity was carried out "mainly in lek" for 71.6% of respondent enterprises and "only in lek" for 21.3% of them.

Around 56.9% of borrowing enterprises had borrowed in lek, 31.7% in euro, and 2% in U.S. dollar. Around 32% of enterprises stated that they had borrowed during the last year, whereas 50.3% had borrowed during a 1-5 year range. For 50.5% of enterprises, the maturity term of the loan was 1-5 years, for 21.4% of enterprises up to 12 months, and for 27.8% of them over 5 years. The loans were mainly used to afford current expenditure for 34.2% of enterprises, and to make a long-term investment for 37.6% of enterprises. The number of enterprises using the loan for the latter purpose increased during 2013 H1. Around 74.2% of enterprises stated that they had pledged real estate as collateral, which is higher from the previous period.

- *BUSINESS DEBT BURDEN*

More than half of respondent enterprises repay the loan by instalments of equal monthly amounts and at a fixed interest rate until the maturity date. The total loan value as a percentage of the capital is about half as much for 73.0% of respondent enterprises, or 1.6 percentage points less than in 2012 H2. As a percentage of income, 71.7% of respondent enterprises affirmed that, in the past six months, they had spent up to 20% of their income on loan repayment, whereas 20.8% of them had spent 20-50%. The change in loan expenditure was almost similar to the previous period, expressed in a positive net balance of 10.6% at end-2013 H1.

Chart 2.2.1 Borrowing process and relations with banks



Source: Bank of Albania, Financial Stability Department.

Expectations for the change in total loan instalment for the next six months point to a positive net balance of 1.28%, expressing a slight increasing tendency, although the results differ across the sectors. Around 83.4% of total respondent enterprises do not plan to borrow in the next six months, which is similar to the previous period. Relations with banks were considered "indispensable" for 48.1% of enterprises and "important" for 47.6% of them. Around 49.2% of enterprises considered the borrowing process as "normal", 38% of them as "difficult" and 7.6% as "very difficult"

* *The sample includes 1210 households across 17 districts of Albania. In the last survey (2013 H1), 96% of the interviewed households answered the survey questions.*

** *The survey results were calculated based on total respondent households.*

3. FINANCIAL MARKETS

The first half of 2013, which corresponded to the pre-election period, saw the Government meeting 90% of the annual plan concerning the budget deficit being financed through domestic debt. The stable demand of economic agents for Government debt securities was followed with the decrease in interest rates on debt for all maturities.

The secondary market trading Government debt securities continued to operate smoothly and registered a slight increase in the number of transactions. Volume in the interbank market increased mainly for the short-term liquidity, 1 and 7-day, corresponding to banks' needs. Weighted average interest rate remained below the key interest rate.

The economic situation in Albania was also transmitted to the foreign exchange market. Over a one-year period, the Albanian lek depreciated slightly against the euro, whereas the exchange rate in effective terms provides signals for further shrinkage in consumption.

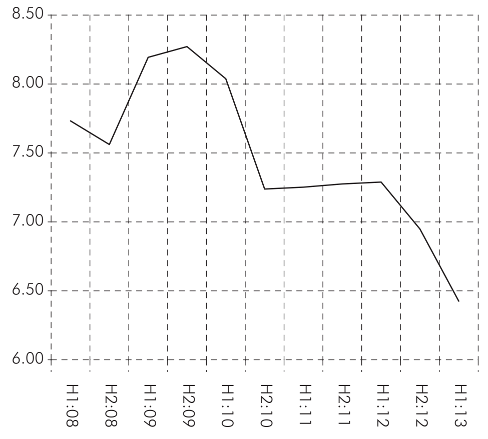
The following provides a detailed analysis of the performance of each market.

3.1 PRIMARY MARKET FOR DEBT SECURITIES

Government financing through domestic debt increased 35.8% during 2013 H1. Accordingly, the volume of debt securities issued amounted to ALL 267.0 billion. The last two years' data show that debt security issues have a tendency to be higher in H1, to later fall in H2. However, as 2013 H1 was a pre-election period, the Government met 90% of the annual plan concerning the budget deficit being financed through domestic debt. T-bills continued to dominate Government financing, at 77.0%. In terms of volume, T-bills with 6 and 12-month maturity registered the highest growth by 44.3% and 49.9%, respectively.

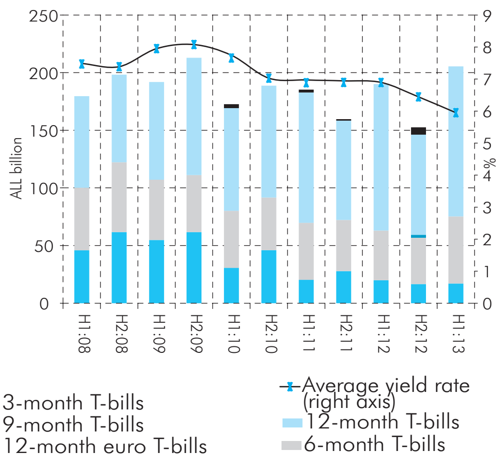
Bid-to-cover ratio in auctions was reported to be lower; however, it did not affect the performance of interest rates. Interest rates on instruments dropped for all maturities. Consequently, the average interest rate on issued debt dropped 52 basis points to 6.42% during 2013 H1.

Chart 3.1.1 Average interest rate on debt securities, in percent



Source: Bank of Albania.

Chart 3.1.2 Volume and weighted average yield rate of T-bills in the primary market



Source: Bank of Albania.

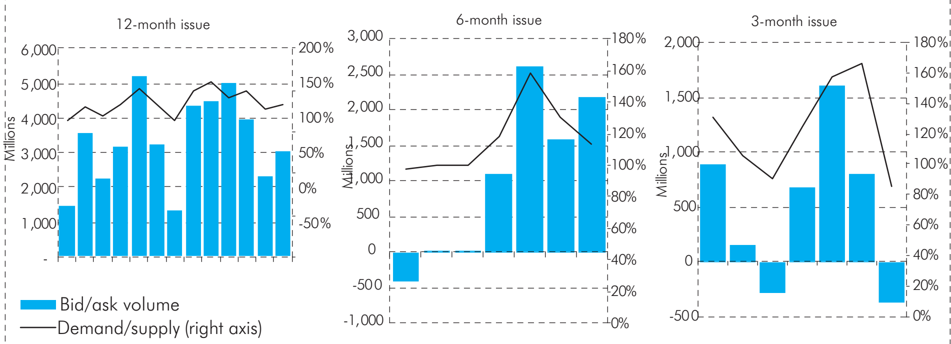
Note: The volume of 12-month T-bills also includes the issue in euro (EUR 20 million, converted into the exchange rate on the date of auction)

During 2013 H1, the Government issued ALL 205.4 billion in auctions, from ALL 152.6 billion in 2012 H2 and ALL 190.2 billion in 2012 H1.

Bidders continued to show greater preference for 12-month T-bills, whose volume grew by almost 50%. Market depth indicators (bid-to-cover ratio) show lower preference for 3-month T-bills. In several cases, the ask amount was not met in auctions. On the other hand, this instrument made the lowest contribution to the decrease in T-bill rate.

As of the end of June 2013, the interest rate on T-bills averaged 5.95%, or 49 basis points lower from 2012 H2, 95 basis points lower from 2012 H1 and 125 basis points lower than the past six years' average.

Chart 3.1.3 T-bill auctions during 2013 H1

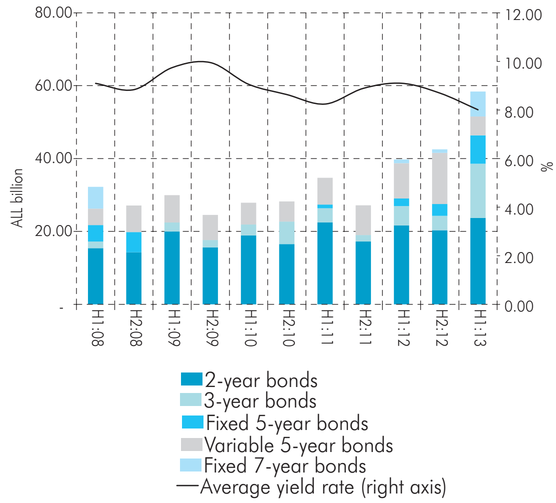


Source: Bank of Albania.

Debt issues in the form of bonds amounted to ALL 61.5 billion, from ALL 44 billion in 2012 H2. In annual terms, borrowing through bonds increased 49.1%, driven by the increase in 7-year bond issues (for both fixed and variable rate) by ALL 7.5 billion or around 300%. Likewise, 3-year bond issues increased ALL 10.9 billion or 277.9% from 2012 H2.

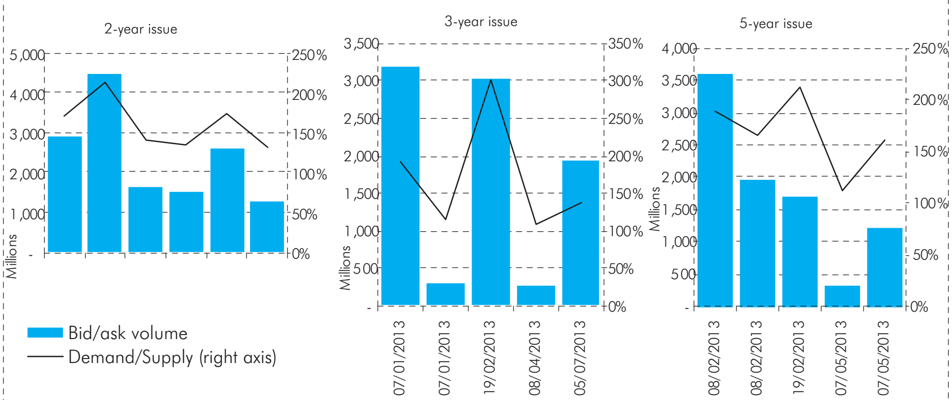
The stable demand for these issues contributed to lowering the yield on all maturities. As of the end of June, it averaged 8.01%, down 69 basis points from 2012 H2 and 109 basis points from 2012 H1. The interest rate on these instruments stood 92 basis points below the past six years' average.

Chart 3.1.4 Volume and weighted average yield rate of bonds in the primary market



Source: Bank of Albania.

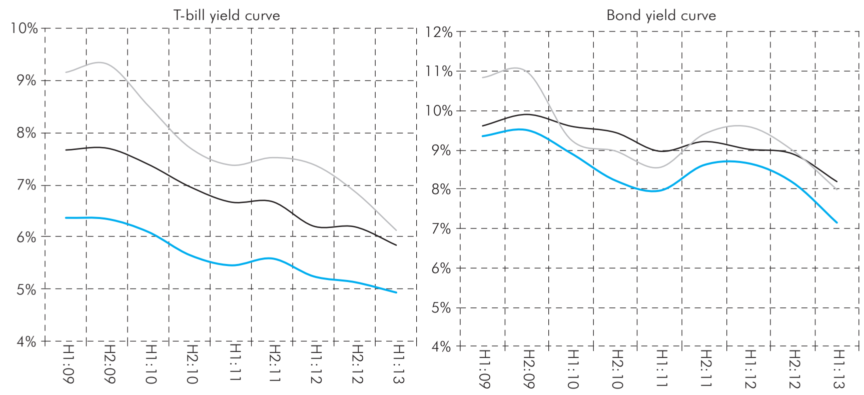
Chart 3.1.5 Bond auctions during 2013 H1



Source: Bank of Albania.

The following shows the yields on Government debt securities by maturity.

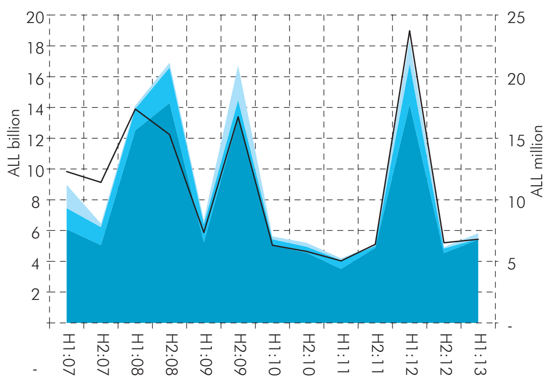
Chart 3.1.6 Average yield rate on debt in the primary market



Source: Bank of Albania.

3.2 SECONDARY MARKET FOR DEBT SECURITIES

Chart 3.2.1 Trading volume of T-bills in the secondary market



Source: Bank of Albania.

In nominal terms, the volume of T-bill transactions amounted to ALL 5.8 billion, up around ALL 0.9 billion or 18.4% from 2012 H2. As shown in the chart, the secondary market operated smoothly, despite last year's structural changes. The number of transactions increased slightly (102 transactions) during 2013 H2. Despite the domination of 12-month T-bill trading (92.8% of total volume), 3-month T-bills increased by nearly ALL 0.3 billion (318.1%) over the period under review.

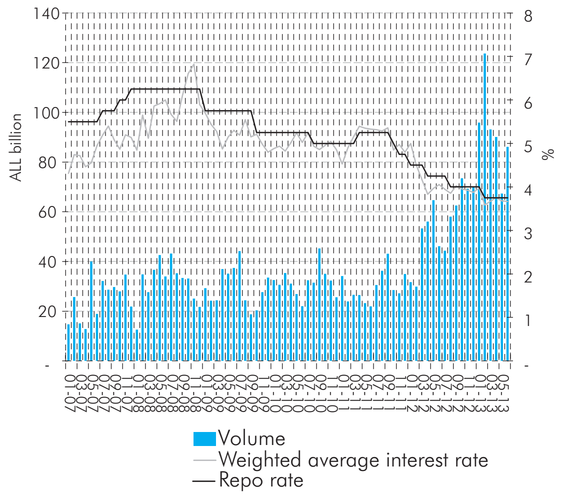
3.3 INTERBANK MARKET

The volume of interbank transactions grew to ALL 556.2 in 2013 H1, up 47.2% from 2012 H2 and 97.4% from 2012 H1. Banks showed greater preference for overnight and one-week borrowing (volume for both maturities grew 33%), whereas one-month borrowing fell during 2013 H1 (ALL 5 billion or 35% from 2012 H2).

The weighted average interest rate in the interbank market remained below the key interest rate[18], at 3.72% from 3.93% in 2012 H2. This difference showed downward path during 2013 Q2.

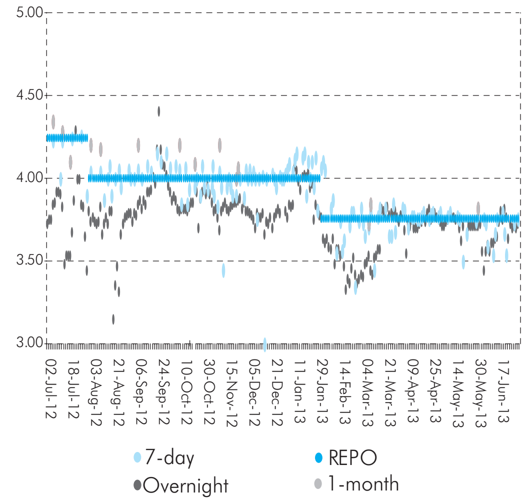
[18] *The Bank of Albania continued to pursue an accommodative monetary policy during 2013 H1. As of the end of January, it lowered the repo rate by 0.25 percentage points to 3.75%, and kept it unchanged for the next five months.*

Chart 3.3.1 Volume and interest rates in the interbank market



Source: Bank of Albania.

Chart 3.3.2 Interbank rates by maturity versus the key interest rate



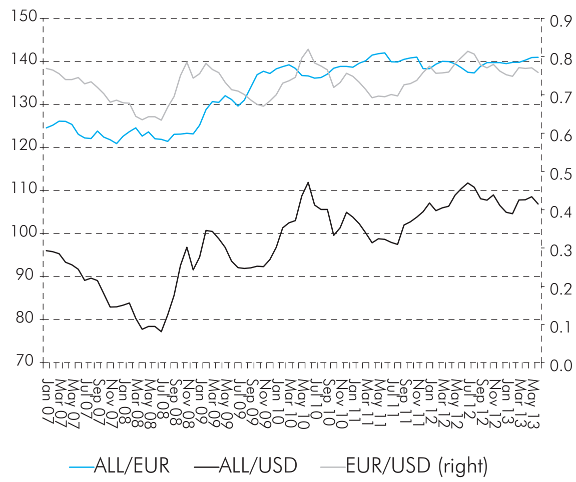
Source: Bank of Albania.

3.4 FOREIGN EXCHANGE MARKET

During June 2012-June 2013, the Albanian lek depreciated 1.77% against the euro and appreciated 3.25% against the U.S. dollar. Lek to euro exchange rate averaged 140.19, from 138.81 in 2012 H2, whereas lek to U.S. dollar exchange rate averaged 106.78, from 109.00 in 2012 H2.

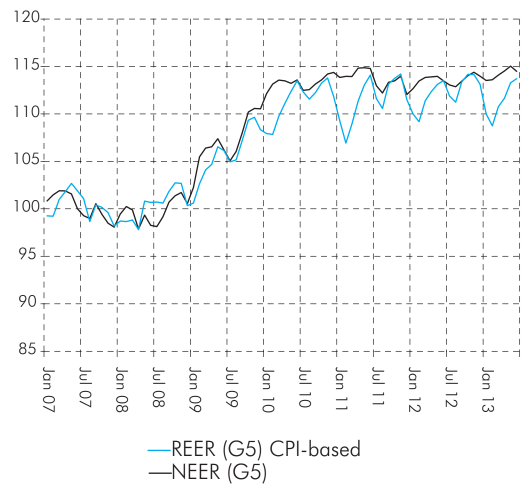
The indicators measuring the changes in lek's exchange rate - Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) - strengthened their respective positions by 0.5% and 0.6%.

