Bank of Albania

FINANCIAL STABILITY REPORT
2014 H2

Published by: Bank of Albania
Sheshi "Skënderbej", nr.1, Tirana
Tel: 355 4 2419301/2/3
Fax: + 355 4 2419409/10/11
E-mail: public@bankofalbania.org
WWW.BANKOFALBANIA.ORG

Printed in: 310 copies
Printed by: ALBDESIGN

C O N T E N T S

B O X E S

T A B L E S

C H A R T S

9. Monitoring banking sector risks

10. Assessing Banking Sector Resilience through Stress-Testing

INTRODUCTION

This is the thirteenth issue of Bank of Albania's half-yearly Financial Stability Report. The purpose of this Report is to identify and assess risks facing the financial system and its infrastructure, in order to provide the public authorities with the possibility to identify the relevant measures for adjustments, as necessary. 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 from other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the developments over the second 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 financial system and banking sector in Albania. 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, income, and specific surveys, it evaluates businesses and households' financial situation, and the impact on the solvency of the banking sector borrowers.

NOTES

As at December 2014, banks in Albania were divided by size of their activity as follows:

- Banks in Peer Group 1 (each sharing 0-2% of total banking sector assets): United Bank of Albania (UBA), Veneto Bank (VB), International Commercial Bank (ICB), First Investment Bank (FIB), Credit Bank of Albania (CBA); They account for around 4.5% of the sector's total assets.

- Banks in Peer Group 2 (each sharing 2-7% of total banking sector assets): Procredit bank (PCB), Credit Agricole bank (CAB), National Bank of Greece (NBG), Societe Generale – Albania (SGA), Alfa Bank – Albania (ABA), Union Bank (UB). They account for around 16.2% of the sector's total assets.

- Banks in Peer Group 3 (each sharing over 7% of total banking sector assets): Raiffeisen bank (RB), Credins Bank (CB), Banka Kombëtare Tregtare [National Commercial Bank] (BKT), Intesa Sanpaolo – Albania (ISBA), Tirana Bank (TB). They account for around 73.8% of the sector's total assets.

As at December 2014, banks in Albania were divided by origin of capital as follows:

- foreign-owned banks: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank - Albania, Veneto Bank (Italy); Alpha Bank - Albania, Tirana Bank, National Bank of Greece (Greece); National Commercial Bank (Turkey); Société Générale Albania, Credit Agricole Bank (France); ProCredit Bank (Germany); First Investment Bank (Bulgaria); International Commercial Bank (Malaysia); United Bank of Albania (Saudi Arabia); Credit Bank of Albania (Kuwait). They account for 87.1% of the sector's total assets.

- Albanian-owned banks: Credins Bank, Union Bank; The account for 12.9% of the sector's total assets.

As at December 2014, only BKT had a branch abroad, in Kosovo.

FINANCIAL STABILITY STATEMENT FOR 2014 H2

Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No 9962, dated 18 December 2006 "On Banks in the Republic of Albania", as amended, to inform the 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 situation and performance of the Albanian banking sector and financial system was stable in the second half of 2014. The volume of activity grew and the financial performance improved further.

The banking sector's liquidity and capitalisation ratios were at an adequate level during the period. The credit portfolio quality improved at the end of the year, although the level of non-performing loans is assessed as still high. Loan loss provisions and collateralisation of non-performing loans were at good 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 a good functioning of financial markets and lower financing costs.

Despite an improved financial situation, the banking sector's risk exposure remains similar to that in the previous period.

The credit risk remains significant as legal and regulatory improvements with regard to collateral execution/management, modalities of bank taxation in the case of loan write offs from banks' balance sheets, and restructuring of non-performing loans need to be interpreted and implemented consistently in order to reinforce their positive impact. Legal ambiguities in the process of borrowers' bankruptcy, especially identified in the case of borrowers exposed to more than one bank, emphasise the need for improvements in this regard as well. Moreover, the sale or transfer of the non-performing loans portfolio from banks to specialised non-bank financial institutions is a process that needs to be specified in regulatory requirements and encouraged through different forms, to prevent legal uncertainties and stir up the interest of these institutions. The Bank of Albania considers that overall, the process of the management and solution of non-performing loans would benefit from a thorough analysis *of the difficulties faced, which would serve as a basis for a coordinated and determined approach by public authorities aimed at providing a systematic and sustainable solution to this problem. The Bank of Albania shall remain active in this regard, in compliance with the legal requirements and the relations with the banking industry.*

Banking sector's exposure to market and liquidity risks remains limited, but requires cautious monitoring. Also, it is important to assess the total, direct and indirect impact arising from fluctuations in the values of market indicators (exchange rate and interest rate) on the banks' balance sheets.

Domestic demand is expected to remain the main factor driving economic growth in Albania. Developments in the external economic and financial environment, especially those related to the EU and euro area, remain unclear about their possible spill-over effect on the Albanian economy. Economic and financial developments in Greece add the uncertainty in financial markets. In the meantime, regulatory requirements for European banking groups, introduced by national supervisory authorities and the European Central Bank, point to the strengthening of requirements pertaining to risk management and capitalisation levels. These developments will exercise pressures on the contribution of their branches in the process of financial intermediation, for both public and private sectors in Albania.

Stress test results suggest that the banking sector is overall resilient to supposed shocks resulting from fluctuations of macroeconomic indicators and of the value of its investment portfolio.

Following is 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

During the second half of 2014, the global economic activity improved gradually, but at lower-than-expected rates[1] and evident divergences between the regions. Inflationary pressures fell globally, reflecting downward commodity prices, mainly of oil and its by-products. The euro depreciated against the major currencies, especially the US dollar. Divergences in economic growth between major regions are reflected in different attitudes of monetary policy by central banks. Financial markets have been generally stable. Global economic activity is expected to continue to improve at slow rates[2], sustained also by the drop in oil prices.

[1] *IMF's World Economic Outlook January 2015 (3.3% annual growth) was down compared to the projection in October 2014 (3.4% annual growth).*

[2] *According to the IMF, global economic growth is projected at 3.5% in 2015 and 3.7% in 2016. (WEO, January 2015)*

During 2014, private consumption and investments provided significant contribution to economic recovery, while the fiscal policy maintains its consolidating trend. In the last quarter of 2014, the Albanian economy was estimated to have grown 2.42% in annual terms or 1.12% from the previous quarter. During the quarter, the contribution of fiscal policy to domestic demand increased. The improvement in terms of the economic activity has not been reflected yet in the labour market, as the unemployment rate rose to 18%. Developments in the external sector of the economy contributed negatively to economic growth. Low inflationary pressures have contributed to the monetary policy of the Bank of Albania remaining accommodative. Preliminary data as at end-2014 show that the consolidation trend of the fiscal policy persists. Although in absolute value the budget deficit stood higher than in the previous year, it fell vis-à-vis the Gross Domestic Product (GDP). In the future, domestic demand is majorly expected to maintain its positive contribution to economic growth. An expected improvement of economic activity in Albania's main trading partners will contribute positively to the growth of foreign demand for Albanian exports.

Households and businesses remain exposed to direct and indirect credit risks. In the second half of 2014, households continued to be oriented towards savings, as reflected by the expansion of deposits both in annual and half-yearly terms. Credit to households grew as well, but slower than deposits. Lending in the national currency made the main contribution to the growth of credit, both for households and businesses. The debt position of businesses was somewhat lower, due to the faster increase in deposits, mainly as a result of the continuation of the payment of arrears. In relation to risks, households decreased, whereas businesses increased their exposure to the indirect credit risk arising from the exchange rate. The credit portfolio quality improved both for households and businesses.

In financial markets, interest rates continued to drop, and the nominal value of the Albanian lek against the main foreign currencies fell. During the period under review, the Albanian financial markets showed a stable performance. Following the accommodative monetary policy of the Bank of Albania, the financial markets were characterised by downward rates, especially in the primary securities market, regarding banking sector's credit and deposit products, and in the interbank market. Lek's exchange rate was steady against the euro, but depreciated against the US dollar and currencies that mimic it. This performance has reflected mostly developments in international foreign exchange markets.

Volume of transactions in the payment systems and use of electronic payment instruments by bank clients increased. AIPS and AECH payment systems operated in compliance with the technical conditions for meeting the banking sector needs for settling payment transactions in the national currency. In both systems, the volume and value of transactions increased. In addition, the volume and value was up in payments by bank clients through other payment instruments, including bank cards and other electronic forms.

During the period under review, the financial system increased its share in Albania's economic activity. As at December 2014, the level of financial intermediation in Albania, calculated as the ratio of financial system assets to the GDP, was estimated at 101.4%.

Banking sector's performance was stable, and the liquidity and capitalisation ratios were adequate, driven also by the improved net financial result. At the end of December 2014 banking sector assets surged to ALL 1,294 billion, expanding by 4.8%, at the end of the year. On the assets side, investments in securities and lending contributed to the expansion of the activity. Banking activity was financed through the increase in public deposits, though at slower rates. Banking sector exposure to non-resident institutions was similar to the previous period, reflecting weak reliance on foreign financing sources. During 2014, credit grew almost 5%, with both lek and foreign currency credit providing positive contribution. The latter was affected by credit to non-residents and the statistical effect of the exchange rate change. The new bank credit during 2014 stood 13.8% higher than in the previous year.

Deposits amounted to ALL 1,072.2 billion, up 4.6% year-over-year. Lek and foreign currency deposits grew 2.8% and 3.7%, respectively, annually. Households' deposits rose 2.6% and businesses deposits surged around 9.2% in annual terms Government's payment of arrears to businesses has also contributed to this performance. The loan-to-deposit ratio was 55.5%.

At the sectoral level, the net profit was positive, amounting to ALL 11.2 billion, from ALL 6.6 billion in the previous year. The main contribution to this result was given by downward expenditure for asset quality and upward net income from interest based on the activity of investment in securities and lending. During the period under review, the regulatory capital marked 1.3% annual increase, rising to ALL 116.7 billion. Risk-weighted assets rose to ALL 692.9 billion or 8% from a year earlier. As a result, at the end of 2014, the capital adequacy ratio fell to 16.8%.

- *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. To consolidate the risk assessment, we have used some representative indices.

Overall, indices show a deceleration of the risk level during the second half of 2014.

Risks to the banking sector, real economy and economic agents are assessed in a single approach by using the Financial Stability Map (FSM). Compared to the end of 2013, the FSM shows that during the period under review, risks to the financial stability were subdued, due to the better performance of economic agents.

In concrete terms, in the case of the 'domestic economy', the increase in the external financing of the public and private sectors, as well as the performance of the exchange rate have contributed to the expansion of risk, whereas the narrowing of the negative output gap has subdued it. For 'households' and 'businesses', the risk is assessed as moderate, benefiting mainly from their better expectations for the outlook of the economy. However, other factors related to the level of unemployment, and the pace and quality of lending had a negative impact on the size of risk of these economic agents. For the 'government', the risk level is assessed as downward, given the positive performance of income, downward borrowing costs and reduction of the budget deficit. The risk arising from the "external economic environment" has decreased slightly, though it remains at average levels, due to improved unemployment rates in countries with stronger economic ties with Albania and a fall in oil prices. For the banking sector, the risk of 'capitalisation and profitability' and of 'financing and liquidity' is considered as average risk, affected by, respectively, the improvement of the financial result, lowering of the non-performing loan ratio, and differences between short-term assets and liabilities.

Risks to the financial system are assessed using the Financial Systemic Stress Index (FSSI). 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. As at December 2014, the systemic risk is assessed as downward, mainly due to the performance of deposits, credit and net margin of interests during the second half of the year.

Accumulation and materialization phases of systemic risk in the financial system are clearly identified using two specific indices: Risk Accumulation Index and Risk Materialisation Index. As at December 2014, the accumulation of the systemic risk from factors related to the banking sector and the real economy appears as upward compared to the same period in the previous year. The contraction of foreign currency lending and the performance of the housing market mitigated the accumulation of the systemic risk, whereas the increase in the debt level in general and foreign currency debt had an opposite effect. The index on the materialisation of the systemic risk stood slightly up from the previous year, reflecting the credit quality deterioration for businesses and households, the higher unemployment rate and deprecation of the national currency, mainly against the US dollar.

Financial risks are subject to the economic agents' perception. The Bank of Albania regularly collects the perception of banking industry about these risks through a special semi-annual survey. For 2014 H2, the industry assesses that the 'worsening of the domestic economy' is the most significant systemic risk, but the perception of the banking sector for this risk has been gradually subduing during 2014. The attention to the risk from 'shocks from the external economy' is up, reflecting the concern over the still-sluggish economy in the euro area, especially in Greece and Italy.

Risks arising from fiscal indicators remain contained. The consolidating trend of the fiscal policy is expected to persist in 2015. Meanwhile, financing of most of public borrowing through foreign sources during this year, if realised as projected, is expected to maintain the pressure on the level of interest rates in the primary market of government debt securities. These factors will diversify the structure of public debt and will keep repayment costs relatively low. At the same time, they will serve to control the size and concentration of financing government borrowing from the banking and non-banking financial sectors, and will serve to create more space for bank lending to the private sector.

Credit risk remains a concern for banking activity. At the end of the period under review, the ratio of non-performing loans to total loans was 22.8%, the lowest in the last two years. The ratio for lek loans stood at 17.5%, down 2.2 percentage points, in annual terms. The ratio for foreign currency loans stood at 26%, up 0.3 percentage points.

Despite the fall in the non-performing loan ratio and the positive impact materialising gradually from the legal improvements and other measures by the authorities, the credit risk remains important. In fact, the insofar experience, shows that legal and regulatory improvements on collateral execution/management, modalities for the taxation of banks in the case of loan write offs from their balance sheets, and restructuring of non-performing loans need to be interpreted and implemented consistently. Legal ambiguities in the process of borrowers' bankruptcy, especially identified in the case of borrowers exposed to more than one bank, emphasise the need for improvements in this regard as well. Moreover, the sale or transfer of the non-performing loans portfolio from banks to specialised non-bank financial institutions is a process that needs to be specified in regulatory requirements and encouraged through different forms, to prevent legal uncertainties and stir up the interest of these institutions. Overall, the process of non-performing loan solution would benefit from a thorough analysis of its performance and difficulties facing it insofar, which would serve as a basis for a coordinated and determined approach by public authorities in order to provide a systematic and definite solution to this problem.

Banking sector exposure to unfavourable fluctuations in the exchange rate and interest rate should be assessed regularly and monitored carefully. The banking sector's open foreign exchange position was long and within the historical levels. Interest rate-sensitive assets and liabilities provide negative difference for maturities up to one year. While the direct impact of exchange rate and interest rate fluctuations is manageable, the banking sector appears sensitive to the negative impact of unfavourable exchange rate and interest rate fluctuations on the situation of the 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 national currency, and variable-rate loans.

Banking sector liquidity risk was assesed as moderate. Like before, deposits are the main source of financing for the banking sector. They grew, even faster than in the previous year. Borrowing from non-residents remained moderate. The sector's liquid assets, both in lek and foreign currency, stood above the minimum levels required by the regulatory framework. The 'credit/deposit' ratio was at optimum levels from risk perspective.

Capitalisation indicators were at good levels; however, banks should cautiously assess potential scenarios for future events and their needs for additional capital. During the period under review, the capital adequacy ratio fell, remaining, however, at good levels. Net financial result improved evidently from a year earlier, thanks to the deceleration in non-performing loans, and decrease in 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. Therefore, a cautious and proactive assessment of their needs for additional capital in line with their operational risk profile and their capital increase, when necessary, is a continuous recommendation for banks.

Stress-testing shows that the stability of the banking sector is similar to the previous period. The Bank of Albania conducts regular stress-testing exercises to assess the sensitivity of the main banking sector capitalization figures to changes in macroeconomic indicators and decline in the value of investments in money and securities markets.

For the first exercise that tests the sector's sensitivity to macroeconomic scenarios, the baseline and adverse risk scenarios include assumptions about changes in GDP growth rate, exchange rate and interest rate, and lending, extending through the end of 2016. For the second exercise that tests the sector's sensitivity to the size of loss in the investment value, the scenarios include assumptions about the loss in value of securities.

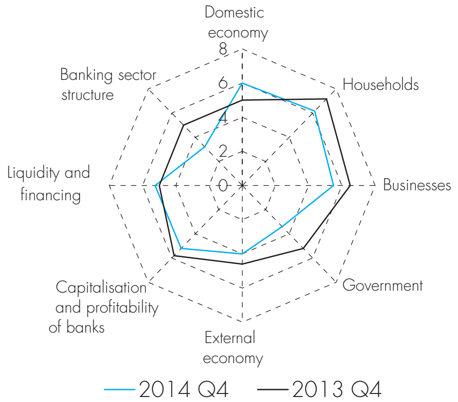
The results of the first exercise show that the banking sector is generally resilient to assumed shocks, in case they materialise. In the event of the baseline scenario, the banking sector capitalisation level remains above the minimum requirement. In the event of the more adverse scenarios, which make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

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

1 OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

Chart 1.1 Financial Stability Map*



*Risk 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. The farther from the centre, the higher the risk. Risk scores are determined by the indices' performance against their historic performance.
Source: Financial Stability and Statistics Department, Bank of Albania

For an overall assessment of risks to the financial stability, we have taken into consideration the main developments in the banking sector, in the in the domestic economy, the financial situation of economic agents, and developments in the external economy[3].

In concrete terms in 2014, risks financial stability risks were mitigated compared to the previous year, driven mainly by the improvement of the economic agents' situation.

Compared to end-2013[4], for the real economy components, we note:

- In the case of the **'domestic economy'**, the increase in the external debt and needs for foreign financing of the economy contributed to the increase in risk. However, in total, this risk is considered as moderate[5] thanks to the positive contribution by the negative output gap narrowing. In the second half, the performance of the exchange rate is assessed to have contributed to higher risk.
- For **'households'**, risk remains 'moderate', due to the performance of the components in the second half of the year. Credit expansion for households, house price rise and positive expectations have all contributed to the mitigation of this risk.
- For **'businesses'**, risk is assessed as downward, rated as 'moderate'. Positive expectations of the sector about the outlook in 2015 H1, and the improvement in the index of the output volume contributed most to this performance. However, the credit portfolio quality and the pace of lending to this sector continue to contribute to the increase in the risk assessment for businesses;
- For **'government'**, risk is assessed as downward, due to budget deficit reduction, lower risk premiums on government debt, and the positive performance of revenues. Albeit the debt level is considered as high, the performance of the above indicators positions it on a downtrend, thus contributing to a lower risk score.

[3] *According to the "Financial Stability Map in Albania", Bulletin of the Bank of Albania, 2014 H1. For a summary of FSM indices, see Annex 1.*

[4] *The risk analysis of real economy components ('domestic economy', 'households', 'businesses' and 'government') is based on data from 2014 Q3.*

[5] *The 'moderate' risk assessment continues to be unchanged in both half-yearly and annual terms.*

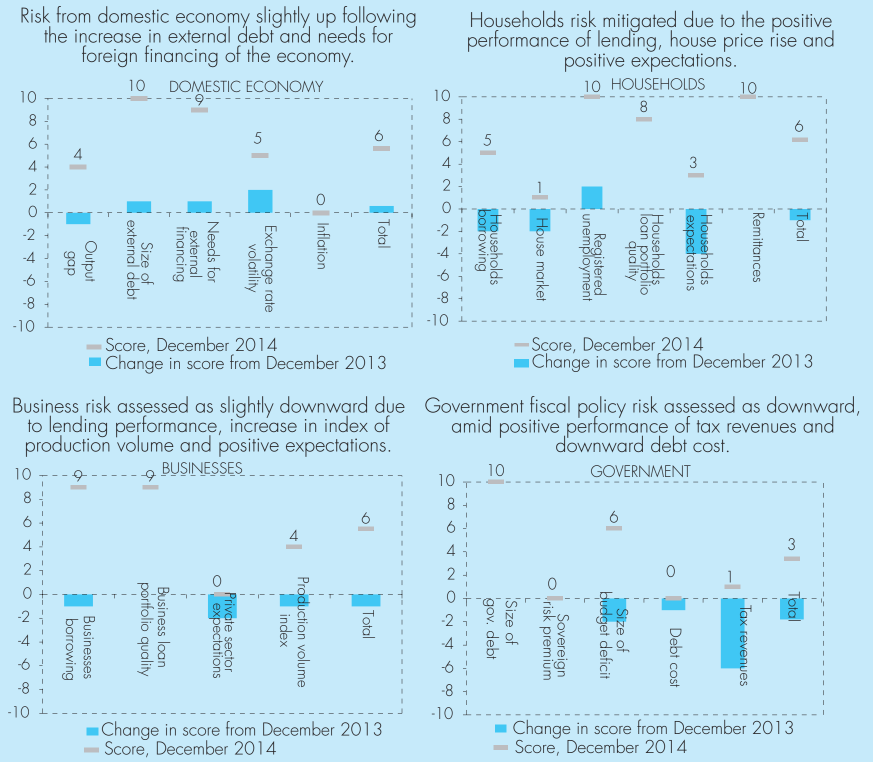
- Risk arising from the **'external economic environment'** was also down, although it remains 'average'. The fall in the unemployment rate in countries hosting Albanian emigrants and the drop in oil prices are two factors contributing most to this risk, in half-yearly and annual terms.

Compared to end-2013[6] for the 'banking sector' components, we note:

- Concerning '**capitalisation and profitability'**, the level of risk is assessed as downward, and is rated as 'average'. While the gap between the actual and the required minimum level of capitalisation has narrowed, the improved financial performance and the fall in the non-performing loan ratio have contributed to the reduction of risk.
- For **'liquidity and funding'**, risk is assessed as 'average'. Within this dimension, expansion of the negative gap between short-term assets and liabilities has contributed to maintaining the risk level.
- Lastly, risk related to **'banking sector structure'** was rated as 'low' down from 'average' in the previous year. Both the lower concentration of bank lending and the higher diversification in the structure of funds have contributed to the downward risk. In half-yearly terms, the positive credit performance has contributed to the reduction of this risk.

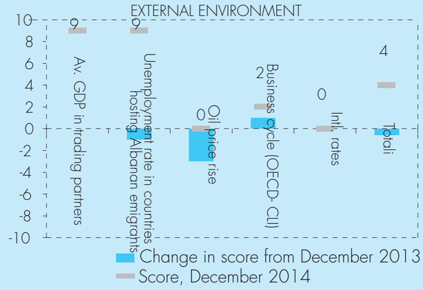
The following charts show all the components of the dimensions of the Financial Stability Map, rating with a 'score' for the risk level against 2013.

Box1.1. Change to risk assessment by category of Financial Stability Map, from end-2013

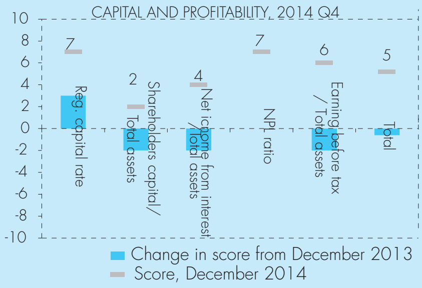


6 *The risk analysis of banking sector components is based on data from 2014 Q4.*

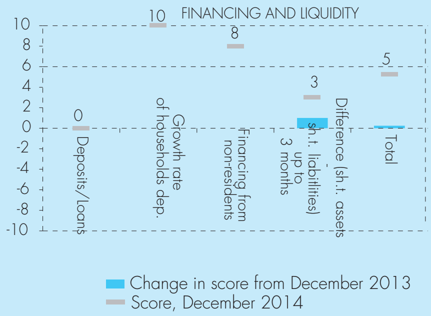
Risk from external economy reduced following the decrease of unemploymnt rate and fall in oil price.



