Bank of Albania

# FINANCIAL STABILITY REPORT 2014 H1

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# C O N T E N T S

## B O X E S



## T B L E S

C H A R T S

# PREFACE

This is the twelfth 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 mainly cover the developments over the first half of 2014. Unless otherwise stated, the expectations for the economic and financial outlook extend through a period of up to 12 months.

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, this report makes an analysis 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 the performance of employment and income, it also evaluates businesses and households' financial situation, and the impact on borrower's solvency.

# NOTES

As of the end of June 2014, banks operating in Albania were divided into the following groups by their share:

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

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

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

As of the end of June 2014, by capital origin, banks operating in Albania were grouped as follows:

**- Foreign-owned banks1[1]**: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank - Albania, Veneto Bank (Italy); Alpha Bank - Albania, Tirana Bank, National Bank of Greece (Greece); National Commercial Bank (Turkey); Société Générale Albania, Credit Agricole Bank (France); ProCredit Bank (Germany); First Investment Bank (Bulgaria); International Commercial Bank (Malaysia); United Bank of Albania (Islamic Development Bank); Credit Bank of Albania (Kuwait).

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

As of the end of June 2014, the National Commercial Bank had its branches network expanded to Kosovo.

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

# FINANCIAL STABILITY STATEMENT FOR 2014 H1

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

The Albanian banking sector and financial system showed stable performance in the first half of 2014. The volume of activity grew and the financial performance improved.

The banking sector's liquidity and capitalisation ratios were at an adequate level during the period. The loan portfolio quality remained a concern, although the non-performing loan ratio appeared more stable and the non-performing loans, in terms of absolute value, were lower year-over-year. Loan loss provisions and collateralisation of non-performing loans were at adequate levels.

The macroeconomic setting is stable, supporting the performance of the financial system. The improved economic growth, and the fiscal and monetary policy actions were accompanied by an adequate functioning of financial markets and lower financing costs.

Banking sector's exposure to credit risk stands similar to the previous period. Credit risk provisions, albeit at an adequate level, must be assessed based on a conservative analysis of future events, to protect banks against any additional costs they may face during the restructuring and collateral management process. Banking sector's exposure to market and liquidity risks remains limited, but requires cautious monitoring. External sector developments suggest the need to assess the potential impact on the banking activity in Albania, of European authorities' actions to review the asset quality, the capitalisation level, and the restructuring measures taken by the largest European banking groups. The banking sector is overall resilient to assumed shocks arising from fluctuations in macroeconomic indicators and the value of its investment portfolio.

The following provides a summary of the main developments in the surrounding economic environment and the financial system, and the risks facing the banking sector activity, including the systemic risk.

- **Economic and financial developments**

**Global economic activity improved during the first half of 2014, driven mainly by the performance of advanced economies.** The economy improved at a slower-than-expected pace, with notable differences across the regions. Global inflationary pressures remained below the historical average, reflecting the stable prices of raw materials and spare capacities in the economy. In the advanced economies, the financial markets remained stable, supported by central banks' policies and positive expectations of market participants. The financial markets were volatile in the developing economies, due to economic deceleration in some countries, political and structural concerns, and expectations for monetary policy tightening in the United States of America. This performance led to depreciation of respective currencies in these countries. Global economic activity is expected to continue to improve for the rest of 2014 and 2015, driven primarily by the positive performance of advanced economies.

**Private consumption and investments are making major contribution to the improvement of the Albanian economy.** In the first quarter of 2014, the Albanian economy expanded by 1.65% and 0.2%, in annual and quarterly terms. Except for the construction sector, all the other sectors of the economy contributed positively to the economic growth. The latter reflected the relative improvement of domestic demand, affected mainly by private consumption and investments. Nevertheless, with the unemployment rate resulting 17.7%, the economic improvement has to become sustainable to affect the labour market. External sector developments made a negative contribution to economic growth. In June 2014, annual inflation decreased to 1.5%, reflecting the incomplete utilisation of domestic production capacities, the low inflation rates in Albania's trading partners, and the downward short-term expectations for inflation. In response to this performance, the Bank of Albania continued to pursue a stimulating monetary policy. At the end of the first half of 2014, the fiscal indicators pointed to a consolidating fiscal policy, with the revenues being higher and the expenditure lower than the annual plan. Domestic demand is expected to strengthen its positive impact on economic growth, driven by private consumption and investments. The expectations for the improvement of economic activity in Albania's main trading partners for the rest of the year will affect the growth of external demand for Albanian exports positively.

**Households and businesses remain exposed to direct and indirect credit risks.** Lending increased slightly from end-2013 and continued to be oriented towards lending in Albanian lek. The loan portfolio quality worsened slightly, both for businesses and households. Business deposits grew at a higher pace than household deposits, driven also by Government's payment of arrears to businesses. Despite the relatively lower exposure to loans unhedged against unfavourable exchange rate and interest rate changes, households and businesses remain exposed to this risk.

**Trading volume in the financial markets increased, while the interest rates decreased during the first half of 2014.** The Albanian financial markets showed a stable performance, characterised by low interest rates. The Bank of Albania's stimulus saw greater impact on the primary securities' market, deposit interest rates and the interbank market. The exchange rate was stable and the Albanian lek strengthened slightly against the two major currencies.

**The technical infrastructure supporting the banking sector activity operated effectively during the first half of 2014.** AIPS and AECH payment systems operated in compliance with the technical conditions for meeting the banking sector needs for settling lek payment transactions. The volume and value of transactions, and the average value per transaction, increased in the two systems.

**The financial system increased its share in Albania's economic activity further.** In June 2014, the level of financial intermediation in Albania, as measured by the ratio of financial system assets to GDP, was 99.3%, close to end-2013 level. The banking sector accounted for 90.3% of financial system assets.

**The banking sector's performance was stable, and the liquidity and capitalisation ratios were at an adequate level, supported also by the improved net financial result.** At the end of June 2014, banking sector assets increased to ALL 1,253 billion, expanding by 4.1% during the last year. On the asset side, interbank and security transactions recorded major increase. Banking activity was financed through the increase in public deposits, though at a lower rate. Banking sector exposure to non-resident institutions was similar to the previous period, reflecting weak reliance on foreign financing resources. Lending shrank 2.2% during the period. The 4.5% growth of lek-denominated lending could not offset the contraction of foreign currency lending by 5.9%. New lending was 16.1% higher than in the corresponding period in 2013.

The ratio of non-performing loans to total loans was 24.1%. The non-performing loan ratio for lek loans was 18.8%, down 1.3 percentage points from June 2013. The same ratio for foreign currency loans was 27.3%, up 0.8 percentage points from June 2013.

Deposits amounted to ALL 1.038 billion, up 3% year-over-year. Lek and foreign currency deposits grew 1.4% and 4.9%, respectively, annually. The annual growth rate of deposits slowed down to 3%, from 4.7% in June 2013. Household deposits, which accounted for around 87.5% of total deposits, grew at the lower annual rate of 2%, from 4.9% a year earlier. Business deposits grew around 9.8% in annual terms, from 8% in the previous year. This performance may have also been affected by Government's payment of arrears to businesses. The loan-to-deposit ratio was 54.7%.

At the sectoral level, the net financial result was positive, amounting to ALL 5.4 billion, from ALL 1.5 billion in the corresponding period in 2013. Net interest income totalled ALL 20.8 billion, or 9.7% higher year-over-year. Loan loss provisions amounted to around ALL 5.7 billion, or 42% lower year-over-year. Paid-in capital did not undergo any significant changes during the period. The regulatory capital fell 1.6%, whereas risk-weighted assets increased by 1%. As a result, the capital adequacy ratio dropped to 17.5%.

- **Risk assessment**

To assess the risks, we consider the banking sector performance and its interaction with developments in the real economy, financial situation of economic agents and other financial system segments. We also use some representative indices.

For a synthesized assessment of risks to the banking sector, real economy and economic agents, we use the Financial Stability Map (FSM). Compared to end-2013, the FSM shows that risks to financial stability continued to move towards economic agents.

More specifically, in the case of the domestic economy, the wider negative output gap and greater need for external financing contributed to a higher risk, which stands at a moderate level. The risk was assessed as moderate for households and businesses, due to the combined impact of factors relating to their expectations for future economic developments, exposure to credit risk and financing resources, in general. The risk was assessed as downward for the government, due to reduced budget deficit and positive performance of tax revenues. However, the size of debt cost has been assigned the highest risk level since end-2012. The risk arising from the external economic environment is assessed as average because of the weaker economy and high unemployment rates in countries with stronger economic ties with Albania. For the banking sector, capitalisation and profitability ratios were assigned moderate risk. Liquidity and financing ratios showed a higher risk level due to wider negative difference between short-term assets and liabilities, further slowdown in the deposit growth rate and relative increase in financing from non-residents. The risk related to the banking sector structure was assessed as average. It has been maintaining a downward trend due to reduced concentration of banking sector activity in the largest banks, both on the asset and liability side.

For the assessment of risk to focus on the financial system, we use the Financial Systemic Risk Index. It measures the level of financial stress in the economy by aggregating the financial information on different segments of the system (banking sector, foreign exchange market, money market, and housing market) into a single index. For the first half of 2014, this index remained above its long-term average. The banking sector contributed to a higher systemic risk due to wider negative gap between loans (contraction) and deposits (slowdown) than the long-term trend. This performance was mitigated by the lower contribution of the housing market, whose prices dropped. The interconnection between different market segments was weaker, mitigating, in turn, the aggregate systemic risk level.

For a clearer insight into the accumulation and materialisation phases of systemic risk in the financial system, we use two indices: the risk accumulation index and the risk materialisation index. At the end of the first half of 2014, there was higher systemic risk accumulation, mainly due to worsened external debt, public debt and current account deficit. The contraction in foreign currency lending and lower housing prices contributed to reduced systemic risk accumulation. The materialisation of systemic risk increased during the period under review, reflecting the worsened quality of business and household loans, and the increased unemployment rate.

Financial risks are subject to economic agents' perception. The Bank of Albania regularly collects the perception of banking industry about these risks through a special semi-annual survey. From March 2012 to June 2014, the banking industry has perceived two phenomena at a potentially high risk: deterioration of the domestic economy and increase in public debt

**Risks arising from fiscal indicators did not increase further during the first half of 2014** Public debt is high, and the size and concentration of Government borrowing financing by banks and non-bank financial sector are associated with certain risk levels. However, risk did not increase during the period thanks to the consolidating fiscal policy, also supported by the arrangement with the IMF; extended term to maturity and lower borrowing cost; adequate liquidity level in the banking sector; and measures to improve the access to liquidity of non-bank financial institutions investing in Government debt securities. In this regard, deeper reforms to boost economic growth are required for a positive and sustainable performance of fiscal indicators.

**Credit risk remains a concern for banking activity.** The absolute value of non-performing loans fell during the period. At the same time, there was a shift towards loss loans and increase in loans past due by up to 90 days. The loan restructuring process at banks may be more effective if viewed more than merely as a change in terms and loan instalment. The risk for further deterioration of the loan quality is still present, and banks are urged to cautiously monitor the loan loss provisioning, suggesting its increase through a proactive approach. To address the non-performing loans, banks are taking more decisive actions with respect to the execution of the collateral, which is typically in the form of real estate. As a result, the value of real estate under banks' management is increasing at a steady rate. This phenomenon may put pressure on banks' resources for the management and maintenance of real estate, particularly if the sale pace in the market is low. Housing prices are showing signs of easing, affecting negatively banks' ability to reach the targeted value from the sale of the collateral . Real estate management is not a typical function of a commercial bank. It is, therefore, necessary for banks to explore and design appropriate strategies to effectively address this concern.

**The banking sector showed limited exposure to direct risk associated with unfavourable exchange rate and interest rate movements, which, however, requires cautious monitoring.**

The banking sector's open foreign exchange position was long and within the historical levels. Interest rate-sensitive assets and liabilities were comparable; however, the difference between the two was negative. Despite the limited direct impact of exchange rate and interest rate movements, the banking sector appears sensitive to the negative impact of unfavourable exchange rate and interest rate movements on banking clients. A significant depreciation of the exchange rate or a similar increase in the interest rate may affect the solvency of banking clients, particularly businesses. The main transmission channel of this risk is represented by foreign currency loans, when the main source for its settlement is in the domestic currency, and variable-rate loans.

**Banking sector liquidity risk was moderate.** Similar to the previous periods, deposits represent the main financing source for the banking sector. They recorded positive growth, though at a slower pace than in the previous period. Borrowing from non-residents, albeit up slightly, remained at a moderate level. The sector's liquid assets, both in lek and foreign currency, were above the minimum levels required by the regulatory framework. The loan-to-deposit ratio was low, reflecting the different performance of lek and foreign currency loans and deposits.

**Capitalisation indicators were at adequate levels; however, banks should cautiously monitor potential scenarios for future events and their needs for additional capital.** The capital adequacy ratio dropped slightly, remaining, however, at an adequate level. Net profit improved thanks to slower increase in non-performing loans, improved value of debt securities and lower provisions for the credit risk of the assets. Banks may face increased expenses due to additional costs associated with the restructuring and collateral execution process. It is, therefore, imperative for banks to continue to cautiously and proactively assess their needs for additional capital in line with their risk profile and, when necessary, boost their capital level.

**Stress-testing exercise should serve banks as a tool to support the assessment of possible needs for additional capital.** The Bank of Albania conducts regular stress-testing exercises to assess the sensitivity of the main banking sector capitalisation figures to changes in macroeconomic indicators and decline in the value of investments in money and securities markets.

For the exercise testing the sector's sensitivity to macroeconomic scenarios, the baseline and adverse risk scenarios make assumptions about changes in GDP growth rate, exchange rate and interest rate, and lending, extending through the end of 2015. For the exercise testing the sector's sensitivity to the size of loss in the investment value, the scenarios make assumptions about the loss in value of securities and investment portfolio held with bank holding groups.

The results of the first exercise show that the banking sector is generally resilient to assumed shocks, in case they materialise. In the event of the baseline scenario, the capitalisation level remains above the minimum requirement.

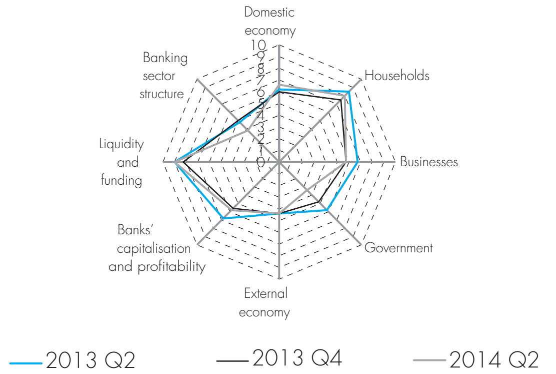
In the event of the more adverse scenarios, which make assumptions about the fall in GDP growth rate, decline in lending and exchange rate depreciation, individual banks may need additional capital.

The results of the second exercise show that individual banks are more exposed to market risk associated with the value of investments in private institutions' securities, whereas exposure to sovereign debt risk is limited. Exposure to placements with bank holding groups is sensitive for medium-sized banks of Greek and French capital origin.

The regulatory and supervisory framework, and the international best practices, require similar exercises to be carried out by banks themselves on a regular basis, in order to assist their decision-making and keep risk in their activity under control.

# 1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

Chart 1.1 Financial Stability Map (move towards the edges signifies higher risk)*




*Risk is rated as: low for scores 0-3 in the map, average for scores 4-5, moderate for scores 6-8, and high for scores 9-10.
Source: Financial Stability and Statistics Department, Bank of Albania.

To assess the main risks to financial stability, we consider the banking sector performance and its interaction with developments in the real economy, financial situation of economic agents and other financial system segments. We also use some representative indices.

## 1.1 FINANCIAL STABILITY

The main indicators of financial stability in Albania are summarised in the form of the Financial Stability Map. This map shows the changes in underlying risks arising from the domestic and external economy, economic agents and the banking sector.

*In 2014 H1, risks to financial stability continued to shift towards real economy agents, and banking sector's liquidity and funding.*

Relative to end-2013, we note the following for the real economy components:

- In the case of the domestic economy, the wider negative output gap and greater need for external financing contributed to a higher risk, which stands at a moderate level;

- For households, the weak expectations for 2014 H2 and the negative performance of housing prices, which remain below their long-term trend, contributed to a higher risk. Conversely, the annual increase in remittances during 2014 Q2 reduced the risk of households, which, in total, is rated moderate.

- For businesses, risk remained unchanged due to positive expectations for the performance of the economy in 2014 H2. However, the contraction in lending and the high level of non-performing loans continued to be assigned maximum risk, hence, maintaining a moderate risk level in this sector.

- For the Government, risk was assessed as downward, due to reduced budget deficit and positive performance of tax revenues. However, the size of debt cost has been assigned maximum risk level since end-2012.

- The risk stemming from the external economic environment did not change. Total external risk is assessed as average, with the vulnerable economic development and high unemployment rate in Albania's trading partners making the highest contribution.

Relative to end-2013, we note the following for the banking sector components:

- Concerning capitalisation and profitability, the level of risk increased slightly, though in total it is rated as moderate. The negative impact from the slight decrease in the capital adequacy ratio and the increase in non-performing loans was mitigated by the positive contribution of the improved net profit before tax;

- Concerning liquidity and funding, risk is assessed as high, reflecting the wider negative gap between current assets and liabilities, further deceleration of the deposit growth rate and relative increase in borrowing from non-residents;

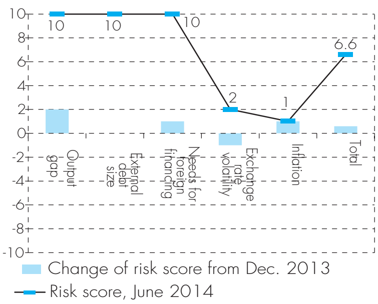
- Risk related to the banking sector structure was lower due to reduced concentration of banking sector activity in the largest banks, both on the asset and liability side. Total risk stemming from the banking sector structure has been assigned average risk.

The next chart shows all FSM components, the score for each risk level as of June 2014, and changes to end-2013.

## Box 1.1 Changes to risk assessment by FSM components relative to end-2013

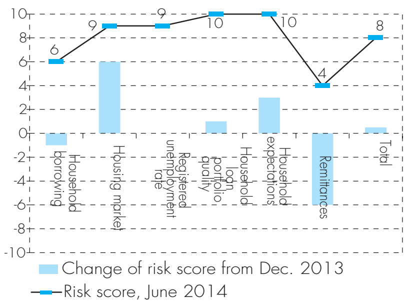
Risk stemming from **the domestic economy** increased slightly due to wider output gap and greater need for external financing.

DOMESTIC ECONOMY



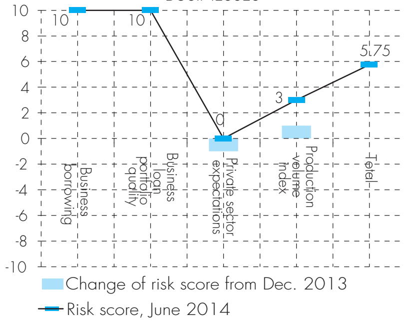

Risk to **households** is higher due to negative performance of the housing market.

HOUSEHOLDS



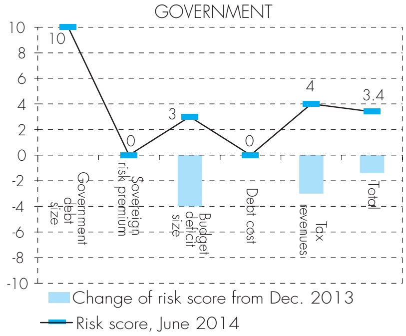

Positive expectations and lower production volume index kept risk to businesses unchanged.

BUSINESSES



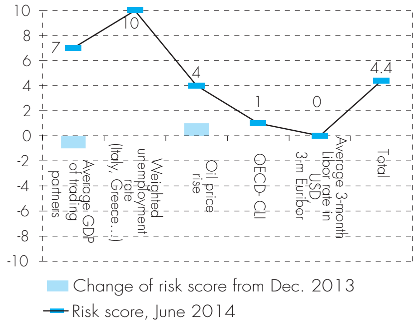

Risk stemming from the **Government's fiscal policy** decreased due to improved budget deficit and tax revenues.

GOVERNMENT



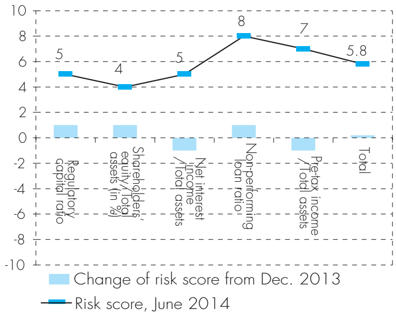

Risk from the **external environment** reduced.

EXTERNAL ENVIRONMENT



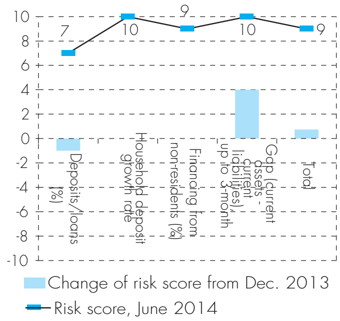

**Capitalisation and profitability** worsened slightly.

CAPITALISATION AND PROFITABILITY



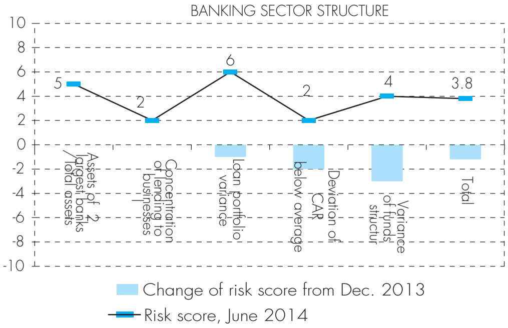

Wider gap between current assets and liabilities increased **liquidity and funding risk.**

FUNDING AND LIQUIDITY




Lower concentration in the banking sector improved the risk stemming from banking sector **structure.**

BANKING SECTOR STRUCTURE

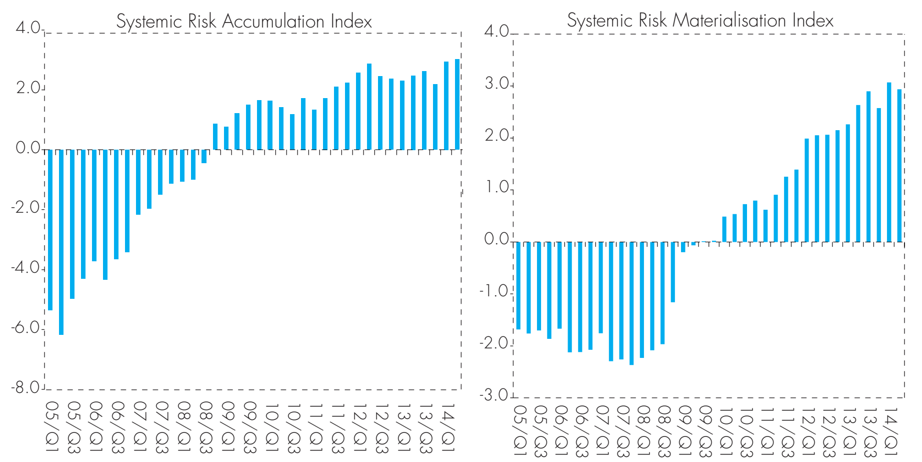



Source: Financial Stability and Statistics Department, Bank of Albania.