Chart 3.4.1 Exchange rate for the three major currencies



Source: Bank of Albania

Chart 3.4.2 Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER)



Source: Bank of Albania.

4. PAYMENT SYSTEMS DEVELOPMENTS

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

Payment systems are an integral part of the financial system structure. They are highly important to a country's economic and financial activities, and are essential to transmitting monetary policies and safeguarding financial stability. Ensuring a high level of safety for different payment instruments also strengthens public confidence in the domestic currency. 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

The number of transactions in the AIPS increased 10% from 2012 H1, whereas their total value increased 18%.

Table 4.1 AIPS transactions

AIPS	January-June 2012	January-June 2013
Number of transactions	37,250	40,847
Value of transactions (in ALL billion)	2,670.66	3,157,693
Average value per transaction (in ALL million)	71.70	77.03

Source: Bank of Albania.

'Customer transactions' continued to have the main share in the number of transactions, accounting for about 65% of the total. This may reflect Bank of Albania's measures of March 2011 applied to banks concerning the ceiling tariff on lek payments.

'Bank of Albania's financial instruments', which at end- 2012 accounted for 56% of transactions' value in the AIPS, accounted for only 37.1% at end-2013 H1, due to liquidity conditions in the market.

AECH SYSTEM

The AECH system processes and clears customer payments below ALL 1.5 million. In 2013 H1, the AECH system processed about 163 thousand payment orders, with an average value per settled transaction of ALL 200 thousand. The number of transactions was 11% lower from 2012 H1, whereas the value of transactions increased slightly by around 2%.

Table 4.2 AECH transactions

AECH system	January-June 2012	January-June 2013
Number of transactions	183,621	163,348
Value of transactions (in ALL million)	32,257	33,018
Average value per transaction (in ALL million)	0.18	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 remained the main contributor to processing small-value payments, respectively by 53% in terms of number and 47% in value.

Activity in the AECH system shows increasing concentration; the four most active banks in the system accounted for 61% of the number of transactions and 67% of their value.

Table 4.3 Concentration indicators for AECH system

AECH system	Number of transactions	Value of transactions (in ALL billion)
4 banks*	42,611	11.2
Share in total (%)	61	67
Total	70,865	16.7

Source: Bank of Albania.

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

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

	Number (%)					Value (%)				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Credit transfers initiated by customers	82.16	81.08	79.15	75.58	74.82	96.08	94.25	95.23	94.53	96.22
1- paper-based credit transfers	97.59	97.29	97.05	96.61	95.68	97.93	97.15	97.25	96.71	97.32
2- non-paper-based credit transfers	2.41	2.71	2.95	3.39	4.32	2.07	2.85	2.75	3.29	2.68
Other payment instruments (bank cards, direct debit and cheques)	17.84	18.92	20.85	24.42	25.18	3.92	5.75	4.77	5.47	3.78

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

Box 3 Regulatory Amendments to the Payments System

In the aftermath of the global financial crisis of 2008, a number of countries strengthened their competences in relation to the oversight and control of payment systems and financial market infrastructure in general. In this context, with a view to further consolidating its supervisory and accelerator role in the National Payments System (NPS), the Bank of Albania, amongst other things, drafted a special law on the payment system. The Payment System Law seeks to establish a legal framework that promotes safety, stability and efficiency of the NPS in Albania. The above-mentioned goal is achieved through standards on licensing, regulation and oversight of important NPS components, and regulation and oversight of payment instruments. This Law also lays down the rules for the protection of systems from insolvency and financial collateral agreements.

The payments system – which includes the Financial Market Infrastructure (FMI) payment, security and derivative transactions – along with financial markets and institutions, are the main components of the financial system. Worth noting is that the Law also mandates the Bank of Albania, in cooperation with the Albanian Financial Supervisory Authority, to regulate and oversee the systems included in post-trading infrastructure of financial instruments, as an integral part of the overall payment system. On the other hand, defining the ultimate character of payments and settlement of transfer orders in the systems, and establishing the rules in the case when insolvency proceedings are opened against a participant in the system, including the liquidation and conservatorship, aim at minimising systemic risk relating to the participation in the payment systems and settlement of securities, and the opening of insolvency proceedings against them.

Lastly, this Law provides a national legal framework applicable for the creation, validity and arrangement of some types of financial collateral agreements. It also aims at minimising/avoiding some possible obstacles relating to the existing administrative procedures in the national legal framework with respect to the form, contents and arrangement of similar agreements, with a view to ensure an efficient use of financial collateral agreements in the domestic financial market.*

More specifically, this Law aims to facilitate the collateral procedures, by acknowledging the right of financial institutions in their role as collateral taker - subject to financial collateral agreements - in relation to the use and execution of contractual obligations. Concerning the mandatory execution of the collateral, the collateral taker has the right to accelerate the debtor's obligations in case of partial or complete failure to comply, and to immediately execute the collateral in compliance with the law provisions, without having to notify or ask the assistance of any state authorities. The protection of financial institutions against financial losses as a result of the insolvency of the other party to the agreement serves to limit the contamination effect that problems in one single institution spread across the financial system in general. The Law provisions may be therefore viewed as instruments that reduce systemic risk with a view to safeguarding financial stability in Albania.

The Law also aims at regulating the procedures relating to the collateral secured by one participant in the system, protecting it against the effect of the opening of insolvency proceedings against the participant in a system. In this context, the Law aims at promoting efficient operation of payments and securities settlement agreements, supporting in this way the free movement of capital and freedom to provide services in the financial market.

* *Within the meaning of this Law, financial collateral are all financial collateral agreements concluded between legal persons for the provision of securities and cash as collateral. These agreements may be in the form of arrangements for the provision of financial collateral or title transfer arrangements, including repurchase agreements (REPO), under the condition that at least one of the parties to this agreement is the Republic of Albania, Bank of Albania, a foreign central bank, a bank, a financial institution, a foreign institution similar to banks and financial institutions, a settlement agent, an operator or a national or international public authority.*

5. FINANCIAL SYSTEM DEVELOPMENTS

Financial system developments were stable in 2013 H1, despite the slow economic activity. The banking sector was well-capitalised and liquid and saw increased banking operations. Non-bank financial institutions expanded their activity and capitalisation. However, credit risk remained high due to the increasing level of non-performing loans. Savings and loan associations, and insurance companies, decelerated their activity. By contrast, private supplementary pension companies and investment funds showed positive performance and saw increased assets.

The top risks for the financial sector arise from the slow economy, generating in turn higher credit risk and a possible decline in banking sector's profitability.

Financial intermediation in Albania, as measured by the ratio of financial system[19] assets to GDP[20], was estimated at 95.4% at end-2013 H1, from 93.9% at end-2012 and 92.8% at end-2012 H1. In terms of volume, financial institutions' assets grew 2.1% from 2012 H2 and 5.1% y-o-y. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 92.9% of total financial system assets and about 88.7% of GDP.

Non-bank financial sector saw improved activity. Total non-bank financial sector assets accounted for about 7.1% of the financial system, from 6.4% at end-2012 and 6.1% in annual terms. The higher share was attributable to the asset increase in investment funds and non-bank financial institutions. As of the end of June 2013, non-bank financial sector's activity as a percentage of GDP was about 6.8%.

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19 *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. The analysis of the banking sector in this chapter is based on data as of the end of June 2013, whereas that of other financial sector segments is based on 2013 Q1 balance sheets and latest publications of the Albanian Financial Supervisory Authority.*

20 *The GDP figure of ALL 1,358,188.34 million is based on Monetary Policy Department calculations of the latest INSTAT and IMF data.*

Table 5.1 Financial system segments as a percentage of GDP across the years (in per cent)

Licensing and Supervisory Authority	Financial System	2008	2009	2010	2011	2012	2013 H1
Bank of Albania	Banking system	76.7	77.5	80.9	84.7	87.9	88.7
	Non-bank institutions	1.7	2.2	2.7	2.5	2.6	2.6
	SLAs and their Unions	0.7	0.8	0.8	0.7	0.7	0.7
Albanian Financial Supervisory Authority	Insurance companies	1.4	1.5	1.4	1.5	1.5	1.6
	Pension funds	-	0.01	0.01	0.01	0.02	0.02
	Investment funds					1.1	1.8

Source: Bank of Albania, Albanian Financial Supervisory Authority.

Box 4 Non-Bank Financial Sector

Activity of Non-Bank Financial Institutions

Non-bank financial institutions saw positive developments in terms of asset growth. In March 2013, non-bank financial institutions' assets totalled ALL 34.8 billion, up 2.4% y-o-y. Lending has major share in the activity of non-bank financial institutions, accounting for 56.7%.

Capitalisation, as measured by the ratio of capital account to total assets, rose to 39.7% in 2013 Q1, from 37.3% a year earlier.

The loan portfolio quality worsened further, with the non-performing loan ratio peaking at 13.3%, from 7.9% in March 2012. The worsening loan quality reflects the overall economic growth slowdown, which has led to lower lending.

Profit of non-bank financial institutions improved in 2013 Q1. Interest income, which have the main share in total income (about 40%), made major contribution to the improved profit.

Table 4.1 Financial indicators of non-bank financial institutions, in ALL billion

	March 2012	June 2012	September 2012	December 2012	March 2013
Total assets	33,9	33,8	34,6	35,3	34.8
Loan portfolio	20,2	20,3	20,2	20,0	19.7
Non-performing loan ratio, in %	7.93	8.99	10.39	8.37	13.30
Capital adequacy, in %	37.27	38.91	38.68	38.90	39.72
Profit, in ALL billion	0,251	0,742	0,719	1,244	0.342

Source: Bank of Albania.

ACTIVITY OF SAVINGS AND LOAN ASSOCIATIONS

Savings and Loan Associations (SLAs) decelerated their activity in terms of asset growth in 2013 H1. SLAs lending shrank, affecting in turn the loan portfolio quality. In addition, they deepened the financial loss in 2013 H1.

Table 4.2 Selected indicators of SLAs and their unions, in ALL billion

	March 2012	June 2012	September 2012	December 2012	March 2013	June 2013
Total assets	9,84	9,90	10,00	10,6	10,4	10,3
Outstanding loans	7,17	7,26	7,13	7,12	6,9	6,8
Outstanding loans/total assets (%)	72.8	73.3	71.2	67.4	67.2	65.8
Non-performing loans	0,436	0,389	0,408	0,451	0,751	0,725
Non-performing loans/outstanding loans (%)	6.1	5.4	5.7	6.3	10.7	10.7

Source: Bank of Albania.

SLAs and their unions deepened their financial loss to ALL 194.2 million, compared to ALL 35.9 million a year earlier. This financial loss was primarily due to higher loan loss provisions of one financial union and increasing administrative expenses.

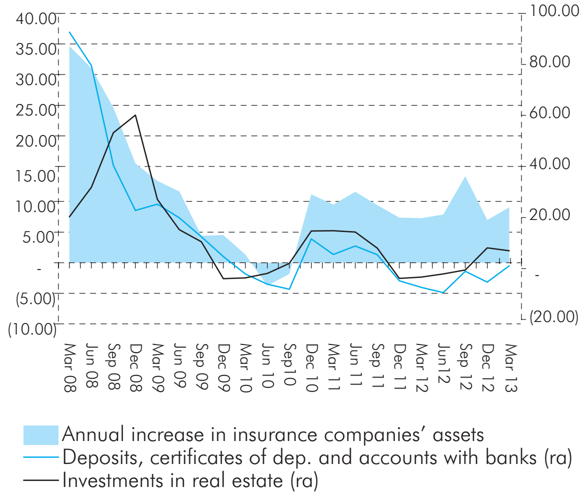
ACTIVITY OF INSURANCE COMPANIES, PRIVATE SUPPLEMENTARY PENSION FUNDS AND INVESTMENT FUND

The insurance market saw decelerated activity during January-June 2013. Gross written premium income fell about 2.4%, whereas paid claims decreased 8.9% from the same period in 2012. Consequently, claim-to-premium ratio, which measures the penetration of the insurance market into the financial system, dropped to 35%, from 37% a year earlier.*

The negative performance in the insurance market was reflected in lower RoE and RoA, capitalisation, and loss ratio. The insurance market remained oriented toward non-life insurance, accounting for 87.5% of total premium volume.

Assets of insurance companies have shown volatile performance over the last five years. They have registered positive rates, despite the overall economic slowdown. 'Deposits, certificates of deposits and bank accounts' and 'real estate investments', which have the main share in assets of insurance companies, accounting for 40% and 9%, were major factors behind the asset performance.

Chart 4.1 Annual increase in insurance companies' assets and related items, in %



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Insurance companies registered negative profit of ALL 467 million in 2013 Q1. It, subsequently, affected RoE and RoA performance, which fell to -4.6% and -2.3%, respectively, from 0.44% and 0.3% over the same period in 2012.

*Private supplementary pension companies** had a positive performance in 2013 Q1. Their assets climbed to ALL 315.6 million, about 11.3% higher than at end-2012. There remain three private pension fund management companies in Albania.*

Assets of the investment fund, a new financial system segment, increased to ALL 25.3 billion in 2013 Q1, about ALL 10 billion higher from end-2012. There is currently only one investment fund management company.

* *Statistical Bulletin "Insurance Market, January - June 2013", Albanian Financial Supervisory Authority, published on 25 July 2013.*

** *Statistical Report "Private Supplementary Pension Market for 2013 Q1", Albanian Financial Supervisory Authority, published on 28 May 2013.*

6. BANKING SECTOR

6.1 ASSETS AND LIABILITIES AND THEIR COMPOSITION

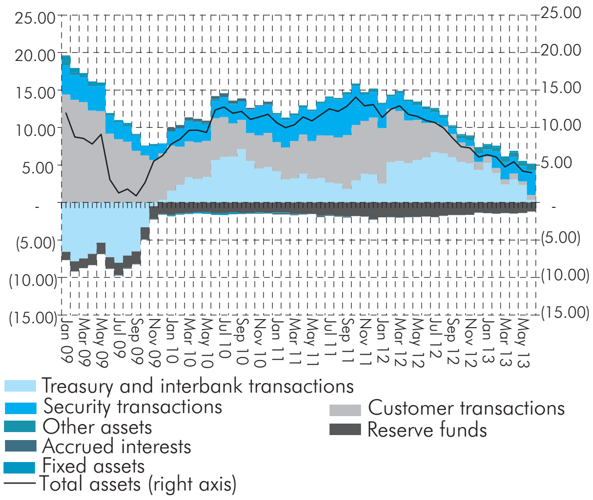
Banking sector assets slowed their growth pace further in 2013 H1.

The increase in securities' investment dominated the asset performance, whereas lending made downward contribution.

Deposits hit the highest level on record as regards the Albanian banking sector financing. They, however, recorded lower growth rates similar to the rest of banking sector activity.

As of the end of June 2013, banking sector assets rose to ALL 1,204 billion, recording modest growth by ALL 16 billion or 1.4% from end-2012. Their annual growth was estimated at 3.4%, from 10.9% a year earlier. As of the end of June 2013, total banking sector assets accounted for about 88.7% of Albania's GDP.

Chart 6.1.1 Contribution to annual growth of assets, in percentage points



Source: Bank of Albania.

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).

Developments in banking sector assets during 2013 H1 continued to show increasing orientation toward low-risk investments. On the other hand, the Albanian Government's decision to concentrate domestic financing at the beginning of the year brought about considerable increase in securities' investment portfolio. The latter recorded a nominal growth of ALL 31.5 billion, offsetting the shrink in banking sector assets in 'Treasury and interbank transactions' and the almost unchanged asset level in 'Customer transactions'[21] (+0.14%) from end-2012.

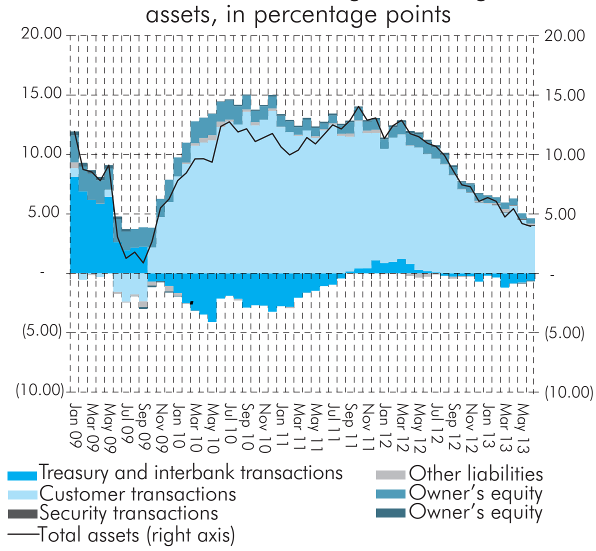
During 2013 H1, non-bank financial institutions acquired 6% of the loan portfolio of one of the large banks under G3 group, consisting primarily of non-performing loans, which gave rise to lower outstanding loans in the system. Despite the further deterioration in loan portfolio quality, loan-loss provisions increased about 21% in annual terms, from 26% at end-2012.

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

Deposits, which accounted for 82.5% of total banking sector liabilities, made extensive contribution to generating funds. As of the end of June 2013, 'Customer transactions'[22] increased further by ALL 4.6 billion (or 0.5%) to ALL 991.4 billion.

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.

Banking sector's foreign currency assets amounted to ALL 670.7 billion (of which ALL 373.6 billion were foreign currency loans), registering a semi-annual growth of 0.7% and an annual growth of 3.86%.

