B a n k o f A l b a n i a

FINANCIAL STABILITY REPORT 2015 H1

Published by: Bank of Albania
Sheshi "Skenderbej", No 1, Tirana
Tel: + 355 4 2419301/2/3; + 355 4 2419409/10/11
Fax: + 355 4 2419408
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 B L E S

C H A R T S

INTRODUCTION

This is the fourteenth issue of Bank of Albania's Financial Stability Report, which is produced half-yearly. 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 first half of 2015. 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.

The report provides a summary of stress-testing exercise results, reflecting the regulatory changes in the way of calculating capital adequacy and has included liquidity stress test scenarios.

NOTES

As of the end of June 2015, banks operating in Albania were divided into the following groups by their share:

- **Banks Peer Group 1** (each sharing 0-2% of total banking sector assets): United Bank of Albania (UBA), Veneto Bank (VB), International Commercial Bank (ICB), First Investment Bank (FIB), Credit Bank of Albania (CBA) Credit Agricole Bank (CAB).They account for around 6.3% of the sector's total assets.

- **Banks Peer Group 2** (each sharing 2-7% of total banking sector assets): Procredit Bank (PCB), National Bank of Greece (NBG), Societe Generale – Albania (SGA), Alfa Bank – Albania (ABA), Union Bank (UB), Tirana Bank (TB). They account for around 26.2% of the sector's total assets.

- **Banks Peer Group 3** (each sharing over 7% of total banking sector assets): National Commercial Bank (NCB), Raiffeisen Bank (RB), Credins Bank (CB), Intesa Sanpaolo Bank –Albania (ISBA). They account for around 68.3% of the sector's total assets.

As of the end of June 2015, by capital origin, the banks operating in Albania were divided as follows:

- **Foreign-owned banks**[1]: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank - Albania, Veneto Bank (Italy); Alpha Bank - Albania, Tirana Bank, National Bank of Greece (Greece); National Commercial Bank (Turkey); Société Générale Albania, Credit Agricole Bank (France); ProCredit Bank (Germany); First Investment Bank (Bulgaria); International Commercial Bank (Malaysia); United Bank of Albania (Saudi Arabia); Credit Bank of Albania (Kuwait).They account for around 86.3% of the sector's total assets.

- Albanian-owned banks: Credins Bank, Union Bank;They account for around 13.7% of the sector's total assets.

As of the end of June 2015, the National Commercial Bank had expanded its branches network to Kosovo.

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

FINANCIAL STABILITY STATEMENT, FIRST HALF 2015

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 the public and financial institutions on the Albanian financial system situation and on the potential risks that may jeopardise its stability, the Bank of Albania releases this periodic statement, part of the Financial Stability Report.

Economic activity in Albania expanded over the first half of 2015, driven by a boost in private investments - being foreign direct investments an important contributor - and by an improved trade balance.

The easing of the monetary policy and the fiscal policy consolidation combined to support the stability of the macroeconomic framework. Volatility of the domestic currency exchange rate and interest rates were low. Government debt securities and interbank market operated normally, amid adequate liquidity conditions. International markets operated within a low interest rate environment, endeavouring to strengthen global economy upward trend.

Financial system's activity expanded during the period, up to 103% of the Gross Domestic Product. In the banking sector, the expansion of the activity was driven by interbank investments and credit growth, mainly in favour of non-residents. Banking sector's deposits rose by 4.4% in annual terms, driven both by domestic and foreign currency deposits. The loan portfolio rose by 5.5% in annual terms, driven by both domestic and foreign currency lending, amid downward trend in interest rates. Nevertheless, the loan portfolio grew only by 0.5%, impacted by the write-offs of lost loans from banks' balance sheet, amounting to ALL 11 billion. The write-off process of "lost loans" from banking sector's balance sheets enhanced the credit quality of the portfolio. The ratio of non-performing loans to total loans fell to 21%, at the end of the period. Loan portfolio quality improved for both domestic and foreign currency loans, as well as for businesses and households. The banking sector's financial performance improved on annual basis, mainly as a result of operational costs control. The largest banks have provided the main contribution to the sector's financial performance.

Overall, positive developments in the real economy and in the banking sector contributed to the strengthening of the financial stability during the period, as evidenced by the performance of the respective indices. However, risks remain present. More concretely:

a) The level of non-performing loans is yet considered as high. The dynamics in non-performing loans during the period were reflected in the increase of loan loss provisions by the banking sector. The high ratio of collateralized non-performing loans enables banks to recover its value; however, the concentration of collateral in "real estate'' type and lack of proper functioning of this market during collateral foreclosure, make this process complex and uncertain. On the other hand, agents' expectations have not yet factorized an acceleration of the economic growth, further impacting their consumption and investments plans. The need of a faster economic growth as an important factor for further deepening of the financial intermediation has been identified by the banking industry as well. For such reasons, loan demand and supply are esteemed to be below their potential, reflecting difficulties impacting non performing loans' resolution.

Under these circumstances, the Bank of Albania:

- will require banks to maintain adequate capital and liquidity levels, whilst they strictly identify non-performing loans;
- will monitor the accomplishment of the common Action Plan with the Government, for lowering non-performing loans level, focusing on legal and regulatory enhancements;
- will maintain a tight communication with the banking industry, to assess problems that may arise in the framework of collateral foreclosure, aiming at identifying the necessary actions for improving the process itself.

b) The short term maturity and the current structure of the banking sector liabilities do not provide the necessary support for a steady revival of the lending process, and expose the sector to the interest rate risk. The banking sector's liabilities have historically been short-term ones, thus determining the structure and size of its assets, as well as the structure and size of the loan portfolio. Currently, liabilities' structure reflects a further increase in the demand deposits' share, due to the downward cycle of interest rates. The increase in short-term liabilities is accompanied with the need to increase the sector's liquid assets and might affect the shortening of the time horizon of its long-term investments. Also, it increases the sensitivity of banks' balance sheet items to interest rate risk, in case of a rapid increase of the rates. Bank of Albania deems that banks should be more proactive in developing and merchandising products that generate long-term financing sources, which improve the balance and the structure of their liabilities.

c) Developments in international markets will be regularly monitored and assessed whether they generate volatility in the domestic financial market. One of these developments is the possibility of global economic growth acceleration and the resumption of a tight monetary policy cycle in advanced economies. Although still uncertain, this development may affect the country by inducing volatility in financial flows and domestic exchange rate against major foreign currencies. According to the balance of payments, financial flows in the form of foreign direct investments, representing long-term and sustainable investment decisions, prevail the inflows in the economy. Temporary portfolio financial flows are not important; hence the effect through this channel might be limited. On the other hand, short-term exchange rate performance reflects the movement of financial flows as well. Considering all other elements as invariable, the lack of temporary financial flows contributes to maintaining low volatility in the exchange rate. The implementation of the new agreement between Greece and the institutional creditors should be monitored carefully, particularly the way banking sector would rebound to normality. Core expectations forecast that the parties will abide by the agreement, and that the Greek banking sector, as part of this agreement, will be recapitalised thanks to the measures taken for the restructuring of its activity and the injection of fresh capital. Bank of Albania will regularly assess the implementation of this agreement and its effects, and will regularly communicate its position to the public and other interested parties.

d) The banking sector is exposed to fluctuations in the exchange rate and interest rate. The most probable transmission channel, in this case, is the size of foreign currency denominated loan portfolio, if borrower's income are in domestic currency. At the end of the period, foreign currency loans accounted for 27% of business loan portfolio versus 31% of households. Although these ratios have decreased during the period in consideration, overall, the debt position of businesses declined and the loan quality of businesses and households improved, whilst exchange rate fluctuations are considered as important in terms of their solvency. Over the last couple of years, the upward trend of expanding domestic currency loan portfolio has diminished this expose; therefore, the banking sector and economic agents should further support such trend. Due to the mismatch between assets and liabilities sensitive to interest rate, the sector is exposed to a rapid increase in the interest rates itself. Although the probability of such event is actually low, banks should incorporate the assessment of this risk in their analyses, and act to minimise it if deemed important.

e) The considerable size of banking sectors' investments in Government debt securities, dictates the need to improve the size and the depth of the market, where these securities are traded, as an important instrument to manage and minimize respective risks. Banking sector's investments in Government debt securities, accounts for around 60% of the domestic debt, and around 25% of their asset's value. This considerable concentration exposes the parties to the reciprocal financial and sustainability performance. The measures for controlling debt levels and expanding this market to other non-banking participants, will further contribute to lowering this dependence. Also, the short term average maturity of the debt exposes the investment risk of non-renovation in debt securities by investing entities. The continuing shift of issued government debt securities toward longer-maturities, and the continuous communication between the parties, contributes in mitigating such risk. On the other hand, the prolongation of the debt maturity term, if not accompanied with a proportional increase in liabilities maturity term, exposes banks to an interest rate increase risk and encourages their hesitation to further investments in securities. This risk would decline, if the absorbing capacity of the secondary market, where these securities are traded, improves. The shift of government's borrowing toward foreign currency borrowing in external market limits the banking sector's exposure to the Government. Since borrowing mainly occurs with international financial institutions, and generally at low interest rates, it might affect the improvement in government's structure debt service. Nevertheless, this borrowing exposes the government to fluctuations in domestic exchange rate and highlights the need for a careful planning and usage of its foreign currency assets.