## 1.2 SYSTEMIC RISK

Systemic risk is defined as the "materialisation of shocks that impair the functioning of a financial system to the point where economic growth and welfare suffer materially". At the end of 2014 H1, there was higher systemic risk accumulation, mainly due to worsened external debt, public debt and current account deficit. The contraction in foreign currency lending and decrease in House Price Index contributed to reduced systemic risk accumulation. The materialization of systemic risk increased due to worsened quality of business and household loans, and increased unemployment rate.

Chart 1.2 Accumulation and materialisation of systemic risk

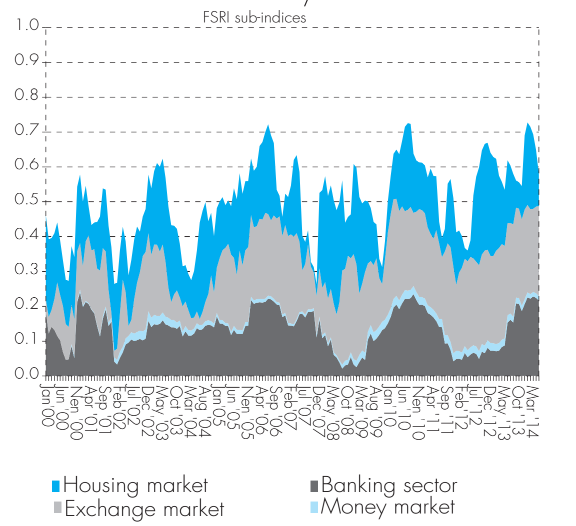



Source: Financial Stability and Statistics Department, Bank of Albania.

According to the Financial Systemic Risk Index[2], systemic risk remained above its long-term average at the end of 2014 H1. The banking sector contributed to a higher systemic risk due to wider negative gap between loans and deposits than the long-term trend. This performance was mitigated by the reduced contribution of the housing market due to lower prices. The interconnectedness between different market segments was weaker, mitigating, in turn, the aggregate systemic risk level.

Focusing more on the financial system, and the banking system in particular, banks were asked to assess the risks with the greatest impact on their activity during 2014 H1 (see Chart 1.4).

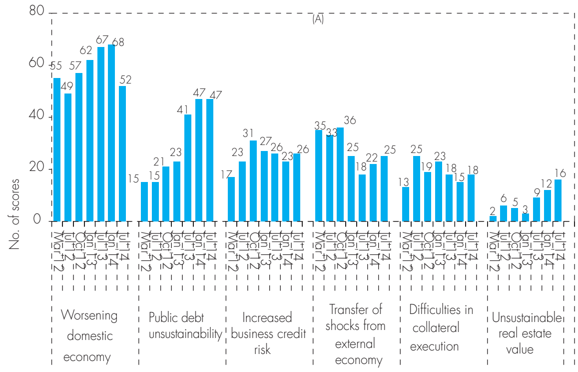
Chart 1.3 Financial Systemic Risk Index




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

[2] *This index measures the level of financial stress in Albania through information on different financial system segments, aggregated into a single index.*

Chart 1.4 Banks' 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. The assessment score is then weighted at the number of banks by each response, resulting in an overall score for each risk.
Source: Financial Stability and Statistics Department.

According to banks, "worsening domestic economy" remains the top systemic risk in Albania. However, banks' perception of the significance of this risk mitigated during the period under review relative to the previous surveys. "Public debt unsustainability" is ranked the second, whereas systemic risk from "lending to businesses" is reported to have increased, due to high level of non-performing business loans.

The following chapters elaborate on the developments in the international and domestic economy, financial system performance, with particular focus on banking sector developments.

# 2. INTERNATIONAL DEVELOPMENTS

Global economic activity improved gradually during 2014 H1, though at a slower-than-expected pace[3] and with sharp differences across the regions. Global inflationary pressures remained below the historical average, reflecting the stable prices of raw materials and spare capacities in the economy. In the advanced economies, the financial markets remained stable, supported by central banks' policies and positive expectations of market participants. The financial markets were volatile in the developing economies, due to economic deceleration in some countries, political and structural concerns, and expectations for monetary policy tightening in the United States of America. This performance led to the depreciation of respective currencies in these countries. Global economic activity is expected to continue to improve for the rest of 2014 and 2015[4], driven primarily by the positive performance of advanced economies.

In advanced economies, economic recovery continued at adequate rates, driven by the accommodative monetary and fiscal policies, and improved private sector balance sheets. Economic growth pace slowed in some emerging market and developing economies, mostly due to geopolitical uncertainties, structural concerns and volatile financial conditions. Future events are conditioned by a possible economic stagnation in the medium term in advanced economies, and worsening financial conditions and unexpected decline in capital flows in emerging market and developing economies.

The economic performance of the United States was disappointing in 2014 Q1, shrinking by 2.9%, due to inventory correction and harsh winter weather which dampened domestic demand and exports. These, however, had only temporary effects and economic activity recovered markedly in 2014 Q2, driven by the increase in exports, consumer spending and private investments (see Table 2.1).

Euro area's economy also recovered gradually, supported by the improved domestic and external demand, and ECB's accommodative monetary policy. Labour market conditions remained stable and the unemployment rate dropped to 11.5% in June 2014. There are, however, sharp differences across the countries, with Greece, Portugal and Spain continuing to record double-digit unemployment rates. Inflation decreased in almost all countries due to low energy prices and absent demand-side pressures. Under these conditions, the ECB cut the reference rate further[5] and conducted other easing operations.

[3] *IMF's World Economic Outlook Projection in July 2014 (3.4% annual growth) was marked down from April 2014 projection (3.6% annual growth).*
[4] *According to the IMF, global economic growth is projected at 3.4% in 2014 and 4.0% in 2015. (July 2014 projection).*
[5] *In June 2014, the ECB cut the reference rate by 10 basis points to 0.15%.*

*Table 2.1 Selected macroeconomic indicators for the United States and euro area*

| | Annual GDP change (annual %) | | | | Unemployment (annual %) | | | Gross government debt (as a percentage of GDP) | |
|---|---|---|---|---|---|---|---|---|---|
| | 2013 | 2014 Q1 | 2014 Q2 | 2015p | 2013 | March 2014 | June 2014 | 2013 | 2014 Q1 |
| U.S. | 2.2 | -2.1 | 4.2 | 3.0 | 7.4 | 6.7 | 6.2 | 104.5 | : |
| Euro area | -0.4 | 0.9 | 0.7 | 1.5 | 11.9 | 11.7 | 11.5 | 92.6 | 93,9 |
| Germany | 0.4 | 2.3 | : | 1.7 | 5.3 | 5.2 | 5.0 | 78.4 | 77,3 |
| France | 0.3 | 0.8 | 0.1 | 1.4 | 10.3 | 10.2 | 10.2 | 93.5 | 96,6 |
| Italy | -1.9 | -0.4 | -0.2 | 1.1 | 12.2 | 12.6 | 12.3 | 132.6 | 135,6 |
| Greece | -3.9 | -1.1 | -0.3 | 2.9 | 27.5 | 26.8 | 27.2 | 175.1 | 174,1 |

*Source: BEA, European Central Bank, Eurostat, IMF.*
*p- IMF's forecast, July 2014; : no available data*

The latest data and performance of confidence indicators suggest that euro area's economy will continue to recover at a gradual pace during the rest of 2014 and 2015.[6] Growth is, however, expected to remain uneven across the region, reflecting financial fragmentation, correction of private and public sector balance sheets, and high unemployment in some economies. The progress in fiscal consolidation and structural reforms is expected to make a positive contribution to economic growth in this region. On the other hand, the escalation of geopolitical tensions and economic performance of emerging regions may dampen demand for European exports.

Euro area's economic recovery made a positive impact on the economic growth of Central, Eastern and South-East European countries, mostly as a result of the higher demand for exports. Countries with good export base like Hungary and Poland registered high growth rates thanks to close commercial and financial ties with the euro area.

The economic growth rate of the countries in the region slowed down in 2014 Q1, compared to the positive performance in 2013 Q4. Labour market conditions improved slightly in some countries (e.g. Macedonia), while continuing to deteriorate in some others (Serbia). The inflationary pressures remained weak in the entire region and three countries[7] saw deflation due to weak economic environment and impact of some external factors, like the fall in raw material prices and, in several cases, appreciation of domestic currencies. Lending remained generally weak due to demand and supply-side factors. Lending grew in Macedonia, Bosnia and Herzegovina, and Kosovo, but continued to shrink in Albania, Serbia and Montenegro. The high level of non-performing loans remains the main banking-related concern in most countries in the region.

[6] *According to the IMF, euro area's economy is expected to grow by 1.1% in 2014 and 1.5% in 2015.*

[7] *Bosnia and Herzegovina, Montenegro and Macedonia.*

Table 2.2 Selected macroeconomic indicators for Central, Eastern and Southeastern European countries

| Central, Eastern and Southeastern Europe | GDP growth (annual %) | | | Unemployment (annual %) | | | Sovereign debt (as a percentage of GDP) | |
|---|---|---|---|---|---|---|---|---|
| | 2013 | T1'14 | T2'14 | 2013 | Mars.'14 | Qer.'14 | 2013 | T1'14 |
| Bulgaria | 0.9 | 1.2 | 1.6 | 12.9 | 12.1 | 11.6 | 18.9 | 20.3 |
| Romania | 3.5 | 3.8 | 1.4 | 7.3 | 7.2 | 7.1 | 38.4 | 39.0 |
| Poland | 1.6 | 3.5 | 3.2 | 10.3 | | 9.1 | 57.0 | 49.5 |
| Western Balkans | | | | | | | | |
| Kosovo* | 3.1 | : | : | 30.9* | : | : | 8.3 | : |
| FYROM | 2.9 | 3.9 | : | 29.0 | 28.4 | : | 35.8 | 34.9 |
| Montenegro | 3.5 | 1.7 | : | 19.5 | 19.1 | : | 58.0 | 57.0 |
| Serbia | 2.5 | 0.1 | -1.1 | 22.1 | 20.8 | 20.3 | 63.0 | 64.2 |

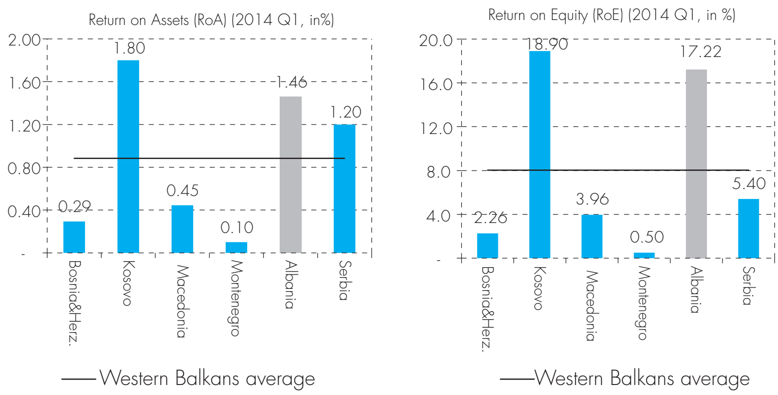
*Source: ECB, Eurostat, IMF, European Commission, respective central banks; respective statistics institutes; : unavailable data.*

Box 2.1 makes a comparative analysis of the main soundness indicators of the banking sector in Albania vis-à-vis the Western Balkans.

## *BOX 2.1 A COMPARATIVE ANALYSIS OF THE ALBANIAN BANKING SECTOR VIS-À-VIS THE WESTERN BALKANS**

*The Albanian banking sector's profitability is high compared to the Western Balkans. Return on Assets (RoA) and Return on Equity (RoE) stand markedly above the region's average, at 0.88% and 8.04%, respectively.*

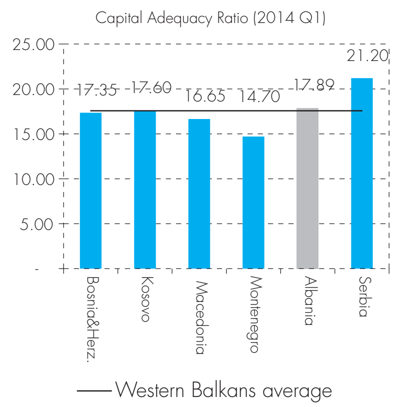
Chart 2.3 Return on Assets (left) and Return on Equity (right)

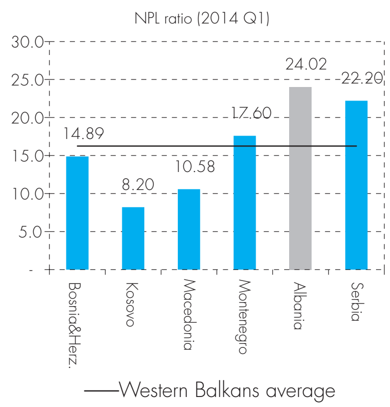



Source: IMF, respective central banks.
Note: As of end-2013 data for Montenegro.

***Capitalisation*** *in the Albanian banking sector is adequate. The capital adequacy ratio stands close to the region's average (17.5%), which sees a high CAR.* ***Asset quality*** *remains the main concern in the Albanian banking sector and some countries in the Western Balkans. However, the non-performing loan ratio in the Albanian banking sector stands above the region's average of 16.2%.*

Chart 2.4 Capital Adequacy Ratio (left) and NPL ratio (right)




Source: IMF, respective central banks.
Note: As of end-2013 data for Montenegro.

* *Western Balkans include: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia.*

## 2.1 HIGHLIGHTS IN FINANCIAL AND PRIMARY COMMODITY MARKETS

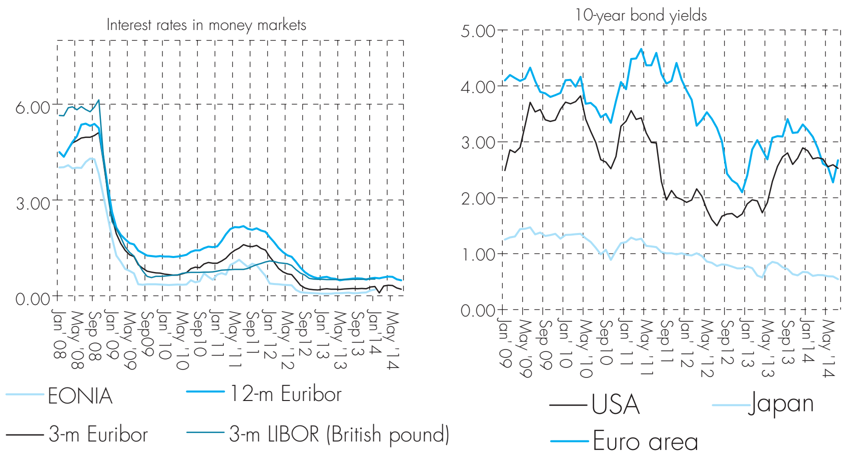
The financial markets were generally stable during 2014 H1.

In advanced economies, the financial markets saw low interest rates due to the accommodative monetary policies of central banks and higher demand for profitable investments. This contributed to improved public and private sector balance sheets as a result of lower funding costs and increased access to financing. The money markets were characterised by stable and often downward rates, which showed low volatility. Sovereign debt markets saw considerably improving investor confidence in countries affected by the debt crisis (Italy, Spain, Greece and Portugal), attributable to Ireland, Portugal and Spain's exit from the bailout programmes, release of their economic data and improved rating in some of these countries. This resulted in lower yields on Government bonds, despite the increased issues. The capital markets also showed a positive performance with the equity prices and volume of issues increasing, while the interest rates in private bond markets showed a downward tendency. These developments were attributable to the positive expectations about the outlook in advanced economies and encouragement of investors for higher returns amid a low-interest-rate environment.

In emerging market and developing economies, the performance of financial markets was more volatile due to lower capital flows into these countries, resulting from the weak economic perspective, political and structural issues, and expectations for tighter monetary policy in the United States.

Despite these positive developments, risks to financial market stability still remain present. An extended period of low interest rates may lead to an increase in risk-taking by firms and households, and appreciation of various assets.

Chart 2.5 Interest rates in main money and government bond markets




Source: European Central Bank, Eurostat.

In the foreign exchange markets, the euro initially appreciated against major trading partners' currencies in Q1, reflecting the relatively optimistic market expectations of euro area's monetary policy and economic outlook. This trend reversed during March-August 2014, with the euro depreciating against major currencies, such as the U.S. dollar and the British pound, and currencies of most Asian and European emerging and developing markets, due to larger room for pursuing a loose monetary policy for an extended period amid return of doubts about economic growth in the region.

In the primary commodity markets, price of crude oil ranged 106-115 USD/barrel during 2014 H1. It fell in Q1 due to weaker global demand for oil amid buoyant supply. This performance reversed during Q2 following the escalating geopolitical conflicts and tensions in major oil-producing countries.[8] The price of oil fell again in the last months due to subdued demand in line with the weak global growth, whereas supply of oil remained at a similar level. Oil market agents expect the price of oil to fall slightly in the medium-term period.

Prices of other primary commodities increased in 2014 Q1, mainly as a result of unfavourable weather conditions in major food exporting countries. This performance reversed in Q2 due to higher seasonal supply, bringing about the fall in primary commodity prices.

[8] *Brent crude oil price spiked 115 USD/barrel in June 2014.*

## *BOX 2.2 ASSESSMENT OF SIGNIFICANT CREDIT INSTITUTIONS BY THE ECB*

*In November 2013, the ECB carried out a comprehensive assessment for 128 significant lending institutions in Europe, as part of the preparatory process for the transition into the Single Supervisory Mechanism (SSM) in November 2014. This comprehensive assessment aims to enhance the transparency relating to the financial soundness of credit institutions under review and unify the supervision practices. The comprehensive assessment comprises two main pillars:*

*1) Asset Quality Review (AQR) of selected institutions, including the assessment of collateral and respective provisioning;*
*2) Stress test analysis to test the resilience of these institutions under the baseline and adverse scenarios, designed by the European Banking Authority and the European Commission.*

*The entire assessment process will conclude in October 2014 with the release of aggregate and individual bank-level data. According to the ECB, banks, which following the asset assessment process, or under the baseline scenario result below capital, will issue new capital within 6 months from the release of results, whereas banks resulting under-capitalised under the adverse scenario will improve their capital position within nine months.*

*The conclusion of ECB's assessment of the main European banks in October this year, part of which are also some significant banking groups* with their subsidiaries in Albania, will remove any uncertainties accompanying this process in terms of asset quality and additional need for capital. Depending on the results and actions to address this concern, the future contribution of a given banking group to increasing financial intermediation may delay or be concentrated only in a few jurisdictions it operates. This risk may be, however, lower than two years ago, taking into account that: a) liquidity in international financial markets has improved also thanks to ECB's measures, and the European banking groups may meet their capital requirements relatively more easily; b) during this period, the European banking groups have taken structural actions to initially improve their capital positions.*

*In this respect, although the subsidiaries of these banking groups operating in Albania generally have adequate capitalisation and profitability parameters, they may become part of banking groups' strategies to control exposures outside the euro area, in their efforts to strengthen their respective balance sheet positions. This may delay a more active bank approach to increasing lending and condition these institutions to reduce their activity for a period of time.*

*The effect of this exercise on the exposure of European banking groups in South-eastern Europe and beyond may be reinforced by the requirements under the restructuring plans approved by the European Commission for those banking groups benefiting state aid to overcome the financial crisis effects. These plans also entail actions targeting the restructuring of activity, which, in practice, also include changes to their geographical distribution. These restructuring plans generally extend through the medium term, enabling the banking groups and supervisory authorities to find adequate and gradual solutions based on market functioning and relevant legislation. In these cases, close communication between banking groups and the respective supervisory authorities is very important for discussing the best options and way of achievement.*

* *The list of large credit institutions operating in Albania with their branches, which were part of ECB's asset review and stress test analysis, includes: Raiffeisen Group, Intesa Sanpaolo S.p.A, Veneto Bank S.c.p.A, Societe Generale SA., Credit Agricole SA, Alpha Bank SA, National Bank of Greece SA, Piraeus Bank SA.*

## BOX 2.3 DEVELOPMENTS IN BANKING GROUPS OPERATING IN ALBANIA

*Table 2.3 shows some main indicators of financial statements of bank holding groups operating in Albania, in relative terms, compared to the same period in 2013. The indicators generally show improved income and adequate capitalisation of these banking groups. The share of banks operating in Albania in total assets of foreign banking groups remained low.*

*Table 2.3 Financial data on foreign banking groups operating in Albania*

| Annual change | Raiffesen Bank International[1] | Intesa San Paolo[2] | Alpha Bank[3] | Piraeus Bank[4] | National Bank of Greece [5] | Societe Generale[6] | Credit Agricole[7] |
|---|---|---|---|---|---|---|---|
| Assets[8] | -2.6% | 0.7% | -4.3% | -3.9% | 1.0% | 9.0% | 1.5% |
| Credit | 0.2% | -3.4% | -6.3% | -4.0% | 0.0% | 1.0% | 1.2% |
| Deposits | -3.1% | 0.9% | 0.5% | 0.3% | 8.0% | 2.0% | 5.0% |
| Loan-loss provisions | 21.1% | -11.5% | - | - | -17.0% | 5.0% | - |
| Net profit | 24.4% | 70.6% | … | … | … | 2.0% | -11.8% |
| Operating income | -2.4% | 4.7% | 3.4% | 7.0% | -5.0% | 4.2% | 0.9% |
| Net interest income | 6.4% | 3.8% | 27.8% | 11.0% | -6.0% | - | - |
| Net commission income | -2.6% | 9.2% | 11.0% | 13.0% | -5.0% | - | - |
| Operating expenses | -6.1% | 1.2% | -2.1% | -11.0% | -12.0% | -0.2% | 0.4% |
| Net operating profit | 2.6% | 8.1% | - | - | - | 14.5% | 1.8% |
| Ratios | | | | | | | |
| Non-performing loans | 10.7% | - | 33.6% | 38.5% | - | 5.9% | - |
| Net interest margin | 3.33% | - | 2.6% | 2.7% | 3.25% | - | - |
| Capital adequacy ratio | 10.4% | 12.9% | 16.3% | 15.1% | 16.2% | 14.0% | 13.8% |
| Bank's assets in Albania to total group assets | 1.51% | 0.16% | 0.76% | 0.76% | 0.26% | 0.04% | 0.01% |

*- unavailable published data.*
*… change in net profit/loss is reported above 100% on a year earlier.*

*[1] Semi-annual financial report for 2014 H1: http://investor.rbinternational.com*
*[2] Press release on 2014 H1: http://www.group.intesasanpaolo.com*
*[3] First half 2014 results, press release: http://www.alpha.gr*
*[4] First half 2014 results: http://www.piraeusbankgroup.com*
*[5] First half 2014 results, press release: https://www.nbg.gr*
*[6] Financial information on first half of 2014: http://www.societegenerale.com*
*[7] First half 2014 results: http://www.credit-agricole.com*
*[8] Change from end-2013 for balance sheet data.*

# 3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

In 2014 Q1, the Albanian economy expanded by 1.65% and 0.2%, in annual and quarterly terms. Except for the construction sector, all the other sectors of the economy contributed positively to the economic growth. However, the services' sector contribution fell markedly. It expanded by only 0.53% in annual terms due to considerable contraction in the transportation sub-sector. The increase in the industry sector was entirely attributable to the extractive industry, which grew 41.62%, whereas the processing industry deepened the contraction by 9.87% in annual terms. The construction sector resumed the negative pace, shrinking 5.3%, y-o-y. Agriculture improved the growth rate and grew 3.06%, in annual terms.