Banking sector's foreign currency liabilities amounted to ALL 623.4 billion, down by 0.2% from end-2012 and registering an annual growth of 2.9%.

Five major banks continue to dominate the Albanian banking sector, with a combined share of 67.4% in the loan portfolio and 74.1% in deposits.

6.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

The Albanian banking sector reliance on external sources of funding curbed during 2013 H1. Banks curbed the increase in their assets abroad and reduced their exposure to parent banks.

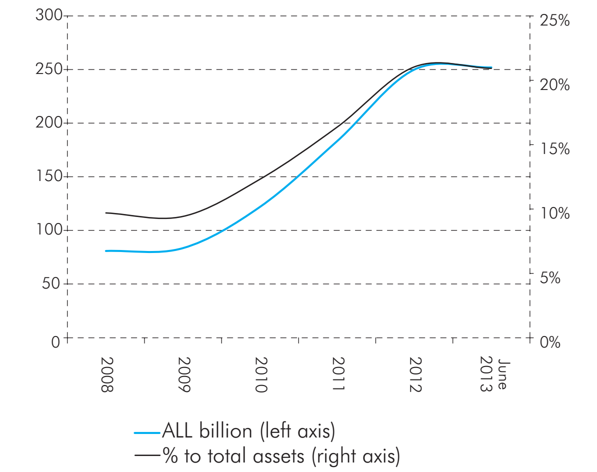
Banking sector investments in non-resident institutions' assets recorded lower growth rates during 2013 H1. Placements in the form of current accounts and deposits decreased, whereas total lines of credit from parent banks remained almost similar to 2012 H2.

Given the high level of resident deposits, the Albanian banking sector has almost zero reliance on external sources of funding. The positive net external position of ALL 166.4 billion at end-2013 H1 increased by more than ALL 31 billion from 2012 H1. It, however, fell slightly by 1.9% from end-2012.

Banking sector investments in non-resident institutions' assets amounted to ALL 251.9 billion, up 0.82% from end-2012 and 17.5% y-o-y. Investments in the form of placements with non-resident institutions fell considerably to ALL 128 billion from ALL 140.6 billion at end-2012, mainly due to the decrease

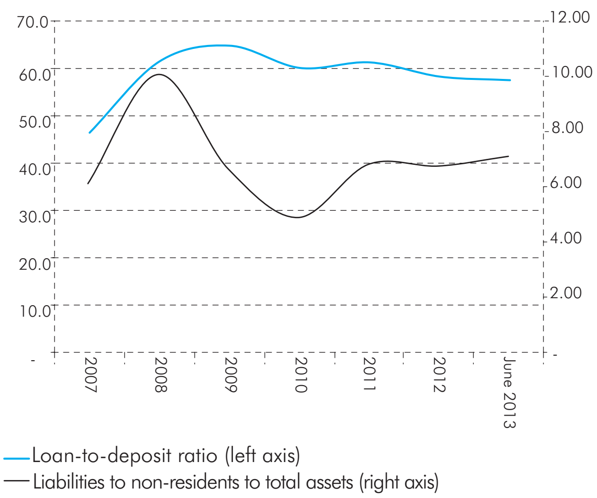
[22] *On the liability-side, 'Customer transactions' represent resident and non-resident deposits, excluding accrued interests.*

Chart 6.2.1 Assets held with non-resident institutions



Source: Bank of Albania.

Chart 6.2.2 Banking sector funding



Source: Bank of Albania.

in time deposits. Assets held with non-resident institutions accounted for 21% of total assets, quite similar to end-2012.

Banking sector liabilities to non-residents amounted to ALL 85.5 billion, accounting for 7.1% of total liabilities, from 6.7% at end-2012. Liabilities to parent banks have major share in liabilities to non-residents.

Lines of credit received from bank holding groups were similar to end-2012. The same tendency was noted in the used and unused part of lines of credit.

Table 6.2.1 Commitments received from parent banks and other group banks

In ALL million	Total line of credit	Used credit line	Unused credit line
June 2013	48,997.4	10,085.4	38,912.0
December 2012	49,045.40	10,116.90	38,928.50
June 2012	55,510.84	13,750.17	41,760.67

Source: Bank of Albania.

The above analysis, which points out that banking sector assets to non-residents were almost three times higher than liabilities to non-residents, shows that there is weak reliance of the Albanian banking sector on parent banks. However, individual banks display higher reliance on their parent banks, which requires cautious monitoring.

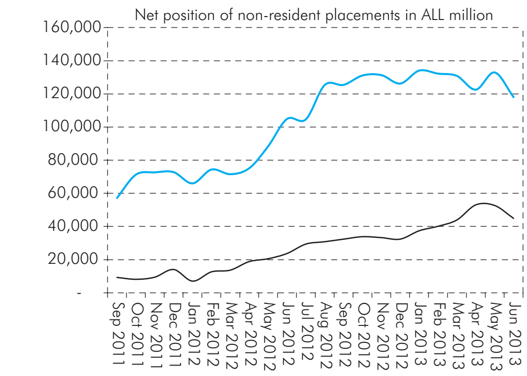
A very weak bank reliance on external sources of funding helps curb the potential negative impact of deleveraging in Europe.

*Box 5 Banking Sector Exposure to Non-Residents**

This Box seeks to elaborate on the characteristics of banking sector exposure to non-resident institutions.

Placements with non-resident institutions, by product: Time deposits have major share in placements with non-resident institutions in assets, accounting for 65.2% of the total, followed by current accounts, 22.5%, and lending to banks, 12.2%. On the liability-site, placements are mainly in the form of loans. As of the end of June 2013, time loans received from banks accounted for 60.4% of total liability placements, whereas financial loans from banks shared 34.7%.

Chart 5.1 Banking sector exposure to non-resident institutions

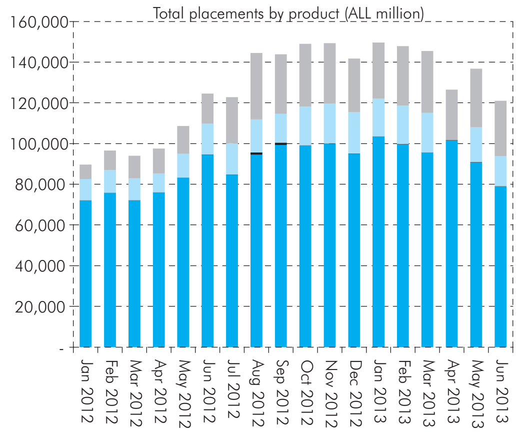


Source: Bank of Albania, Financial Stability Department.

Composition of placements by currency: As of the end of June 2013, non-resident placements on the asset-side were denominated mainly in euro at 72.8%, and in U.S. dollar at 19.9%. Euro placements with parent banks accounted for 78.9% of the total. A similar setting was also shown for liabilities to non-residents, mostly parent banks, with the euro accounting for 98.9% of placements with non-residents.

Maturity structure of placements: Placements with non-resident institutions are generally of short-term maturity. As of the end of June 2013, up to one-month placements with non-residents accounted for 73.1% of total placements, whereas up to one-month liabilities accounted for 10.3% of time placements. On the liability-side, liabilities with a maturity of more than six months accounted for the main share in total liabilities, at 89.8%.

Chart 5.2 Composition of placements with non-resident institutions



Source: Bank of Albania, Financial Stability Department.

Composition of placements by geographical distribution: Total asset placements with non-resident institutions are mainly concentrated in the euro area, whereas only a short portion is placed outside it. As of the end of June 2013, 71.5% of total asset placements were with the euro area. Placements with Greece accounted for 9.2%, whereas those with Italy shared 12.7% of total placements with non-residents. Placements with the European Union, but outside the euro area, accounted for 7.3% of these claims. Liability-side placements were also concentrated with the euro area countries, accounting for 83.5%.

Composition of placements by origin of capital: By origin of capital, total asset-side placements with non-resident institutions have the following composition: Greek banks at 20.8%, Italian banks at 11.3%, French banks at 7.1% and Albanian banks at 9.7%. These placements were lower than at end-2012 and end-June 2012 for all banking groups, excluding the Albanian group. Concerning asset-side placements with parent banks, those with the Greek and French groups increased from end-2012. The falling rates of liability-side placements with non-resident institutions were attributable to their decrease for all banking groups relative to the previous periods. As of the end of June 2013, the share of liability-side placements of banks by origin of capital in total non-resident liabilities was as follows: Italian banks at 34.7%, Greek banks at 28.5%, whereas French banks do not have such liabilities any longer. The *net position of placements remained positive for all groups. It shrank for Italian and Greek banks, while increasing for the French and Albanian group.*

* *This Box is based on operational data as reported by the banking sector on operations with non-resident institutions*

6.3 OUTSTANDING LOANS

The lower pace of bank lending remains major concern for the outlook of the Albanian economy. The growth of lending remained markedly below its historical rates.

Bank lending slowed further in 2013 H1, registering an annual growth of 1.3%, the record low for the past 11 years. As of the end of June 2012, lending grew 9.3%. This performance reflected the weak demand for credit and the tight lending standards applied by banks due to the higher credit risk. In addition, the available low-risk investment alternatives during this period may have impacted banks' decisions on the pace of lending to the private sector.

The ratio of non-performing loans to total loans rose to 24.2% in June 2013, from 22.5% in December 2012 and 21.1% in June 2012.

Lending to businesses in particular, which accounts for 69.3% of total lending and has been the main driver of lending over the past three years, fell 0.2% in annual terms, from the 1.5% growth in December 2012. Lending to households improved by 3.1% in annual terms, from the 0.4% growth in December 2012.

There was a reawakening of interest in household borrowing, mainly for house purchase and consumption purposes. This was, in turn, supported by banks, which offered lower prices on these products.

During 2013 H1, one of the large banks under G3 group sold 6% of its loan portfolio, consisting primarily of non-performing loans, which gave rise to lower outstanding loans and non-performing loan portfolio in the system.

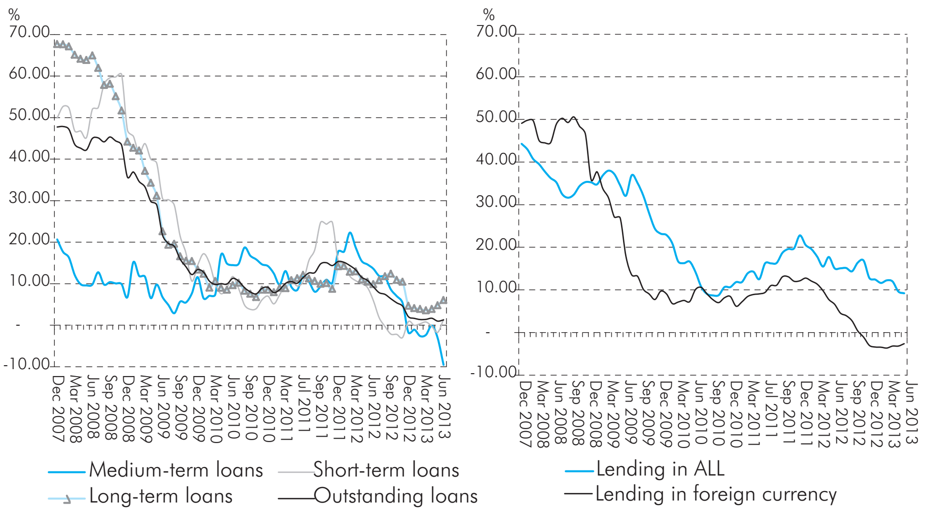
As of the end of June 2013, lending was estimated at 42.6% of Albania's GDP[23] and amounted to ALL 579.2 billion[24].

By term to maturity, the growth was driven by long-term lending, which grew 6% in annual terms. In 2013 H1, long-term loans grew ALL 7.8 billion or 2.9%. Short-term loans recorded negligible growth, whereas medium-term loans continued to maintain the downtrend by around ALL 9.1 billion or

[23] *Based on Bank of Albania's GDP projection.*
[24] *Including accrued interests.*

7.8% from end-June 2012. At end-June 2013, long-term loans accounted for about 48% of total loan portfolio.

Chart 6.3.1 Annual growth rate of lending by maturity and currency



Source: Bank of Albania.

By currency, foreign currency lending fell 2.6% in annual terms, whereas lek lending grew 9.2%, despite the lower share in the loan portfolio (35.5%). Foreign currency lending grew by only ALL 0.9 billion or 0.2% from end-2012, whereas lek lending grew ALL 0.4 billion or 0.2%.

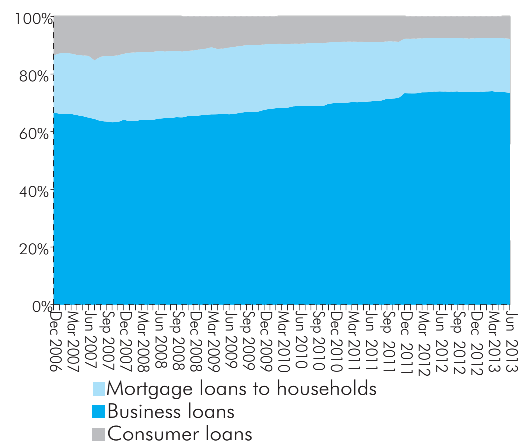
Lending to businesses curbed, whereas that to households registered modest growth during the period.

Lending to businesses fell ALL 1.5 billion or 0.4% in June 2013, while the annual growth hit -0.23%, the record low of the past six years.

For the first time since 2011, the lending survey reported the growth of household demand for loans, mainly for house purchase and consumption purposes, which was also driven by the easier lending standards applied to this item.[25] Lending to households grew ALL 2.9 billion or 1.9%.

Lending to the public sector was negligible during 2013 H1.

Chart 6.3.2 Lending to the economy

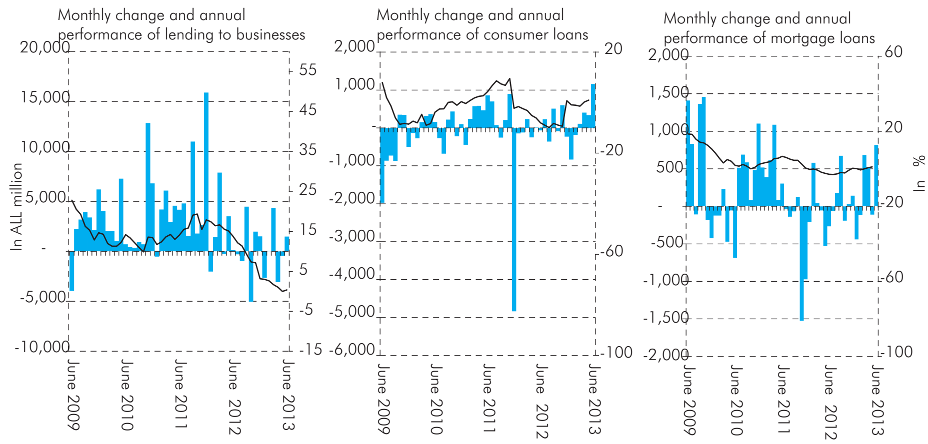


Source: Bank of Albania.

Note: Data in Chart 6.3.2 refer to lending to residents. As of the end of June 2013, 100% of total lending to businesses (including state-owned enterprises) and 94.9% of total lending to households were lending to residents.

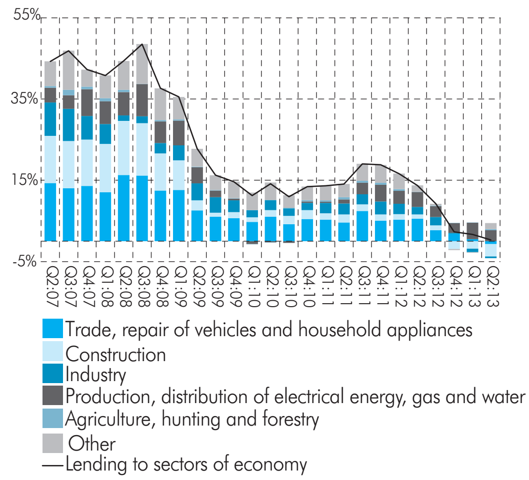
[25] *"Bank Lending Survey, 2013 Q2", published by Monetary Policy Department, Bank of Albania.*

Chart 6.3.3 Monthly change (left-hand axis) and annual performance (right-hand axis) of lending to businesses, consumer loans and mortgage lending to households



Source: Bank of Albania.

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



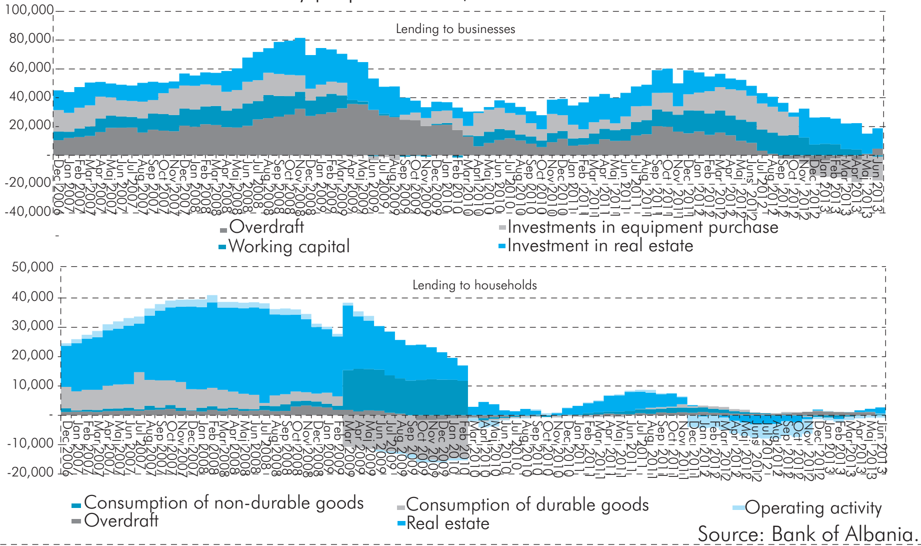
Source: Bank of Albania.