The banking sector financial performance is assessed as good and stable. Indicators of the capitalisation and liquidity levels of the activity stand at good levels and the banking sector generates profit. Therefore, its resilience to various shocks has strengthened over the period. This is also confirmed by the stress test exercise in accordance with macroeconomic scenarios and various risks for the liquidity situation.

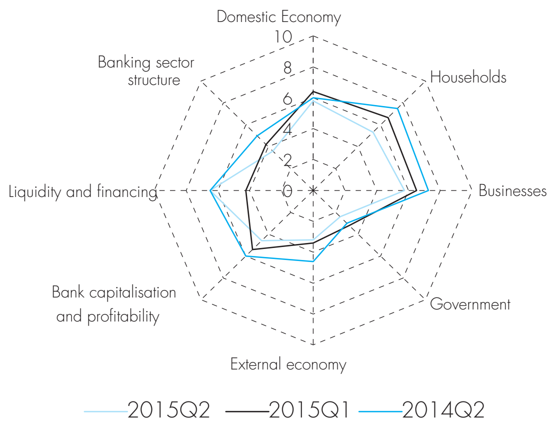
Please find below a detailed analysis of the macroeconomic environment in which the banking activity operates, and of the main financial indicators of the banking sector for the first half 2015.

1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

(1) **Developments in the Financial Stability Map[2] for 2015 H1 reflect an improvement in the indicators of the financial stability compared with the same period of 2014.** The components of "households", "businesses" and "external economy" of real economy, and "banks' capitalisation and profitability" and "banking sector structure" in the banking activity, showed highest improvement.

(2) Compared with the same period in 2014, for the real economy components, we note:

Chart 1.1. Financial Stability Map*



*Risk rated as: "low" for scores 0-3, "average" for 4-5, "moderate" for scores 6-8 and "high" for 9-10. The farther from the centre, the higher the risk.
Source: Financial Stability and Statistics Department, Bank of Albania.

- For "domestic economy", this risk is assessed as "moderated", close to the levels of the previous year. The size of external debt and the increased volatility in the exchange rate were the main contributors to this performance.
- For "households", risk is assessed as "average" and downward in annual terms. The increase in borrowing attributable to the improved portfolio quality, the reduction of the unemployment rate and the increase in remittances contributed to the reduction of this risk.
- For "businesses", risk is assessed as "moderate" and downward in annual terms. The improved credit portfolio quality to this sector provided the positive contribution to the reduction of the risk level.
- For "government", risk is assessed as "low" and trending down, compared with the same period in the previous year. The size of government debt maintains the high risk score, whereas the overall risk level is down from its low historical value of cost and control on budget deficit.
- For "external economy", risk is "down" in annual terms. This risk is assessed as low compared with the score "average" a year earlier. The growth of the Gross Domestic Product (GDP) in Albania's trading partners, in addition to the fall in the unemployment rate in countries hosting Albanian emigrants and the drop in oil prices are the factors

[2] *This map assesses the financial system's exposure to risks from the domestic and external economy, economic agents and the banking sector.*

contributing most to this risk reduction.

(3) Compared to the same period of 2014, for the "banking sector" components, we note:

- For "capitalisation and profitability", the level of risk is assessed as downward from the previous year, and is rated as "average". The negative impact from the narrowing of the gap between the value of regulatory capital and the required minimum level of capitalisation is offset by the positive impact from the increase of shareholders' equity, and the improvement in the loan portfolio quality, net interest income and net financial result.

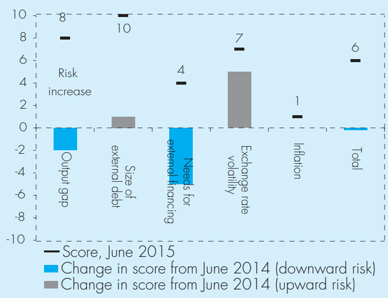
- For "liquidity and financing", risk is assessed as "moderate" and "stable". Within this dimension, the negative impact on risk from the expansion of the gap between short-term assets and liabilities is offset by the narrowed financing from non-residents.

- For "banking sector structure", although it continues to be rated as "average", the risk has been falling in annual terms. The higher diversification in lending to private sector, the structure of the sector and its financing funds have contributed to the downward risk.

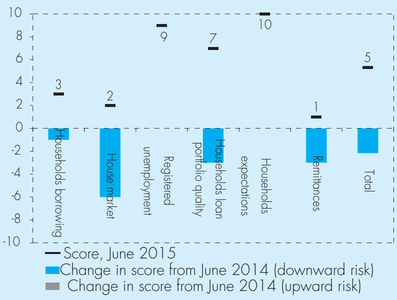
(4) Box 1 shows Financial Stability Map components over 2015 H1, the score for each risk level and the comparison with the scores for 2014 H1.

Box 1.1. FSM components

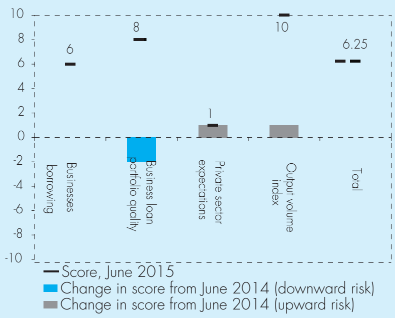
Risk from **"domestic economy**' remains moderate in the ambit of volatile exchange rate and external debt size.



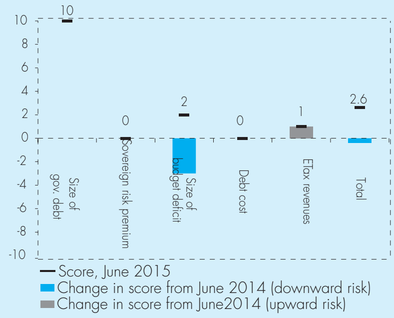
Risk for **"households"** fell due to the positive performance of households borrowing; registered unempolyment rate; credit portfolio quality and remittances.

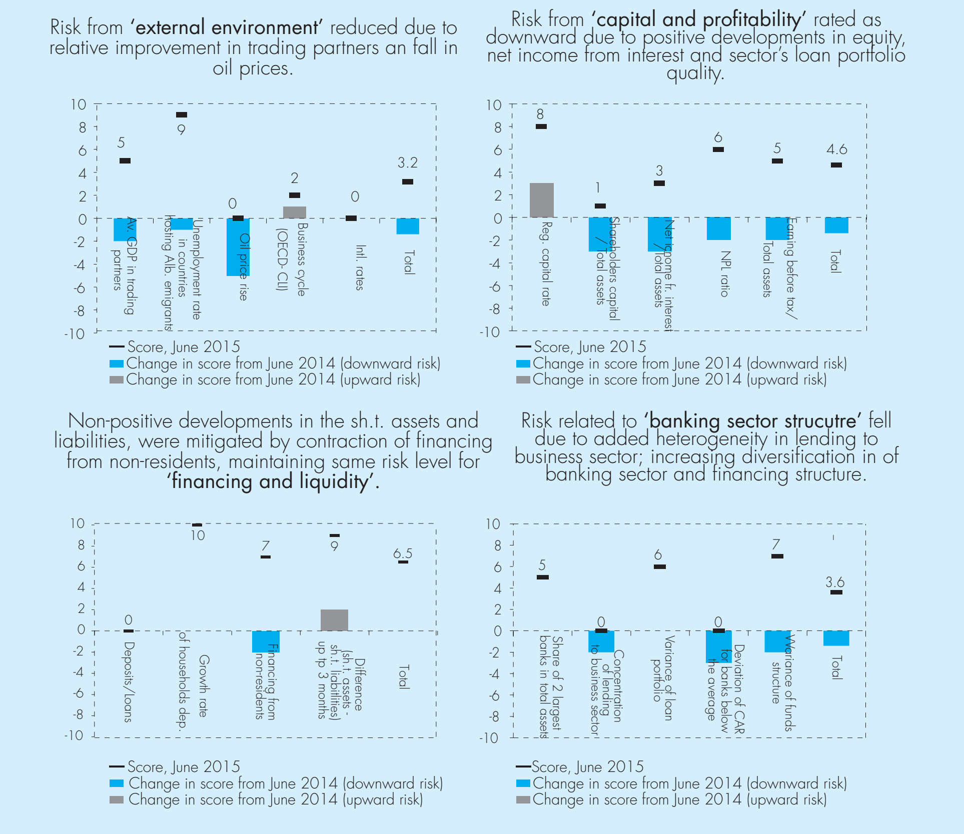


Risk for **'businesses'** rated as moderate again; improvement of credit portfolio quality hada positive effect on risk mitigation.



Risk from '**Government fiscal policy**' rated as low, given the reduction of the size of the budget deficit.





