Bank of Albania

FINANCIAL STABILITY REPORT
2013 H2

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Printed in: 310 *copies*
Printed by: ALBDESIGN

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PREFACE

This is the eleventh 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 H2. Unless otherwise stated, the expectations for the economic and financial outlook extend until end-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 December 2013, banks operating in Albania were divided into the following groups by their share:

- **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;

- **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;

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

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

- **Foreign-owned banks***: 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 (Islamic Development Bank, Saudi Arabia); Credit Bank of Albania (Kuwait).

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

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

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

FINANCIAL STABILITY STATEMENT FOR 2013 H2

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

The Albanian banking sector and financial system were stable in 2013 H2. Despite the lower economic growth, developments in the macroeconomic setting sustained the performance of the financial system. The macroeconomic setting was characterised by low exchange rate volatility and weak inflationary pressures, notwithstanding the easing monetary policy. Moreover, government borrowing costs dropped significantly, in spite of the budget deficit and public debt increase. The agreement with the International Monetary Fund is an important step toward ensuring macroeconomic stability and stabilising economic agents' expectations. However, the acceleration of economic growth assumes primary importance with regard to placing the financial activity on a stable growth track. In financial markets, the volume of trading and number of transactions have been steady. In the banking sector, capitalisation and liquidity indicators were at sound levels, supported by the improved net financial result. The banking activity volume expanded at slower rates, as deposits' increase decelerated and crediting contracted. Non-performing loans have grown at the lowest annual rates since 2008. Credit risk poses the most important challenge to the banking sector, but its size is expected to be more contained. In the near future, it is expected to trend down gradually due to effects from legal amendments and operational measures that will enter into force, or be applied more effectively, during 2014. Such measures will enhance the banking industry's capability to handle non-performing loans systematically. In the meantime, the banking sector's exposure to market and liquidity risks remains limited.

Following is a summary of key developments in the economic landscape and financial system, and assessment of risks facing the banking sector activity, including systemic risk.

• ECONOMIC AND FINANCIAL DEVELOPMENTS

The global economy continued to improve steadily during the second half of 2013, although at lower rates and at different pace across different regions.

Advanced economies showed positive signs of stability, whereas some of the developing economies slowed down their growth pace. The US economy continued to grow at a satisfactory rate, sustained by higher consumption and exports. The euro area economy is showing steady signs of gradual recovery, although unevenly across Member States. Developing economies continued to be the main contributors to global growth during 2013, but at a slower pace than a year earlier. This phenomenon has reflected the weaker domestic demand in some of these economies, also as a result of tighter lending terms, political uncertainties and more tense financial markets. Globally, inflationary pressures have been low due to stable commodity prices, spare production capacities and well-anchored inflation expectations. In the context of a positive but modest economic performance, the monetary policy in advanced economies continued to be accommodating.

Economies in Central East and South-east Europe continued to recover gradually, also thanks to the economic recovery in the euro area. The economies in our region improved during 2013. GDP grew at positive rates in the countries that had been in recession during 2012. Rates also improved in the rest of the countries. However, low levels of credit to the private sector and rise in non-performing loans are the main challenges for these countries' economic recovery and financial stability.

Financial markets continued to stabilise under the positive effect of support measures by central banks and the better economic performance of advanced economies. In these economies, lending terms eased during the second half of 2013, mainly in the sovereign debt markets in euro area countries. Risk premiums on government securities in the debt-stricken countries have fallen and fragmentation inside the market is lessened. In developing markets, lending terms have been tighter, triggered especially by the actions of the Federal Reserve to reduce its quantitative easing programmes, and the reinstatement of traditional monetary policy in advanced economies.

The global economy is expected to continue improving in the current year, sustained primarily by the recovery of advanced economies. However, a number of risks remain, mainly related to the very low inflation, and the likelihood of sudden rise in interest rates, as a result of unexpected developments in financial markets.

The need to accelerate economic growth in the country became even more evident, after the significant slowdown in 2013.

After contracting 2.5% in the third quarter, Albania's economy posted 1.1% real growth in the fourth quarter, from the same period a year earlier. The average growth rate for 2013 was 0.44%. In spite of improvement in the fourth quarter in some sectors of the economy such as industry, agriculture and construction, aggregate demand is assessed as weak, given that private investments are low and unemployment rate is higher. During the period under review, foreign demand contributed negatively to economic growth, as current account deficit expanded. Still, exports performed well, driven by the energy and mineral products. During the period, the fiscal policy was overall expansionary, but the volatility in the fiscal performance was higher, reflecting some changes to the decision-making policy dictated by political developments. Budget deficit was funded mainly by domestic resources, with downward costs. In response to these developments and contained inflationary pressures, the Bank of Albania continued to implement a stimulating monetary policy. This was reflected in falling interest rates in financial markets at home, which better support the countercyclical actions for the activity of the banking sector, undertaken during 2013.

In the future, albeit improving, foreign demand will remain limited. Contribution of consumption and private investments to domestic demand may improve, sustained by economic agents' improved expectations because of low interest rates and better liquidity indicators. Fiscal policy is expected to be expansionary, similar to 2013. However, the acceleration of economic growth remains highly important to place the financial activity on a stable growth track. Therefore, reforms for improving the business climate and payment of arrears for public works done by private businesses may provide a significant contribution.

Households and businesses were exposed to indirect credit risks, at similar levels to previous periods.
During the period under review, households and businesses were more inclined to save, as reflected by deposits performance. Lending to households expanded at low rates, whereas lending to businesses shrank. Only lek-denominated credit gave positive contribution to credit performance. Credit quality improved for households and moderately deteriorated for businesses, generally because of the slowdown of non-performing loans increase. Households and business remain exposed to indirect credit risk, depending on their exposure to credit unhedged against unfavourable exchange rate and interest rate fluctuations.

In financial markets, trading volume increased, whereas interest rates sharpened their downward trend.
In the government debt securities' market, demand for borrowing was met by investor's higher interest in investing. This has been an additional factor for downward interest rates on all maturities. In the secondary market of government debt securities, the number of transactions fell slightly, whereas yield on 3 and 6-month T-bills increased. In the interbank market, the volume increased significantly, mainly for the short-term 1 and 7-day maturities. Although more volatile at the end of the period, the average weighted interest rate ranged

below the base rate, overall, reflecting the better liquidity situation. In the foreign exchange market, throughout the year, the lek depreciated slightly against the euro and appreciated against the US dollar, reflecting the demand and supply in the domestic market and developments in the international forex market.

Technical infrastructure supporting banking sector operation functioned effectively.
During the period, AIPS and AECH payment systems operated in compliance with the technical conditions for meeting banking sector needs for settling lek payment transactions. In both systems, the volume and the value of transactions increased. The average value per transaction increased, as well.

The financial system increased its share in Albania's economic activity, in the second half of 2013.
Financial intermediation, calculated as the ratio of financial system assets to Gross Domestic Product (GDP), was up 3 percentage points, to 99.1%, during the period. The banking sector remained the dominant segment of financial intermediation in Albania. Its assets accounted for about 91.4% of total financial system assets and around 90.5% of GDP.

In the banking sector, capitalisation and liquidity levels were adequate, also supported by the improved net financial result.
Banking sector's total assets rose to ALL 1,234.3 billion, posting 3.9% annual growth. On the asset side, interbank and security transactions registered major increase, reflecting primarily the higher participation of the banking sector in government debt security auctions. Banking activity was financed by increase in public deposits, albeit at lower rates. Banking sector exposure to non-resident institutions was similar to the previous period, reflecting banking sector's low reliance on foreign financing sources. During the year, credit shrank 1.8%. The 2.4% lek credit growth could not offset the 4.2% foreign currency credit contraction. Credit stock fell significantly due to banks' selling off non-performing loans and their write offs.

New loans by the banking sector were 16% down from the same period a year earlier. At the end of 2013, the ratio of non-performing loans to total loans was 23.5%, from 22.5% at end-2012 and 24.2% at end-June 2013. The non-performing loan ratio for lek loans was 19.7%, down 0.4 percentage points from June 2013. The non-performing loan ratio for foreign currency loans was 25.7%, down 0.8 percentage points from June 2013. Deposits totalled ALL 1,013.5 billion, up 3.6% from a year earlier. Lek and foreign currency deposits grew 5.2% and 1.7%, respectively, year on year. The credit to deposit ratio stood at 55.6%. This ratio in lek stood at 40.8%, being stable in the last two years, while in foreign currency, it stood at 69.8%, the lowest rate since 2007, reflecting mostly the contraction of foreign currency loans.

At sectorial level, banks recorded positive profit, with accumulated net profit of ALL 6.6 billion, from ALL 3.8 billion a year earlier. Net interest income totalled ALL 39.5 billion, or 0.6% lower than a year earlier. Loan-loss provisions increased by around ALL 14.9 billion, or 49% lower than a year earlier. During the period, paid-in capital rose by around ALL 10.5 billion, or 11.3%. Regulatory capital rose to ALL 115.2 billion, up 10.6%, whereas risk-weighted assets slipped to ALL 641.3 billion, down 0.4%. Subsequently, the capital adequacy ratio rose to 18.0%.

• RISK ASSESSMENT

To assess risks, the banking sector performance and its interaction with the real economy, as well as the financial situation of economic agents and other segments of the financial system were considered. To assess the stability of the banking sector against unfavourable macroeconomic developments and the activity of the banking sector, a stress test exercise was conducted.

For a synthesised evaluation of risks to the banking sector, real economy and economic agents, the Financial Stability Map (FSM) is used. For 2013, the FSM shows that risks to the financial stability have moved slightly towards economic agents. More specifically, in the case of the domestic economy, the exchange rate stability and low inflation rates were reflected in an almost unchanged risk level, despite the expansion of the negative output gap, in the context of economic growth deceleration. The risk is assessed as increased for businesses, due to contraction of business credit, deterioration of its quality, and downward production index, from a year earlier.[1] For households, the significant increase in the unemployment rate and pessimistic expectations on the economic outlook for the first half of 2014 were reflected in the increase of their risk from a year earlier, regardless of the relative quality improvement of household borrowing at the end of 2013. For the government, the expansion of the budget deficit and the performance of tax revenues contributed to higher risk, from a year earlier. However, this contribution is mitigated by the considerable fall of the sovereign risk premium, due to the downward debt interest rates. Risks arising from the external economy are assessed as downward, because of the relative improvement of economic growth in Albania's main trading partners and decline of interest rates in financial markets, in spite of the high unemployment rate and stable oil and commodity prices. For the banking sector, risks are assessed as downward from a year earlier, mainly because of the improvement of capitalisation and income before taxes, vis-a-vis total assets. Risk related to the structure of the banking sector is down, mainly because of the reduced concentration in banks' activity.

In order to focus the assessment of risk to the financial system, the Financial Systemic Stress Index is used. It measures the financial stress in the economy by aggregating into a single index the financial information on various segments of the system (banking sector, foreign exchange market, money market, and housing market). For 2013, it shows that the systemic risk is down from a year earlier, although the index remains above the long-term average. In concrete terms, credit and deposit performance below the long-term average is reflected

[1] *These developments are likely to be downward in 2014, mainly due to payment of arrears to businesses.*

in higher contribution by the banking sector to the overall level of systemic risk. During the period, volatility in the foreign exchange market was low, thus providing no added contribution to the index. On the other hand, given its significant impact on the financial system, the contribution of the exchange rate to the index has ranged in similar levels to that of the banking sector. The downward trend of the interest rate spread has lowered the contribution of the money market to the systemic risk level. Developments in the housing market have also contributed to the fall of the systemic risk index, as the House Price Index increased slightly. Finally, the correlation between the segments of the financial market has increased from the first half of the year and has contributed to higher systemic risk.

To determine more clearly the accumulation and materialisation phases of systemic risk, we use two special indices. The Systemic Risk Accumulation Index identifies the increase of systemic risk until the end of 2012, and the downward pace of accumulation during 2013. The main factors affecting the risk accumulation were quick crediting (especially before 2007), current account deficit expansion, and public debt increase. The Systemic Risk Materialisation Index identifies the emergence of the systemic risk, especially after the first half of 2008. This period is related to shocks to the liquidity of the banking sector, depreciation of the exchange rate and beginning of the deterioration cycle of credit to households and businesses.

Systemic financial risks are subject to economic agents' perception. Therefore, through a special semi-annual survey, the Bank of Albania collects the banking industry's risk perception. From March 2012 to end-2013, the banking industry has perceived two phenomena as developments with a high risk potential: deterioration of the domestic economy and increase of public debt.

Fiscal policy is expected to play an active role in financial stability, during 2014.

In general, this role will be determined by the ability to find a stable equilibrium for fiscal indicators development, to sustain economic growth. In particular, this role will be especially important to the financial system, because of the liquidity injection in the form of payment of arrears for public works done by the private sector, estimated at 5% of GDP. To achieve the fiscal and development objectives, the authorities have reached an agreement with the IMF, which provides funds and other structural guarantees for meeting these objectives. The agreement is an important step towards ensuring macroeconomic stability and stabilising economic agents' expectations. It creates the necessary space to boost the banking sector's intermediation and its contribution to economic growth. Overall, the agreement envisages objectives for fiscal, monetary and structural indicators, allowing also the necessary flexibility for their achievement. Therefore, the possibilities for meeting the final objectives are considerable, and risks relate mostly to the quality of planning and coordination of intermediate actions by authorities towards achieving these objectives.

Credit risk in the banking sector remains a cause for concern to both the banking industry and the Bank of Albania, but expectations for the current year are better.

The presence of a high non-performing loan stock in banks' balance sheets increases banks' costs, impairs their ability to engage in financial intermediation and leads to added and inefficient use of their capacities.

Taking into account the actual level of non-performing loans, the risk for a significant increase in the non-performing loan ratio in the foreseeable future is low. Credit risk size is expected to be more contained and start a gradual downtrend in the short-term future. During 2013, the trend of the past two years was reinforced and the non-performing loans increased at notably lower rates. This performance owes primarily to the work done by the banking industry and the Bank of Albania for early identification of non-performing loans, transactions to write them off from balance sheets, through selling them off, and amendments to the regulatory framework to encourage credit restructuring. These factors are associated with higher provisions for covering the credit risk and non-performing loans.

In the near future, legal amendments related to collateral execution and other legal measures on tax treatment of non-performing loans write off are expected to be more broadly and effectively used. Also, payment of arrears to businesses for the public works they have done is expected to take place soon. These developments would improve the conditions for a systematic treatment of non-performing loans by the banking industry, and would contribute significantly to gradually decreasing non-performing loans. However, positive developments in this regard may be stable if the performance of macroeconomic indicators is stabilised and economic growth is improved. Given the above, these developments become important for containing the banking sector's exposure to indirect credit risk.

The banking sector’s exposure to direct risk from unfavourable exchange rate and interest rate movements was limited.

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. However, banks appeared sensitive to the effect that the exchange rate and interest rate movements have on their clients. A significant depreciation of the exchange rate or similar increase in the interest rate may harm the solvency of banks’ clients, especially businesses. This risk is mainly transmitted through the foreign currency loan, when the main source of borrower’s income for its settlement is in the domestic currency, and through the variable-rate loan.

Banking sector liquidity risk was moderate.

Deposits continued to be the main source of funding for the banking sector. Albeit at decelerated rates, they increased during the past period, as well. Their average maturity term expanded, as clients prefer higher return. Despite the slight increase, non-resident borrowing remains at moderate levels. The sector's liquid assets, both in lek and foreign currency, are above minimum levels required by the regulatory framework. Negative values of the spread between liquid assets and short-term liabilities, by maturity term, up to a year, declined. The credit to deposit ratio is low, reflecting the different performance of credit and deposits, both in lek and in foreign currency.

Capital indicators stood at adequate levels; however, banks should cautiously monitor possible scenarios for future developments and their needs for additional capital.
The capital increase and lower growth of risk-weighted assets made major contribution to banks' activity capitalisation, during this period. The net financial result of the sector improved thanks to non-performing loans slowdown and provisions for credit risk. Due to the reduction in the non-performing loans stock, after the sales and write offs, the coverage of net non-performing loans with capital improved. Although these are not encouraging developments, it is too soon to consider them as stable. It is, therefore, imperative for banks to continue to cautiously and proactively assess their needs for additional capital in line with their risk profile. When necessary, according to this assessment, banks should take relevant actions to strengthen their capital situation.

The stress test exercise should serve banks as a tool to support the assessment of possible needs for additional capital.
The Bank of Albania conducts regular stress test exercises to assess the sensitivity of the main banking sector capital figures against changes in macroeconomic indicators. Baseline and adverse risk scenarios, which extend through the end of 2015, include assumptions relating to changes in GDP growth rate, exchange rate and interest rate, and lending.

The stress test results revealed that the banking sector was generally resilient to assumed shocks. The banking sector's capitalization remained above the minimum requirement in the event of the baseline scenario. In the event of the adverse scenarios, which include the respective assumptions of decline in GDP growth rate, 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 regularly conducted by banks, to assist their decision-making process.

Evaluation under the FSAP programme identified the banking system capacities to conduct a stable activity and made relevant recommendations for effective risk management.
In October-November 2013, upon the request of the Albanian public authorities, the financial system and supervisory framework of its activity were subject to an assessment by the International Monetary Fund (IMF) and World Bank (WB) group. All the segments of the financial system were assessed for the way they are supervised, approximation with international standards, capability of public authorities to identify and administer various risks, and international cooperation in this regard.

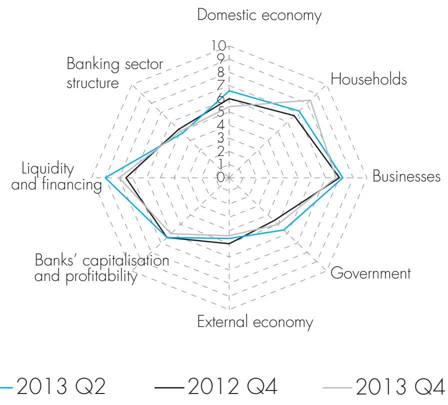
The IMF and WB assessments are published in relevant reports by the IMF and the WB. These reports acknowledge, in a realistic way, the progress made in the functioning and supervision of the financial system (since the assessment in 2005), and identify a number of recommendations for improvement. The focus is on strengthening the institutional, legal and operational framework for managing potential risks to the financial system activity. Therefore, recommendations for improvement focus on all financial system segments, on their supervision methodology. They also identify a number of structural actions related to economic and financial policies, which have an impact, in this regard. Recommendations are both for the short and long term. Some of these recommendations have been incorporated in the terms of the recent agreement with the IMF. Thus, their timely and qualitative realisation assumes particular importance.

1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

1.1 FINANCIAL STABILITY

Financial Stability Map (FSM) summarises the key financial stability indicators for the country (Chart 1.1). It shows changes in the underlying risks arising from the domestic economy, external economy, economic agents and the banking sector (Box 1.1).

Chart 1.1 Financial Stability Map (closer to centre signifies less risk)



Source: Financial Stability and Statistics Department, Bank of Albania.

At end-2013, the risks to financial stability moved slightly toward economic agents. In the domestic economy, exchange rate stability and low inflation rates contributed to keeping an almost unchanged risk level, despite the expansion of the negative output gap. The risk to businesses increased due to contracted business credit, deteriorated credit quality, and lower production volume index than a year earlier.[2] For households, the significantly increased unemployment rate and pessimistic expectations for the 2014 H1 economic outlook contributed to higher risk than a year earlier, notwithstanding the relatively improved quality of household borrowing at end-2013. Finally, for the government, the increased budget deficit and lower tax revenues contributed to higher risk than a year earlier. However, this contribution was mitigated by the considerably reduced sovereign risk premium due to debt interest rate cut.[3] However, within this dimension, the debt cost size is estimated at the maximal risk score since end-2012.

Risks arising from the external economy were downward due to the relatively improved economic growth in Albania's main trading partners and falling interest rates in financial markets, against the backdrop of a high unemployment rate and stable oil price.

For the banking sector, risks are assessed as downward on a year earlier, mainly due to improved levels of capitalisation and income before taxes to total assets, hence bringing greater stability to capitalisation level and bank profitability. Risk associated with the banking sector structure has fallen, mainly due to reduced concentration of banks' activity, measured by several

[2] *For 2014, these developments are likely to be downward due to payment of arrears to businesses for their public works.*

[3] *Also, the arrangement with the IMF, concluded in 2014, is expected to reduce uncertainties about fiscal policies and the respective risk evaluation.*

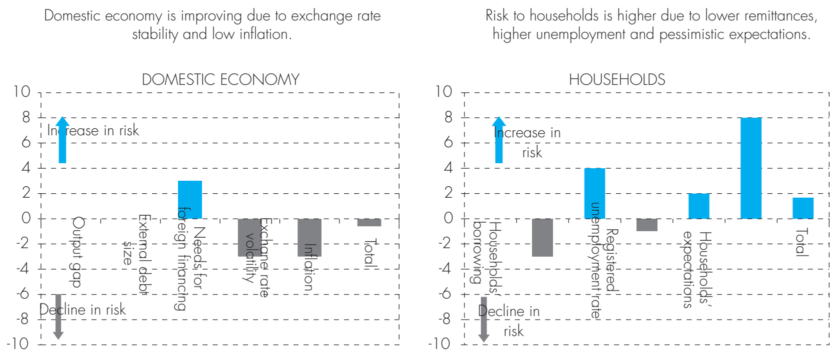
indicators. The concentration of the banking sector activity, measured by the share of two largest banks' assets in total banking sector assets, has fallen. Concentration of business loan portfolio, extended by large banks, also displayed the same behaviour. Thus, the share of credit extended by four G1 banks, in the largest bank in the country, has increased. Similarly, there has been lower concentration in banks' financing structure, for which the variance of activity financing sources is measured. At end-2013, banks diversified their financing structure, contributing to reducing the risk for this category. Finally, liquidity indicators fell slightly on a year earlier, mainly due to higher financing from non-residents and significantly slowing deposit growth rate. Chart 1.2 shows all FSM components and annualised changes in risk assessment for December 2013.

Box 1.1 Financial Stability Map (FSM)

Risks to banking sector derive from developments in its internal activity and the interplay between the internal and external environment. The purpose of this box is to present the Financial Stability Map (FSM) as a new synthesized instrument providing information on above risks, including economic agents (households, businesses and government). Therefore, this instrument improves communication with the public on financial risks.

To map the state of financial stability, initially, there was selected a set of sub-indices (for each dimension of the map), considered as the most appropriate for visualising risks to financial stability (Appendix 2). Then, each sub-index was given a score, considering whether the increase (or decrease) in the indicator's values brings higher (or lower) risk to financial stability. The score for each sub-index ranged from 0 to 10. Finally, the scores of sub-indices were aggregated into a composite index representing the overall dimension. The final score assessment, according to FSM dimensions, was shown through a cobweb diagram, in which a lower score signified a low risk level, while moving away from the diagram centre signified higher risk to financial system.

Chart 1.2 Changes in risk assessment by FSM category on a year earlier*



*The chart shows the spread between the risk score for each sub-index as of December 2013 and the score assessed as of December 2012. When the column is missing from the chart, it implies that the sub-index score has not changed from a year earlier.

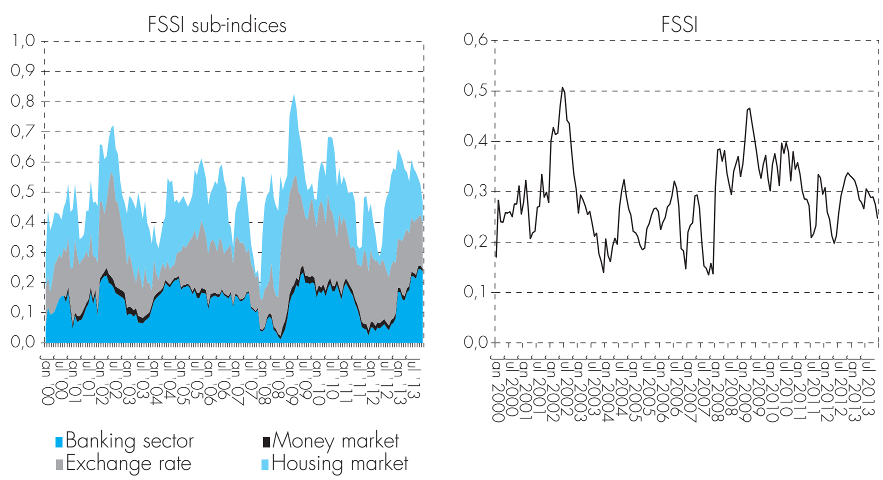
Source: Financial Stability and Statistics Department, Bank of Albania.

1.2 SYSTEMIC RISK

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". According to the Financial Systemic Stress Index (FSSI)[4], as of end-2013, the systemic risk fell slightly on a year earlier, albeit remaining above its long-term average. More specifically, the performance of credit outstanding and deposits in their long term trend has been reflected in banking sector's higher contribution to overall systemic risk level. Despite the unchanged trend of developments in the exchange rate, its significant impact on the financial system has been reflected in a contribution similar to that of the banking sector sub-index. On the other hand, the downtrend of interest rate spreads has lowered the money market contribution to systemic risk level, in spite of its low share in the composite index. The reduced systemic risk index was also influenced by developments in the housing market, in which the House Price Index increased slightly, positively contributing to lowering the financial stress level. Finally, the contribution of correlation between financial market segments has increased relative to 2013 H1, showing higher systemic risk from interaction between various market segments

In assessing systemic risks to financial system, we refer to results from the survey on bank perception of the systemic risk for 2013 H2.