By sectors of economy, production and distribution of electrical energy, gas and water continued to be supported with bank lending, also due to the priority and support government institutions have been providing to Albania's hydro energy potentials. Lending to this sector grew by ALL 2.4 billion or 5.2% during 2013 H1. Lending to hotels and restaurants grew ALL 2.3 billion or 13.3%. Trade, which has the main share in total lending, grew modestly, whereas lending to construction and real estate and leasing shrank ALL 4. 3 billion or 6.8% and ALL 3 billion or 51.1%, respectively. Chart 6.3.4 shows the contribution of major sectors to lending.

By purpose of use, overdrafts, which dominate lending to businesses, registered the highest growth during 2013 H1, by ALL 5 billion or 4.2%. Working capital loans grew ALL 3.4 billion or 4.3% less than in 2012 H2. The growth of lending to households was oriented towards real estate investment, which grew ALL 1.4 billion or 1.4%.

Chart 6.3.5 shows the structural changes in the distribution of lending by purpose of use over the past years.

Chart 6.3.5 Annual growth of lending to businesses and households by purpose of use, in ALL million



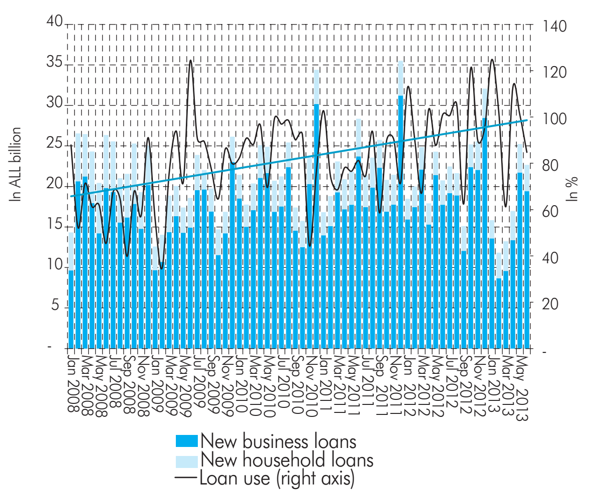
Source: Bank of Albania.

Box 6 New Loans

In 2013 H1, new loans amounted to ALL 105.8 billion, ALL 36.3 billion or 25.5% less than at end-2012. Relative to 2012 H1, new loans were ALL 20.5 billion or 16.3% less.

Over the same period, the banking sector's recovered loans amounted to ALL 103.7 billion, down ALL 35.2 billion (25.3%) from end-2012 and ALL 12.7 billion (10.9%) y-o-y.

Chart 6.1 New loans and loan use ratio



Source: Bank of Albania.

Loan use ratio, which represents the ratio of recovered-to-extended loans, was estimated at 98.1%, from 97.8% at end-2012 and 92.2% at end-June 2012.

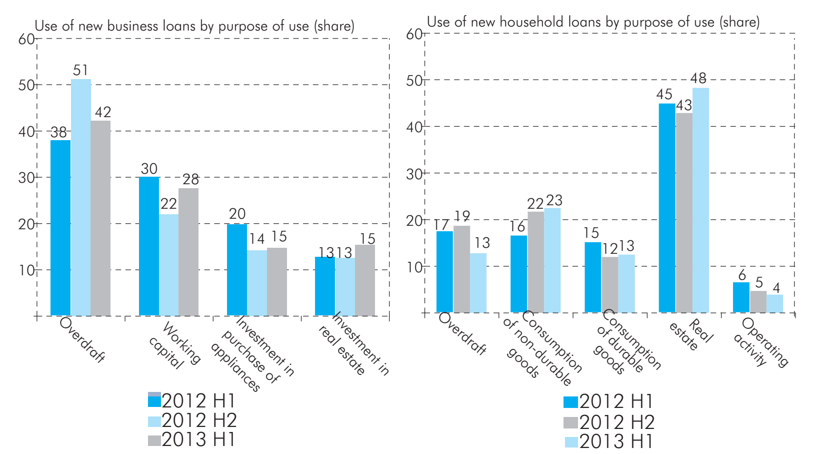
By user, households and businesses were extended 18.4% and 81.6%, respectively, of new loans. There was a shift to new lending to households, despite the lower recovery of household loans.

Chart 6.1 shows the performance of new loans to households and businesses, and the loan use ratio in monthly terms.

The distribution of new loans by purpose of use shows the decrease in business overdrafts by ALL 26.5 billion or 42.1%. For the same period, household overdrafts fell ALL 1.1 billion or 30%. New loans to the private sector fell in all other items, particularly for equipment purchase purposes.

Households were extended new loans for real estate investment purposes, being also driven by the Government's social initiative to support households with soft financing for residential purposes. This category of lending grew ALL 1.2 billion or 15.1% in 2013 H1. Lending for the consumption of durables and non-durables also grew, whereas lending for operating activity continued to shrink.

Chart 6.2 Distribution of new business and household loans by purpose of use



Source: Bank of Albania.

Chart 6.3 shows the distribution of new loans by main sectors of the economy. Lending to 'Production and distribution of electrical energy, gas and water' and 'Trade' shrank ALL 11.2 billion or 50.9% and ALL 8.9 billion or 20.4%, respectively, whereas lending to 'Hotels and restaurants' grew ALL 1.1 billion or 46%.

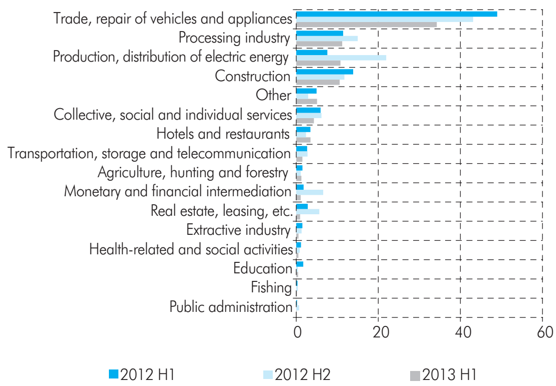
The distribution of new loans by currency shows downward performance for all currencies. New lending in lek posted the biggest decline by ALL 37.6 billion or 53.6%. New lending in euro fell ALL 15.6 billion or 25.2%, whereas that in U.S. dollar fell ALL 2.4 billion or 24.6%.

INTEREST RATES ON NEW LOANS

Interest rates on new loans denominated in foreign currency dropped slightly in 2013 H1, whereas those in lek recorded modest increase. The performance of interest rates in the Albanian market was affected by the rates in the global markets. The interest rate on U.S. dollar loans dropped to 6.54%, 0.5 percentage points lower than in 2012 H2, whereas that on euro dropped to 6.81%, or 0.3% lower. The interest rate on new loans in the Albanian lek rose to 10.9%, or 0.3 percentage points higher than in 2012 H2.

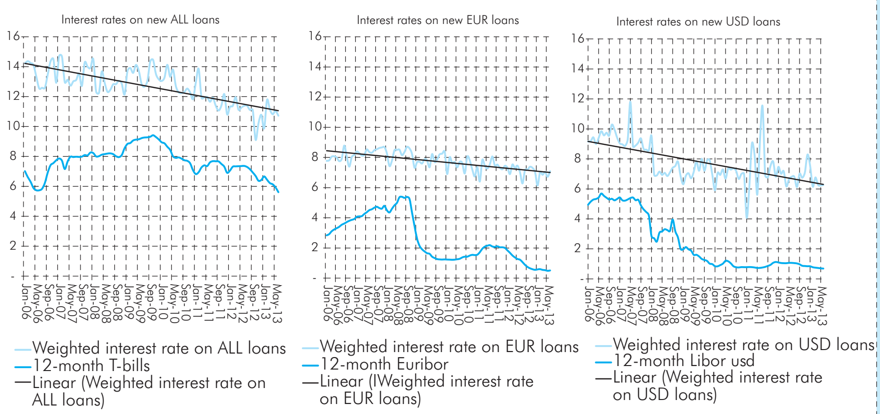
Interest rates on new business loans for real estate investment registered major drop by about 1.2 percentage points, to 7.9%. Interest rates on new household loans for operating activity were more favourable in 2013 H1. They dropped to 12.57%, or 0.8 percentage points lower.

Chart 6.3 New loans by sectors of economy, in ALL billion



Source: Bank of Albania.

Chart 6.4 Interest rates on new lek and foreign currency loans

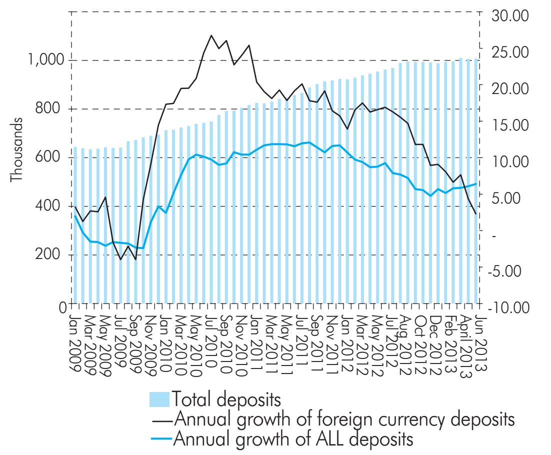


Source: Bank of Albania.

6.4 DEPOSITS

Banking sector deposits continued to grow during 2013 H1, albeit at a slower pace than in the previous periods.

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



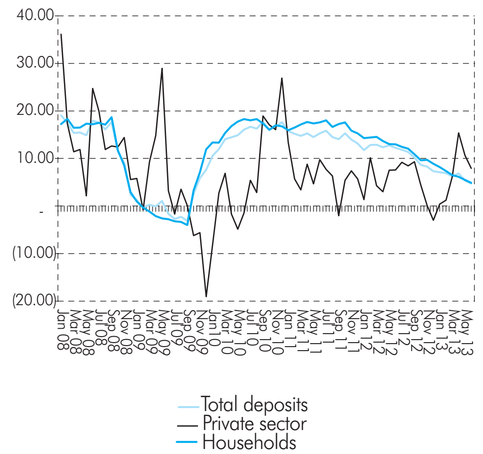
Source: Bank of Albania.

Deposits in the banking sector grew ALL 15.4 billion or 1.5%, to ALL 1,007 billion.[26] The annual growth rate of deposits slowed to 4.7% in June 2013, from 12.2% a year earlier. Household deposits, which accounted for about 87.5% of total deposits, grew at a lower annualised rate of 4.9%, from the 13% growth in 2012. Business deposits grew 8% in annual terms, almost at a similar pace to the previous year.

Deposits continued to remain concentrated in the largest banks in the banking sector; however, the degree of their concentration fell y-o-y.[27]

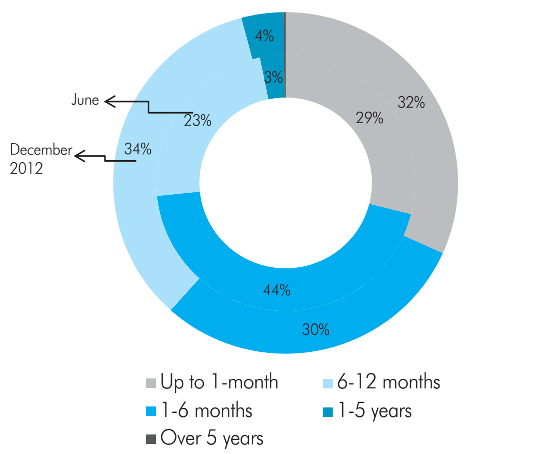
The deposit structure showed significant shift to deposits with shorter maturity. More specifically, there was a higher share of 1 to 6-month deposits than of up to 1-year deposits. This performance may reflect public's lower tendency to save following the decrease in deposit rates.

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.

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26 *Including accrued interests.*

27 *Deposit concentration ratio, as measured by Herfindahl index, fell to 1478, from 1576 in 2012. Despite the lower index, the banking sector showed levels of concentration in the recovery of deposits.*

Concerning the structure of deposits by currency, lek-denominated deposits increased, whereas foreign currency deposits fell during 2013 H1. While sharing a similar weight in total deposits in the previous periods, in 2013 H1, lek deposits shared above 51% in total deposits, and amounted to ALL 515 billion.

*Box 7 New Time Deposits**

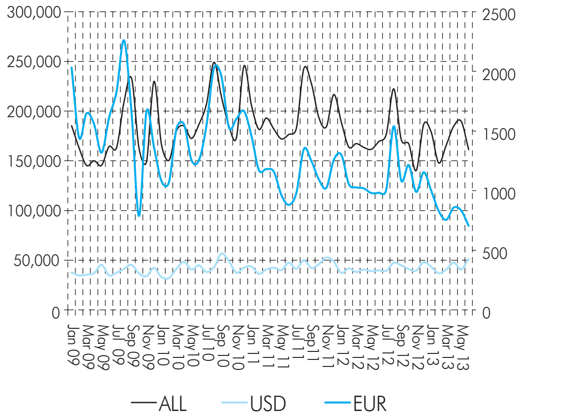
New lek time deposits fell in 2013 H1. The banking system accepted ALL 230 billion in new time deposits, or 20% less than in 2012 H1. This decline occurred at a time when the average interest rate on lek deposits dropped to 4.3%, from 4.5%. Concerning the maturity structure of new lek deposits, the share of new 1-month deposits reduced by about 20 percentage points, to 17.2%. During the same period, the share of new 12-month deposits increased by about 13.8 percentage points, to 45%.

In 2013 H1, new U.S. dollar time deposits amounted to USD 337.6 million, about 7.2% less than in 2012 H1. The deposit structure shows a higher share of 12-month deposits by 7.6 percentage points and a lower share of 1-month deposits by 4.6 percentage points. The interest rate on new U.S. dollar deposits averaged 1.8%, from 1.6% in the corresponding period in 2012.

New euro time deposits amounted to EUR 1.27 billion, down by 24.5% from 2012 H1. The average interest rate dropped to 2%, from 2.5%. Concerning the maturity structure of new euro deposits, the share of 12-month time deposits increased by 10.3 percentage points to 37%, whereas the share of 1-month time deposits dropped by 15 percentage points, to 20%.

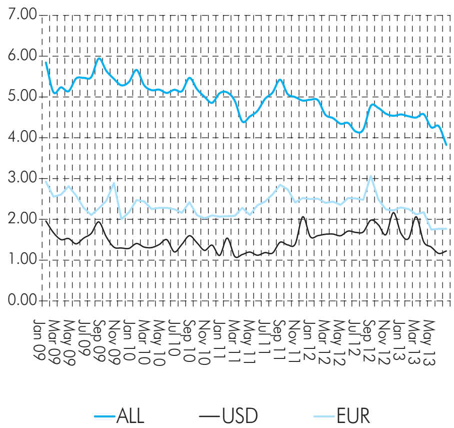
* *The analysis of new deposit figures should take into account the fact that a considerable portion of new deposit flows is attributable to the renegotiation of existing deposit contracts.*

Chart 7.1 New time deposits by currency, in million monetary units



Source: Bank of Albania.
Note: Lek deposits - left-hand axis; euro and U.S. dollar deposits - right-hand axis.

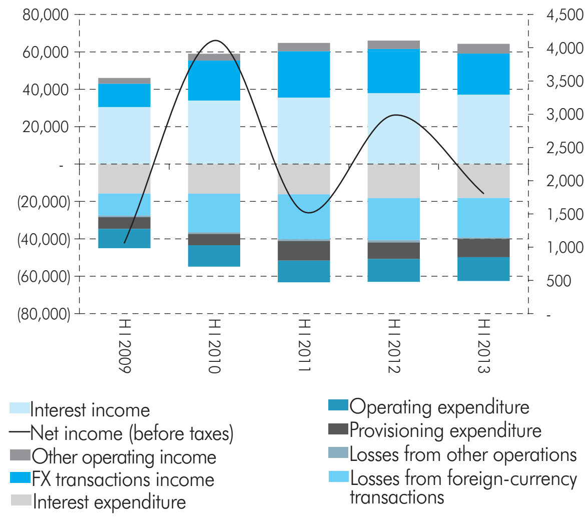
Chart 7.2 Interest rates on new time deposits, in percentage



Source: Bank of Albania.

6.5 PROFITABILITY AND RESOURCE EFFICIENCY

Chart 6.5.1 Income and expenditure structure of the banking system, in ALL billion



Source: Bank of Albania.

The banking sector's net profit was ALL 1.5 billion at end-June 2013, down by 36% from a year earlier. Almost the entire change in the Albanian banking sector's net profit was due to considerably higher provisioning expenses – mainly driven by foreign-currency security price deterioration in banks' portfolios, which led, in turn, to higher provisions for these investments.

Profit from the main banking operation - net interest income – fell slightly (4%) on a year earlier, while net income from other operations increased 21.4%. The increase in settlements contributed positively to net profit, mitigating the eroding effect of the loan portfolio deterioration.

Table 6.5.1 Profitability ratios, in per cent (cumulative)

Indicators	June 2011	December 2011	June 2012	December 2012	June 2013
Interest income/interest-earning assets	8.06	7.78	7.76	7.73	7.39
Interest expenses/interest-earning assets	3.94	3.57	3.72	3.72	3.61
Net Interest Margin (NIM)	4.13	4.20	4.04	4.01	3.78

Source: Bank of Albania.