In light of this performance, aggregate demand improved from end-2013, driven mainly by private consumption and investments. The external sector made a negative contribution to economic growth. The weak aggregate demand, lower imported inflation and contained expectations kept inflation at the lower bound of Bank of Albania's target. In June 2014, annual inflation decreased to 1.5%, reflecting the incomplete utilisation of domestic production capacities, the low inflation rates in Albania's trading partners, and the downward short-term expectations for inflation. In response to this performance, the Bank of Albania continued to pursue a stimulating monetary policy.

At the end of 2014 H1, the fiscal indicators pointed to a consolidating fiscal policy. Revenues amounted to ALL 175.2 billion during H1, up 11.5% annually, reflecting the positive performance of tax revenues. General expenditure amounted to ALL 197.4 billion, down 3.8% in annual terms, reflecting particularly the sharp decrease in capital and current expenditure. Budget deficit fell to ALL 22.2 billion or 54.3% from the previous year. It accounted for 1.6% of GDP[9] and was mainly financed through domestic resources, at 74.2%.

At the end of 2014 H1, the current account deficit deepened by 21.5% in annual terms, to EUR 617.9 million. The net exports deficit in goods and services amounted to EUR 898.5 million, up 9.2% from the previous year. It reflected the increase in exports by 12.1% in annual terms, which was insufficient to offset the increase in imports by 11.1%. Remittances totalled EUR 250.7 million in 2014 H1, standing at a similar level to 2013. For the same stated period, the financial account amounted to EUR 432.9 million, or 4.2% less than in 2013 H1. Direct investments decreased by 13.3% in annual terms, amounting to EUR 333.9 million. Portfolio and other investments also shrank in annual terms.

[9] *Preliminary estimate of GDP.*

The performance of the labour market pointed to increased unemployment rate, which reached 17.7% at the end of 2014 H1, from 17% at the end of 2013. Employment in the private non-agricultural sector improved, and employment in the agricultural sector showed signs of recovery in Q2, after several consecutive periods of decline. The expectations about employment in 2014 H2 are positive for all the sectors of the economy.[10]

There are great expectations that the increase in domestic demand will be reflected into improved economic growth. The Government will have to re-evaluate the possibility of carrying out investments as planned in the budget for the rest of the year, and the implications for the size of the fiscal deficit. The inflationary pressures in the economy are expected to remain weak. The expectations for the improvement of economic activity in Albania's main trading partners for the rest of the year will affect the growth of external demand for Albanian exports positively.

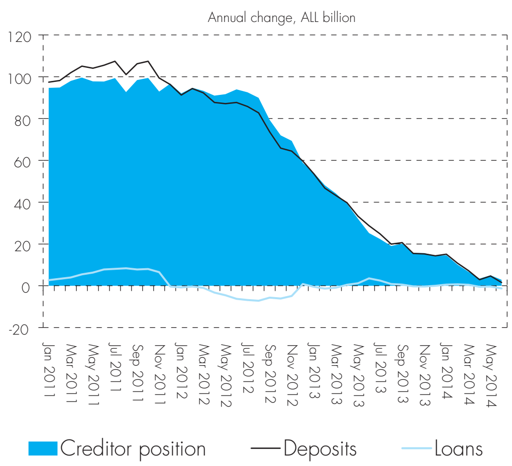
[10] *Business Confidence Survey, 2014 Q2, Bank of Albania.*

# 4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

In 2014 H1, households remained oriented towards savings, though at a sluggish pace as reflected by the slower deposit growth. Lending grew slightly from end-2013 and continued to be oriented towards lending in lek. The loan portfolio quality worsened during the period under review. Business lending from the financial system increased slightly, mitigating the negative performance of business lending from the banking sector. This type of lending was oriented towards that in lek, whereas business deposits continued to grow, being also affected by Government's payment of arrears to businesses. Businesses reduced their exposure to indirect credit risk, whereas the loan portfolio quality continued to deteriorate.

## 4.1 HOUSEHOLDS

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




Source: Bank of Albania.

In 2014 H1, households' creditor position[11] amounted to ALL 681.33 billion, widening by only ALL 2.8 billion from the previous year, and narrowing by ALL 7.3 billion from end-2013. This performance reflected the contraction in household deposits by ALL 6.3 billion and increase in lending by only ALL 1 billion from end-2013.

By currency, households are creditors of ALL 361.26 billion in lek and ALL 320.07 billion in foreign currency. While the creditor position in lek shrank in annual and semi-annual terms, that in foreign currency expanded. These developments reflect a negative performance of household lek deposits, accompanied by a negative performance of foreign currency loans. Consequently, the increased creditor position in foreign currency reflects directly the contraction in foreign currency loans, whereas the developments in the Albanian lek reflect the decrease in lek deposits.

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

### 4.1.1 CREDIT RISK

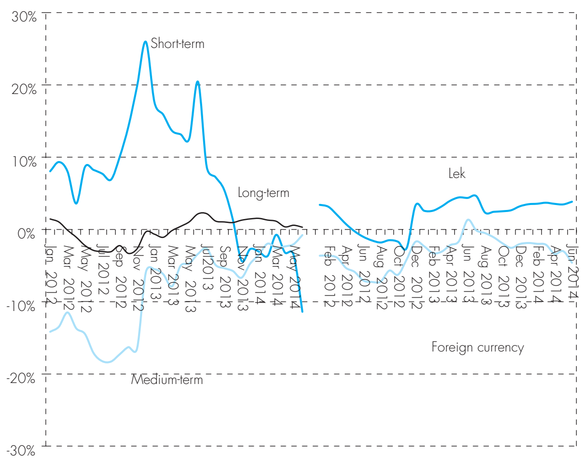
In 2014 H1, banking sector lending[12] to households shrank 0.81% in annual terms. The contraction in lending reflected the considerable decline in foreign currency lending by 4.6%, whereas lending in the Albanian lek increased 3.82%. Consequently, the share of foreign currency lending fell to 52.7%, whereas that in lek rose to 47.3%, thereby narrowing the spread between them. Relative to end-2013, household loans increased slightly by 0.5%. By term to maturity, long-term household loans increased to 79.7% of the loan portfolio, whereas short-term loans continued to shrink to 7.3% of the loan portfolio.

In June 2014, the non-performing loan ratio for households rose to 16.62%, from 16.19% at end-2013. This ratio, however, was lower than in 2013 H1, at 18.44%, though the decline was mostly attributable to the sale of non-performing loans by some banks. In annual terms, the contraction in non-performing loans at a faster pace than household loans was reflected in the decline of this ratio.

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

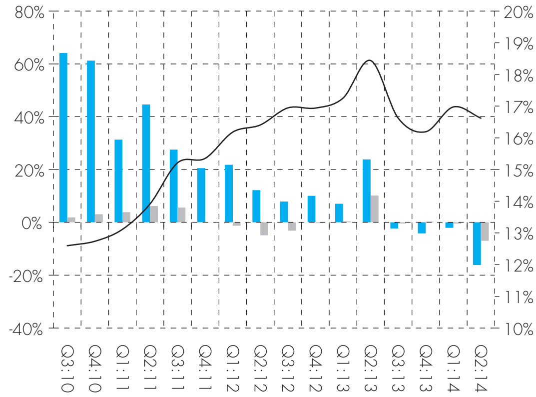
Households continued to lower their exposure to loans unhedged against exchange rate risk. In June 2014, these loans fell to around 31.7% of total household outstanding loans, from 34.2% at end-2013. Around 85.01% of household loans unhedged against exchange rate consisted in 'House purchase loans', up 0.5 percentage points from end-2013. 'Consumer loans' accounted for 7.9%, standing close to end-2013 (see Chart 4.4, right).

Chart 4.2 Annual growth rate of household loans




Source: Bank of Albania.

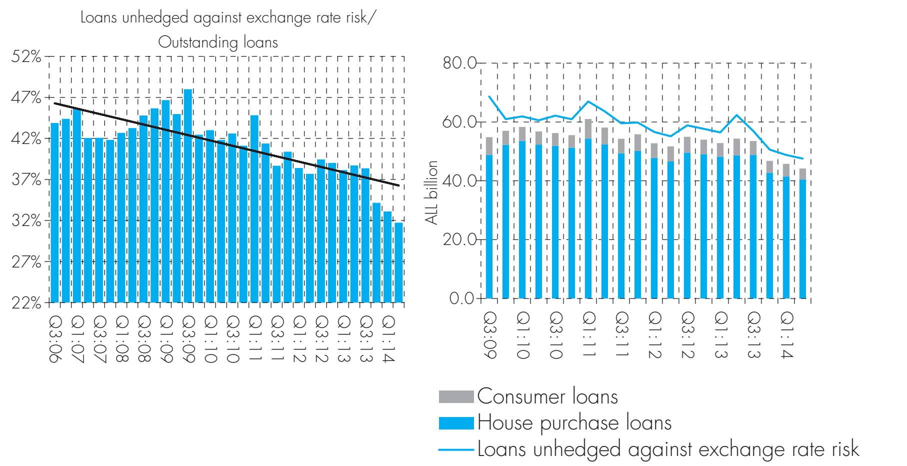
Chart 4.3 Household loan portfolio quality




Source: Bank of Albania.

[12] *The calculations include only residents.*

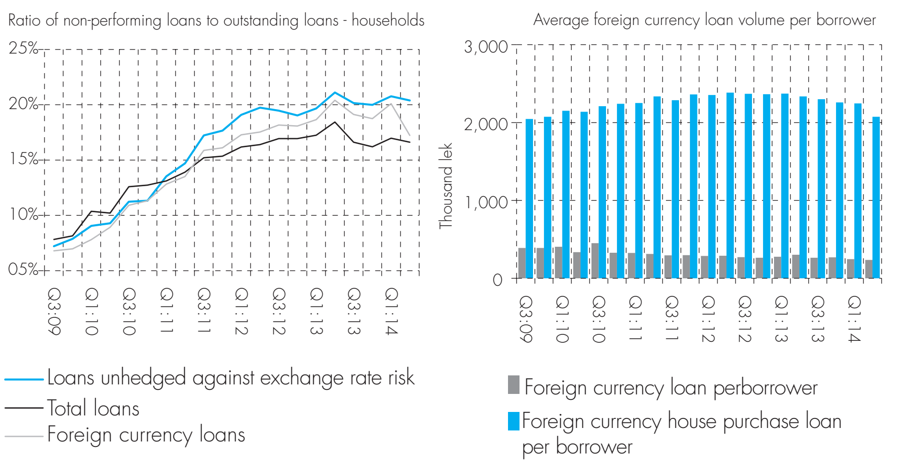
Chart 4.4 Household exposure to indirect credit risk arising from the exchange rate




Source: Bank of Albania.

In June 2014, the non-performing loan ratio for household loans unhedged against exchange rate risk was estimated at 20.4%, from 20.1% at end-2013 and 21.1% in June 2013. The non-performing loan ratio for the foreign currency loan portfolio improved to 17.23%, from 18.74% at end-2013 and 20.4% in June 2013 (see Chart 4.5, left).

Chart 4.5 Household loan portfolio quality and average foreign currency loan per borrower



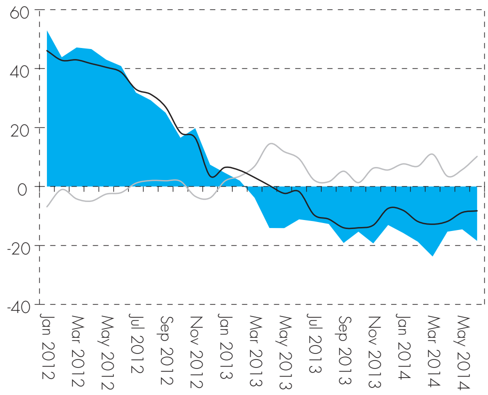

Source: Bank of Albania.

Average foreign currency loan per borrower reduced to ALL 2,075 million, from ALL 2,260.1 million at end-2013. The number of borrowers of foreign currency loans increased, whereas household foreign currency loans for house purchase fell (see Chart 4.5, right).

## 4.2 BUSINESSES

Businesses narrowed their debtor position to the financial system[13] to ALL 266.88 billion in June 2014. The debtor position narrowed by ALL 18 billion in annual terms, and ALL 9 billion in semi-annual terms. This performance mostly reflected the annual shrinkage in business loans by ALL 8.26 billion. Deposits grew ALL 10.2 billion, which was also attributable to payment of Government arrears to businesses. Relative to end-2013, business loans extended by the entire financial system increased slightly by ALL 182 million, whereas the growth of deposits continued to remain above the average annual long-term growth since 2007.

Chart 4.6 Businesses' debtor position to the financial system, annual change in ALL billion. A positive value implies wider debtor position and vice-versa




Source: Bank of Albania.

By currency, businesses are debtors of ALL 80.01 billion in the Albanian lek and ALL 186.87 billion in foreign currency. Relative to June 2013, the debtor position in lek increased slightly by ALL 1.3 billion, whereas that in foreign currency narrowed by ALL 19.7 billion. This performance mostly reflected the shrinkage in foreign currency loans; lek loans increased slightly.

### 4.2.1 CREDIT RISK

Bank lending to businesses has been shrinking since April 2013. During 2014 H1, it fell 2.38% annually. This performance was mostly due to the contraction in foreign currency loans by 5.6%, whereas lek loans accelerated the annual growth to 4.31%. Relative to end-2013, lending to businesses shrank 0.3%. By business size, large businesses accounted for 62.6% of the loan portfolio, whereas small and medium-sized businesses accounted for 18% and 19.4%, respectively. By term to maturity, loans to large businesses fell in all maturities, mostly reflected in long-term loans. Medium-sized businesses increased slightly only the short-term loans, whereas small-sized businesses increased only the long-term loans. By currency, business loans denominated in the Albanian lek increased, accounting for 34.7% of total business loans.

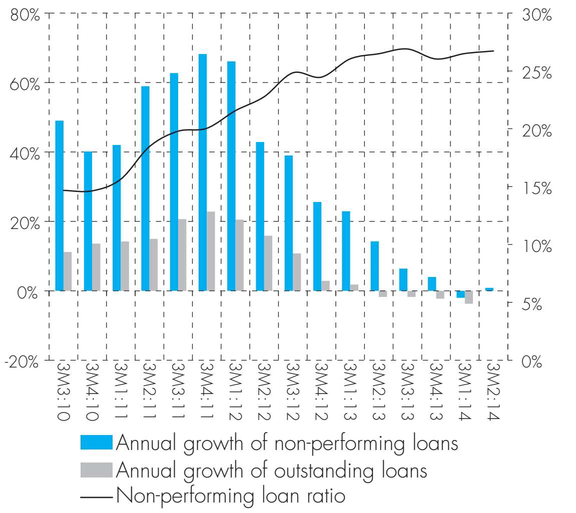
The quality of the business loan portfolio worsened slightly from end-2013. In June 2014, the non-performing loan ratio was 26.72%, from 26.03% in December 2013 and 26.49% in June 2013.

*[13] Businesses' financial position is measured as the difference between business deposits and loans in the Albanian financial system (which includes all bank and non-bank financial institutions in Albania). If the difference is negative, businesses are debtors to the system.*

Chart 4.7 Distribution of lending to businesses, annual growth


Source: Bank of Albania .

Chart 4.8 Business loan portfolio quality

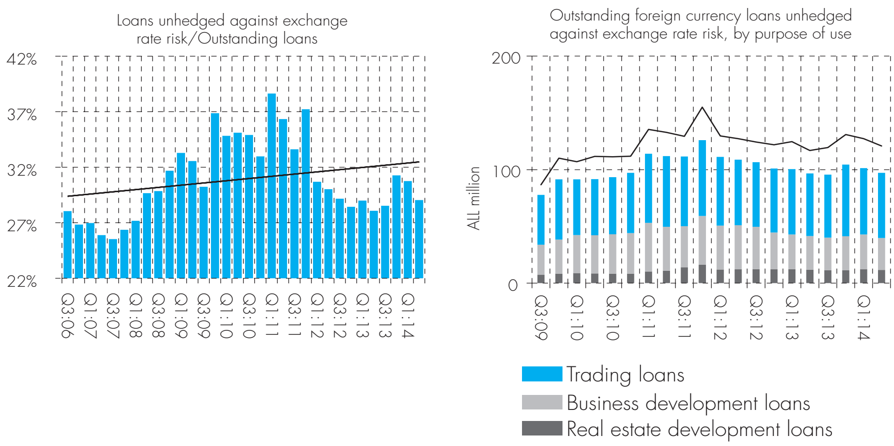



Source: Bank of Albania.

## 4.2.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

During 2014 Q2, business exposure to exchange rate movements lowered, unlike the uptrend in the previous quarters. In June 2014, business outstanding foreign currency loans unhedged against exchange rate risk decreased to 29.1% of total business loans, from 31.3% in December 2013 (see Chart 4.9, left). The share of foreign currency loans in total business loans fell to 64.8%, from 65.6% at end-2013.

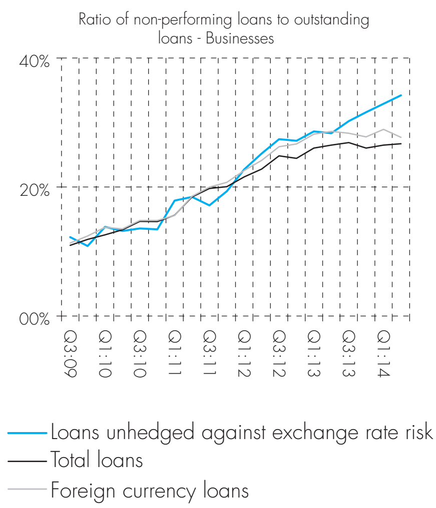
Chart 4.9 Business exposure to indirect credit risk arising from the exchange rate

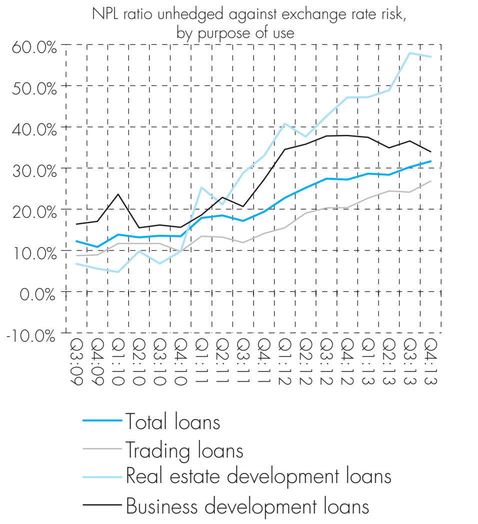



Source: Bank of Albania.

The structure of business loans unhedged against exchange rate risk showed the decline in 'Trade loans' to 47.6%, while 'Business development loans' and 'Real estate development loans' accounted for 23.3% and 9.7%, respectively (see Chart 4.9, right). The quality of this portfolio worsened to 34.2%, from 31.6% at end-2013 and 28.4% at end-June 2013 (see Chart 4.10, left). The worsened quality in this portfolio remained sharper in 'Real estate development loans', with the non-performing loan ratio accounting for 56.8%. On the other hand, the share of non-performing foreign currency loans improved to 27.71% in June 2014, from 27.78% in December 2013 and 28.64% in June 2013.

Chart 4.10 Business loan portfolio quality




Source: Bank of Albania.

*BOX 4 SURVEY ON HOUSEHOLDS AND BUSINESSES' FINANCIAL SITUATION AND BORROWING*

*For an elaborate assessment of Albanian households and businesses' financial situation and borrowing, the Bank of Albania, besides other analyses, carries out a semi-annual survey. The last survey was carried out in May-June 2014 and focused on developments during 2014 H1, whereas the expectations refer to 2014 H2.*

*1. SURVEY RESULTS OF HOUSEHOLDS' FINANCIAL SITUATION AND BORROWING*

*The survey is based on a sample of 2010 households across 16 districts of Albania, with 90% of interviewed households responding.*

- *Financial situation*

*The number of income-earning members fell 4% from December 2013 and June 2013. 'Self-employment' (27%), 'Retirement' (26%) and 'private sector employment' (25%) have the main share in total income. The share of employed persons in the 'Public sector' (10%) fell, whereas the share of 'Remittances' as a source of income remained unchanged at 5%. Broken down by income level, households continued to show a downward trend in the share of households at extreme income levels (upper or lower) and concentration around the average or below-average level.*

- Borrowing

The total number of households stating that they have a loan or more to repay, regardless of the type, source, or value, was 311 or around 29% of respondents (around 26% of the sample), down by 22 households from the previous survey. Around 55% of borrowing households belong to the 'ALL 17-50 thousand' monthly income range, down from the previous survey and below the average. Around 40% of borrowing households had borrowed from formal sources (banks and other non-bank financial institutions) and 60% from informal sources (natural persons and stores). 'Purchasing/renovating a property' (34%) and 'Consumption' (32%) remained the top two purposes for borrowing. The share of borrowing for 'Purchasing/ renovating a property' did not change from the previous survey, whereas the share of borrowing for 'Consumption' purposes fell 5 percentage points after an uptrend in the past two years.