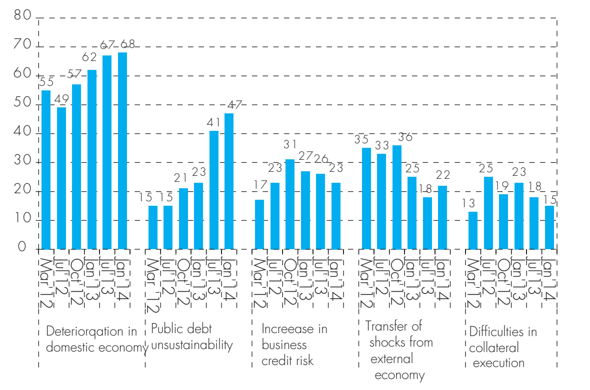
Chart 1.3 Financial Systemic Stress Index



Source: Financial Stability and Statistics Department, Bank of Albania.

[4] *This index measures the level of financial stress for Albania, aggregating information from different segments of the financial system into a single index.*

Chart 1.4 Bank perception of main systemic risks*



*Each bank has listed the top five systemic risks in a descending order, which, in their perception, may threaten the financial system if they materialise: the top systemic risk scoring 5; the least systemic risk scoring 1. Then the assessment score is weighted at the number of banks by each response, resulting in an overall score for each risk.

Source: Financial Stability and Statistics Department, Bank of Albania.

Based on the survey results, banks stated that 'deterioration in the domestic economy' and 'public debt unsustainability' were the main systemic risks, while the perception of credit risk continued mitigating. Three less concerning systemic risks to the banking system, presented in a descending order and by frequency of choice by banks, are: 1) Problems in payment system operation; 2) Problems in the inter-bank market operation; 3) Domestic inflation risk.

Box 1.2. Systemic risk accumulation and materialisation

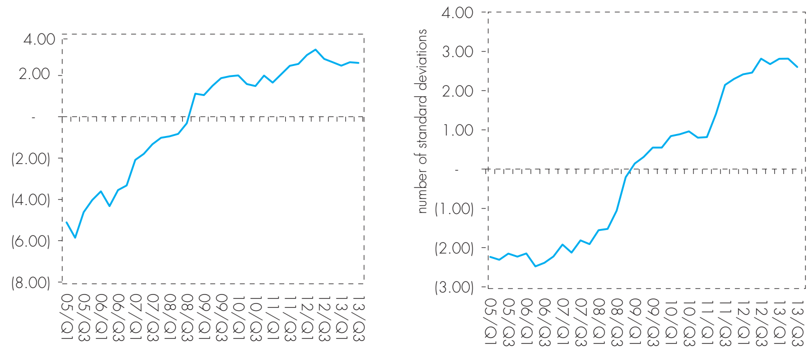
This box presents a new method for assessing the manner of systemic risk accumulation and materialisation along the time, using the respective indices. Risk Accumulation Index (RAI) consists of 12 variables, while Risk Materialisation Index (RMI) consists of 6 variables (Table 1.2). The related data cover the period 2005-2013.*

Table 1.2 Indicators suggesting accumulation or decrease of systemic risk and its materialisation

Sources of accumulation of systemic risk	Indicators	Sources of materialisation of systemic risk	Indicators
Asset structure with respect to interest rate variability	Loans by interest rate variable within one year/Total loans	Business sector	NPL to total loans ratio
Currency structure of assets and liabilities	Unhedged foreign currency loans/total loans Foreign currency deposits/total deposits	Household sector	NPL to total loans ratio
Business sector	Lending to businesses /GDP Rate of change in business loans	Macroeconomic trends	Unemployment rate Inflation Weighted exchange rate according to asset structure of commercial banks
Household sector	Lending to households/GDP Rate of change in household loans	Financial markets	Risk premium for Albania
Real estate	Real estate price index		
Macroeconomic trends	External debt/GDP Public debt/GDP Current account balance/GDP		
Financial markets	Prices of shares*=Long-term (2-year) yield - Short-term yield (3-month T-bill)- Yield curve slope		

Source: Financial Stability and Statistics Department, Bank of Albania.

Chart 1.5 Indicators of risk accumulation (left) and risk materialisation (right)

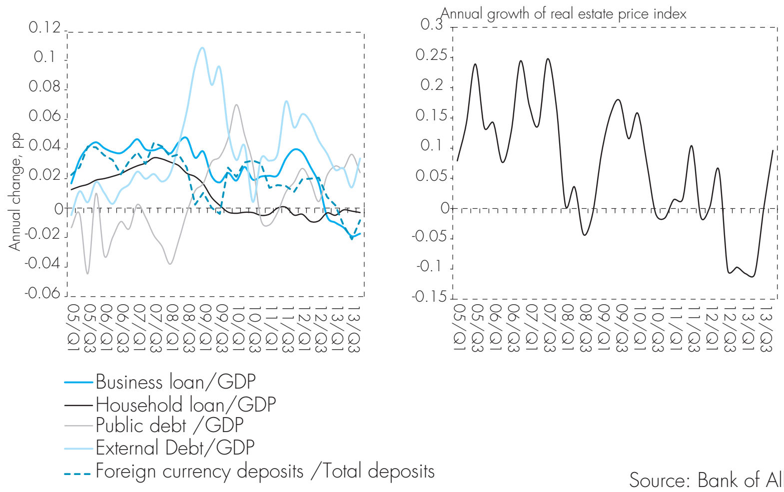


Source: Bank of Albania.

Risk Accumulation Index (RAI) suggests that most risks were accumulated in the system mainly before the global financial crisis, in the period from mid-2005 to end-2008. After that period, the systemic risk accumulation trend appeared volatile but with lower deviations than in the pre-crisis period. After rising over a short period of time, RAI fell in 2012 Q2, suggesting a lower level of systemic risk accumulation. On the other hand, Risk Materialisation Index (RMI) assessments suggest that the systemic risk materialisation started after mid-2008 and increased sharply during the next period.

Analysing components of each index reveals that the sharp increase in lending to businesses and households, and in foreign currency deposits during the pre-crisis period are the main generators of the risk accumulation process in the system. This process was influenced less by increase in interest rate-sensitive credit, Real Estate Price Index, and external debt uptrend, and to a lesser extent, by increase in the public debt (chart 1.6).

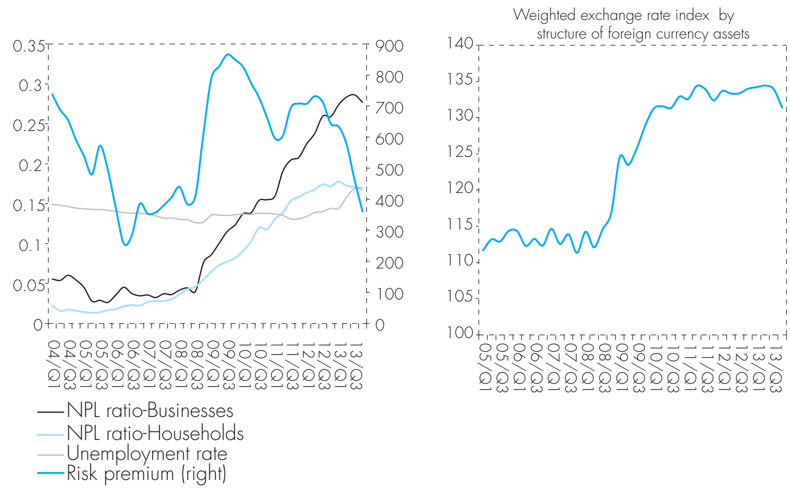
Chart 1.6 Components of risk accumulation indicators



Source: Bank of Albania.

*Concerning the systemic risk materialisation, in the period up to the escalation of the financial crisis**, the ratio of non-performing loans to total loans for businesses and households was at low levels. Also, the unemployment rate was falling, the risk premium estimating the cost of foreign borrowing was volatile but downward, while the weighted exchange rate index by banks'asset structure was stable and slightly appreciated (Chart 1.7). Although this was an apparently stable period marked by positive trends for the economy and the banking sector, the major part of the systemic risk started to materialise in 2008 H2 and onward. This period saw a surge in non-performing loans to businesses and households and depreciation of the domestic currency, as shown by the performance of the exchange rate weighted index values.*

Chart 1.7 Components of risk materialisation indicators



Source: Bank of Albania.

* *Based on the Financial Stability Report, National Bank of Croatia, July 2013-Box on Systemic Risk Indicators, page 20*

** *We underline that the crisis effects on Albania, mainly on the banking sector, appeared at end- 2008 and during 2009. During this period, the Bank of Albania took measures to maintain an optimal liquidity level in the interbank market – According to Bank of Albania's statement "On financial system stability in Albania for 2008 H2", Publication date 31/03/2009.*

The overview on risks to financial stability in Albania is followed by sections that present in detail, global developments, domestic developments and performance of the financial system, focusing specifically on developments in the Albanian banking sector.

2. GLOBAL DEVELOPMENTS

During 2013 H2, global economic activity continued to improve steadily but at slow and uneven paces across different regions. Advanced economies showed positive signs of stability, while some emerging market and developing economies slowed down their paces of growth.

Global economic growth picked up gradually in 2013 H2, sometimes even more than anticipated by experts.[5] In advanced economies, the economic activity picked up as a result of strong internal and external demand, accommodative monetary policy stances and improved household balance sheets. The US economy continued to grow at a satisfactory rate, sustained by higher consumption and exports. In the meantime, the euro area turned the corner from recession to gradual recovery, though the recovery was broadly uneven across Member States. Emerging market and developing economies continued to be the main drivers of global growth in 2013, but at a slower pace than in 2012. This reflects the weaker domestic demand in some of these economies, also as a result of tighter lending terms, political uncertainties and stressed financial markets. Global inflationary pressures were subdued due to generally stable primary commodity prices, spare production capacity and well-anchored inflation expectations. During the last months, inflationary pressures increased slightly in most advanced economies, while data on emerging market and developing economies are different and volatile. Against the backdrop of a positive but modest economic growth, the monetary policy stance in advanced economies stays accommodative.

Financial markets continued to stabilise under the positive impact of support measures taken by central banks and better economic performance of advanced economies. In the latter, financing conditions were easing during 2013 H2, mainly in the euro-area sovereign debt markets. Risk premiums on government securities of crisis-hit countries and market fragmentation decreased. In emerging market economies, financing conditions remained tight, particularly influenced by the Federal Reserve's announcement for tapering its quantitative easing programme, and advanced economies' returning to conventional monetary policies.

Global economy is expected to improve further during the current year, largely on account of recovery in advanced economies.[6] However, several risks remain, mainly related to very low inflation and the risk of a sudden rise in

5 *IMF's world economic outlook in January 2014 (annual growth by 3.7%) improved compared to October 2013 world economic outlook (annual growth by 3.6%).*

6 *According to the IMF, global growth is projected to be at around 3.7% in 2014, rising to 3.9% in 2015.*

interest rates as a result of unexpected developments in financial markets. In emerging market economies, capital outflows and exchange rate volatility remain the main concern, given Fed's tapering.

The euro area economy has already entered the recovery phase, registering positive (quarterly) growth in the first three quarters of 2013. It was a result of improved internal demand due to European Central Bank's accommodative monetary policy, improved financing conditions, advanced fiscal consolidation and structural reforms. Big exporting countries, such as Germany and France, have maintained their share in growth, while the peripheral euro area countries, such as Italy and Greece, have decelerated their contraction. Labour market conditions remained sluggish, though with signs of stabilisation, particularly in 2013 Q4, when the unemployment rate fell to 11.9%. However, distinctions across countries were noticeable. Positive developments characterised the fiscal sector as well. Public debt fell in 2013 Q3, for the first time since end-2007. The latest data and confidence indicators suggest that the euro area economy will grow further in 2014-15[7], increasingly driven by rising demand for EU exports. The recovery is expected to be modest for the debt crisis-hit countries and conditioned by the success of initiated reforms. The yet unclear situation of the European banking sector poses another challenge. Reassessment of financial position of the main euro-area banks by the ECB in 2014 is expected to mitigate these uncertainties. Also, high debt, both public and private, and financial fragmentation may hold back economic growth.

Table 2.1 Selected macroeconomic indicators for the US and euro area

	GDP change (annual percentage)			Unemployment (annual percentage)			Gross government debt (percentage of GDP)		
	2012	2013 Q3	2013 Q4	2012	Sept. 2013	Dec. 2013	2012	2013 Q2	2013 Q3
US	2.8	2.0	2.7	8.1	7.2	6.7	90.0	93.7	93.5
Euro area	-0.6	-0.3	0.5	11.4	12.1	11.9	90.7	93.4	92.7
Germany	0.7	0.6	1.4	5.5	5.2	5.2	81.9	79.8	78.4
France	0.0	0.3	0.8	10.3	10.9	10.8	90.2	93.6	92.7
Italy	-2.4	-1.9	-0.8	10.7	12.5	12.7	120.7	133.3	132.9
Greece	-6.4	-3.0	-2.6	24.3	27.7	27.5	156.9	168.8	171.8

Source: European Central Bank, IMF

The Central, Eastern and Southeastern Europe continued to recover gradually, supported by the euro-area economic improvement. Major exporting countries, such as Romania, Poland and Hungary, recorded higher growth rates, driven by their close trading and financial links with the euro area. In the meantime, low lending to the private sector and increased non-performing loans are the main challenges to growth and stability of these countries.

The economic performance of the countries in the region also improved during 2013. GDP growth resulted positive in the countries that had been in recession during 2012, while the pace of growth improved even for the rest of the countries. In most of these countries, the activity was supported by export growth, pushed up by favourable weather conditions. In some cases, the economic growth was translated into improved labour market

[7] *According to the IMF, euro-area growth is projected to be at around 1.5% in 2014, and 1.4% in 2015.*

conditions. However, unemployment in the countries in the region remained high. Average inflation rate for 2013 fell in all the countries in this region. Excluding Turkey, the current account deficit in these countries continued to mitigate, mainly as a result of decline in trade deficit. On the other hand, the fiscal sector performance was uneven across countries and more problematic in the countries with a high fiscal deficit and public debt (such as Albania, Montenegro and Serbia).

Table 2.2 Selected macroeconomic indicators for Central, Eastern and Southeastern Europe

Central and Eastern Europe	GDP Change (annual percentage)			Unemployment (annual percentage)			Gross government debt (percentage of GDP)		
	2012	2013 Q3	2013 Q4	2012	*2013 Q3	**2013 Q4	2012	2013 Q2	2013 Q3
Hungary	-1.7	1.7	2.8	11.0	10.0	8.8	79.2	81.5	80.2
Poland	1.9	1.8	2.2	9.8	10.2	9.9	55.6	58.3	58.0
Southeast Europe									
	2012	2013 Q2	2013 Q3	2012	2013 Q3	2013 Q4	2012	2013 Q2	2013 Q3
Turkey	2.2	4.5	4.4	9.2	9.7	:	37.9	:	:
Serbia	-1.5	0.6	3.7	23.9	:	20.1	60.0	61.6	60.8
Kosovo	2.5	:	:	30.9	:	:	8.3	8.6	8.9
Montenegro	-2.5	3.4	4.0	13.5	13.3	15.0	54.0	53.2	55.8

Source: European Central Bank, Eurostat, IMF, European Commission, respective central banks.
**Data for September, 2013*
** * Data for December, 2013*

2.1 FINANCIAL AND COMMODITY MARKET HIGHLIGHTS

Financial markets generally stabilised during 2013 H2, except in summer, when tensions increased after the US Federal Reserve (Fed) announced for tapering its quantitative easing in the near future. As a result, the long term interest rates rose, particularly in the US government security market. Capital markets were characterised by price volatility in some categories of assets and weak demand for risky assets. From the regional viewpoint, rise in tensions hit emerging markets, in particular. Uncertainty about the future monetary policy stance of the US and other advanced economies, and worsened economic outlook for some of them, held back capital flows to these countries. This situation led to economic activity slowdown and in some cases, to currency depreciation. On the other hand, money markets have generally stabilised at low interest rates, reflecting accommodative policies and buoyant liquidity in the interbank markets. Positive developments were seen in euro-area sovereign debt markets, with eased trading conditions and mitigated financial fragmentation. This was a result of mitigated market risk perception for indebted countries, influenced by the euro-area positive economic performance and ongoing support policies.

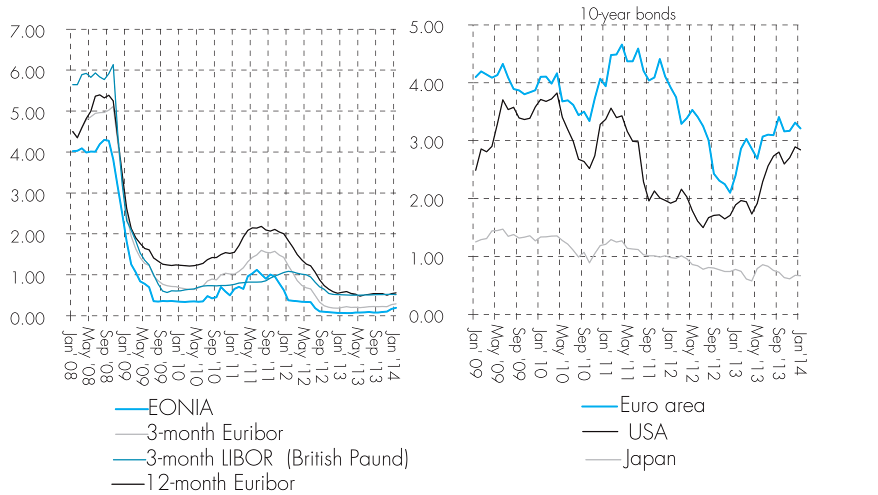
However, summer 2013 shocks were temporary. The Fed's decision to continue with the financial easing programme and the ECB's decision to cut the key interest rate in November[8] while continuing liquidity-providing operations, brought markets back to 'normal'. However, the summer episode

[8] *At its meeting in November, the ECB decided to cut the key interest rate by 0.25 percentage points to 0.25%.*

raised concerns about market response, at the moment when central banks would complete the financial support programmes and return to more conventional monetary policies. The Fed began tapering the $85 million per month quantitative easing programme by $10 billion in December 2013. It continued tapering by another $10 billion per month after the March 2014 meeting. The Fed is likely to continue this process through 2014, winding down the quantitative easing programme by end-2014 and returning to a more conventional monetary policy in the years to come.

In the foreign exchange market, during 2013 H2, the euro generally appreciated against major currencies – the US dollar and Japanese yen, reflecting the interest rate expectations and positive market perceptions on economic performance of the euro area. This tendency appears to have changed by the year end, when the euro depreciated against the major currencies due to expectations for a change in monetary policy stance.

Chart 2.1 Interest rates in main money markets and government bonds



Source: European Central Bank, Eurostat.

In the primary commodity markets, crude oil price was up during June-September, to USD 116 per barrel.[9] This was attributed to a combination of lower supply from oil producing countries, mainly due to elevated geopolitical tensions and simultaneous increase in the demand. The tendencies changed at the end of the last quarter of the year and the crude oil price fell between USD 110-112 per barrel, reaching almost the same level as a year earlier. This was attributed to increase in supply, while demand remained stable. Prices of other primary commodities, in aggregate terms, were generally stable during 2013 H2, except in summer, when they fell as a result of seasonally increased supply.

EU banking sector. Despite mitigated tensions in financial markets, the economic environment and the perspective of banks in the euro area remained subdued. Their profitability was generally low during the first three quarters of 2013,

[9] *Brent Crude Oil index, ECB.*

due to high provisioning levels and weak income rise as a consequence of the very low interest rate. The financial performance was closely related to bank size and geographic location. Banks in the euro-area periphery realised lower profits. Financial performance of large and complex banking groups was more positive than that of small groups. Notwithstanding the low profitability, most banks of the euro area strengthened their capital position, to different extents, awaiting ECB's assessment. In the meantime, asset quality performed differently. Non-performing loans (NPL) indicator was generally stable for the large banking groups but deteriorated for small banks. Credit risk remained at high levels in the second half of the year, posing a challenge, particularly to banks of the countries with a poor economic performance. Using various methods in calculating the NPL indicator has created uncertainty in markets, as regards the level of banking sector exposure in different countries. Therefore, since November 2013, the ECB and the European Banking Authority have initiated a process for assessing the asset quality and capitalisation level of banks in the euro area and in the other European countries.

Box 2.1 Developments in banking groups operating in Albania

Table 2.3 shows some of the main indicators obtained from the financial statements of large banking groups operating in Albania. They show, in general, an improved level of income and good capitalisation of these banking groups, remaining at satisfactory levels and without needing addition to existing capital under the regulatory requirements. The share of banks operating in Albania in total assets of foreign banking groups owning them remains low.

Table 2.3 Financial data on foreign banking groups operating in Albania

Annual change	Raiffesen Bank International[I]	Intesa San Paolo[II]	Alpha Bank[III]	Piraeus Bank[IV]	National Bank of Greece[V]	Societe Generale[VI]	Credit Agricole[VII]
Total assets	-4.0%	-7.0%	26.5%	30.7%	6.0%	-1.2%	-4.3%
Customer loans	-3.2%	-8.7%	27.4%	39.8%	-1%	-5%	-3.6%
Customer deposits	0.2%	-2.8%	49.3%	46.8%	7.0%	2.0%	1.4%
Loan-loss provisions	13.9%	51.3%	15.4%	14.9%	-36.0%	9.0%	—[1]
Net profit[2]	-23.6%	...	72.1%[3]	...	...	...	...
Operating income	8.2%	-8.9%	59.0%	14.4%	16.0%	-1.2%	1.6%
Net interest income	7.4%	-13.8%	19.8%	61.7%	-6.0%	—	—
Net commission income	7.2%	12.8%	36.3%	31.7%	7.0%	—	—
Operating expenses	2.5%	-6.3%	23.8%	80.1%	1.0%	-0.1%	-1.6%
Personnel cost	1.9%	-9.6%	23.6%	108.7%	-4.0%	—	—
Net operating profit	17.2%	-11.4%	—	—	—	-3.9%	7.6%
Ratios							
Non-performing loan	10.7%	9.1%	32.7%	36.6%	—	6.0%	—
Net interest margin	3.11%	—	2.3%	—	3.40%	—	—
Capital adequacy ratio	10.7%	12.8%	15.9%	13.9%	11.2%	13.4%	13.1%
Bank's total assets in Albania to total group assets	1.56%	0.15%	0.73%	0.71%	0.25%	0.04%	0.01%

I Annual Report, 2013, (http://investor.rbinternational.com)
II Press release, 2013, (www.group.intesasanpaolo.com)
III Financial results, 2013, press release, (www.alpha.gr)
IV Financial statements for 2013, (www.piraeusbankgroup.com)
V Results for 2013, Press release, (www.nbg.gr/en)
VI Financial information for 2013, (www.societegenerale.com)
VII Financial results for 2013, (www.credit-agricole.com)
1 — shows lack of official data publication
2 shows that the change in net profit/loss is reported above 100% on a year earlier.
3 Deepening of financial loss

3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

3.1 REAL ECONOMY

In 2013 Q4, the Albanian economy registered 1.1% real growth relative to end-2012. The economic activity improved even relative to 2013 Q3, when the economy had registered 2.5% annual contraction. Excluding the services sector, all the branches of the economy contributed positively to economic growth for 2013 Q4. It is worth noting that construction grew its economic activity by 3.66%, in contrast with the continuous contraction in 2012. Agriculture increased marginally by 1.23% in annual terms, while industry improved 7.19% over the whole period. On the other hand, the services sector continued contracting, down by 1.16% in annual terms, furthering the performance begun in 2013 Q2.

Further to these developments, aggregate demand remained weak. Private consumption and investment stayed at low levels. Developments in the external sector of the economy remained weak, under the conditions of slow increase in the external demand, in 2013 H2. Responding to these developments, Bank of Albania's monetary policy remained stimulating. Weak aggregate demand, low imported inflation, and anchored expectations contributed to keeping inflation within the lower limit of Bank of Albania's target. In 2013 Q4, inflation averaged 1.5%, unchanged from 2013 Q3. During this period, the easing monetary policy was reflected in downward interest rates in Albania's financial markets, supporting the macro prudential stimuli undertaken by the Bank of Albania during 2013.

Regarding the labour market developments, in 2013 Q4, the unemployment rate was 17%.[10] For the same period, the employment rate was 42.6%, down by 6 percentage points, in annual terms. The main contribution to decline in employment was given by the construction sector, where employment trended down throughout 2013.[11] Employment expectations for 2014 Q1[12] appear more optimistic for the industry sector, and low but positive for the services and construction sectors.

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[10] *Unemployment rate is obtained from a specific survey on the labour market conditions, based on a new methodology applied by INSTAT, according to international standards evidenced in the 19th International Conference of Labour Statisticians, Geneva, October 2013.*

[11] *According to the Labour Force Survey, INSTAT.*

[12] *According to the Business Confidence Index for 2013 Q4, expectations index for employment in industry stood at 9.8, in services at 3.3, in construction at 2.4 and in trade at -1.8.*

Fiscal indicators as of the end of 2013 H2 showed an expansionary fiscal policy. Revenues recorded a cumulative annual value of ALL 328.6 billion, down by 0.5% from end-2012. Total expenditures increased 4.7% or ALL 394.1 billion, in annual terms, reflecting the simultaneously increased capital and current expenditures. Budget deficit continued to widen, to ALL 65.4 billion or 4.8% of GDP.[13] This deficit was financed mainly by domestic resources (83.5%), through domestic borrowing and privatisation receipts, while foreign financing continued falling.

At end-2013, current account deficit expanded 4.9% in annual terms, to EUR 1.03 billion. Trade deficit recorded EUR 1.7 billion, down by 3.5% from the same period a year earlier. This contraction reflected the export increase by 13.5% and import decrease by 1.8%, in annual terms. Remittances continued to fall, recording EUR 497.2 million for 2013, or down by 26.4% on a year earlier. For the same period, capital and financial account reached EUR 815.3 million, or up by 4.6% from end-2012. Foreign investment increased 38.6% in annual terms, registering EUR 923 million. In the meantime, portfolio investment and other investment fell in annual terms. Coverage ratio of financing the current account deficit through capital and financial accounts stood at 79.4%, almost similar to end-2013.