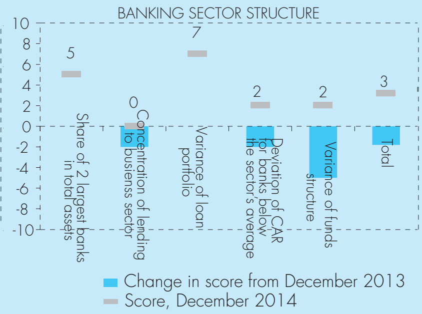
Risk from capital and profitability assessed as downward due to lower concentration of bank lending and higher diversification in fund structure.



Risk from liquidity and financing assessed as average. Within this dimension, expansion of negative difference betw. short-term assets and liabilities contributed to maintaining risk levels.



Lower concentration in banking sector improved risk arising from structure.



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

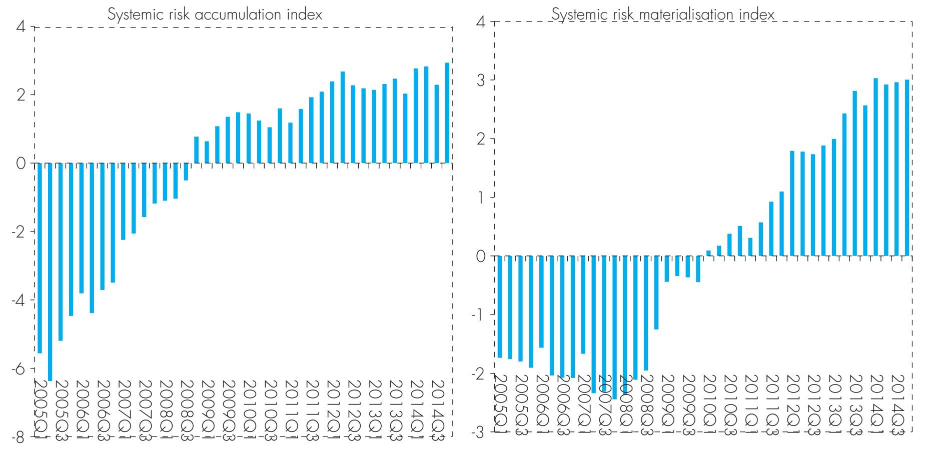
1.2 SYSTEMIC RISK

Systemic risk is defined by the European Central Bank as follows: "systemic risk is the materialisation of shocks when financial instability becomes so widespread that it impairs the functioning of the financial system to the extent that economic growth and welfare suffer materially". As at December 2014, the accumulation of the systemic risk arising from factors relating to the banking sector and the real economy appears as upward compared to the same period in the previous year. The contraction of foreign currency lending and the performance of the housing market mitigated the accumulation of the systemic risk, whereas the increase in the debt level, and foreign currency debt had an opposite effect. The index on the materialisation of the systemic risk stood slightly up from the previous year, reflecting the credit quality deterioration for businesses and households, the higher unemployment rate and deprecation of the national currency, mainly against the US dollar.

As at December 2014, the systemic risk is assessed as downward also according to the Financial Systemic Stress Index[7]. The improvement in the performance of deposits, credit, and net interest margin during 2014 H2 contributed to the mitigation of the banking sector's systemic risk.

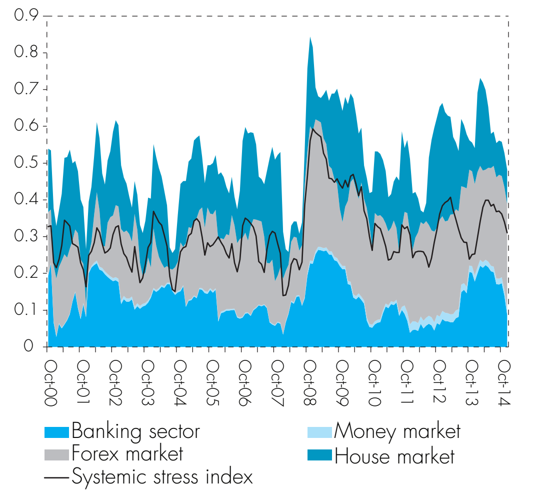
[7] *This index measures the level of financial stress in Albania through information on different financial system segments, aggregated into a single index. The methodology was presented in the Financial Stability Report of the Bank of Albania, 2013 H2.*

Chart 1.2. Accumulation and materialisation of systemic risk



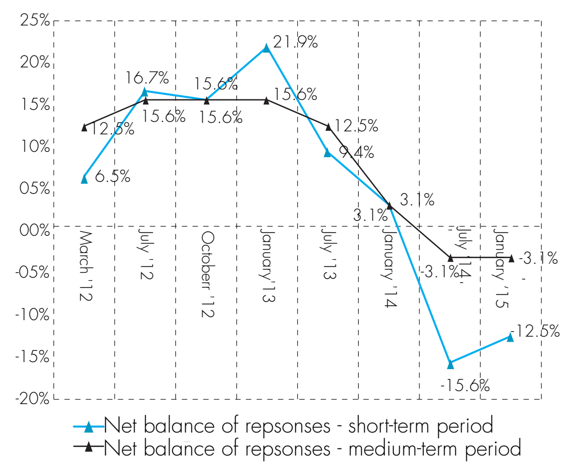
Source: Bank of Albania.

Chart 1.3. Financial Systemic Stress Index



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

Chart1.4. Probability of occurrence of a systemic risk*



*Net balance of banks responses, systemic risk perception survey, 2014 H2.

Source: Financial Stability and Statistics Department.

In a special survey, the banking industry is asked on its perception for systemic risks facing its operations. For 2014 H2, the industry assesses that the 'worsening of the domestic economy' is the most significant systemic risk, but the perception of the banking sector for this risk has been gradually subduing during 2014. The attention to the risk from 'shocks from the external economy' is up, reflecting the concern over the still-sluggish economy in the euro area, especially in Greece and Italy. Systemic risks relating to 'lending to businesses' and 'difficulties on collateral execution' continue to be listed among the 5 most significant risks. Following the downward assessment of systemic risk, banks perceive a lower probability of its materialisation in the short term (up to 12 months) and long term (1-3 years), according to Chart 1.4.

After the overview of risks to the financial stability, the following chapters elaborate in detail developments in the international and domestic economy, as well as the performance of the financial system, with particular focus on banking sector developments.

2 INTERNATIONAL DEVELOPMENTS

During the second half of 2014, the global economic activity improved gradually, but at lower-than-expected rates[8], while evident divergences between the regions persist. Inflationary pressures fell globally, reflecting downward commodity prices, mainly of oil and its by-products. The euro depreciated against the major currencies, especially the US dollar. Economic divergences between major regions are reflected in different monetary policy stances by central banks. Financial markets were overall stable during 2014 H2, except October-November 2014, when uncertainties rose mainly due to the deterioration of the global economic outlook. The global economic activity is expected to continue to improve at slow rates[9], driven also by the significant drop in oil prices.

The performance of advanced economies was characterised by evident divergences within the group, whereas in developing countries it was affected negatively by the escalation of geopolitical conflicts and fall in oil and commodity prices for producing countries.

Beyond forecasts, the US economy grew 5% in annual terms during 2014 Q3, driven mainly by the growth of exports and public and private expenditures. The pace slowed down to 2.6% in Q4, as a result of the turning point in the performance of the above-mentioned factors. The conditions in the labour market continued to improve, while inflationary pressures remain low, reflecting the appreciation of the US dollar and the fall in oil prices. In October 2014, the Federal Reserve ended the liquidity support programmes, but continues to keep the key rate unchanged.

The euro area economy improved gradually during 2014 H2, driven mainly by the consolidation of the domestic demand. Conditions in the labour market showed signs of recovery and the unemployment rate for the region, at the end of the year stood at 11.4%. However, marked differences among countries remain, with countries such as Greece, Spain, and Portugal still reporting high unemployment rates. In the public sector, fiscal consolidation continues. At the end of 2014 Q3, public debt fell to 92.1% of the region's GDP (Table 2.1). The fall in oil prices and absence of pressures from the external demand contributed to the further weakening of inflationary pressures in this region, resulting in negative rates at the end of the year[10]. In the banking sector,

---

[8] *IMF's World Economic Outlook January 2015 (3.3 % annual growth) was down from the projection in October 2014 (3.4% annual growth).*

[9] *According to the IMF, global economic growth is projected at 3.5% in 2015 and 3.7% in 2016. (WEO, January 2015)*

[10] *According to Eurostat, in December 2014, the annual rate of inflation in the euro area resulted -0.2%.*

credit demand and supply showed signs of recovery, and lending standards were eased somewhat. However, these indicators remained below their historic average, affected by the incomplete consolidation/cleaning of banks' balance sheets. Under these conditions, the European Central Bank (ECB) intensified the accommodative stance of its monetary policy. In addition to lowering the key interest rate it introduced new quantitative easing measures.

Latest data and confidence indicators suggest that euro area's economic recovery will continue at moderate rates during 2015. Economic activity is expected to be driven by domestic demand strengthening, affected by low oil prices, easing of the monetary policy, and more neutral fiscal policy. Also, the depreciation of the euro against the currencies of the main trading partners is expected to promote European exports. On the other hand, the still-high unemployment and unutilized capacities, as well as the insofar progress of reforms in the private and public sectors continue to bear risk to the economic recovery in the euro area. The fall of inflation rates to negative levels, amid an environment with weak growth, is considered as a new risk to the stability of the region.

Table 2.1. Selected macroeconomic indicators for the U.S. and euro area

	GDP change (annual %)				Unemployment (annual %)		Gross government debt (as %of GDP)	
	2014*	2015p	2014 Q3	2014 Q4	Sept 2014	Dec 2014	2014 Q2	2014 Q3
U.S.	2.4	3.6	5.0	2.6	5.9	5.6	101.7	101.3
Euro area	0.8	1.2	0.8	0.9	11.5	11.4	92.7	92.1
Germany	1.5	1.5	1.2	1.5	5.0	4.8	75.3	74.8
France	0.4	0.9	0.4	0.2	10.3	10.3	95.2	95.3
Italy	-0.4	0.4	-0.5	-0.3	13.0	12.9	133.8	131.8
Greece	:	:	1.6	1.7	26.0	:	177.5	176.0

Source: European Central Bank, Eurostat, IMF, Bureau of Economic Analysis (BEA), Federal Reserve.
** IMF estimates, January 2015; P- IMF projections, January 2015, : no available data.*

In the main Central and Eastern European countries, economic activity expanded at variable rates during 2014 H2, driven mainly by the improvement of domestic demand. Their exports were down, due to the weakening of the trade activity under the negative impact of geopolitical tensions Russia - Ukraine.

Economies of our region grew at positive rates during Q3 and Q4, though at a different pace. By contrast, Serbia's economy continues to contract (Table 2.2). Unemployment rate fell slightly across the countries (more pronounced in Serbia); however, the conditions in the region's labour market remain problematic and subject to structural reform. Low inflationary pressures persist across the entire region, with three countries registering deflation.[11] In the rest of the countries its rates remained below the central banks' target. Bank lending showed signs of recovery, with the credit growth accelerating and credit standards' easing in most of the countries. The high level of non-

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

performing loans remains the main concern of the banking sector across most of the countries of the region.

Table 2.2 Selected macroeconomic indicators for CESEE

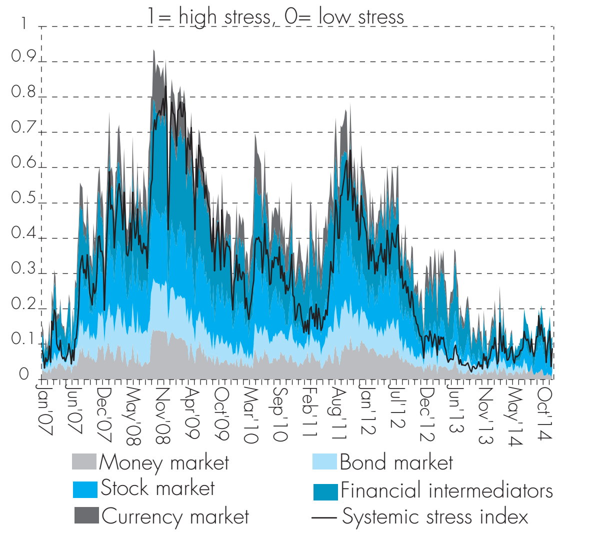
CESEE	GDP change (annual percentage)			Unemployment (% annual basis)		Sovereign debt (% of GDP)	
	2014	2014 Q3	2014 Q4	Sept 2014	Dec 2014	2014 Q3	2014 Q4
Bulgaria	1.4	1.5	1.2	11.4	10.3	23.6	:
Romania	2.4	3.2	2.5	6.7	6.4	38.1	:
Western Balkans							
	2014	2014 Q3	2014 Q4	2014 Q3	2014 Q4	2014 Q3	2014 Q4
Serbia	-2.0	-3.6	-1.6	17.6	16.8	67.9	70.9
Macedonia	3.9p	4.1	:	27.9	:		
Montenegro	2.0p	1.3		:	:		
B&H	:	0.6		43.7	43.6		

Source: ECB, Eurostat, European Commission, respective central banks.
P - ECFIN projections, October 2014.

2.1 MAIN HIGHLIGHTS IN FINANCIAL AND PRIMARY COMMODITY MARKETS

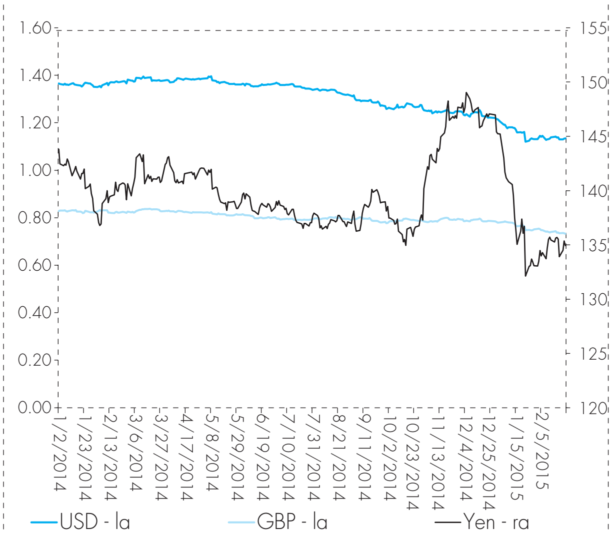
Conditions in financial markets were overall stable during 2014 H2, except for October-November 2014, when uncertainties rose mainly due to the deterioration of the global economic outlook. This led to a temporary decrease of prices in stock markets, increase in volatility and risk premiums. However, the central banks' accommodative policy, especially the measures taken by the ECB, contributed to the return of markets to normality and descent of stress to pre-crisis levels.

Chart 2.1. European systemic stress index (CISS)



Source: European Central Bank.

Chart 2.2. EUR exchange rate against major currencies



Source: European Central Bank.

Money markets, especially European ones, were characterised by downward rates and ample liquidity, reflecting ECB's decision to further ease its monetary policy. In sovereign debt markets, the ask yields on return were generally down. Developments in the shares markets were characterised by two different periods. Until October 2014, prices in these markets, especially those in European ones, were generally downward. This performance reflected the slowdown of the economy in the euro area, negative financial and political developments in some countries and heightened market uncertainties relating to the global economic outlook. However, in the last months of the year, prices in these markets recovered almost totally, mainly following ECB decisions on quantitative easing.

Notwithstanding overall positive developments in financial markets, amid an environment with rather low interest rates, the risk of investors' withdrawal from high-risk investments to seek more profitable alternatives became more pronounced. On the other hand, the shock of markets during October - November, revealed their still-high sensitivity to shocks form the real economy.

In the currency markets, the euro was generally depreciated against the currencies of the main trading partners especially the US dollar, reflecting expectations on the monetary policy and economic outlook for the euro area vis-à-vis other countries. In commodity markets, crude oil prices fell during 2014 H2. The fall was dictated mainly by the ample supply by producing countries, whereas demand remained limited, in line with the sluggish growth of the global economy. For the medium term, participants in this market expect a slight rise in oil prices. In addition, commodity prices were down during Q2 and Q3, given the high supply and sluggish demand globally. Commodity prices changed somewhat in Q4, as a result of the overall decline in supply due to cold weather and Russia-Ukraine conflict, the two major exporters of cereals.

Regarding the banking sector, in H2, global systemic banks, especially American and European ones, continued to adopt higher regulatory standards. Banks improved their capital position and financial leverage ratio, anticipating new requirements that will enter into force in 2015. The improvement of banks financial resilience has facilitated their entrance in capital markets. However, banking sector profitability remains overall low, dictated also by the weak credit growth.

In an effort to anticipate the process of assessing the financial soundness of the 130 largest European banks, the latter have worked for consolidating their balance sheets and improve their capital positions. During 2014, they were subject of the stress test exercise by the ECB and EBA, based on the activity indicators for the end of 2013 (see Box 2.1). The exercise revealed that 25 banks were undercapitalised. However, financial markets reacted positively after the publication of the results from this test, against the backdrop of undercapitalisation levels significantly lower than in previous exercises. In the meantime, all banks had fulfilled capital requirements during 2014.

During 2014 H2, banking groups active in the Central, Eastern and South-East Europe (CESEE) confirmed that they have continued to reduce their exposure to the region, mainly through the sale of assets and/or branches. About half of them expect the process to extend also in the next six months[12].

[12] *CESEE Bank Lending Survey results, September 2014*

Credit demand and supply conditions improved, but remained nonetheless at low levels. Profitability and return on assets for the region result below the overall value for the group, whereas the credit quality and implementation of the regulatory framework are the main factors obstructing credit recovery. Overall, these banks state that they continue to remain engaged in the CESEE, but differentiating their strategies for each country, in conformity with the structural differences and economic outlook for each of them. In this context, they are revaluating the potential of the local markets wherein they operate, which may lead to refocusing their activity in the future.

Box 2.1. Examination results of the resilience of the largest banks in the euro area

On 26 October, the ECB published the results of an examination of the resilience and positions of the 130 largest banks in the euro area that had started in November 2013. This process consisted of the asset quality review (AQR) and a stress test exercise, referring to banks balance sheets as at end-2013. In total, 25 participating banks failed the test, after the assessment identified a capital shortfall of EUR 24.6 billion. During 2014, ten of these banks raised new capital amounting to EUR 18.59 billion, reducing the capital shortfall to EUR 9.47 billion.

Among banks that operate in Albania, the National Bank of Greece, Piraeus Bank and Veneto Banca have shown the need for raising additional capital according to the exercise. However, during 2014, these banks have taken the measures to improve their capital positions and, subsequently, the capital shortfall is either absent or low. The other groups successfully passed the stress test, standing above capital requirements, both in the case of the AQR, baseline scenario (8% of CET1) and the adverse scenario (5.5% of CET1).

Table 2.1 Outcomes of the assessment for banking groups that operate in Albania

Banking groups that operate in Albania	Asset quality review		Baseline scenario		Adverse scenario		New capital - 2014 (EUR bln)	Net capital shortfall (EUR bln)
	CET1 (>8%)	Additional capital needed (EUR bln)	CET1 (>8%)	Additional capital needed (EUR bln)	CET1 (>5.5%)	Additional capital needed (EUR bln)		
Intesa Sanpaolo	11.7%	0.00	11.2%	0.00	8.3%	0.00	-	0.00
Veneto Banka SCpA	5.7%	0.58	5.8%	0.57	2.7%	0.71	0.74	0.00
Alpha Bank S.A.	14.1%	0.00	13.8%	0.00	8.1%	0.00	-	0.00
National Bank of Greece S.A	7.5%	0.27	5.7%	1.28	5.7%	3.43	2.50	0.93
Piraeus Bank S.A.	10%	0.00	9.0%	0.00	4.39%	0.66	1.00	0.00
RZB Group	9.7%	0.00	9.5%	0.00	7.8%	0.00	-	0.00
Credit Agricole	10.8%	0.00	11.1%	0.00	8.8%	0.00	-	0.00
Société Générale	10.7%	0.00	10.6%	0.00	8.2%	0.00	-	0.00

Source: European Central Bank
CET1-Ratio (to risk-bearing assets) of the most qualitative tranche of the core capital.

Box 2.2. Developments in foreign banking groups operating in Albania

Table 2.2 shows some of the main indicators of financial statements of bank holding groups operating in Albania, in relative terms, compared to the same period in the previous year. 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 2.2 Financial data on foreign banking groups operating in Albania

Annual change	Raiffesen Bank International	Intesa San Paolo	Alpha Bank	Piraeus Bank	National Bank of Greece*	Societe Generale	Credit Agricole
Assets*	1.1%	3.6%	4.5%	-6.8%	2.0%	8.0%	4.4%
Credit	2.4%	-1.4%	-8.4%	-3.0%	0.0%	4.0%	0.9%
Deposits	2.1%	2.9%	3.7%	0.7%	2.0%	5.0%	2.6%
Loan-loss provisions	35.4%	-36.0%	-26.7%	28%	-14.0%	18.0%	-
Net profit	24.4%	38.8%	76.5%	...	...	31.7%	-4.1%
Operating income	-	4.0%	5.9	-	-3.0%	20.9%	-1.4%
Net interest income	4.2%	3.3%	21.1%	12.10%	-3.0%	0.4%	-
Net commission income	-2.8%	10.5%	9.2%	17.6%	3.0%	-3.1%	-
Operating expenses	-5.5%	3.0%	-5.0%	-12.2%	-11.0%	-1.9%	-0.1%
Net operating profit	-	5.1%	-	-	-	-	1.8%
Ratios							
Non-performing loans	11.1%	8.8%	33.6%	39.0%	23.4%	6.0%	-
Net interest margin	3.29%	-	2.6%	-	1.14%	-	-
Capital adequacy ratio	15.5%	13.3%	15.9%	13.6%	15.8%	14.3%	13.1%
Banks' assets in Albania to total group assets	1.47%	0.16%	0.72%	0.77%	0.25%	0.04%	0.01%

Source: Official websites of banking groups.
: unavailable published data.
… change in net profit/loss is reported above 100%, on a year earlier.
** Difference from the end of the same period in the previous year for balance of sheet components.*

3 MACROECONOMIC DEVELOPMENTS IN ALBANIA

In 2014 Q4, economic activity was estimated to have grown 2.42% in annual terms, or 1.12% from the previous quarter. By sector of the economy, construction recorded a significant annual increase by 10.81%, while industry grew by 1.61% driven entirely by the expansion of the processing industry. In annual terms, transport expanded by 3.01%, and other services by 3.21%, whereas post telecommunications and agriculture contracted.

Following these developments, domestic demand growth is estimated as the main component driving economic growth. The simulating monetary conditions, the enhanced economic agents' confidence, in addition to the downward risk premiums, drove the domestic demand, but the external demand was weaker than expected.

In December 2014, annual inflation fell to 0.7%, reflecting low inflationary pressures from both the internal and external economy. In response to these developments, the Bank of Albania continued to pursue an accommodative monetary policy throughout 2014.

As at December 2014, fiscal indicators[13] show that the consolidating trend of the fiscal policy continues. Revenues amounted to ALL 366.7 billion cumulative up 12.1%, in annual terms, reflecting the positive performance mainly in income from special funds and the local government, followed by tax revenues.[14] General expenditure were also up by 11.3% in annual terms, reaching ALL 438.8 billion, due to the increase in expenditure for the local government budget, and those for special funds.[15] Budget deficit is estimated to amount to around 5.1% of GDP and was financed mainly through domestic resources, at 58.5%.