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

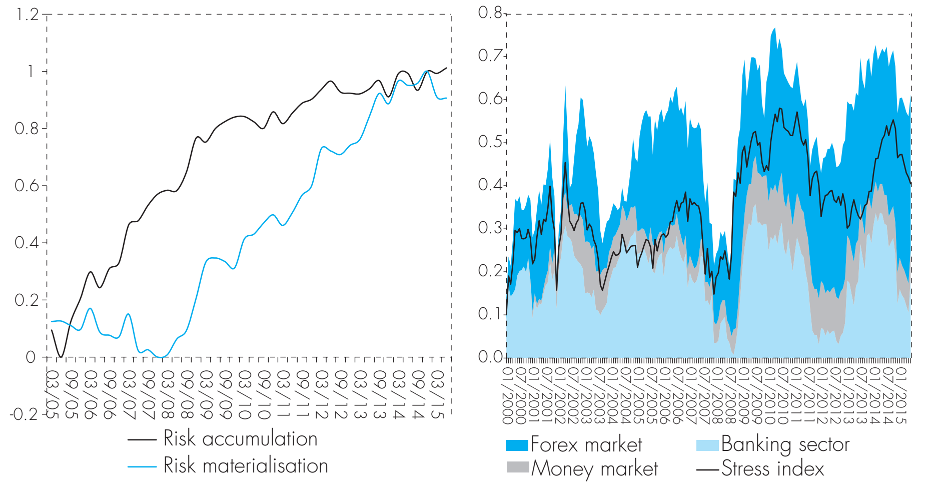
1.2 SYSTEMIC RISK

(5) In 2015 H1, the accumulation of the systemic risk[3] arising from factors relating to the banking sector and the real economy appears slightly up compared with the same period in the previous year. The increase in both the size of public external debt and in lending affected the increase in risk accumulation.

(6) The index on the materialisation of the systemic risk fell slightly from the previous year, reflecting the improvement of credit quality for businesses and households and the fall in the unemployment rate (see Chart 1.2, left). During the period, financial stress is assessed as downward due to the improved financial situation in the banking sector, while the increasing fluctuation of exchange rate contributed to the increase of this risk (see Chart 1.2, right)

[3] *Systemic risk is defined as "the possibility for the materialisation of shocks that impair the functioning of a financial system to the point where economic growth and welfare suffer materially".*

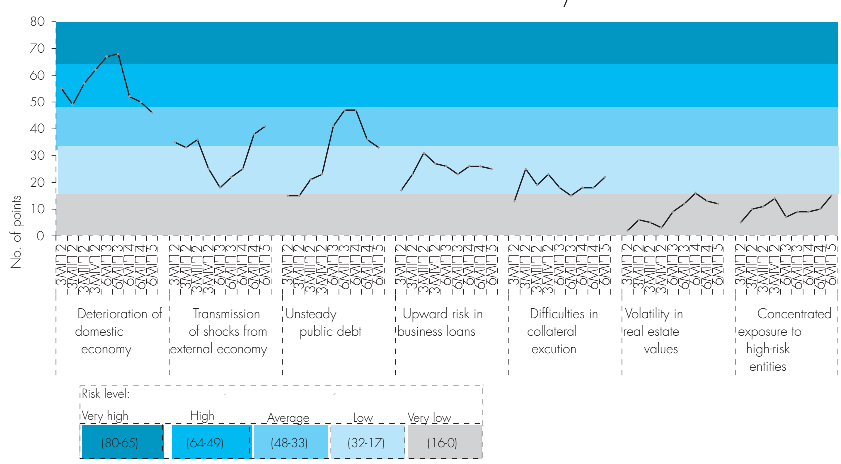
Chart 1.2. Accumulation and materialisation of systemic risk (left), Financial Systemic Stress Index (right)



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

(7) **Banking sector's expectations for the economic growth in Albania remain unstable and the weak economic growth is assessed as a source of risk.** In a special survey, the banking industry is asked on its perception for systemic risks facing its operations. For 2015 H1, the banking sector assesses that the "worsening of the domestic economy" continues to be the most significant systemic risk, but the perception of the banking sector for this risk has been gradually subsiding during the last two years. Banks' attention to the risk from 'shocks from the external economy' continued to be up, mainly reflecting the concern over the deterioration of the economic and financial situation in Greece. Banks perceive an average probability of systemic risk materialisation in the short run (up to 12 months) and long run (1-3 years), in both periods. In the short run, the probability of risk materialisation has trended up. To mitigate systemic risk in the short-run, banks state to rely mainly on the strengthening of the internal controls and the reduction of specific exposures, while in the medium term they focus on the increase of diversification.

Chart1.3 Bank assessment of main systemic risks*



*Each bank has ranked, in descending order, 5 main systemic risks: 5 - highest rated systemic risk; 1 - lowest rated systemic risk 1. For each bank, the total sum of points is calculated . The interval 0-80 (in which 80 is the highest score a risk may be rated , (if all the banks rank it as first at the same time) and 0 the lowes number), is divided in 5 equal sub-intervals, according to 5 risk levels.

Source: Financial Stability and Statistics Department, Bank of Albania

After the overview of risks to the financial stability in Albania, the following chapters focus on the developments in the global and domestic economy, financial system performance, with particular focus on banking sector developments.

2. INTERNATIONAL DEVELOPMENTS

During 2015 H1, the global economic activity recovered gradually. After the slowdown in the first quarter, due to the economic slowdown in the Unites States of America and in some main emerging economies, the global economy restored the previous pace, but with sharp differences across regions. Global trade slowed down, mainly due to the fall in imports from emerging economies. Global inflationary pressures remain subdued, affected by the fall in the prices of oil and its by-products during the previous year. Financial markets performed positively till June - July 2015, when uncertainty was up due to the aggravation of the financial situation in Greece. Overall, the euro depreciated against the major currencies, especially the US dollar. Global economic activity is expected to improve at a slow pace[4], driven by the positive performance of the advanced economies, while the pace of economic activity in emerging economies is expected to slow down further, under the main impact of Russia, Brasil and China.

(8) **Economic development in advanced economies was stable and higher than in emerging economies, albeit inflationary pressures remain, overall, weak**. Economic growth slowed in advanced economies during 2015 Q1, mainly reflecting the slowdown in the US economy attributable to the adverse weather conditions, the US dollar appreciation and the fall of investments in the energy sector. The growth pace improved in 2015 Q2, driven by the recovery of production in the USA and United Kingdom, the improved conditions in the labour market, the easing of fiscal policies in euro area and the pick up of domestic demand in most countries. In emerging economies, the growth pace slowed down during 2015 H1, affected by the fall in oil price, the tightening of external financing terms and conditions owing to the Greek crisis, the structural and cyclical factors and the negative impact of geopolitical conflicts. Inflationary pressures remain weak. Inflation was slightly up in some advanced economies, albeit remaining at low rates. This indicator performed differently across emerging economies. Overall, the future performance of oil and assets' prices in developing markets is considered as actual risks to the medium-term perspective in the global economy.

(9) **Notwithstanding the more accommodative monetary conditions, economic recovery in the euro area remains weak and segmented, unable to be translated in notable benefits in the labour market for many member states.** The euro area economy recorded positive moderate growth during the two first quarters of 2015 (see Table 2.1), mainly driven by the strengthening of the domestic demand. Conditions in the labour market improved gradually

[4] *According to the IMF, global economic growth is projected at 3.3% in 2015 and 3.8% in 2016. (Forecast July, 2015)*

and the unemployment rate dropped to 11.1% in June 2015. However, marked differences among countries remain, with countries such as Germany and the Czech Republic recording the lowest unemployment rates, 4.7% and 4.9%, respectively, and Greece, 25.6% in April and Spain, 22.5% recording the highest unemployment rates. The fall in oil prices and the weak external demand contributed to maintaining low inflationary pressures, recording negative values at the beginning of year. Under these conditions, the European Central Bank (ECB) intensified the accommodative stance of its monetary policy through quantitative easing programmes, bringing the inflation rate in positive territory during the last months. In the banking sector, lending improved, yet it remains weak, mainly oriented to the private non-financial sector. Bank lending rates continue to fall and bank lending survey results in the euro area reveal improved lending standards and increase of loan demand. Notwithstanding the positive trends, banking sector indicators remained below their historic average, affected by the still incomplete consolidation/cleaning of banks' balance sheets.

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

	GDP change (annual %)				Annual inflation (annual %)		Unemployment, in %		Gross government debt (as % of GDP)	
	2014	2015p	2015 Q1	2015 Q2	2015 Q1	2015 Q2	2015 Q1	2015 Q2	2014	2015 Q1
U.S.	2.4	2.5	0.6	3.7	-0.1	0.1	5.5	5.3	102.8	102.9
Euro area	0.8	1.5	1.5	1.6	-0.1	0.1	11.2	11.1	92.0	92.9
Germany	1.6	1.6	1.1	1.6	0.2	0.1	4.8	4.7	74.9	74.4
France	0.2	1.2	0.9	1.0	0.0	0.3	10.3	10.2	95.6	97.5
Italy	-0.4	0.7	0.1	0.5	0.0	0.2	12.6	12.7	132.1	135.1
Greece	0.7	2.5	0.5	1.4	-1.9	-1.1	25.8	25.0	177.1	168.8

Source: European Central Bank, Eurostat, IMF, Bureau of Economic Analysis (BEA).
** P- IMF projections, July 2015.*

(10) **Notwithstanding the risks, forecasts show a better economic growth for the euro area in the next months.** The latest data and confidence indicators suggest that euro area's economy will continue to recover at a moderate pace during 2015 H2, and will accelerate in 2016[5]. Domestic demand will be supported by the accommodative policy of ECB, the positive effects in financial markets, and the progress in implementing the fiscal and structural reforms. On the other hand, the low oil prices will continue to contribute positively to households' disposable income and companies' profit, thus sustaining both private consumption and investments. Financial developments in Greece, albeit not having considerable negative consequences in other euro area countries, remain a potential risk to the economic and financial stability of the region. Also, the considerably low inflation, amid a weak economic growth environment, remains a dangerous combination to the economic perspective of euro area.