Assessments of future developments show that external demand will remain limited but upward. The same assessment stands for fiscal stimulus as well, while inflationary pressures will be weak. Developments in private consumption and investment will continue to drive economic growth.

3.2 HOUSING MARKET

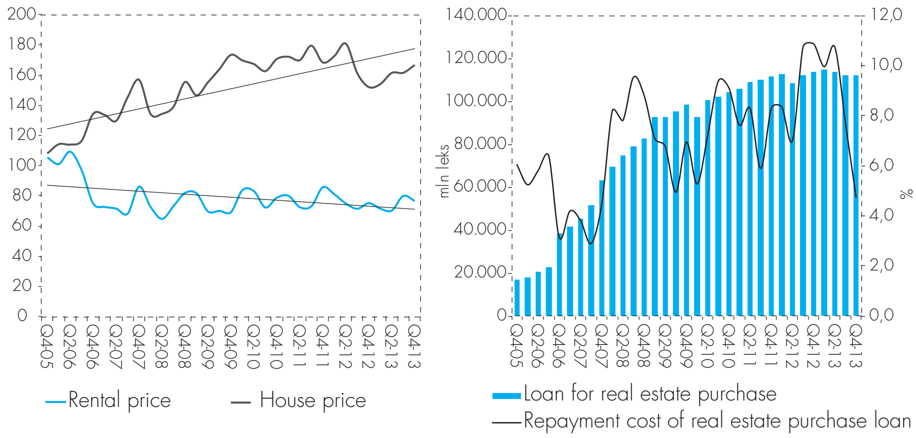
During 2013 H2, the house and rental price indices picked up. At the same time, real estate loans dropped and their quality worsened slightly, while the relative cost of real estate purchase fell sharply.

In 2013 H2, House and Rental Price Indices[14] changed direction, recording an average annual increase by 4.9% and 7%, respectively. Price-to-rent ratio stood at 2.17 as of end-2013, down by 2.3 units from a year earlier.

13 Preliminary estimate of GDP as of end-2013.

14 House and Rental Price Indices refer only to Tirana.

Chart 3.2 Housing market developments



Source: Bank of Albania.

Outstanding loans for real estate purchase fell by 1.26% as of end-2013, in annual terms, after performing positively in 2013 H1 reaching high rates of increase (on average 3.5%). As of end-2013, the weighted interest rate on real estate loans fell by 1.5 percentage points, in annual terms, continuing the downtrend begun in 2013 H1. Relative repayment cost of real estate loan[15] fell by 6.1 percentage points in 2013 H2, reflecting better conditions for real estate purchase from borrower's viewpoint.

Real estate loan portfolio quality, estimated by the ratio of non-performing real estate loans to outstanding real estate loans, worsened by 0.7 percentage points in annual terms, to 13.6%. Nevertheless, the real estate loan portfolio quality remained in check and far better than the total loan portfolio quality due to the form of collateral imposing a prudent behaviour by banks and borrowers.

[15] *Relative repayment cost of real estate loan 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.*

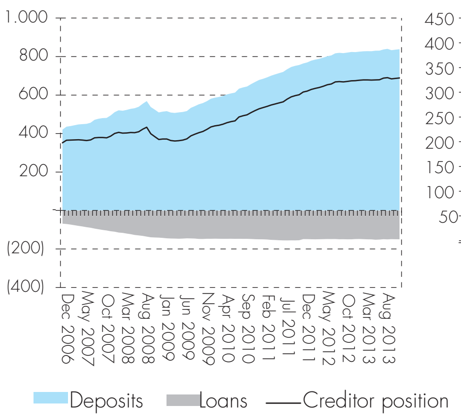
4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

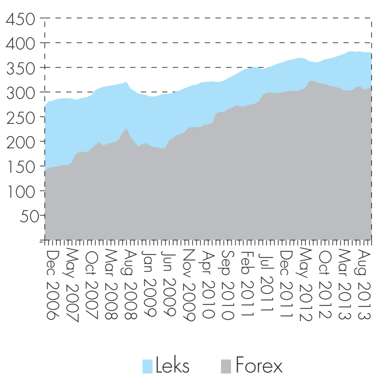
In 2013 H2, the financial position of individuals/households maintained a similar trend to 2013 H1. Households tended to save, although at slower paces, as shown by the decelerated deposit growth. Lending was positive and expanded slowly, totally sustained by ALL-denominated credit. Credit quality also performed positively, improving by year-end due to lower non-performing loans stock. However, households remained exposed to credit risk. Total business loans shrank, though ALL loans and deposits expanded slightly on a year earlier.

4.1 HOUSEHOLDS

As of end-2013, households' creditor position[16] amounted to ALL 691.4 billion, up by ALL 8.5 billion on a year earlier. The widening of this position slowed due to slower growth in deposits (ALL 14.35 billion) and credit (only ALL 5.9 billion) on a year earlier. Annual growth of deposits and credits remained significantly below their long-term average, by ALL 61.8 billion and ALL 22.5 billion, respectively.

Chart 4.1 Households' financial position to the financial system, in ALL billion





Source: Bank of Albania.

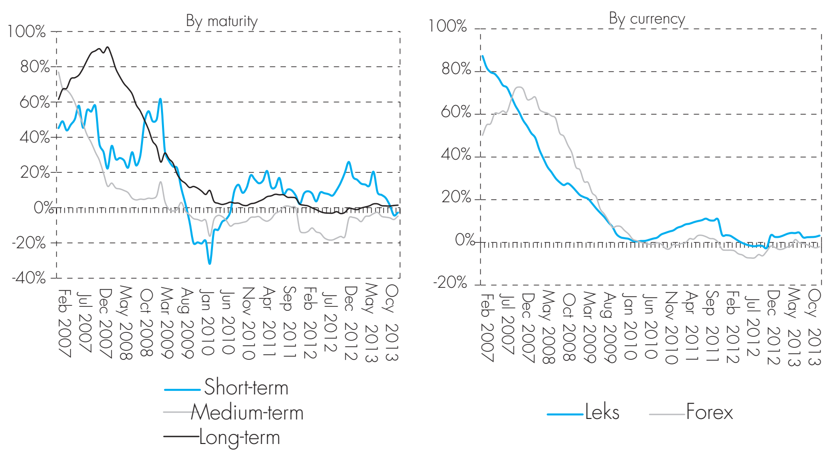
[16] *Households' financial position is measured as the difference between deposits and loans of resident households in the Albanian financial system (which includes all bank and NBFIs in Albania). If this difference is positive, households are creditors to the system, and if it is negative, they are debtors to the system.*

By currency, households are creditors of 380.3 billion in lek and 311.05 billion in foreign currency. On a year earlier, the creditor position in lek increased by around ALL 14.05 billion, while in foreign currency it continued the downtrend begun in June 2013, down by ALL 5.6 billion. This development reflects the decline in foreign currency-denominated deposits and loans.

4.1.1 CREDIT RISK

At end-2013, lending[17] to households increased slightly by 0.31% in annual terms. It was supported by ALL credit growth (3.2%), while foreign currency credit fell (2.0%). As a consequence, the share of foreign currency credit fell to 54%, while that in lek rose to 46%, hence lowering the spread between them. By maturity, lending to households increased, with long-term loans accounting for 79.9%, medium-term loans 12.7% and short-term loans 7.4% of the portfolio.

Chart 4.2 Annual growth rates of lending to households



Source: Bank of Albania.

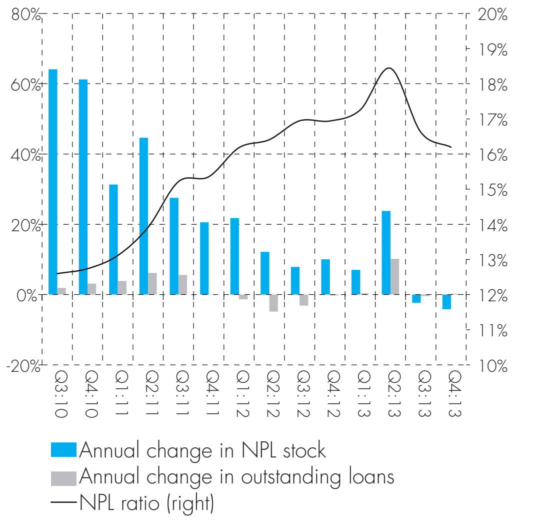
In 2013 H2, household loan portfolio quality improved. This reflects banks' operations for selling off the non-performing loans and writing them off their balance sheets, and the continuation of increase in lending to households, while the total loan portfolio has contracted. In December 2013, the NPL ratio for this category fell to 16.19%, from 18.44% in June 2013.

[17] *Calculation includes only residents.*

4.1.2 INDIRECT CREDIT RISK ARISING FROM EXCHANGE RATE

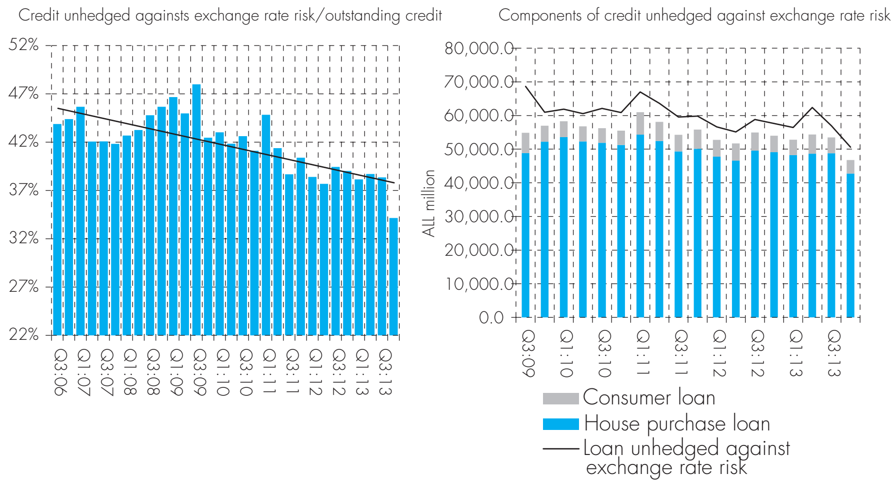
Households continued to lower their exposure to credit unhedged against exchange rate risk. At end-2013, this credit fell to about 34.2% of total household outstanding loans, from 38.7% in 2013 H1. About 84.5% of household credit unhedged against exchange rate risk is composed of 'House purchase loans', up by 6.8 percentage points from 2013 H1; 'Consumer credit' accounts for 8%, down by 1.1 percentage points during the period.

Chart 4.3 Household loan portfolio quality



Source: Bank of Albania.

Chart 4.4 Household exposure to indirect credit risk arising from the exchange rate

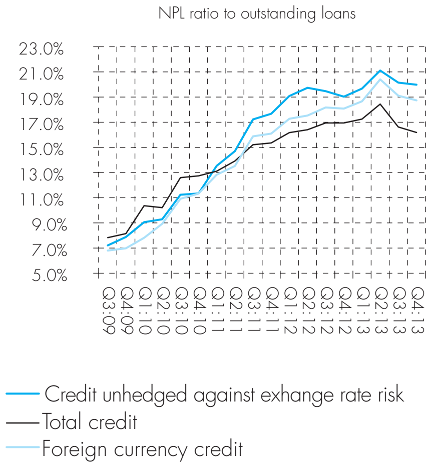


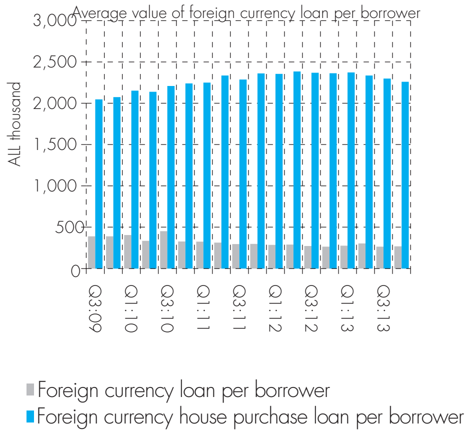
Source: Bank of Albania.

In 2013 H2, the quality of foreign currency loan portfolio unhedged against exchange rate risk and household foreign-currency loans improved (Chart 4.5, left).

In December 2013, the average foreign currency loan per borrower decreased, to about ALL 268 thousand, from ALL 303 thousand at the end of 2013 H1. (Chart 4.5, right). In total foreign currency loans, the average share of house purchase loans fell to ALL 2.26 million per borrower, from ALL 2.34 million in June 2013. The quality also deteriorated, to 20.1% at year-end, from 18.7% at the end of 2013 H1.

Chart 4.5 Household loan quality and average loan per borrower





Source: Bank of Albania.

4.1.3 INDIRECT CREDIT RISK ARISING FROM INTEREST RATE

At end-2013, household exposure to indirect credit risk arising from unfavourable interest rate movements remained similar to end-2013 H1. The ratio of variable-interest rate loans to total household outstanding loans was 23.4%, up only 0.1 percentage point from end-June 2013. For the same period, the interest rate on household lek-denominated loans fell by 0.58 percentage points, while that in foreign currency changed only marginally.

These changes reflect the supply and demand volatility, and the interest rate cut in the money market due to Bank of Albania's easing monetary policy. The bank lending survey also confirms the downward interest rates on new loans, mainly in lek. Results show that at end-2013, the banks eased their lending standards for households, which were reflected mainly in narrowing the average credit margin.[18]

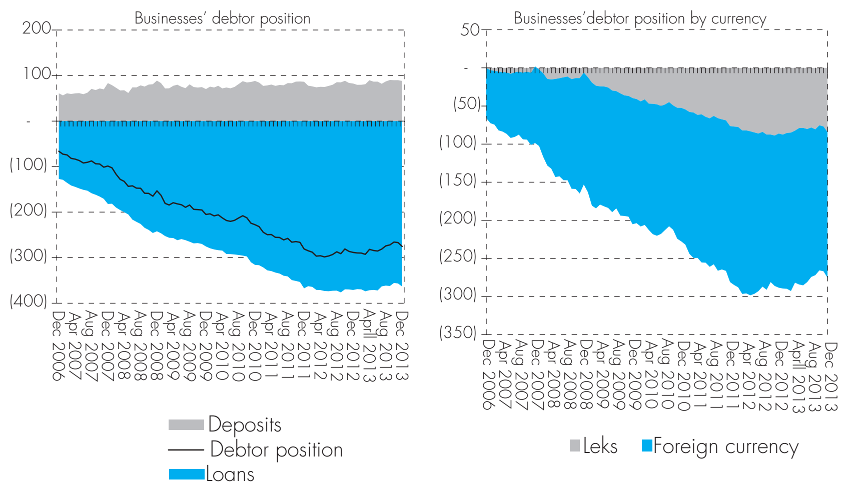
4.2 BUSINESSES

At end-2013, businesses' debtor position[19] was ALL 275.39 billion, contracting by ALL 13 billion on a year earlier. This reflected the contraction in business loans by ALL 7.45 billion, while deposits grew by only ALL 5.6 billion on a year earlier. Though at low levels, deposit growth remained above the ALL 3.4 billion annual long-term average, starting from 2007.

[18] *According to 2013 Q4 Bank Lending Survey, the banks narrowed their average margin on loans, measured as the spread between the interest rate on credit and the bank's reference interest rate.*

[19] *Businesses' debtor position is measured as the difference between business deposits and loans in the financial system (including all the financial institutions in the country, banks and non-banks). If this difference is negative, businesses are debtors to the system.*

Chart 4.6 Businesses' financial position to the financial system, in ALL billion



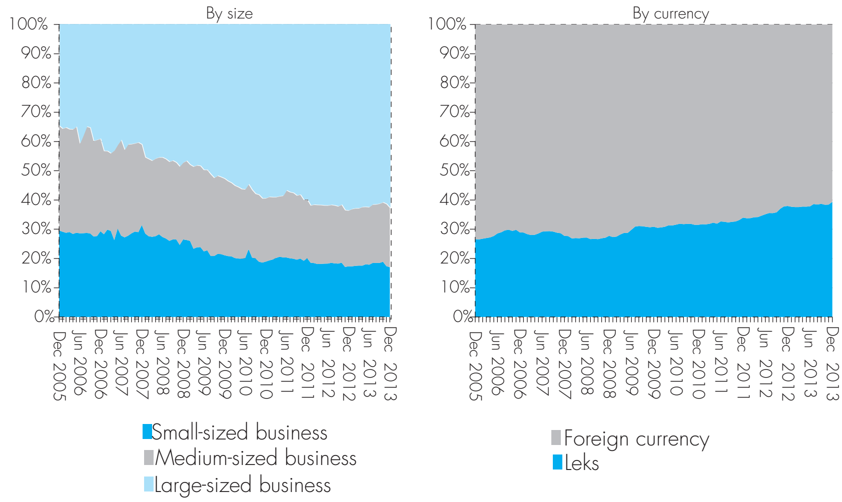
Source: Bank of Albania.

By currency, businesses' debtor position in lek was ALL 84.18 billion and in foreign currency was ALL 191.2 billion. On a year earlier, debtor's position shrank by ALL 1.96 billion in lek and ALL 11.1 billion in foreign currency. These developments reflected mainly the contraction in foreign currency loans and the slight increase in ALL loans.

4.2.1 CREDIT RISK

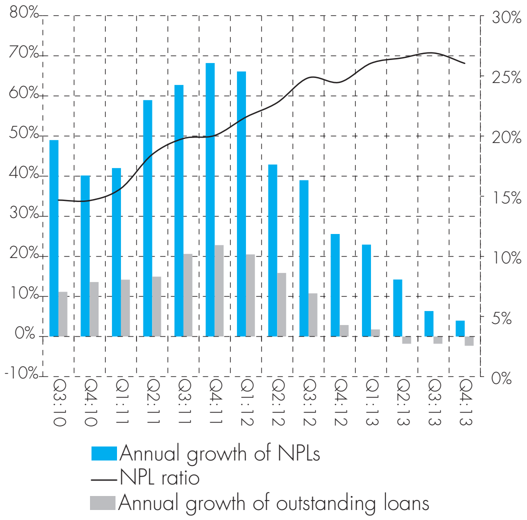
Lending to businesses has continued to contract since 2013 Q2. It fell by 2.16%, in annual terms, as of end-2013. This behaviour was conditioned mainly by contraction in foreign currency loans by 3.78%, while ALL loans increased slightly by 1.13%. By business size, lending to large enterprises accounted for 62.7% of the business loan portfolio, while lending to small and medium-sized enterprises accounted for about 17% and 20.3%, respectively. By loan maturity, large businesses tended to increase their share in short-term loans, while small and medium-sized businesses increased their share in long-term loans. By loan currency, lending in lek increased, accounting for 34% of total loans. Over the period, small businesses showed a stronger tendency for increasing lending in lek, while medium-sized businesses showed a slower pace in this regard.

Chart 4.7 Distribution of lending to businesses



Source: Bank of Albania.

Chart 4.8 Business loan portfolio quality



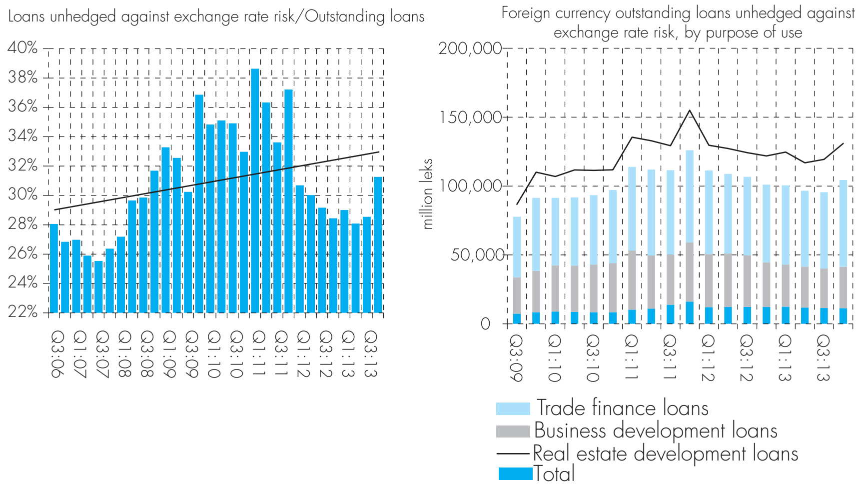
Source: Bank of Albania.

Business loan portfolio quality improved as of end-2013, reflecting mainly the banks' selling off non-performing loans and writing them off their balance sheets. At year-end, the business NPL ratio was 26.03%, from 26.5% at end 2013 H1.

4.2.2 INDIRECT CREDIT RISK ARISING FROM EXCHANGE RATE

During 2013 H2, business exposure to exchange rate movement increased, differently from the downward trend begun since early 2012. In December 2013, business outstanding foreign-currency loans unhedged against exchange rate risk accounted for around 31.3% of total business loans (or around ALL 131 billion),from 28.1% in June 2013 (Chart 4.9, left). While the share of foreign currency loans in total business outstanding loans fell, the share of loans unhedged against exchange rate risk rose to 47.7% of foreign-currency loans, from 42.2% in June 2013.

Chart 4.9 Businesses' exposure to indirect credit risk arising from exchange rate

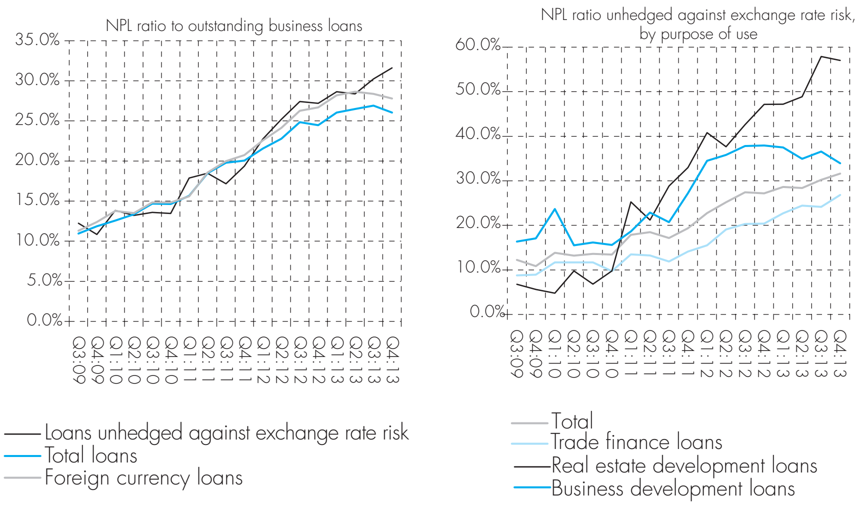


Source: Bank of Albania.

The structure of business loans unhedged against exchange rate risk reflected the increase in 'trade finance loans', to 48.12% of this portfolio, while 'business development loan' and 'real estate development loan' accounted for 23% and 8.7%, respectively (Chart 4.9-right).

The quality of business loans unhedged against exchange rate movements deteriorated to 31.6%, from 28.4% at the end of 1013 H1 (Chart 4.10, left). This behaviour is in contrast to the downtrend of the share of non-performing loans in foreign currency loan portfolio, which improved to 27.78%, from 28.64% in June 2013, and in total business loan portfolio. In business loans unhedged against exchange rate risk, the quality deterioration was sharper for real estate development loans, in which the share of non-performing loans rose to 57%, from 48.9% in June 2013 (Chart 4.10, right).

Chart 4.10 Business loan portfolio quality



Source: Bank of Albania.

4.2.3 INDIRECT CREDIT RISK ARISING FROM INTEREST RATE

At the end of 2013 H2, businesses' exposure to indirect credit risk arising from the interest rate was lower. Ratio of variable-rate loans to business outstanding loans was 61.2%, from 61.9% in 2013 H1, being close to the long-term average of 59.8%. Interest rates on new business loans fell on both lek and foreign currency loans. The fall was sharper on new lek loans (by 1.85 percentage points) than on new euro loans (by 0.05 percentage points) relative to 2013 H1.

Easing monetary policy and interest rate cut in the money market, unstable demand for business loans and lending-term changes are factors that will jointly affect the performance of lending size and interest rate on new business loans in the short run.

Box 4 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 by end-2013 and focused on developments in 2013 H2, while assessments of expectations refer to 2014 H1.

Survey on Households' Financial Situation and Borrowing

To analyse households' financial situation and borrowing, the sample included 1210 households across 17 districts of Albania. In the survey, 96% of respondent households answered the questions.

- *FINANCIAL SITUATION*

The total number of households earning income (from employment or other sources) fell by 2% from 2013 H1. Of total employed persons: self-employed account for 27%, down by 1% from the previous survey. The share of people employed in the public sector fell below the actual average and from 2013 H1, while the share of those earning income from remittances equalled the 5% average. More than half of respondents (58% or 673 households) reported that their monthly income was 'ALL 17 - 50 thousand". This share is higher than in 2013 H1 or a year earlier. Breaking down households by income level, we see a downward trend of the share of households at extreme income levels (upper or lower) and concentration around the average or below-average level.

- *BORROWING*

Total number of households stating that they had, at least, one loan to repay, despite the type, source, or value, was 333 households or 29% of respondents (around 28% of the sample). This shows an increase by only 12 households from 2013 H1, but a decline by around 5 percentage points (or 68 households) from the actual average. Around 61% of borrowing households belong to the 'ALL 17-50 thousand' monthly income group. This share has increased from 2013 H1 and from the actual average. About 45% of borrowing households had borrowed from formal sources (such as, banks and other non-bank financial institutions) and 55% of borrowing households had resorted to borrowing from informal sources (such as from natural persons and stores). 'Purchasing/renovating a property' (34%) and 'consumption' (37%) continued to be the top two borrowing purposes. Both items increased by 2 percentage points, respectively, from 2013 H1

- *HOUSEHOLD SOLVENCY*

The net balance of responses on household solvency was -18%, showing that it worsened at similar paces to 2013 H1. Of households reporting worsened solvency, 55% attributed it to 'lower income', while 23% to 'higher living costs'. Concerning expectation for the next six-month period, the net balance of responses was -1%, indicating that household solvency is likely to deteriorate but at a slow pace.