At end-June 2013, average interest-earning assets climbed to ALL 1,004.6 billion, accounting for about 84.1% of the banking sector's total average assets. They increased by ALL 12.3 billion or 1.2% from end-2012 and ALL 27.1 billion or 2.8% on a year earlier. 'Average interest-bearing liabilities to average interest-earning assets' stood at 102.2%, up by 2% from end-2012 and 2.5 percentage points from a year ago.

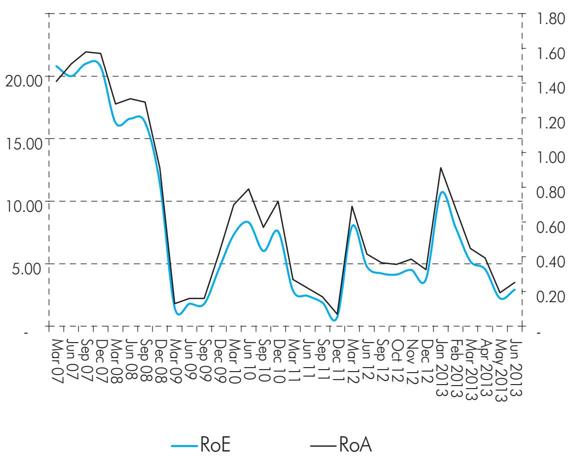
Banking sector's net operating income was ALL 24.3 billion, almost unchanged from the same period a year earlier. Operating expenses recorded ALL 12.7 billion, or 3.2% higher than a year earlier. Consequently, the ratio of operating expenses to net income stood at 52.1%, from 50.8% in the same period a year earlier.

The ratio of general operating expenses to income climbed to 95%, from 87.6% in June 2012, due to decline in provisions by around ALL 955 million.

Banking system profitability deteriorated on a year earlier. Return on Equity (RoE) was 2.9%, from 4.8% a year earlier. The decomposition of RoE components[28] provides a more detailed analysis of factors affecting its deterioration:

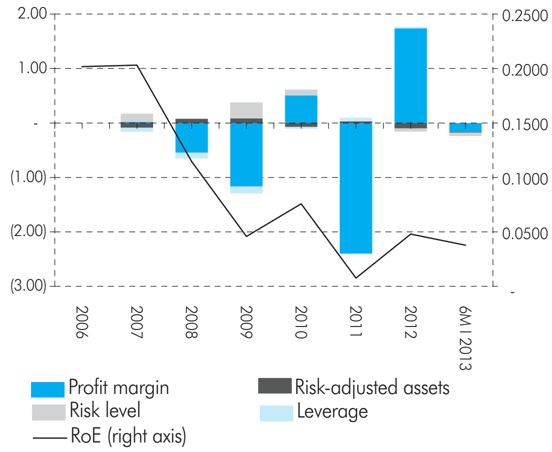
$$Roe = \frac{\text{Net profit}}{\text{Operating income}} \times \frac{\text{Operating income}}{\text{Risk-weighted assets}} \times \frac{\text{Risk-weighted assets}}{\text{Total assets}} \times \frac{\text{Total assets}}{\text{Equity}}$$

Chart 6.5.3 RoE and RoA (right axis), in per cent



Source: Bank of Albania.

Chart 6.5.2 RoE's linearised composition and performance*



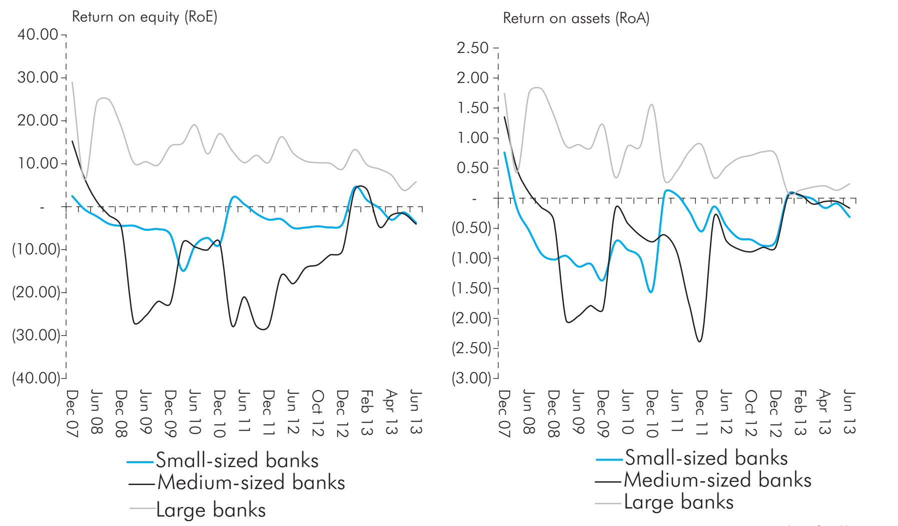
*2013 H1 values are compared to those of 2012 H1.
Source: Bank of Albania.

Change in RoE over the period was almost exclusively due to the profit margin (ratio I in the decomposition), while the leverage (ratio IV) increased slightly. Risk-adjusted income (ratio II) dropped, while risk level (ratio III) remained almost flat.

[28] *Financial Stability Report 2012 H1 provides a more detailed explanation about RoE components.*

Return on Assets (RoA) was 0.25%, from 0.42% a year earlier.

Chart 6.5.4 RoE and RoA by banks peer groups, in per cent



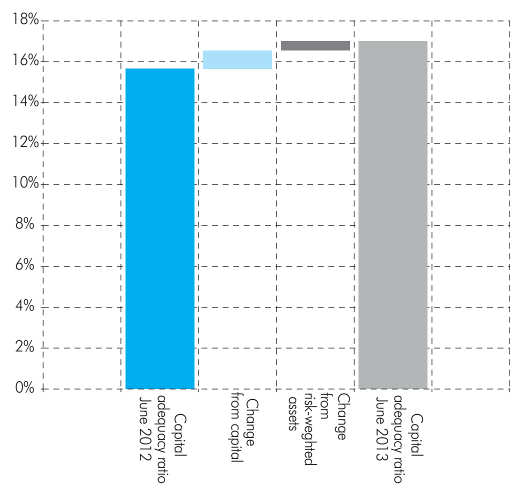
Source: Bank of Albania.

6.6 BANKING BUSINESS CAPITALISATION

The positive profit, capital injection and narrower risky investment portfolio improved the banking sector's capitalisation indicator in 2013 H1.

Capital adequacy ratio[29] reached 17%, up by 0.83 percentage points. Regulatory capital reached ALL 105.7 billion in 2013 H1, up by 1.6% from end-2012 and 5.6% y-o-y.

Chart 6.6.1 Rising contribution of banking sector capitalisation, in percentage points



Source: Bank of Albania.

The regulatory capital structure remained favourable in terms of its capacity to cover any potential losses, with core capital accounting for a considerable part of it.

Banking sector's core capital expanded ALL 1.8 billion, from ALL 95.5 billion at end-2012. This expansion was due to paid-in capital injections by four banks of the sector, whose assets account for 33.8% of total assets. Consequently, the banking sector's paid-in capital amounted to ALL 98.6 billion, from ALL 92.3 billion at end-2012. Core capital accounted for around 90.3% of total regulatory capital, while subordinated debt remained low.

For the first time in 2013 H1, the historical performance of total risk-weighted assets recorded negative growth in annual terms. Specifically, risk -

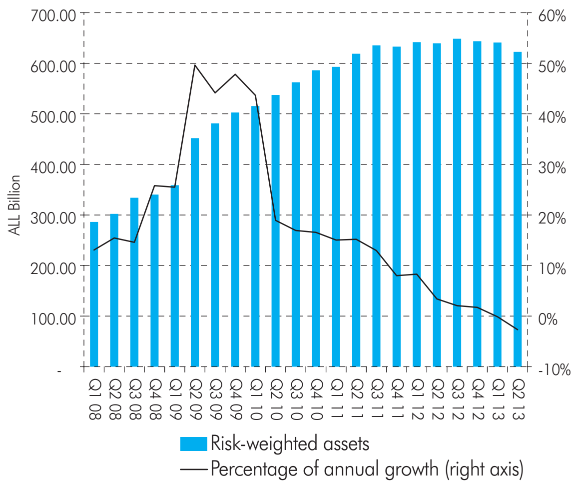
[29] *Capital adequacy ratio is calculated as the ratio of regulatory capital to risk-weighted assets.*

weighted assets fell to ALL 622.3 billion, about ALL 17.3 billion (or 3%) lower than in 2012 H1.

In 2013 H1, banking sector's capitalisation level exceeded the 12% required minimum. The increased share of banks with this ratio within the 14%-16% range and above 20%, evidences improved capitalisation of the banking sector. Banks with the adequacy ratio within the 14%-16% range have the largest share, accounting for 62.8% of total banking sector assets, from 28.3% at end-2012.

Table 6.6.1 shows the capital adequacy ratios for the banking sector and banks peer groups by business size and capital origin.

Chart 6.6.2 Risk-weighted assets



Source: Bank of Albania.

Table 6.6.1 Capital adequacy ratio, in per cent

Period	Sector	G1	G2	G3	Italian	French	Greek	Albanian
June 2013	17.00	29.9	15.5	16.7	24.2	15.0	17.5	14.8
December 2012	16.17	25.10	15.14	16.01	19.65	14.74	16.68	13.90
June 2012	15.7	28.5	13.4	15.8	20.2	13.2	15.2	14.5

Source: Bank of Albania.

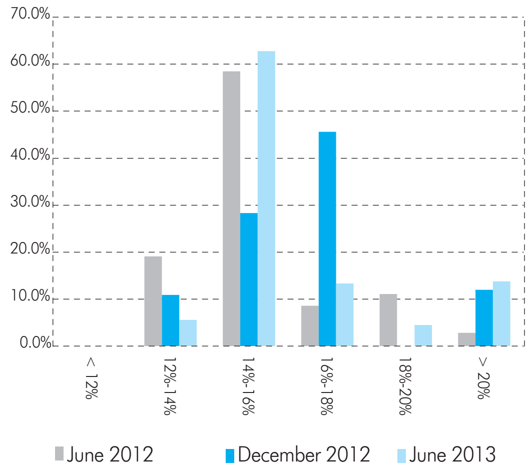
G2 banks and those of Albanian origin present a lower capitalisation ratio than the other groups, at 15.5% and 14.8%, respectively.

In 2013 H1, shareholders' equity increased slightly to ALL 102.2 billion, up by ALL 360 million from end-2012.

Leverage ratio (total assets to shareholders' equity) was 11.8 in 2013 H1, slightly volatile relative to end-2012.

Table 6.6.2 shows the leverage ratio by banks peer groups and capital origin.

Chart 6.6.3 Banks' assets by capital adequacy ratio



Source: Bank of Albania.

Table 6.6.2 Leverage ratio, in per cent

Period	Sector	G1	G2	G3	Italian	French	Greek	Albanian
June 2013	11.8	5.6	12.7	12.2	8.7	10.2	12.2	13.2
December 2012	11.67	6.43	12.19	12.03	9.09	9.92	11.34	11.95
June 2012	11.6	5.6	13.3	11.8	9.3	10.8	11.2	12.1

Source: Bank of Albania.

7. MONITORING BANKING SECTOR RISKS

7.1 MARKET RISKS

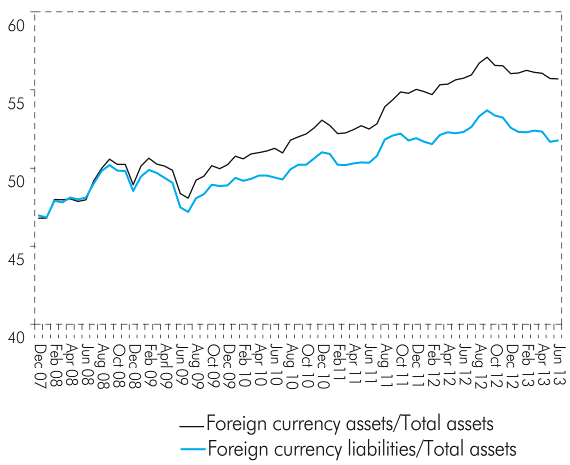
The Albanian banking sector is relatively hedged against direct risk from adverse exchange rate and interest rate movements but the sensitivity is higher.

Banks' open foreign exchange positions to regulatory capital suggest better hedging and are within the historical levels. The gap between interest rate-sensitive assets and liabilities to total assets is insignificant. The spread on major currency pairs widened slightly for the lek and euro, exposing the system to indirect interest rate risk for both currencies.

7.1.A EXCHANGE RATE RISK

The banking sector is exposed to foreign-currency assets more rapidly than to foreign-currency liabilities, their balance sheet equivalent. On the other hand, the open foreign exchange position to regulatory capital suggests significant hedging against adverse exchange-rate movements, though this exposure increased slightly in 2013 H1. Currency mismatch shows low exposure to indirect exchange rate risk.

Chart 7.1.1.1 Share of foreign currency assets and liabilities in total banking sector assets, in per cent



Source: Bank of Albania.

In 2013 H1, foreign-currency assets totalled ALL 670.7 billion, up by 0.7% from end-2012, whereas foreign-currency liabilities fell by 0.1% to ALL 623.3 billion. The share of foreign-currency assets and liabilities in total assets was 55.7% and 51.8%, respectively at end-June 2013, from 56% and 52.6% at end-2012.

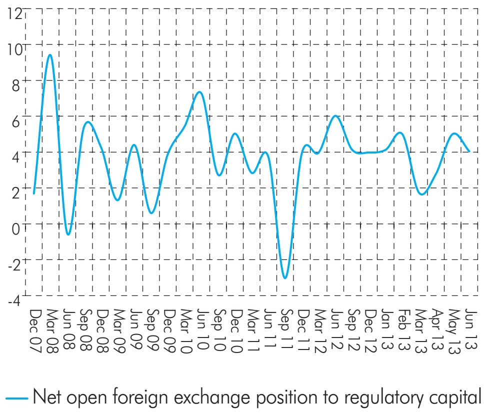
The open foreign exchange position to regulatory capital increased slightly to 4.04% in 2013 H1, from 3.98% at end-2012. By major currencies, banks expanded their positions in U.S. dollar and euro, accounting for 2.75% and -0.17%, respectively, to regulatory capital, from 2.72% and -2.1% at end-2012.

Foreign exchange short and long positions by banks peer group reversed from end-2012. Small-sized banks (G1), which had held a foreign exchange short position in 2012, went long in 2013 H1, and hence higher exposure to exchange rate, given the high ratio of their net foreign exchange positions to regulatory capital (about 7.9%, from -0.3% at end-2012). Large banks (G3) went short in 2013 H1, from going long at end-2012.

Modified Currency Mismatch Index[30] continued to show a low exposure of the banking system to indirect exchange rate risk.

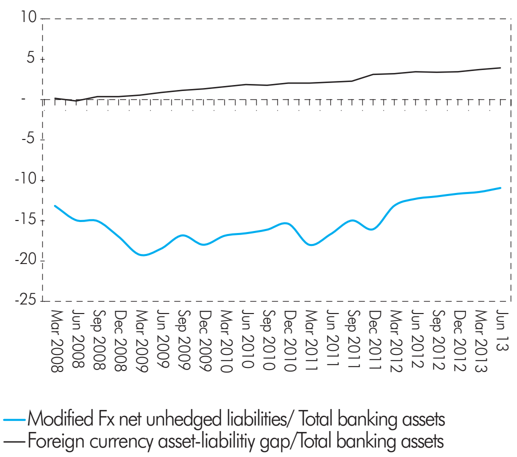
Its improvement to 10.95% in 2013 H1, compared to 11.7% in December 2012, was mainly due the decline in foreign-currency business loans unhedged against exchange rate risk[31], and the positive performance of foreign-currency assets.

Chart 7.1.1.2 Net open foreign exchange position to regulatory capital, in per cent



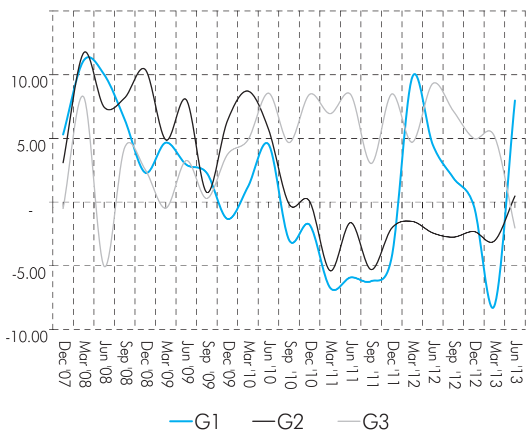
Source: Bank of Albania.

Chart 7.1.1.4 Modified Currency Mismatch Index, in per cent



Source: Bank of Albania.

Chart 7.1.1.3 Net foreign exchange position to regulatory capital for banks peer groups by business size, in per cent

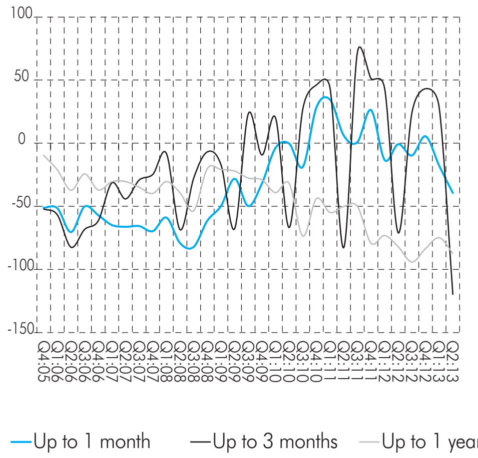


Source: Bank of Albania.