During 2014 Q4, the current account recorded a deficit amounting to EUR 378 million, surging 12% in annual terms. During this period, net exports deficit in goods and services expanded to EUR 639 million, or 9% from the previous year. For the same-stated period, in the capital and financial account, the foreign currency inflow amounted to EUR 268 million, of which around EUR 21 million in the form of grants for capital investment, and EUR 247 in the form of net financial flows. Net balance in capital transactions,

13 Data are cumulative and preliminary, as published by the Ministry of Finance

14 Special revenues and local government revenues grew 16.5% and 15% respectively, in annual terms. 15% in annual terms Main items contributing to the increase were 'social insurance' and 'property tax'; whereas tax revenues rose 12% in annual terms.

15 Expenditure for the local government budget and special funds increased 10.4% and 8.5% in annual terms Main items contributing to the increase were 'economic assistance' (18%) and 'health insurance' (18.5%).

during the period, provided the financing of current deficit at 71%. Preliminary data on foreign direct investments suggest that their net flow amounted to EUR 229 million, or 93% of the financial account.

Lastly, developments in the labour market as at end-2014 point to an increase in the unemployment rate, which reached 18.0% from 17.1% in the previous year. Employment in the private non-agricultural sector improved, whereas employment in the agricultural and public sector fell, in annual terms. The agricultural sector, however, has started to show signs of recovery, mainly during the first three quarters of 2014, after several consecutive periods trending down, during 2013. Expectations about employment in 2015 H1 are positive for the industry and services sectors of the economy. Conversely, expectations about employment in the construction sector are downward[16] .

Forward looking, economic growth is expected to pick up, driven by the domestic demand, low interest rates and gradual credit recovery. Contribution of external demand to the economy will continue to remain unfavourable, given the sluggish economic activity in Albania's trading partners and the risk of deflation in the euro area.

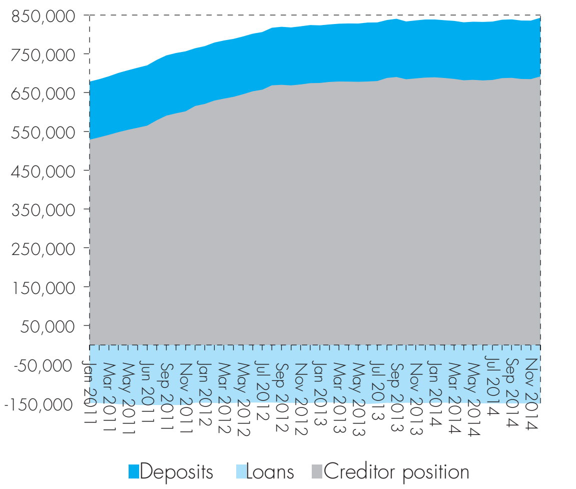
[16] *Businesses Confidence Survey, 2014 Q4.*

4 FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

In the second half of 2014, households' inclination to save continued, as reflected by the slow expansion of deposits both in annual and half-yearly terms. Lending reflected a slight expansion compared to the end of 2013, both for households and businesses. For households and businesses, credit continues to be oriented in the national currency. In relation to risks, households decreased, whereas businesses increased their exposure to the indirect credit risk arising from the exchange rate. The credit portfolio quality improved both for households and businesses.

4.1 HOUSEHOLDS

Chart 4.1. Households financial position in financial system



Source: Bank of Albania.

In 2014 H2, households' creditor position[17] amounted to ALL 691.55 billion, widening by ALL 2.95 billion from 2013 H2, and ALL 10.22 billion from 2014 H1. These developments reflected the increase in household deposits by ALL 4.48 billion, against the increase in lending by only ALL 1.53 billion, from end-2013.

By currency, households are creditors of ALL 360.91 billion in lek and ALL 330.64 billion in foreign currency. Meanwhile, the creditor position in lek narrowed - both in annual and half-yearly terms - whereas the position in foreign currency expanded. The expansion of the creditor position in foreign currency reflects the faster growth of foreign currency deposits.

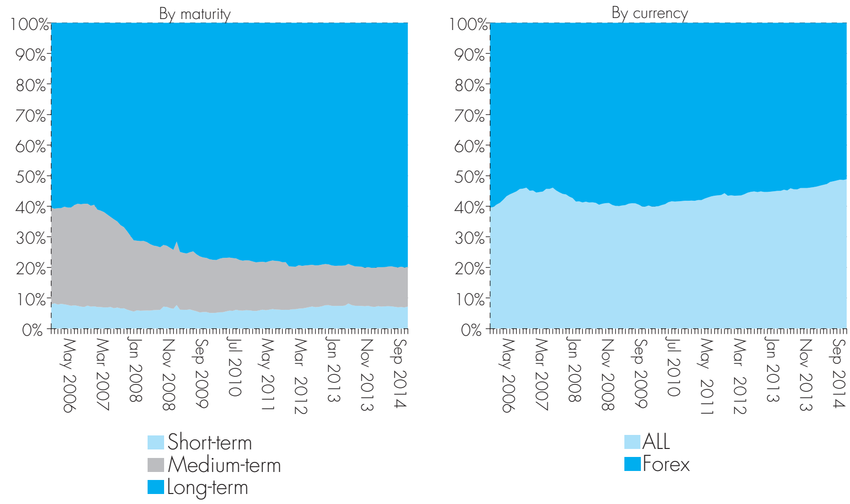
4.1.1 CREDIT RISK

In 2014 H2, bank lending to households expanded 1.32% in annual terms. Credit expansion reflected the decrease in foreign currency credit by 4.1%, against the increase in lek credit by 7.7%. Consequently, the share of foreign currency credit fell to 51.2%, whereas lek credit rose to 48.8%, thereby narrowing the spread between them. By maturity, for households medium-term

[17] 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.

credit expanded to 13% of the portfolio, whereas long-term credit and short-term credit contracted slightly in annual and half-yearly terms, accounting for 79.8% and 7.2%, respectively of the credit portfolio.

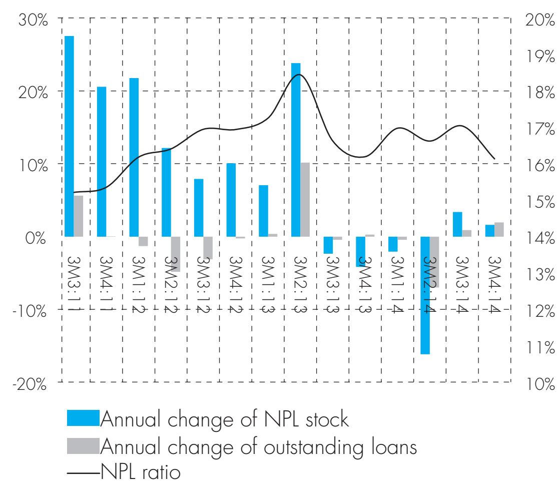
Chart 4.2. Households loan structure



Source: Bank of Albania.

As at December 2014, the non-performing loan ratio for households fell to 16.13%, from 16.19% in 2013 H2 and 16.62% in 2014 H1. The rapid expansion of credit outstanding for households compared to the stock of non-performing loans is reflected in the downward ratio during the year.

Chart 4.3. Households portfolio quality

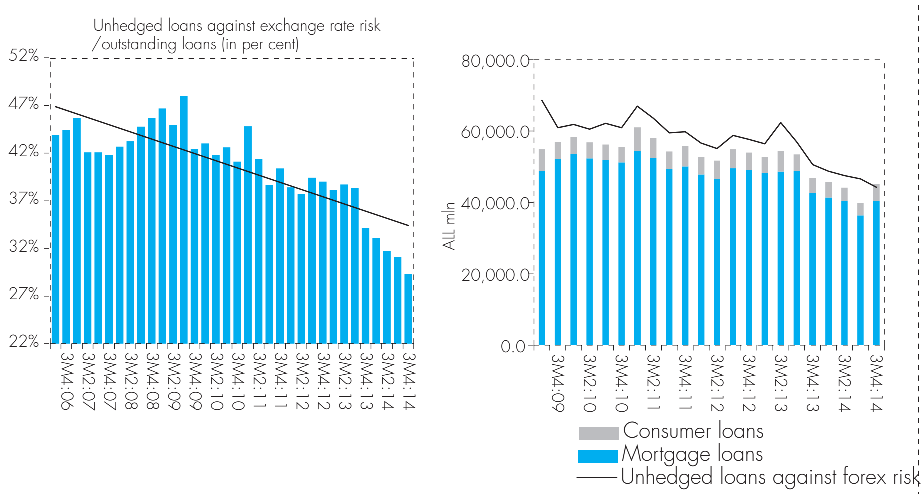


Source: Bank of Albania.

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 December 2014, these loans fell to around 29.3% of total household outstanding loans, from 34.2% at end-2013. Around 91.2% of household loans unhedged against the exchange rate risks consisted in 'House purchase loans', which was up 6.74 percentage points from end-2013; 'Consumer loans' accounted for 10.7% of loans unhedged against the exchange rate risk, up 2.7 percentage points from end-2013.

Chart 4.4. Households exposure to indirect risk arising from exchange rate

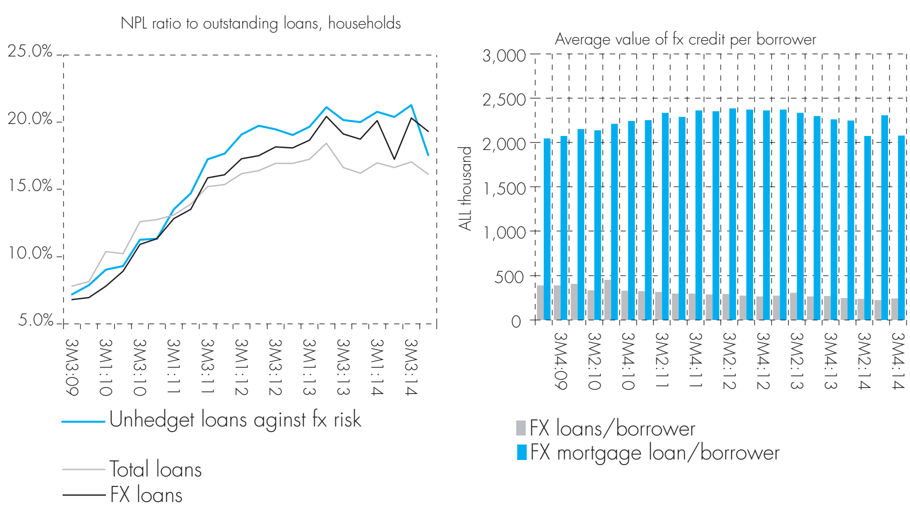


Source: Bank of Albania.

As regards the portfolio quality of loans unhedged against exchange rate risk, in December 2014, the non-performing loan ratio stood at 17.5%, from 20.0% in 2013 H2, and 20.4% at the end of 2014 H1. In the meantime, the portfolio quality for foreign currency loans deteriorated to 19.31%, from 18.74% in 2013 H2 and 17.23% in 2014 H1

Average foreign currency loan fell to ALL 2.1 million per borrower, from

Chart 4.5. Households credit quality and average credit value per borrower



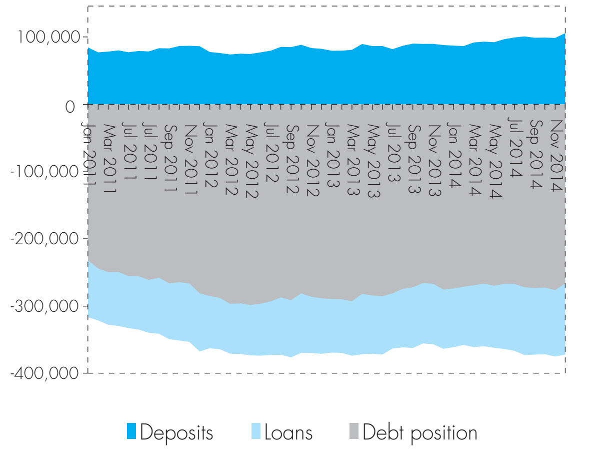
Source: Bank of Albania.

ALL 2.3 million at end-2013. The fall reflects the drop in the stock of foreign currency loans for house purchase purposes, for a higher number of borrowers.

4.2 BUSINESSES

Businesses narrowed their debtor position to the financial system[18] to ALL 266.36 billion, in December 2014. The debtor position narrowed by ALL 9 billion in annual terms, and ALL 0.52 billion in half-yearly terms. This performance mostly reflected the annual sluggish expansion in business loans by ALL 8.63 billion, while deposits expanded by ALL 17.7 billion. Expansion of business deposits, driven by payment of government arrears, remains above the long-term average of annual growth since December 2007, whereas credit remains significantly below the long-term average.

Chart 4.6. Businesses debt position in financial system



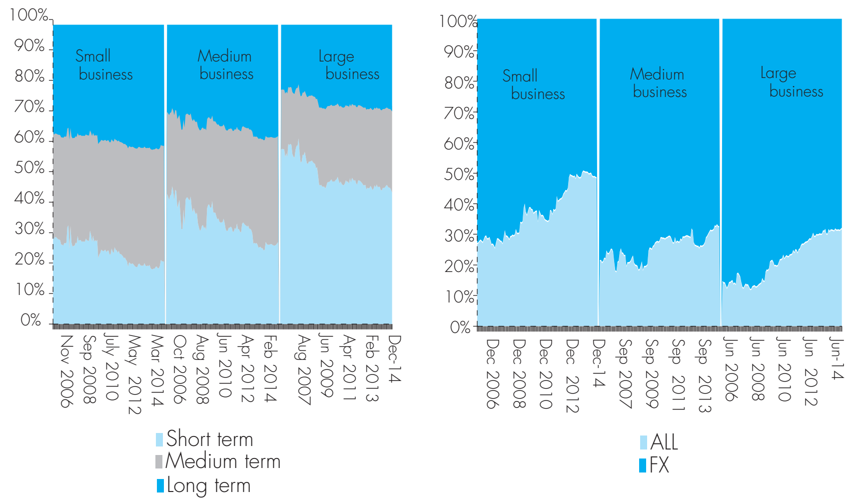
Source: Bank of Albania.

By currency, businesses are debtors of ALL 79.5 billion in the national currency and ALL 186.9 billion in foreign currency. Compared to a year earlier, the debtor position in the national and foreign currency narrowed by ALL 4.7 billion and ALL 4.3 billion, respectively. These developments reflect mainly the faster increase in deposits.

4.2.1 CREDIT RISK

Bank lending to businesses grew both in annual and half-yearly terms, by 2.0% and 2.3%, respectively. This performance was mostly due to the

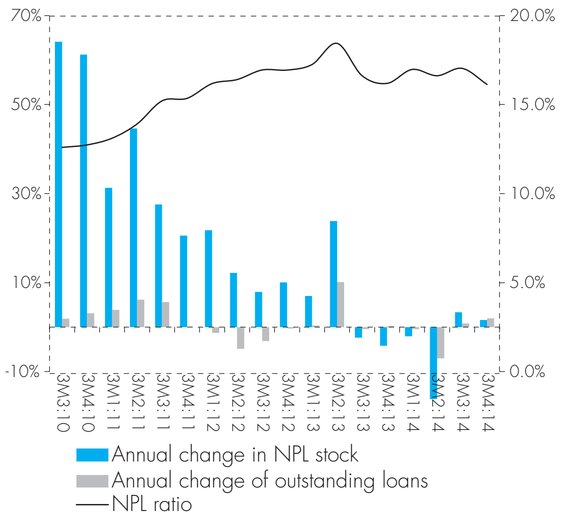
Chart 4.7. Business loan structure



Source: Bank of Albania.

[18] *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). When the difference is negative, businesses are 'debtors' to the system.*

Chart 4.8. Business portfolio quality



Source: Bank of Albania.

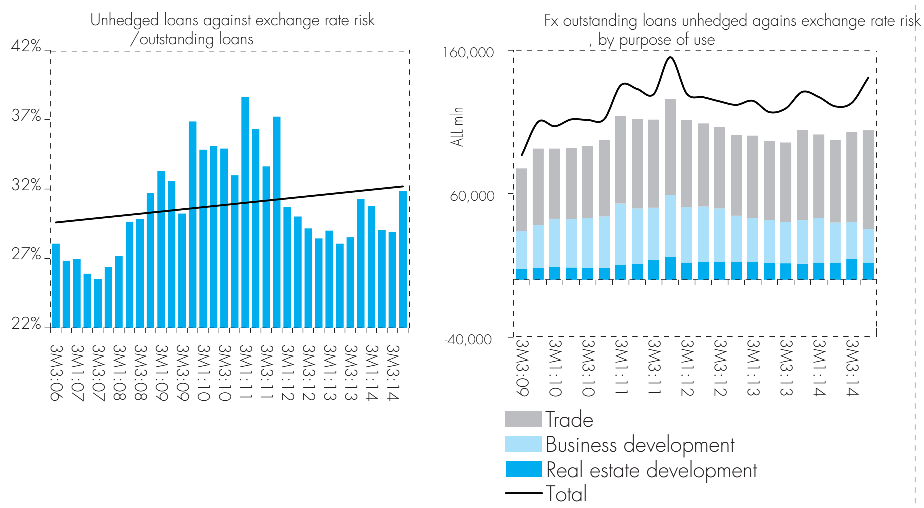
expansion in lek loans by 4.7%, while foreign currency loans expanded only 0.6%. As a result, the share of lek loans expanded to 34.9% of the total. By business size, larger businesses accounted for 61.7% of the loan portfolio, whereas small and medium-sized enterprises accounted for 18.9% and 19.4%, respectively. By term to maturity, short-term loans to large businesses shrank, reflected in the expansion of medium and long-term loans. Small and medium-sized enterprises expanded slightly the short and long-term credit, narrowing the medium-term one. By currency, lending in the national currency expanded.

The quality of the business loan portfolio improved from end-2013. As at December 2014, the non-performing loan ratio stood at 25.11%, from 26.03% in December 2013 and 26.72% in 2014 H1.

4.2.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

During 2014 H2, business exposure to exchange rate movements increased, in contrast to the downtrend noted in 2014 H1. In December 2014, business outstanding foreign currency loans, unhedged against exchange rate risk, rose to 31.9% of total business loans, from 31.3% at the end of 2013. The share of foreign currency loans in total business loans rose to 65.5%, from 64.8% at end-June 2014. On a year earlier, the share of foreign currency loans remained almost unchanged, around 65.6%.

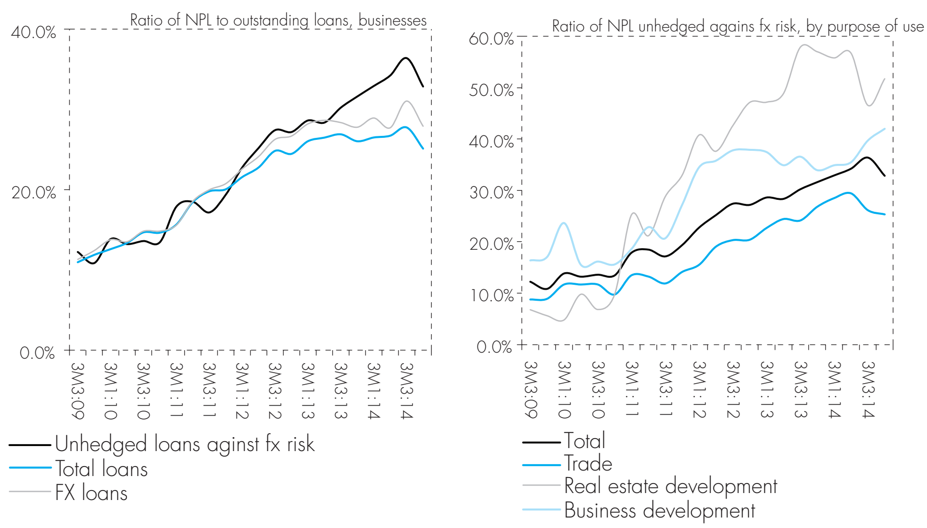
Chart 4.9. Business exposure to indirect risk arising from exchange rate



Source: Bank of Albania.

The structure of business loans unhedged against exchange rate risk showed the growth in 'commercial-related loans' to 48.8 %, while 'business development loans' and 'real estate development loans' accounted for 16.7% and 8.5%, respectively. The quality of this portfolio deteriorated and the ratio of non-performing loans rose to 32.9% from 31.6% at end-2013. In half-yearly terms, this ratio improved by 1.4 percentage points. The quality of this portfolio improved more markedly in 'real estate development loans', whose ratio of non-performing loan fell to 51.8% from 57.0% a year earlier. In 'business development loans', the ratio of non-performing loans stood at 42%. The credit quality deteriorated both in annual and half-yearly terms. In the meantime, the share of non-performing loans in the foreign currency portfolio increased slightly to 27.9% in December 2014, from 27.8% in December 2013 and 27.7% in June 2014.

Chart 4.10. Business loan quality



Source: Bank of Albania.

Box 4.1. Survey on Households and Businesses' financial situation and borrowing

The Bank of Albania conducts a half-yearly survey on the financial situation and borrowing from households and businesses. The latest survey focuses on developments in the second half of 2014, while expectations refer to the first half of 20145.

4.1.1 SURVEY RESULTS OF HOUSEHOLDS' FINANCIAL SITUATION AND BORROWING

The survey is based on a sample of 1210 households across 16 districts of Albania, with 88% of respondent households answering the questions.

- *FINANCIAL SITUATION*

The number of income-earning members fell by 1.8% compared to 2014 H1, and

5.5% from 2013 H2. Total number of employed persons (public sector, private sector and self-employed) was also down in the three sectors, more markedly in the private sector. In aggregate, the level of income at the end of 2014 is downward, compared to the first half of the year, while the level of expenditure is estimated as upward, thence deteriorating the balance of households' balance of 'income-expenditure'.

- *BORROWING*

The total number of households stating that they have a loan or more than one loan to repay as at the moment of interview, despite the type, source, or value, was 318 or around 30% of respondents (around 26% of the total sample), This is up (7 households) form 2014 H1 but down (15 households) from 2013 H2. Around 74% of borrowing households report 'ALL below 17 000 (25%) and 'ALL 17 000-50 000' (49%) monthly income. Households used both bank loans and alternative sources of borrowing. 'Consumption' (34%) and 'Purchasing/renovating a property' (29%) remained the top two purposes for borrowing. The share of borrowing for 'Purchasing/renovating a property' fell both in half-yearly and annual terms, whereas borrowing for 'Consumption' increased in half-yearly terms.

- *HOUSEHOLDS PAYMENT CAPACITY*

The net balance of responses on household solvency was -31.4%, implying it deteriorated during the reporting period. Of households reporting 'worsened payment capacity', 58% attributed it to 'lower income', and 40% to 'higher living costs'. Concerning the expectations for solvency in the next six months, around 84% of respondents stated they 'do not expect any changes', whereas the net balance of responses for those that expect changes was -10%, indicating downward expectation for the next six months.

4.1.2 SURVEY RESULTS OF BUSINESSES' FINANCIAL SITUATION AND BORROWING

The survey is based on a sample of 721 enterprises extended across Albania, operating in the main sectors of the economy.

- *FINANICAL SITUATION*

In 2014 H2, active enterprises report an increase of their sales, in all the three sectors (industry, construction and services). In aggregate terms, the financial result improved and a tendency for activity expansion is noted. Compared to 2014 H1, the use of sales as the only source of financing the activity increased, especially among enterprises operating in the industry sector.