Survey on Businesses' financial situation and borrowing

In order to analyse Albanian businesses' financial situation and borrowing, a sample of 728 enterprises was surveyed, geographically extended throughout the country.

- *FINANCIAL SITUATION*

Reflecting the economic situation, businesses continued to report decline in sales, albeit at slower paces than in 2013 H1. This was associated with a lower financial result and contracted investments throughout the sectors. However, sales remained the main source of funding business activity, particularly the services sector. In the meantime, industry and construction sectors combined sales income with borrowing to finance their activity during 2013 H2.

- *BORROWING*

About 58.9% of respondent enterprises (or 47.4% of the sample of 345 enterprises) stated that they had a loan to repay; hence the borrowing percentage was 5.2 percentage points higher than in 2013 H1. The purpose of borrowing was to afford short-term expenses (working capital) and to a lesser extent, to invest. Albanian lek loans dominated the lending to enterprises. About 78.2% of them reported having borrowed in the last five years. The share of businesses having pledged real estate as loan collateral was 71.6%, very close to the long-term average. Enterprises reporting collateral value above the 120% of the loan value had the largest share in the industry sector, while those reporting a collateral value up to 50% of the secured loan value had the largest share in the services and construction sectors. In general, for 89.1% enterprises, the loan value did not exceed the firm's capital value. For around 91% of businesses, the loan repayment accounts for up to 50% of their income. For the enterprises affirming change in their loan repayment amount, this change reflected mainly the increase in the payment value, which was afforded by cutting other expenses, using various reserves or increasing the price of products for sale. For the next six months, enterprises in industry and construction sectors expect their loan repayment value to increase, whereas those in the services sector expect it to fall.

- *RELATIONS WITH BANKS*

Concerning relations with banks, more than half of enterprises consider the high interest rate as the most difficult element.

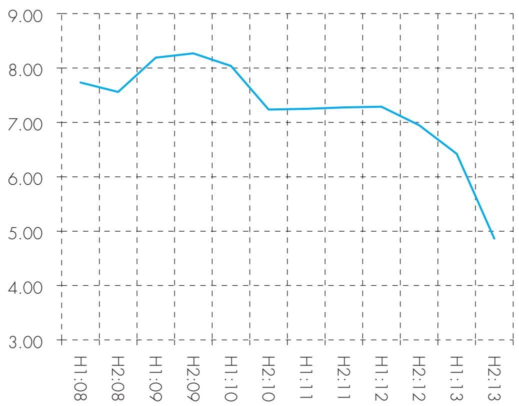
Businesses consider other elements, such as loan collateral terms, loan structure adjustment to activity development cycle and lack of transparency about the way bank loans are approved and monitored, as elements of average difficulty. Despite the sectors in which they operate, around 95% of enterprises consider relations with banks as necessary or indispensable.

5. FINANCIAL MARKETS

In the government securities market, the demand for funding was high, being an additional factor for lowering interest rates on all maturities. The secondary market for government debt securities recorded a slightly lower number of transactions, evidencing, however, higher interest in 3 and 6-month T-bills. The volume of interbank transactions increased significantly, mainly for short-term overnight and one-week maturities. Though more volatile at the end of the period, the average weighted interest rate remained generally below the key interest rate, reflecting the good liquidity situation. In the foreign exchange market, during the year, the lek depreciated slightly against the euro and appreciated against the US dollar, reflecting the demand and supply in the domestic market and developments in the international foreign exchange market.

5.1 PRIMARY MARKET FOR DEBT SECURITIES

Chart 5.1 Average interest rate on debt securities, in %



Source: Bank of Albania.

During the period, the government met its financing needs by increasing the volume of issued debt securities to ALL 297.2 billion. This performance was driven by significantly falling incomes, against the backdrop of a year of parliamentary elections and change of government. Financing through T-bills (74.7%) continued to dominate the issues structure. Increase in the issues structure was distributed almost evenly among 3, 6 and 12-month T-bills.

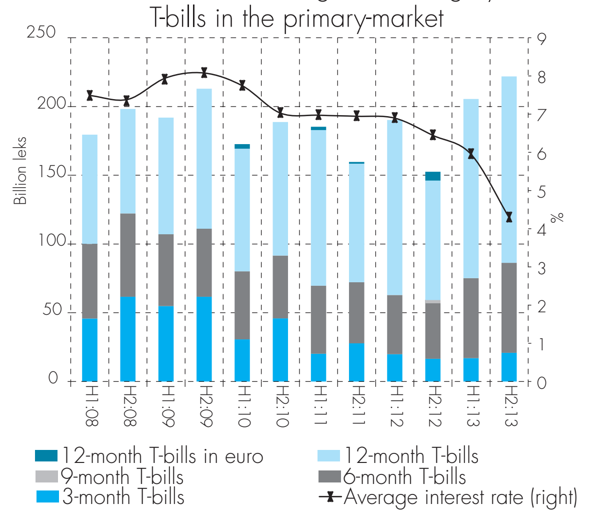
During the period, the interest rates in the primary market auctions of government debt securities fell sharply, reflecting the continuing key interest rate cut by the Bank of Albania. The interest rate cut was sharper for 12-month maturities and longer-term maturities. As a result, the average interest rate on debt securities issued during 2013 H2 fell to 4.9%, from 6.4% in 2013 H1.

During 2013 H2, the Government issued ALL 222 billion T-bills in auctions, from ALL 205.5 billion in 2013 H1 and ALL 190.2 billion in 2012 H1. Bidders' interest in auctions remained in 12-month T-bills, whose share was 61.1% in total T-bills.

Market depth indicators (estimated by bid-to-cover ratio on different instruments) showed a lower preference for 3-month T-bills, and hence the ask amount was not met in several auctions. On the other hand, this instrument contributed less to decline in T-bill yield. In fewer cases, the ask amount was not met even for 6-month T-bills.

At period end, T-bill yield was 4.3%, around 1.66 percentage points lower than in 2013 H1 and 2.2 percentage points lower than at end-2012. The average yield on T-bills has fallen constantly since 2009 H2.

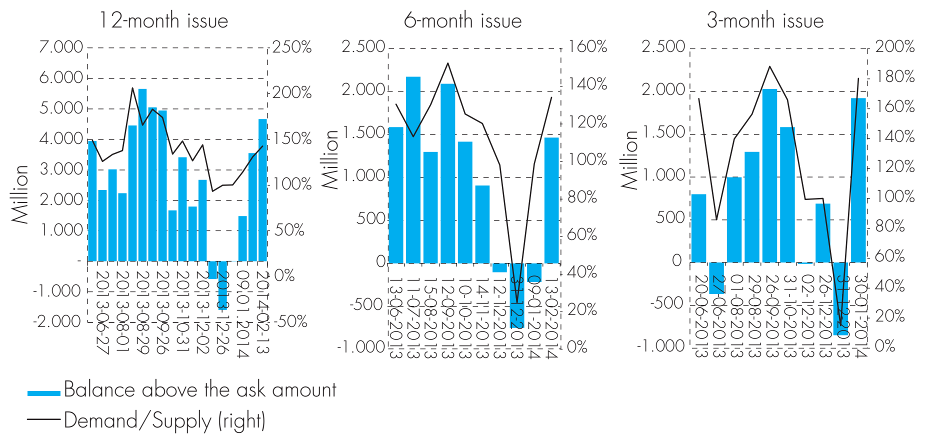
Chart 5.2 Volume and weighted average yield on T-bills in the primary-market



Note: The 12-month T-bill volume includes issues in euro as well.

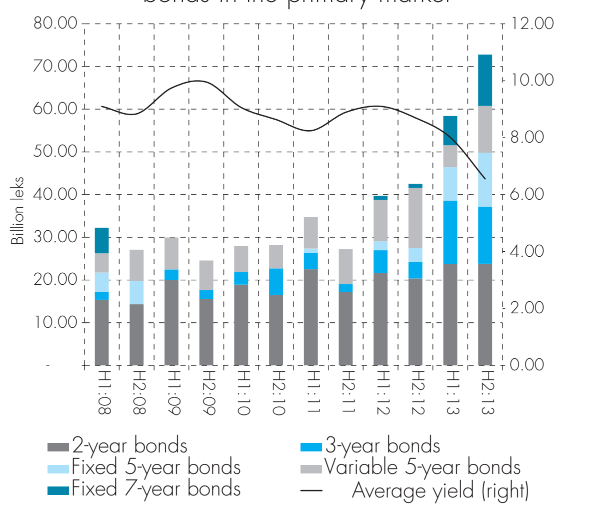
Source: Bank of Albania.

Chart 5.3 T-bill auctions during 2013 H2



Source: Bank of Albania.

Chart 5.4 Volume and weighted average yield on bonds in the primary market

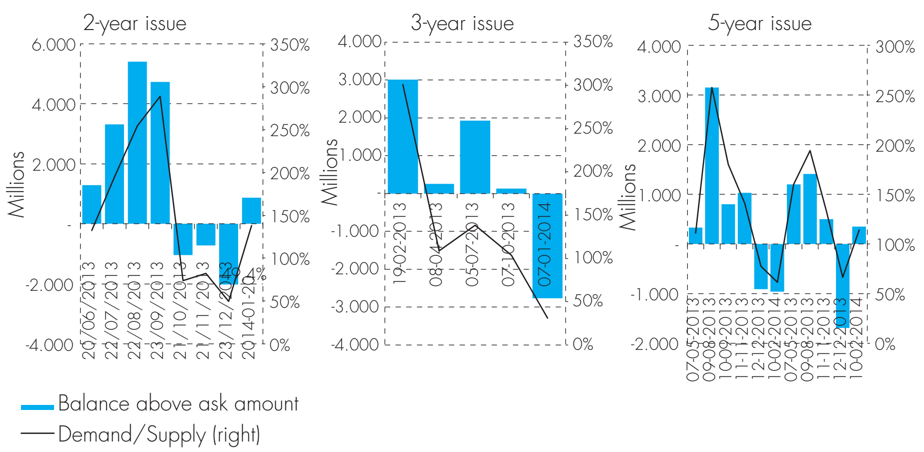


Source: Bank of Albania.

Issues of government debt bonds amounted to ALL 75.3 billion, from ALL 61.5 billion in 2013 H1, up by 71.1% from the same period a year earlier. By structure, the issues of 2 and 3-year bonds did not change much from the previous six-month period. The 7-year fixed-rate bond issues almost doubled to around ALL 12 billion, while 5-year bond issues (for both fixed and variable rates) increased by ALL 10.5 billion or 81% from 2013 H1.

The stable demand for T-bills and bonds contributed to lowering the ask yield on all maturities. At the end of the period, the average yield was 6.55%, down by 1.5 percentage points from 2013 H1 and 2.1 percentage points from end-2012. The yield on these instruments was 2.4 percentage points below the five-year average.

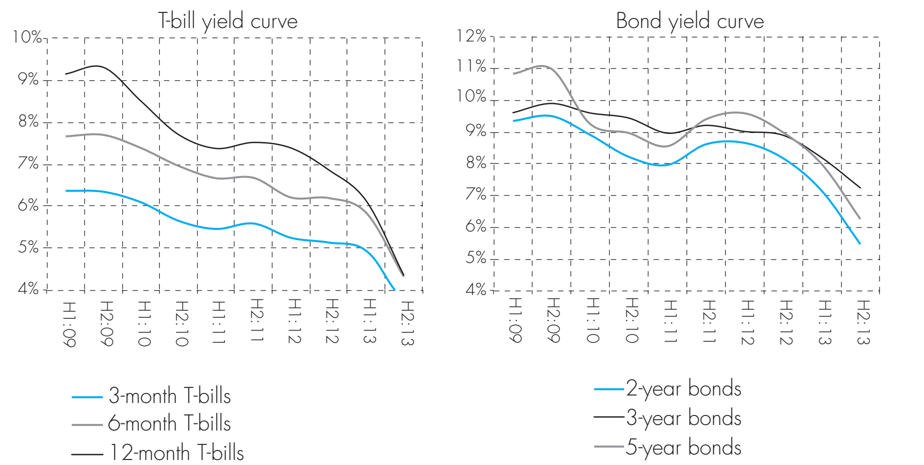
Chart 5.5 Bond auctions during 2013 H2



Source: Bank of Albania.

Chart 5.6 shows the yields on Government debt securities by maturity.

Chart 5.6 Average yield on debt securities in the primary market

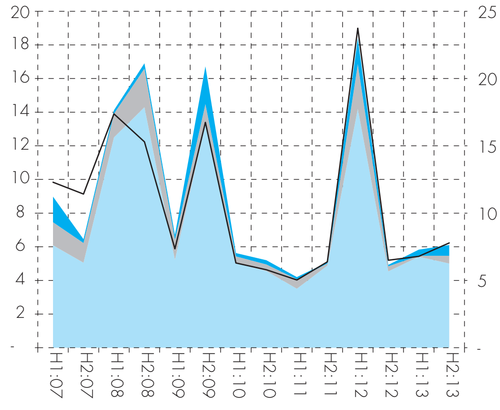


Source: Bank of Albania.

5.2 SECONDARY MARKET FOR DEBT SECURITIES

In nominal terms, the volume of T-bill transactions totalled ALL 6.1 billion, up around ALL 270 million or 4.7% from 2013 H1. As the chart shows, the secondary market operated smoothly, despite the structural changes a year earlier. The number of transactions fell slightly (by 75 transactions) during this period. Though 12-month T-bills prevailed over total T-bills traded, accounting for 82%of the total volume for the period, the trading of 3 and 6-month T-bills increased by ALL 270 million and 400 million, respectively.

Chart 5.7 Trading volume of T-bills in the secondary market



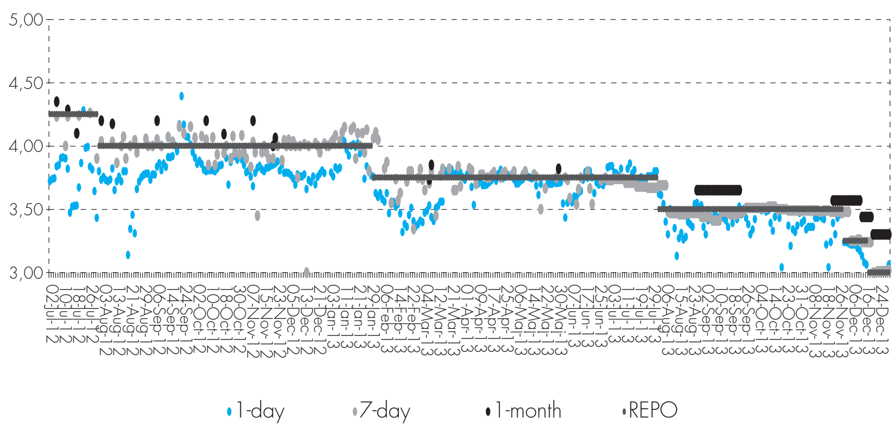
Source: Bank of Albania.

5.3 INTERBANK MARKET

Interbank transactions increased 49.3% during the period, to ALL 556.2 billion at the end of 2013 H2. Banks preferred overnight and one-week borrowing, while one-month borrowing was used sporadically and at low volume.

During the period, the weighted average interbank rate was 3.06%, from 3.72% in 2013 H1. It stood below the key interest rate[20] during the major part of the period, reflecting the benign liquidity situation in the market. In 2013 Q4, interest rates on overnight, weekly and monthly borrowing were more volatile than the key interest rate, reflecting banks' repositioning to government financing transactions.

Chart 5.8 Spread between interbank rates and key rate, by maturity

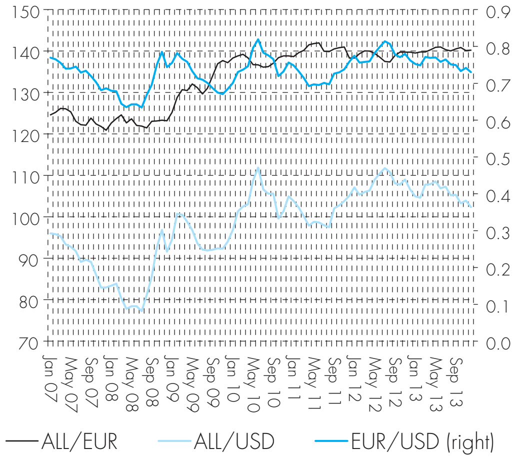


Source: Bank of Albania.

[20] *The easing monetary policy operations continued during 2013 H2, lowering the Repo rate to 3% at end-December 2013.*

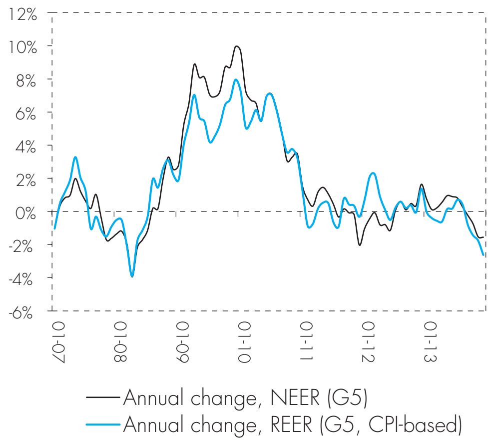
5.4 FOREIGN EXCHANGE MARKET

Chart 5.9 Exchange rates for the three major currencies



Source: Bank of Albania.

Chart 5.10 Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER)



Source: Bank of Albania.

In 2013 H2, lek's nominal value depreciated slightly against the euro, reflecting economic agents' higher demand for and supply of foreign currency, lower remittances, and euro's appreciation in the international foreign exchange markets. However, lek's appreciation against the US dollar and increased share of trading exchanges with China and Turkey, kept lek's Nominal Effective Exchange Rate (NEER) at lower levels than in the same period a year earlier, indicating lek's appreciation in the second half of the year.

During 2013, the lek depreciated around 0.4% against the euro and appreciated around 3.9% against the US dollar. Lek to euro exchange rate averaged 140.3, changing only marginally from 2013 H1, whereas lek to US dollar exchange rate averaged 104.6 in 2013 H2, from 106.8 in 1013 H1.

The indicators measuring the changes in lek's exchange rate - Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) - indicated lek's appreciation by 1.9% against the euro and 3.1% against the US dollar.

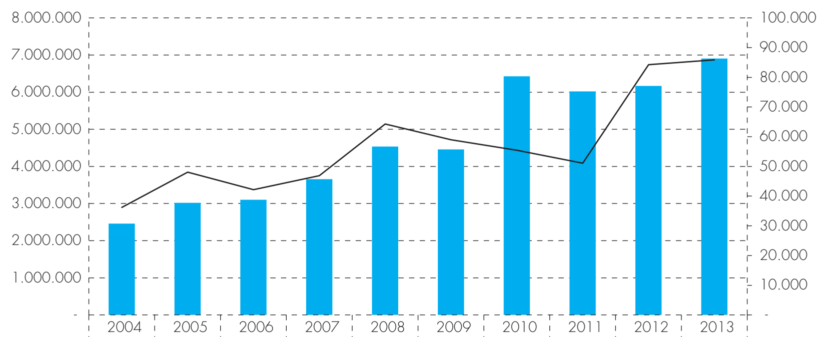
6. PAYMENT SYSTEM DEVELOPMENTS

The functioning of the basic national Lek payment infrastructure showed safety and efficiency. These characteristics are necessary for meeting Bank of Albania's objective on payment systems, contributing to safeguarding financial stability and maintaining public confidence in the domestic currency.

Payment systems are an integral part of the financial system structure, as channels that enable transfer of funds among banks and/or final users of banking services. Hence, their safety, efficiency and stability requires due diligence to promote and support financial stability.

'Albanian Interbank Payment System (AIPS)' and 'Albanian Electronic Clearing House (AECH)' have operated in accordance with relevant rules and procedures. At end-2013, all commercial banks operating in the Republic of Albania were direct participants in these systems. Since 2011, the Ministry of Finance has also been an indirect participant in these systems, generating about three-fourths of the number of transactions in the AECH, and about one-fourths of the number of transactions in AIPS. During 2013, about 86,350 transactions averaging ALL 80 million per transaction were processed in AIPS, showing a rise in the number and value of transactions by 12% and 2%, respectively, from the same period a year earlier.

Chart 6.1 Value and number of transactions processed in the AIPS during 2004- 2013



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Number	30.775	37.783	38.793	45.730	56.717	55.701	80.356	75.269	77.090	86.350
Value (in million leks)	2.898.570	3.843.141	3.375.759	3.749.441	5.145.930	4.718.394	4.436.661	4.085.059	6.743.429	6.871.611

Source: Bank of Albania.

By typology, 'Interbank payments', and 'Customer payments' increased their contribution to total transactions processed in this system, while 'Bank of Albania Financing Instruments' continued to fall during 2013.

Albanian Electronic Clearing House (AECH) clears payments below ALL 1.5 million. During 2013, payment orders processed in this system increased by 0.54% in volume and 8.62% in value.

Table 6.1 Developments in AECH system

AECH system	January-December 2012	January-December 2013
Number of transactions	361,552	363,507
Value of transactions (in ALL million)	66,990.11	72,767.50
Average value per transaction (in ALL million)	0.19	0.20

Source: Bank of Albania.

During 2013, about ALL 8.7 million customer payments were made, totalling ALL 3,624 billion, recording 9% annual increase in number and 5% decline in value, relative to 2012. By payment instruments, customer credit payments account for 74% in volume and 97% in value to total customer payments, in which paper-based credit transfers continue to dominate (around 95%), versus electronic payments (around 5%).

Developments in the banking system infrastructure for supporting e-commerce in Albania have led to creating for the first time virtual POS[21] terminals in the Albanian market. Their application would promote the use of card payments, hence curtailing use of cash. The banks reported that three virtual POS terminals operate in the Albanian market, as of end-2013.

[21] *It functions similarly to a regular POS terminal but makes transactions via internet or by phone, through online accessible bank cards.*

7. FINANCIAL SYSTEM

7.1 FINANCIAL SYSTEM STRUCTURE

The value of Albanian financial system assets has increased, notwithstanding the economic growth slowdown and impacts from international financial markets. The banking sector continues to dominate the financial system. Therefore, direct credit risk passed through to the banking sector from other financial system segments is assessed as limited and has not undergone any significant changes during the period. Moreover, concentration of exposure of other financial system segments to the banking sector further increases their sensitivity to performance of the latter.

In 2013 H2, the level of financial intermediation in Albania, estimated as the ratio of financial system assets[22] to Gross Domestic Product (GDP),[23] increased by 3 percentage points, to 99.1%. The banking sector accounted for 91.4% of total financial system assets. In this context, identifying and assessing risks from the banking sector activity is highly important for assessing the financial stability.

The other segments of the financial system have a small share in the banking sector. Therefore, the financial and direct risks from their activity to the Albanian financial system are regarded as limited.

Table 7.1 Financial system segments as a percentage of GDP, in years

Licensing and Supervisory Authority	Financial System	2008	2009	2010	2011	2012	2013
Bank of Albania	Banking system	76.7	77.5	80.9	84.7	89.6	90.5
	Non-bank institutions	1.7	2.2	2.7	2.5	2.7	2.5
	SLAs and their unions	0.7	0.8	0.8	0.7	0.8	0.8
Albanian Financial Supervisory Authority	Insurance companies	1.4	1.5	1.4	1.5	1.6	1.6
	Pension funds	-	0.01	0.01	0.01	0.02	0.03
	Investment funds					1.21	3.7

Source: Bank of Albania, Albanian Financial Supervisory Authority.

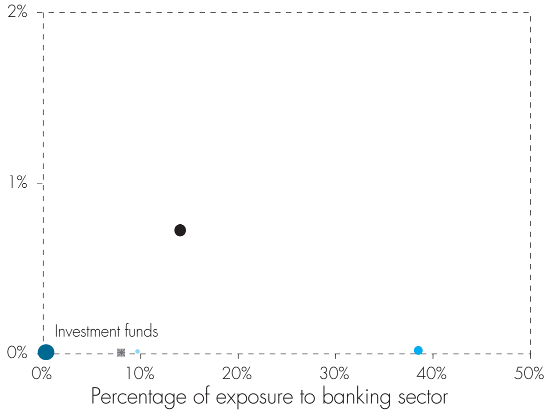
[22] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. In analysing this chapter, please consider that only the banking activity and investment fund activity are based on the data of end-2013; as regards the other segments, the activity is based on the 2013 Q3 balance sheets and the latest publications of the Albanian Financial Supervisory Authority.*

[23] *ALL 1,363,773.6 million of GDP refers to Bank of Albania's estimates based on annual economic growth figures, as published by the INSTAT and IMF.*

Direct dependence of the banking sector on other financial system components was low, in both the investments (in the balance sheet assets - claims) and funds collected by them (in the balance sheet liabilities - liabilities).

As of end-2013, exposures to non-bank financial institutions (NBFIs) in Albania, in the banking sector's balance sheet assets, account for about 1% of total banking sector assets. Funds collected by NBFIs in Albania, in the banking sector's balance sheet liabilities, account for about 1.2% of total banking sector assets. These low levels of exposure and generation of funds to non-bank financial segments, limit the direct financial risks that may pass through from inter-sectoral relations. However, there are also non-financial risks posing an indefinite indirect risk, whose effect is difficult to measure.

Chart 7.1 Main links between the banking sector and other financial system components (December 2013)



Source: Bank of Albania, Albanian Financial Supervisory Authority.
Note: The circular-and-dotty surface is related to the relative share of institutions in the financial system - Investment funds (3.7%); Non-bank financial institutions (2.6%); Insurance companies (1.6%); Savings and loan associations (0.8%), and Pension Funds (0.03%).