(11) **Central and Eastern European (CEE) countries are showing a faster economic growth pace**. Economic activity in the major CEE countries recovered steadily, driven by the improved domestic demand and the more positive economic performance of euro area countries. Nevertheless,

5 *According to the IMF, global economic growth is projected at 1.5% in 2015 and 1.7% in 2016. (Forecast July, 2015)*

inflationary pressures remain subdued due to the downward oil and primary commodity prices.

(12) The increase in exports, the strengthening of private consumption and the increase of lending, sustained, at different extents, the pace of economic growth in Western Balkans. Overall, economic performance was positive during the first quarter in most countries of the region, except for Serbia's economy that continues to contract. The conditions in the region's labour market remain problematic, with unemployment in double digits. Inflationary pressures are low, but prices varied considerably across the countries. Bank lending showed signs of recovery, with the credit growth accelerating and credit standards' easing, mainly to households, in most of the countries. On the other hand, the high level of non-performing loans remains the main concern of the banking sector across most countries of the region. Economic and financial exposure of a part of this region to Greece, remains another considerable risk to their steady economic recovery.

Table 2.2 Selected macroeconomic indicators for Central, Eastern and South-East European countries

CESEE	GDP change (annual %)				Unemployment (% annual basis)		Sovereign debt (% of GDP)	
	2014	2015p	2015 Q1	2015 Q2	2015 Q1	2015 Q2	2014	2015 Q1
Bulgaria	1.4	1.2	2.0	2.2	9.9	9.6	27.6	29.6
Romania	2.4	2.7	3.7	3.7	6.6	7.0	39.8	38.4
Western Balkans								
	2014	2015p	2015 Q1	2015 Q2	2015 Q1	2015 Q2	2014	2015 Q1
Serbia	-2.0	-0.5	-1.8	:	19.2	:	70.9	73.3
Macedonia	3.7	3.8	3.2	:	27.3	:	38.2	36.0
Montenegro	1.1	4.6	3.2	:	18.2	:	:	:
B&H	0.8p	2.3p	2.1	:	43.6	:	30.4	:

Source: ECB, Eurostat, European Commission, respective central banks, respective ministries of finance; P - ECFIN projections, July 2015

2.1 HIGHLIGHTS IN FINANCIAL AND COMMODITY MARKETS

Overall, advanced financial markets performed positively in 2015 H1, except the June-July period, when tensions rose due to the economic and financial developments in Greece. Funding conditions in emerging markets were somewhat tighter. In primary commodity markets, oil prices remained low, reflecting the stable supply and the weak demand.

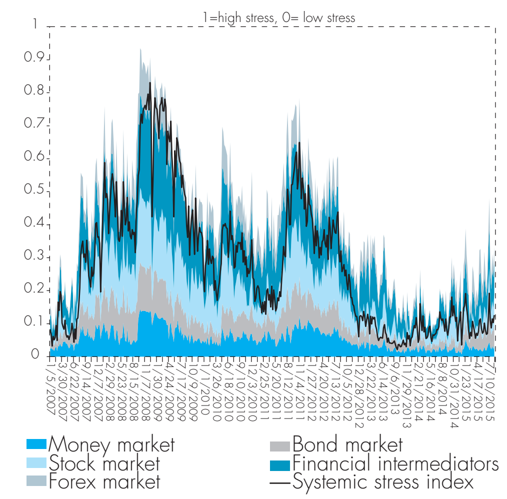
(13) In 2015 Q1, the accommodative monetary conditions were accompanied with a fall of interest rates in financial markets and increase of investors' optimism. Overall, the funding conditions in advanced markets were positive during 2015 Q1, characterised by downward interest rates and low volatility. In money markets, interest rates fell to negative values, reflecting the ample liquidity provided by ECB through the accommodative policies and the quantitative easing. In the European sovereign debt markets, the ask yields were down, registering historical low rates in April 2015. The economic and financial situation in Greece did not affect the spread of debt securities interest rates of Italy, Spain or Portugal, which further narrowed compared with the German ones. The fall in interest rates in sovereign debt markets drove investors to capital markets, for higher profits. As a result, prices in equities market, particularly in European markets, increased considerably, and lending standards in capital markets improved. The accommodative monetary policies drove to the increased optimism of investors regarding the economic outlook in advanced economies.

(14) The dominant political and economic developments in Greece, in 2015 Q2, were handled without considerable negative impact. In June, due to the failure of the agreement between Greece and its institutional creditors on the loan agreement conditions, the markets reacted with concern reflecting increase in ask yields of sovereign debt securities and fall in stock prices. The Greek crisis' effects were temporary and limited in specific market segments. The commitment of the ECB to employ all the necessary instruments to maintain integrity and financial stability in the euro area, and the finalisation of the agreement between Greece and creditors on the next instalment, led to the lowering of tensions and recovery of prices in markets.

(15) The volatility in foreign exchange markets and the fall in primary commodity prices affected negatively the expectations for economic growth in emerging economies. Funding conditions in the main emerging economies appeared somewhat tightened and investor's uncertainty was up. The fall in oil and primary commodity prices and the appreciation of the US dollar against the currencies of these countries (considering the high level of borrowing in US dollar), drove to the increased concern of investors about the economic outlook of these countries. This is reflected in the reduction of capital flows and decrease of prices in stock markets, particularly of Chinese shares.

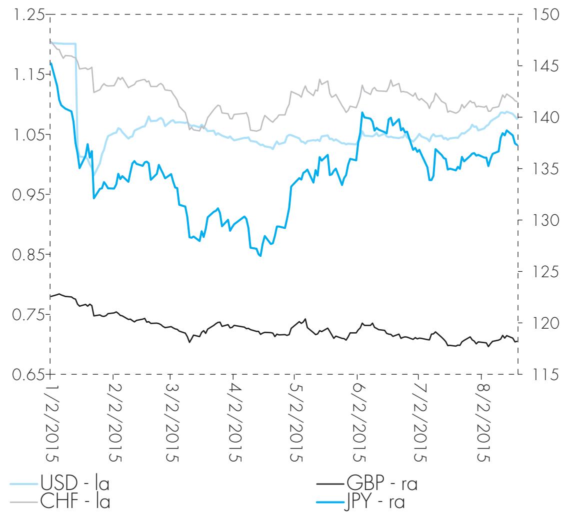
(16) Overall, in foreign exchange market, the euro depreciated against the currencies of main trading partners. This performance reflected first the quantitative easing policies implemented by the ECB and then the aggravation of the economic and financial situation in Greece during the summer. During June-July 2015, the euro depreciated against the US dollar, Japanese yen and British pound. On the other hand, the European currency gained territory against the currencies of the exporters of primary commodities and against most of the CEE countries.

Chart 2.1. European systemic stress index (CISS)



Source: ECB, Eurostat

Chart 2.2 Euro exchange rate against major currencies



Source: ECB.

(17) Oil price remains close to the low levels recorded at the end of the previous year, thus aggravating the financial position in exporting countries. In primary commodity markets, after the considerable fall at the end of 2014, gross oil prices recovered somewhat during February and at the beginning of March 2015, due to demand growing beyond expectations. Nevertheless, prices in these markets remain below the historical levels and the increase of supply from producing countries exercised pressure on their further fall during the second quarter of the year. For the medium term, participants in this market expect a slight increase in oil prices.

(18) Notwithstanding the stable global financial markets over the period under review, the real economy and the monetary and fiscal risk factors remain present. Albeit the overall more positive performance in markets, expectations for a slowdown of the Chinese economy and a generally more unstable situation in emerging economies, the possibility on a tightening of monetary policy by the Federal Reserve following the positive indicators of the US economy growth and the still unclear situation in Greece are factors that may drive to an increase in financial markets volatility.

Box 2.1 Developments in banking groups operating in Albania

Table 2.2 shows some of the main indicators of financial statements of banking groups operating in Albania, in relative terms, compared to the same period in the previous year. The indicators overall show improved income and adequate capitalisation of these banking groups, except for the group of Albanian banks with Greek capital, whose activity was negatively affected by the delay in the agreement between Greece and the institutional creditors. The share of banks operating in Albania in total assets of foreign banking groups remains low.