- Household solvency

The net balance of responses on household solvency during the period was -12.5%, indicating the worsening of household solvency, though at a slower pace than in the previous survey. Of households reporting 'Worsened solvency', 48% attributed it to 'Lower income', while 38% to 'Higher living costs'. Concerning the expectations for solvency in the next six months, the net balance of responses was +1%, indicating a gradual tendency towards improvement.

## 2. SURVEY RESULTS OF BUSINESSES' FINANCIAL SITUATION AND BORROWING

The survey is based on a sample of 707 enterprises extended across Albania and the main sectors of the economy.

- Financial situation

Businesses reported lower sales in 2014 H1, which was associated with lower profit, though at a more moderate pace than in 2013 H1. Despite reporting lower sales, businesses continued to show significant reliance on sales to fund their activity. Relative to end-2013, there was an increased use of sales as the sole source of business activity funding, particularly in the industry sector. In addition, a considerable number of enterprises have combined sales with borrowing from banks to fund their activities.

- Borrowing

Around 53.6% of respondent enterprises (or 49.1% of the total sample of 347 enterprises) stated that they had a loan to repay, down 5.2 percentage points in semi-annual terms. Enterprises reported greater use of borrowing to make an investment than to afford current expenses. By sector, this tendency was shown in industry and services sectors. Euro-denominated loans dominated lending to enterprises. Around 70% of borrowing enterprises reported that they had borrowed in the last five years (22.9% during the past year), while 71.4% of them reported that they will repay the loan over the next five years. The share of enterprises having pledged real estate as collateral was 74.6%, 3 percentage points above the long-term average. In the industry sector, enterprises reporting a collateral value ranging 50-100% of the loan value have the main share. In the services sector and construction sectors, enterprises reporting a collateral value up to 50% and above 120%, respectively, accounted for the major share. For 86.7% of enterprises, the loan value did not exceed the firm's capital. For 68.8% of enterprises, the loan repayment accounted for up to 20% of their total income, and for 23.1% of them, it accounted for 20-50% of total income. The enterprises reporting a change in the loan repayment *amount indicated an increase in the payment value, though at a more moderate rate than in the previous periods. For the next period, the enterprises expect the loan instalment amount to fall.*

- *Relations with banks*

*Enterprises consider that relations with banks are indispensable and important, whereas the borrowing process is considered to range between normal and difficult. Under enterprises' view, borrowing from banks remained expensive. For the next period, 85% of enterprises do not plan any potential borrowing.*

# 5. FINANCIAL MARKETS

*The Albanian financial markets showed a stable performance in 2014 H1, characterised by low interest rates. Bank of Albania's stimulus saw greater impact on the primary securities' market, deposit interest rates and the interbank market. The exchange rate was stable and the Albanian lek appreciated slightly against the two major currencies.*

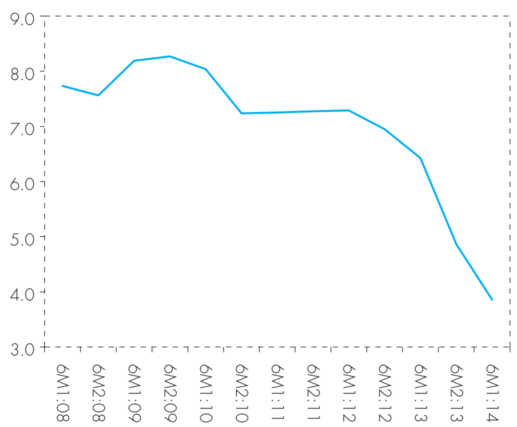
During 2014 H1, the Government reduced the domestic debt financing by around 26% in annual terms. The volume of issued debt securities amounted to ALL 220.2 billion, with 84.6% being issued in T-bills. The structure of issues saw a shift towards longer maturities.

## 5.1 PRIMARY MARKET FOR DEBT SECURITIES

The yields in the primary market auctions of Government debt securities dropped significantly across all maturities, reflecting the continuous key interest rate cut.[14] As a result, the average yield on debt securities issued during 2014 H1 fell to 3.9%, from 4.9% in 2013 H2.

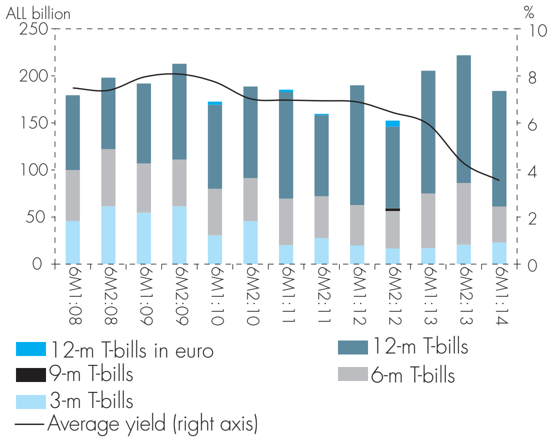
During 2014 H1, the Government issued ALL 187 billion in T-bill auctions, from ALL 220 billion in 2013 H2 and ALL 205 billion in 2013 H1. Bidders' interest in auctions remained higher for the 12-month T-bills, accounting for

Chart 5.1 Average yield on debt securities, in percent




Source: Bank of Albania.

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

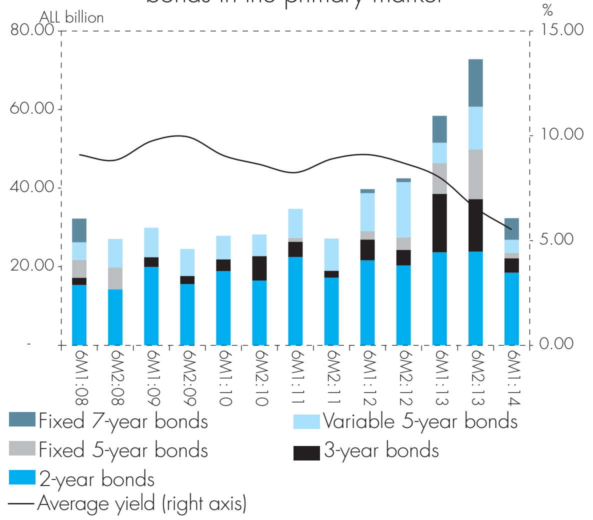



Note: The volume of 12-month T-bills also includes the issues in euro.
Source: Bank of Albania.

[14] *The Bank of Albania cut the key interest rate by 0.25 percentage points in May 2014, to a record low of 2.5%.*

65.8% in total T-bills. Market depth indicators (bid-to-cover ratio) showed less preference for 6-month T-bills. In several cases, the ask amount was not met in auctions. At the end of 2014 H1, the T-bill yield averaged 3.6%, down 0.7 percentage points from end-2013 and 2.4 percentage points from June 2013. The average yield on T-bills has maintained a downward trend since 2009 H2.

Chart 5.3 Volume and weighted average yield on bonds in the primary market

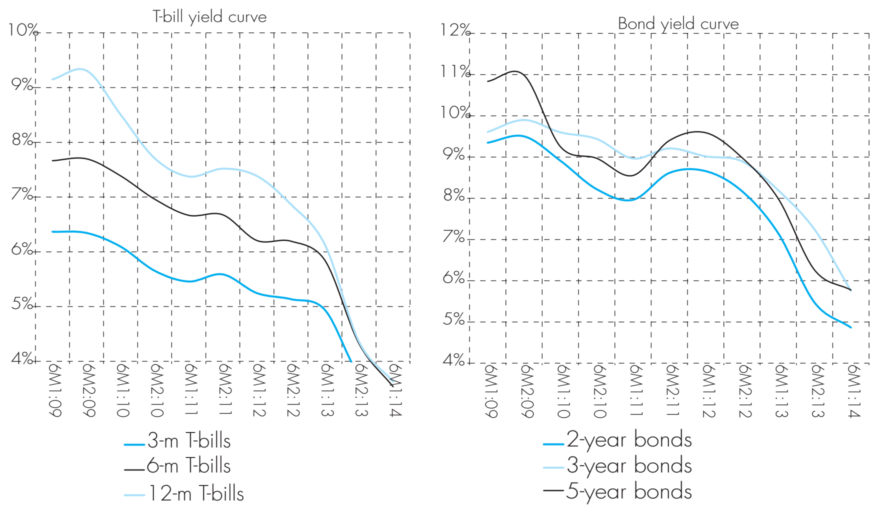



Source: Bank of Albania.

Issues of Government debt bonds fell to ALL 33.8 billion, from ALL 75.3 billion in 2013 H2, down 45% y-o-y. Issues of 2-year bonds fell slightly, whereas 5-year bonds made major contribution to the general decline in bonds, with the fixed and variable-rate bonds falling by around ALL 19 billion. The stable demand for 2-year bonds contributed to lowering the ask yield on bonds. It averaged 5.5% in 2014 H1, down 1 percentage points from end-2013 and 2.5 percentage points from 2013 H1. Despite the bidders asking smaller-than-announced amounts for longer maturities (particularly during the second half of the period), the bond yield has, by and large, been on a downward trend in the last two years.

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

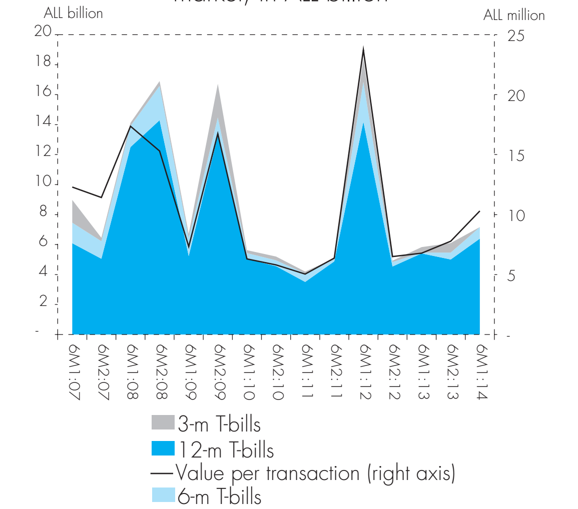
Chart 5.4 Average yield on debt securities in the primary market




Source: Bank of Albania.

## 5.2 SECONDARY MARKET FOR DEBT SECURITIES

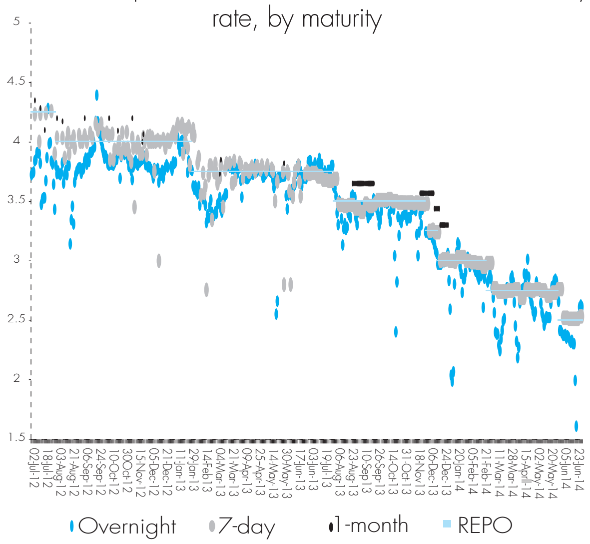
Chart 5.5 Trading volume of T-bills in the secondary market, in ALL billion




Source: Bank of Albania.

The volume of T-bill transactions grew to ALL 7.16 billion, or 17% from the previous period. The secondary market continued to operate smoothly, without displaying any structural changes. The number of transactions decreased slightly (by 89 transactions) during this period. T-bills of 12-month maturity accounted for 89% of the trading volume, whereas 3-month T-bills fell significantly to around ALL 7 million, from ALL 637 million.

Chart 5.6 Spread between interbank rates and the key rate, by maturity




Source: Bank of Albania.

## 5.3 INTERBANK MARKET

Interbank market transactions increased during 2014 H1. At the end of the period, the volume of transactions amounted to ALL 1,485 billion, almost three times higher than in 2013 H2. Banks showed preference for overnight and one-week borrowing, whereas one-month maturity was employed scarcely and at a low volume. Interbank market rates continued to show a downward trend, standing below the key interest rate.[15] At the end of 2014 H1, the weighted average interest rate in the interbank market was 2.36%, from 3.06% at end-2013.

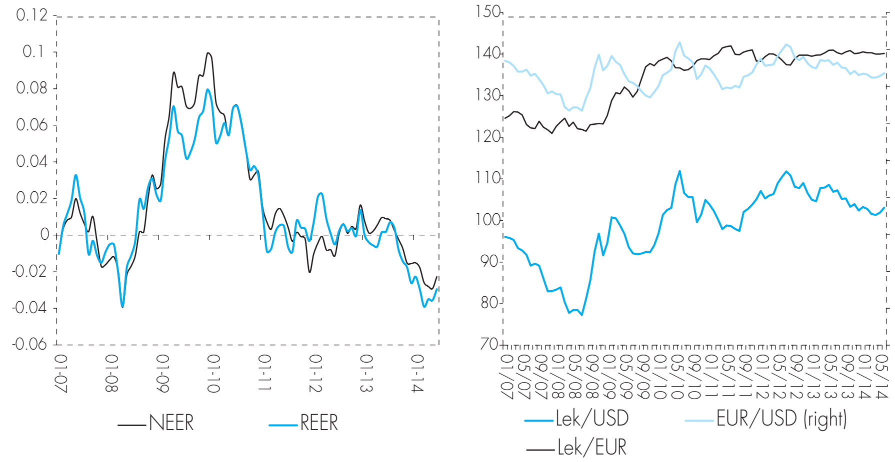
## 5.4 FOREIGN EXCHANGE MARKET

The exchange rate was stable and displayed no significant fluctuations during 2014 H1. The Albanian lek appreciated slightly against the euro, reflecting the seasonal effect, which was absent in June last year due to parliamentary elections. The U.S. dollar depreciated against the lek, reflecting mostly the euro/U.S. dollar trajectory in the international markets.

In annual terms, the Albanian lek appreciated around 0.6% against the Euro and around 3.6% against the U.S. dollar. During 2014 H1, lek/euro exchange rate averaged 140.1, down negligibly from the previous period. Lek/U.S. dollar exchange rate averaged 103.1, from 102.4 in 2013 H2.

15 *The easing monetary policy operations continued during 2014 H1, lowering the repo rate to 2.5% at end-May 2014.*

Chart 5.7 Annual change in NEER and REER, and the exchange rate in the domestic foreign exchange market




Source: Bank of Albania.

During 2014 H1, the Nominal Effective Exchange Rate (NEER[16]) continued the appreciation trend begun since September 2013, appreciating by 2.3%, on average, in annual terms. In annual real terms, the Albanian lek appreciated by 3.2%.

## 5.5 HOUSING MARKET

The real estate market saw the downward trend in the House Price Index and the increase in the Rental Price Index. Real estate loans decreased despite the higher demand and easier lending standards applied to this type of loans.[17] The real estate loan portfolio quality worsened and the relative cost of real estate purchase fell.

In June 2014, the House and Rental Price Indices[18] showed opposite annual performance. House Price Index fell around 1% in annual terms, whereas the Rental Price Index rose 11%. Price-to-rent ratio stood at 2, falling slightly from 2.2 in 2013 H1.

The downward housing market performance is also confirmed by the "Real estate market survey" results (see Box 5.1) and the decline in outstanding loans for real estate purchase by 9.6% from 2013 H1. Mortgage loans fell despite the weighted interest rate on this type of loans falling by almost 1 percentage point and the relative repayment cost[19] of real estate loans decreasing by around 3.2 percentage points, in annual terms.

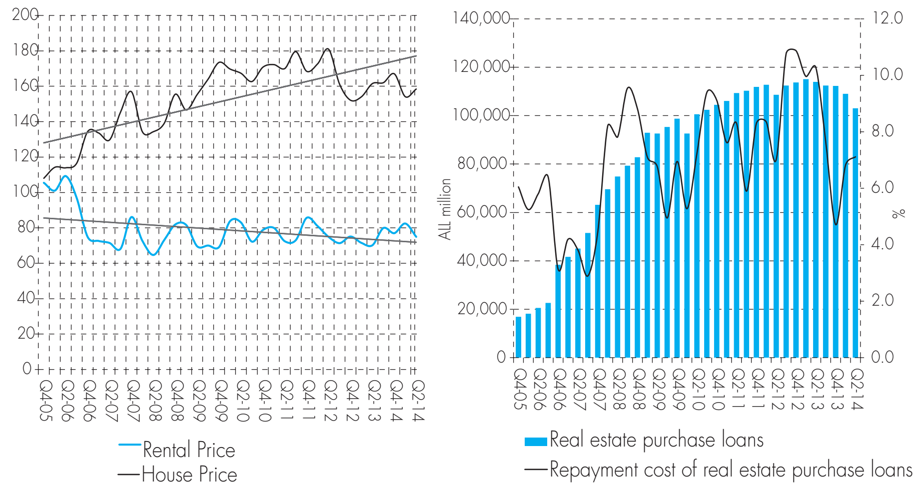
[16] *NEER (Nominal Effective Exchange Rate) is measured against the currencies of Albania's five main trading partners: Italy, Greece, Germany, Turkey and China. An increase in NEER implies lek's depreciation.*

[17] *Bank Lending Survey, 2014 Q2, Bank of Albania.*

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

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

Chart 5.8 Housing market developments




Source: Bank of Albania.

At the end of June 2014, the real estate loan portfolio quality worsened on a year earlier to 14%, up around 0.4 percentage points from 2013 H1. Nevertheless, its quality remained better than the total loan portfolio quality due to the form of collateral, which imposes cautious banking sector and borrower's behaviour.

*BOX 5.1 REAL ESTATE MARKET SURVEY*

*Real estate makes up a significant part of collateral for banks in Albania and an important form of investment for agents in the economy. Given the importance of this market segment, the Bank of Albania, in cooperation with INSTAT, has carried out a survey with real estate agencies and construction investors on a national level. The real estate market survey has been carried out at quarterly, starting from 2013 Q1. Its main purpose is to assess the real estate market performance in Albania and process data relating to house and commercial property prices. This survey extends further the information obtained from the House and Rental Price Indices, which cover only Tirana. It provides additional information on the real estate market and commercial property developments across the country. It also collects agents' assessment of the current and expected situation in this market.*

*For 2014 Q1, the net balance of responses showed worsened performance of the real estate market. However, the negative net balance narrowed to 34%, from 50% in 2013 Q1.*

*Concerning the house prices, Fisher's House Price Index, on a national level, pointed to their fall by 1.8% from end-2013 and 16.8% from 2013 Q1. The survey indicates a negative net balance for 2014 Q2 as well, reflecting further fall in house prices. The negative net balance, however, appeared more moderate than at end-2013. In addition, there are more optimistic expectations for seaside and commercial property prices.*

*Concerning the sale of properties, 67% of respondents reported the lack of house sales, the peak since the beginning of this survey. The same ratio was 51% in* *the corresponding period in 2013. The situation appeared worse in commercial property sales, with the majority of respondents (92%) reporting the lack of sales during this quarter.*

*The respondents expect the overall situation in the real estate market to be more positive in 2014 Q3. The agents remain sceptical about Tirana, though less pessimistic than before. In a longer term perspective, they appear optimistic, reporting improved expectations and a positive net balance.*

# 6. PAYMENT SYSTEM DEVELOPMENTS

Interbank transactions in the Albanian lek were settled efficiently and safely, in accordance with all the rules and procedures of the two systems managed by the Bank of Albania. In February 2014, the Bank of Albania upgraded the two systems in order to enhance the financial infrastructure safety and stability.

During 2014 H1, transactions in the Albanian Interbank Payment System, AIPS, grew 1.15% in volume, and 11% in value, from the corresponding period in 2013.

*Table 6.1 AIPS*

| AIPS | 2010 | 2011 | 2012 | 2013 | 2014* |
|---|---|---|---|---|---|
| Number of transactions | 80,356 | 75,269 | 77,090 | 86,365 | 41,317 |
| Value of transactions (in ALL billion) | 4,436.66 | 4,085.06 | 6,743.43 | 6,871.61 | 3,533.42 |
| Average value per transaction (in ALL million) | 55.21 | 54.27 | 87.47 | 79.56 | 85.51 |

*Source: Bank of Albania.*
**January-June*

Intraday Liquidity Facility (ILF) recorded an annual increase in value and number, by 71% and 50%, respectively. Despite the increased use of this liquidity facility in absolute terms, the coverage ratio of AIPS transactions with ILFs pointed to its decline, reflecting stable liquidity situation.

*Table 6.2 AIPS*

| AIPS | 2010 | 2011 | 2012 | 2013 | 2014* |
|---|---|---|---|---|---|
| Number of ILF | 278 | 200 | 270 | 264 | 193 |
| Value of ILF (in ALL billion) | 74.99 | 84.39 | 90.80 | 252.53 | 257.87 |
| Average value per transaction (in ALL million) | 269.75 | 421.95 | 336.30 | 956.55 | 133.6 |

*Source: Bank of Albania.*
**January-June*

Transactions in the Albanian Electronic Clearing House system, AECH, continued to show an upward annual trend in value and number, by 13.5% and 20%, respectively.

*Table 6.3 AECH system*

| | 2010 | 2011 | 2012 | 2013 | 2014* |
|---|---|---|---|---|---|
| Number of transactions | 332,777 | 388,208 | 361,552 | 363,507 | 195,985 |
| Value of transactions (in ALL billion) | 43.98 | 64.10 | 66.99 | 72,767.50 | 37,477.45 |
| Average value per transaction (in ALL million) | 0.13 | 0.17 | 0.19 | 0.20 | 19.12 |

*Source: Bank of Albania.*
**January-June*

# 7. FINANCIAL SYSTEM

## 7.1 FINANCIAL SYSTEM STRUCTURE

The value of Albanian financial system assets increased in 2014 H1. The direct risk of transmission to the banking sector of risks from other financial system segments was assessed as limited. Moreover, concentration of exposures of some financial system segments to the banking sector remained high, increasing their sensitivity to the performance of the latter.

In June 2014, financial intermediation in Albania, estimated as the ratio of financial system assets[20] to GDP[21], was 99.3%, close to the end-2013 level. The banking sector accounts for 90.3% of financial system assets. In this context, identifying and assessing risks from the banking sector activity is highly important for assessing the financial stability framework.