- *BORROWING*

More than half of respondent enterprises (57% or 358 enterprises in total) stated that they actually had a loan to repay, up 3 percentage points from the first half, but down from the previous year. Around 92% of enterprises have borrowed only from banks, whereas the rest has combined alternative borrowing sources. Main borrowing purposes remain long-term investments (mainly industry and services sectors) and current expenditure (mainly the construction sector). The share of enterprises having used the loan for current expenditure purposes increased both in half-yearly and annual terms. Around 49% of enterprises borrowed in the national currency and

43% in foreign currency. The share of lek borrowing against the foreign currency borrowing increased in half-yearly terms. Around 20% of enterprises state they have to repay the loan within 12 months and this share has increased throughout 2014. Most enterprises (74.6%) state they have collateralised their loan, mainly pledging real estate as collateral. For 87.6% of enterprises, the loan value did not exceed the firm's capital value. Around 93% of enterprises spend less than 50% of their income to service the loan; the share has shown an upward trend. For 2015 H1, most enterprises expect a further decline in loan repayment.

- *RELATIONS WITH BANKS*

Most enterprises assess as upward the importance of their relations with banks for the performance of their activities. On the other hand, borrowing is considered somewhat difficult mainly due to the high cost of credit.

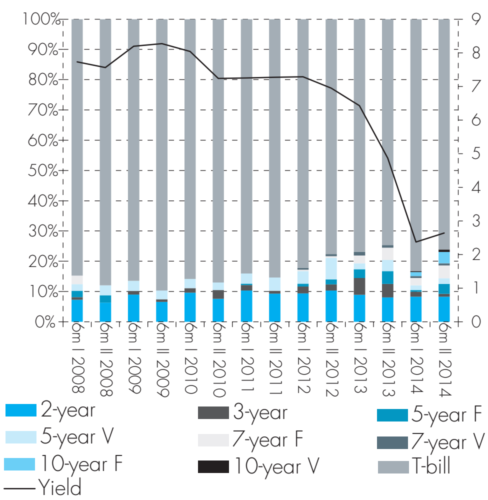
5 FINANCIAL MARKETS

The Albanian financial markets showed a stable performance in 2014 H2. Following the accommodative monetary policy of the Bank of Albania, the financial markets were characterised by downward rates, especially in the primary securities market, regarding banking sector's credit and deposit products, and in the interbank market. Lek's exchange rate was steady against the euro, but depreciated against the US dollar and currencies that mimic it. This performance has reflected mostly developments in international foreign exchange markets.

During 2014 H2, the Government reduced the domestic borrowing by around 31.6% in annual terms. The volume of government debt securities during the period under review amounted to ALL 203.3 billion (from ALL 224 billion in 2014 H1), with 76% issued in Treasury bills. The structure of issues shows a shift towards longer-than-12-month issues.

5.1 PRIMARY MARKET FOR GOVERNMENT DEBT SECURITIES

Chart 5.1. Average yield on Governement debt securities, in per cent



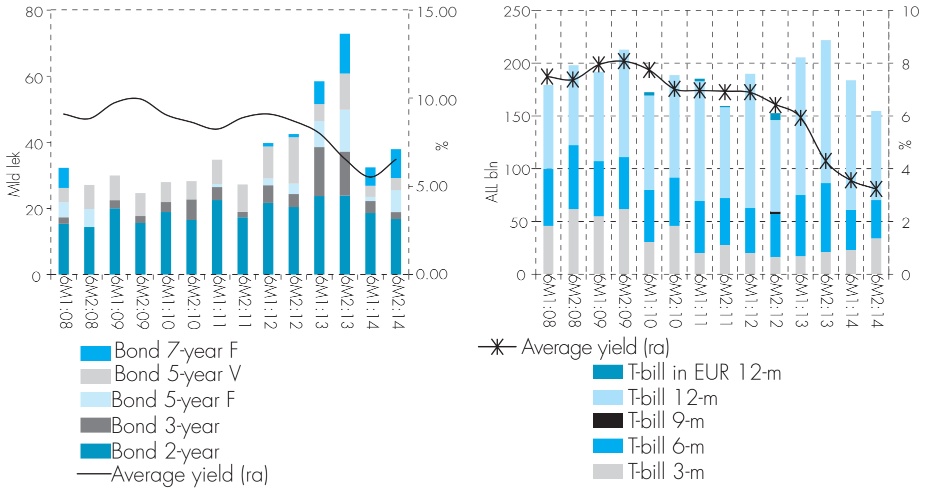
Source: Bank of Albania.

The yields in the primary market auctions of Government debt securities reflected the performance of the key interest rate[19], and the issues structure and investors demand. Overall, the average yield on government securities was around 4%, unchanged from the previous half of the year.

During 2014 H2, the Government issued ALL 155 billion in T-bill auctions, from ALL 187 billion in 2014 H1 and ALL 222 billion in 2013 H2. Bidders' interest in auctions remained higher for the 12-month T-bills, accounting for 55% in total T-bills. Market depth indicators and the bid-to-cover ratio by structure of issue suggest less preference by investors for 3 and 6-month maturities. In some auctions the ask amount was not met (Chart 5.2 left). Issues of Government debt bonds rose to ALL 48.6 billion, from ALL 37.4 billion in 2014 H1. Compared to the previous year, Government debt bonds fell 36%. By structure, issues of 2-year bonds fell slightly, whereas 5, 7 and 10-year fixed-rate bonds made major contribution to the general increase in bonds, increasing in aggregate by around ALL 13 billion.

[19] The Bank of Albania lowered the key interest rate by 0.25 percentage point in November 2014, to the new 2.25% record low (until the end of 2014).

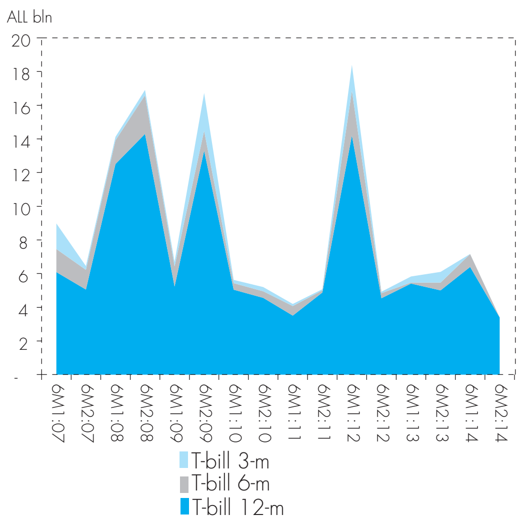
Chart 5.2. Volume and weighted average yield on primary market T-bills (left) and bonds (right)



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

At the end of the period under review, the yield on Treasury bills averaged 3.2%, 0.4 percentage point lower than in the previous half of the year and 1.1 percentage point lower than in the previous year. The downtrend has been reflected since 2009 H2. The government's preference for longer-term borrowing and bidders asking smaller-than-announced amounts is followed by the rise to 6.5% of the average yields on bonds, from 5.9% in the previous half of the year.

Chart 5.3. Volutme of T-bill trading in secondary market



Source: Bank of Albania.

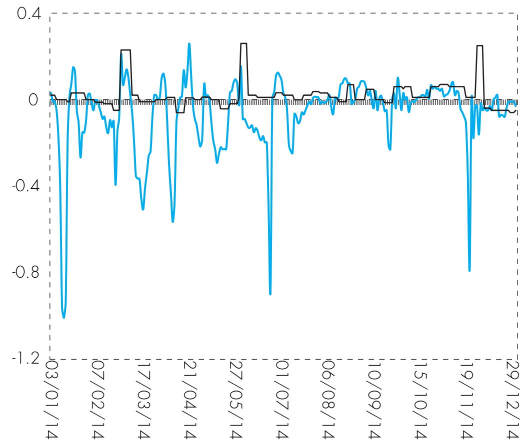
5.2 SECONDARY MARKET FOR DEBT SECURITIES

The secondary market continued to be characterised by a low volume of transactions. The volume of transactions fell to ALL 3.4 billion in H2, reduced almost by half compared to H1. While the number of transactions was higher, up by 125 transactions, the average value per transaction dropped significantly, from ALL 10.3 million, to ALL 4.1 million. Bills of 12-month maturity prevailed in the securities trading volume.

5.3 INTERBANK MARKET

Interbank market transactions decreased during 2014 H2. Liquidity conditions were reflected in low volatility in interest rates. At the end of the period, the volume of transactions amounted to ALL 230 billion, 33.6% lower than in 2014 H1. Banks continue to use more often overnight and one-week borrowing, whereas one-month maturity was employed scarcely and their trading volume was low. Interbank market rates continued to trend down, remaining close to but below the key interest rate. At the end of 2014 H2, the weighted average interest rate in the interbank market was 2.44%, from 2.65% at the end of 2014 H1.

Chart 5.4. Spread between interbank rates and the key rate, by maturity



Source: Bank of Albania.

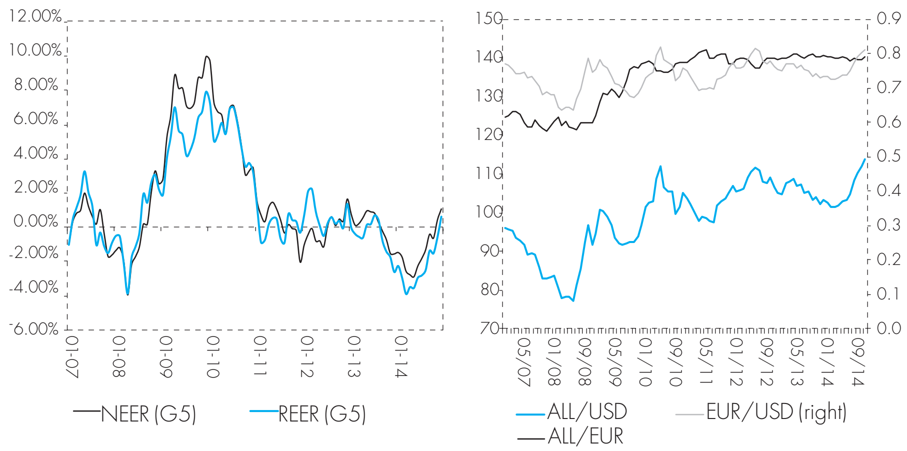
5.4 FOREIGN EXCHANGE MARKET

In 2014 H2, the Albanian lek exchange rate was steady against the euro but depreciated against the US dollar, reflecting mainly the trajectory of the EUR/USD exchange rate in international markets. In real terms, the Albanian lek continued to appreciate, due to faster fall in inflation in euro area trading partners, relative to domestic inflation.

During 2014 H2, the ALL/EUR exchange rate averaged 139.7, down negligibly from the previous period. The ALL/USD exchange rate averaged 104.6, from 102.4 in 2014 H1. In annual terms, the Albanian lek appreciated around 0.4% against the euro and depreciated around 3.9% against the U.S. dollar.

In the same-stated period, the Nominal Effective Exchange Rate (NEER[20]) fell on average terms, reflecting an appreciation of lek by around 0.5%, in annual terms. In real terms (REER), the Albanian lek appreciated by 1.7% in annual terms.

Chart 5.5. Annual change in NEER and REER and exchange rate in domestic foreign currency market



Source: Bank of Albania.

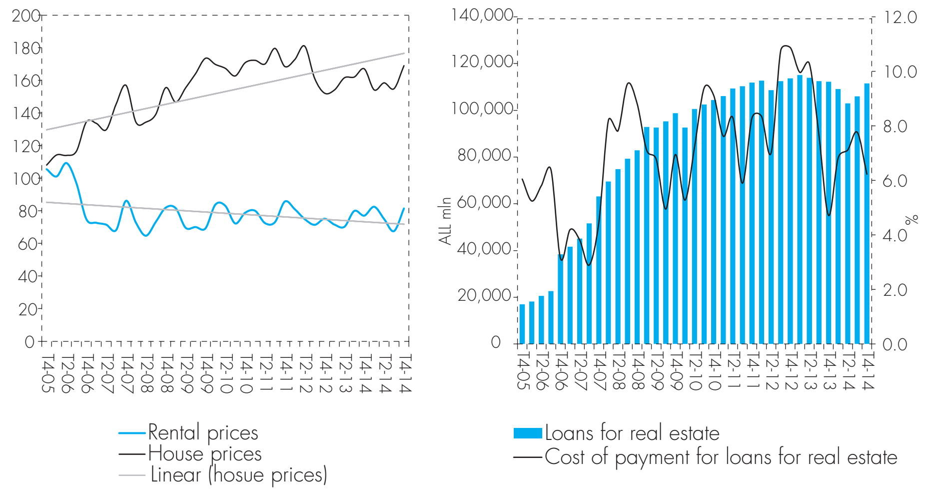
[20] NEER (Nominal Effective Exchange Rate) is calculated against the currencies of Albania's five main trading partners: Italy, Greece, Germany, Turkey and China. An increase in NEER implies the lek's depreciation.

5.5 HOUSE MARKET

At the end of 2014, the situation in the real estate market was slightly improved. The House Price Index for Tirana was up, while the expectations of real estate agents are more optimistic. Real estate loans improved in the second half of the year and the interest rates on this portfolio fell. However, the real estate loan portfolio quality worsened.

During 2014 Q4, the House Price Index[21] improved 1.2% from the previous year. In the same period, outstanding loans for real estate purchase improved significantly against H1, up by 8.3%. In 2014, however, this type of loan resulted 1% lower than in 2013. In 2014 H2, the weighted interest rate on real estate loans fell to 6.7%, following the downtrend in interest rates on loans in the market, as a result of the accommodative monetary policy. Subsequently, the relative repayment cost[22] of real estate purchase loans fell, reflecting more favourable conditions for real estate purchase from the borrower's perspective.

Chart 5.6. House market developments



Source: Bank of Albania.

The real estate loan portfolio quality continues to worsen. The ratio of non-performing loans for real estate purchase rose to 15.1% from 14% in the first half of 2014 and 13.6% a year earlier. Nevertheless, the real estate loan portfolio quality remains better than that of the total loan portfolio quality, due to the form of collateralisation, which dictates a cautious banking sector and borrower's behaviour.

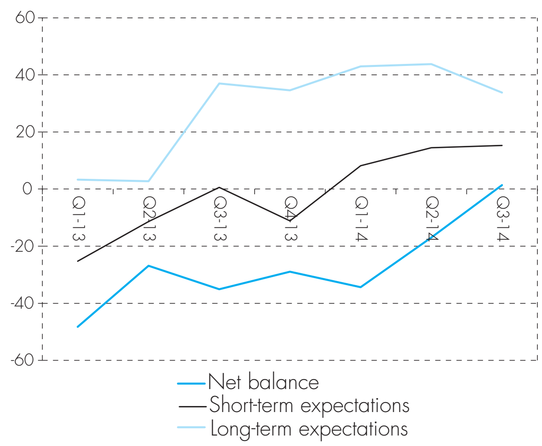
---

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

[22] *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.*

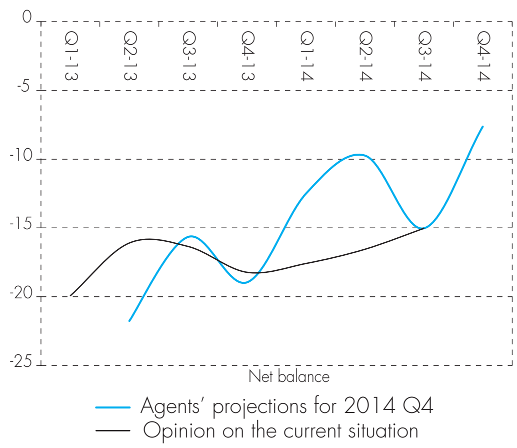
Box 5.1. Real Estate Market Survey

Chart 5.7. Situatioin and expectations in real estate market



Source: Financial Stability and Statistics Department.

Chart 5.8. Perception and expectations on house price level



Source: Financial Stability and Statistics Department.

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 quarterly, starting from 2013 Q1.*

Situation in the real estate market - In aggregate, respondents report an improved situation in the Albanian real estate market (Chart 5.8). The size of the net balance (difference between positive and negative expectations) shifted to positive rates +1.4% from -17% in the previous period. The share of respondents reporting a better situation expanded, whereas the number of responses for a 'worse' situation remains almost unchanged.

In relation to expectations, the overall situation in the real estate market across the country reflects a positive trend. For Tirana and coastal areas, agents remain more sceptical. In a longer term perspective, they appear optimistic, reporting greater expectations and a positive net balance.

*Asked about the expectations for the house prices for the actual period**, the net balance remains negative, but less so than in the beginning of 2013. The aggregate of responses moves towards neutral values, except for 'other areas'. Expectations remain in aggregate with negative net balance, but improved from previous periods.*

** The quality information collected in this survey is treated in the form of an index, for all the periods, according to the net balance. The net balance is calculated as a difference between the shares of 'better' and 'worse' responses. In this way, the change in net balance may be used to compare the trends over time of the phenomena for which information is collected. Net balance range above or below 'zero'. A positive change in the index implies upward activity, and vice versa. The distance of the index from zero measures the level of rise or fall. A change in the index given by a number shows the direction and amount of change together. Quantitative information is used to construct the index of real estate (house) prices for Tirana and countrywide - base period = 2013 Q1.*

*** For example, in the case of field surveys for 2014 Q3, with field interviews conducted in October 2014, the actual period shall imply 2014 Q4 and the reference period shall imply 2014 Q3.*

6 PAYMENT SYSTEM DEVELOPMENTS

During 2014, the technical infrastructure supporting the banking sector activity operated effectively. During the period under review, AIPS and AECH payment systems operated in compliance with the technical conditions for meeting the banking sector needs for settling lek payment transactions. In both systems, the volume and value of transactions increased. In addition, the volume and value increased for payments by bank clients through other payment instruments, including bank cards and other electronic forms.

The activity in AIPS rose by 5.6% of the value of processed transactions, whereas their number remains close to that in 2013.

Table 6.1 AIPS

AIPS	2010	2011	2012	2013	2014
Number of transactions	80,356	75,269	77,090	86,365	86,430
Value of transactions (ALL billion)	4,436.66	4,085.06	6,743.43	6,871.61	7,253.74
Average transaction value (ALL million)	55.21	54.27	87.47	79.56	83.92

Source: Bank of Albania.

During 2014, both the number and the value of transactions cleared in the AECH increased. Thus, compared to 2013, the number of cleared transactions rose by 22.13% and the value by 14.24%.

Table 6.2 AECH system

	2010	2011	2012	2013	2014
Number of transactions	332,777	388,208	361,552	363,507	433.977
Value of transactions (ALL billion)	43.98	64.10	66.99	72,767.50	83,133.08
Average transaction value (ALL million)	0.13	0.17	0.19	0.20	0.19

Source: Bank of Albania.

The payments cleared in the AECH increased due to the combined effect of the both increased payments by the Ministry of Finance (the participant with the main share in the system, accounting for 54% in terms of number and 49% in terms of value) and of payments cleared by banks for the account of their clients. The payments cleared by banks continued to increase for the third successive year, due to the measures taken by the Bank of Albania in March 2011[23].

[23] *Bank of Albania Supervisory Council Decision No 12, dated 23.02.2011 stipulates the following: raise to 1.5 million (from 1 million) the threshold for processing in AECH, add a third clearing session in AECH, differentiate tariffs by session, and lower commissions and fees for this system as well as define a maximum ALL 500 commission, which may be applied by banks for lek payments cleared in AECH.*

During 2014, payments carried out by clients through various instruments increased by around ALL 10.5 million, reaching ALL 4.289 billion. This is up around 21% in annual terms, in the number of transactions and 18% in their total value. Beyond the total increase in the use of various payment instruments, during this year, the use of electronic payment instruments increased faster. The main instruments that are being used more broadly in the Albanian economy are home banking and banking cards.

7. FINANCIAL SYSTEM

7.1 FINANCIAL SYSTEM STRUCTURE

Financial intermediation in Albania, estimated as the ratio of financial system assets to GDP, increased at a more moderated pace from a year earlier. Main structural changes in the Albanian financial system are attributable to the considerable growth of private investment funds, and the moderated expansion of banking system. The direct risk of transmission to the banking sector of risks from other segments of the financial system remains low. On the other hand, non-bank financial segments' exposures to the banking sector are considerable.

In December 2014, financial intermediation in Albania, estimated as the ratio of financial system[24] assets to GDP, was 101.4%, up compared to the first half of 2014 and the end of the previous year. Banks have the main share in the assets structure of financial system. Currently, the banking sector accounts for 90.4% of financial system assets and 91.7% of GDP. In this context, identifying and assessing risks from the banking sector activity is highly important for assessing the financial stability framework.

Table 7.1 Share of financial system segments to GDP in years

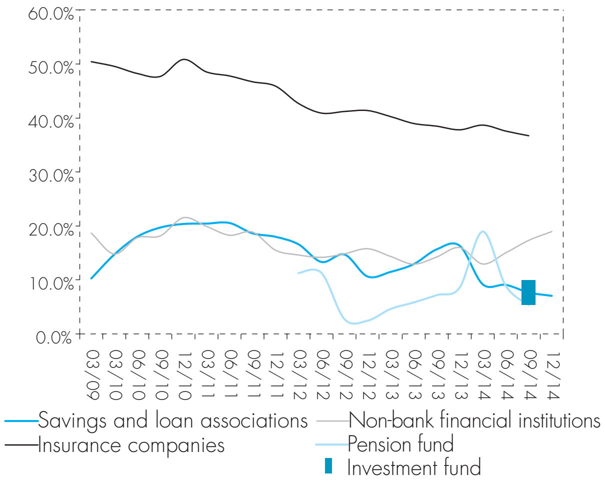
Licensing and Supervisory Authority	Financial System	2008	2009	2010	2011	2012	2013	2014
Bank of Albania	Banking Sector	76.7	77.5	80.9	84.7	89.6	90.5	91.7
	Non-bank institutions	1.7	2.2	2.7	2.5	2.7	2.5	2.7
	SLAs and their Unions	0.7	0.8	0.8	0.7	0.8	0.8	0.8
Albanian Financial Supervisory Authority	Insurance companies	1.4	1.5	1.4	1.5	1.6	1.6	1.7
	Pension funds	-	0.01	0.01	0.01	0.02	0.03	0.04
	Investment funds					1.21	3.7	4.5
Financial intermediation		80.5	82.01	85.81	89.41	95.93	99.13	101.44

Source: Bank of Albania, Albanian Financial Supervisory Authority.

In December 2014, banking sector exposure to other segments of the financial system in Albania remained low, accounting for about 1% of assets' value. This exposure was mainly in the form of loans and participation in the capital of 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 are also non-financial risks whose effect is difficult to measure.

[24] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. When analysing this chapter, investment fund and savings and loan associations are based on the data of end-2014; the data base for non-bank financial institutions, insurance companies and supplementary pension funds refer to September 2014.*

Chart 7.1. Exposures (as placements) of non-banking financial segments to banking sector, as a ratio to thier total assets



Source: Bank of Albania, Albanian Financial Supervisory Authority.

On the other hand, exposures of non-bank financial segments to banking sector were considerable in their activity, thus increasing their sensitivity to the latter's performance. At the end of 2014, insurance companies, savings and loan associations (SLAs) and non-bank financial institutions[25] (NBFIs) were more significantly exposed to the banking sector. Insurance companies' deposits in the banking sector accounted for about 37% of their assets, while SLAs and NBFIs investments' share in the banking sector accounted for 7% and 17%, respectively, of their assets.

Chart 7.1 shows the performance in time of the exposures of financial system segments to banking sector, assessed as portfolios ratio they hold with banking sector to the respective total assets.

[25] Data refer to 2014 Q3.