On the other hand, non-bank financial segments' exposures to the banking sector are considerable. At end-2013, insurance companies and NBFIs were most exposed to the banking sector. Bank deposit placements accounted for about 38% of insurance companies' assets. In the same light, NBFIs investment in the banking sector accounted for 14% of their assets. At the same time, the banking sector made a relatively limited contribution to financial sources of other financial sectors.

Box 7.1 Non-Bank Financial Sector

Non-Bank Financial Institutions (NBFIs) registered a profit and an upward capitalisation level. However, these institutions' asset quality continued falling. Savings and loan associations grew their activity but deepened their financial loss. Insurance companies decelerated their activity due to a lower number of concluded contracts and gross written premiums. Private supplementary pensions and investment funds performed positively and their assets increased.

Non-bank financial institutions' activity fell marginally (by 0.9%) in annual terms. In December 2013, their assets totalled ALL 35 billion, down by about ALL 318 million from end-2012.Lending contracted by 2% in annual terms, while capitalisation level - measured as the ratio of capital account to total assets - improved to 40.9%, from 38.9% a year earlier.

Credit risk remains the main risk to non-bank financial institutions' activity, reflected in the ratio of "non-performing loans/total loans" at 13.2%, from 8.4% a year earlier. NBFIs increased their financial result with a net profit of ALL 1.5 billion, from ALL 1.2 billion at the end of the previous year. Increase in commission income made the main contribution (by 12.2%), while interest income continued to account for the major share (by 43.2%).

Table 7.2 Financial indicators of non-bank financial institutions' activity (in EUR million)

	March 2012	June 2012	September 2012	December 2012	March 2013	June 2013	September 2013	December 2013
Total assets	33,978	33,771	34,575	35,348	34,807	34,363	34,532	35,030
Loan portfolio	20,166	20,297	20,187	20,040	19,743	19,502	19,533	19,646
NPL ratio (%)	7,9	9,0	10,4	8,4	13,3	14,1	14,7	13,2
Capital adequacy (%)	37,3	38,9	38,7	38,9	39,7	39,8	40,7	40,9
Financial result	0,252	0,742	0,720	1,244	0,343	0,520	1,060	1,502

Source: Bank of Albania.

The activity of savings and loan associations was characterised by asset growth by 2.5% in annual terms, though lending contracted by about 8.3% in 2013 Q3. During a year, the loan portfolio quality indicator for this financial segment, measured as the ratio of non-performing loans to total loan portfolio, deteriorated sharply, to 13.3% from 5.8%. SLAs and their unions deepened their financial loss to ALL 284 million, from ALL 41 million a year earlier, mainly due to higher loan-loss provisioning.

Table 7.3 Selected indicators for SLAs and their unions, in ALL billion

	March 2012	June 2012	September 2012	December 2012	March 2013	June 2013	September 2013
Total assets	9,840	9,900	10,000	10,600	10,408	10,289	10,256
Credit outstanding	7,170	7,260	7,130	7,120	6,900	6,772	6,534
Credit outstanding/total assets (%)	72,8	73,3	71,2	67,4	67,2	65,8	63,7
Non-performing loans	0,436	0,389	0,408	0,451	0,751	0,753	0,866
Non-performing loans/Credit outstanding (%)	6,1	5,4	5,8	6,4	11,0	11,1	13,3

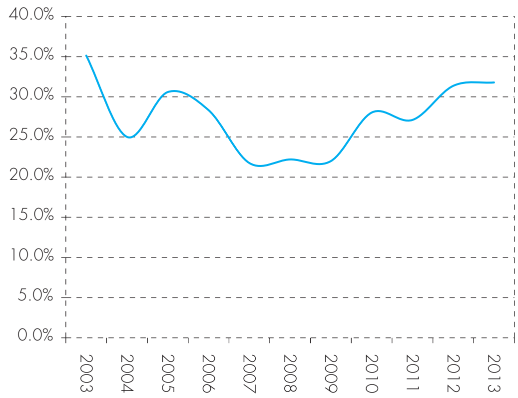
Source: Bank of Albania.

Insurance companies. At end-2013, there were 12 insurance companies licensed to carry out insurance activity in Albania. At end-September 2013, insurance companies' assets totalled ALL 21.2 billion, up by 1.7% from end-2012. Insurance liabilities (or technical provisions) grew by 11.5% to ALL 1.6 billion, while total capital fell by 8.8% to ALL 9.9 billion. The share of total insurance companies assets in total financial system sassets remained unchanged during 2012 and 2013, to around 1.6%.

*Gross written premiums * - the main indicator of insurance company activity - fell by 4.6%, to ALL 8.5 billion. A year earlier, this indicator performed positively, by 8.9%. Insurance penetration - the ratio of premiums to GDP - was 0.63%, from 0.68% at end-2012.*

Loss indicator – the ratio of paid claims to gross written premiums - increased slightly by 0.4 percentage points, to 31.8% (Chart 7.2). It shows that one thirds of claims are covered by written premiums. The higher this ratio, the higher the financial vulnerability of insurance companies, in the case of compulsory increase in payments. Gross paid claims fell by 3.3% to ALL 2.7 billion, while a year earlier insurance companies paid around 26% more claims.

Chart 7.2 Performance* of the ratio of insurance company losses



*The performance of this indicator over the years is based on data from the Annual Report published by the AFSA in 2012.
Source: Albanian Financial Supervisory Authority.

Insurance sector's investment portfolio in low risk assets leads to maintaining a low risk level for investments. At end-2013 Q3, investments were mainly in the form of time deposits at commercial banks (about ALL 3.3 billion) and Albanian government treasury bills (about ALL 1.9 billion). In September 2013, exposure of insurance companies to sovereign debt accounted for 8.8% of total assets.

Also, because of the conservative structure of insurance companies' investment portfolio, and asset and liability maturity matching, the insurance companies are less exposed to price volatility in the financial market than financial institutions are. Exposure of insurance companies to liquidity risk is relatively low, given that their premium incomes are allocated unevenly in time and claim payments are occasional.

The share of insurance market in the financial system remains small. Economic recovery, higher household disposable income, and competitive development in other insurance products were the main factors that would speed up insurance market developments. Due to the limited size of the sector, benign liquidity situation and conservative structure of investments, eventual risks to insurance companies remain subdued. However, the risk level is higher, if we consider their role in bank collateral insurance and the possibility of facing compulsory payment in the event of damage from the Force Majeure.

*Investment fund highlights** At end-2013, two investment funds operated in Albania, with a net value of assets by around ALL 50.3 billion, up by 214.4% from end-2012. Investments in government bonds, accounting for 83.9% of funds' assets, dominate this market. Actually, investment funds' assets account for 3.7% of GDP, from 1.2% a year earlier.*

*Private supplementary pension highlights.*** According to the latest data published, three private supplementary funds operate in Albania. Data analysis reveals that pension funds' activity increased by 41.4% during the year, since their assets climbed to ALL 400.9 million. The number of pension fund members increased 7.8% from end-2012. Pension funds account for a small share in Albania's GDP and in total financial system assets, by only 0.03%.*

** AFSA, Statistical Bulletin "Insurance Market in 2013", 22 January 2014.*
*** Publication by the AFSA, 5 February 2014.*
**** AFSA "Developments in the private supplementary pension market, 30 September 2013".*

8. BANKING SECTOR

8.1 BANKING SYSTEM STRUCTURE

The banking sector continued to expand its activity during 2013, albeit at a slower pace than in 2012. This performance was driven by the deceleration in Albania's economic growth and banking industry concerns over the quality of assets, and lending in particular. In the face of weak domestic demand and lending constraints, banks continued to discourage borrowing from domestic and foreign resources, resorting to investments in instruments of the domestic and foreign financial markets.

The weak lending, coupled with the downward trend of interest rates in the financial market[24], exerted pressure over the performance of income. However, the sharper deceleration in the increase in loan loss provisions drove the banking sector to almost double its positive profit in 2013, against a year earlier.

Overall, the banking sector remains liquid and well-capitalised, and capable to withstand various shocks. However, at the individual level, banks should, on an ongoing basis, assess their resilience to various shocks and take appropriate preliminary measures to weather them.

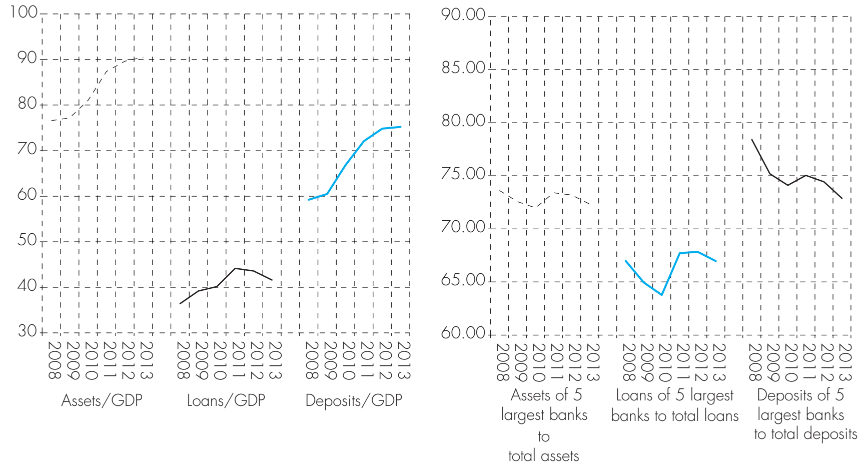
8.1.1 FINANCIAL INTERMEDIATION AND CONCENTRATION OF THE ALBANIAN BANKING SECTOR

During 2013, the banking sector increased its share in GDP by 1 percentage point, to 90.5% (see Chart 8.1). However, the ratio of private sector credit to GDP fell to 41.6%, from 43.6% in 2012, due to shrinking loan portfolio and higher GDP. The shrinking loan portfolio did not only reflect the weak demand for borrowing, but also the sale of the non-performing loan portfolio by banks. On the liability side, the share of business and household deposits in GDP increased by 0.4 percentage points, to 75.2%, at end-2013.

The banking sector activity continued to show high concentration. Despite down by 1 percentage point during 2013, the combined share of the five largest banks in total banking sector's assets, settled at 72.3% at year-end. Deposits showed a similar performance and level of concentration during 2013.

[24] *Interest rates dropped sharply in the primary market for debt instruments, interbank market and the deposit market, whereas those in the credit market decreased at a more moderate pace.*

Chart 8.1 Financial intermediation and concentration of the Albanian banking sector

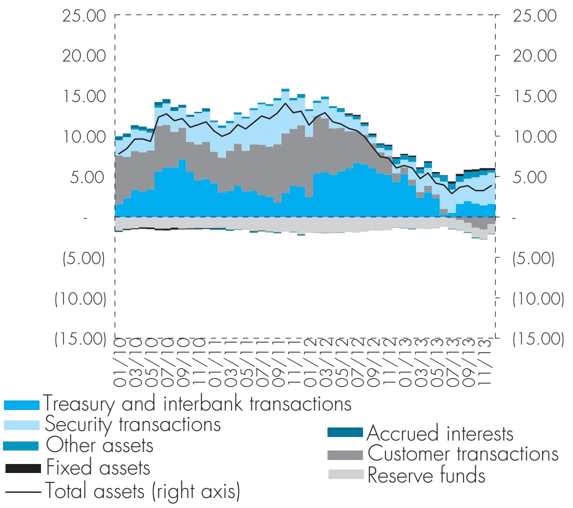


Source: Bank of Albania.

8.1.2 BANKING ACTIVITY

During 2013 H2, the banking sector activity saw: (i) a slower pace of banking activity growth, which was provided by the higher deposit base; (ii) shrinking lending, driven primarily by the lower foreign currency lending (mainly due to the sale of the non-performing loan portfolio by banks); (iii) a wider base of foreign currency deposits; (iv) continued increase in banking sector investments in money market liquid assets and securities, particularly sovereign debt securities.

Chart 8.2 Contribution to annual asset growth, in percentage points



Source: Bank of Albania.

As of end-2013, banking sector assets increased to ALL 1,234 billion, up ALL 30.2 billion or 2.5% from 2013 H1. They rose by 3.9% in 2013, against the 6.1% increase in 2012. The increase in banking sector assets was largely attributable to the expanding interbank transactions portfolio.

Lending, represented by 'Customer transactions'[25] in banks' balance sheets, shrank by 1.8% in annual terms, to ALL 563.1 billion, mainly due to weak demand and concerns over its quality. Under these conditions, banks sold off their non-performing loans and wrote them off from the balance sheets, bringing about, in turn, the decrease in outstanding loans.[26] In the face of lending-related concerns, banks resorted to investments in other domestic and foreign financial instruments. During the period, 'Treasury and interbank transactions' grew by ALL 28.8 billion

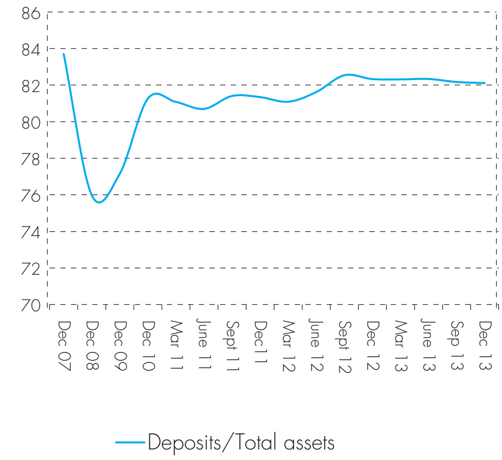
[25] *On the asset-side, 'Customer transactions' represent banking sector lending to residents and non-residents, excluding accrued interests.*

[26] *Excluding the sale of the non-performing loan portfolio by banks, the annual increase in 'Customer transactions, gross' is reported to be however low, 0.02%.*

or 8%, to ALL 413.9 billion. Banks increased their portfolio investments in securities by ALL 14.2 billion, to ALL 302.4 billion. As of end-2013, banking sector investments in Government debt securities accounted for around 25% of total bank assets, up around 5% in annual terms.

Deposits represent the primary funding source for banks' operations, accounting for 82% of total sector's assets. Household deposits held with banks account for 87% of the total, displaying a strong creditor position in relation to the banking sector. Household savings, generally fixed-term, are considered a stable funding source with a positive impact on banking sector stability.

Chart 8.3 Deposit funding, in per cent

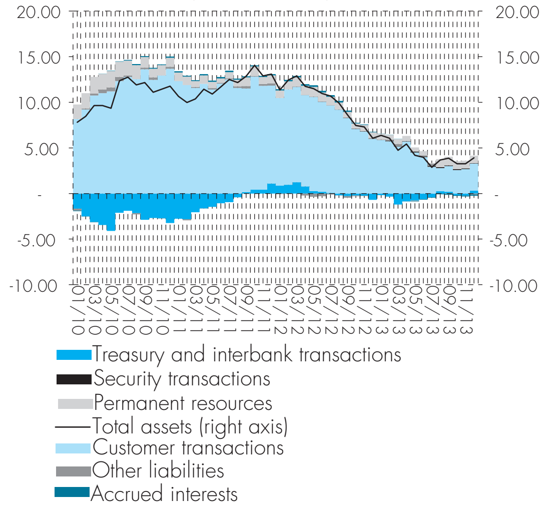


Source: Bank of Albania.

During 2013, deposits increased by 3.6%, reducing the growth rate by half from a year earlier. The deceleration in lek deposits made major contribution to the lower deposit growth rate. This performance was driven by the lower deposit interest rates and the increased investments in competitive instruments of non-bank financial institutions. During 2013 H2, deposits grew by ALL 22 billion or 2.2%, to ALL 1,013.5 billion.

Banks preserved the capital use ratio ('Permanent resources') to finance their operations, observing the regulatory capital requirements.

Chart 8.4 Annual financing of banking sector assets, in percentage points



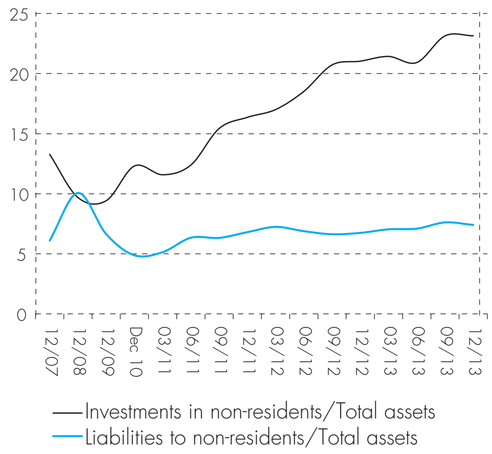
Source: Bank of Albania.

Banking sector assets denominated in foreign currency amounted to ALL 670.7 billion, of which ALL 373.6 billion were foreign currency lending. Foreign currency assets increased by 0.7% during 2013 H2, and by 3.86% on a year earlier. Banking sector liabilities denominated in foreign currency amounted to ALL 651.7 billion, of which ALL 511.3 billion were foreign currency deposits. Foreign currency liabilities increased by 4.5% during 2013 H2, and by 4.3% on a year earlier.

8.1.3 BANKING SECTOR'S POSITION TO NON-RESIDENTS

There was limited reliance of the Albanian banking sector on external sources of financing due to the considerable share of resident deposits. Borrowing from parent banks fell and banks decelerated the increase in their investments abroad also due to the impact of Bank of Albania's countercyclical measures.

Chart 8.5 Banking sector position to non-residents, in per cent



Source: Bank of Albania.

As of end-2013, assets held with non-residents accounted for around 23% of total assets (or ALL 285.7 billion), from 21% at end-2012. Banking sector liabilities to non-residents accounted for 7.4% of total assets (or ALL 91.5 billion), from 6.7% at end-2012. The net positive external position of the Albanian banking sector was estimated at ALL 194.2 billion, up 14.5% in annual terms, and 17% during the period under review.

Bank of Albania's countercyclical measures[27] contributed to a slower increase in banking sector investments in non-resident assets. Their average annual growth fell to 14.3%, from 31% in 2013 H1 and 53.5% in 2012. Investments in the form of placements with non-resident institutions (mainly fixed-term) amounted to ALL 150.4 billion, up 6.9% y-o-y.

Liabilities to parent banks, mainly in the form of lines of credit, make up the largest portion of liabilities to non-residents. The used portion of the lines of credit fell on a year earlier.

Table 8.1 Commitments received from parent banks and other group banks

In ALL million	Total line of credit	Used line of credit	Unused line of credit
December 2013	48,379.9	7,449.4	40,930.5
June 2013	48,997.4	10,085.4	38,912.0
2012	49,045.4	10,116.9	38,928.5
2011	63,422.4	16,903.9	46,518.5

Source: Bank of Albania.

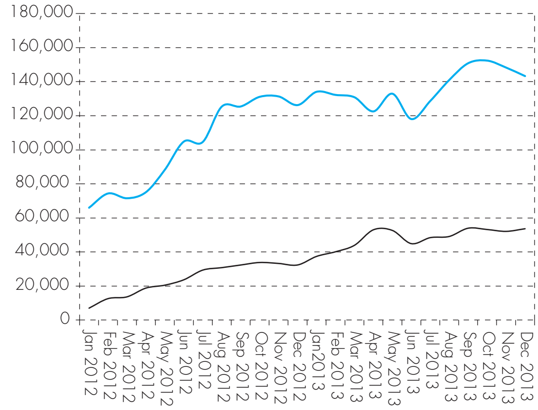
[27] *In May 2013, the Bank of Albania adopted some regulatory amendments, which increased the capital requirements for new bank investments with non-resident institutions.*

*Box 8.1 Banking sector exposure to non-resident institutions**

Net position of placements with non-resident institutions: As of end-2013, the banking sector's net positive position expanded on a year earlier. A similar tendency was also maintained in terms of the exposure to parent banks.

Placements with non-resident institutions, by product: Time deposits have major share in placements with non-resident institutions in assets, accounting for 75.3%, followed by current accounts, 16.2%, and lending to banks, 8.4%. On the liability-side, 76.4% represent term loans borrowed from banks, and 17.5% financial loans.

Chart 8.6 Net position of placements with non-resident institutions, in ALL million



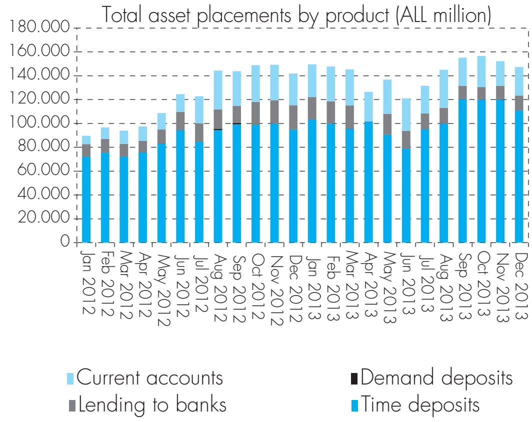
Source: Financial Stability and Statistics Department, Bank of Albania.

Composition of placements by currency: At the end of 2013, non-resident placements on the asset-side were denominated mainly in euro at 74.6%, and in U.S. dollar at 19.5%. Euro placements with parent banks accounted for 90.6% of the total. Similarly, 93.2% of placements on the liability-side were denominated in euro.

Maturity structure of placements: Placements with non-resident institutions are generally of short-term maturity. On the asset-side, 67% of placements have a maturity of up to one month, whereas liability-side placements with a similar maturity accounted for 79.5%.

Composition of placements by geographical distribution: Total asset placements with non-resident institutions were mainly concentrated in the euro area, around 76.3%, whereas placements with the European Union, but outside the euro area, accounted for 5.9%. On the liability-side, 76.4% of placements were with the euro area countries.

Chart 8.7 Composition of placements with non-resident institutions



Source: Financial Stability and Statistics Department, Bank of Albania.

Composition of placements by origin of capital: By origin of capital, total asset-side placements with non-resident institutions had the following composition: Greek banks 22.2%, Italian banks 14.8%, French banks 6.2%, and Albanian banks 7.3%. These placements were higher on a year earlier for all banking groups. 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 reflected in their decrease for all banking groups relative to the previous period. At the end of 2013, the share of liability-side placements of banks by origin of capital in total non-resident liabilities was as follows: Greek banks 53.3%, Italian banks 17.5%, Albanian banks 0.25%, whereas French banks continued to have zero liabilities. The net position of placements remained positive for all these groups and slightly higher in annual terms.

* *This Box is based on operational data as reported by the banking sector, and refers only to placements with non-resident institutions.*

8.1.4 OUTSTANDING LOANS

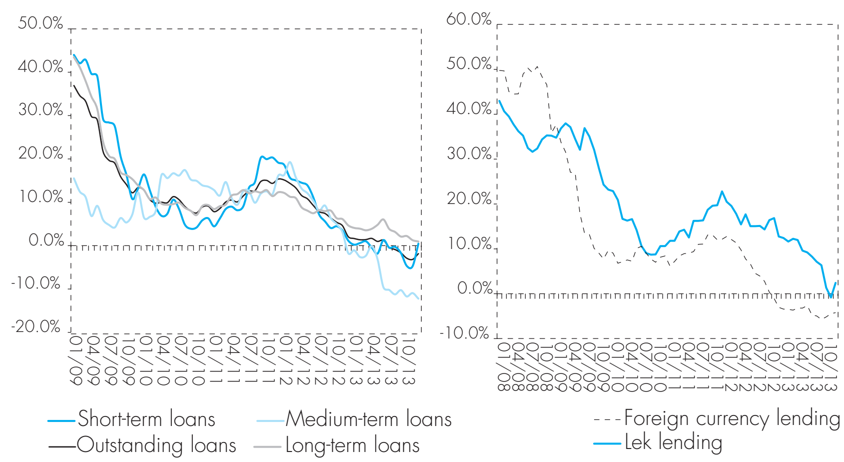
Bank lending activity shrank in 2013 H2, as banks continued to sell their non-performing loan portfolio. The loan shrinkage was affected by the contraction in lending to businesses and foreign currency lending. However, lending to businesses still accounted for 69% of the total loan portfolio.

As of end-2013, bank lending amounted to ALL 567.1 billion, down 2% from end-2013 H1 and 1.8% from end-2012.

Lending to businesses, in particular, which accounted for 69% of the total, shrank 3% in 2013, against the increase by 1.5% in 2012. Lending to households grew slightly during 2013 (particularly in H1), preserving the positive annual growth rate, albeit at a low level of 0.1%. The performance of lending to households was driven primarily by the increase in mortgage loans.

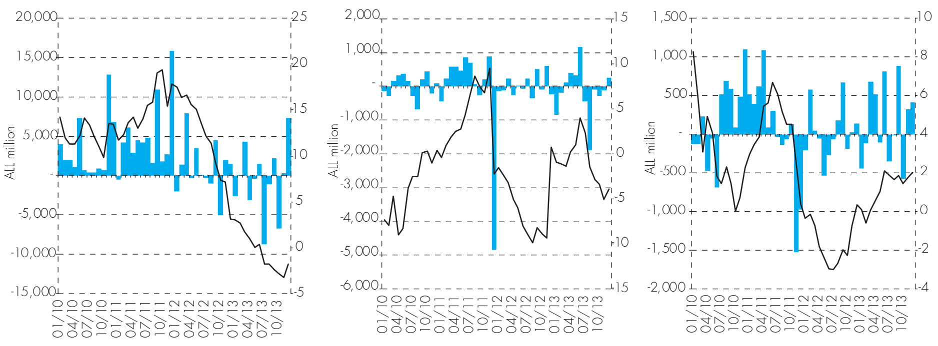
By maturity, long-term loans increased by 1% in 2013, whereas medium-term loans hit an all-time low of around 12.2%. By currency, foreign currency lending fell by 4.2% in 2013, whereas lending in lek grew by 2.4%, and its share in the loan portfolio climbed to 37%. Foreign currency lending fell by around ALL 16.5 billion or 4.4% from 2013 H1, whereas lek lending grew by ALL 4.5 billion or 2.2%.