*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 | June 2014 |
|---|---|---|---|---|---|---|---|---|
| Bank of Albania | Banking Sector | 76.7 | 77.5 | 80.9 | 84.7 | 89.6 | 90.5 | 89.6 |
| | Non-bank institutions | 1.7 | 2.2 | 2.7 | 2.5 | 2.7 | 2.5 | 2.6 |
| | SLAs and their Unions | 0.7 | 0.8 | 0.8 | 0.7 | 0.8 | 0.8 | 0.7 |
| Albanian Financial Supervisory Authority | Insurance companies | 1.4 | 1.5 | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 |
| | Pension funds | - | 0.01 | 0.01 | 0.01 | 0.02 | 0.03 | 0.04 |
| | Investment funds | | | | | 1.21 | 3.7 | 4.7 |

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

As at end-June 2014, banking sector exposure to other segments of the financial system in Albania accounted for about 1% of assets' value, or 7% of capital. This exposure was mainly in the form of loans and participation in capital in non-bank financial institutions on the assets side, and in the form of funds collected by them (various accounts) on the liabilities side. The low exposures to non-bank financial segments limited the direct financial risk that may be passed through from cross-sectorial relations. However, there were also non-financial risks posing an indefinite indirect risk, whose effect was difficult to measure.

[20] *The financial system consists of banks, non-bank financial institutions, savings and loan associations, insurance companies, private supplementary pension funds and investment funds. When analysing this chapter, please consider that only banking and investment fund activities are based on the data of June 2014; Insurance companies are analysed based on the data of the first quarter of 2014, made available by the Albanian Financial Supervisory Authority.*

[21] *ALL 1,398,140.87 million of GDP refers to Bank of Albania's estimates based on annual economic growth figures, as published by the INSTAT and IMF.*

Exposures of non-bank financial segments to banking sector were considerable in their activity, thus increasing their sensitivity to the latter's performance. At end- June 2014, insurance companies, savings and loans associations (SLAs) and non-bank financial institutions (NBFIs) were more significantly exposed to the banking sector. Thus, insurance companies' deposits in the banking sector accounted for about 39% of their assets. Likewise, SLAs and NBFIs investments in the banking sector accounted for 17% and 10%, respectively, of their assets.

## *BOX 7.1 NON-BANK FINANCIAL SECTOR*

*Non-Bank Financial Institutions expanded their activity driven by increased lending. Financial result was positive and capitalisation adequate. However, these institutions' asset quality continued falling. Savings and loan associations decreased the financial loss and considerably increased the capitalisation level. Insurance companies expanded their activity due to a higher number of concluded contracts and gross written premiums. Also, private supplementary pension companies and investment funds performed positively and their assets increased.*

Non-Bank Financial Institutions. They increased their activity, by 6.6% y-o-y. As at end 2014 Q2, total assets accounted for ALL 36.6 billion, with an annual improvement of about ALL 2.3 billion. In annual terms, lending grew by 0.94%, standing at ALL 19.7 billion, while capitalisation improved by 4.8 percentage points, standing at 44.6%. Credit risk remained the main risk to non-bank financial institutions' activity. The ratio of "non-performing loans to total loans" stood at 15%, from 13.2% as at end-2013. However, the net profit amounted to ALL 0.6 billion, due to the fall in the operational expenses.

*Table 7.2 Financial indicators of non-bank financial institutions' activity*

| (ALL billion) | 06- 2012 | 12-2012 | 06-2013 | 12-2013 | 06-2014 |
|---|---|---|---|---|---|
| Total assets | 33.771 | 35.348 | 34.363 | 35.030 | 36.626 |
| Loan portfolio | 20.297 | 20.040 | 19.502 | 19.646 | 19.685 |
| Non-performing loan ratio, % | 8.9 | 8.3 | 14.1 | 13.2 | 15.1 |
| Capital adequacy, % | 38.9 | 38.9 | 39.8 | 40.9 | 44.6 |
| Profit | 0.742 | 1.244 | 0.520 | 1.502 | 0.576 |

*Source: Bank of Albania.*

Savings and Loan Associations. Their activity was characterised by a slight increase in assets. The quality of the lending portfolio continued to deteriorate, to 13%, from 11% a year earlier. The "Provisions to non-performing loans" ratio stood at 67%. After the process of writing off bad loans, provisioning expenses decreased, hence narrowing the negative financial result.

*Table 7.3 Selected indicators of SLAs and their unions*

| (ALL Billion) | 06- 2012 | 12-2012 | 06-2013 | 12-2013 | 06-2014 |
|---|---|---|---|---|---|
| Total assets | 9.900 | 10.600 | 10.289 | 9.752 | 9.831 |
| Outstanding loans | 7.260 | 7.120 | 6.772 | 6.391 | 6.317 |
| Outstanding loans/total assets ,% | 73.3 | 67.4 | 65.8 | 65.5 | 64.3 |
| Non-performing loans/outstanding loans, % | 5.4 | 6.4 | 11.1 | 12.0 | 12.9 |
| Profit | -0.04 | -0.04 | -0.19 | -0.23 | -0.05 |

*Source: Bank of Albania.*

Insurance companies. At end-June 2014, there were 12 licensed insurance companies. At end-March 2014 insurance companies' assets were ALL 22.8 billion, with an annual growth of 6.4%. Insurance liabilities (or technical provisions) grew by 56.7%, y-o -y, to ALL 2.4 billion, while total capital grew by 3.2%, to ALL 10.2 billion. The share of insurance company assets in total financial assets has remained unchanged during the last years, to around 1.6%. Gross written premiums* - the main indicator of insurance company activity - fell by 34.6%, y-o-y, to ALL 5.3 billion. The indicator of insurance penetration in the market - the ratio of premiums to GDP - was 0.38%.

Loss indicator measured as the ratio of paid claims to gross written premiums, improved to 24.8%. This ratio shows that around 1/4 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. The indicator of gross paid claims fell by about 2.4% to ALL 1.32 billion, from 8.9% a year earlier. Investment portfolio of the insurance sector toward low risk assets provides for maintaining a low risk level for investments. As at end-2014 Q1, investments were mainly in the form of time deposits at commercial banks (about ALL 4.03 billion) and Albanian government treasury bills (about ALL 1.41 billion). Exposure of insurance companies to sovereign debt accounted for 6.2% of total assets.

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. Exposure of insurance companies to liquidity risk is relatively low, given that their premium incomes are evenly distributed in time and claim payments are occasional.

Due to limited size of the sector, good liquidity situation and conservative structure of investments, eventual risks to insurance companies remain subdued. However, the risk level increases, if we consider their role in bank collateral insurance and the possibility of facing compulsory payment in the event of damage arising from a Force Majeure.

Investment fund highlights** At end-June 2014, two investment funds operated in Albania, with a net value of assets around ALL 65.1 billion, up by 29% from end-2013 and 122%, y-o-y. Their investments are denominated by those in Government debt securities, accounting for 80% of funds' assets and have considerably increased since their foundation. This considerable exposure increases the need to evaluate and address risks related to the fiscal performance of the Government on the one side, and the flexibility in this portfolio management according to the needs of funds, on the other. Currently, investment funds' assets account for 4.7% of GDP, from 2.2% a year earlier.

Private supplementary pensions' highlights*** According to the latest published data, three private supplementary funds operate in Albania. Data analysis shows that pension funds' activity increased by 51.5%, compared to a year earlier - at an assets level of ALL 535.9 million. Though the number of their members increased by 8%, y-o-y, pension funds continue to have a low share in Albania's GDP and in total financial system assets.

* *AFSA, Statistics, January-July 2014 "Insurance Market: January-June 2014", published on 25 July 2014*

** *Published by AFSA, 30 June 2014.*

*** *AFSA "Developments in the private supplementary pensions", 31 July 2014".*

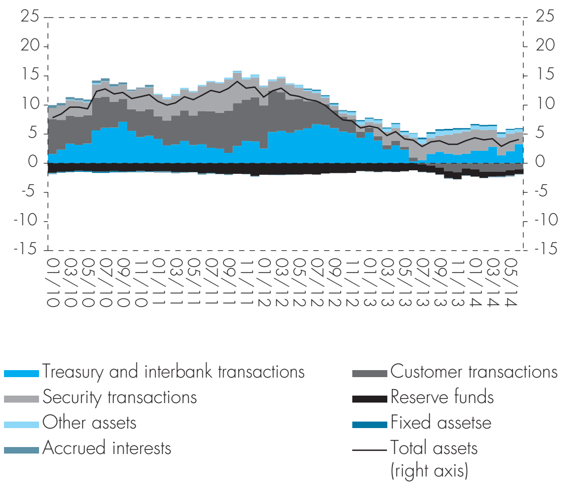
## 7.2 BANKING SECTOR

In 2014 H1, banking sector expanded even further its activity. Overall, it remained liquid, well capitalised and capable to withstand various shocks. Notwithstanding the good liquidity and capital situation, lending remained weak given the slow economic growth and the problems in portfolio quality. Some preliminary indicators reflected a relative expected improvement in the demand for loans.

### 7.2.1 BANKING ACTIVITY

As at end-June 2014, banking sector assets increased to ALL 1,253 billion, expanding by 4.1% during the last year. Assets' behaviour continued to be negatively influenced by the shrinking lending, due to the unstable demand for loans and the sale of non-performing loan portfolio by banks. For that reason, banks preferred to expand the activity towards other instruments in the domestic and foreign markets, particularly towards the money and securities market (see Chart 7.4)

Chart 7.4 Contribution to annual asset growth, in percentage points




Source: Bank of Albania.

During the period, "Treasury and interbank transactions" grew by 3%, to ALL 412 billion. Banks investments in securities were up ALL 10.7 billion, amounting to ALL 313 billion. Banking sector investment in Government debt securities accounted for around 25% of total bank assets, up around 1% during the period. They also accounted for 60% of debt issued by the Government.

The size and concentration of Government debt securities portfolio owned by banks represented a potential risk source: a) for banks in case of Government solvency incapacity, and b) for the Government in case of banks inability to renovate the investment in securities. Currently, this risk is assessed as downward, given that: 1) Government's solvency improved due to the consolidated fiscal policy and the agreements with the IMF providing alternative income in foreign currency; and 2) banks are in good liquidity and capital conditions, and do not currently prefer other forms of investment.

The banking activity continued to be entirely financed by deposits, which accounted for about 82% of total assets. Deposits' expansion slowed down, recording an annual growth rate of 3%, driven by the higher return demand from investments of banking products abroad, and the performance of businesses' accounts impacted by the payment of Government arrears. Household deposits, which accounted for about 87.5% of total deposits, grew at a lower annualised rate of 2%, from the 4.9% growth a year earlier. Businesses' deposits grew by about 9.8%, from 8% a year earlier.

By currency, banking sector assets denominated in foreign currency increased to ALL 707 billion, expanding by 5% in annual terms. Foreign currency loans shared 55% of assets denominated in foreign currency. Banking sector liabilities denominated in foreign currency amounted ALL 657 billion, up by 5.4% during the last year. Foreign currency deposits accounted for 80% of liabilities denominated in foreign currency.

Banks maintained the capital use ratio to finance their operations, and complied with the regulatory capital requirements.

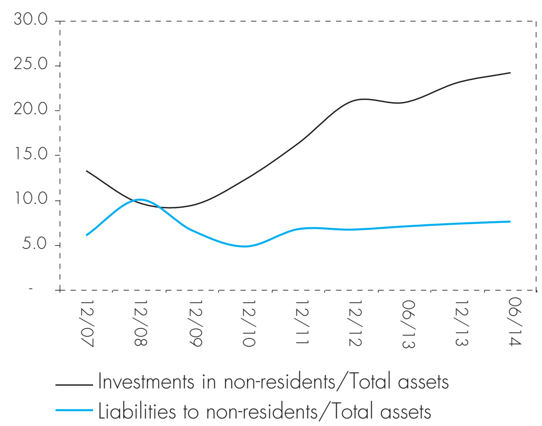
### 7.2.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

Net position of banking sector to non-residents remained considerably on the crediting side, and continued to increase during the period, albeit at a low pace. Borrowing from parent banking groups fell.

As of end-June 2014, assets held with non-residents accounted for 24% of total assets and are estimated at ALL 304 billion. Banking sector liabilities to non-residents accounted for 7.6% of total assets, estimated at ALL 95.7 billion. Net lending position of banking sector to non-residents expanded by 25% in annual terms and 7.2% from 2013 H2, up to ALL 208 billion.

The countercyclical measures[22] taken by the Bank of Albania in May 2013 contributed to slower increase in banking sector investments in non-resident assets. Their average annual growth fell to 16%, from 22% in 2013 and 53.5% in 2012. The major part of liabilities consisted in liabilities to parent banking groups, mainly in the form of lines of credit. The used part of lines of credit fell by 61.5% in semi-annual terms, and 71.5% in annual terms, down to ALL 2.9 billion.

Chart 7.5 Banking sector position to non-residents, in per cent




Source: Bank of Albania.

*Table 7.4 Commitments received from parent banks and other group banks*

| In ALL million | Total line of credit | Used line of credit | Unused line of credit |
|---|---|---|---|
| June 2014 | 35,310.1 | 2,870.4 | 32,439.7 |
| 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.*

[22] *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 7.2 BANKING SECTOR EXPOSURE TO NON-RESIDENT INSTITUTIONS*

*Asset of non-residents' placements. As of end- 2014 H1, 69.6% of placements at non-resident institutions in assets were in the form of time deposits, slightly down from end -2013. Placements in EUR amounted 74.1% and US dollar amounted 20.3%. Placements with non-residents in assets continued to be mainly concentrated in the euro area, accounting for 73.5%. By banking groups, 75.5% of placements to non-residents in assets belongs to G3, 21.3% to G2 and the rest of 3.2% to G1. By origin, Greek group placements shared 19.6%, Italian group placements shared 16.2%, French group placements shared 6.7% and the Albanian group placements shared 9.6%.*

*Liability of non-residents' placements: Placements on the liability side were mainly in the form of loans, where time loans borrowed by banks accounted for 65.5%. 78.2% of placements on the liability side were denominated in euro. Liabilities to euro area countries accounted for 68.3% of total non-resident placements on the liability side. By banking groups, G3 shared 69.7% of total liabilities to non-resident institutions, G2 shared 16.2% and G1 shared 14.1% of them. The main part of total placements to non-residents on the liability side consists in the Greek group placements accounting for 49.4%, followed by the Albanian group placements 17.6%, and the Italian group 14.1%.*

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

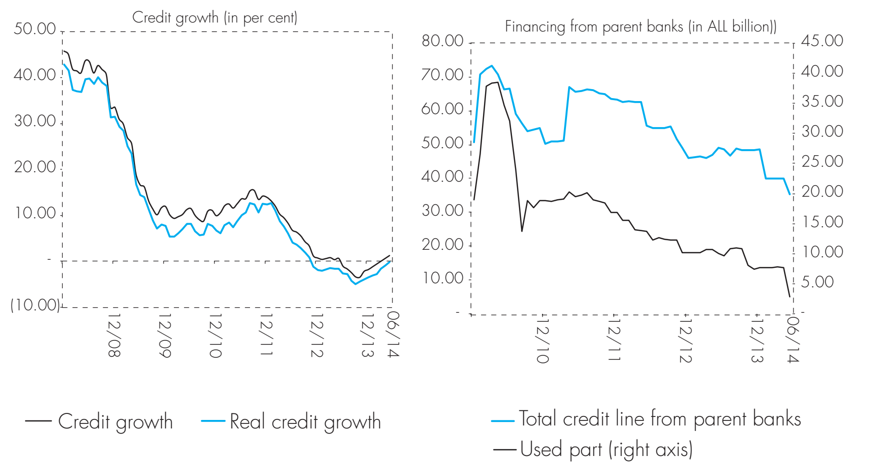
## *BOX 7.3 BANKS' BALANCE-SHEETS – CREDIT GROWTH*

*Credit growth in Albania slowed down considerably in 2013 and shrunk in the first half of 2014. Both supply-side and demand-side factors impacted this performance. Changes in parent bank policies, the weakening of banks' balance sheets at home and the application of tightened lending standards were the factors that contributed to the shrinkage of the credit supply. In parallel, the market agents' credit demand fell down, given the weak perspectives of economic activity and high uncertainties.*

*Since the end of 2008, credit growth pace has slowed down, slipping to negative territory in 2013 H2. Credit growth dropped to 11% in 2009 - 2012, from 45% in 2006 - 2009, and decreased averagely to –0.9% in 2013. Credit growth was estimated averaging -0.2% in 2014 H1.*

*Credit fall was accompanied by an increase in investments in liquid assets and improvement of banking sector liquidity situation, given the continuing increase of deposits and reduction of financing by parent banking groups. Liquid assets increased, in the form of investments in non-resident entities' products, and in the Albanian Government's debt securities. Investments in non-resident entities' products increased faster in 2011-2012. In this period, the banking sector recorded the fasted growth in foreign currency deposits, also because of the inflows due to the Greek crisis. Afterwards, these flows performed normally.*

Chart 7.6 Credit growth (left) and financing from parent banks (right)

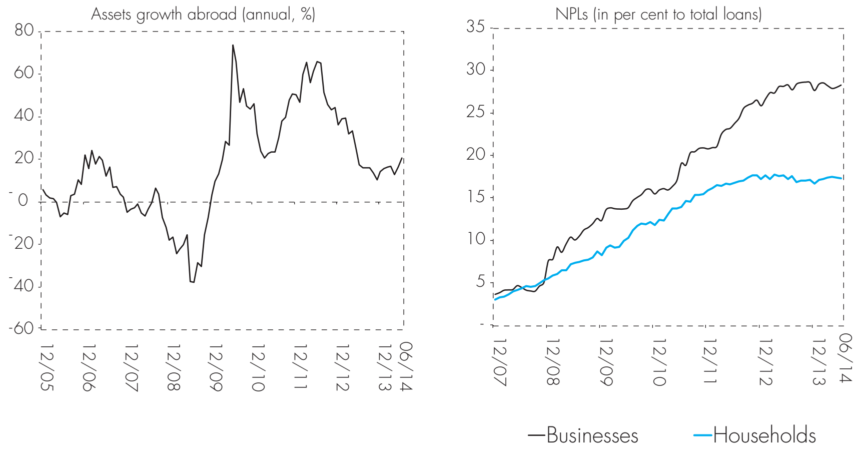



Source: Bank of Albania.

*At the same time, the tightening of lending standards, partially imposed by the regulatory changes at European level, and partially from the increase of bad loans in banks' balance sheets, further reinforced the slowing trend of lending.*

*The impact of supply-side factors on lending increased due to the weak performance of credit demand, mainly from business and households. The slowdown of economic growth was accompanied by the worsening of private sector's balance sheets and the increased uncertainty surrounding the outlook of the economy. The savings tendency of households was manifested in the form of deposits' increase and fall of consumption.*

Chart 7.7 Assets growth abroad and non-performing loans ratio




*The accommodative monetary policy, along with a set of legal and structural measures to address non-performing loans applied during 2013-2014, aimed to address the problems related to both supply and demand for credit. As a result, the increasing trend of non-performing loans stopped, and interest rates on loans trended down. Considering the needed time for the transmission of these policies to economy, they are expected to help establish a more favourable climate for the lending activity during the current year.*

## 7.2.3 OUTSTANDING LOANS

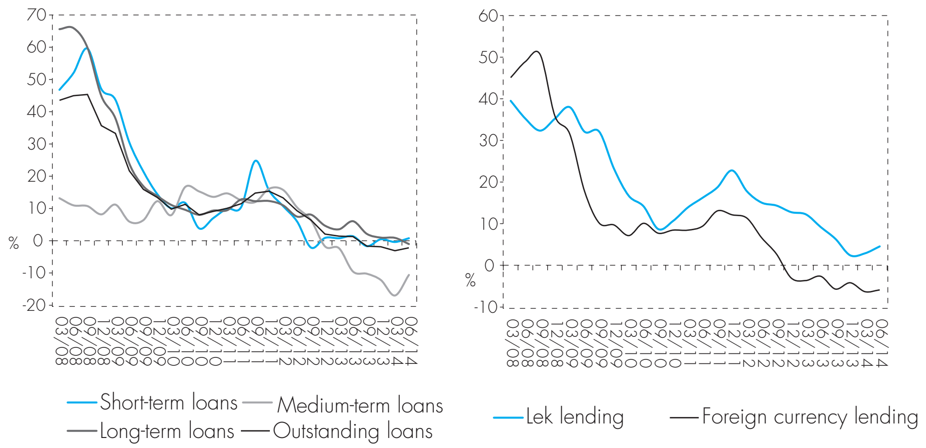
Bank lending continued to shrink in 2014 H1 driven by the fall in lending to businesses and foreign currency lending. Credit growth improved in the second part of the period, due to developments in lek lending and the continuing fall in the interest rate applied to this loan.

In June 2014, bank lending amounted to ALL 566.5 billion, down 0.12%, from end-2013, and 2.2%, from a year earlier. By maturity, short-term loans increased in annual terms by 0.8%, while medium and long-term loans decreased by 10.6% and 1%, respectively. By currency, foreign currency lending fell by 5.9% compared to a year earlier, whereas lek lending grew by 4.6% and its share in the loan portfolio climbed to 38%. Foreign currency lending fell by around 1.6%, whereas lek lending grew by 2.3%, from end-2013.

Lending to businesses, which accounted for 69% of total lending, contracted slightly by 0.4%[23] compared to end-2013, and 3% compared to June 2013. Lending to households increased slightly during 2014 H1, by 0.6%, whereas in annual terms it fell 1.2%.

[23] *The payment of liabilities to public sector also contributed to the fall in outstanding loans to businesses. Banks report that till end-June 2014 about ALL 22.4 billion of Government arrears were paid back.*

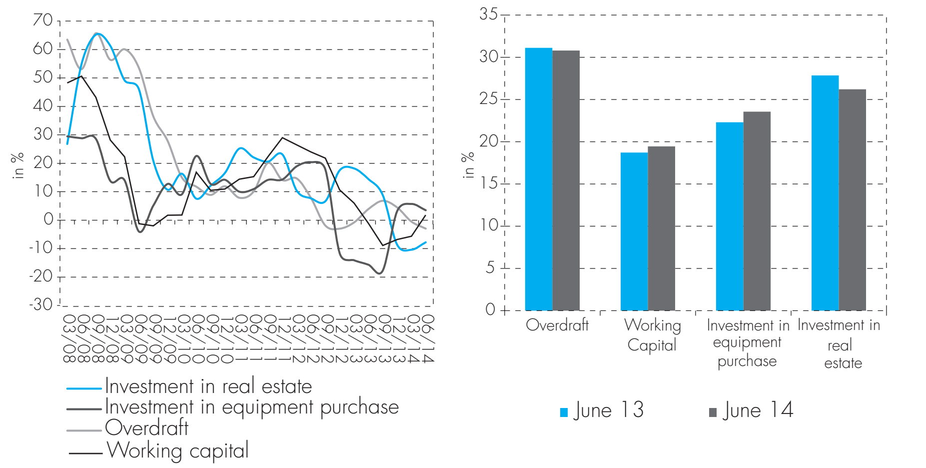
Chart 7.8 Annual growth rate of lending by maturity and currency




Source: Bank of Albania.