Box 7.1 Non-Bank Financial Sector

In 2014 H2, Non-Bank Financial Institutions expanded their activity, driven by the expansion of mutual relationships with deposits corporates (banks). Financial result was positive, capitalisation satisfactory and assets quality appears improving. Savings and loan associations slowed down their activity, but their financial loss narrowed and the quality of loan portfolio improved. Insurance companies expanded their activity due to a higher number of concluded contracts and gross written premiums. The assets growth in their balance sheets was mainly based on investments in deposits and accounts in banks and on securities different from shares. Private supplementary pension markets and investment funds performed positively and their assets increased.

Non-Bank Financial Institutions increased their activity, by 5.1% in 2014 H2, and by 9.7% in annual terms, standing at ALL 38.4 billion. Lending activity returned to the moderated growth pace (at +0.4%, from -2% a year earlier), standing at ALL 19.7 billion, while the activity expansion pointed to the increase of investments in banking sector (in the form of short-term deposits). This performance was mainly due to the increased financing, which during the year was provided at short-term maturity. Businesses have the largest share in loan portfolio, 92.3%, concentrated in the sectors of trade and agriculture, 27% and 12%, respectively. Credit risk remains the main risk to non-bank financial institutions' activity. The ratio of "non-performing loans to total loans" improved slightly as at end-2014, standing at 13.7%, from 15.05% in June 2014, after the narrowing in the non-performing loans stock. Profitability showed positive, albeit down from a year earlier, after the narrowing of commission income, while interest income performed steadily.

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

	2012	06-2013	2013	06-2014	2014
Total assets (in ALL billion)	35,348	34,363	35,030	36,546	38,415
Loan portfolio (in ALL billion)	20,040	19,501	19,646	19,685	19,733
Non-performing loan ratio, in %	8.37	14.15	13.21	15.05	13.74
Capital adequacy, in %	38.90	39.78	40.94	44.79	43.49
Profit, in ALL billion	1,244	0,520	1,502	0,576	0,947

Source: Bank of Albania.

The activity of Savings and Loan Associations was characterised by a slight increase in assets. The quality of the lending portfolio improved to 11%, from 13% at end-June 2014. The "Provisions to non-performing loans" ratio stood at 75%. After the process of writing off bad loans, provisioning expenses narrowed, thus driving to the positive financial result, after some periods of losses.

Table 7.3 Selected indicators of SLAs and their unions

	2012	06-2013	2013	06-2014	2014
Total assets (in ALL billion)	10.60	10.29	9.75	9.83	10.65
Outstanding loans (in ALL billion)	7.12	6.77	6.39	6.32	6.60
Outstanding loans/total assets (%)	67.44	65.82	65.53	64.26	61.99
Non-performing loans/outstanding loans (%)	6.42	11.12	11.95	12.91	11.06
Profit, in ALL billion	(0.04)	(0.19)	(0.23)	(0.05)	0.09

Insurance companies. In September 2014, there were 12 licensed insurance companies. During the first nine months of year, insurance companies' assets expanded at ALL 24.5 billion, with an annual growth of 16%. Insurance liabilities (or technical provisions) expanded considerably by 56.5%, in annual terms, standing at ALL 2.6 billion, while total capital recorded an annual growth of 7.1%, to ALL 10.6 billion. Insurance companies expanded slightly their share to GDP, at 1.7%. Gross *written premiums* - the main indicator of insurance company activity - expanded by 36.2%, y-o-y, standing at ALL 11.6 billion. The indicator of insurance penetration in the market - the ratio of premiums to GDP - was 0.82%.*

Loss indicator measured as the ratio of paid claims to gross written premiums, improved to 24.3%, from 31.6% a year earlier, after the more rapid performance of agreed contracts compared to the payments of claims. This ratio shows that around 1/4 of claims were covered by written premiums. The indicator of gross paid claims increased by 4.7%, to ALL 2.8 billion.

Investment portfolio of the insurance sector toward low risk assets provides for maintaining a low risk level for investments. At end- September 2014, investments were mainly in the form of time deposits at commercial banks (about ALL 4.4 billion) and Albanian government treasury bills (about ALL 2.4 billion). Exposure of insurance companies to sovereign debt expanded at 8.3% 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.

*Investment fund highlights**. At the end of 2014, two investment funds operated in Albania, with a net value of assets around ALL 63.7 billion, a slight fall of 2% during the period under review and annual growth of 27%. Funds list 32,700 investors, whose major part are households, and this participation expanded by 14.5% during 2014. Their investments are denominated by those in Government debt securities, accounting for 93% of total funds' assets. Around 15% of funds' investments are of short-term maturity, owing around 11% of the domestic sovereign debt. This interdependence 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. The regulator approved the new rules related to capital requirements addressing the stability of this financial sectors' segment, during 2014. Investment funds expanded their share to GDP, at 4.5%.*

*Private supplementary pensions highlights***. In September 2014, three voluntary private supplementary funds operated in Albania. Data analysis shows that pension funds' activity increased by 45%, compared to a year earlier - at an assets level of ALL 581 million. Their activity is dominated by investments in Government debt securities, about ALL 554 million, up by about 31.4% from end-2013.Though the number of their members continues to be up, the annual growth stood at 7%. Pension funds have a low share in the financial intermediation in Albania.*

* AFSA, "Insurance Market Statistical Report: Year 2014", published on 23 January 2014.
** Published by the Albanian Financial Supervisory Authority, 31 December 2014.
***AFSA, Statistical Report "Developments in the private supplementary pensions", 30 September 2014.

8. BANKING SECTOR

In 2014 H2, banking sector expanded further its activity, supported by the expanded investments in securities and credit. It maintained satisfactory levels of return and liquidity. Credit risk is assessed as high and a concern, although non-performing loans ratio fell at the end of period. Exposure to market risks remains subdued, but it should be monitored and assessed regularly. Exposure to exchange rate depreciation is somewhat mitigated by the overall long foreign exchange positions of banking sector. The continuing reduction of interest rates drives to the improvement of the borrowers' solvency, although the risk on return of interest rates at higher levels is present and should be considered.

The activity of banking sector, albeit showing up, reflects the difficulties in lending to private sectors and the more discrete position of dominant banking groups following the requirements by regulatory authority of European Union (EU) and Eurozone. The high level of non-performing loans held back the banking activity, but the steps taken in the framework of accelerating the execution process of collateral, payment of Government's arrears, and the writing off loss loans from banks' balance sheet, will positively impact the gradual mitigation of this risk. On the other hand, the willingness of dominant banking groups of EU origin, to expand their activity and lend the economy of regional countries, including Albania, continues to remain low.

8.1 BANKING ACTIVITY

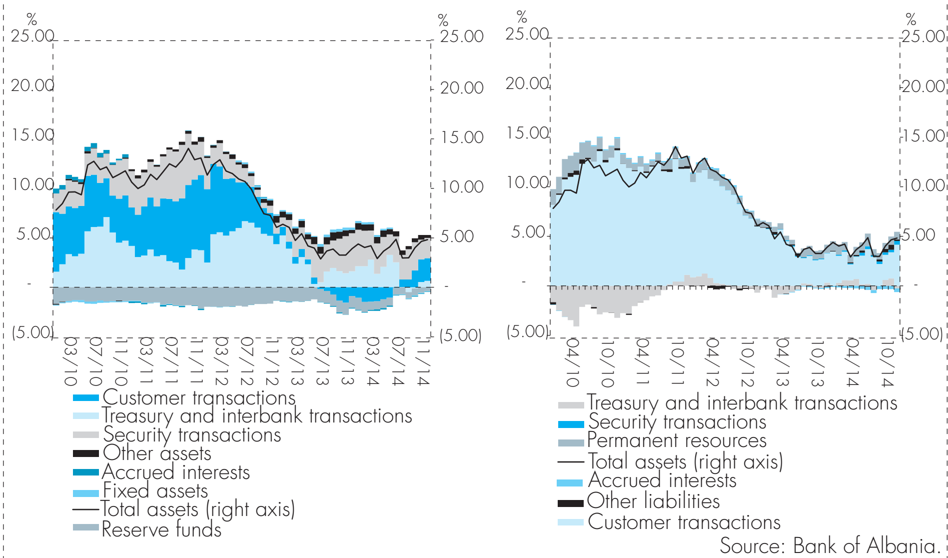
In December 2014, banking sector assets increased to ALL 1.294 billion, with an annual growth of 4.8%, from 3.9% a year earlier.

In 2014 H2, lending activity manifested recovery signs, supported by the improved economic activity, further decrease in financing costs and the payment of Government's arrears. In parallel with these developments, credit supply was more positive, by reflecting banks' behaviour looking for improvement of profits[26]. At end-December 2014, "Customer transactions"[27] surplus was estimated at ALL 591.3 billion. The surplus of this item expanded by ALL 28.2 billion in 2014 H2. Loan portfolio accounted for about 45% of banks' total assets, compared to the average of about 48% in the two previous years.

[26] *Monetary Policy Report 2014 Q4 "Box 4: CESEE Bank Lending Survey Results, 2014 H2".*

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

Chart 8.1 Annual assets expansion and contribution in assets financing



Source: Bank of Albania.

On the other hand, assets' performance in annual terms continues to be dominated by banks' investments in securities (see Chart 8.1, left), which consist mainly in securities of Government. At the end of 2014, this portfolio is assessed ALL 324.5 billion, with an annual growth of 4.5%, accounting for about 25.1% of total assets. During the period under review, the growth pace stood at about 2%, lower than previously, given the lowering of the borrowing demand from Government.

Banking sector owns about 60% of total domestic debt issued by the Albanian Government. Size and concentration of securities portfolio of government debt as owned by banks, makes them sensitive to the fluctuations in interest rates and value of government' domestic debt securities. Government's debt classified by banks as "held to maturity" accounted for higher than 80% of the whole portfolio, due to the low average duration of Government's debt. The latter exposes the Government against the non-renovation risk of debt by its holder.

The banking activity was mainly financed by deposits, which accounted for about 82% of total assets. Deposits base[28] expanded about 5% annually, from 3.6% a year earlier. Both, Lek and foreign currency deposits provided a positive contribution to the growth of deposits. These developments were impacted by the payment of arrears of the Government to businesses[29], and for statistical purposes of changes in exchange rate of the Albanian lek against main currencies (mainly the depreciation against US dollar). The measured effect of the Albanian lek performance against main currencies expanded the base expressed in Lek of foreign currency denominated deposits by about ALL 8.2 billion during 2014. By maturity, about 71% of deposits were one-year deposits, and 21% of them were current accounts. On the other hand, households accounted for about 86% of total deposits in the system.

28 *Here we refer to" customer transactions", at banks' balance sheet excluding the accrued interest.*

29 *The process of Government payment of arrears to businesses started in March 2014 and finished in December 2014, recording an amount of ALL 33.8 billion (Ministry of Finance).*

Transactions grouped in "Treasury and interbank transactions", consisting in the foreign borrowing from parent banks, provided negative contribution to the growth of assets during 2014, shrinking by 5.5%. The shrinkage of credit lines granted by parent banks to their subsidiaries in Albania decreased the level of external liabilities of banking sector[30].

In 2014, financing structure of banking system showed an increase of funds established through securities, which were purchased and bought through reverse (REPO)[31] transactions. However, the volume of these funds remains low.

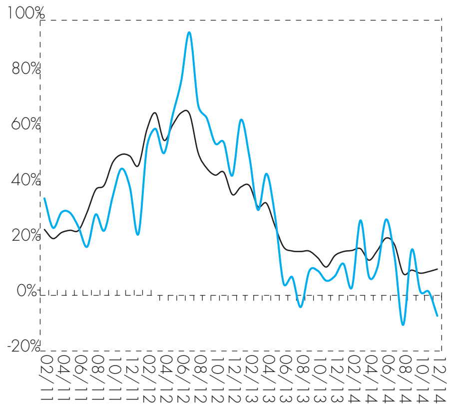
By currency, banking sector assets denominated in foreign currency increased to ALL 730.2 billion, expanding by 3.2% in semi-annual terms, and 4.9% annually. Foreign currency loans shared 49.1% of assets denominated in foreign currency. Banking sector liabilities denominated in foreign currency stood at ALL 677.5 billion, up by 4% during the last year. Foreign currency deposits accounted for 79% of liabilities denominated in foreign currency.

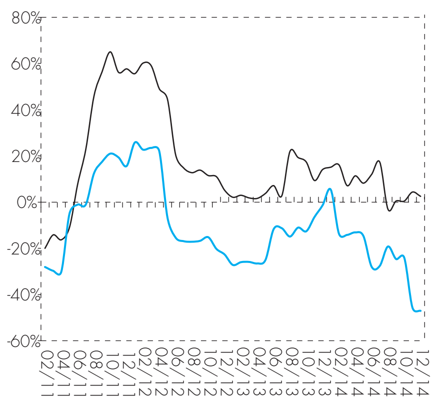
Banks maintained the capital use ratio to finance their operations, and complied with the regulatory capital requirements.

8.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

Net position of banking sector to non-residents remained on the crediting side and continued to increase during the period under review. Borrowing from parent banking groups fell.

Chart 8.2 Exposure to non-residents





Source: Bank of Albania.

30 *At end-2014, total line of credit from parent banks and their use fell in annual terms, by 47% and 55%, respectively. The annual fall was 1.4% and 26.4%, respectively, a year earlier.*

31 *At end-2014, the expanded "Security transactions" contributed to the funding of sector's activity, at 0.37 percentage point (of 4.18% of asset' expansion).*

In December 2014, assets held with non-residents accounted for 24% of total assets and were estimated at ALL 312 billion. Banking sector liabilities to non-residents accounted for 8.1% of total assets, estimated at ALL 93.7 billion, mainly in the form of lines of credit. At end-2014, borrowing of banks fell considerably compared to a year earlier. The used part of lines of credit pointed at ALL 3.3 billion in the period under review, down by 55.4% from end-December 2013. The net lending position of banking sector to non-residents expanded by 5.2% semi-annually, and 12.8% annually, up to ALL 219 billion.

Table 8.1 Placements and commitments received from parent banks and other group banks

In ALL million	Total placements	Total line of credit	Used line of credit	Unused line of credit
December 2014	139,340.42	25,625.05	3,320.48	22,304.57
June 2014	163,176.22	35,310.1	2,870.4	32,439.7
December 2013	150,420.71	48,379.9	7,449.4	40,930.5
June 2013	128,115.72	48,997.4	10,085.4	38,912.0
2012	140,654.72	49,045.4	10,116.9	38,928.5
2011	98,221.21	63,422.4	16,903.9	46,518.5

Source: Bank of Albania.

*Box (NBFIs) 8.1 Banking sector exposure to non-resident institutions**

Asset of non-residents' placements. The main part of placements at non-resident institutions in assets was in the form of time deposits, accounting for 49.9% of total. Placements in euro amounted 77.8% and in US dollar amounted 15.3%. Placements with banking groups accounted for about 21.8% of total placements, where Euro and British pound (GBP) had the main share of banking groups to the total, by 24.2% and 28.8%, respectively. Placements with non-residents in assets continued to be mainly concentrated in the euro area, accounting for 71.1%. By banking groups, 80.4% of placements with non-residents in assets belong to G3, 14.5% to G2 and 5.2% to G1. By origin, placements of both Italian and Greek group had the main share in total placements, by 19.3% and 17.5%, respectively.

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 56.0% of total. Placements on the liability side were mainly denominated in euro, by 70.0% of total, and 93.3% of liabilities to banking groups. Liabilities to euro area countries accounted for 58.6% of total non-resident placements on the liability side. By banking groups, G3 shared 85.0% of total liabilities to non-resident institutions and G1 shared 15.0% of total liabilities. The main part of total placements to non-residents on the liability side consists in the Greek group placements accounting for 55.9%, followed by the Albanian group placements 26.4%, and the Italian group 14.9%.

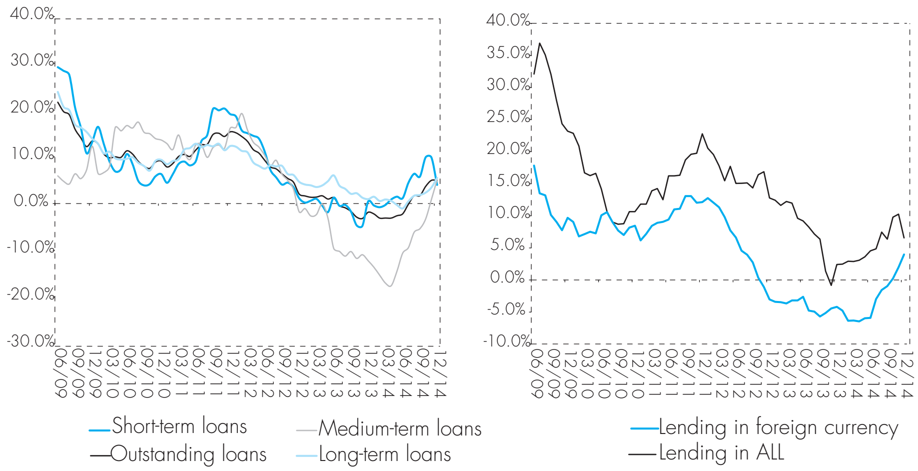
* *This Box is based on operational data as reported by the banking sector and refers only to placements with non-resident institutions.*

8.3 OUTSTANDING LOANS

Bank lending showed recovery signs, in the second half of 2014, more notably in the last quarter, mainly driven by the lending to businesses. Bank lending recovered due to the improved confidence of the economic agents, the lowering of financing costs and the payment of Government's arrears. In parallel, credit supply was more flexible by reflecting the increased attention of banks to products of better return rates of interest.

In December 2014, the outstanding loans[32] of the banking sector pointed at ALL 59 5.1 billion and the annual growth rate 4.93%. By maturity, the loan portfolio expanded for the whole spectrum of maturities, with the highest increase for medium and long-term maturities, by 12% and 4.6%, respectively. By currency, foreign currency lending increased by 4% compared to a year earlier. Lek lending grew by 6.6% and its share in the loan portfolio climbed to 38%. The impact of Lek exchange rate depreciation against US dollar was estimated at about ALL 4.6 billion (share of US dollar lending to total foreign currency lending was about 13%).

Chart 8.3 Annual growth rate of lending by maturity and currency



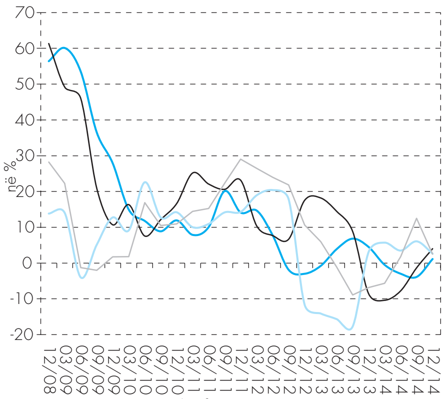
Source: Bank of Albania.

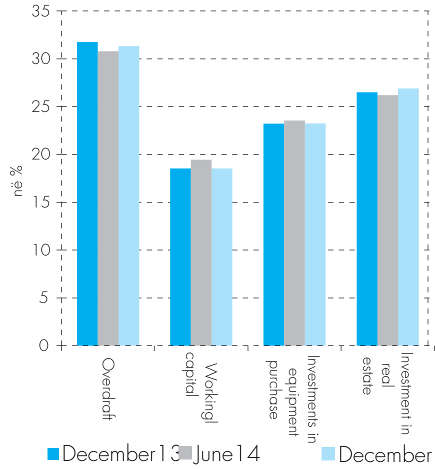
Lending to businesses, accounting for 67% of total lending, expanded by 6.4% during the period under review, and by 6% from end-2013. By purpose of use, the real estate investment loan recorded the highest expansion, by 4%. "Overdraft" loan, accounting for about 1/3 of loan granted to businesses, expanded slightly by 1.1%; and loan for "working capital" and "investment in equipment purchase" expanded by 3%, respectively.

[32] *Outstanding loans is taken as a value from banks' balance sheet. It consists in the loan to residents and non-residents, and including the loan principal and the accrued interest.*

Lending to households expanded during the period under review by 0.7%, while its annual growth stood at 1.2%. The annual expansion of lending to households was mainly oriented towards "Consumption of durable goods", by 14%. "Real estate investment" loan, whose share accounted for 71.1% of total, narrowed by about 0.1% compared to a year earlier.

Chart 8.4 Annual growth rate of lending by purpose of use (left) and each item's share in total lending to businesses (right)



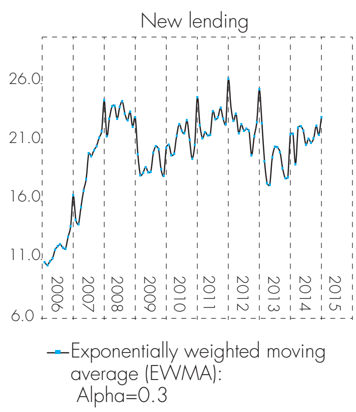


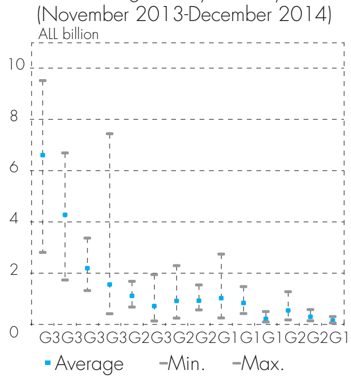
Source: Bank of Albania.

*Box 8.2 New lending**

In 2014 H1, new loans granted by banking sector accounted for ALL 136.3 billion, about 8% higher from the previous period and 13.8% higher in annual terms. Restructured loan during 2014 stood at ALL 32.15 billion, accounting for 12% of new loan. Banks of G3 provided the main contribution to the annual growth of new loan, about 71% of the growth. Over the same period, the banking sector's recovered loans amounted to ALL 124 billion. The loan use ratio, which represents the ratio of recovered-to-extended loans, fell at 91%, from 100.4% in June 2014,

Chart 8.5 New lending – annual change (6M average), and contribution in the change of loan use during one year.





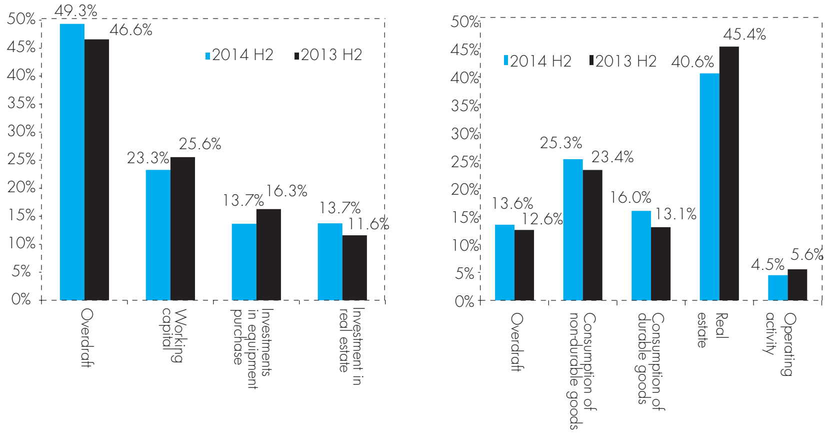
Source: Bank of Albania.

and 107.2% a year earlier. The more rapid growth of new loan provides the highest contribution to the fall of the loan use.