[30] *This is a new index based on the methodology provided by Romain Ranciere, Aaron Tornell and Athanasios Vamvakidis under "A New Index of Currency Mismatch and Systemic Risk". This index measures fully the banks' exposure to exchange rate. It 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 borrowers + foreign currency lending to unhedged non-financial firms]} / [total bank assets]*

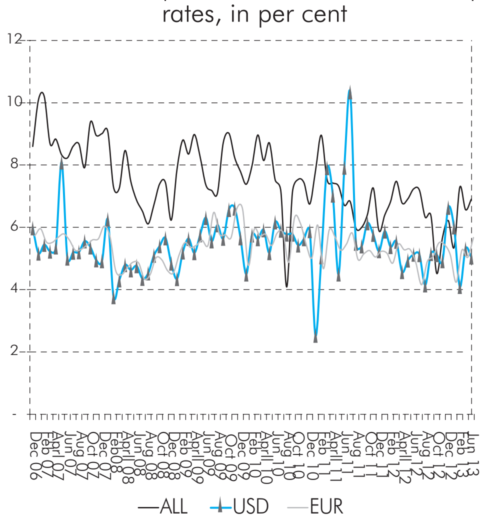
[31] *Loan in a currency other than that of borrower's income serving to repay the loan. Foreign currency lending to businesses unhedged against the exchange rate risk dropped to ALL 116.8 billion, from ALL 121.8 billion in December 2012.*

Chart 7.1.2.1 Maturity gap by reprising period, in ALL billion



Source: Bank of Albania.

Chart 7.1.2.2 Spread between loan and deposit rates, in per cent



Source: Bank of Albania.

7.1.B INTEREST RATE RISK

Banking sector's exposure to interest rate volatility is limited, despite the higher weight of rate-sensitive gap to total assets[32]. However, the fact that the asset-liability gap is negative for all maturities (one-month, three-month and one-year) exposes the banking sector less to income risk, if interest rates go up.

During 2013 H1, the spread on major currency pairs was rising for the lek and euro relative to end-2012, exposing the system more significantly to indirect interest rate risk for both currencies. Specifically, the spread on both currencies amounted to 6.9% and 5.3%, from 6.2% and 4.7% at end-2012.The spread on the U.S. dollar narrowed due to a sharper decline in the U.S. dollar-denominated loan rate over this period.

7.2 CREDIT RISK

Credit risk remains the main risk to banking sector stability.

Slow economic development is the main driver of higher credit risk to banks' balance sheets. Economic outlook uncertainty, sluggish labour market, income and remittance instability, and structural vulnerabilities contributed to deteriorating the quality of business and household loans.

The poor loan portfolio performance during the year was associated with banks' tight lending standards and orientation of financing resources toward safer assets.

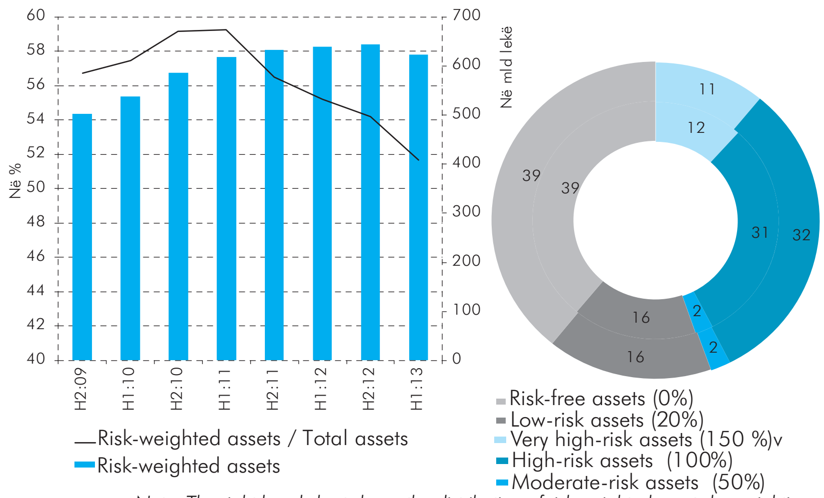
However, the high liquidity level and lower profit margins have eased lending, mainly to households, whose loans were offered at lower commissions and average margins over the period. The forthcoming period will verify whether this is a short-term phenomenon or a new trend in lending.

During the period, the risk-weighted assets contracted ALL 21.4 billion or 3.3% relative to end-2012. This performance brought about further decline in 'risk-weighted assets to total assets' to 51.7%, from 54.2% in 2012 H2.

[32] *The ratio of rate sensitive assets and rate sensitive liabilities of up to one-month maturity to total assets was -3.3%, whereas the same ratio for the three-month maturity and up to one-year was -9.9% and -7.2%, respectively.*

Concerning asset composition by risk coefficients, the increase in high-risk assets (risk-weighted at a 100% coefficient) by ALL 14.2 billion or 3.9% was offset by the increase in risk-free assets (risk-weighted at a 0% coefficient) by ALL 7.3 billion or 1.6% and the decline in very high-risk assets (risk-weighted at a 150% coefficient) by ALL 7.1 billion or 5.2%.

Chart 7.2.1 Risk-weighted assets in ALL, in per cent

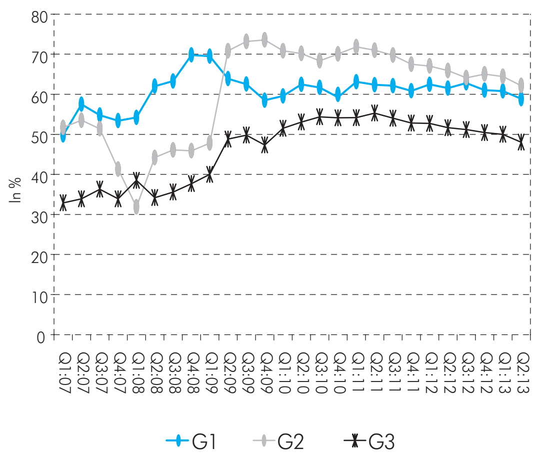


Note: The right-hand chart shows the distribution of risk-weighted assets by weighting coefficients.

Source: Bank of Albania.

The ratio of risk-weighted assets to total assets was downward by individual bank and banks peer group. G2, which has the highest exposure, presented a sharper decline in this ratio by 2.9 percentage points to 62.2% during the six-month period.

Chart 7.2.2 Risk-weighted assets to total assets by banks peer group, in per cent



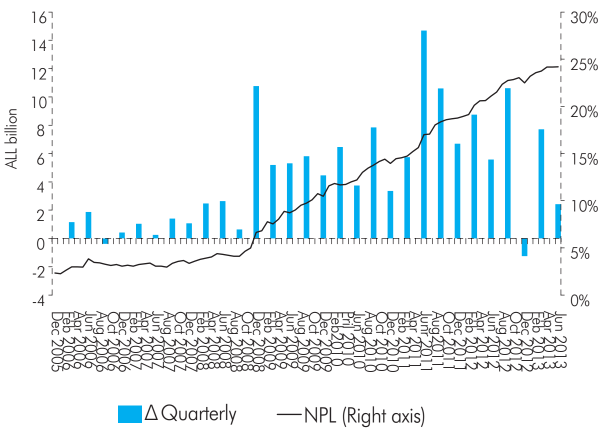
Source: Bank of Albania.

After falling slightly at end-2012, the banking system credit risk moved back up.

Banks' efforts to increase the level of receipts from late loan payments at financial year-end improved slightly the stock of non-performing loans at end-2012. However, as shown graphically, the banking sector's non-performing loans increased by ALL 10.1 billion or 7.8%, to ALL 140.1 billion in 2013 H1.

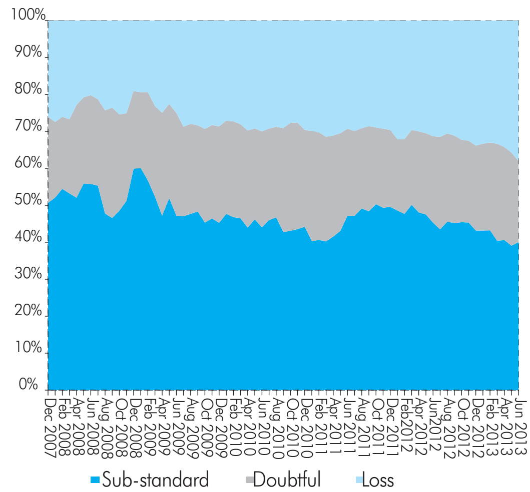
Credit risk to banks' balance sheets, expressed as a ratio of non-performing loans to total loans, continued to trend up, amounting to 24.2% at end-2013 H1, from 22.5% at end-2012 and 21.1% at end-2012 H1.

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



Source: Bank of Albania.

Chart 7.2.4 Non-performing loan portfolio classification, in per cent



Source: Bank of Albania.

At period-end, the share of non-performing private sector loans increased by 2.5 percentage points to 28.4%. The share of non-performing household loans was 17.2%, remaining unchanged from the previous period.

During 2013 H1, standard loans contracted ALL 15.6 billion or 4% to ALL 384.1 billion, reducing their share in total classified loans by 2.9 percentage points to 66.3%. Special-mention loans increased ALL 7.1 billion or 14.8%, suggesting the need for prudentially monitoring the possibilities that would shift part of it to non-performing loans.

The group of non-performing loans saw increase in 'loss' loans by ALL 9.3 billion or 21.1%. Chart 7.2.4 presents the non-performing loans classification.

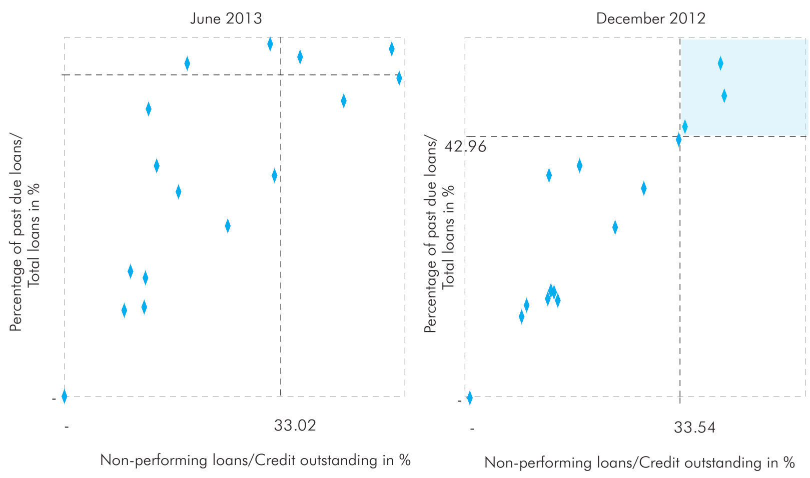
Chart 7.2.5 shows the point combination of the ratios: 'non-performing loans to outstanding loans' and 'past due loans[33] to outstanding loans' for banks in the system. Categorisation of point combinations for each bank considers the 75th quartile ratio of the indicators[34] to capture the number of banks falling under extreme levels of these indicators.

Relative to 2012 H2, the banking system presented a relatively higher level of the 75th quartile for past due loan ratio (from 42.96% to 60.10%) but a slightly lower one for the non-performing loan ratio (from 33.54% to 30.02%). The increase in past due loans raises the probability of their transition to non-performing loans. The probability is higher for banks falling under the coloured quadrant the Chart 7.2.5.

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

[34] *For example, in 75% of the cases, the ratio of non-performing loans to outstanding loans falls below 33.54%.*

Chart 7.2.5 Credit risk to balance sheet for each bank in the system



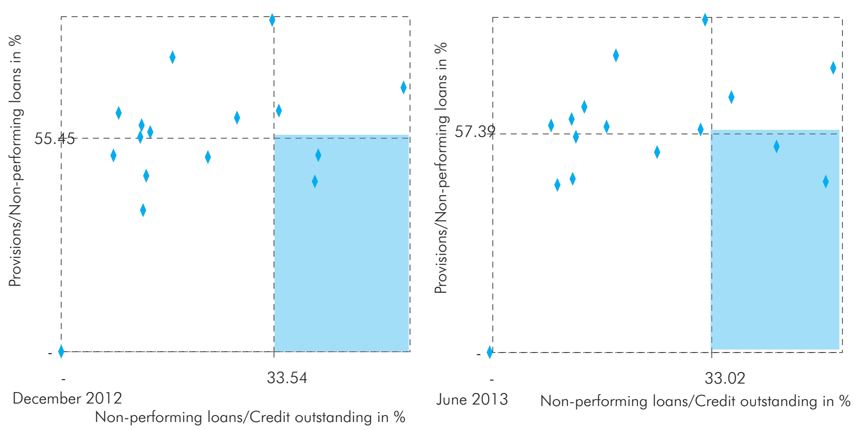
Source: Bank of Albania.

The shift of loans to lower-quality classes is associated with higher provisions. Thus, the banking sector increased provisions by ALL 8.3 billion or 11.6% during the six-month period, making 'provisions to outstanding loans' and 'provisions to non-performing loans' reach the highest levels since 2008, to 13.9% and 57.4%, respectively. At end-2012, these ratios were 12.5% and 55.4%, respectively.

Bank distribution map of the loan loss provisioning (chart 7.2.6) highlights that most banks fall under higher coverage ratios than the system's, which increased during the quarter (from 55.45% to 57.39%).

However, there are some banks that present a risk combination with a below-average NPL coverage ratio and a high level of non-performing loans. The number of banks exceeding the 75th quartile of non-performing loans and not providing adequate NPL coverage compared to the system's average is similar to 2012 H2.

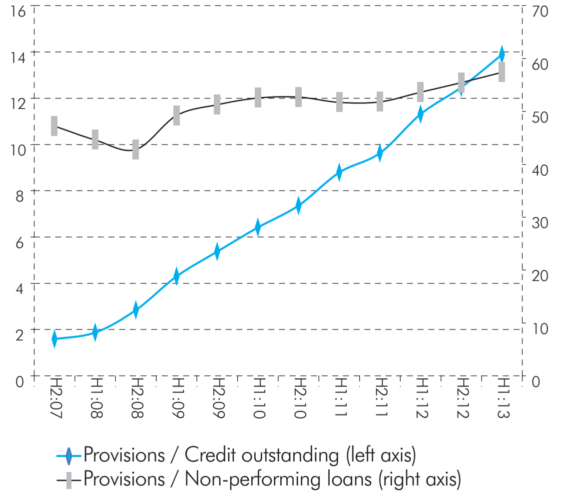
Chart 7.2.6 NPL coverage ratio for each bank in the system



Source: Bank of Albania.

The ratio of net non-performing loans to outstanding loans was 10.3%. It increased 0.3 percentage points from December 2012 and 1.5 percentage points from the past three-year average.

Chart 7.2.7 Provisions and NPL coverage ratio, in per cent



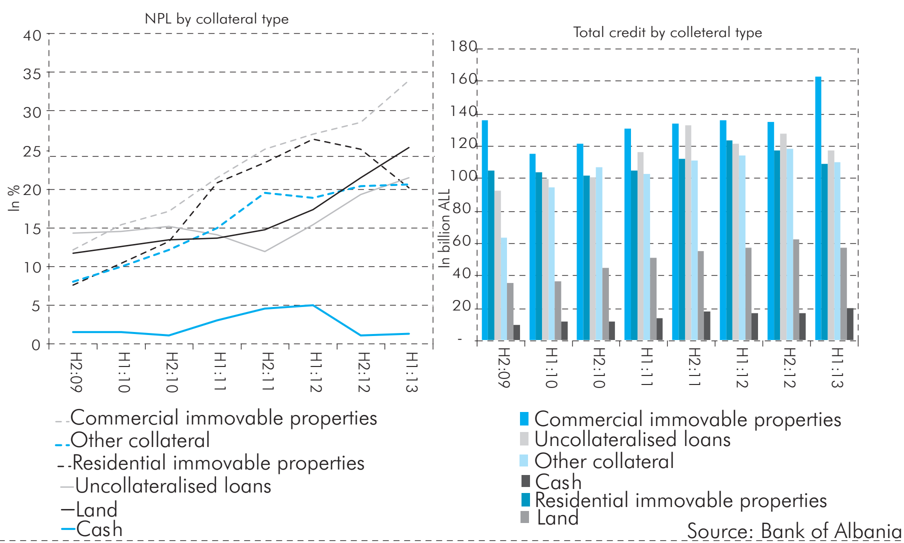
Source: Bank of Albania.

Non-performing loans net of provisions to regulatory capital', amounted to 56.4%, from 55.6% in December 2012.

Loan collateralisation, another important hedge against credit risk, improved slightly in 2013 H1. Specifically, the collateral coverage ratio increased 1.8 percentage points, from 79.7% in 2012 H2. The data show that lending collateralised by commercial immovable property increased significantly by ALL 28.4 billion or 21%, and lending collateralised by cash increased ALL 3.8 billion or 23%. This phenomenon is obvious in both business and household loans. Also, the uncollateralised household loans increased (ALL 3.1 billion or 12.2%), a sign of eased lending standards by the banking sector.

The non-performing loan portfolio also highlights a slightly increased collateral coverage ratio from 81.1% to 82.1% during the period. These developments are evidenced within the category of lending collateralised by commercial immovable property, where the share of non-performing loans has increased by 5.6 percentage points to 34%.