By purpose of use, "Overdraft" loan, which dominates lending to businesses, 30.8%, and the real estate investment loan, fell by 3% and 7.8%, respectively in annual terms. Financing for "working capital" and "investment in equipment purchase" expanded by 1.8% and 3.5%, respectively.

Chart 7.9 Annual growth rate of lending to businesses by purpose of use (left) and each item's share in total lending to businesses (right)



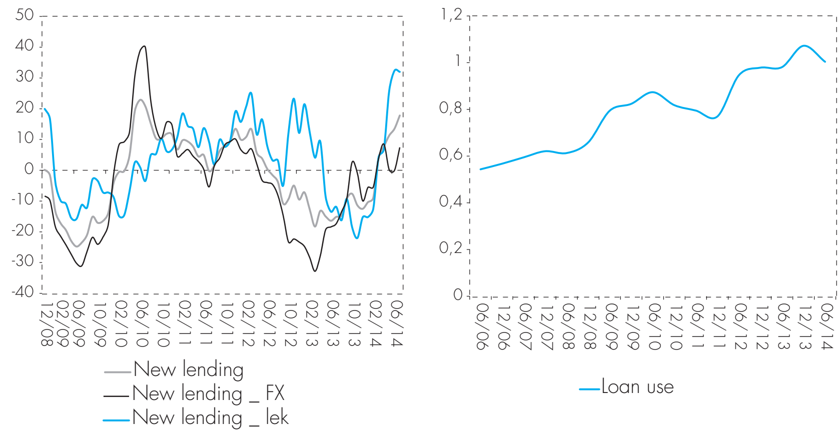

Source: Bank of Albania.

The annual growth of lending to households was mainly oriented towards "Real estate investments" by around 0.7% and "Consumption of durable goods" by around 11.5%. "Real estate investment loan" dominated the total of loan to households, sharing 71.8%.

## BOX 7.4 NEW LOANS

*In 2014 H1, new loans granted by banking sector accounted for ALL 126.1 billion, an annual growth of ALL 20.4 billion. Over the same stated period, the banking sector's recovered loans amounted to ALL 126.6 billion, from ALL 103.7 billion a year earlier. The loan use ratio, which represents the ratio of recovered-to-extended loans, was estimated at 100.4%, from 98.1% a year earlier. In annual terms, 77% of new lending growth was attributable to the lending in lek.*

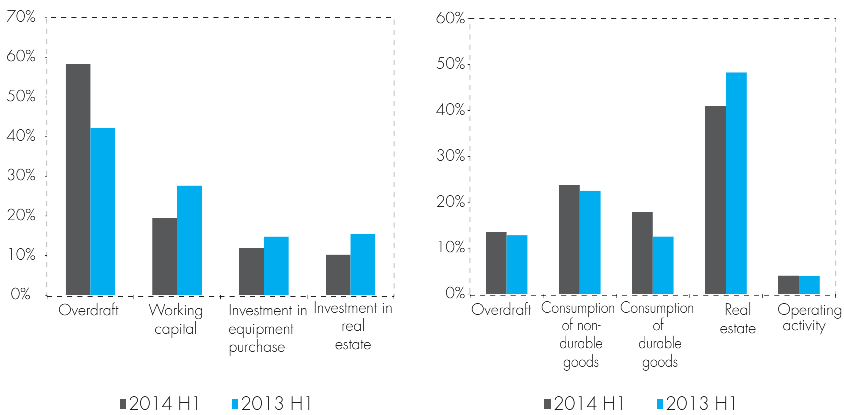
Chart 7.10 New lending – annual change (6M average), and loan use




Source: Bank of Albania.

*By group of users, the business sector was extended 85% of new loans, up by about 24% against the previous year. Loan granted as "Overdraft" had the main share of new loans to businesses (58%);other categories of use have been falling. New loans to households fell by 2.1% y-o-y, due to the fall of new loans for "real estate", by about 17%. The new loans for "real estate" had the main share in households sector (41%).*

Chart 7.11 Distribution of new lending to businesses and households by purpose of use, in per cent



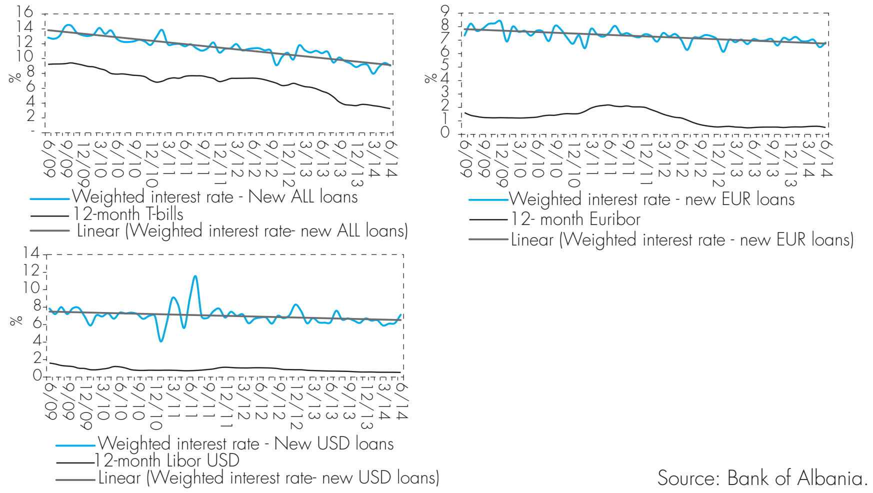

Source: Bank of Albania.

*Lending by economy branches was in line with the economic activity performance. The industry sector, especially the extractive industry, was the sector with the largest credit growth. Also, new lending to the trade sector expanded.*

- INTEREST RATES ON NEW LOANS

*Interest rates on new loans denominated in the three major currencies continued the downward trend in this six-month period. The interest rate on new lek loans averaged 8.9%, against 9.7% in 2013 H2, and 10.9% in 2013 H1. Interest rates on new euro and US dollar loans averaged 6.9% and 6.4%,respectively, by recording a slight increase of 0.1 percentage points in euro, and a fall of 0.15 percentage points in US dollar, compared to a year earlier.*

Chart 7.12 Interest rates on new loans by currency and respective reference rates, in per cent




Source: Bank of Albania.

## 7.2.4 DEPOSITS

Banking sector deposits grew during the period, albeit at a slower pace compared to the previous six-month period. Business deposits provided the main contribution to the growth of deposits, impacted by the Government payment of arrears. Households' deposits recorded a lower growth, due to demand for higher return, and the shift towards other instruments.

Deposits base for banking sector were up by ALL 12.5 billion or 1.2% in 2014 H1, to ALL 1,038 billion[24]. Deposits continued to remain concentrated in the largest banks; however, the concentration rate fell in annual terms[25].

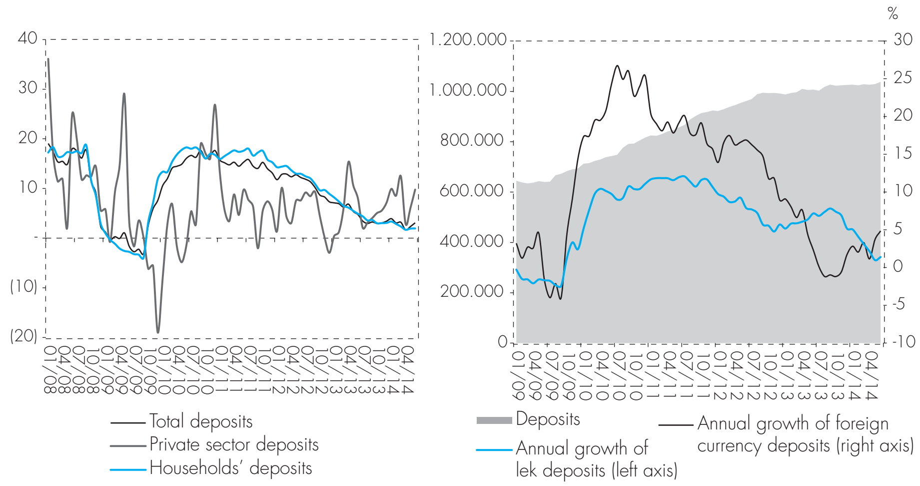
The annual growth pace of deposits slowed down to 3%, compared to 4.7% in June 2013. Household deposits, which accounted for about 87.5% of total deposits, grew at a lower annualised rate of 2%, from the 4.9% growth rate

[24] *Including accrued interests.*

[25] *Deposit concentration ratio, as measured by Herfindahl index, fell to 1478, from 1576 a year earlier. Despite the lower index, the banking sector showed levels of concentration in the collection of deposits.*

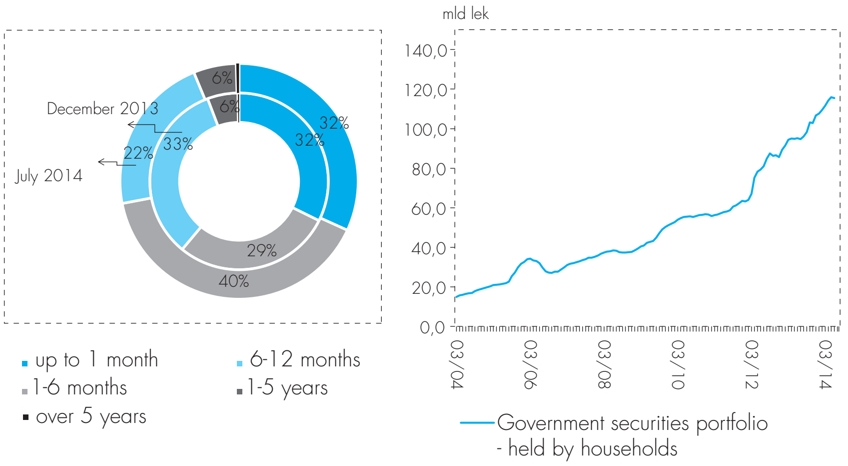
a year earlier. Businesses' deposits grew by about 9.8% in annual terms, from 8% a year earlier.

Chart 7.13 Deposits, annual growth rate and volume in ALL million




Source: Bank of Albania.

Chart 7.14 Banking sector deposit structure by maturity (left) and Households portfolio in Government debt securities (right)



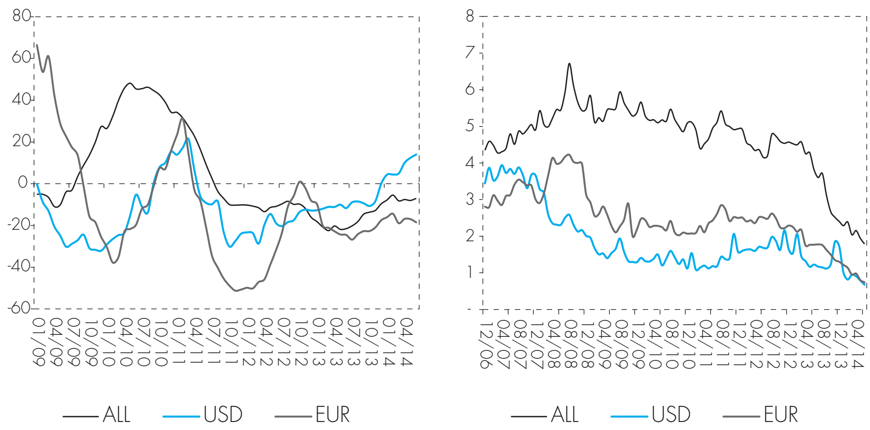

Source: Bank of Albania.

The deposit structure pointed to a shift to deposits with shorter maturities. The share of deposits with a maturity of one to six months increased versus those with a maturity from six to twelve months. The share of deposits with maturity more than 12 months remained unchanged from the previous period. Households further increased their participation in Government debt securities during the period. As at end-June 2014, households portfolio in Government securities was estimated at about ALL 115.5 billion, with an annual increase of about 21.3%, and growth during the period of about 8.2%. The whole increase in this portfolio, during the period, owed to the expansion of households' investments in Government bonds. This performance reflected the shift of households to longer-term instruments, to realise a higher profit rate given the lowering of interest rate.

By currency, the share of lek and foreign currency deposits remained almost unchanged compared to the end-2013, by 50.3% and 49.7%, respectively.

During 2014 H1, ALL 17 billion less than a year earlier were deposited in the banking system. During this period, return rates for lek deposits dropped to 2.1%[26], from 4.4% in the previous period. Also new euro deposits fell from EUR 1,270 million to EUR 1,034 million, following the fall in return rates from 2% to 1%. US dollar deposits increased from 337 million to USD 353 million, although the return rate on them fell, from 1.5% to 0.9%.

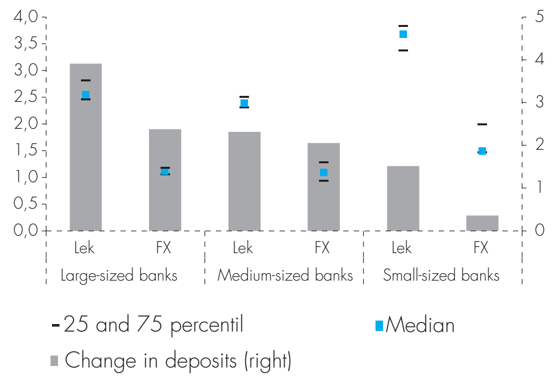
Chart 7.15 New deposits flow-annual change of the semi-annual moving average; interest rates on new time deposits (right-hand chart)




Source: Bank of Albania.

Large banks held the lowest return rates on deposits with a more heterogeneous allocation in this regard. Small banks provided the highest return rates on deposits.

Chart.7.16 Semi-annual growth of deposits base and the interest rate (weighted interest rate in 2014 H1, in %; expansion of deposits base in ALL billion, right)




Source: Bank of Albania.

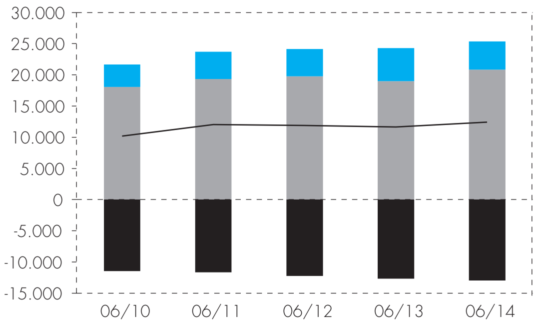
## 7.2.5 PROFITABILITY AND EFFICIENCY IN USING RESOURCES

The banking sector improved the profitability indicators during the period. Net interest income increased and offset the decreasing contribution of income from other operations. At the same time, activity costs, albeit slightly up, are covered adequately by the activity income.

As at end-2014 H1, the banking sector's net positive profit was ALL 5.43 billion, 3.6 times higher compared to the June 2013 profit. Interest income fell about ALL 3.5 billion, being offset by a lower level of expenses for interest, in line with the falling interest rate on deposits.

[26] *Weighted averages for the respective six-month periods.*

Chart 7.17 Banking activity income and cost (in ALL million)




Source: Bank of Albania.

The downward provisioning expenses contributed to improving profitability. This development mainly reflected the improved prices of foreign-currency securities in banks' portfolios, which led, in turn, to lower provisions for these investments. At the same time, banks' provisioning for loans decreased, driven by the reduction of non-performing loan portfolio in some of them.

Net interest margin revealed a slight increase due to the faster fall in interest expenses, compared to the fall in interest income. This development showed a weak lending activity, low interest rates environment and increase of loss assets, which did not generate any interest. In terms of average assets, in June 2014, net interest income dropped to 6.4%, from 7.3% at end- 2013, and 7.4% in June 2013, reflecting the slowdown in banks' main operation.

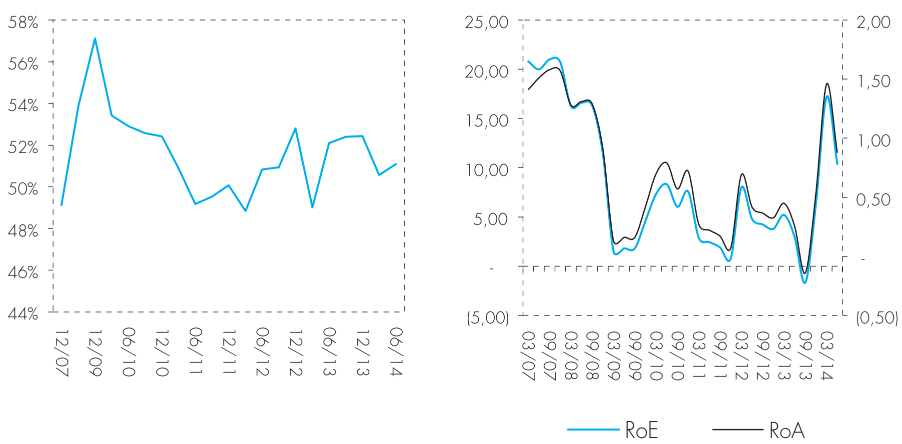
*Table 7.5 Profitability ratios, in per cent (cumulative)*

| Indicators | 06-2011 | 06-2012 | 06-2013 | 06-2014 |
|---|---|---|---|---|
| Interest income/average earning assets | 7.74 | 7.76 | 7.39 | 6.41 |
| Interest expenses/average expending liabilities | 3.78 | 3.74 | 3.54 | 2.40 |
| Net Interest Margin (Net interest income/average earning assets) | 4.21 | 4.04 | 3.78 | 3.97 |

*Source: Bank of Albania*

The low level of expenses relative to income and low provisioning rate of loss loans means that banking sector profitability improved during the period. In 2014 H1, average Return on Equity (RoE) for the banking sector improved to 10.4%, from 2.9% a year earlier. Return on Assets (RoA) was 0.88%, about 3.5 times higher than a year earlier.

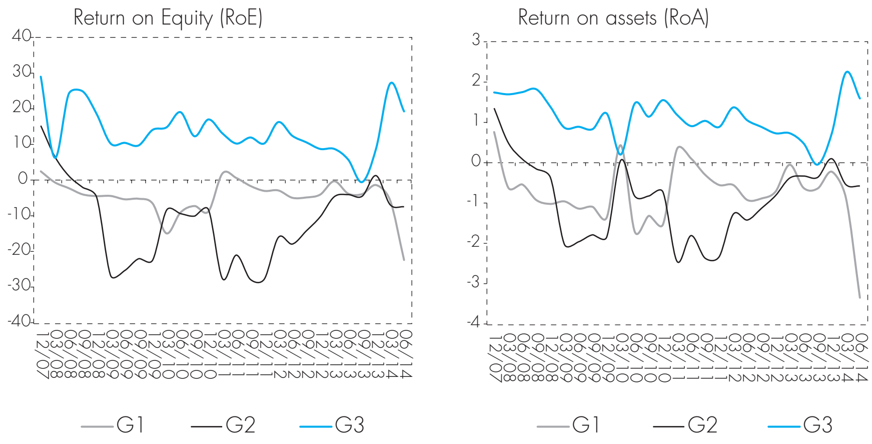
Chart 7.18 Cost as a ratio to income (left) and RoE, RoA profitability (right)




Source: Bank of Albania.

By banking groups, only large-sized banks (G3) contributed to the increased RoA and RoE indicators, while G1 and G2 banks showed negative values.

Chart 7.19 RoE and RoA by banking groups, in per cent




Source: Bank of Albania.

## 7.2.6 BANKING BUSINESS CAPITALIZATION

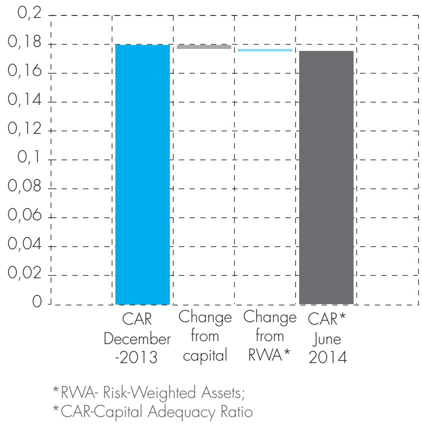
The sound banking business capitalisation remains a distinguishing feature of the Albania banking sector.

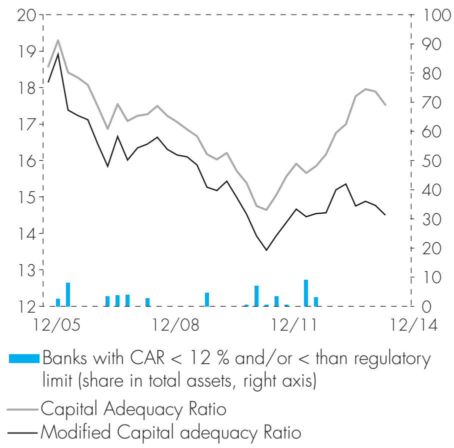
In June 2014, capital adequacy ratio[27] stood at 17.5%, from 18% as at end- 2013 and 17% a year earlier. Risk-bearing assets increased only 1%, at ALL 646.8 billion, while regulatory capital narrowed by about 1.6%, mainly due to the contracted core capital. Negative effects of these developments on capital adequacy ratio were -0.16 p.p and -0.28 p.p, respectively (see Chart 7.20, left).

Nonetheless, since 2013 H2 additional share (subordinated debt) increased in regulatory capital, whose structure remained favourable in terms of the banking sector's capacity to absorb possible losses. The core capital dominated more than 83% of the regulatory capital (See Chart 7.20, right).

[27] *The capital adequacy ratio (CAR) is calculated by regulatory capital to risk-weighted assets.*

Chart 7.20 Capital adequacy ratio, June 2014 and performance (right)*




*Capital adequacy ratio is calculated as the ratio of "Regulatory capital to Risk Weighted Assets"; The Modified Capital Adequacy Ratio is measured as the ratio of "Core Capital to Risk Weighted Assets".
Source: Bank of Albania.