*By group of users, the business sector was extended 85% of new loans and households 15%. New lending to business sector performed positively, expanding during the period under review by 7.4% (or ALL 8 billion) and 15.4% (or ALL 15.4 billion) y-o-y. Loan for "working capital"**, by ALL 5.9 billion and for "real estate investment" by ALL 4.9 billion provided the main contribution to the growth of new lending for the period. The loan granted in the form of "Overdraft" fell by around ALL 5.7 billion. The loan granted in the form of "Overdraft" albeit downward, had the main share of new loan granted to business by about 49%. In annual terms, the expansion of new loan was impacted by the expanded of new "Overdraft" loan, by about ALL 10.4 billion and for "real estate", by about ALL 4.2 billion.*

New loan to households expanded by 11% (or ALL 2.1 billion) during the period, mainly for "non-durable consumption goods" and for "real estate", respectively by ALL 0.8 billion. The new loan granted for "real estate" to households, had the highest share, about 41%. In annual terms, new loan to households expanded by 5.8% (or ALL 1.2 billion). Loan for "consumption of durable goods" and "consumption of non-durable goods", provided the main contribution to the expansion of new loan to households.

Chart 8.6 Distribution of new lending to businesses and households by purpose of use, in per cent

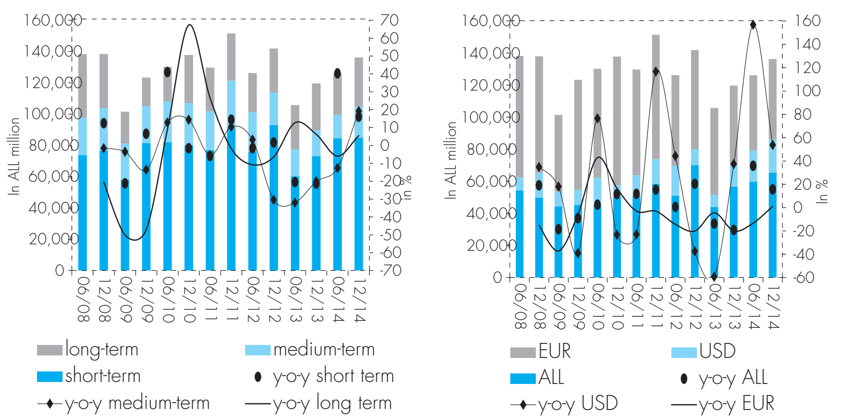


Source: Bank of Albania.

By currency, new lending expanded in the three main currencies, during the period under review and year on year. The new lending granted in the domestic currency had the main share in the expansion of new lending. By terms of maturity, long-term maturity had the highest share in the expansion of the new lending, during the period under review.

Medium-term maturity recorded the highest annual expansion, about 19.1%. Lending by economy branches was in line with the economic activity performance. Agriculture and constructions were the sectors with the largest credit growth. Trade sector had the highest share in the expansion of new lending (during the period under review and compared to a year earlier).

Chart 8.7 Distribution of new lending by maturity (left) and currency (right)

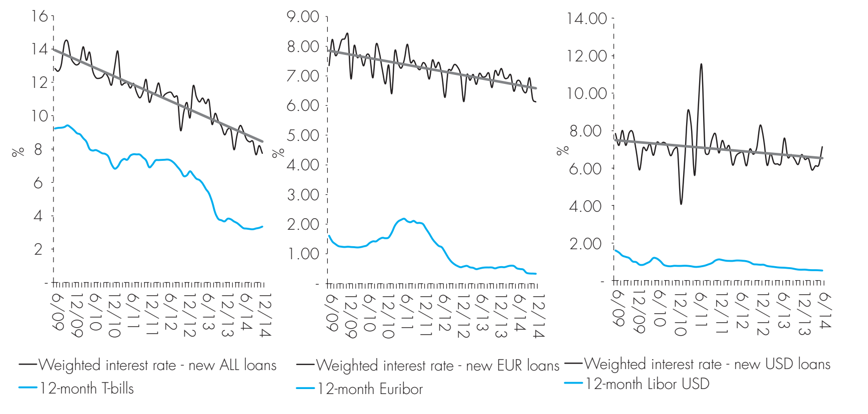


Source: Bank of Albania.

- *INTEREST RATES ON NEW LOANS*

Interest rates on new loans denominated in all currencies continued the downward trend, during 2014 H2, compared to the previous year. The interest rate on new lek-denominated loans averaged 8.2%, from 8.9% in 2014 H1, and 9.7% at end- 2013. Interest rates on new euro and US dollar loans averaged 6.5% each, recording a slight fall of 0.46 percentage points in EUR and 0.18 percentage points in US dollar, compared to a year earlier.

Chart 8.8 Interest rates on new loans by currency and respective reference rates, in per cent



Source: Bank of Albania.

* *The data for the new loan are taken from SRU forms, constructed for the purposes of monetary policy, these forms consider lending to residents, without the accrued interest, adding the loan granted to non-bank financial institutions.*

** *Loan outstanding to private sector in the form of "working capital" loan fell during the period, while new loan expanded considerably. The narrowing of loan stock was due to the considerable increase of the loan collected for this sector (during the period under review ALL +10.7 billion).*

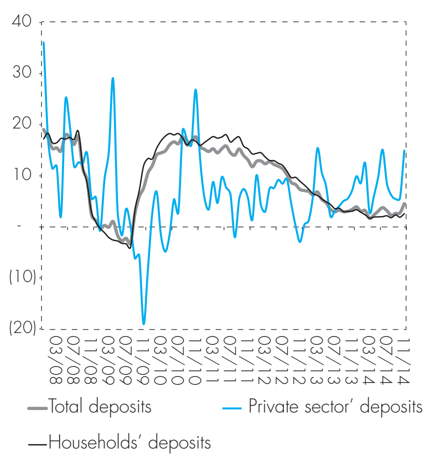
8.4 DEPOSITS

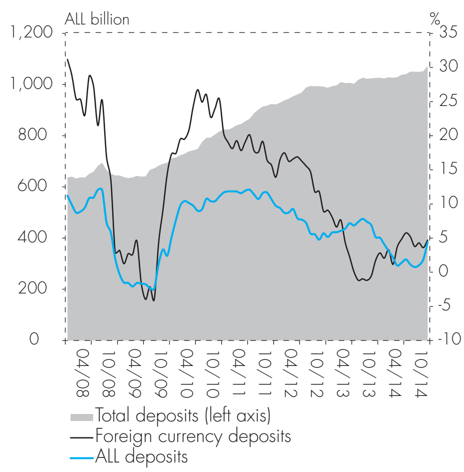
Volume of deposits in banking sector grew at a more rapid pace than a year earlier. Foreign currency deposits provided the main contribution. Households expanded their investments on Government's securities, thus impacting the performance of deposits in the banking system.

At the end of 2014, deposits[33] of banking sector stood at ALL 1,072.2 billion[34], up by ALL 46.7 billion or 4.6% from a year earlier. Deposits' growth was more rapid during 2014, from 2013, when the annual growth was 3.4%. This performance was driven by the more rapid growth of deposits during 2014 H2[35], by ALL 34.1 billion, or 3.3%, from 1.2% in 2014 H1. Nevertheless, the expansion of banking sector's deposits remains below the historical trend (see Chart 8.9 left).

Foreign currency deposits grew by ALL 19.3 billion, or 3.7% during the period under review, from 0.9% in 2014 H1. This performance reflects the statistical effect of changes in the exchange rate of Albanian lek against main currencies. The Albanian lek contribution was ALL 8.2 billion. The Albanian lek-denominated deposits grew by ALL 14.8 billion, or 2.8% during the period under review, from 1.5% in 2014 H1. Notwithstanding the slow performance, the Albanian lek deposits exceeded the threshold 50% of banking sector's total deposits for the first time.

Chart 8.9 Deposits, annual growth rate and volume in ALL billion





Source: Bank of Albania.

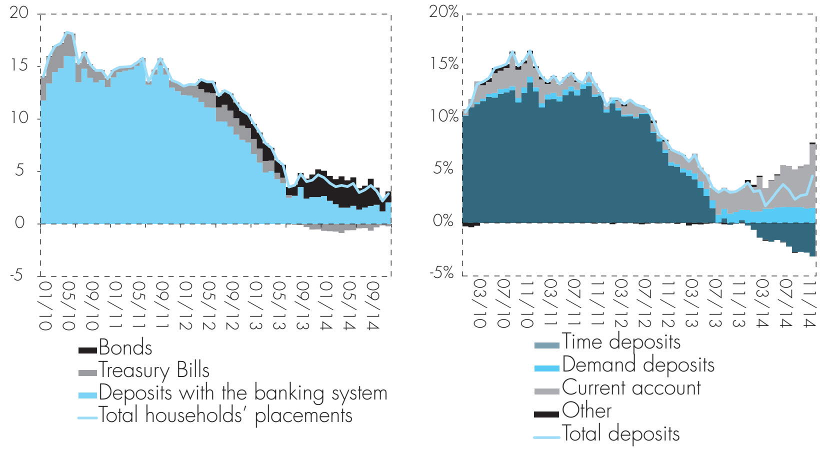
Households' deposits expanded by ALL 20.8 billion, or 2.3% in 2014 H2, from 0.3% a period earlier. Annual growth rate was 2.6%. Households' deposits accounted for 85.7% of total, 1.6 percentage points lower than a year earlier. This development reflected the shift of households' savings to government debt securities, mainly in the first half of year.

33 Deposits' stock with the accrued interest.

34 Including accrued interests.

35 About 60% of deposits expansion during the second half of year was evidenced in December. A large-sized bank of the system (G3 group) provided the half of the contribution.

Chart 8.10 Households' placements contribution to the annual growth * (left); Deposits in banking sector by type of product in % (right)



*Households' deposits consist in deposits with banking system and Government debt instruments.
Source: Bank of Albania.

Households' participation in Government debt instruments portfolio expanded by ALL 9.2 billion, or 8.3% from the previous year. Preference of public for Government bonds increased considerably. They offer the highest rate of return (see Chart 8.10, left). Treasury Bills portfolio, owned by households, narrowed by ALL 2.4 billion, or 3.4% during the year. Bonds portfolio increased by ALL 11.6 billion or 29.1%. This shift was reflected on the weak performance of time deposits in the banking system (see Chart 8.10, right).

Time deposits, accounting for 70.4% of public's deposits, fell during the period under review by about ALL 17.4 billion or 2.3%, recording an annual fall of 4.2%. Current account and demand deposits increased by ALL 44.1 billion or 22.3% and ALL 6.5 billion or 9.8%, respectively. Their annual growth rates were 37.2% and 27.3%, respectively.

Businesses recorded higher growth rates, impacted also by the payment of Government's arrears. Business' deposits grew by ALL 10.4 billion or 9.2%, from 5.3% in 2014 H1. Annual growth rate was 14.9%. Public sector' deposits grew by ALL 2.9 billion or 11.2%, from 18.6% in 2014 H1. Annual growth rate was 33.2%.

The large-sized banks (G3) provided the main contribution to the increase of total deposits during the period under review, by ALL 33.6 billion or 4.5%, respectively. Small-sized banks (G1) expanded the deposits base by ALL 3.7 billion or 8.4%, while deposits at medium-size banks (G2) narrowed by ALL 3.2 billion or 1.3%.

Deposit concentration ratio, as measured by Herfindahl index, showed an increase during the period under review at 1,378, but without exceeding the range of 100 points. At the end of 2014 H2, this index resulted 23 points higher, but compared to the same period a year earlier, this index was 15 points lower. Index calculated for the large banks group of the system stood at 1, 276. This group manages about 73.4% of total deposits.

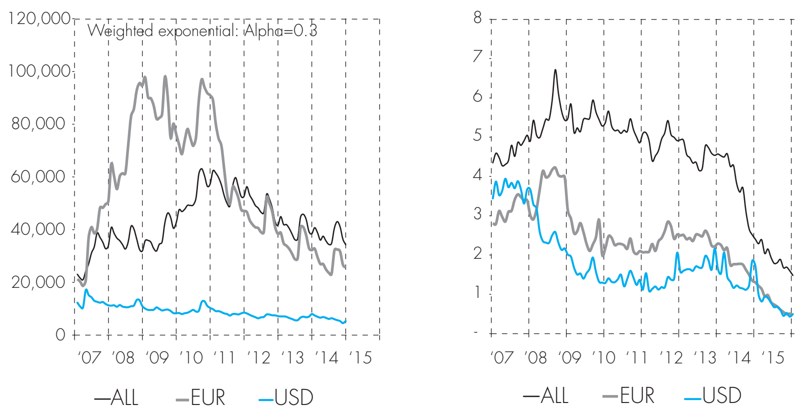
Large-sized banks (G3) collect about 73.4% of total deposits. By customers, small-size banks of the system (G1) showed the highest exposure to large depositors. 10, 20 and 50 largest depositors accounted for 12%, 16% and 24%, respectively of the group and up compared to the previous periods. Related to G2 and G3 banks, this ratio was slightly down.

8.4.1 NEW DEPOSITS

During 2014 H2, banking system collected ALL 438.3 billion in new time deposits, about ALL 42.6 billion or 10.8% higher than in 2014 H1. The new time deposits accounted for about 17% of new deposits' value during the period under review. The structure of time deposits reflected a shift to longer maturities, mainly concentrated in the 12-month maturity term. By currency, new deposits in the Albanian lek and euro increased by ALL 16 billion or 7.5% and EUR 230 million or 22.2%, respectively, during the considered period. New deposits in US dollar fell by about USD 62.7 million or 17.7%.

Average interest rates trended down for the three currencies. For the Albanian lek was 1.5% from 1.8% in 2014 H1, and 2.4% a year earlier. For euro and U.S.dollar the interest rate was 0.5%, from 0.7% in 2014 H1, and 1.3% and 1.7%, respectively a year earlier.

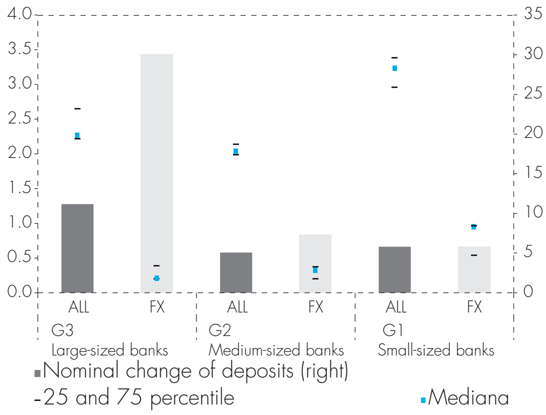
Chart 8.11 Moving average of new time deposit by currency (left); interest rates on new time deposits (right)



Source: Bank of Albania.

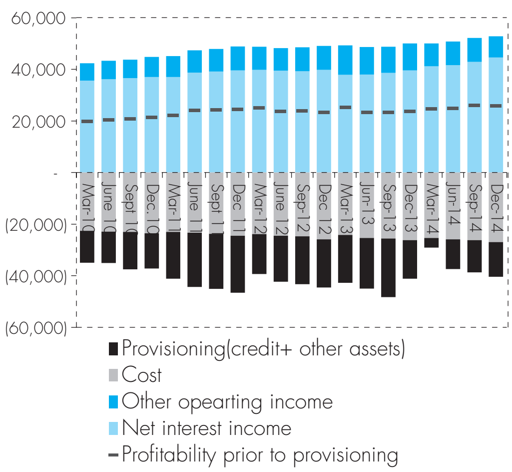
Large-sized banks maintain a low level of interest rates of deposits, showing a more heterogeneous distribution and pointing to low rates. On the other hand, small-sized banks provided higher return rates on deposits.

Chart 8.12 Expansion of deposits base (semi-annual growth) by currency and banking groups and the distribution of weighted interest rates on new deposit



Source: Bank of Albania.

Chart 8.13 Profitability prior to provisioning



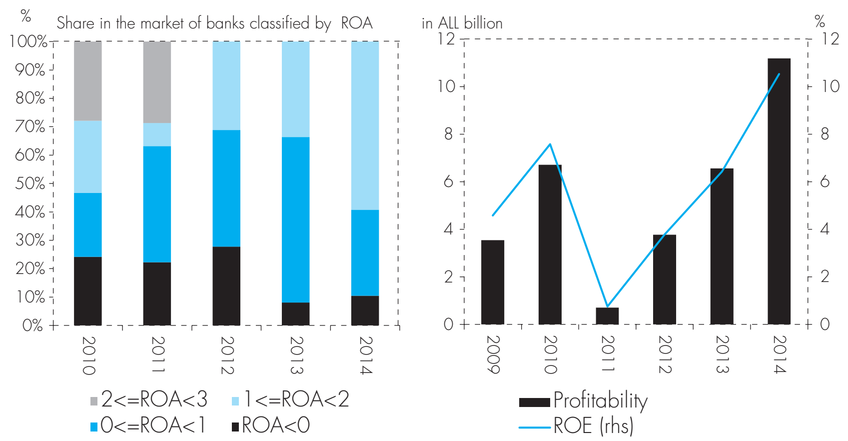
Source: Bank of Albania.

8.5 PROFITABILITY AND EFFICIENCY IN USING RESOURCES

As at-end 2014, banking sector reported a positive profitability of about ALL 11 billion, considerably up from a year earlier. The fall in loss provisioning by the activity and the increased net income from the main activities (investments and lending) provided the main contribution. Interest income shrank owing to the negative performance of lending and low interest rates in the international financial markets. The fall in financing cost (in ALL and foreign currency) impacted the improvement of net interest income. Other operating income fell mainly due to the lower return on investments in securities portfolio. Also, activity costs, albeit slightly up, were covered adequately by the activity income, providing a positive impact on the operative profitability (prior to provisioning).

The positive developments in terms of profitability are concentrated at large-sized banks. Banks of negative profitability shared 10.4 percentage points of total assets of the sector, during 2014, 2.4 percentage points higher than at end-2013. The share of banks with negative profitability and the amount of loss has been falling since the period 2010-2011 (see Chart 8.14, left). At aggregate level, main indicators of profitability, Return on Assets (RoA) and the Return on Equity (RoE) were 0.9% and 10.5% (see Chart 8.14, right)

Chart 8.14 Share in the market of banks classified by RoA (left) and profitability (right)



Source: Bank of Albania.

At the end of 2014, net interest margin increased slightly, from end-2013, mainly due to the faster fall in interest expenses. This development subdued the shrinkage of interest income due to the fall of loan interest rate and the slowdown of lending activity. In terms of average assets, at the end of 2014, net interest income dropped to 6.3%, from 7.3% at end- 2013, and 6.4% in June 2014, reflecting the slowdown in banks' main operation.

Table 8.3 Profitability ratios, in per cent (cumulative)

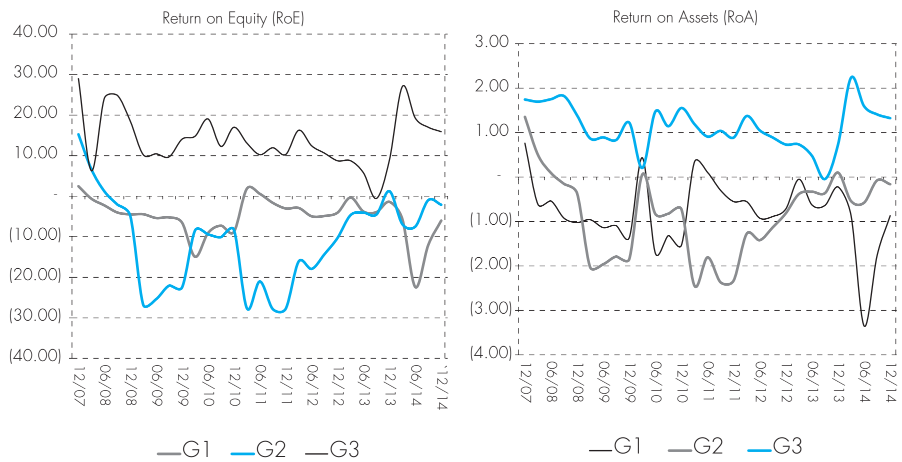
Indicators	2011	2012	2013	2014
Interest income/average earning assets	7.78	7.73	7.32	6.28
Interest expenses/average expending liabilities	3.79	3.71	3.31	2.14
Net Interest Margin (Net interest income/average earning assets)	4.20	4.01	3.89	4.18

Source: Bank of Albania.

Chart 8.15 Cost as a ratio to income (left) and by banking groups (right)

Source: Bank of Albania.

Chart 8.16 RoE and RoA by banking groups, in per cent



Source: Bank of Albania.

In the light of these developments, banks showed prudent to maintain the falling ratios of cost to income, mainly concentrated in large- and small-sized banks. By banking groups, only large-s ized banks (G3) contributed to the increased RoA and RoE indicators, while G1 and G2 banks showed negative values.

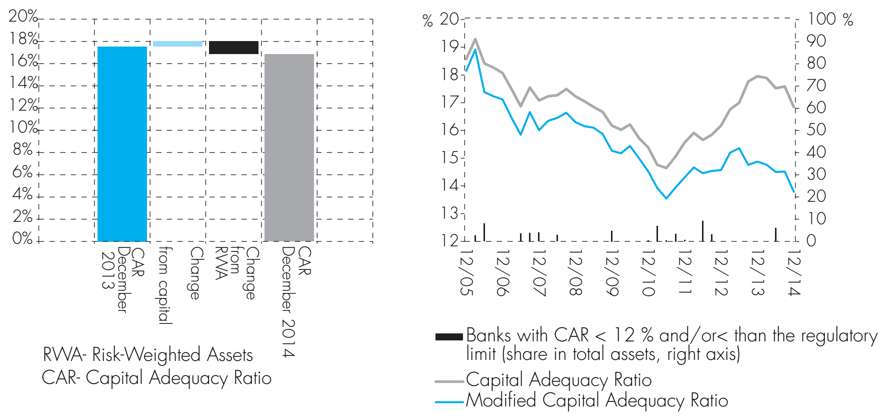
8.6 BANKING BUSINESS CAPITALIZATION

Banking business capitalisation maintains satisfactory rates. Capital injection and improved banking sector's profitability provided positive impact on the performance of regulatory capital. Risk-weighted assets expanded more rapidly.

In December 2014, capital adequacy ratio[36] fell at 16.8%, from 17.5% in 2014 H1 and 17.96% a year earlier. The rapid increase in risk weighted assets provided the main contribution. The risk weighted assets expanded by about ALL 46 billion (or 7.1%) semi-annually and by ALL 51.6 billion (or 8%) annually, up at ALL 692.9 billion.

Regulatory capital increased at ALL 116.7 billion, up by 1.3% during the year, and by 2.9% from June 2014. Performance of regulatory capital alongside the positive profitability was impacted by the capital injection of banking sector. The rate of paid-in capital was up at ALL 106 billion or ALL 3.3 billion higher from end-2013. The isolated effects of change of regulatory capital and of risk-weighted assets on capital adequacy ratio were +0.5 percentage points and -1.2 percentage points, respectively (see Chart 8.17, left).

Chart 8.17 Capital adequacy ratio, December 2014 and performance (right)*



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

Share of added capital (subordinated debt) in regulatory capital is up since 2013 H2. The structure of the regulatory capital remained favourable in terms of the banking sector's capacity to absorb possible losses. The core capital dominated 82% of regulatory capital (see Chart 8.17, right). Table 8.4 summarises the capital adequacy ratio for the banking sector and banking groups, by business size and origin of capital.

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

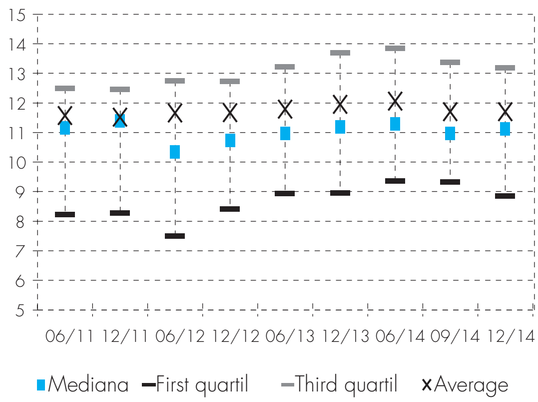
Table 8.4 Capital adequacy ratio, in per cent

Period	Sector	G1	G2	G3	Italian group	French group	Greek group	Albanian group
12/2014	16.8	22.5	15.1	17.0	17.4	14.5	17.2	14.5
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

Source: Bank of Albania.