Chart 8.8 Annual growth rate of lending by maturity and currency



Source: Bank of Albania.

Chart 8.9 Monthly change (left axis) and annual performance (right axis) of lending to businesses, consumer loans and mortgage lending to households



Source: Bank of Albania.

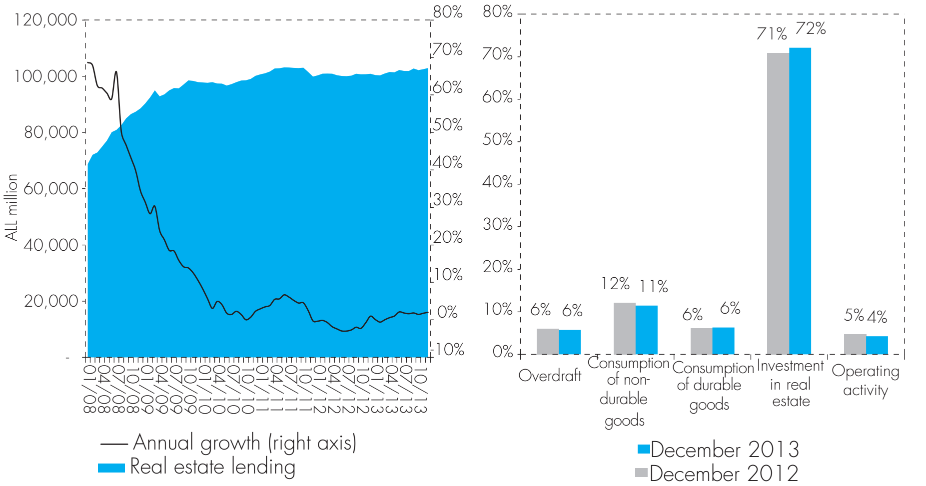
By purpose of use, overdrafts, which dominate business loans, and loans for investment in equipment purchase grew by 2% and 8%, respectively, in annual terms, increasing the share in total lending to this sector (see Chart 8.10). During 2013, lending for working capital and real estate investment fell by 3% and 12%, respectively.

Chart 8.10 Annual growth rate of lending to businesses by purpose of use (left) and share of items in total lending to businesses (right)

Source: Bank of Albania.

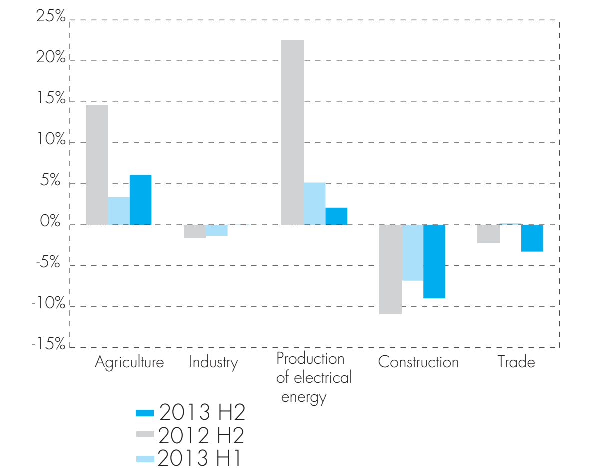
The annual growth of lending to households was mainly oriented towards 'Real estate investments', by around 2%, (dominating the total lending to households, at 72%) and 'Consumption of durable goods', by around 4%.

Chart 8.11 Annual growth rate of lending for real estate purposes (left) and share of items in total lending to households (right)



Source: Bank of Albania.

Chart 8.12 Growth rate of lending by main sectors of the economy



Source: Bank of Albania.

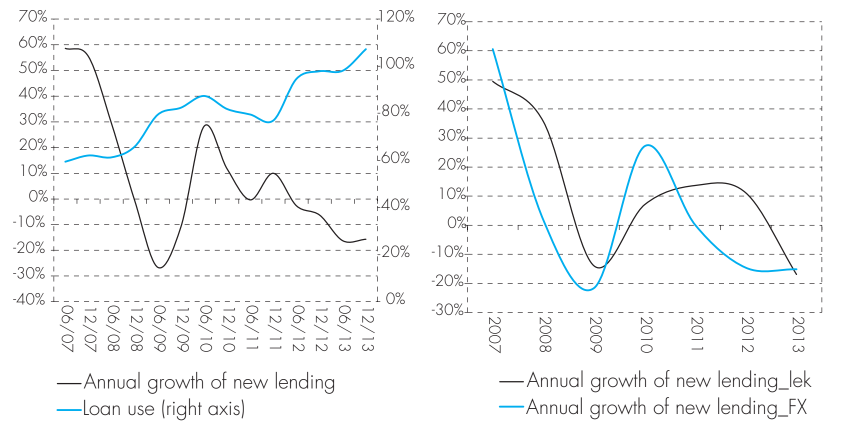
By main sectors of the economy, lending to 'Agriculture' and 'Production and distribution of electrical energy' increased during 2013 H2, whereas lending to other sectors shrank.

Box 8.2 New Lending

In 2013 H2, new lending amounted to ALL 119.7 billion, down by around ALL 22.3 billion or 16% y-o-y. Over the same stated period, the banking sector's recovered loans amounted to ALL 128.4 billion, from ALL 138.9 billion in 2012 H2. The loan use ratio, which represents the ratio of recovered-to-extended loans, was estimated at 107.2%, against 97.8% in 2012 H2, due to new lending falling faster than recovered lending.

By user, the business sector was extended 83% of new lending, amounting to around ALL 99.7 billion.

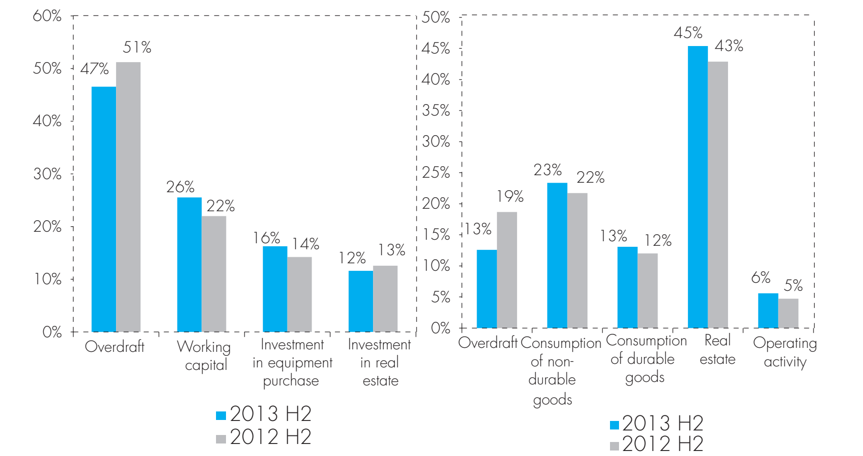
Chart 8.13 New lending



Source: Bank of Albania.

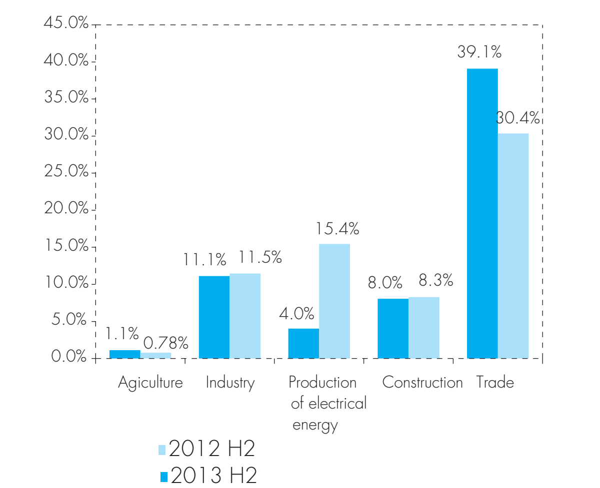
The distribution of new lending to businesses points to its fall for all purposes of use, with 'Overdrafts' registering the largest fall. New lending to households declined only in 'Overdrafts', while increasing in the other items, in annual terms.

Chart 8.14 Distribution of new lending to businesses and households by purpose of use, in per cent



Source: Bank of Albania.

Chart 8.15 New lending by sectors of economy



Source: Bank of Albania.

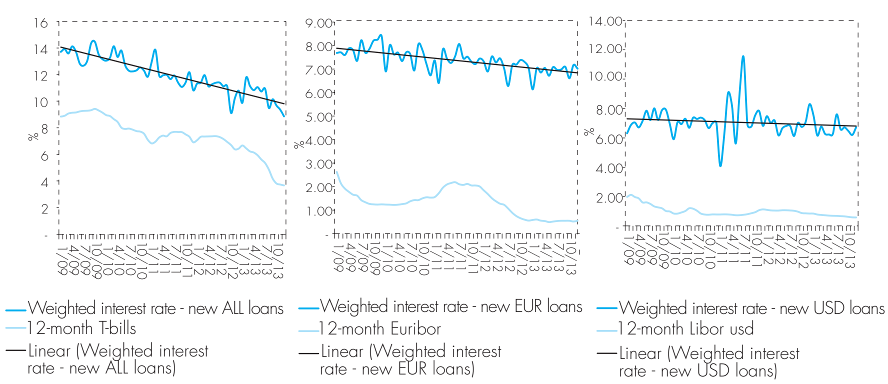
By currency, new lending in U.S. dollar increased by 37% y-o-y, whereas new lending in lek and euro shrank by 19% and 20%, respectively.

By sectors of economy, the trade sector received the largest portion of new lending during 2013 H2. New lending to construction and industry remained similar to a year earlier, whereas new borrowing from the sector of 'Production and distribution of electrical energy, gas and water' registered a sharp decline.

Interest rates on new loans

During 2013 H2, interest rates on new loans denominated in the three major currencies dropped on a year earlier. This trend reflects, albeit not at the same intensity, the performance of reference rates. The interest rate on new lek loans averaged 9.7% in 2013 H2, against 10.9% in H1 and 10.6% in 2012 H2. The interest rates on new euro and U.S. dollar loans averaged 6.9% and 6.7%, down by 0.2 and 0.3 percentage points from the corresponding period in 2012.

Chart 8.16 Interest rates on new loans by currency and respective reference rates, in per cent



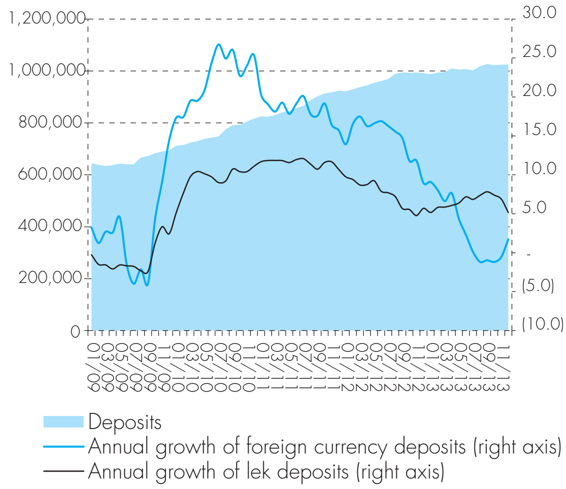
Source: Bank of Albania.

8.1.5 DEPOSITS

Banking sector deposits continued to grow at a slower pace during the period, reflecting the moderate economic activity, lower interest rates and increased investment in competitive products of non-bank financial institutions.

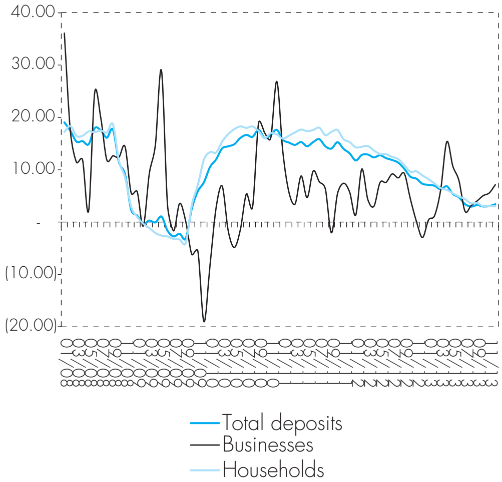
At the end of 2013, deposits climbed to ALL 1,025.6 billion[28], up 3.4% in annual terms, against the 7.3% growth during 2012. Household deposits, which accounted for around 87.3% of total deposits, grew at an annualised rate of 3.1%, from the 8.9% growth in 2012. Business deposits grew by around 7.1% in annual terms, against the 3% shrinkage in 2012. Deposits continued to remain concentrated in the largest banks of the banking sector; however, the degree of their concentration fell markedly annually.[29]

Chart 8.17 Total deposits and deposits by currency, in ALL million and in per cent



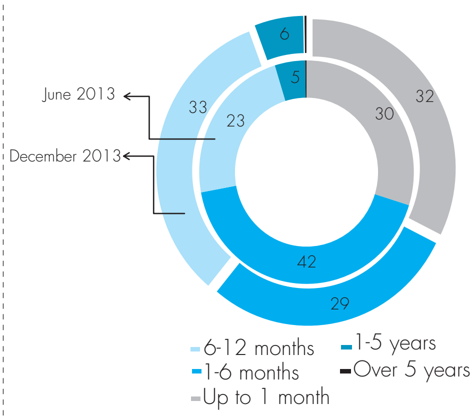
Source: Bank of Albania.

Chart 8.18 Annual growth rate of deposits, in per cent



Source: Bank of Albania.

Chart 8.19 Banking sector deposit structure by maturity



Source: Bank of Albania.

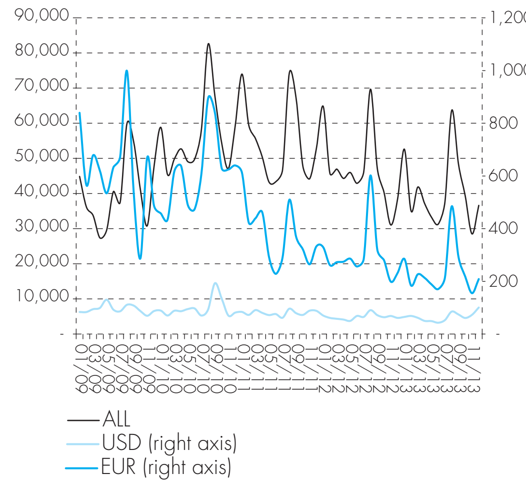
The deposit structure pointed to a significant shift to deposits with longer maturities. More specifically, the share of deposits with a maturity of six to 12 months increased versus the deposits with a maturity of one to six months. This performance may reflect the public's tendency to save and the shift in the maturity curve in pursuit of a higher rate of return on investment. However, short-term deposits with a maturity of up to 12 months continued to dominate the structure of deposits in the banking sector.

28 *Including accrued interests.*

29 *Deposit concentration ratio, as measured by the Herfindahl index, fell to 1392, from 1541 in 2012. Despite the lower index, the banking sector showed levels of concentration in the collection of deposits.*

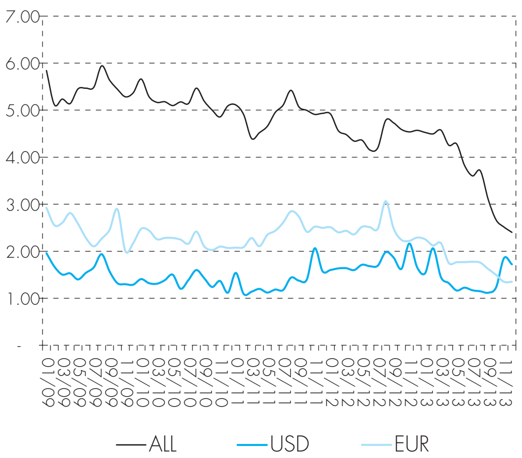
By currency, lek-denominated deposits fell during the period, whereas foreign currency-denominated deposits increased. Consequently, as of end-2013, lek and foreign currency deposits had an almost equal share in total deposits.

Chart 8.20 New time deposits by currency, in million monetary units



Source: Bank of Albania.

Chart 8.21 Interest rates on new time deposits, in per cent



Source: Bank of Albania.

*Box 8.3 New Time Deposits**

New lek time deposits fell in 2013 H2. The banking sector collected ALL 254 billion in new lek time deposits, or around 7% less than in 2012 H2. This fall occurred at a time when the average interest rate on lek deposits dropped to 3.1%, from 4.6%, as a reflection of Bank of Albania's accommodative monetary policy. Concerning the maturity structure of new lek deposits, there was a slight shift to new deposits with a maturity of one and two years, which increased their share to 49.6% and 5%, respectively. New deposits with a maturity of less than 12 months lowered their share during 2013 H2.

In 2013 H2, new U.S. dollar time deposits amounted to USD 447.6 million, or around 6.1% more than in 2012 H2. The deposit structure showed a higher share of one-month deposits by 16.1 percentage points, and a lower share of 12-month deposits by 7.6 percentage points. The interest rate on new U.S. dollar deposits averaged 1.4%, against 1.8% in the corresponding period in 2012.

New euro time deposits amounted to EUR 1.57 billion, down by 18% on a year earlier. The interest rate on new euro deposits averaged 1.6%, from 2.6% in 2012 H2. Concerning the maturity structure of new euro deposits, the share of 12-month deposits increased by 7.7 percentage points to 51.1%, whereas the share of one and three-month deposits dropped slightly to 14% and 17%, respectively.

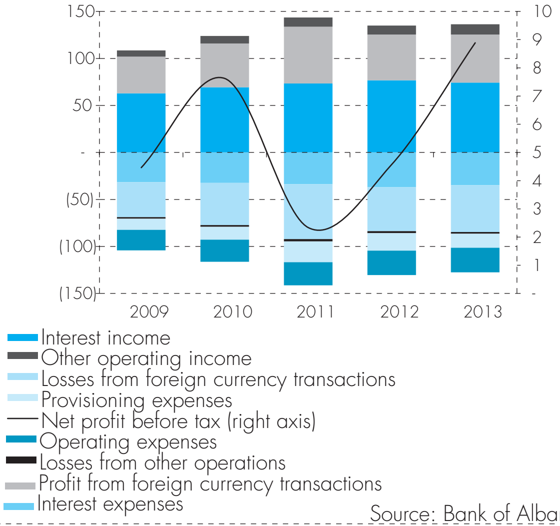
* *The analysis of new deposit figures should take into account the fact that a considerable portion of the new deposit flows is attributable to the renegotiation of the existing deposit contracts.*

8.1.6 PROFIT AND EFFICIENCY OF FUNDS

In 2013, the banking sector's net positive profit was considerably higher than in 2012. However, the sluggish lending reduced the interest income for the banking sector.

As of end-2013, the banking sector's net profit was positive at around ALL 6.6 billion. It improved by 74% from 2012, largely reflecting the lower general and loan loss provisions, as a result of the improved foreign currency security price and the considerable deceleration in non-performing loans.

Chart 8.22 Banking sector income and expenses structure – net profit before tax, in ALL billion



Source: Bank of Albania.

Net interest income dropped slightly by 0.6% in annual terms, reflecting the lower loan-to-deposit ratio and the reduced intermediation margins, despite the higher investments in public debt securities.

The sector's net income from other operations increased by around 12.3% in annual terms.

In terms of average interest-earning assets, net interest income dropped to 7.3% at end-2013, against 7.4% in June 2013 and 7.7% in December 2012, reflecting the slowdown in banks' main operation.

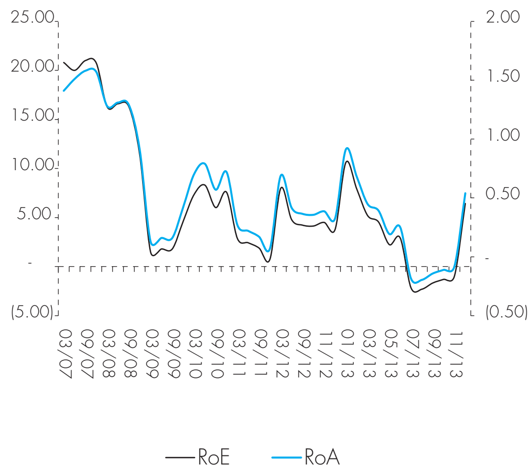
Table 8.2 Profitability ratios, in per cent (cumulative)

Ratios	December 2010	December 2011	December 2012	December 2013
Interest income/average earning assets (1)	8.11	7.78	7.73	7.32
Interest expenses/average earning assets (2)	3.78	3.57	3.72	3.42
Net Interest Margin (NIM) {(1)-(2)}	4.32	4.20	4.01	3.89

Source: Bank of Albania.

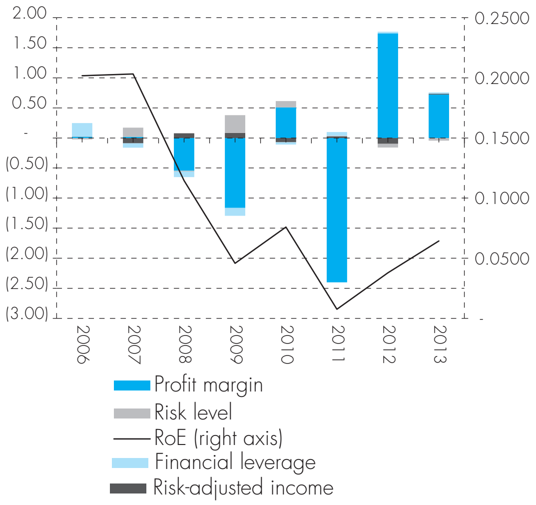
Banking system profitability, assessed through RoAA (Return on Average Assets) and RoAE (Return on Average Equity), improved due to increased net profit. Return on Assets (RoA) was 0.54%, around 1.67 times higher than a year earlier. Return on Equity (RoE) was 6.4%, against 3.8% a year earlier.

Chart 8.23 RoE and RoA (right axis)



Source: Bank of Albania.

Chart 8.24 Impact of four factors on RoE (linearised)



Source: Bank of Albania.

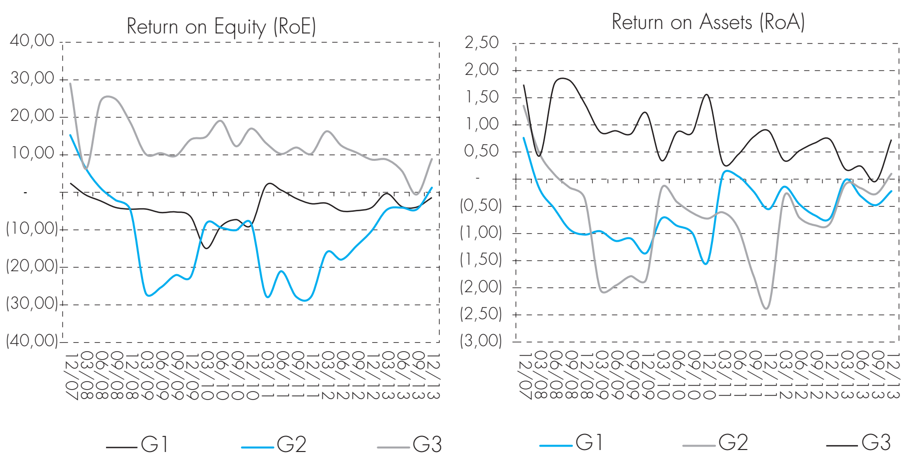
The decomposition of RoE components[30] provides a more detailed analysis of factors impacting its improvement:

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

The profit margin (ratio I) made the main positive contribution to RoE's increase in 2013. The financial leverage (ratio IV) rose slightly and contributed positively to RoE's increase, despite showing increased exposure from the financial stability point of view. The level of risk (ratio III) fell due to lower risk-weighted assets, being, in turn, an additional positive factor in RoE's increase.

Chart 8.25 shows the performance of RoE and RoA for banking groups by size.

Chart 8.25 RoE and RoA by banking groups, in per cent



Source: Bank of Albania.

[30] Financial Stability Report 2012 H1 provides a more elaborate description of RoE components.

8.1.7 BANKING BUSINESS CAPITALISATION

The sound banking business capitalisation remains a distinguishing feature of the banking sector, sustained by the increased banks' capital in response to Bank of Albania's supervisory requirements, and slower performance of risk-weighted assets.

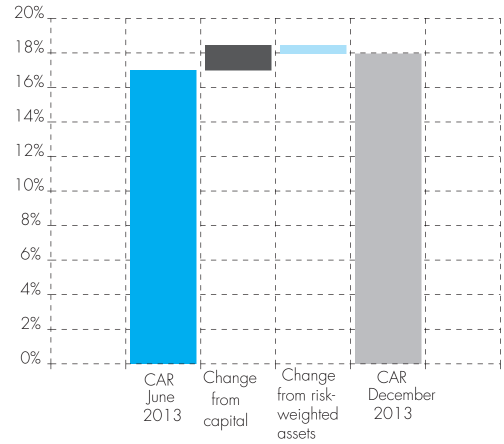
As of end-2013, the capital adequacy ratio[31] rose to 18%, from 17% in June 2013 and 16.2% at end-2012.

During 2013 H2, banks' risk-weighted assets increased by 3.1% (after the fall in H1), to ALL 641.3 billion. Their increase impacted the capital adequacy ratio negatively by 0.5 percentage points, which was offset entirely by the positive effect of the regulatory capital rise by 1.5 percentage points (see Chart 8.26).

The structure of the regulatory capital appeared favourable in terms of the banking sector's capacity to absorb possible losses, with core capital accounting for the major share (see Chart 8.27). The latter increased by 2% during 2013. As of end-2013, the regulatory capital was estimated at ALL 115.2 billion, up ALL 9.3 billion or 8.8% from June 2013, and around ALL 11 billion or 10.6% from end-2012.