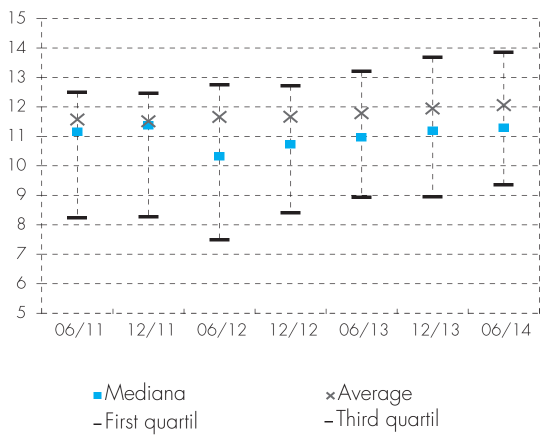
Table 7.2 summarises the capital adequacy ratio for the banking sector and banking groups, by business size and origin of capital

*Table 7.6 Capital adequacy ratio, in per cent*

| Period | Sector | G1 | G2 | G3 | Italian group | French group | Greek group | Albanian group |
|---|---|---|---|---|---|---|---|---|
| 06/2014 | 17,5 | 23,7 | 14,7 | 18,2 | 19,7 | 14,1 | 16,3 | 14,9 |
| 12/2013 | 18,0 | 27,5 | 15,9 | 18,1 | 21,4 | 15,0 | 17,5 | 14,5 |
| 06/2013 | 17,0 | 29,9 | 15,5 | 16,7 | 24,2 | 15,0 | 17,5 | 14,8 |

*Source: Bank of Albania.*

Chart 7.21 Financial leverage ratio




Source: Bank of Albania.

The Albanian banking sector was characterised by a low financial leverage ratio. As of end-June 2014, the financial leverage[28] ratio was 12.1, from 11.9 a year earlier. Individual banks did not differ significantly in terms of financial leverage.

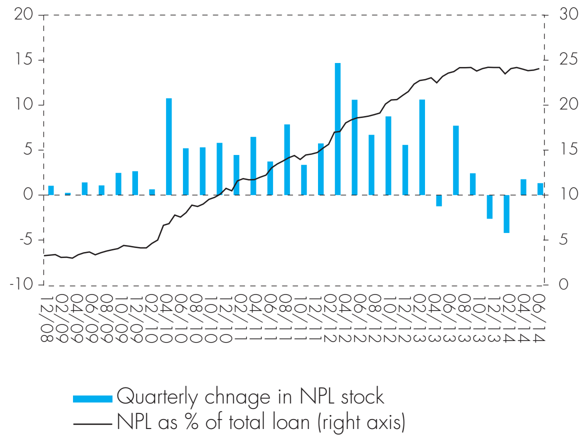
[28] *Financial leverage ratio is an additional measure that reflects the position of banks' equity, and is calculated as a ratio of total assets to shareholders' equity.*

# 8. MONITORING BANKING SECTOR RISKS

## 8.1 CREDIT RISK

In June 2014, non-performing loan ratio increased slightly at 24.1%. This portfolio increased for both private sector and households, by 0.6 percentage points, standing at 28.3% and 17.3%, respectively. In semi-annual terms, portfolio quality indicator considerably worsened for small-sized banks (G1) by about 5 percentage points, standing at 20%. While, for medium-sized banks (G2) and large-sized banks (G3), the non-performing loans ratio increased by 1 and 0.1 percentage point, respectively, standing at 27% and 24%.

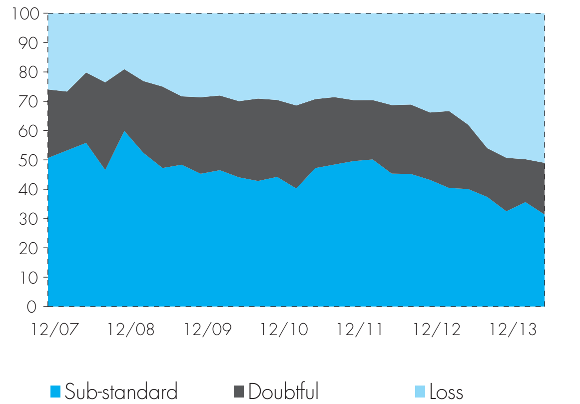
Chart 8.1 Annual growth of non-performing loans




Source: Bank of Albania.

The slight increase of non-performing loans reflected mostly the increase of non-performing loans stock (contributing by 58% to the increase of the ratio) and less the contraction of outstanding loan. Regulatory amendments introduced to ease terms for loan restructuring have produced effects for individual banks. At sector level, in June 2014, the non-performing loans indicator was 1.46 percentage points higher (or at 25.5%), if excluding the impact of the measure.

Chart 8.2 Non-performing loan portfolio rating, in per cent




Source: Bank of Albania.

The sector revealed potential increase of banks' exposure to credit risk - the category of completely sound loans narrowed (no arrears), while the value of "past due loan"[29] on date of the instalment maturity increased by 38% referred to the end-2013.

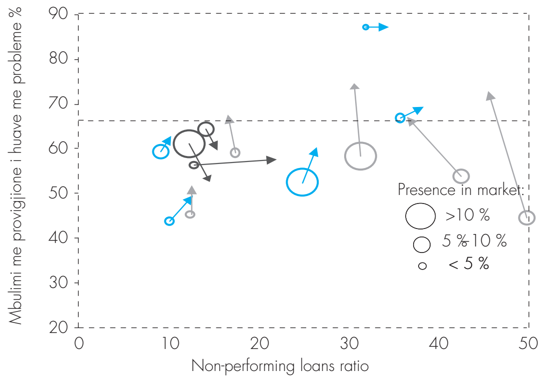
During the period, non-performing loans continued to migrate to "loss loans" category. As of end-June 2014, loss loans accounted for about 51% of non-performing loans.

Loan quality worsening was accompanied by an increase of loan loss provisioning ratio, pointing at

[29] *"Past due loan" are loans not repaid on the loan instalment due date. This category includes the loans repaid 1 to 90 days past the due date. This category does not include "non-performing loans".*

66.3% from 65.2% in December 2013 and 57.4% a year earlier. Although provisioning of non-performing loans at sectorial level was prudent and up, some banks remained considerably lower than the sector's average rates related to non-performing loans provisioning (see Chart 8.3).

Chart 8.3 Annual change in the provisioning ratio for banks, June 2014




Note: The Chart shows only the banks with a presence of higher than 1% of banking system total assets. Grey shows improvement, black shows worsening and blue shows an unclear development in risk combination. Interrupted line marks the average ratio of non-performing loan hedging at sector level, 66.3% at end- June 2014.

Source: Bank of Albania.

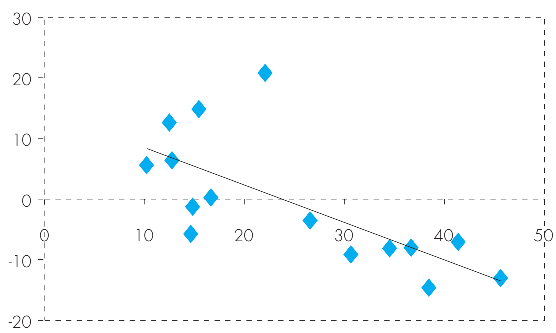
A close considering of the year on year change at hedging ratios, reveals that banks have maintained or even increased the non-performing loans provisioning ratio. Only two banks revealed that, at the same time, the provisioning rate fell and non-performing loans increased - albeit the level of non-performing loans in these two banks was about 9 percentage points lower than the banking sector average.

The provisioning rate of non-performing loans reflected a low ratio of non-performing loans to outstanding loans. In June 2014, this ratio narrowed to 8.1%, from 10.3% in June 2013.

The presence of a high non-performing loan stock in banks' balance-sheets increased, in turn, the cost of banks' operations. The contraction of loan is mainly notable in banks with the highest indicators of non-performing loans (see Chart 8.4).

Banks continued to reduce the exposures to risk investments portfolios. The ratio of risk-weighted assets to total assets fell about 7.5 percentage points in the last three years, 2011-2013. As at-June 2014, the ratio stood at 51.6%, slightly down compared to end-2013 and from a year earlier, by 0.3 percentage points and 0.1 percentage points, respectively. The downward trend showed in these years was affected by the large-sized banks (G3), while the ratio of small-sized banks (G1) and medium-sized banks (G2) expanded by 2.1% and 1.5%, respectively (see Chart 8.5).

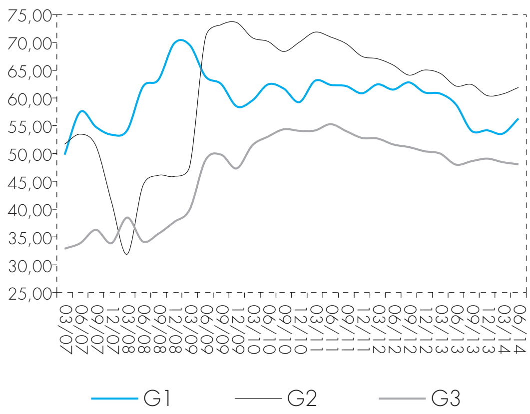
Chart 8.4 The annual growth of loan (Y axis ) and the degree of non-performing loans of a bank (X axis).




Source: Bank of Albania.

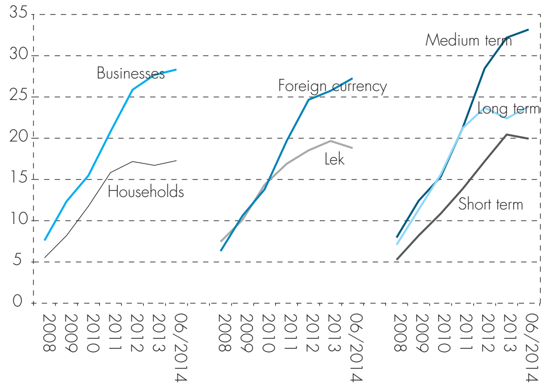
Banks were more exposed to credit risk for the medium-term loan portfolio, foreign currency credit and private sector credit. As at end-June 2014, the share of non-performing loans in these portfolios was 32.2%, 27.3% and 28.3%, respectively, up from end-2013, with foreign currency credit portfolio worsening most.

Chart 8.5 Risk-weighted assets to total assets by banking groups, in per cent




Source: Bank of Albania.

Chart 8.6 Non-performing loans in the Albanian banking sector

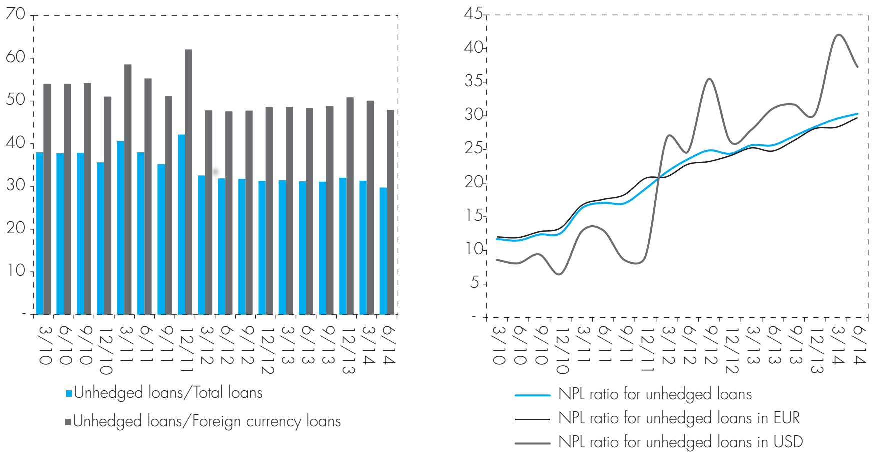



Source: Bank of Albania.

Banks continued to decrease their exposure to indirect credit risk. In 2014 H1, outstanding loans denominated in foreign currency, when the borrower's income is in lek, fell by about 7.2% to ALL 168 billion accounting for 30% of total outstanding loans and 48% of foreign currency outstanding loans. This phenomenon was more significant in euro-denominated loans.

The non-performing loan ratio for foreign currency loans unhedged against indirect credit risk rose to 30%, from 28.4% at end-2013, due to the impact of euro-denominated loans.

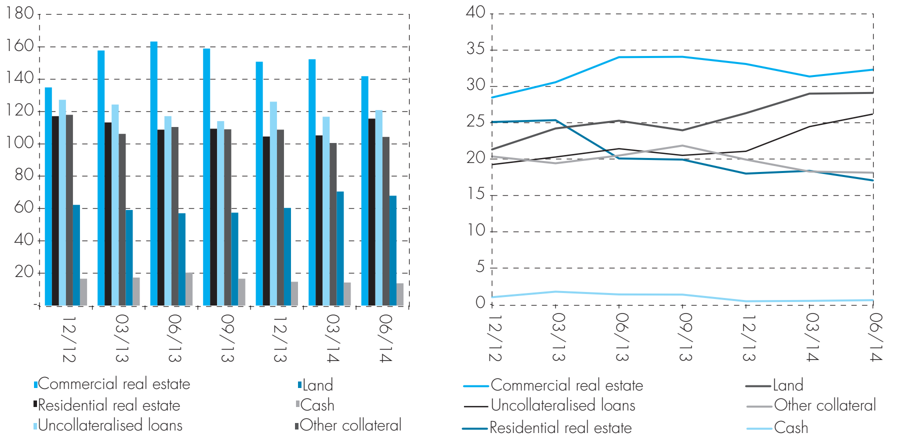
Chart 8.7 Quality of the loan portfolio unhedged against exchange rate risk, in per cent




Source: Bank of Albania.

The collateral coverage[30], an important hedging factor against credit risk, was 78.6%, almost equal to end-2013. Loans collateralized by real estate accounted for 55.8% of total collateral-based loans (see Chart 8.8. left).

Chart 8.8 Loans by type of collateral, in ALL billion (left) and the non-performing loan ratio by type of collateral (right)




Source: Bank of Albania.

In 2014 H1, the non-performing loan collateral coverage ratio was about 80%. The quality of loans collateralized by residential and commercial real estate slightly improved, by one percentage point (see Chart 8.8, right). Conversely, the quality of loans collateralized by land worsened by 3 percentage points; however, the use of this type of collateral is low, only 15%.

Loan collateral coverage was estimated as adequate; nevertheless, it enhanced the sensitivity to the well-functioning of the real estate market and the collateral execution process. At the same time, the type of collateral used in bank lending needs to be diversified.

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 39.6% at end-June 2014, from 40.2% at end-2013.

30 Collateral in the form of real estate (residential, commercial or land), cash etc.

*BOX 8.1 COLLATERAL EXECUTION PROCESS*

*As at end-June 2014, loans in execution process accounted for about 19.2% of total credit portfolio of the system. The mandatory execution order, as at end 2014 Q2, stood at ALL 107.9 billion, where 74% was for businesses and 26% for households, almost at the same rates with the previous quarter.*

*The economy sectors having the highest amount of the mandatory order were "Construction" (20.5%),"Trade, repair of vehicles and home appliances" (16.5%), and "Processing industry" (13.7%).*

*The obligation rate collected at the end of execution process, as at end- 2014 H1, was about 27.4% in relative terms of the mandatory execution order, being 1 percentage point higher compared to March 2014, and 7.8 percentage points higher from June 2013.*

*The amendments to the Civil Procedure Law, which entered into force in September 2013, aim at easing legal and execution procedures by minimising the legal spaces tolerated by the previous provisions in the Civil Procedure Law related to the suspension of execution.*

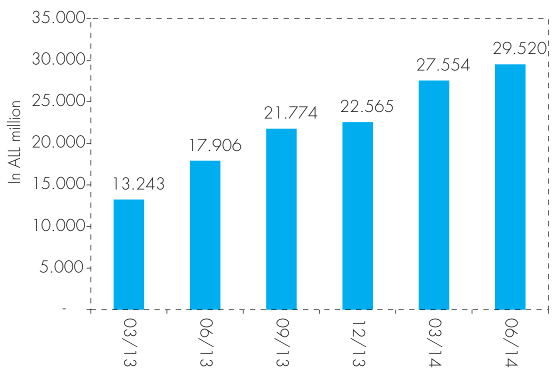
*The recovered amount increased 7.1%, from end-March 2014, and 65% from a year earlier. Compared to 2013 Q3, when the amendments to the Civil Procedure Law entered into force, the recovered amount grew by 35.6%.*

*The improved collected amount may be affected by the amendments to the Civil Procedure Law.*

*After the execution of collateral, the bank has recovered about 52.1% fixed assets, 38.7% cash, and 9.3% a combination of cash/fixed assets. A quarter earlier these ratios stood at 51.2% fixed assets, 40% cash, and 8.8% a combination of cash/fixed assets. A year earlier, these rates pointed at 64.5% fixed assets, 30% cash and 5.5% cash/fixed assets combination.*

*The transfer of real estate management to banks, following the execution of collateral, calls for an assessment of their management capacities for this increasing portfolio.*

Chart 8.9 The amount collected at the end of each quarter



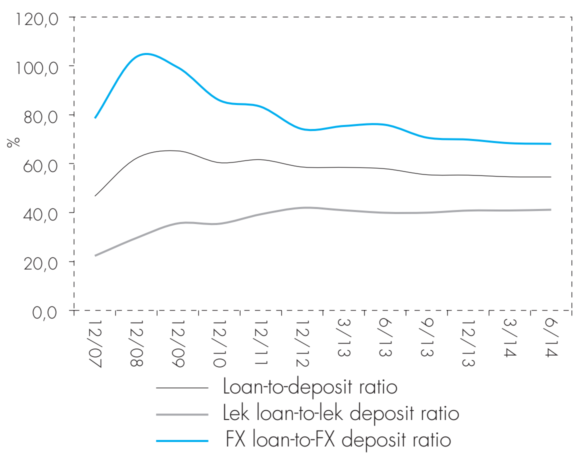

Source: Banks' reports and calculations of the Supervision Department.

## 8.2 LIQUIDITY RISK

Liquidity risk of banks was estimated as moderate, and did not pose any important risk to banking sector stability. Deposits remained the main source of funding, increasing at a slow pace and oriented toward short-term maturities. The liquidity ratios, both in lek and foreign currency, were above the minimum regulatory ratios.

Deposits remained the main source of funding for the banking sector operations. As at end- 2014, customer deposits covered the total loan amount around 1.8 times.

Chart 8.10 Loan-to-deposit ratio



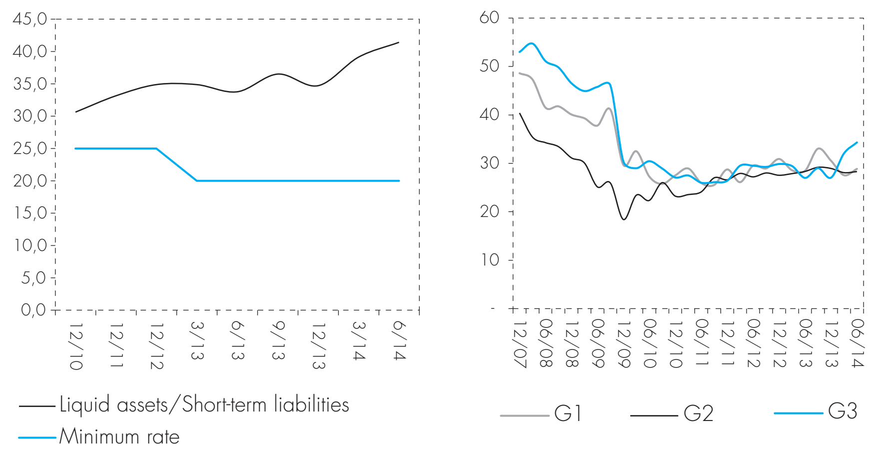

Source: Bank of Albania.

The loan-to-deposit ratio was 54.6%, lower compared to 55.3% at end-2013 and 57.9% a year earlier.

The contraction of lending and the portfolio expansion towards more liquid assets in money and capital markets, led to the increase of liquid assets ratio in banks' balance sheets.

At end-June 2014, the liquid assets accounted for 32.7% of total banking sector's assets, almost five percentage points higher from end-2013 and a year earlier. Banks observed the regulatory requirements relating to the ratio of liquid assets to short-term liabilities both in total and for each currency: lek, euro and U.S. dollar. At aggregate level, in June 2014 this ratio expanded to 41.4%, from 34.7% at end-2013. By currency, compared to the end-2013, the domestic currency ratio climbed to 55.2%, improving by 12.5 percentage points, while in foreign currency it climbed to 27.7%, expanding by 1 percentage point.

Chart 8.11 Liquidity ratios for the banking sector, in per cent

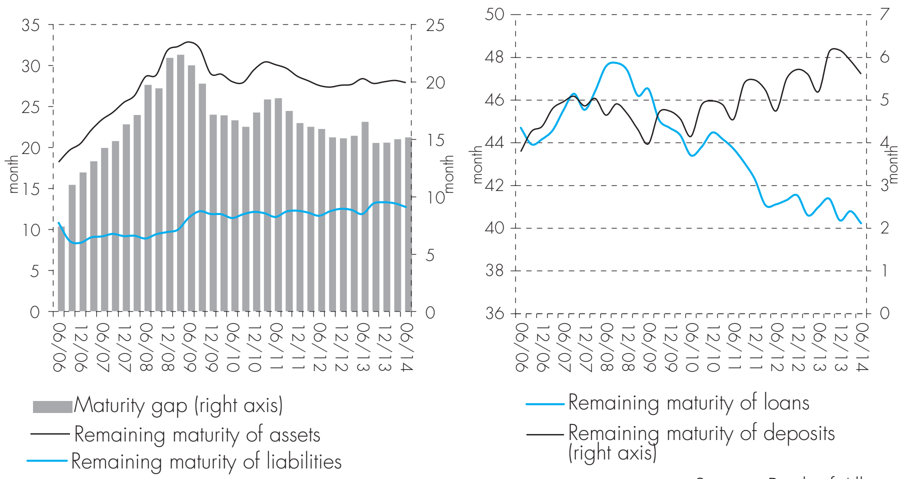



Source: Bank of Albania.

The increase of the liquidity ratios - "liquid assets to total assets" and "liquid assets to total short-term liabilities" - was driven by G3 banks. In semi-annual terms, the ratios expanded by 7.3 and 9.7 percentage points, respectively, to 34.3% and 43.4%. These indicators were slightly down for the other two bank peer groups (see Chart 8.11, right)

In 2014 H1, the maturity gap between assets and liabilities slightly expanded compared to end-2013, by around 0.5 months, to 15.2 months. This fact revealed a sharper fall of the average remaining maturity of liabilities to assets (see Chart 8.12, left)

Chart 8.12 Average remaining maturity of assets and liabilities (left); and Average remaining maturity of loans and deposits (right), in months




Source: Bank of Albania.