The Albanian banking sector was characterised by a low financial leverage ratio. At the end of 2014, the financial leverage was 11.7, from 12 in 2014 H1 and a year earlier. Individual banks did not differ significantly in terms of financial leverage.

Chart 8.18 Financial leverage ratio

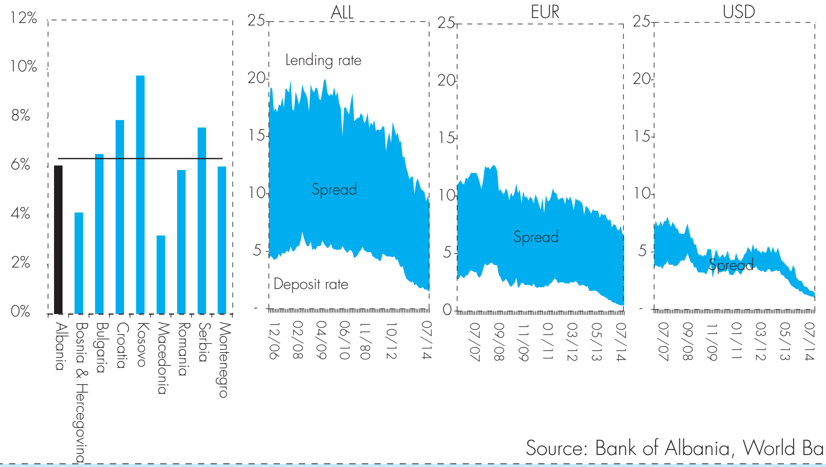


Source: Bank of Albania.

Box 8.3 Decomposition of ex-post financial intermediation cost in the Albanian banking sector

Ex-post financial intermediation cost is an important indicator of financial stability, aiming at measuring effectiveness of banking sector. The analysis is based on the estimation of net interest margin, measured as a difference between lending and deposit rates. Related to Albanian banking sector, credit interest rates and mainly interest rates on deposits are assessed as downward, but their spread is maintained (see Chart 8.19, right). Albania, compared to regional countries, shows spread rates rather close to the average of countries.*

Chart 8.19 Spread for regional countries and their average during 2008-2013 (left) and by currencies for 2006-2014 of the Albanian banking sector (right)



Source: Bank of Albania, World Bank.

*The following presents the ex-post estimation of financial intermediation rate and cost** for the period 2006-2014 into four components***. Lending rate and tariffs and commissions are the two main components of ex-post financial intermediation cost. Ex-post cost consists in the financing cost, operational cost, risk cost and regulatory cost.*

Table 8.5 Intermediation cost decomposition for the Albanian banking sector

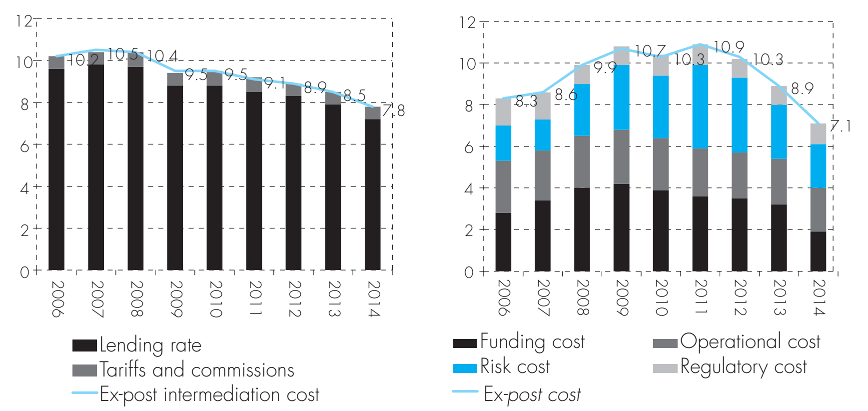
Description	2006	2007	2008	2009	2010	2011	2012	2013	2014
Ex-post intermediation rate	10.2	10.5	10.4	9.5	9.5	9.1	8.9	8.5	7.8
-Lending rate	9.6	9.8	9.7	8.8	8.8	8.5	8.3	7.9	7.2
-Tariffs and commissions	0.6	0.6	0.7	0.6	0.7	0.7	0.6	0.6	0.6
Ex-post cost	8.3	8.6	9.9	10.7	10.3	10.9	10.3	8.9	7.1
Funding cost	2.8	3.4	4.0	4.2	3.9	3.6	3.5	3.2	1.9
Operational cost	2.5	2.4	2.5	2.6	2.5	2.3	2.2	2.2	2.1
Risk costs	1.7	1.5	2.5	3.1	3.0	4.0	3.6	2.6	2.1
Regulatory costs	1.3	1.3	0.9	0.9	1.0	1.0	0.9	0.9	1.0
-Taxes	0.4	0.4	0.2	0.1	0.2	0.2	0.1	0.1	0.2
-Required reserve	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Residual[1]	1.8	1.8	0.3	(1.3)	(0.8)	(1.8)	(1.4)	(0.4)	0.7
Profitability	1.4	1.5	0.9	0.4	0.7	0.1	0.3	0.5	0.9

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

[1] The residual reflects errors that result from combining data from income statement (flow data) and stock data from the consolidated balance sheet, as well as making the simplifying assumptions about the estimated ratios.

Results show that intermediation rates are down since 2008, after the financial crisis, recording the lowest rate of 7.8% at the end of 2014. Lending rates are the main contributor in the performance of ex-post financial intermediation rate, while tariffs and commissions maintained the same levels (see Chart 8.20, left).
On the other hand, developments in the intermediation cost structure show that funding and risk costs have the dominant effect on the margin. Funding costs pursued

Chart 8.20 Ex-post intermediation cost and rate



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

the developments of deposits volume (a lower growth pace in the last years), and mainly the fall in interest rates on them. Risk costs decreased their share in the formation of margin during the last years, due to the fall of expenses for loan loss provisions. The latter fell in the framework of the slowdown in the deterioration of *loan portfolio quality, early loan restructuring and the process of write off loan loss from the balance sheet. Banks reduced the operational costs owing to the narrowed expenses of the activity. Regulatory costs, albeit the rates, reflect the requirements of fiscal framework (see Chart 8.20, right).*

* *Analysis of cost decomposition was firstly published in the Financial Stability Report for 2012 H2.*

** *The decomposition of the financial intermediation cost is based on the methodologies proposed by Randall (1998) Interest Rate Spreads in the Eastern Caribbean, IMF/ WP/ 98/59 and Hansen & Rocha (1986) High interest rates, spreads, and the cost of intermediation, Industry and Finance Series 18, WB, and the working paper by Kallucit (2010) "Determinants of Net Interest Margin in the Albanian Banking System, Bank of Albania".*

*** *The consolidated income and expenditure statement of banks defines profit (P) as interest income (II), plus non-interest income (NII), minus interest expense (IE), minus operating costs (OC), minus provision for loan losses (Prov),and minus paid tax:*

P≡II+NII-IE-OC-Prov-Taxes.

To decompose the components, the identity is transformed as the share of ratios to average lending (L), deposits average (D) and contribution in intermediation expansion (A), which is measure as the ratio of loan to averaged total asset during the year, as in formula (1):

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

9. MONITORING BANKING SECTOR RISKS

9.1 CREDIT RISK

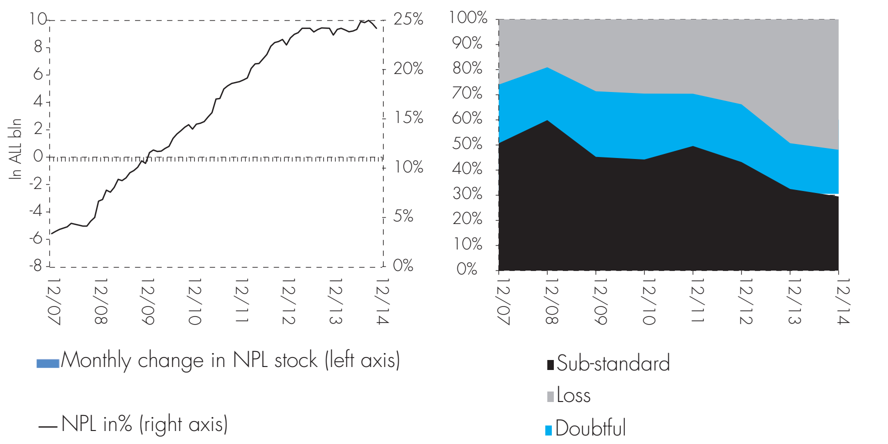
Loan portfolio quality improved slightly and banks showed more active in the process of write off loss loans from the balance sheet.

9.1.1 LOAN QUALITY

In December 2014, non-performing loans ratio fell at 22.8%, from 24.1% in June 2014. Base effect, which is the increased loan portfolio[37], provided the higher contribution to the improved loan portfolio quality ratio. Stock of non-performing loans fell during the period under review, standing at ALL 135.7 billion, or by 0.5%. Its annual growth stood at 1.9%, from 2.5% in December 2013 (see Chart 9.1, left). In 2014, credit growth was assessed at 5%.

Related to lek-denominated loan, non-performing loans ratio stood at 17.5%, narrowing by 1.3 percentage points during 2014 H2, and by 2.2 percentage points throughout the year. In terms of foreign currency loan, the non-performing loans ratio was 26%, down by 1.3 percentage points semi-annually and by a slight expansion of 0.3 percentage point annually.

Chart 9.1 Non-performing loans ratio (left) and structure of non-performing loans (right)



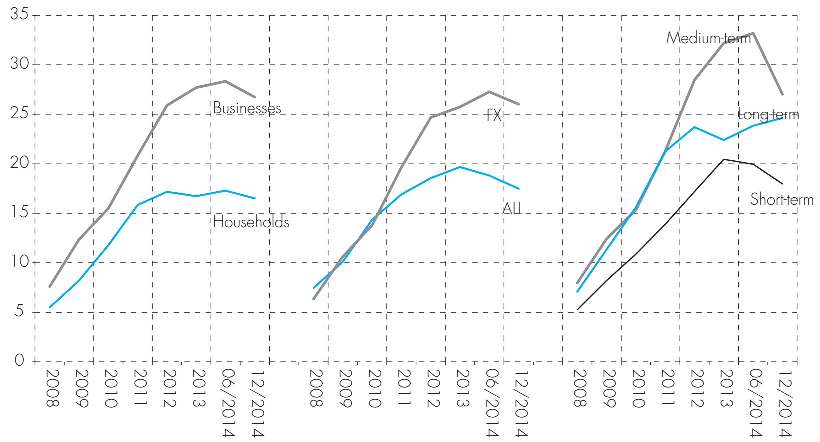
Source: Bank of Albania.

37 *The calculated effect of loan portfolio expansion during the 6-month period on the above improved ratio was 92%.*

The non-performing loans continued to migrate to "loss loans" category, during the period under review. In December 2014, loss loans accounted for about 52% of non-performing loans. The expansion of loss loans during 2014 was considerably lower (2 percentage points) compared to 2013, where "loss loans" category expanded by 15.5 percentage points in the structure of non-performing loans (see Chart 9.1, right).

Banking sector continued to be more exposed to credit risk for the medium-term loan portfolio, foreign currency credit and private sector credit. In December 2014, the share of non-performing loans in these portfolios was 27%, 26% and 27%, respectively. Except for long-term loan quality, all other credit portfolios improved.

Chart 9.2 Non-performing loans in the Albanian banking sector



Source: Bank of Albania.

Banks showed active in the process of writing off loss loans. During the year, 12 of 16 banks of the sector wrote off and/or transfer loss portfolios from their balance sheets. In semi-annual terms, portfolio quality indicator considerably improved for small-sized banks (G1) by about 5 percentage points, standing at 15%. Also, medium-sized banks (G2) and large-sized banks (G3) improved slightly this ratio by 1 and 1.1 percentage points, respectively, at 23.7% and 23%. Regulatory amendments[38] that encourage the early restructuring of loan continue to produce effect for individual banks. At sector level, as at end-December 2014, the non-performing loans indicator was 0.86 percentage point higher (or at 23.7%), if excluding the impact of the applied measures.

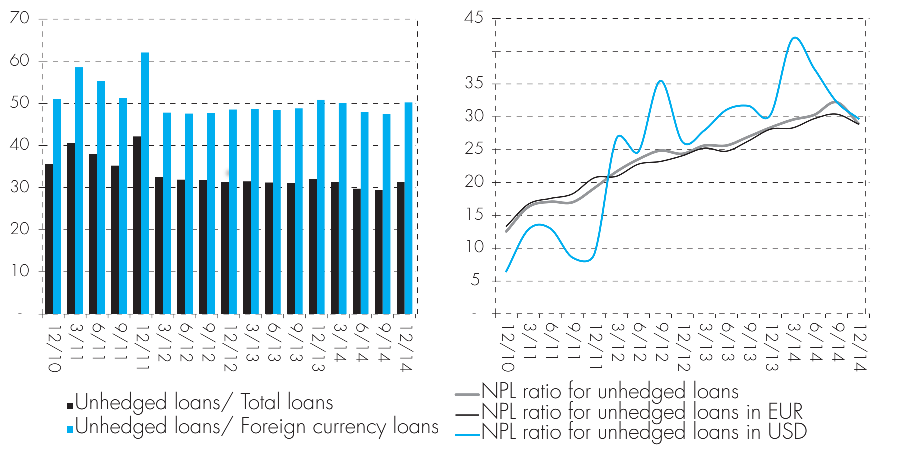
[38] *Amendments proposed by the Bank of Albania in May 2013, as part of the counter-cyclical measures package to introduce the ease terms for loan restructuring to address the increasing phenomenon of non-performing loans.*

9.1.2 INDIRECT CREDIT RISK

Exposure to indirect credit risk continues to remain high. In 2014 H2, outstanding loans in foreign currency, when the borrower's income is in ALL (following the unhedged foreign currency loan), expanded by 11%, at ALL 186.4 billion. This loan accounts for 31.3% of total outstanding loans and 50% of foreign currency outstanding loans. Notwithstanding banking sector narrowed lending in foreign currency, within this portfolio, the share of unhedged loan against exchange rate fluctuations continues to remain at considerable and stable rates.

Portfolio quality of unhedged loan in foreign currency improved slightly during the period under review, due to the expansion of loan portfolio in foreign currency. Overall, non-performing loan outstanding for the unhedged loan in foreign currency increased during the period under review by about 6%, but the increase of base was more rapid. In December 2014, non-performing loan ratio for the unhedged loan in foreign currency was 29%, from 30% at end June 2014. The unheged loan denominated in euro provided the main contribution to this performance.

Chart 9.3 Quality of the loan portfolio unhedged against exchange rate risk



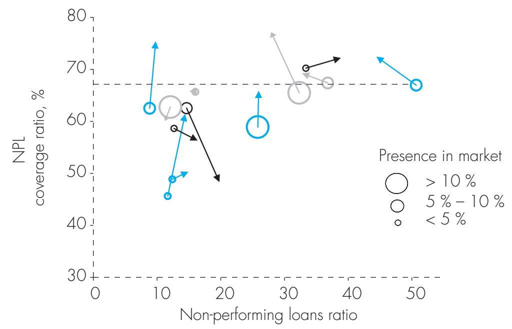
Source: Bank of Albania.

9.1.3 PROVISIONING

The satisfactory rates of provisioning mitigate the credit risk. At the end of 2014, provisioning of non-performing loans, at sectorial level, was 67.1% from 66.3% in June 2014, and 65.2% a year earlier. Compared to end-2013, 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. Nevertheless, the level of non-performing loans in these two banks was lower than the banking sector average, by mitigating this development.

During 2014, at sectorial level, the ratio of net non-performing loans to outstanding loans narrowed at 7.5%, from 8.1% in June 2014. At the end of 2013, this ratio was 8.2%. The banking sector's capacity to cover non-performing loans with capital improved. At end -2014, the ratio of "non-performing loans, net, to regulatory capital" dropped to 38.3%, from 40.5% at end-June 2014, mainly impacted by the expansion of regulatory capital.

Chart 9.4 Annual change in the provisioning ratio for banks



Note: Grey shows improvement, black shows worsening and blue shows an unclear development in risk combination. All banks of Albanian banking sector are included. Interrupted line marks the average ratio of non-performing loan loss provisions at sector level, 67.1% as at end- December 2014

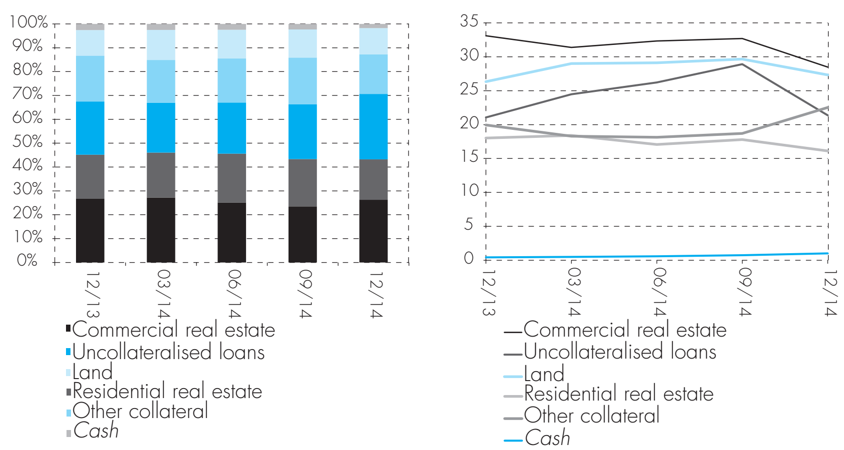
Source: Bank of Albania.

9.1.4 COLLATERAL COVERAGE

In December 2014, the collateral coverage[39], an important hedging factor against credit risk, was 73%, down from June 2014 (79%) and December 2013 (78%). This behaviour reflects the lending performance to overdrafts (for short-term financing purposes), where the trend for collateral is lower. Loans collateralized by real estate accounted for 60% of total collateral-based loans. Notwithstanding at satisfactory covering rate, banking sector continues to remain sensitive to the well-functioning of the real estate market and the collateral execution process. Related to systemic risks, banks assess that sensitivity against improvement of collateral structure increased, while the measures taken to accelerate the execution process of collateral are expected to provide positive impact in the medium term[40].

At end-December 2014, the non-performing loan collateral coverage ratio was about 74%. During 2014 H2, loan quality ratios by collateral improved (see Chart 9.5, right).

Chart 9.5 Loans by type of collateral and the non-performing loan ratio by type of collateral



Source: Bank of Albania.

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

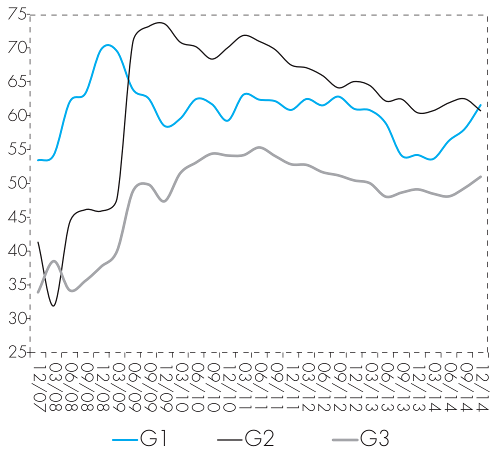
[40] Results taken from the survey of systemic risk, at six-month frequency at banks.

The quality of loan portfolio covered by "other collateral" deteriorated, sharing 23% of outstanding covered with collateral and narrowed during the last years.

9.1.5 RISK-WEIGHTED ASSETS

Lending activity, concentrated at the end of year, is reflected in the expansion of exposures in risk-investments portfolios. In December 2014, the ratio of risk-weighted assets to total assets stood at 53.6%, expanding slightly from end-June 2014 and end-2013, by 1.9 percentage points and 1.6 percentage points, respectively. The slight increase in exposure was driven by the small-sized banks (G1) and medium-sized banks (G2), which showed expansion of ratio during the period, by 5.3 percentage points and 2.9 percentage points, respectively. Large-sized banks (G3) continue be more prudent against exposures in the framework of regulatory policies of parents banking groups.

Chart 9.6 Risk-weighted assets to total assets by banking groups



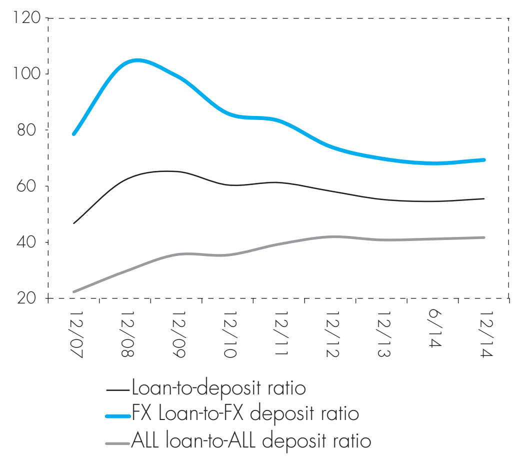
Source: Bank of Albania.

Despite the fall in the non-performing loan ratio and the positive impact materialising gradually from the legal improvements and other measures by the authorities, the credit risk remains important. The experience of last year, showed that legal and regulatory improvements on collateral execution/ management, modalities for the taxation of banks in the case of loan write offs from their balance sheets, and restructuring of non-performing loans need to be interpreted and implemented consistently. Legal ambiguities in the process of borrowers' bankruptcy, especially identified in the case of borrowers exposed to more than one bank, emphasise the need for improvements in this regard as well.

Moreover, the sale or transfer of the non-performing loans portfolio from banks to specialised non-bank financial institutions is a process that needs to be specified in regulatory requirements and encouraged through different forms, to prevent legal uncertainties and stir up the interest of these institutions. Overall, the process of the management and solution of non-performing loans would benefit from a thorough analysis of the difficulties faced, which would serve as a basis for a coordinated and determined approach by public authorities aimed at providing a systematic and sustainable solution to this problem.

9.2 LIQUIDITY RISK

Chart 9.7 Loan-to-deposit ratio



Source: Bank of Albania.

Liquidity position of banks stands at good levels. Deposits remain the main source of funding, increasing at a slower pace from the historical trend and are oriented toward more extreme maturities, mainly short-term maturities. The liquidity ratios, both in the Albanian lek and in foreign currency, were above the minimum regulatory ratios.

Deposits continue to remain the main source of funding for the banking sector operations. The loan-to-deposit ratio was 55.5%, slightly up from the previous periods.

The slow performance of lending and the portfolio expansion towards more liquid assets in money and capital markets provided high rates of liquid assets ratio in banks' balance sheets. Liquidity ratios ("liquid assets to short-term liabilities") by currency are considerably assessed upper the minimum regulatory ratios.