Change (%)	Raiffesen Bank International[1]	Intesa San Paolo[2]	Alpha Bank[3]	Piraeus Bank[4]	National Bank of Greece[5]	Societe Generale[6]	Credit Agricole[7]
Assets	2.1%	3.3%	0.1%	-1.0%	7.0%	8.0%	12.3%
Credit	3.3%	1.5%	0.3%	-1.0%	2.6%	1.3%	1.3%
Deposits	3.2%	2.9%	-16.0%	-15.3%	-8.0%	5.6%	4.0%
Loan-loss provisions	-7.4%	-28.8%	-44.8%	-42.2%	-61.0%	13.4%	-
Net profit	-48.1%	...	...	72.1%	...	77.8%	11.5%
Operating income	-16.9%	9.7%	10.4%	4.4%	5.0%	48.7%	8.3%
Net interest income	-16.2%	-6.0%	-2.8%	4.5%	-	3.5%	-
Net commission income	-4.2%	14.6%	-1.7%	4.0%	-	2.5%	-
Operating expenses	-8.5%	2.1%	-16.7%	12.2%	4.0%	8.4%	2.3%
Net operating profit	-27.6%	16.7%	-	-2.0%	-	-	6.0%
Ratios							
Non-performing loans	11.9%	4.1%	33.8%	38.9%	24.3%	5.7%	3.6%
Net interest margin	2.94%	-6.0%	2.6%	-	0.01%	0.7%	-
Capital adequacy ratio	14.8%	13.3%	13.1%	12.0%	12.1%	10.4%	13.2%
Bank' s share in Albania to the group	0,57%	0,55%	0,94%	0,58%	0,80%	2,35%	0,57%

1 *Semi-annual financial report for 2015 H1:*
2 *Press release on 2015 H1:*
3 *Financial Results, 2015 Q1, changes in quarterly basis*
4 *Financial statements for 2015 Q1, changes in quarterly basis*
5 *The results in 2015 Q1, press release, changes in quarterly basis*
6 *Financial information for 2015 H1*
7 *Financial results for 2015 H1*

3. MACROECONOMIC DEVELOPMENTS

In 2015 H1, the economy expanded, driven by the improved activity in the main sectors. In 2015 Q2, economic activity in Albania grew both in annual and quarterly terms, by 2.53% and 0.23%, respectively. In 2015 Q1, the activity grew at 2.82% and 0.32%, respectively. The better performance in the sectors of construction, industry, services and agriculture, contributed to the economic growth. Final consumption by the population and the government fell in annual terms; hence the economic growth mainly reflects the positive performance of investments (driven by the foreign direct investments flow) and the improved trade balance with other countries.

(19) **Amid weak inflationary pressures, the monetary policy of the Bank of Albania has maintained its deeply accommodative profile**. In June 2015, annual inflation stood at 1.4%, reflecting the weak inflationary pressures attributable to the presence of spare capacities in the economy of Albania, the weak demand in Albania's trading partners (low imported inflation) and the low expectations for inflation in 2015 H2. Aiming at a gradual sustainable narrowing of the output gap and the return of inflation rate close to 3% in the medium term, the Bank of Albania's monetary policy remained considerably accommodative, with the key rate standing at 2%, since February 2015.

(20) **Fiscal policy maintained its consolidating trend, the approved levels of the budget deficit and the structure of its financing, notwithstanding the realisation of income below the forecast.** At the end of June 2015, the fiscal indicators pointed to a consolidated fiscal policy in annual terms. Revenues amounted to ALL 182.97 billion cumulative, with an annual growth of 4.4%, reflecting the positive performance mainly in non-taxable income and in income from special funds, followed by local government revenues. General expenditure dropped by 0.9 in annual terms, reaching ALL 195.64 billion, reflecting also the reduction of interest expenses (of the domestic debt). Budget deficit was ALL 12.67 billion, or 42.9% lower from a year earlier, financed mainly through external resources, at 57.9%. Realisation of budget income at lower levels than planned is followed with the revision of the budget and reduction of the expected income and expenditure level, aiming to maintain the budget deficit level. Eurobond maturity in the fourth quarter of the year may impact the budget deficit financing structure and liquidity conditions in the interbank market, particularly if international financial markets do not support its reissue.

(21) **In the second quarter, the stability of financial flows in the financial and capital account have fully financed the current account deficit.** At the end of 2015 Q2, the current account deficit was EUR 181 million, around 43%

lower in annual terms. The fall in the current account deficit was attributable mainly to the drop of trade deficit in goods, the increase of positive balance in both services and secondary income account. Trade deficit narrowed around 8% in annual terms, compared with the previous year, reaching at EUR 488 million. Services recorded a surplus around EUR 121 million, or around EUR 71 million higher compared to the same period in the previous year. Remittances pointed at around EUR 162 million in 2015 Q2, by recording an annual growth of 18%. In the period under review, Albania recorded a net foreign inflow of EUR 213 million in the capital and financial account. Of them, EUR 21 million were in the form of grants for capital investments, the rest in the form of net financial flows. This position provided the complete funding of the current deficit. Foreign Direct Investments in Albania grew at EUR 198 million, or around 38% in annual terms.

(22) **The conditions in the labour marked are assessed as tightened, albeit the falling unemployment rate.** Developments in the labour market reflected the fall in unemployment, which stood at 17.3% at the end of 2015 Q2, from 17.7% in the previous year. Although this development is considered as positive, expectations about the employment for the rest of 2015, reflect tightened conditions in the labour market in the sectors of industry, construction and services[6].

(23) **The positive trend of economic activity over 2015 H1 is expected to continue in 2015 H2, by maintaining the similar growth profile.** The inflationary pressures in the economy are expected to increase gradually during 2015, remaining, however, restricted.

[6] *Businesses Confidence Survey, 2015 Q2.*

4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

In 2015 H1, households remained oriented towards savings, as shown by the expansion in deposits' level. Lending to households expanded by 2.5% in annual terms, remaining oriented in the national currency. Hence, the share of the Albanian lek credit to households was higher than foreign currency credit, for the first time. Businesses' deposits expanded, both dominated in lek and foreign currency, during the same period. Lending to businesses narrowed by reflecting the loss loan write offs from banks' balance sheets. Foreign currency lending to businesses provided the main contribution to the contraction of outstanding credit.

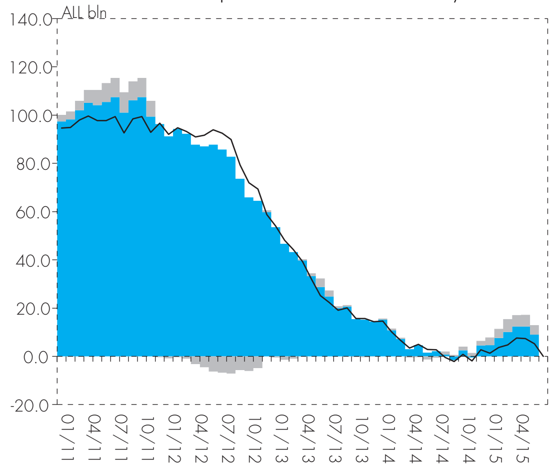
Households and businesses decreased their exposure to the indirect credit risk. Attributable to the loss loans write off, credit quality to households and businesses improved both in the period under review and compared with the previous year.

4.1 HOUSEHOLDS

(24) In 2015 H1, households remained oriented towards savings, with the main contribution arising from positive performance of foreign currency denominated deposits and lek-denominated credit. The resident households' creditor position[7] amounted to ALL 686.54 billion. This position widened by ALL 5.21 billion from the previous year, but it recorded a narrowing by ALL 4.75 billion during the period, by reflecting the acceleration of credit. By currency, resident households are creditors of ALL 357.3 billion in the national currency and ALL 329.3 billion in foreign currency. The creditor position in lek narrowed - both in annual and half-yearly terms, whereas the position in foreign currency narrowed, yet remaining higher from the previous year. Annual developments reflect a positive performance of lek-dominated deposits of households, followed by a positive performance and at a higher growth pace of credit in lek; while developments in creditor position in foreign currency reflect an increase of deposits in foreign currency and contraction of credit in foreign currency.

[7] *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.*

Chart 4.1 Contribution of annual expansion of households financial position in financial system

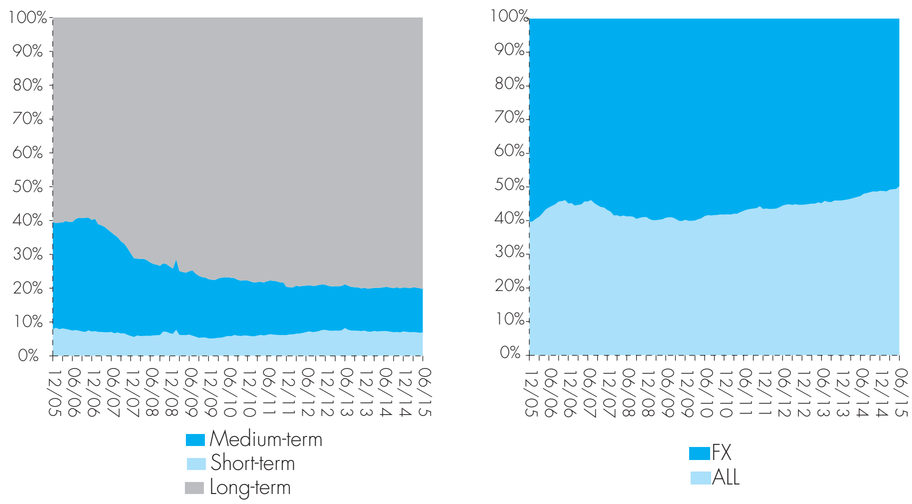


Source: Bank of Albania.