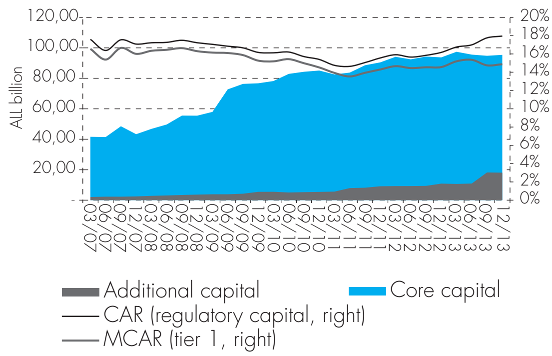
The increase in elements of the additional capital and the core capital accounted for 85% of the regulatory capital rise. During 2013, the banking sector injected ALL 10.4 billion in capital, boosting the paid-in capital to ALL 102.8 billion.

Chart 8.26 Rising contribution of the banking sector capitalisation



Source: Bank of Albania.

Chart 8.27 Components of the regulatory capital and capital adequacy ratio*



*The CAR refers to the Capital Adequacy Ratio, as measured by the ratio of 'Regulatory capital to risk-weighted assets'. MCAR refers to the Modified Capital Adequacy Ratio, as measured by the ratio of 'Core capital (Tier 1) to risk-weighted assets'.

Source: Bank of Albania.

31 *The capital adequacy ratio is calculated as the ratio of bank's regulatory capital to risk-weighted assets.*

Table 8.3 summarizes the capital adequacy ratio for the banking sector and banking groups, by business size and origin of capital.

Table 8.3 Capital adequacy ratio, in per cent

Period	Sector	G1	G2	G3	Italian group	French group	Greek group	Albanian group
December 2013	17.9	27.5	15.9	18.1	21.4	15.0	17.5	14.5
December 2012	16.2	25.1	15.1	16.0	19.6	14.7	16.7	13.9
December 2011	15.5	27.9	14.1	15.5	20.2	12.5	16.6	13.9

Source: Bank of Albania.

The financial leverage ratio (ratio of total assets to shareholders' equity) was 11.9, against 11.7 at end-2012.

Table 8.4 shows the performance of the financial leverage ratio for banks by peer groups and equity ownership.

Table 8.4 Financial leverage ratio

Period	Sector	G1	G2	G3	Italian group	French group	Greek group	Albanian group
December 2013	11.9	6.6	12.7	12.3	8.8	10.4	13.3	12.7
December 2012	11.7	6.4	12.2	12.0	9.1	9.9	11.3	11.9
December 2011	11.5	5.6	12.7	11.8	9.6	11.9	10.1	12.2

Source: Bank of Albania.

9. MONITORING BANKING SECTOR RISKS

Credit risk remains a concern for banking industry and the Bank of Albania. However, the risk for a considerable increase in the non-performing loan ratio in the foreseeable future has fallen considerably. The past two years' trend intensified during 2013 and the non-performing loans increased at markedly lower rates. This performance was attributable to banking industry and Bank of Albania's actions to ensure the early identification of non-performing loans and their write off from the balance sheet (through sale), and to some amendments to the regulatory framework to encourage credit restructuring. These factors were associated with higher provisions for covering the credit risk and non-performing loans.

In the near future, the legal amendments relating to collateral execution are expected to materialize more broadly and effectively. In addition, other legal measures relating to the tax treatment of non-performing loans written off from balance sheets are expected to come into force. Also, the Government will commit to paying off the arrears to the private sector for carrying out public works. These developments will improve the banking industry conditions to address the non-performing loans in a more systematic fashion, and may have considerable impact on reducing the level of non-performing loans. However, positive developments in this regard may be stable if the performance of macroeconomic indicators is stable and economic growth improves. These developments are conditional factors for curbing the banking sector's exposure to indirect credit risk.

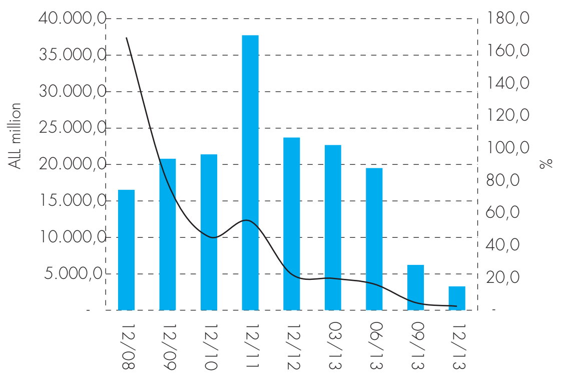
The banking sector's liquidity situation was adequate and related risk was low. The accumulation of liquid assets and the positive performance of deposits in terms of their growth and average maturity made major contribution. The direct impact of market risks on the banking sector remained in check.

9.1 CREDIT RISK

NON-PERFORMING LOANS

As of end-2013, the banking sector's non-performing loans amounted to ALL 133.2 billion, from ALL 140.1 billion in June 2013 and ALL 130 billion in December 2012. During 2013, non-performing loans hit the lowest annual growth since 2008.

Chart 9.1 Annual growth of non-performing loans

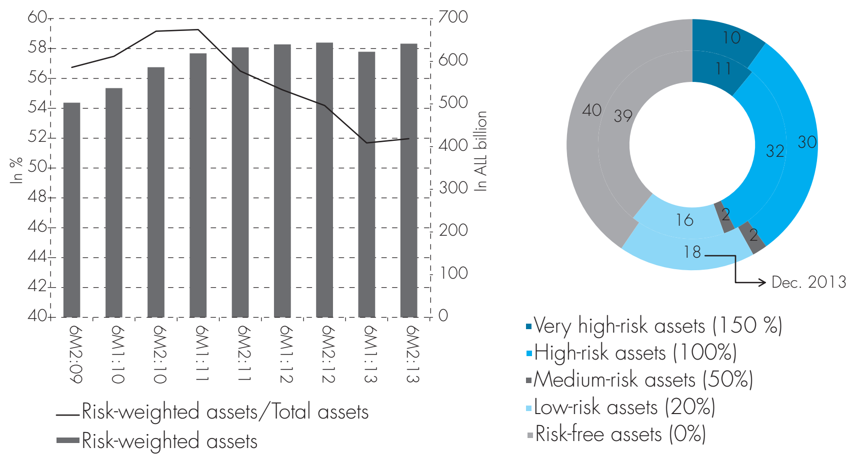


Source: Bank of Albania.

The slower growth of non-performing loans was mainly attributable to the sale of non-performing loan portfolios and their write off from balance sheets. During 2013, banks sold off around ALL 10 billion in non-performing loans, which has, in turn, shrunk the loan portfolio and reinforced the previous deceleration trend of risk-weighted assets. The latter fell by 0.4% y-o-y, and the ratio of risk-weighted assets to total assets dropped by 2.2 percentage points over the same stated period.

The ratio of risk-weighted assets[32] to total assets was lower, both on an individual and banking groups level. Group 1 and Group 2 saw the largest decline in the ratio during 2013, by 6.8% and 4.6%, respectively.

Chart 9.2 Risk-weighted assets in ALL, in per cent

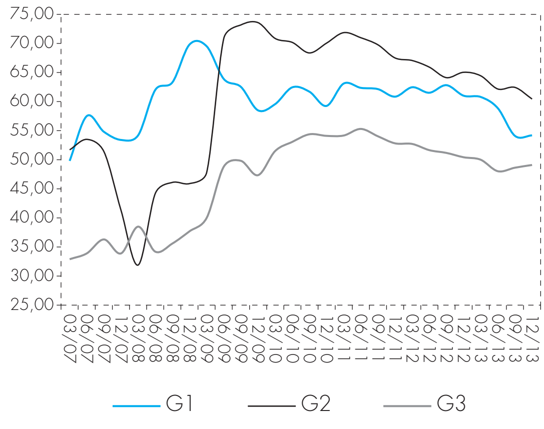


**Note: The right-hand chart shows the distribution of risk-weighted assets by risk coefficients.*
Source: Bank of Albania.

32 *It should be taken into account that the risk-weighted assets have been at a higher level since June 2013, due to macro prudential measures – additional capital to increase investments abroad.*

Concerning the composition of risk-weighted assets, the banks continued to shift their investment portfolio from lending to investments in liquid assets in the money and capital markets.

Chart 9.3 Risk-weighted assets to total assets by banking groups, in per cent



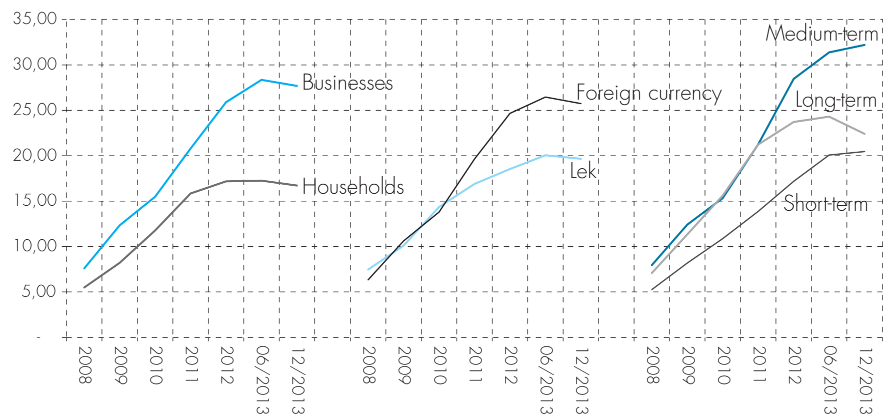
Source: Bank of Albania.

NON-PERFORMING LOAN RATIO

As of end-2013, the non-performing loan ratio was 23.5%, registering an annual increase of 1 percentage point in annual terms, the lowest since 2007. Its performance was also affected by the regulatory amendments encouraging the early restructuring of loans. More specifically, if we excluded the effect of amendments proposed by the Bank of Albania in May 2013 as part of the package of countercyclical measures, the non-performing loan ratio for the entire banking sector would be around 0.8 percentage points higher at end-2013. This impact appears more considerable in individual banks.

By banking groups, medium-sized banks (G2) and small-sized banks (G1) improved the non-performing loan ratio. The improvement was more considerable for G2 banks, with the non-performing loan ratio falling by 2.3 percentage points against June 2013, and by 1.6 percentage points from end-2012. As of end-2013, the ratio of non-performing loans for G1 and G2 banks stood at 14.8% and 23.7%, respectively. For large banks (G3), it worsened by 2.3 percentage points, y-o-y, (entirely concentrated in 2013 H1) rising to 24%.

Chart 9.4 Non-performing loans in the Albanian banking sector



Source: Bank of Albania.

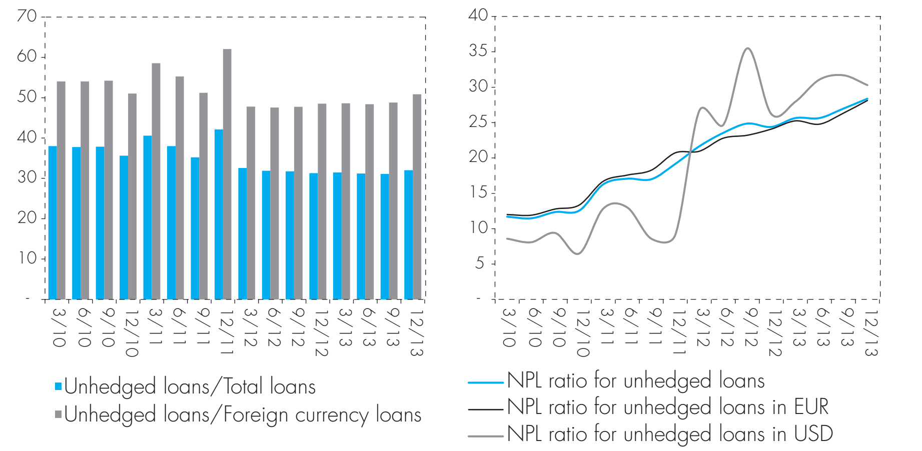
Banks were more exposed to credit risk for the medium-term loan portfolio, foreign currency credit and private sector credit. The share of non-performing loans in these portfolios was 32.2%, 25.7% and 27.7%, respectively, from 31.4%, 26.5% and 28.4% at end-2012.

By sector composition, in 2013 H2, there were positive developments in the loan portfolio quality of the construction sector (by around 2.2 percentage points), and trade and processing industry (by 0.8 percentage points), which account for 14% and 48%, respectively, of the credit stock.

The banking sector increased slightly its exposure to indirect credit risk, which remains high. Outstanding loans denominated in foreign currency (when the borrower's income is in lek) increased slightly by around 0.5% to ALL 181.5 billion, accounting for 32% of total outstanding loans and 51% of foreign currency outstanding loans. This phenomenon is more significant in euro-denominated loans.

The non-performing loan ratio for foreign currency loans unhedged against indirect credit risk rose to 28.4%, from 25.6% at end-2013 H1, due to the impact of euro-denominated loans.

Chart 9.5 Quality ratios of the loan portfolio unhedged against exchange rate risk, in per cent



Source: Bank of Albania.

CREDIT RATING

The structure of non-performing loans saw the shift of non-performing loans to loss loans, and of standard loans to special-mention loans. This shift exerted pressure over banks' financial performance, which was, however, alleviated by the slower growth of non-performing loans. The increased value of loss loans highlights the importance of an efficient collateral execution process.

During 2013 H2, standard loans increased slightly by 1%, accounting for 68.4% of total loans. Special-mention loans increased by 17% over the same stated period. Loss loans increased by ALL 12 billion or 23%. Chart 9.6 shows the rating of the non-performing loan portfolio.

HEDGING FACTORS AGAINST CREDIT RISK

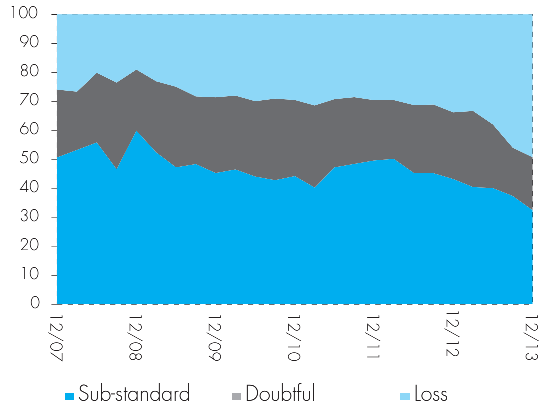
The transition of loans to lower quality ratings was associated with higher provisioning. Consequently, the ratio of non-performing loans, net, to outstanding loans dropped by 1.9 percentage points from December 2012, to 8.2%.

Bank distribution map with respect to non-performing loan provisioning (see Chart 9.7) shows that most banks fall under coverage bands higher than the system's ratio, which rose to 65.2% during 2013 H2, from 57.4% in H1. On the other hand, banks, whose non-performing loan provisioning stands below the sector's average, showed a relatively low non-performing loan ratio. There were no banks falling under quadrant IV, which implies the non-performing loan ratio exceeding the 75th quartile and the banking sector being below the average with respect to coverage by provisions.

Collateral cover[33], an important hedging factor against credit risk, was 77.7%, down slightly by 2 percentage points from 2013 H1. The non-performing loan collateral coverage ratio showed a similar performance, dropping to 80%, from 83% in June 2013.

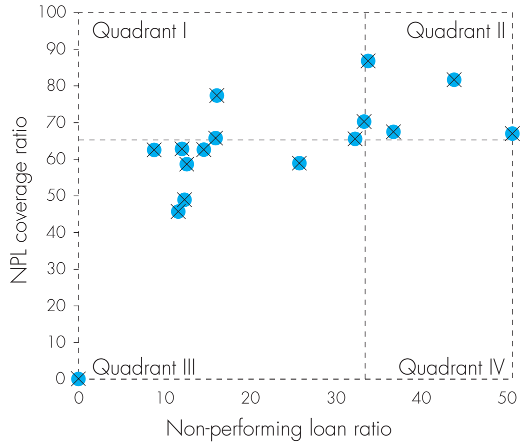
Note: The boundaries of the quadrants were chosen as the average NPL coverage ratio in the sector and the 75th quartile of the NPL ratio by banks[34], in order to distinguish the number of banks falling to extreme levels of this indicator.

Chart 9.6 Non-performing loan portfolio rating, in per cent



Source: Bank of Albania.

Chart 9.7 Non-performing loan coverage ratio for each bank in the system, as of December 2013

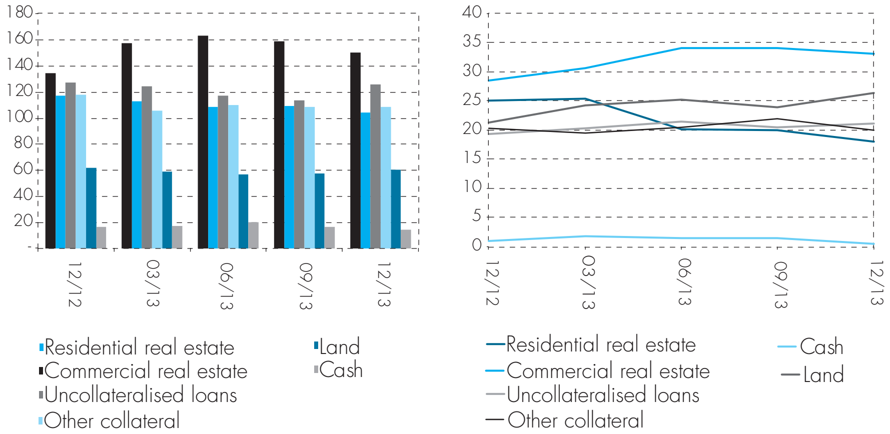


Source: Bank of Albania.

Loans collateralized by real estate accounted for 55.8% of total collateral-based loans. The quality of loans collateralized by residential real estate improved by 7.1 percentage points during 2013. Conversely, the quality of loans collateralized by commercial real estate worsened by 4.6 percentage points. It is worth noting that loans collateralized by commercial real estate have the largest share in total real estate-secured loans. The quality of land-secured loans also worsened by 5 percentage points; however, there is little use of this type of collateral, accounting for 14% of total real estate-secured loans. Cash-secured loans fell by 11%, accounting for a small share in collateral-based loans (3.3%).

[33] *Collateral in the form of real estate (residential, commercial or land), cash, etc.*
[34] *For example, in 75% of the cases, the ratio of non-performing loans to outstanding loans falls below 33.54%.*

Chart 9.8 Loans by type of collateral (in ALL billion) and the non-performing loan ratio by type of collateral



Source: Bank of Albania.

Collateral coverage, albeit slightly lower, was at adequate levels. This enhances the sensitivity to the well-functioning of the real estate market and the collateral execution process, and calls for the diversification of the type of collateral used in bank lending.

The banking sector capacity to cover non-performing loans with capital has improved. The ratio of non-performing loans, net, to regulatory capital dropped to 40.2% at end-2013, from 55.6% at end-2012.

9.2 MARKET RISKS

The banking sector showed low exposure to the direct risk of unfavourable exchange rate and interest rate movements. There is, however, higher sensitivity. The limited net open foreign exchange position in the balance sheet to the regulatory capital, and their "long" position suggested limited exposure to the exchange rate risk. The difference between rate-sensitive assets and rate-sensitive liabilities divided by total assets remained at historical levels. The modest increase in the euro spread exposed the banking system slightly to the relevant interest rate risk, while there was no significant volatility in the lek and U.S. dollar spreads.

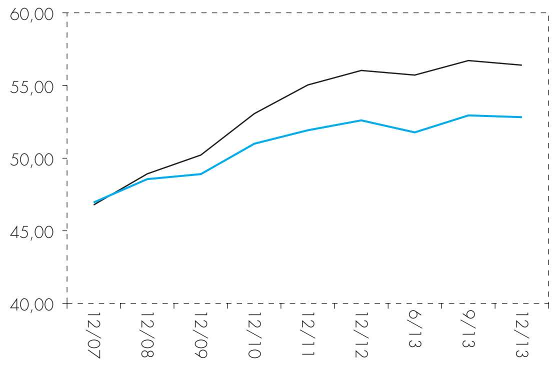
Besides the direct impact, the interest rate and exchange rate movements may generate indirect credit risk through the exposure of businesses and households to these movements. This risk should be, therefore, monitored on an ongoing basis.

9.2.1 EXCHANGE RATE RISK

In 2013 H2, the open foreign exchange position to the regulatory capital was very close to the previous half of the year, increasing only slightly in annual terms. It remained within historical levels, suggesting adequate hedging against unfavourable exchange rate movements.

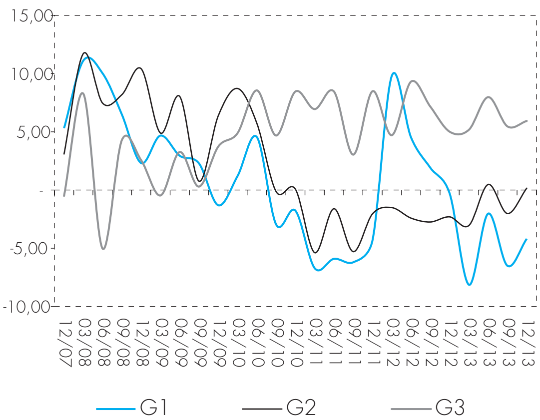
As of end-2013, the banking sector's foreign currency assets amounted to ALL 696.2 billion, up 3.8% during the period, and 4.6% during 2013. The share of foreign currency assets and liabilities in total assets was 56.4% and 52.8%, respectively, remaining quite close to end-2012 (see Chart 9.9).

Chart 9.9 Share of foreign currency assets and liabilities in total banking sector assets, in per cent



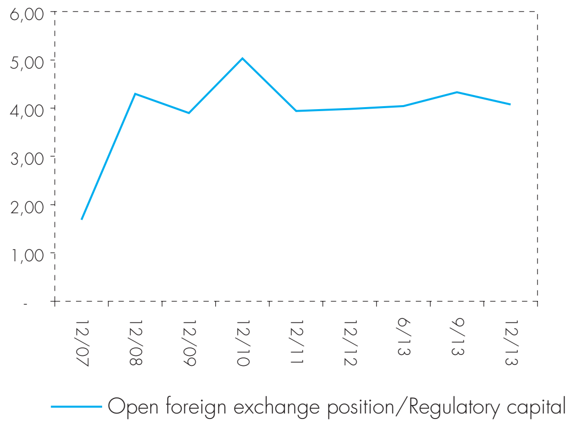
Source: Bank of Albania.

Chart 9.11 Net foreign exchange position to the regulatory capital by banking groups, in per cent



Source: Bank of Albania.

Chart 9.10 Net open foreign exchange position to the regulatory capital, in per cent

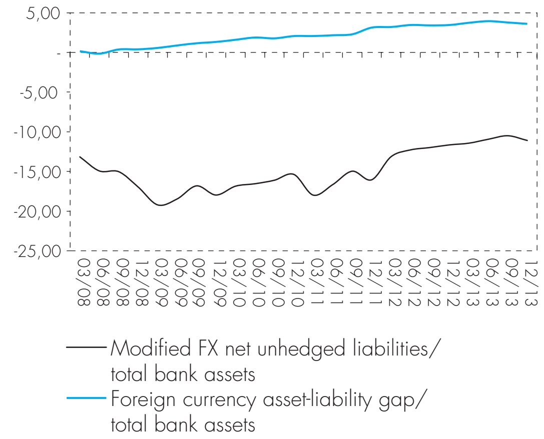


Source: Bank of Albania.

The net open foreign exchange position to the regulatory capital was estimated at 4.1%, from 4% in 2013 H1, and 3.98% at end-2012.

Large banks (G3) continued to hold a long position, increasing slightly the exposure to the exchange rate in annual terms. Medium-sized banks (G2) showed the lowest exposure to the exchange rate, whereas small-sized banks (G1) strengthened their short position, increasing their exposure, both in semi-annual and annual terms.

Chart 9.12 Modified Currency Mismatch Index, in per cent



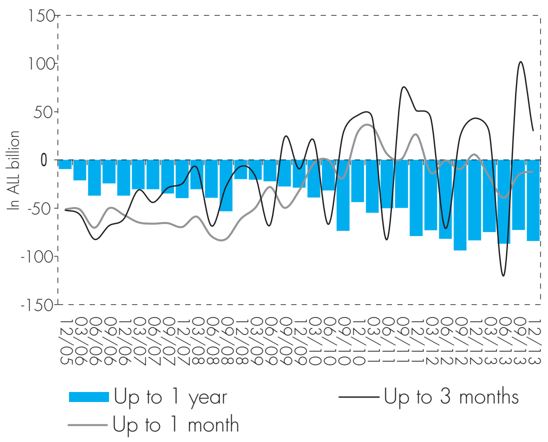
Source: Bank of Albania.

The Modified Currency Mismatch Index[35] enables a more complete measurement of banks' exposure to the exchange rate. For 2013 H2, this index showed a slight increase in the banking sector exposure to indirect exchange rate risk versus 2013 H1.

During 2013 Q4, the Modified Currency Mismatch Index rose slightly to 11.1%, from 10.9% in 2013 H1, and 11.7% in 2012 Q4. The increase in business loans unhedged against exchange rate risk, by 12% and 7.4% in semi-annual and annual terms, increased the banking sector sensitivity against indirect risk. However, the shrinking position of household loans unhedged against exchange rate risk helped slightly mitigate the deepening Index.

9.2.2 INTEREST RATE RISK

Chart 9.13 Maturity gap by reprising period, in ALL billion



Source: Bank of Albania.

Banking sector's exposure to interest rate fluctuations was limited, as evidenced by the inconsiderable difference between rate-sensitive assets and rate-sensitive liabilities divided by total assets.[36]

The cumulative gap between rate-sensitive assets and rate-sensitive liabilities with maturities of up to one-month and up to one-year narrowed the negative positions from June 2013, and was estimated at ALL 12.2 billion and ALL 84 billion, respectively. The cumulative gap for the up to three-month maturity was positive at ALL 30.3 billion, lower than a year earlier. The different positions offset the impact of interest rate fluctuations on the banking sector performance.