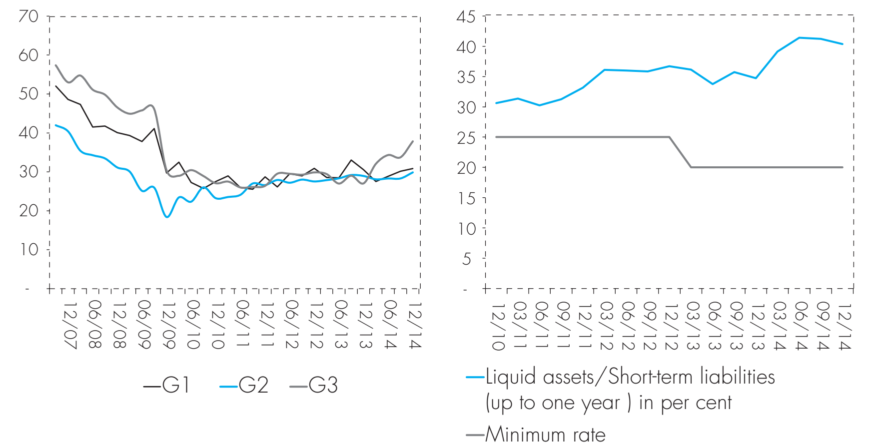
At end of 2014, liquid assets shared 31.9% of banking sector's total assets, slightly down during the first half of year, but 4.3 percentage points higher than in the same period a year earlier. Large-sized banks (G3) determined the considerable part of this indicator. Their ratio expanded by 3.5 percentage points during the period under review and by 10.8 percentage points from a year earlier, standing at 37.8%.

The ratio "liquid assets to total short-term liabilities" narrowed by 1.1 percentage points during the period under review. This ratio expanded by 5.7 percentage points from a year earlier, standing at 40.4%. The large-sized banks (G3) determined the annual performance. The expanded current accounts and demand deposits during the period under review drove to the narrowing ratio of this group by 2 percentage points, standing at 41.4%.

By currency, the ratio was down for euro[41], by 8.5 percentage points compared to 2014 H1, and 2.4 percentage points from a year earlier, at 32.1%. The ratio for the domestic currency and US dollar, during the period under review, showed slight fluctuations, but in annual terms, the domestic currency ratio increased by 12.3 percentage points, at 55%.

[41] *Mainly due to the increase in foreign currency deposits of short-term maturity.*

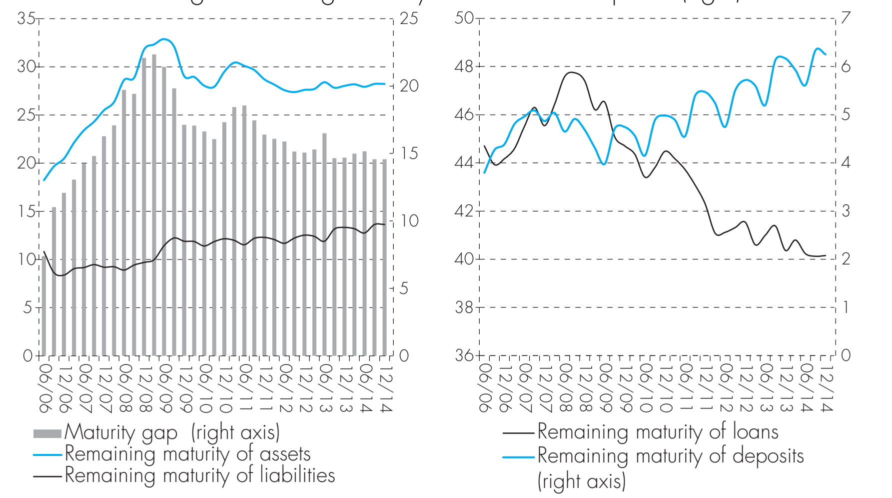
Chart 9.8 Ratio of "liquid assets to total assets" by banking group (left); and the ratio of "liquid assets to total short-term liabilities" (right)



Source: Bank of Albania.

The maturity gap between assets and liabilities narrowed slightly, by around 0.6 months, to 14.6 months, during the period under review. The gap showed a slight narrowing and a sharper increase of the average remaining maturity of liabilities to assets over 2014 (see Chart 9.9, left).

Chart 9.9 Average remaining maturity of assets and liabilities (left); and Average remaining maturity of loans and deposits (right)



Source: Bank of Albania.

The remaining maturity of deposits, the main liability item, and loans the main asset item of the banking sector, continued to perform at opposite directions (see Chart 9.9, right). Remaining maturity of loans fell slightly at 40.2 months. Remaining maturity of deposits narrowed at 6.3 months.

Banking sector remained considerably financed by deposits of customers and does not show any dependence from the use of financing from parent banks. Related to banks that own lines of credit from banks peer group, their level of use remains low. In December 2014, the lines of credit amounted to

ALL 25.6 billion, from ALL 35.3 billion in 2014 H1 and ALL 48.4 billion a year earlier. The degree of the use of line of credit stood at 13%.

9.3 MARKET RISKS

The banking sector's open foreign exchange position was long and within the historical levels. Interest rate-sensitive assets and liabilities provide negative differences for maturities up to one year. Despite the manageable 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.

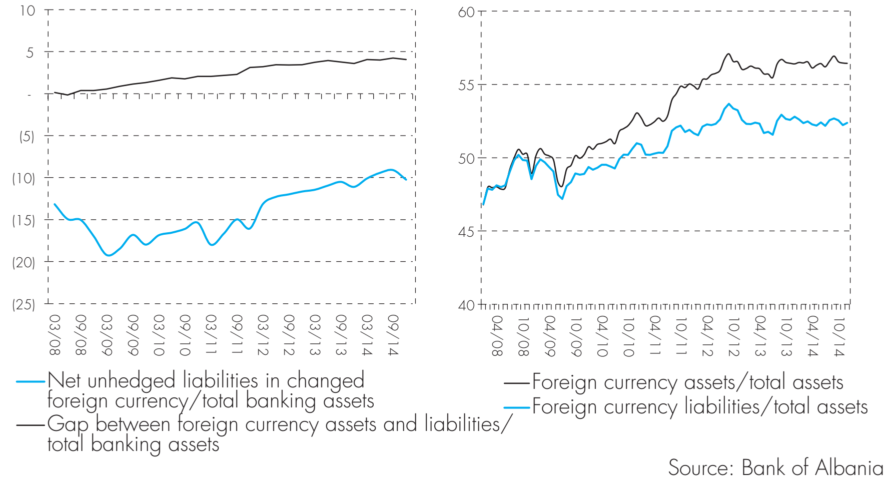
9.3.1 EXCHANGE RATE RISK

Banks' exposure to exchange rate risk measured through the Modified Currency Mismatch Index[42] shows the exposure to indirect exchange rate risk. At end-2014, the Modified Currency Mismatch Index deteriorated slightly at -10.2%, from -9.4% in 2014 H1, due to the larger expansion of foreign currency liabilities along with the unhedged loan compared to foreign currency assets. The Modified Currency Mismatch Index stood at -11.1% a year earlier (see Chart 9.10, left).

In 2014 H2, foreign currency assets of the sector accounted for ALL 730.2 billion, expanding 3.3% during the period under review, and 4.9% from a year earlier. Developments in foreign currency liabilities, which were estimated at ALL 677.5 billion, performed similarly. As at end-2014, the share of foreign currency assets and liabilities in total assets was 56.4% and 52.4%, respectively, fluctuating slightly at the rates of a year earlier (See Chart 9.10, right).

[42] *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].

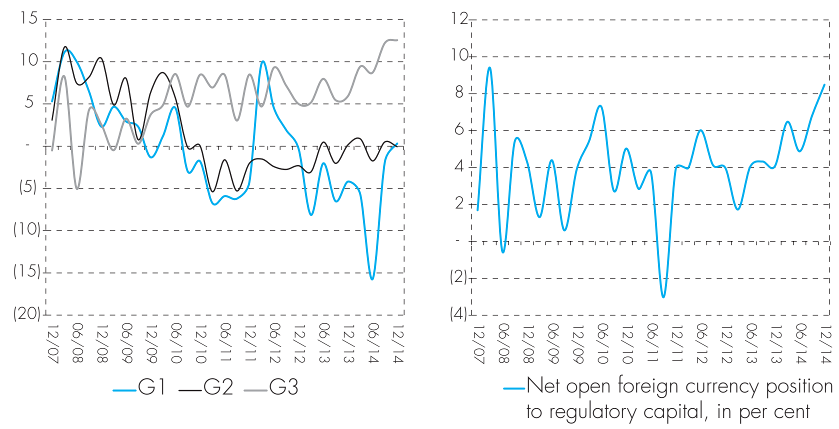
Chart 9.10 The Modified Currency Mismatch Index, in per cent (left); share of foreign currency assets and liabilities in total banking sector assets, in per cent (right)



Source: Bank of Albania.

Large-sized banks (G3) continued to hold a long position of foreign currency, almost doubling the position from a year earlier, and further increasing the exposure to an appreciation of lek exchange rate. Medium-sized banks (G2) and small-sized banks (G1) showed lower exposure to the exchange rate (see Chart 9.11, left). The net open foreign exchange position to the regulatory capital was estimated at 8.5%, from 4.9% a period earlier, and 4.1% a year earlier (see Chart 9.11, right).

Chart 9.11 Open foreign exchange position to the regulatory capital for banking groups by size of activity (left); and for the system (right) in per cent



Source: Bank of Albania.

9.3.2 INTEREST RATE RISK

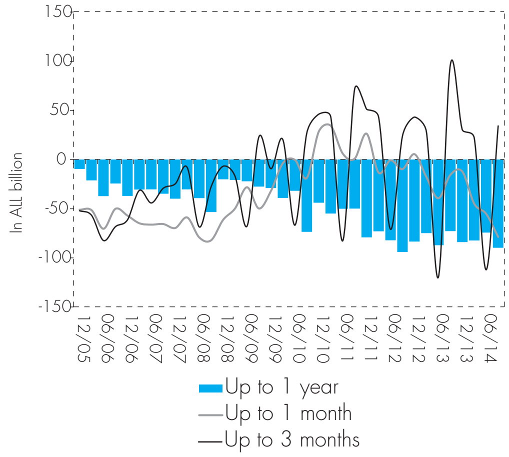
Banking sector was exposed to interest rate fluctuations, as evidenced by the negative[43] difference between rate-sensitive assets and rate-sensitive liabilities to interest rate. This risk should be assessed regularly given the considerable

[43] *As at end-2014 H2, the gap between rate-sensitive assets and rate-sensitive liabilities with maturities of 1, 3 and 12 months to total assets, stood at (-3.9%), 0.3% and (-8%), respectively.*

fall of interest rates in the domestic and international market, and the impact on their increase in future.

The cumulative differences between rate-sensitive assets and rate-sensitive liabilities with up to 1-month and up to 3-year maturities narrowed and were estimated at ALL -49.8 billion and ALL +4.3 billion, respectively. This development led to the decrease of sector's exposure to the interest rates sensitivity. The cumulative gap for the maturity up to one-year expanded, standing at ALL -104 billion, by increasing the exposure of sector in the event of a possible increase of interest rates. Total exposure was up compared to a period earlier.

Chart 9.12 Maturity gap by repricing period, in ALL billion



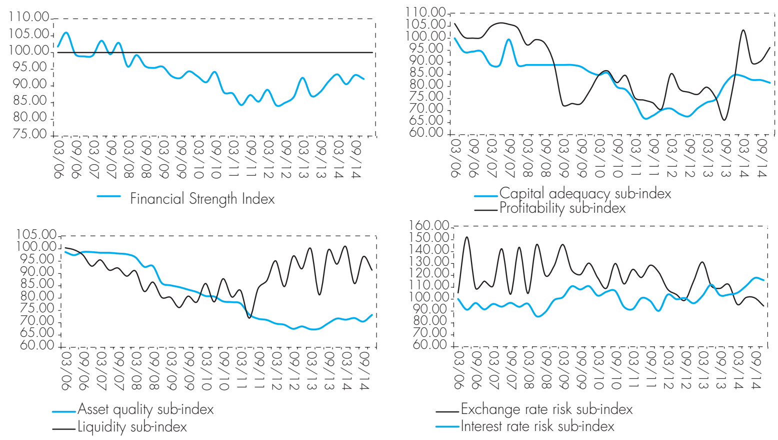
Source: Bank of Albania.

The spread on loan and deposits rates (interest rates spread) appeared down for the three main foreign currencies, during the second half of 2014. The spread on the Albanian lek was 1 percentage point lower from 2014 H1, standing at 6.3%.The spread on U.S. dollar 0.6 percentage points at 5.9% and on euro 0.4 percentage points at 5.7%. Over the one-year period, on the Albanian lek and euro, the highest fall of interest rates was more for loans than for deposits. While the opposite resulted on U.S. dollar driving to the expansion of spread between them. Nevertheless, the transmission mechanism of interest rates fall is accompanied by the maintaining of the margin rates.

Box 9.1 Financial Strength Index

The Financial Strength Index (FSI) assesses the banking sector's risks at a common index. As at end-2014, the Financial Strength Index was up, standing at 92.1 from 90.5 in 2014 H1, and from 91.4 in the same period a year earlier. At the end of 2014, FSI components that provided a positive contribution to its performance were the improved assets quality, increased profitability and the lower exposure to fluctuations of interest rates. The slowdown of capital adequacy ratios, the decreased liquidity indicators and the higher exposure to unfavourable fluctuations of exchange rate contributed to the opposite direction.

Chart 9.13 Financial Strength Index and its sub-indices



Source: Bank of Albania.

10. ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING[44]

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.

10.1 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 2016.

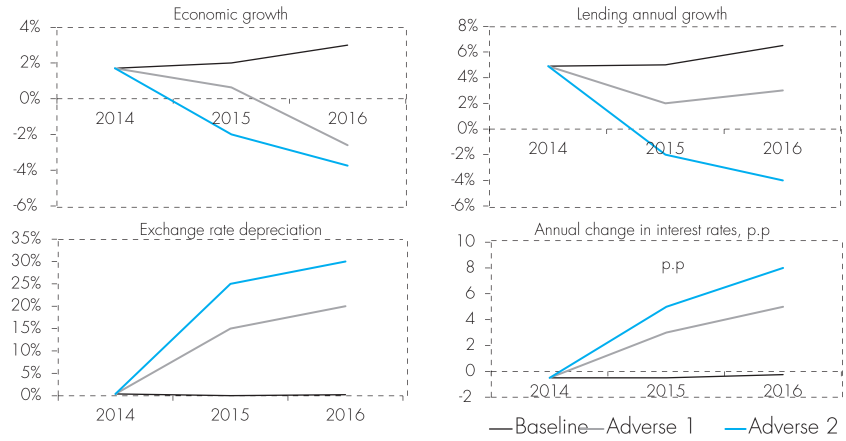
The stress-test exercise assesses the impact of macroeconomic situations on the banking sector's financial standing, excluding the possibility of an increase in the paid-in capital during the period under review. This analysis includes three scenarios: the baseline scenario and two adverse scenarios. The adverse scenarios assume a "stressed" situation with a low probability of occurrence[45], based on three probable shocks to the Albanian economy: a) lending slowdown; b) market interest rates increase; and c) domestic currency depreciation.

In the baseline scenario, economic growth is assumed to gradually improve at 3% as at end-2016. In the first adverse scenario, the assumptions on the depreciation of the Albanian lek exchange rate to 25% increase of interest rates by 5 percentage points and a slowdown of annual lending rate at 3% as at and-2016, drive to a weak economic growth of 0.6% for 2015 and a shrinkage by 2.6% for 2016. In the event of second adverse scenario, the assumptions on the Albanian lek exchange rate depreciation by 30%, accompanied by an increase of interest rate by 8 percentage points and annual shrinkage of loan at 4%, are reflected at a shrinkage of the economic activity for both years included in the exercise, by 2% and 3.7%, respectively.

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

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

Chart 10.1 Stress-testing assumptions



Source: Bank of Albania.

10.2 RESULTS

Baseline scenario shows that non-performing loans ratio will gradually improve for the period 2015-2016. At the end of 2015, this ratio will be considerably impacted by the process of writing off loss loans[46], pursuant to the regulatory requirement that enters into force in January 2015[47]. This accumulated effect will be transmitted during 2016 and will be strengthened further by the economic sustainability, the low interest rates and the gradual improvement of lending activity in Albania. The trajectory of loan quality, reflects the impact that originates from the payment of Government's arrears and the improvement in terms of collateral execution pursuant to the legal changes undertaken by the authorities.

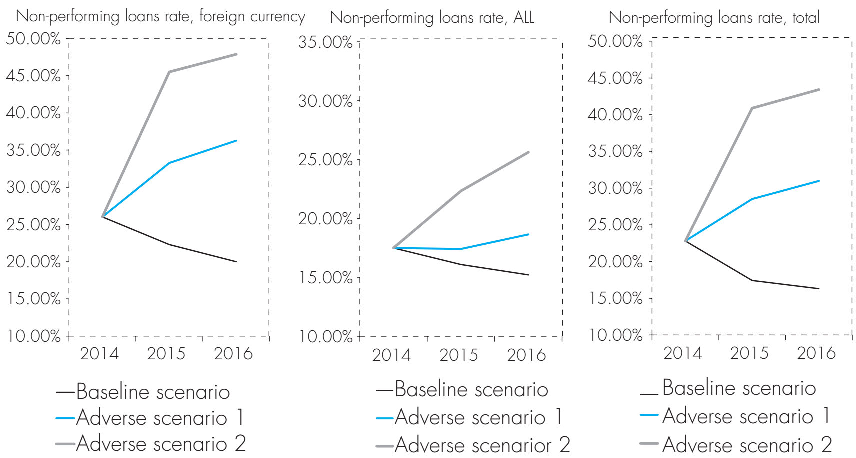
In the event of adverse scenarios, credit risk is the main exposure of banking sector activity, where loan quality deteriorates considerably. Related to foreign currency loan, the economic slowdown or shrinkage and the exchange rate depreciation in adverse scenarios, are reflected in a rapid increase of non-performing loans ratio. For lek-denominated loan, the main effect arises from the deterioration of economic activity, and at a lower extent, from the assumed increase in interest rates. The combined effect of deteriorated economic activity, depreciated exchange rate and increased interest rate in the event of first adverse scenario, is reflected in the increase (deterioration) of non-performing loans ratio by 6 percentage points at end-2015 and 14 percentage points at end-2016, compared to the baseline scenario. In the second adverse scenario, the non-performing loans ratio deteriorates by 13.2

46 At end of 2015, the impact of write off loans is estimated at 3 percentage points.

47 Pursuant to this requirement, banks should write off from their balance sheets, the loans classified as "loan loss" for more than three years. This accounting operation, does not avoid the bank's commitment to continue the effort for the collection of loan, in accordance to all the forms stipulated by the law.

percentage points in the first year of exercise and 23.7 percentage points in the second year, compared to baseline scenario.

Chart 10.2 Assessment of non-performing loans ratio under the baseline, moderated and adverse scenarios



Source: Bank of Albania.

The deterioration of non-performing loans ratio drives to the increase of provisioning expenses by draining the banking sector's profitability. Profits from open foreign position which remains in long position, hedges partially banks from losses related to loan, given the depreciation of exchange rate. Increase of interest rates also reflects losses for banks in the light of transformation process of maturities. The increase at the same rates of deposits and loans drive to a more rapid increase of interest expenses than interest income, being reflected in loss of net interest income. The aggregate impact of these effects in terms of capitalisation of banking sector is introduced following:

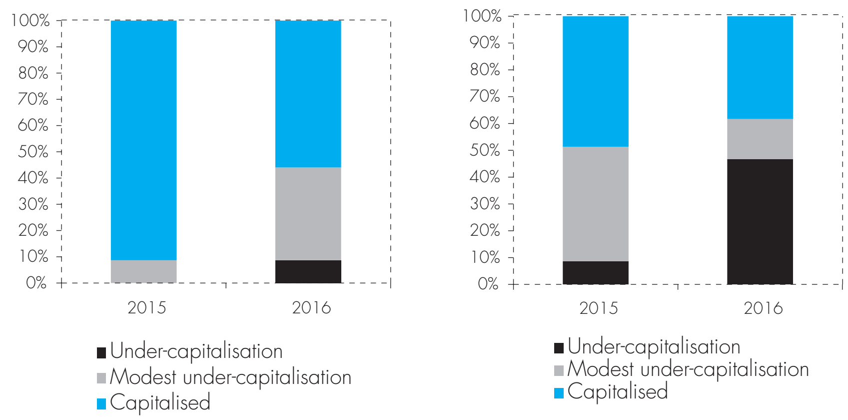
- In baseline scenario, capital adequacy ratio of the sector improves at 17.4% at end-2015, and 18% at end-2016, following the improvement of loan quality.
- In the first adverse scenario, banking sector continues to remain well-capitalised at aggregate level. However, individual banks falls under capitalisation (see Chart 10.3, left)
- In the event of second adverse scenario, due to the economic shrinkage and deepen exchange rate depreciation, at aggregate level, the sector shows a modest under capitalisation only at end-2016 (see Chart 10.3, right).

In the baseline scenario, total need for additional capital is estimated at ALL 0.14 billion as at end-2015. In the event of first adverse scenario, the need for additional capital is about ALL 1 billion, as at end of 2015 and ALL 16.9 billion as at end of 2016. In the event of second adverse scenario, the need for additional capital is about ALL 13.7 billion, as at end-2015, and ALL 52.9 billion as at end-2016. Against the backdrop of earlier developments, during 2014, the banking sector increased its capital by ALL 3.3 billion, compared to ALL 10.4 billion a year earlier.

10.3 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 scenario includes shocks in the form of a haircut[48] to the value of investment in foreign securities above the market value reported by banks[49].

Chart 10.3 Capitalisation rate by adverse scenario 1 (left); and adverse scenario 2 (right), in per cent of banking sector's assets



Financial Stability and Statistics Department, Bank of Albania.

At end of December 2014, 8 banks in the system had sovereign and commercial securities. At aggregate level, securities portfolio of banking sector stood at ALL 82,348.85 million. When applying haircuts on the market price of sovereign debt securities, the loss is estimated at ALL 825.6 million. When applying haircuts on commercial securities, the loss of the banking sector expands, reaching 4.7% of investment value.

Table 10.1 Stress-test results

Current investment ALL million	Total loss ALL million	Loss from sovereign risk ALL million	Loss from commercial risk ALL million	Total loss in the share to current investment
82,348.85	3,887.9	825.6	3,062.3	4.7%

Source: Financial Stability and Statistics Department.

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

48 *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 assumptions 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 and, later, in a linear way, the haircuts for each maturity term are constructed.*

49 *The market value for securities was reported for 4 March 2015.*

ANNEX 1 FINANCIAL SOUNDNESS RATIOS

In per cent	2007	2008	2009	2010	2011	2012	2013	2014
Capital-based ratios								
Regulatory capital to risk-weighted assets	17.08	17.23	16.17	15.40	15.56	16.17	17.96	16.84
Core capital to risk -weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79
Shareholders' equity to total assets	7.62	8.57	9.57	9.40	8.69	8.57	8.37	8.58
Asset quality								
Net non-performing loans to regulatory capital	10.05	21.74	28.24	35.95	52.01	55.62	40.22	38.25
Gross non-performing loans to total loans	3.36	6.64	10.48	13.96	18.77	22.49	23.49	22.80
Profitability								
Return on Equity (RoE, on an annual basis)	20.74	11.35	4.58	7.58	0.76	3.78	6.43	10.53
Return on Assets (RoA, on an annual basis)	1.57	0.91	0.42	0.72	0.07	0.33	0.54	0.89
Net open foreign position to capital								
Net open foreign position to regulatory capital	1.69	4.30	3.89	5.03	3.94	3.98	4.08	8.49
Net open foreign position to core capital	1.80	4.54	4.12	5.33	4.29	4.41	4.92	10.37
Asset-based ratios								
Liquid assets to total assets	49.77	42.83	27.65	25.95	26.53	29.37	27.64	31.94
Liquid assets to short-term liabilities (up to one year)	73.96	64.86	32.58	30.62	33.15	36.71	34.71	40.36
Customers' deposits to total loans	215.45	162.60	154.32	166.39	163.20	171.62	180.83	180.16