4.1.1 CREDIT RISK TO HOUSEHOLDS

(25) **Owing to the faster expansion of lek credit to households, the share of lek credit exceeded for the first time the share of foreign currency credit.** In 2015 H1, bank lending to households expanded 2.51% in annual terms. Credit expansion reflected the decline in foreign currency credit by 3.2%, and the increase in lek credit by 8.9%. Consequently, the share of foreign currency credit to households fell by 2.9 percentage points, to 49.8%, whereas lek credit to 50.2%, thereby exceeding the share of foreign currency credit for the first time in the last ten years. By term to maturity, long-term household credit accounts for 80.2% of the portfolio, up by 0.5 percentage point in annual terms; short-term credit dropped at 6.9% of the total portfolio (down by 0.4 percentage point in annual terms); and medium-term credit maintained almost the same share of 12.8%.

Chart 4.2 Households loan structure by maturity (left) and currency (right)



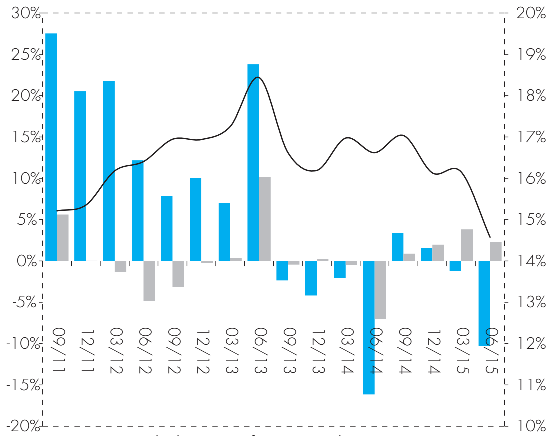
Source: Financial Stability and Statistics Department, Bank of Albania.

(26) **The loss loans write off from banks' balance sheet has highlighted the positive impact of lek credit growth to the fall in non-performing loans ratio for households.** In June 2015, the non-performing loan ratio for households fell to 14.6%, from 16.6% in June 2014 and 16.1% at the end of 2014. The considerable narrowing of non-performing loans by 8.3%, in the framework of the write offs, and the increase in outstanding loan to households by 2.3%, affected the fall in this ratio.

4.1.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

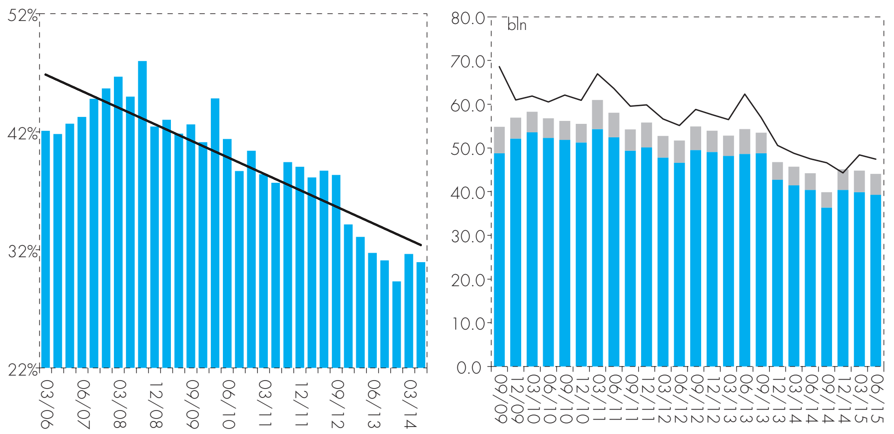
(27) **Households lowered their exposure to loans unhedged against the exchange rate risk[8] and the quality of this loan has improved.** In June 2015, these loans fell to around 31.0% of total household outstanding loans, from 31.7% in June 2014[9]. Around 82.8% of household loans unhedged against exchange rate consisted in "mortgage loans", down by 8.4 percentage points during the period.

Chart 4.3 Households loan portfolio quality



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

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



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

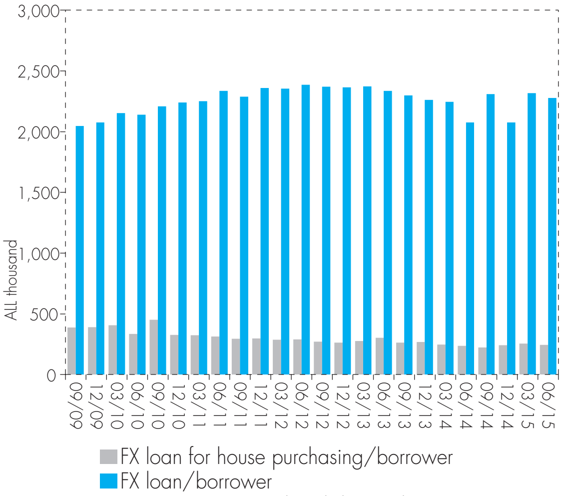
In June 2015, the quality[10] of loans unhedged against the exchange rate improved and the non-performing ratio fell to 17.8%, from 20.4% in the previous year, and 17.5% at the end of December 2014. Credit portfolio quality in foreign currency stood at 17.6%, remaining at the same level with the previous year (17.2%). In half-yearly terms, this indicator improved by 1.7 percentage points.

[8] *This is the case when the loan is received in a currency different from the one in which the borrower receives the major part of incomes; for example when the loan is received in foreign currency and the incomes are mainly in lek.*

[9] *Unlike the annual trend, in half-yearly terms, this exposure was up 1.6 percentage points; nevertheless, during the first months of 2015, this exposure has trended down.*

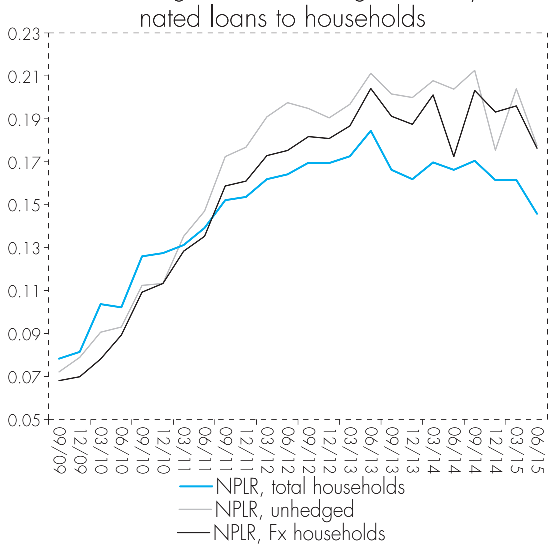
[10] *The quality is presented by the non-performing loans ratio to outstanding loans denominated in foreign currency for houesolds.*

Chart 4.5 Households credit portfolio quality



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

Chart 4.6 Average value of foreign currency denominated loans to households



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

The average level of unhedged loan for house purchase increased to ALL 2.276 million during the period under review.

4.2 BUSINESSES

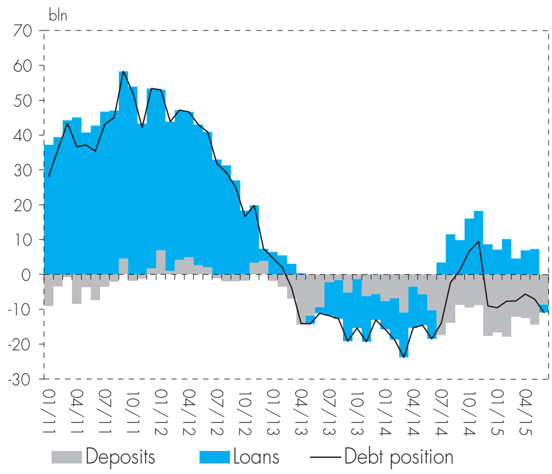
(28) Owing to the increase in deposits and contraction of credit, particularly in foreign currency, resident businesses narrowed considerably their debt position to the financial system[11]. The debt position amounted to ALL 255.98 billion, at the end of the period, narrowing by ALL10.9 billion in annual terms. However, the whole reduction happened during 2015 H1, by around ALL 10.4 billion. This performance mostly reflected the annual expansion of resident businesses' deposits by ALL 8.63 billion, whereas the credit narrowed ALL 2.28 billion. By currency, businesses are debtors of ALL 82.7 billion in the national currency and ALL 173.3 billion in foreign currency. Relative to the previous year, the debtor position in lek expanded by ALL 2.7 billion, whereas that in foreign currency narrowed by ALL 13.6 billion. This trend is reflected also in the half-yearly developments.

[11] *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.*

4.2.1 CREDIT RISK TO BUSINESSES

(29) **The loans write off has driven down the loan stock to businesses in the financial system**. Lending to resident businesses fell in annual terms and half -yearly terms, by 0.5% and 2.7%, respectively. This performance reflects the loss loans write off from the banks' balance sheet, mainly foreign currency loans. They shrank by 4.6% during the period, while lek loans expanded slightly by 0.8%. By size, larger enterprises accounted for 63.0% of loan portfolio, whereas small and medium-sized enterprises accounted for 19.4% and 17.6%, respectively.