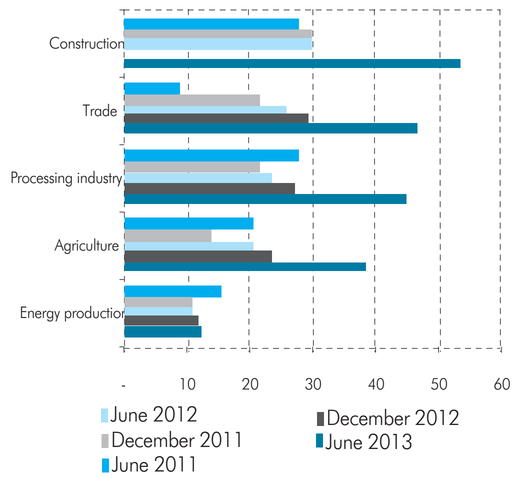
Chart 7.2.8 Loans by type of collateral



Source: Bank of Albania.

Banks are more exposed to credit risk of the medium-term loan, foreign currency loan and private sector loan portfolios. The share of non-performing loans in these portfolios was 31.4%, 26.5% and 28.4%, respectively, compared to 28.5%, 24.7% and 25.9% at end-2012.

Chart 7.2.9 Loan portfolio quality by main sectors of the economy, in per cent



Source: Bank of Albania.

Credit quality has deteriorated in most representative sectors of the economy. The sectors leading the deterioration in non-performing loans are industry, processing industry, and trade, where the non-performing-loan ratio climbed to 53.2%, 44.6% and 46.2%, respectively, from 32.3, 27.7% and 29.2% in 2012 H2.

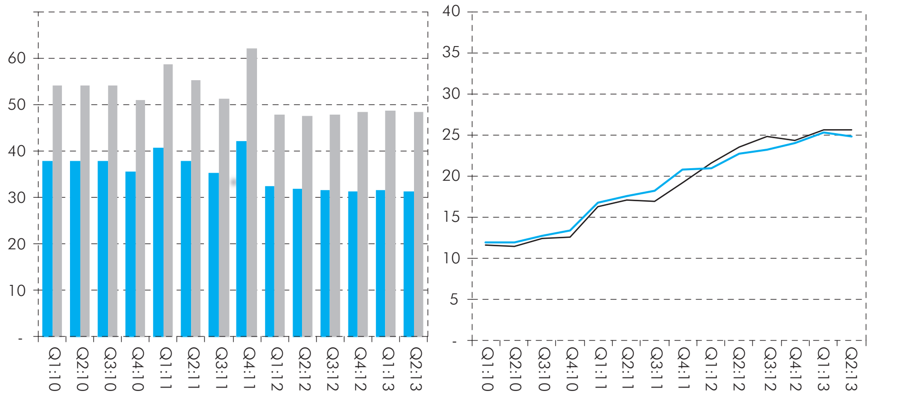
The banking sector's exposure to indirect credit risk has improved slightly but is still high. In 2013 H1, foreign-currency outstanding loans (when borrower's income is in lek), fell slightly by 0.2% to ALL 180.6 billion, accounting for 31.2% of total outstanding loans and 48.4% of foreign-currency outstanding loans.

Performance by currency highlights increase in outstanding euro-denominated loans unhedged against exchange rate risk (All 2.5 billion or 1.7%), while outstanding USD-denominated loans unhedged against exchange rate risk continued to fall (ALL 2.8 billion or 9.7%). These currencies account for 85.5% and 14.3% of outstanding credit unhedged against exchange rate risk.

Foreign-currency credit quality deteriorated. The ratio of 'non-performing foreign currency loans (when borrower is unhedged against exchange rate risk) to foreign-currency outstanding loans (when borrower is unhedged against exchange rate risk) climbed to 25.6%, from 24.4% at end-2012. The largest contribution was made by the USD-denominated credit (unhedged against exchange rate risk), which has the highest value of this ratio[35].

[35] *By currency, the ratio of non-performing loans (Eur/Usd) (when the borrower is unhedged against the exchange rate risk) to outstanding loans (Eur/Usd) (when the borrower is unhedged against the exchange rate risk) in euro was 24.8%, from 24.1% in 2012 H2, while in U.S. dollar it recorded a larger increase, to 31.1%, from 26.2% in 2012 H2.*

Chart 7.2.10 Quality of the portfolio unhedged against exchange rate risk, in per cent

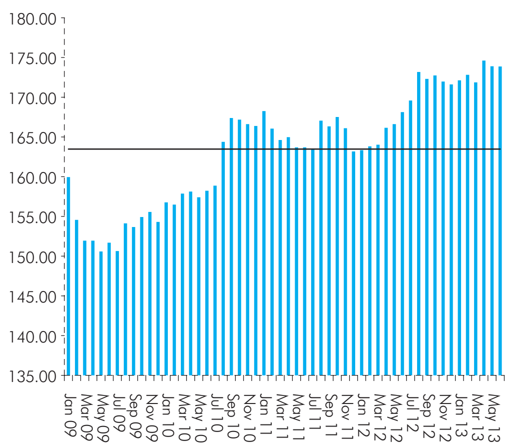


Source: Bank of Albania.

7.3 LIQUIDITY RISK

Banking sector liquidity risk was moderate and liquidity figures were stable. Deposits remained the main source of funding, albeit at a slow pace. Banking sector liquid assets in lek and foreign currency remained above the minimum regulatory ratios. Maturity gap between assets and liabilities expanded but remained within the historical values.

Chart 7.3.1 Loan-to-deposit ratio, in per cent



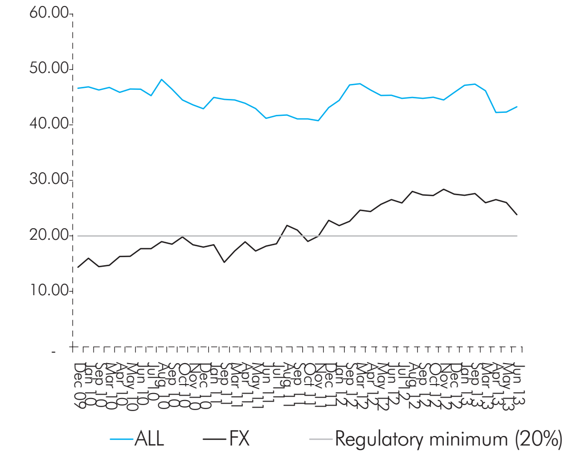
Source: Bank of Albania.

Customer deposits funded considerably the Albanian banking sector activity, covering loans by 1.7 times.

At end-June 2013, banks were liquid and met the regulatory rates for 'liquid assets to short-term liabilities' in the lek, euro and U.S. dollar. At end-2013, this ratio in lek was 43.3% from 45.4% a year earlier, while in foreign currency it was 23.8% from 26.6% a year earlier.

At end-2013, liquid assets accounted for 33.8% of total short-term liabilities and 27.4% of total assets, from 36% and 29% a year earlier[36]. It is worth mentioning that of banks peer groups by business size, these indicators increased only in G2 banks. Broken down by origin, the Italian banking group posted considerable decline in both indicators, causing almost exclusively the decline in these indicators for the overall Albanian banking system. Table 7.3.1 shows liquid assets to total assets by banking group origin.

Chart 7.3.2 Liquid assets to short-term liabilities by currency, in per cent



Source: Bank of Albania.

Table 7.3.1 Liquidity ratio by banking groups, in per cent

	G1	G2	G3	Italian group	French group	Greek group	Albanian group
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
June 2013	28.46	28.33	27.00	16.47	26.13	31.21	22.16

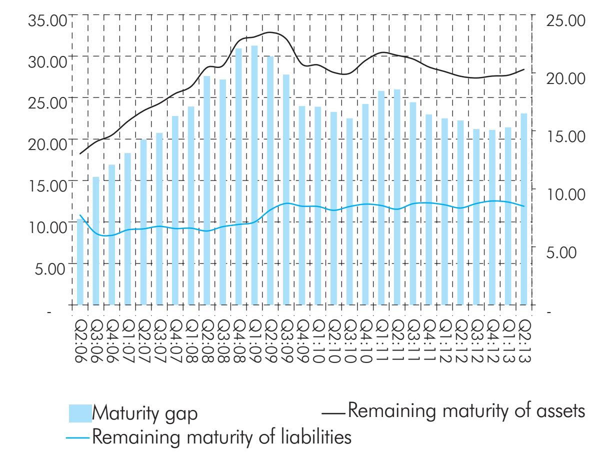
Source: Bank of Albania.

In 2013 H1, maturity gap between assets and liabilities expanded relative to 2012 H2, due to increase in the remaining maturity of assets and decrease in that of liabilities.

In 2013 H1, banking sector assets had an average remaining maturity of 28.4 months, from 27.6 months at end-2012. Banking sector liabilities had an average remaining maturity of 11.9 months, from 12.5 months in December 2012.

The maturity gap between assets and liabilities expanded to 16.5 months, up by 1.4 months. This expansion was mainly due to drop in remaining maturity of deposits - the main liability item - , by 0.5 months to 5.2 months relative to end-2012.

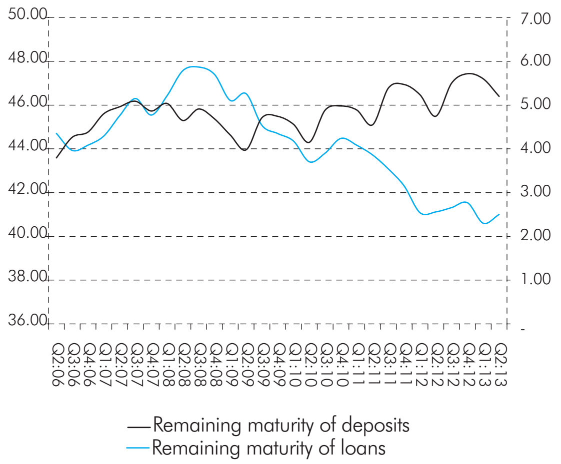
Chart 7.3.3 Average remaining maturity of assets and liabilities, in months



Source: Bank of Albania.

[36] *2013 Q2 evidenced lower liquidity in the system due to the reduced regulatory limit, as amended by the Supervisory Council's decision No. 28, dated 27.03.2013.*

Chart 7.3.4 Average remaining maturity of assets and liabilities, in months



Source: Bank of Albania.

7.4 ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING[37]

A forward-looking stress-testing analysis is conducted to assess financial system's resilience and banking sector's capital adequacy over a period of up to end-2014. The stress-testing exercise assesses the impact of macroeconomic situation on the banking sector's financial condition, excluding the possibility of increase in paid-in capital during the period under review. In practice, the situation deteriorates gradually and banks have time to take appropriate measures by injecting capital. This analysis includes three scenarios: the baseline scenario and two adverse scenarios.

The baseline scenario is built on economic and financial indicators forecast, generally based on their historical performance. The adverse scenarios assume a 'stressed' situation of low probability of occurrence. They are based on two probable shocks to the Albanian economy:

a) Decline in annual credit growth by 50% (which also implies increase in market rates) (Adverse scenario 1);

b) Decline in annual credit growth by 50% and lek's depreciation by 10% (Adverse scenario 2).

Table 7.4.1 Stress-test assumptions

	Baseline scenario		Adverse scenarios			
			Adverse scenario 1 (credit decline by 50%)		Adverse scenario 2 (Lek's depreciation by 10%+credit decline by 50%)	
	2013	2014	2013	2014	2013	2014
	Value in average terms					
Annual GDP growth, in %	2.09	1.55	1.64	1.08	1.36	-0.49
Annual interest rate rise, in pp	0	0.5 pp	0.5 pp	2 pp	0.5 pp	2 pp
The Lek's depreciation against both major currencies (EUR and USD), in %	2.1	1.98	2.1	1.98	12.4	12.2
Projected annual growth of outstanding credit, in %	2.2	5	1.1	2.5	1.1	2.5

Source: Financial Stability Department Assumptions and Research Department Projections, Bank of Albania.

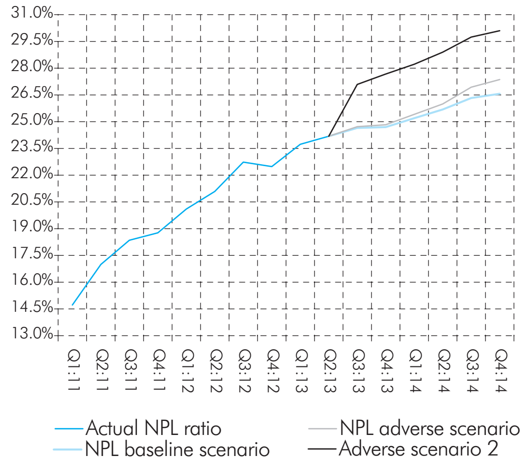
Note: For 2013, the respective assumptions and projections cover the rest of the year (2013 Q3 and Q4).

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

Chart 7.4.1 shows estimates on the loan portfolio quality as at end-2013 and end-2014, under the baseline and adverse scenarios.

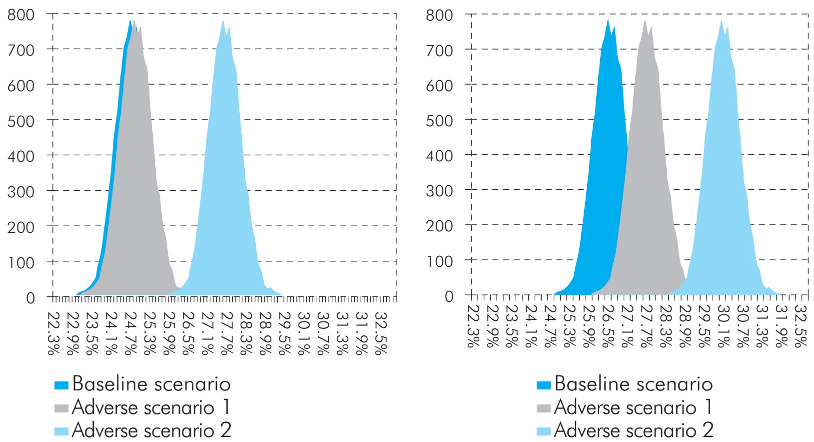
The charts show that the decline in annual credit growth by 50% makes an insignificant effect on loan portfolio deterioration (adverse scenario 1) Adding the lek's depreciation scenario to the lending slowdown, the effect on the loan portfolio is heavier.

Chart 7.4.1 Actual and projected non-performing loans under baseline and adverse scenarios



Source: Bank of Albania, Financial Stability Department.

Chart 7.4.2 Density distribution of the NPL values for Q4 of 2013 and 2014 using Monte Carlo simulations under baseline and adverse scenarios



Source: Bank of Albania, Financial Stability Department.

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

Table 7.4.2 Stress-test results for end-2013

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

1/ Below 12%
2/ Below 8%
3/ Below 6%
4/ Below 3%

Source: Financial Stability Department.

Table 7.4.3 Stress-test results for end-2014

	Baseline scenario		Adverse scenario 1		Adverse scenario 2	
	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)		Capitalised		Capitalised		Capitalised
Modest under-capitalisation 3/	No		Yes		Yes	
Severe under-capitalisation 4/	No		No		Yes	

1/ Below 12%
2/ Below 8%
3/ Below 6%
4/ Below 3%

Source: Financial Stability Department.

The stress-test results reveal that the overall banking sector remains resilient to all assumed scenarios. The banking sector capitalisation remains above the minimum required ratio. However, under baseline and adverse scenarios, certain banks may need additional capital.

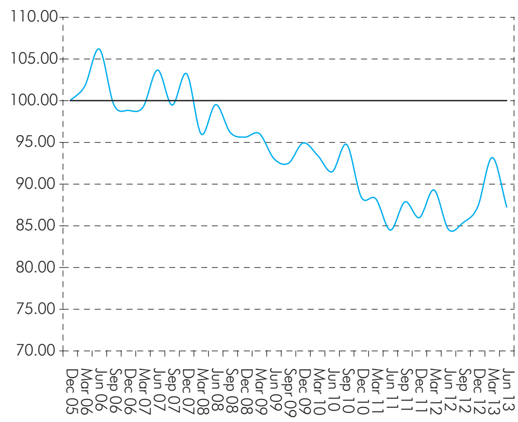
ANNEX 1. FINANCIAL STRENGTH INDEX[38]

FINANCIAL STRENGTH INDEX OF THE BANKING SECTOR

June 2013

The financial strength index was steady in 2013 H1 but significantly improved in annual terms. At end-June 2013, the financial strength index was 87.3, from 84.6 in the same period a year earlier. The main positive drivers of this performance were: banking sector's lower exposure to exchange rate and interest rate risks, and improved capitalisation mainly due to slowing investments in risky assets.

Chart 1.1 Financial Strength Index



Source: Bank of Albania.

Despite the positive index in annual terms, June 2013 highlighted a slower performance of the banking sector than in 2013 Q1. The financial strength index dropped to 87.3, from 93.2 in March 2013. This drop was due to the combined effect of its sub-index components, as follows:

Liquidity sub-index dropped[39] to 81.6 from 102.6 due to drop in 'assets of up to three-month maturity/liabilities of up to three-month maturity' - its component ratio - to 69.8 in 2013 H1, from 91.7%.

Exchange-rate risk sub-index dropped, indicating a larger exposure to exchange-rate risk due to reverse calculation of this sub-index. This larger exposure was due to increase in the ratio of 'balance sheet items[40]/regulatory capital' to 8.4%, from 4.2% at end-March 2013.

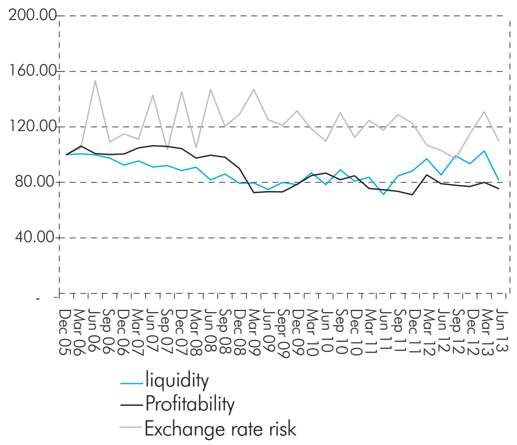
Profitability sub-index slowed down in June 2013, to 75.5, from 79.9 in March 2013, due to simultaneous decline in both ratios composing this sub-index, specifically in 'net profit to total assets' and 'net profit to shareholders' equity".