Deposits, the main liability item, and loans the main asset item of the banking sector, resulted at a narrowed remaining maturity, at 5.6 and 41 months (see Chart 8.12, right).

Despite remaining an important source for several banks, the use of financing from parent banks has been decreasing in the last years. In June 2014, the lines of credit amounted to around ALL 35.3 billion, from ALL 48.4 billion at end-2013.

## 8.3 MARKET RISKS

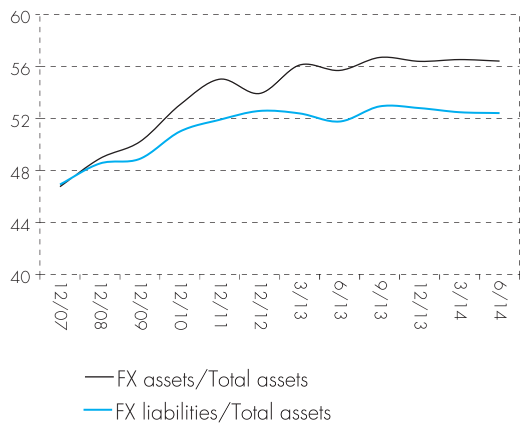
Banking sector showed limited exposure to direct exchange rate risk and interest rate. The limited net open foreign exchange position in the balance sheet to the regulatory capital, and their "long" position suggested limited impact of the unfavourable exchange rate movements. The gap between interest rate-sensitive assets and liabilities to total assets is not considerable. The major currency spread expanded slightly for the lek and euro, exposing the system to indirect interest rate risk for both currencies.

### 8.3.1 EXCHANGE RATE RISK

The open foreign exchange position to regulatory capital suggested for a significant hedging against unfavourable exchange rate movements, even though this exposure increased slightly. The currency mismatch showed a low exposure to indirect exchange rate risk.

As at end-June 2014, foreign currency assets of the sector accounted for ALL 707 billion, slightly expanding 1.6%, semi-annually and and 5.4% annually. Developments in foreign currency liabilities, which were estimated at ALL 657 billion, performed similarly.  In June 2014, the share of foreign currency assets

Chart 8.13 Share of foreign currency assets and liabilities in total banking sector assets, in per cent



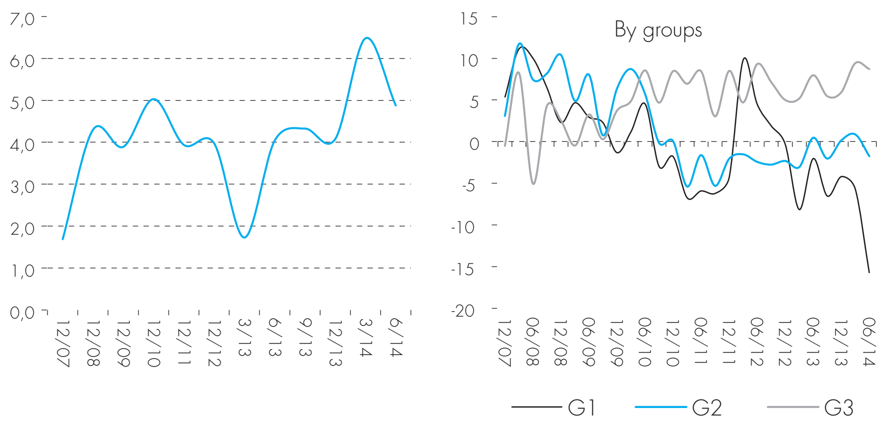

Source: Bank of Albania.

and liabilities in total assets was 56.4% and 52.4%, respectively, remaining quite close to the previous year.

The net open foreign exchange position to the regulatory capital was estimated at 4.9%, from 4.1% in December 2013, and 4% a year earlier (see Chart 8.14, left).

Large-sized banks (G3) continued to hold a long position and increased the exposure to a possible strengthening of lek position. Medium-sized banks (G2) showed a lower exposure to the exchange rate, whereas small-sized banks (G1) strengthened their short position, increasing the exposure to the possible weakening of Lek (see Chart 8.14, right).

Chart 8.14 Net open foreign exchange position to the regulatory capital, in per cent




Source: Bank of Albania.

The Modified Currency Mismatch Index enables a more complete measurement of banks' exposure to the exchange rate[31]. In 2014 H1, the Modified Currency Mismatch Index narrowed slightly to 9.4%, from 11.1% at end- 2013, and 10.9% in the same period a year earlier. The shrinking position of unhedged loan[32] against the exchange rate risk to total loan, a direct consequence of the negative performance of lending in foreign currency, mitigated the exposure of banking sector to foreign exchange indirect risk. However, the considerable share it continued to have in total credit portfolio (about 30%) makes the banking sector sensitive against unfavourable movements in the exchange rate.

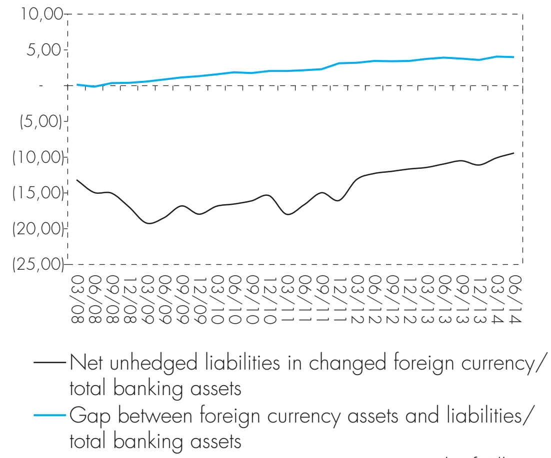
[31] *The index is calculated as follows: Foreign currency denominated net unhedged liabilities / total bank assets = {[foreign currency foreign liabilities + foreign currency domestic liabilities] - [foreign currency foreign assets + foreign currency domestic assets] + [foreign currency lending to unhedged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

[32] *Loan in a currency other than that of the borrower's income serving to repay the loan.*

### 8.2.2 INTEREST RATE RISK

Banking sector was exposed to interest rate fluctuations, as evidenced by the negative difference between rate-sensitive assets and rate-sensitive liabilities. However, the exposure was estimated relatively limited given that the share of this difference to total assets was not at considerable values[33].

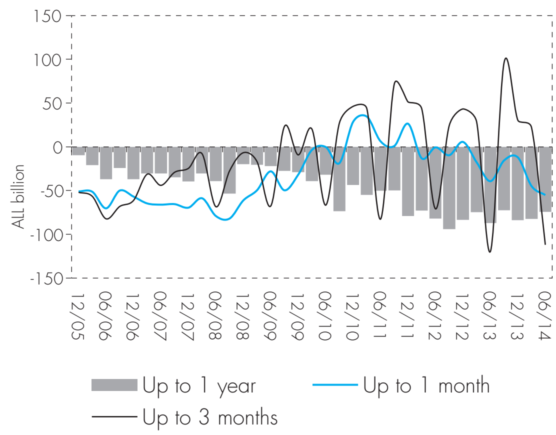
Chart 8.15 Modified Currency Mismatch Index, in per cent




Source: Bank of Albania.

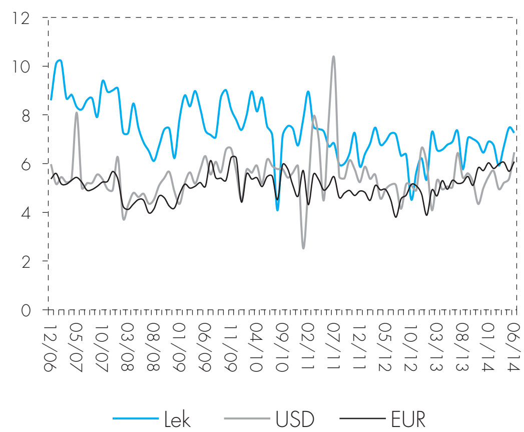
The cumulative gap between rate-sensitive assets and rate-sensitive liabilities with up to 1-month and up to 3-year maturities expanded the negative positions, as at end June 2014, and were estimated at ALL -55.3 billion and ALL -112 billion, respectively. This development led to the increase of sector's exposure in the event of interest rate increase. On the other hand, the cumulative gap for the maturity up to one-year narrowed the negative position by about 11.5%, standing at ALL -74.3 billion, by decreasing the exposure of sector in the event of interest rate increase. The different positions offset the impact of interest rate fluctuations on the banking sector performance.

Chart 8.16 Maturity Gap by repricing period, in ALL billion




Source: Bank of Albania.

Chart 8.17 Spread between loan and deposit rates, in %




Source: Bank of Albania.

The spread on loan and deposits rates appeared slightly up for the main foreign currencies, where the most stable expansion was for the euro (see Chart 8.17). Average fluctuations are lower, albeit expanding, for the two other currencies.

[33] *As at end-June 2014, the gap between rate-sensitive assets and rate-sensitive liabilities with 1, 3 and 12 months maturities to total assets stood at (-4.4%), (-8.9%) and (-5.9%), respectively.*

# 9. ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING[34]

Stress-test results reveal that the banking sector is resilient to macroeconomic shocks. However, because of the lower initial level of the capital adequacy ratio for medium-sized banks, their exposure to adverse scenarios is higher. The assessment of the spill-over effect in the banking sector shows that certain banks are exposed to the market risk in relation to investments in securities, whereas exposure to sovereign risk is limited. Exposure to placements in parent banking groups is significant for medium-sized banks as well as Greek and French-owned banks.

## 9.1 ASSESSING THE RESILIENCE TO MACROECONOMIC SHOCKS

A forward-looking stress-test or analysis is run to assess the financial system's stability and banking sector's capital adequacy, for a period extending to the end of 2015. The stress-test exercise assesses the impact of macroeconomic situations on the banking sector's financial standing, 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 adverse scenarios assume a "stressed" situation with a low probability of occurrence[35], based on three probable shocks to the Albanian economy: a) lending slowdown; b) market interest rates increase; and c) domestic currency depreciation.

*Table 9.1: Stress-test assumptions*

| | Baseline scenario | | Moderate scenario | | Adverse scenario | |
|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2014 | 2015 | 2014 | 2015 |
| Assumptions | | | | | | |
| Annual change in interest rates | 0 | 0.5 p.p | 1 p.p | 2 p.p | 1 p.p | 2 p.p |
| Depreciation of the exchange rate | -0.15% | -0.8% | -0.15% | -0.8% | 20% | 20% |
| Annual credit growth | 1% | 2.5% | 0.5% | 1.1% | 0.5% | 1.1% |
| Impact on GDP | | | | | | |
| Annual GDP growth | 1.2% | 2.3% | 1.1% | 2.2% | 0.8% | -0.8% |

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

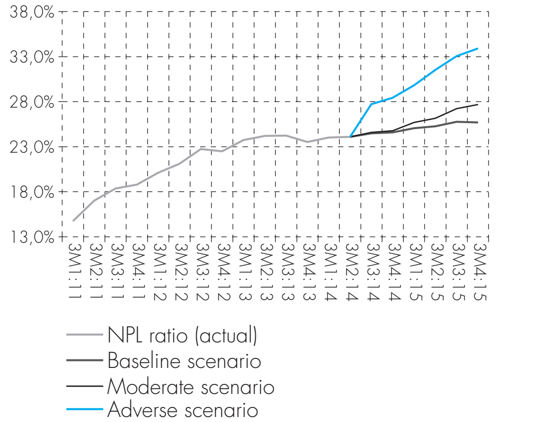
[34] *Stress-testing does not represent a way of forecasting. Intentionally, the scenarios include adverse and extreme events with a low probability of occurrence to test the banking sector resilience against them. Though banks are urged to assess the capacity of their financial situation withstand the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

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

Chart 9.1 presents the performance of the non-performing loan ratio according to the above-listed scenarios. According to the results, as at end 2015, if the moderate scenario materialised, the non-performing loans would rise by 2 percentage points, whereas the adverse scenario would drive this ratio up by 8.2 percentage points, compared to the assessment of the scenario. The baseline scenario does not include the assessment of the credit portfolio quality, the impact from the payment of Government arrears, and the potential write-off of non-performing loan by banks.

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

Chart 9.1. Actual and projected non-performing loan ratio under the baseline and adverse scenarios




Source: Financial Stability and Statistics Department, Bank of Albania

*Table 9.2 Capital adequacy ratio results*

| | End 2014 | | | | End 2015 | | | |
|---|---|---|---|---|---|---|---|---|
| | Banking sector | G3 | G2 | G1 | Sektori bankar | G3 | G2 | G1 |
| June 2014 | 17.52% | 18.2 % | 14.7% | 23.7 % | 17.52% | 18.2 % | 14.7% | 23.7 % |
| Baseline scenario | capitalised | capitalised | capitalised | capitalised | capitalised | capitalised | capitalised | capitalised |
| Moderate scenario | capitalised | capitalised | capitalised | capitalised | capitalised | capitalised | undercapitalis. | capitalised |
| Adverse scenario | capitalised | capitalised | capitalised | capitalised | capitalised | capitalised | undercapitalis. | capitalised |

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

The stress-test exercise results show that, albeit affected at the same degree by macroeconomic shocks in terms of the capital adequacy ratio (CAR), medium-sized banks appear more exposed due to the lower initial CAR level, falling below the required regulatory minimum as of end-2015.

In the baseline scenario, the total need for additional capital is estimated at ALL 334.54 million at end-2015. In the moderate scenario, the total need for additional capital is estimated at ALL 4,498.89 million at end-2015. In the adverse scenario, the total need for additional capital is estimated at ALL 1,398.69 million for 2014 and ALL 12,607.21 for 2015.

Against the backdrop of earlier developments, during 2013, the banking sector has added its capital by ALL 10,418.13 million.

## 9.2 ASSESSMENT OF THE SPILL-OVER EFFECTS ON THE ALBANIAN BANKING SECTOR

### 9.2.A EXPOSURE TO FOREIGN SOVEREIGN RISK AND SECURITIES

This exercise aims at assessing the exposure of the Albanian banking sector to the sovereign risk of investing in foreign public debt securities and foreign securities. The risk includes shocks in the form of a haircut[36] to the value of investment in foreign securities above the market value reported by banks[37].

At end June 2014, six banks in the system had sovereign and commercial securities. When applying haircuts on the market price of sovereign debt securities, the loss is estimated at ALL 704 million. When applying haircuts on securities of private entities, the loss expands significantly, due to the size of their portfolio. In terms of the actual investments in securities, the total loss would reach 4.1%.

Table 9.3 Stress-test results.

| Investments in securities (ALL million) | Loss from haircut application - sovereign | Loss from haircut application - commercial | Total loss | Loss in % of investment |
|---|---|---|---|---|
| 71,848.08 | 704.6238 | 2,267.383 | 2,972.007 | 4.1% |

Because of their small size in terms of the regulatory capital, the CAR after the shock is not significantly affected for all the banks.

### 9.2.B EXPOSURE TO PLACEMENTS IN PARENT BANKING GROUPS

The purpose of this exercise is to assess the exposure of banks to placements in parent banking groups[38]. Results were obtained in two ways:

a) Assumption of loss in placements with parent banking groups through a shock amounting to 100% and 50%.
b) Assessment of size of loss of such exposures, so that they affect the regulatory capital adequacy rate (12%) (indirect analysis)

[36] *The difference between a market value of a security placed as collateral and its value used to calculate the granted credit, expressed as a percentage to the market value. The suppositions related to the haircut are determined on the basis of the historic distribution of changes in Government securities yields by country, based on shocks arising from the 90th percentile of this distribution. Calculations are made for Government securities up to 5-years maturity. Later, in a linear way, the haircuts for each maturity term are constructed.*

[37] *The market value for securities was reported for 25 June 2014.*

[38] *For the purpose of calculating the capital adequacy rate, the value of above-mentioned losses reduces in a direct and equal manner the value of regulatory capital. Moreover, the value of risk-bearing assets lowered in the amount of loss, reduced by the respective risk coefficient.*

*Table 9.4 Stress-test results*

| | | | | | Indirect analysis | |
|---|---|---|---|---|---|---|
| | Placements with parent bank | CAR actual | Shock 100% | Shock 50% | Necessary loss, ALL million | % in actual exposure for affected banks |
| G3 | 30194.3 | 18.2% | Slight undercapitalis. | Capitalised | 27,897.2 | 92% |
| G2 | 17638.2 | 14.7% | Undercapitalis. | Undercapitalis. | 5,030.2 | 29% |
| G1 | 750.4 | 22.2% | Capitalised | Capitalised | 2,981.5 | 397% |

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

In the case of a shock 100% of total placements with parent banking groups, the CAR falls below the minimum requirement for G3 (11.5%) and G2 (4.9%). G2 is also affected by a 50% shock, with the capitalisation rate falling to 9.9%. Even according to results obtained by the indirect analysis, loss of placements with parent banking groups amounting to around 29% for G2 is needed in order for the CAR to fall below the permissible minimum level.

This exercise has been conducted also for placements in the parent banking groups, divided by capital origin.

*Table 9.5 Stress-test results*

| | | | | | Indirect analysis | |
|---|---|---|---|---|---|---|
| Group | Placement, ALL million | CAR actual | Shock 100% | Shock 50% | Necessary loss, ALL million | % in actual exposure for affected banks |
| Greek | 16923.8 | 16.3% | Undercapitalis. | Undercapitalis. | 5,080.9 | 30% |
| Italian | 9957.1 | 19.7% | Undercapitalis. | Capitalised | 5,995.6 | 60% |
| French | 5494.3 | 14.1% | Undercapitalis. | Undercapitalis | 1,445.0 | 26% |

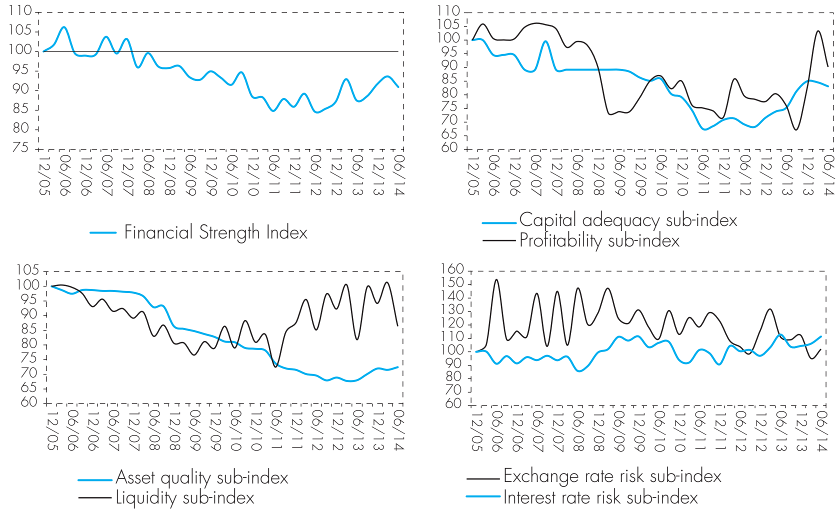
*Source: Financial Stability and Statistics Department, Bank of Albania.*

The Greek group is most affected by the 100% loss of placements, which after the shock records 1.6% capitalisation rate, followed by the French group with 5.9% and the Italian group with 6.8%. With 50% loss of placements, only the Italian group would be well capitalised. According to the indirect analysis, a 26% loss of actual exposure for the French group and 30% for the Greek groups is needed for the CAR of these groups to fall below 12%.

# ANNEX 1: FINANCIAL STRENGTH INDEX[39]

The Financial Strength Index (FSI) recorded adequate levels in semi-annual and annual terms, signalling a downward exposure to risks. At the end of the first half of 2014, the value of the index was 90.91 from 87.5 in the same period a year earlier. Most FSI components provided a positive contribution to its performance, with the improved profitability and capitalisation levels recording the highest increase in annual terms. Also, the exposure to liquidity risk was lower. In annual terms, the banking sector appears more sensitive to the exchange rate risk and interest rate risk.

Chart 1. Financial Strength Index and its sub-indices




Source: Bank of Albania.

[39] *The methodology for constructing the FSI is presented in the Financial Stability Report 2010 H1.*

Table 1 Financial soundness ratios

| In per cent | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 06/2014 |
|---|---|---|---|---|---|---|---|---|
| Capital-based ratios | | | | | | | | |
| | | | | | | | | |
| Regulatory capital to risk-weighted assets | 17.1 | 17.2 | 16.2 | 15.4 | 15.6 | 16.2 | 18.0 | 17.5 |
| Core capital to risk-weighted assets | 16.0 | 16.3 | 15.3 | 14.5 | 14.3 | 14.6 | 14.9 | 14.5 |
| Shareholders' equity to total assets | 7.6 | 8.6 | 9.6 | 9.4 | 8.7 | 8.6 | 8.4 | 8.3 |
| | | | | | | | | |
| Asset quality | | | | | | | | |
| Net non-performing loans to regulatory capital | 10.1 | 21.7 | 28.2 | 35.9 | 52.0 | 55.6 | 40.2 | 40.5 |
| Gross non-performing loans to loans outstanding | 3.4 | 6.6 | 10.5 | 14.0 | 18.8 | 22.5 | 23.5 | 24.1 |
| | | | | | | | | |
| Profitability | | | | | | | | |
| Return on Equity (RoE, on an annual basis) | 20.7 | 11.4 | 4.6 | 7.6 | 0.8 | 3.8 | 6.4 | 10.4 |
| Return on Assets (RoA, on an annual basis) | 1.6 | 0.9 | 0.4 | 0.7 | 0.1 | 0.3 | 0.5 | 0.9 |
| | | | | | | | | |
| Net open foreign position to capital | | | | | | | | |
| Net open foreign position to regulatory capital | 1.7 | 4.3 | 3.9 | 5.0 | 3.9 | 4.0 | 4.1 | 4.9 |
| Net open foreign position to core capital | 1.8 | 4.5 | 4.1 | 5.3 | 4.3 | 4.4 | 4.9 | 5.9 |
| | | | | | | | | |
| Asset-based ratios | | | | | | | | |
| Liquid assets to total assets | 49.8 | 42.8 | 27.6 | 25.9 | 26.5 | 29.4 | 27.6 | 32.7 |
| Liquid assets to total short-term liabilities (up to one year) | 74.0 | 64.9 | 32.6 | 30.6 | 33.1 | 36.7 | 34.7 | 41.4 |
| Customer deposits to total loans | 215.5 | 162.6 | 154.3 | 166.4 | 163.2 | 171.6 | 180.8 | 183.3 |

*Source: Bank of Albania.*