During 2013 H2, the spreads on the major currencies pointed to a slightly higher spread on the euro from 2013 H1 and 2012 H2. The spread on the lek and the U.S. dollar showed negligible volatility on the downside against 2013 H1.

[35] The index is calculated as follows: Foreign currency denominated net unhedged liabilities / total bank assets = {[foreign currency foreign assets + foreign currency domestic assets] - [foreign currency foreign liabilities + foreign currency domestic liabilities] - [foreign currency lending to unhedged households + foreign currency lending to unhedged non-financial firms]} / [total bank assets].

[36] As of end-December 2013, the gap between rate-sensitive assets and rate-sensitive liabilities with maturities of one, three and 12 months to total assets stood at (-0.9%), 2.4% and (-7%), respectively.

9.3 LIQUIDITY RISK

The banking sector exposure to liquidity risk was low due to an adequate liquidity situation. The liquidity ratios, both in lek and foreign currency, were above the minimum regulatory ratios. Deposits continued to grow, albeit at a slower pace, and their maturities were longer. Consequently, there was low reliance of the banking sector on foreign sources of funding.

Deposits remained the main source of funding for the banking sector operations. At the end of 2013, customer deposits covered the total loan amount around 1.8 times. The loan-to-deposit ratio was 55.3%, down from June 2013 (57.5%) and end-2012 (58.3%).

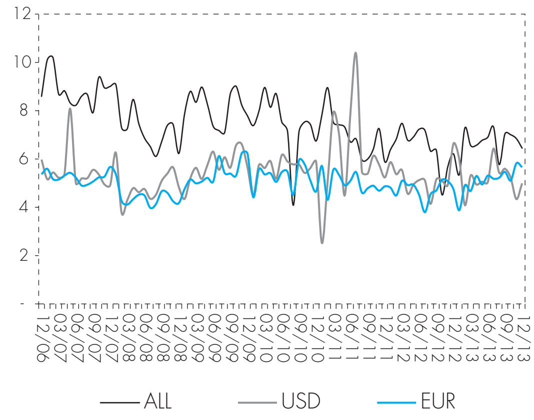
At end-2013, the liquid assets accounted for 27.6% of total banking sector's assets, down from a year earlier when they were estimated at 29.4%. Banks observed the regulatory requirements relating to the ratio of liquid assets to short-term liabilities, both in total and for each currency, the lek, the euro and the U.S. dollar. At end-2013, this ratio in lek was 42.7%, from 45.8% a year earlier, while the same ratio in foreign currency was 26.6%, from 23.8%.

The ratio of liquid assets to short-term liabilities for the sector rose slightly to 34.7%, from 33.8% at end-June 2013. At end-2012, it stood at 36.7%.

By size, G1 banks recorded the largest increase in the liquidity ratios: 'liquid assets to total assets' and 'liquid assets to total short-term liabilities' by 2.1 percentage points and 3.6 percentage points, respectively, to 30.5% and 42%. In annual terms, the downward performance of the liquidity ratios was, to a large extent, driven by G3 banks, whose ratios dropped by 2.8 percentage points and 3.2 percentage points, to 27% and 33.7%.

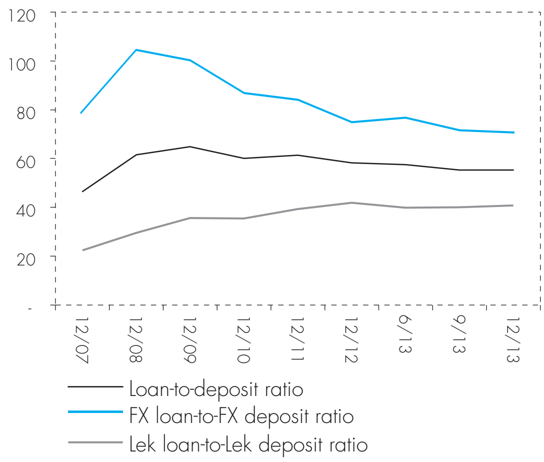
Chart 9.17 shows the ratio of liquid assets to total assets by banking groups.

Chart 9.14 Spread between loan and deposit rates, in per cent



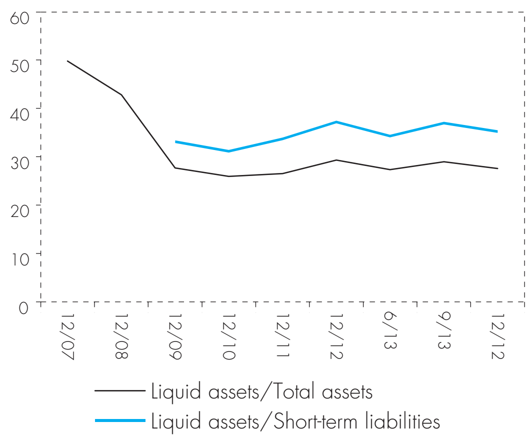
Source: Bank of Albania.

Chart 9.15 Loan-to-deposit ratio



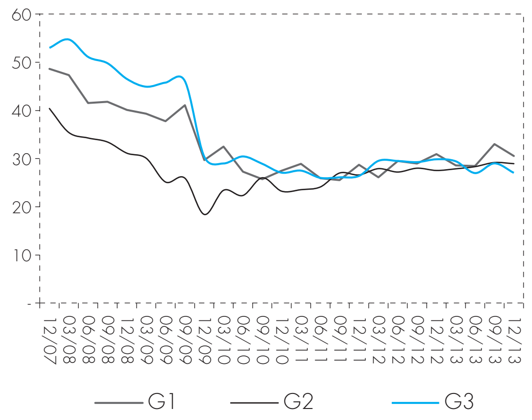
Source: Bank of Albania.

Chart 9.16 Liquidity ratios for the banking sector, in per cent



Source: Bank of Albania.

Chart 9.17 Liquid assets to total assets by banking groups, in per cent



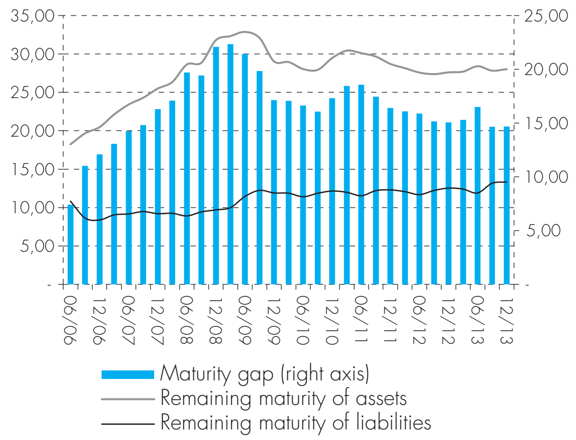
Source: Bank of Albania.

The maturity gap between assets and liabilities narrowed due to increased remaining maturity of liabilities. The narrowing gap between assets and liabilities signals lower exposure to the liquidity risk.

At end-2013, the maturity gap between assets and liabilities narrowed to 14.7 months, against 16.5 months in June 2013, mainly due to the remaining maturity of the main liability item, deposits, increasing by 0.97 months.

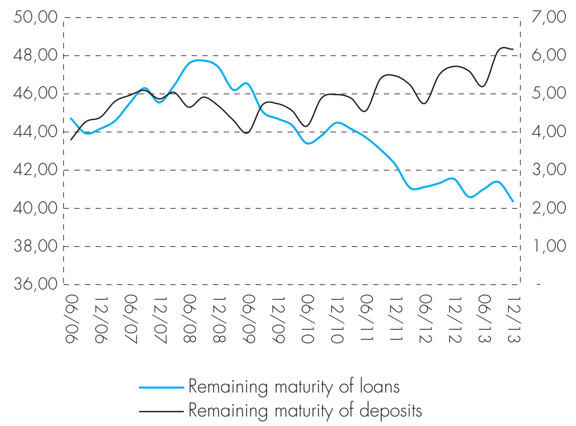
Despite remaining an important source for several banks, the use of lines of credit from parent banks has been decreasing in the past few years. At end-2013, the lines of credit amounted to around ALL 48.4 billion, from ALL 49 billion at end-2012, and ALL 63.4 billion at end-2011.

Chart 9.18 Average remaining maturity of assets and liabilities, in months



Source: Bank of Albania.

Chart 9.19 Average remaining maturity of loans and deposits, in months



Source: Bank of Albania.

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

A forward-looking stress-test exercise or analysis is run to assess the financial system stability and banking sector's capital adequacy for a period extending through the end of 2015. The stress-test exercise assesses the impact of macroeconomic situations on the banking sector's financial condition, by

[37] *Stress-testing does not represent a way of forecasting. Intentionally, the scenarios include adverse and extreme events with a low probability of occurrence to test the banking sector resilience. Though banks are urged to assess their financial position capacity to withstand the impact of these scenarios, they should not regard them as events expected by the Bank of Albania to take place in the future. The scenarios vary over time, depending on the economic and financial developments. In addition, the scenarios do not take into consideration operations that banks and authorities may carry out to constantly strengthen their financial position and resilience to risks.*

excluding the possibility of an increase in the paid-in capital during the period under review. This analysis includes three scenarios: the baseline scenario and two adverse scenarios.

The baseline scenario is built on the forecast of economic and financial indicators, generally based on their historical performance. The adverse scenarios assume a "stressed" situation of low probability of occurrence[38]. They are based on three probable shocks to the Albanian economy: a) further slowdown in lending; b) increase in market interest rates; and c) depreciation of the domestic currency.

Compared to the stress-test exercise run in 2013 H1, the baseline scenario is based on a more pessimistic performance of economic activity, mainly in terms of lending. The same trend is followed in the construction of the adverse scenarios.

Table 9.1 Stress-test assumptions

	Baseline scenario		Adverse scenarios			
			Credit scenario		Adverse exchange rate scenario	
	2014	2015	2014	2015	2014	2015
	Value in average terms					
Annual GDP growth	1.2%	2.5%	0.89%	2.4%	-0.6%	0.83%
Annual increase in interest rates	0	0.5p.p	0.5p.p	2p.p	0.5p.p	2p.p
Lek's depreciation against euro and U.S. dollar	1.7%	0.8%	1.7%	0.8%	20%	20%
Projected annual growth of outstanding loans	-0.3%	2.0%	-4.2%	-1.9%	-8.1%	-5.8%

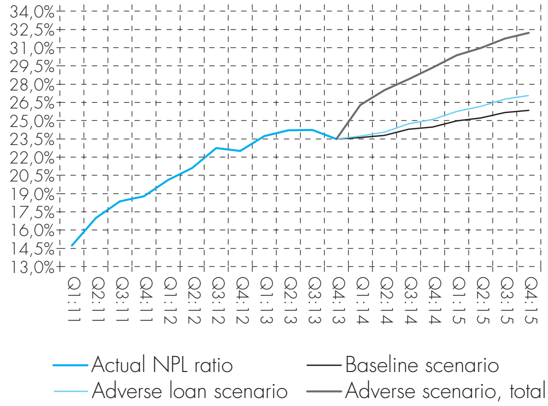
Source: Financial Stability and Statistics Department assumptions, and Research Department projections, Bank of Albania.

The first adverse scenario assumes the contraction in domestic lending, followed by an increase in interest rates. The contraction in lending is reflected in slower economic activity, whereas the increase in the interest rate is reflected in higher new borrowing costs, increased difficulties in current borrowers' repayment capacity and banks' net profit, displaying, in turn, mismatches between rate-sensitive assets and rate-sensitive liabilities. As a result of these assumptions, under this scenario, the Albanian economy will grow by 0.89% and 2.4% in 2014 and 2015 (against 1.2% and 2.5% under the baseline scenario).

The second adverse scenario assumes that besides the more severe shocks to lending and the interest rate, the exchange rate depreciates by 20%. In the event this shock materializes, banks will be directly affected through the open foreign exchange position (direct exchange rate risk) and the change in the repayment capacity of those borrowers who have borrowed in foreign currency, but whose income is in the Albanian lek (indirect credit risk arising from exchange rate movements). The effect of lek's depreciation on the external trade is based on the assumption that the adjustment of import prices to exchange rate movements is not immediate, being reflected into slower economic growth during the period covered by the stress test. These assumptions have been reflected into economic growth shrinking by 0.6% during 2014, and later growing by 0.83% during 2015 (against 1.2% and 2.5% in the baseline scenario).

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

Chart 9.20 Actual and projected non-performing loan ratio under the baseline and adverse scenarios



Source: Bank of Albania, Financial Stability and Statistics Department.

Chart 9.20 shows the estimates for the loan portfolio quality as of end-2015, under the baseline and adverse scenarios.

As shown by the chart, the macroeconomic performance in the baseline scenario points to a slow increase in the non-performing loan ratio. In the adverse scenario, the exchange rate depreciation would be reflected into the non-performing loan ratio increasing by 6.5 percentage points from the ratio assumed in the baseline scenario for 2015.

Table 9.2 shows the estimation results in terms of the banking sector capital ratios.

Table 9.2 Capital adequacy ratio results

	End 2014			
	Sector	G3	G2	G1
December 2013	17.9%	18.1%	15.9%	27.5%
Baseline scenario	Capitalised	Capitalised	Capitalised	Capitalised
Credit scenario	Capitalised	Capitalised	Capitalised	Capitalised
Severe exchange rate scenario	Capitalised	Capitalised	Capitalised	Capitalised
	End 2015			
	Sector	G3	G2	G1
December 2013	17.9%	18.1%	15.9%	27.5%
Baseline scenario	Capitalised	Capitalised	Capitalised	Capitalised
Credit scenario	Capitalised	Capitalised	Capitalised	Capitalised
Severe exchange rate scenario	Capitalised	Capitalised	Modest under-capitalisation	Capitalised

Source: Bank of Albania, Financial Stability and Statistics Department.

The stress-test exercise results show that, overall, the banking sector remains resilient even if the assumed extreme scenarios materialise. As of end-2015, the capital adequacy ratio falls below 12% only for G2 banks, mainly due to a lower CAR at end-2013, relative to the other banking groups.

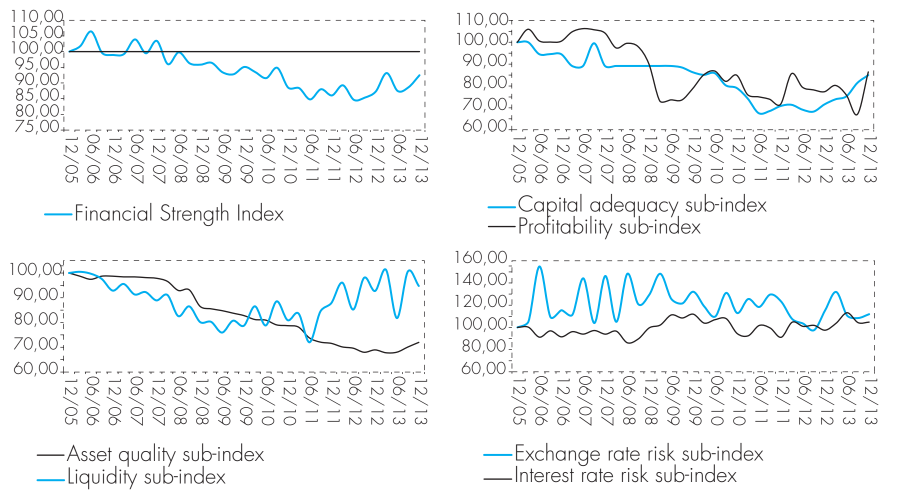
The stress-test exercise results show that, overall, the banking sector is resilient to macroeconomic shocks, mainly due to an adequate capitalisation at present. However, under the baseline and adverse scenarios, individual banks need additional capital.

ANNEX 1 FINANCIAL STRENGTH INDEX[37]

DECEMBER 2013

Financial Strength Index (FSI) recorded adequate levels in semi-annual and annual terms, due to the improved performance of banking soundness indicators, signalling a downward exposure to risks. As of end-2013, the FSI stood at 92.5, from 87.3 at end-2012. Almost all FSI components provided a positive contribution to its performance, with the improved profitability and capitalisation level recording the highest increase in annual terms. There was also lower exposure to credit, liquidity and interest rate risk. The banking sector appeared hedged against the exchange rate risk; however, as at end-2013, it appeared more vulnerable to this risk.

Chart 1 Financial Strength Index and its sub-indices



Source: Bank of Albania.

[39] *The methodology for the construction of the Financial Strength Index is presented in the Financial Stability Report for 2010 H1 (www.bankofalbania.org).*

Table 1 Financial soundness sub-indices

Sub-indices	Asset quality	Liquidity risk	Exchange rate 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	98,71	100,48	105,24	105,95	100,00	100,18	101,76
Jun-06	97,45	99,71	154,88	100,65	94,58	91,22	106,42
Sep-06	98,71	97,59	109,38	100,10	94,58	96,89	99,54
Dec-06	98,71	92,88	115,44	100,46	94,58	91,52	98,93
Mar-07	98,43	95,57	111,38	104,76	89,17	96,17	99,25
Jun-07	98,43	91,34	144,16	106,23	89,17	93,99	103,89
Sep-07	98,15	92,30	103,93	105,72	99,55	97,20	99,47
Dec-07	97,87	88,93	146,31	104,21	89,17	93,94	103,40
Mar-08	96,63	91,14	105,04	97,45	89,17	96,59	96,00
Jun-08	92,95	82,59	148,31	99,52	89,17	86,15	99,78
Sep-08	93,20	86,52	120,85	98,09	89,17	89,65	96,25
Dec-08	86,50	80,18	129,48	90,13	89,17	99,63	95,85
Mar-09	85,53	80,27	148,31	73,13	89,17	102,18	96,43
Jun-09	84,80	75,95	125,67	73,66	89,17	111,22	93,41
Sep-09	83,78	80,72	121,58	73,60	88,49	108,49	92,78
Dec-09	82,81	78,72	132,11	78,84	86,30	111,90	95,11
Mar-10	81,22	86,55	118,84	85,11	85,10	103,86	93,45
Jun-10	80,96	78,81	109,81	86,86	85,88	107,02	91,56
Sep-10	79,04	88,56	131,09	82,14	80,34	107,84	94,83
Dec-10	78,73	80,96	112,91	84,96	79,11	94,43	88,52
Mar-11	78,14	83,64	125,55	76,04	74,32	92,47	88,36
Jun- 11	73,77	72,01	118,41	75,05	67,61	101,75	84,77
Sep-11	72,08	84,47	129,59	73,96	68,53	99,43	88,01
Dec-11	71,58	87,85	123,21	71,62	70,84	91,12	86,04
Mar-12	70,15	96,10	107,57	85,63	71,41	104,70	89,26
Jun-12	69,63	85,23	103,39	79,43	69,18	100,92	84,63
Sep-12	67,99	98,07	97,59	78,23	68,29	101,82	85,33
Dec-12	68,94	92,73	115,46	77,39	71,58	97,50	87,27
Mar-13	67,79	101,30	131,93	80,27	73,91	103,81	93,17
Jun-13	68,03	81,77	110,64	75,88	75,27	113,20	87,47
Sep-13	70,11	100,61	108,43	67,02	81,41	104,27	88,64
Dec-13	71,98	94,76	111,91	86,44	84,97	104,77	92,47

Source: Bank of Albania.

Table 2 Financial soundness ratios

In %	2007	2008	2009	2010	2011	2012	2013
Capital-based ratios							
(i) Regulatory capital to risk-weighted assets	17,1	17,2	16,2	15,4	15,6	16,2	17,9
(ii) Core capital to risk-weighted assets	16	16,3	15,3	14,5	14,3	14,6	14,8
(iii) Shareholders' equity to total assets	7,6	8,6	9,6	9,4	8,7	8,6	8,37
Asset quality							
(iv) Net non-performing loans to regulatory capital	11,2	25,7	28,2	35,9	52,2	55,6	40,2
(v) Gross non-performing loans to loans outstanding	3,4	6,6	10,5	14	18,8	22,5	23,5
Profitability							
(vi) Return on Equity (RoE, on an annual basis)	20,7	11,4	4,6	7,6	0,8	3,8	6,4
(vii) Return on Assets (RoA, on an annual basis)	1,6	0,9	0,4	0,7	0,1	0,3	0,5
Market risk (exchange rate)							
(viii) Net open foreign position to regulatory capital	1,7	4,3	3,9	5	3,9	4	4,9
(ix) Net open foreign position to core capital	1,8	4,5	4,1	5,3	4,3	4,4	4,1
Liquidity							
(x) Liquid assets to total assets	49,8	42,8	27,6	25,9	26,5	29,4	27,6
(xi) Liquid assets to total short-term liabilities	55,6	104,7	32,6	30,6	33,1	36,7	34,7
(xii) Customer deposits to total loans	215,5	162,6	154,3	166,4	163,2	171,6	180,8

Source: Bank of Albania.

ANNEX 2 NOTES TO THE FINANCIAL STABILITY MAP INDICES

Category	Indicators	Description of indicator	Category rating
Domestic Economy	Output gap	Difference between actual GDP and its historical trend, divided by GDP	5
	Size of the external debt	Ratio of external debt stock to annualised GDP	
	Need for external financing	Current account balance plus the external debt payment (short-term debt plus amortization on medium- and long-term debt)	
	Exchange rate volatility	Annual REER increase, which includes developments in lek's exchange rate in relation to the currencies of Albania's five main trading partners, in real terms	
	Inflation	Annual change in Consumer Price Index	
HOUSEHOLDS	Household borrowing	Difference between the actual performance and the historical trend of the ratio of household loans to annualised GDP	8
	Housing Market	Gap between House Price Index and its long-term trend	
	Unemployment rate	Registered unemployment rate	
	Household loan portfolio quality	Ratio of non-performing loans to outstanding loans - Households	
	Household expectations	Household expectations about the financial situation in the next three months according to the Consumer Confidence Survey	
	Remittances	Annual change in remittances	
BUSINESSES	Business borrowing	Difference between the actual performance and the historical trend of the ratio of business loans to annualised GDP	8
	Business loan portfolio quality	Ratio of non-performing loans to outstanding loans - Businesses	
	Business expectations	Business expectations about the financial situation in the next three months	
	Output Volume Index	Gap between Output Volume Index and its long-term trend	

Category	Indicators	Description of indicator	Category rating
GOVERNMENT	Government debt size	Public debt to GDP ratio	5
	Debt cost	Interest expenditure to GDP ratio	
	Sovereign risk premium	Spread between the 3-month Albanian T-Bill rate and German Bund rate	
	Fiscal deficit	Seasonally-adjusted fiscal deficit to GDP ratio	
	Tax revenues	Tax revenues to GDP ratio	
EXTERNAL ECONOMY	Real GDP of main trading partners	Weighted average of real GDP growth (annual change) of Albania's eight trading partners (Italy, Greece, Germany, China, Turkey, Spain, Macedonia, and France)	4
	Weighted unemployment rate	Weighted average of annual unemployment rate for Italy, Greece and United Kingdom	
	Oil price in international markets	Oil price rise, Crude Oil (petroleum), Price index, 2005 = 100	
	OECD CLI Index Total	An international index signalling turning points in the business cycle	
	Average interest rate	Simple average of 3-month LIBOR denominated in USD (BBA) and 3-month EURIBOR	
CAPITAL AND PROFITABILITY	Capital adequacy ratio difference	Difference between the capital adequacy ratio of the banking system and the minimum requirement of 12%	6
	Share of shareholders' equity in total assets	Ratio of total shareholders' equity to banking system's total assets	
	Non-performing loan ratio, in %	Share of banking sector's non-performing loans outstanding in total sector's loans outstanding	
	Share of net interest income in total assets	Ratio of banking sector's net interest income to total assets – seasonally adjusted	
	Net profit before tax/Total assets	Ratio of banking sector's net profit before tax to total assets – seasonally adjusted	
LIQUIDITY AND FINANCING	Deposit-to-loan ratio	Ratio of total banking sector deposits to total loans outstanding	8
	Household deposits growth rate	Quarter-on-quarter annualised change (in %), of household deposits in the banking system. Household deposits include all types of deposits (time deposits, demand deposits, and current accounts)	
	Financing from non-residents	Ratio of total liabilities to non-residents to banking sector total assets	
	Short-term liquidity gap	Difference (in ALL million) between short-term assets and short-term liabilities, with a maturity of up to 3 months, for the banking sector	

Category	Indicators	Description of indicator	Category rating
BANKING SECTOR STRUCTURE	Share of largest banks' assets in total assets	Ratio of two largest banks' assets to total banking sector assets	5
	Concentration of lending to businesses	This indicator includes only lending to businesses by the five banks extending the largest amount of lending to this sector at a given moment (these five banks may change over time), and is constructed as: the ratio of total business loans outstanding by banks 2, 3, 4, 5 to total loans outstanding extended by bank 1 (the bank that has extended the largest amount of loans to businesses).	
	Deviation of banks' loan portfolio from the market portfolio	Banks' total loan portfolio is divided into three main sub-groups: (1) private sector credit, (2) public sector credit, (3) household credit, expressed as the share in per cent in total banking sector. Then, the series of deviations between the credit structure of each bank and the total sector (market) is constructed.	
	Deviation of banks' fund structure from the market	We exclude own funds from total financing resources. The rest is grouped into six sub-groups for the total banking sector and for each individual bank: 1. Treasury and interbank transactions; 2. Current accounts (public administration + private sector); 3. Demand deposits (public administration + private sector); 4. Time deposits (public administration + private sector); 5. Other (public administration + private sector); 6. Securities + Other liabilities. Then, we derive the difference between the fund structure, in per cent, between each bank and the fund structure of the total banking sector.	
	Negative deviation from the banking sector's average capitalisation ratio	Variance of difference between the capital adequacy ratio of individual banks and the banking sector's average, only for those banks whose CAR stands below the average.	

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

ANNEX 3 GLOSSARY

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.

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