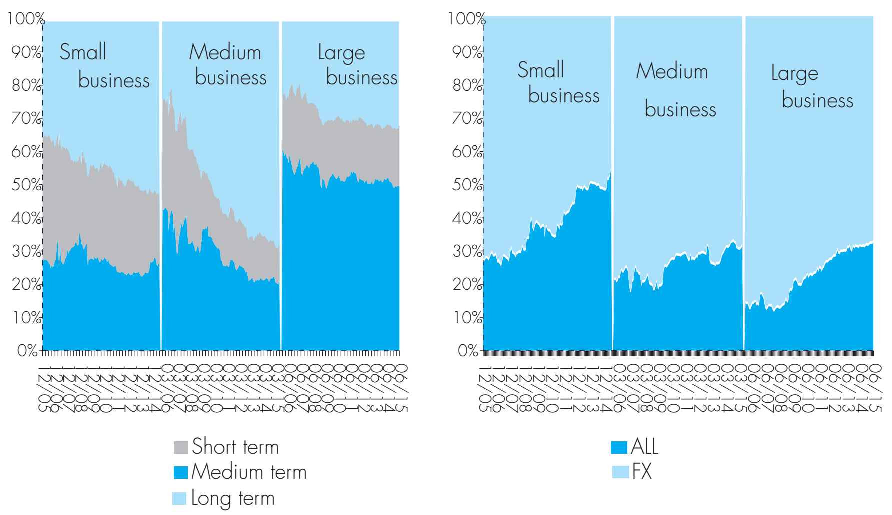
Chart 4.7 Contribution to the annual expansion of businesses debt position in the financial system



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

(30) **Businesses were mainly credited in lek and increased their preference for long-term loans, during the period under review**. By term to maturity, for large enterprises short-term credit shrank, but medium and long-term credit expanded. For medium-sized enterpises the short and medium-term credit narrowed, in favour of long-term credit. Small enterprises narrowed the medium-term credit, but expanded the short and long-term credit. By currency, lek lending increased for the three categories of enterprises.

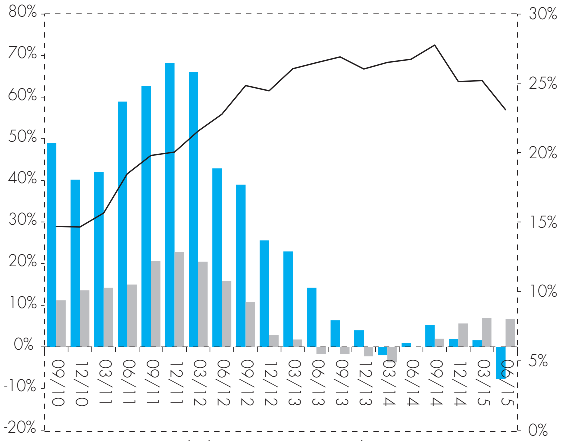
Chart 4.8 Businesses loan structure by maturity (left) and currency (right)



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

(31) **The quality of the business loan portfolio improved.** In June 2015, the non-performing loans ratio was 23.1%, from 25.1% in December 2014 and 26.72% in the previous year. The stock of non-performing loans fell owing mainly to the loss loans write off.

Chart 4.9 Business loan portfolio quality

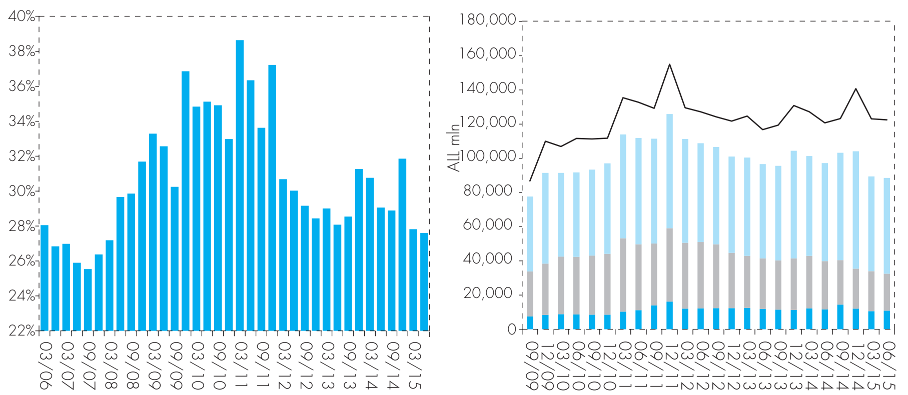


Source: Financial Stability and Statistics Department, Bank of Albania.

4.2.2 INDIRECT CREDIT RISK TO BUSINESSES ARISING FROM THE EXCHANGE RATE

(32) The write off of foreign currency loss loans has contributed to the fall in the credit portfolio exposed to credit risk arising from exchange rate volatility. At the end of the period, the share of foreign currency loans in total business loans rose to 65.2%, from 64.8% at end-June 2014, and 65.5% in December 2014. During the period, the portfolio of business loans, sensitive to volatilities in the exchange rate, was down, in contrast to the increase in the previous period. The business outstanding loans, unhedged against the exchange rate risk fell to 26.7% of total credit to businesses, from 31.9% at the end 2014.

Chart 4.10 Business exposure to indirect credit risk arising from the exchange rate

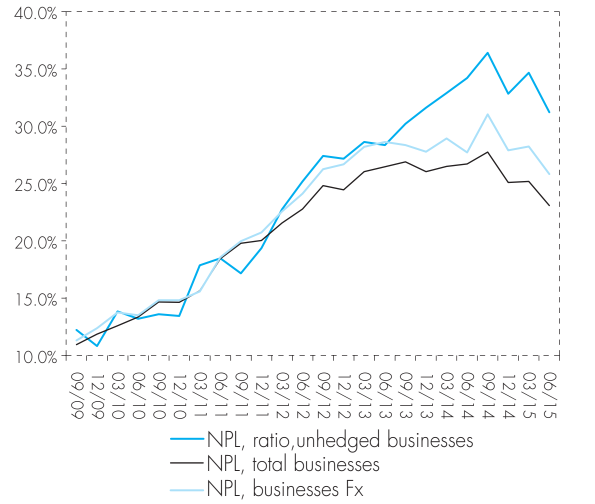


Source: Financial Stability and Statistics Department, Bank of Albania.

The structure of business loans showed growth in "Commercial-related loans" to 45.8% of this portfolio, while "Business development loans" and "Real estate development loans" accounted for 17.7% and 8.9% of the portfolio, respectively, during the period under review.

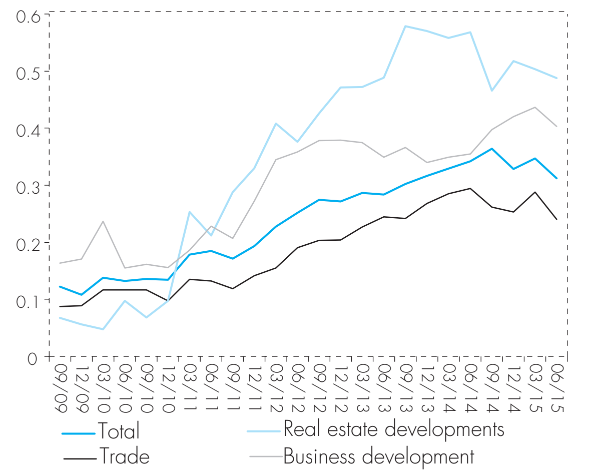
(33) The quality of this portfolio improved, appearing more pronounced in the loan for "Real Estate Development". The ratio of non-performing loans to loan portfolio sensitive to exchange rate fluctuations, fell to 31.2%, from 34.2% at the end of June 2014 and 32.9% at the end of December 2014. In this portfolio, the improvement of quality remains more pronounced in "real estate development loans", whose ratio of non-performing loans stood at 48.8%, from 56.8% in the previous year. On the other hand, the level of non-performing loans for "business development loans" was up, around 4.9 percentage points in annual terms, accounting for 45.2% of this loan.

Chart 4.11 Business loan quality



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

Chart 4.12 Unhedged loan quality



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

The share of non-performing loans in the foreign currency portfolio improved to 25.8% in June 2015, from 27.9% in December 2014, and 27.7 % in June 2014. The loss loans write off improved considerably the foreign currency and unhedged portfolio, which is assessed as the most exposed one to credit risk.

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

For an elaborate assessment of Albanian households and businesses' financial situation and borrowing, the Bank of Albania conducts, besides other analyses, a half-yearly specific survey. The latest survey was conducted in May-June 2015 and focused on developments during 2015 H1, while the expectations refer to 2015 H2.

A. Survey results of households' financial situation and borrowing

The survey is based on a sample of 1200 households across 16 districts of Albania, with 89% of respondent households answering the questions.

- *FINANCIAL SITUATION*

The number of income-earning members was up, driven by the increased number of employed persons. Broken down by income and expenditure level, the structure has shifted somewhat to the average level of income and a slightly lower level of expenditure.

- *BORROWING*

The total number of households stating that they have one or more than one loan to repay as at the moment of interview, despite the type, source, or value, was 295 or around 27% of respondents. This share is lower from 2014 H2 and the previous year. About 40% of borrowing households had borrowed from formal sources (such as banks and other non-bank financial institutions) and 60% of borrowing *households had borrowed from informal sources (such as natural persons and stores). The structure of outstanding loan distribution is oriented to "formal sources" 78%, "informal sources" 17%, and "combined sources" (formal and informal) 5%. The outstanding loan fell during the period and the structure shifted toward formal borrowing. "Purchasing/renovating a property" (28%) and "Consumption" (42%) remained the top two purposes for borrowing. This distribution continues to shift to the borrowing for consumption.*

- *HOUSEHOLDS SOLVENCY*

The net balance of responses on household solvency was -29.1%, improving by 2.1 percentage points from the end of 2014. Of households reporting "Worsened solvency", 60% attributed it to "Lower income", while 33% 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 -7.2%, improving compared to the end of 2014.