[38] *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 of building the Financial Strength Index is presented in the Financial Stability Report on 2010 H1.*

[39] *The system's liquidity dropped due to the reduced regulatory limit, as amended by the Supervisory Council's decision No. 28 of 27/03/2013.*

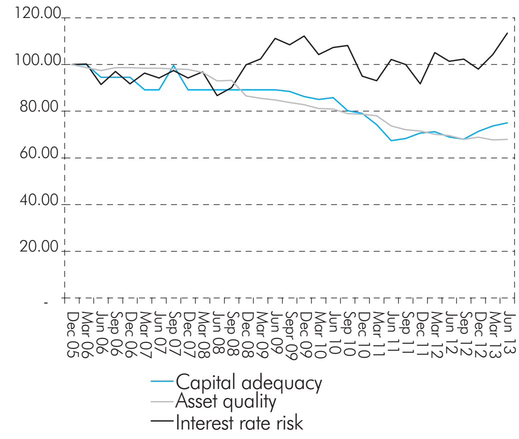
[40] *The balance sheet items refer to the difference between foreign-currency assets and foreign-currency liabilities, excluding off-balance sheet items.*

Chart 1.2 Sub-indices affecting negatively the financial strength index



Source: Bank of Albania.

Chart 1.3 Sub-indices affecting positively the financial strength index



Source: Bank of Albania.

Chart 1.2 shows the trend of these three sub-indices:

Factors affecting positively but insufficiently to raise the aggregate value of the financial strength index, were: higher capitalisation of banking business, lower exposure to interest rate risk, and slightly improved asset quality as a result of lower increase in non-performing loans.

Table 1.1 Performance of sub-indices and financial strength index for the banking sector

Sub-indeces	Asset Quality Index	Liquidity risk	Foreign exchange risk	Profitability	Capital Adequacy	Interest rate risk	Financial Strength Index
Dec-05	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Mar-06	98.69	100.55	105.03	106.08	100.00	100.18	101.75
Jun-06	97.41	99.79	153.23	100.69	94.57	91.41	106.18
Sep-06	98.69	97.55	109.06	100.14	94.57	97.01	99.50
Dec-06	98.69	92.51	114.99	100.49	94.57	91.74	98.83
Mar-07	98.41	95.48	111.07	104.87	89.14	96.34	99.22
Jun-07	98.41	90.99	142.87	106.38	89.14	94.24	103.67
Sep-07	98.13	92.10	103.70	105.87	99.60	97.40	99.47
Dec-07	97.86	88.54	145.28	104.32	89.14	94.24	103.23
Mar-08	96.60	90.96	104.97	97.44	89.14	96.89	96.00
Jun-08	92.98	81.81	146.99	99.55	89.14	86.68	99.52
Sep-08	93.22	86.09	120.43	98.10	89.14	90.09	96.18
Dec-08	86.52	79.36	128.90	89.99	89.14	99.86	95.63
Mar-09	85.53	79.53	146.99	72.67	89.14	102.39	96.04
Jun-09	84.78	74.88	125.08	73.21	89.14	111.21	93.05
Sep-09	83.76	80.01	121.13	73.15	88.46	108.49	92.50
Dec-09	82.78	78.35	131.52	78.49	86.27	112.17	94.93
Mar-10	81.18	86.78	118.49	84.87	85.06	104.26	93.44
Jun-10	80.91	78.44	109.68	86.66	85.84	107.31	91.48
Sep-10	78.98	88.94	130.24	81.85	80.26	108.17	94.74
Dec-10	78.67	80.82	112.45	84.73	79.03	94.99	88.45
Mar-11	78.07	83.70	124.73	75.63	74.21	93.06	88.23
Jun-11	73.71	71.19	117.75	74.63	67.43	102.18	84.48
Sep-11	72.03	84.59	128.80	73.51	68.34	99.94	87.87
Dec-11	71.52	88.24	122.60	71.12	70.64	91.77	85.98
Mar-12	70.09	97.04	106.93	85.41	71.20	105.10	89.29
Jun-12	69.56	85.32	103.03	79.09	68.96	101.39	84.56
Sep-12	67.91	99.16	96.97	77.87	68.04	102.30	85.37
Dec-12	68.85	93.39	114.84	77.00	71.36	98.05	87.25
Mar-13	67.69	102.63	130.86	79.94	73.69	104.26	93.18
Jun-13	67.92	81.65	110.02	75.47	75.05	113.43	87.26

Source. Bank of Albania.

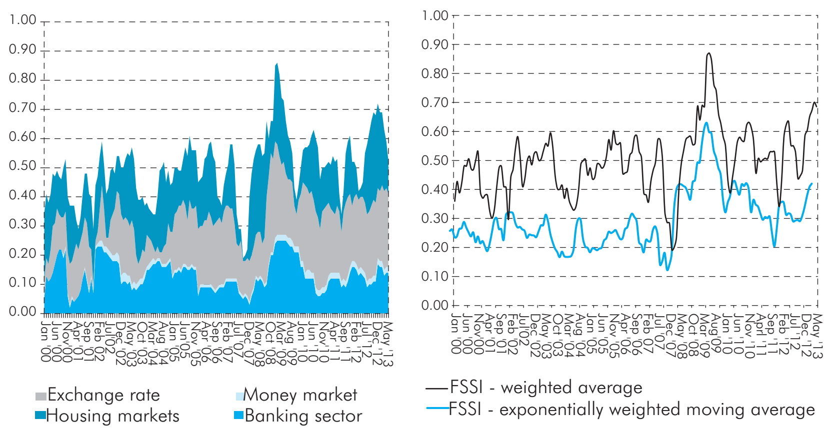
ANNEX 2 SYSTEMIC RISK IN ALBANIA

2.1 FINANCIAL SYSTEMIC STRESS INDEX FOR ALBANIA

Quantifying and analysing the systemic risk[41] help identify and assess threats to financial stability of a country.

Therefore, the Financial Systemic Stress Index for Albania[42] (FSSIA) is constructed to measure the level of financial stress in Albania through data on different financial system segments, which are aggregated into a single index. The employed indicators grouped into 4 sub-indices, represent the principal segments of the financial system: banking sector, money market, foreign exchange market (exchange rate) and housing market. These sub-indices aim to provide different and complementary data on the level of financial stress in different market segments. They are weighted to present their contribution to the financial system and economic activity in Albania.

Chart 2.1.1 Financial Systemic Stress Index for Albania (FSSIA)



Source: Financial Stability Department.

The above chart shows the FSSIA by contribution of each sub-index to systemic stress index (left), and by estimates of correlation using relevant variance-covariance of each sub-index (right).

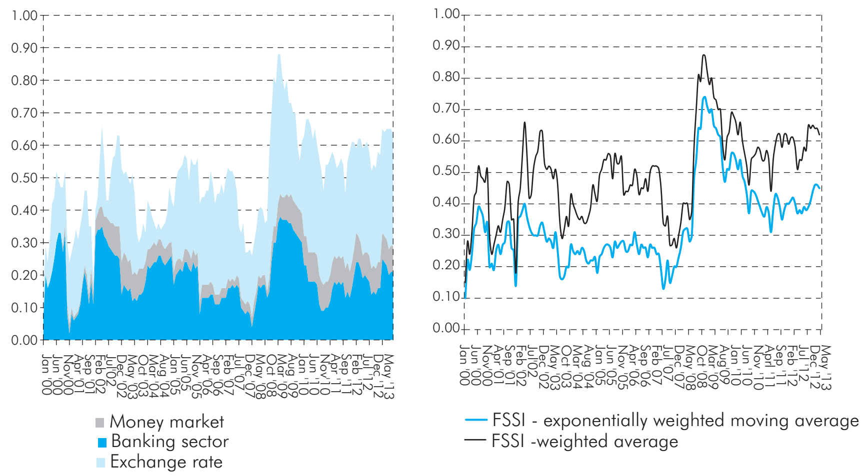
[41] *Systemic risk is the materialisation of shocks when financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially (Hollo et al., 2011).*

[42] *For a detailed description on the methodology of constructing the Systemic Stress Index for Albania, see the paper "Financial systemic stress index for Albania", by Vasilika Kota and Arisa Saqe, published on Bank of Albania's website under research and working papers, 2013.*

This index highlights the main periods of a higher financial stress level. The underlying stress situation has been distinct since late 2008, due to the financial crisis. This situation is reflected through fluctuations of this index even in the following periods, with an augmented financial stress level at end-2012 due to several factors. However, in 2013 H1, the FSSIA improved, leading to a lower financial stress level than at end-2012, mainly due to the housing market segment and its interactions with other financial system segments aggregated into this index.

Though not part of the financial system, by aggregating the housing market into this index, we aim to assess its direct exposure and vulnerability to other financial system segments in Albania. To distinguish it, the FSSIA is constructed even by excluding the housing market and its interactions with these segments, i.e., taking into account only the financial system segments. Chart 2.1.2 shows the FSSIA excluding the housing market.

Chart 2.1.2 Financial Systemic Stress Index for Albania excluding the housing market sub-index



Source: Financial Stability Department.

In this case,the risk exposure was slightly higher in 2013 H1 than at end-2012. As expected, the banking sector and exchange rate remain the major drivers of the financial systemic stress level due to their share in this index.

2.2 SYSTEMIC RISK SURVEY RESULTS

To identify and assess Albanian banks' opinion about financial stability in the country and potential challenges to its stable development in the future, the Bank of Albania conducts quarterly surveys on risks posed to the Albanian banking sector. Banks assess the main sources of threats to the Albanian financial system, the probability of occurrence of negative events, and their potential impact on the domestic financial system in the short and medium term.

The survey gathers opinions of experienced and senior representatives of the banking sector about the domestic situation of the financial system. This analysis presents a summary of opinions of respondent banks and not the official views or assessments of the Bank of Albania or its staff. In the overall process of opinions and analytic analysis of responses, individual banks are assigned equal weight, despite their share in the banking sector.

The results of their responses referring to 2013 H1 highlight:

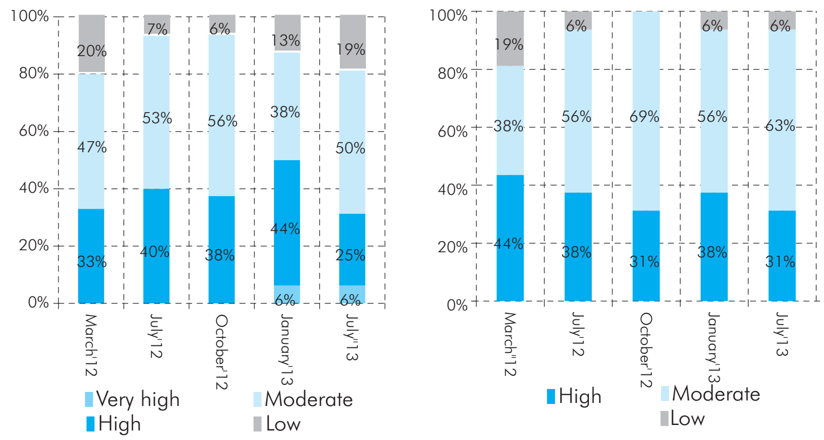
The top five systemic risks cited by banks, listed by size of their impact on the financial system if they were to materialise, are: 1) Domestic economy deterioration; 2) Transfer of shocks from the external economy; 3) Increase in business credit risk; 4) Public debt unsustainability; and 5) Increase in credit risk for all borrowing entities. Compared to the previous survey results, this survey highlights increasing concerns about 'public debt unsustainability' and 'domestic economy deterioration' risks. On the other hand, the risk perception of 'shocks from the external economy' has mitigated.

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

The two most challenging systemic risks to manage at bank level remain similar to those of the previous survey: 'Domestic economy deterioration' due to its vast and complex nature, and 'Difficulties in collateral enforcement' which, according to banks, relates to legal and regulatory deficiencies delaying the collateral enforcement process.

About 31% of banks perceive a high and very high probability of occurrence of a systemic risk in the short term (up to 12 months), a lower frequency than in the previous survey. In the medium term (1-3 years), the perception of the probability of a systemic risk occurrence is slightly mitigated, with 63% of respondent banks considering it average, while no bank considers it 'very high'.

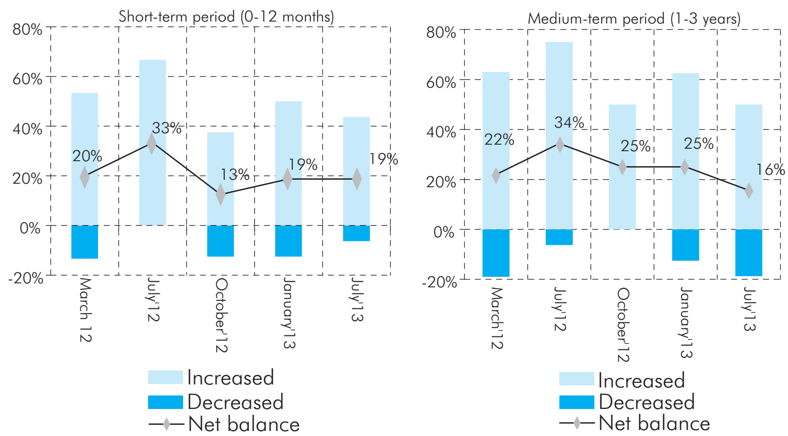
Chart 2.2.1 Results about the probability of occurrence of an important systemic risk in the short term (left) and medium term (right)



Source: Bank of Albania, Financial Stability Department.

50% of respondent banks think that the probability of occurrence of a systemic risk has not changed in the short term; 44% of them think that it has increased and 6% of them think that it has decreased. The net percentage of responses is +18.8%, similar to January 2013 Survey, indicating that during the six-month period, the perception at sector level has not changed. In the medium term (1-3 years), the perception at sector level is slightly mitigated and the net percentage of responses is +15.6%, i.e., downward compared to the short-term period and the previous survey.

Chart 2.2.2 Results of bank responses on change in the probability of occurrence of an important systemic risk in the short and medium term



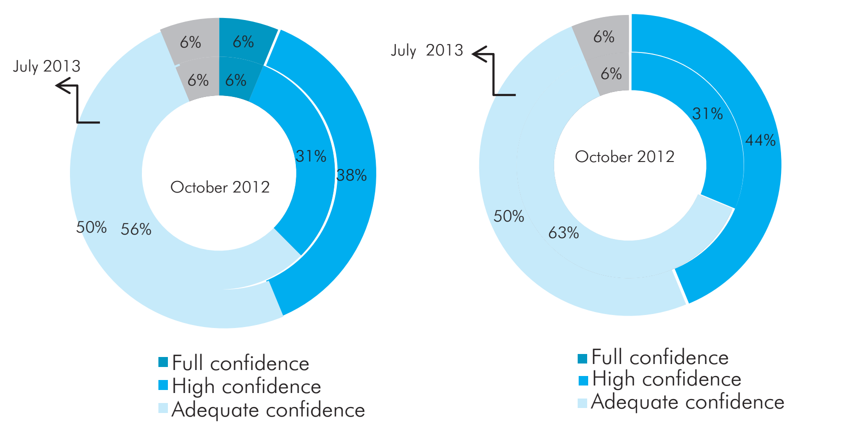
Source: Bank of Albania, Financial Stability Department.

The banks cite the following top strategies to mitigate the systemic risk in the short term: strengthening internal audit system", "reducing exposure, especially to foreign currency" and "improving collateral structure". In the medium term, banks emphasize the need for longer-term strategies such as 'orienting toward strategic sectors', 'diversifying operations' and 'diversifying funding sources'.

Regarding confidence in the Albanian financial system, as in previous surveys, most banks have a positive opinion about its stability in the short and medium term. The first half of 2013 highlighted a higher confidence, reflected in banks moving from 'adequate confidence' category to 'full confidence', compared to October 2012. This tendency is even more noticeable about the banks' perspectives in the medium term.

When respondent banks were asked about the change in the level of confidence in the financial system over 2013 H1, 15 banks (out of 16 respondents) stated that their confidence level has not changed because the system is well-capitalised and liquid. Only one bank reported a higher confidence in the financial system.

Chart 2.2.3 Banks' confidence in the Albanian financial system in the short term (left) and medium term (right)



Source: Bank of Albania, Financial Stability Department.

GLOSSARY

Adverse scenario - A stress-testing scenario, which assumes a 'stressed' situation with a low probability of occurrence, based on potential 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 owned 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 interbank lek 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 to 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 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 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 an ultra competitive environment; below 0.15 indicates a slightly concentrated 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 - A borrowing arrangement, where the borrower can draw down on the line of credit as long as he or she does not exceed the maximum set in the arrangement.

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 other countries' currencies being traded within a pool of countries with a common characteristics (for example, trading partners), with the significance weights that each country has toward countries of other 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 or other repayable funds 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 results 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 a pension account is opened in the pension fund, and is entitled to benefit from this pension fund in the future, according to the pension fund contract with the managing company, to the extent of owned quotas.

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, with the significance weights that each country has toward the countries of other 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.

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 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 assets - Pursuant to the capital requirement, banks are required to generate a capital ratio based on their assets, weighted by an attached risk factor. A different risk factor is applied to different asset categories.

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

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 some 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). (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 adequate capital to conduct its normal business operations.

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