B. Survey results of businesses' financial situation and borrowing

The survey is based on a sample of 714 enterprises operating across Albania in the main sectors of the economy.

- *FINANICAL SITUATION*

In 2015 H1, the overall sales and financial result of enterprises deteriorated compared to the end of 2014, in all sectors. The expansion of the activity slowed down. The importance of sales in financing the activity increased compared to the other funding sources. The sales as the only source of financing the activity were mostly used by the enterprises operating in the sectors of industry and services. The enterprises operating in construction preferred most a combination of several sources.

- *BORROWING*

More than half of respondent enterprises (51% or 332 enterprises in total) stated that they actually had a loan to repay, down 4 percentage points from the previous half. Around 92% of enterprises have borrowed only from banks, whereas the rest has combined alternative borrowing sources, such as "borrowing from natural persons" or from "other companies". Main borrowing purposes remain current expenditure (mainly the construction sector) and long-term investments (mainly industry and services sectors). The share of enterprises having used the loan for current expenditure purposes increased both in half-yearly and annual terms. The loan demand of enterprises was down, mainly in the sectors of construction and services. Around 42% of enterprises borrowed in the national currency, 47% in foreign currency and 11% combined both in the domestic currency and foreign currency. Around 20% of enterprises state they have to repay the loan within 12 months and this share has not changed compared to the previous survey. Most enterprises (77%) state they have collateralised their loan, by only pledging real estate as collateral and this share is increased somewhat compared to 2014 H2. For 85% 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 a downward trend. For 2015 H2, enterprises expect a further decline in loan repayment.

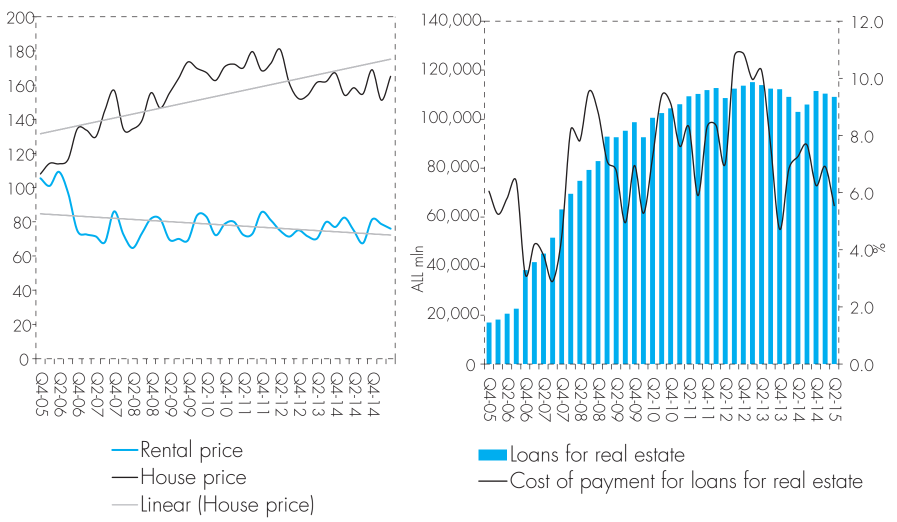
• *RELATIONS WITH BANKS*

Most enterprises assess as upward the importance of their relations with banks for the performance of their activities. For the next period, 48% of enterprises do not plan any borrowing. The rest plans at different levels to address banking sector for a loan, but only 3% of enterprises state to be confident about this decision

4.3 HOUSING MARKET

(34) **The demand in real estate market remained unstable, albeit the real estate loans were up during the last year, following this loan quality improvement and interest rates trending down.** During 2015 H1, the House Price Index[12] fell by 1.3% from the previous year. The demand did not exceed the supply for real estate, albeit being sustained by some factors. In more concrete terms, outstanding loans for real estate purchase were 6% higher compared to the same period in the previous year; the weighted interest rate on real estate loans was 6.8%, within the downtrend of the last two years; the relative repayment cost[13] of real estate purchase loans was down reflecting more favourable conditions for real estate purchase from the borrower's perspective[14]; loans for construction fell close to 12.8% of total loans to businesses (compared to the average value of 20% during the period 2007-2011).

Chart 4.13 Housing market developments



Source: Bank of Albania.

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

[13] 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.

[14] In 2015 H1, the fall in the average rate of houses purchase exceeded the effect of the increase of interest rates for these loans, driving to the implementation of easier lending standards for house purchase.

At the end of the period, the real estate loan portfolio quality improved. The non-performing loans ratio was down to 13.5%, from 15.1% at the end of 2014, and 14% a year earlier. 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 prudent banking sector and borrower's behaviour.

(35) Banking sector is significantly exposed to the real estate market[15], either directly or indirectly. For this reason, the sensitivity to fluctuations in real estate prices is considerable. In June 2015, 54% of loans are real estate collaterised, or around 68% of loans to households and around 50% of loans to businesses. Collaterised loans, which show problems, account for around 12% of outstanding loans and are mainly concentrated in the business sector. The presence of collateral mitigates the credit risk, in terms of preventing its materialisation and recovering the value of the loan in case of its loss. The second quality depends on the effectiveness of collateral execution and the performance of its price in the market. A non-effective process of collateral execution combined with downward real estate prices provide negative impact on the financial result of banks.

[15] *In this case, the exposures worsens from the loan for real estate or collateralised by real estate; loans to companies operating in construction sector; and the real estate loans portfolio that is established in banks as e result of taking the collateral following the execution of the obligation.*

Box 4.2 "Real estate market" and performance of House Price Index, 2015 H1 Survey

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 (230 entities), since the beginning of 2013. The survey is conducted on quarterly basis.

House prices

During 2015 H1, the house prices, Fisher's House Price Index, on a national level, increased by 8.6% from the base period (year 2013), compared to 2.6% in 2014 Q3. Tirana provided the main contribution to this performance, up by 5.6% from the base period (mainly supported by the central area), and the coastal areas. Nevertheless, net balance of agents' responses that reported a sale, regarding the overall situation in real estate market in 2015 H1, was negative, albeit lower from the previous period.

Sales of properties

Around 33.1% (or 62 agents) of respondent entities, reported sales over 2015 H1. The respondents assessed that the average time of sale for real estate has been decreased, mainly attributable to the sales in the coastal areas and in the rest of the country. In the case of Tirana, the average time of sale increased. Although agents report an increase in the number of unsold properties, the pace of its growth has slowed considerably down compared to the previous year. On the other hand, the number of properties registered for the first time at the real estate agencies, at national level, fell, mainly affected from houses.

Real estate purchase financing

Agents assessed that around 70% of the sold real estate are purchased with loans, from 60% in September 2014. This indicator is the highest rate reported since the start of this questionnaire. In average terms, the loan accounts for 56% of the house value, showing slight fluctuations since the start of the survey. The results are similar regarding trading properties, for both above indicators.

Agents' expectations related to the market they conduct their activity

In the last survey, agents showed more pessimistic for the short-term period for the territory they operate in. The negative balance of expectations deepened to -22%, from the neutral value in the previous period. Around 35% of agents expect a fall of prices in the short run, from 24% in the previous period. These agents assess that prices will fall averagely by 5%, maintaining the same assessment as in the previous periods.

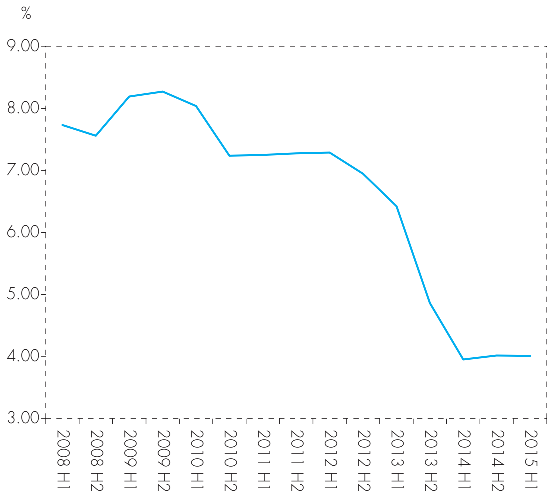
Agents' expectations for the real estate market at national level

In the short run, the respondents' expectations, about the overall situation in the real estate market in Albania, are almost unchanged from the current situation (the responses have a negative balance at a low value). The sub-item of agents that report sales reflects also a negative balance of expectations. Like previously, agents show optimistic for the future, particularly regarding the long-term period.

5. FINANCIAL MARKETS

The Albanian financial markets showed a stable performance in 2015 H1. Monetary policy operations of the Bank of Albania have oriented the performance of short-term interest rates close to the key monetary policy. Primary market yields on government debt securities have fluctuated depending on expectations for government's demand for funding. Lek's exchange rate was steady against the euro, but it depreciated against the US dollar and currencies that follow it. This performance has reflected mostly developments in international foreign exchange markets.

Chart 5.1 Average yield on debt securities

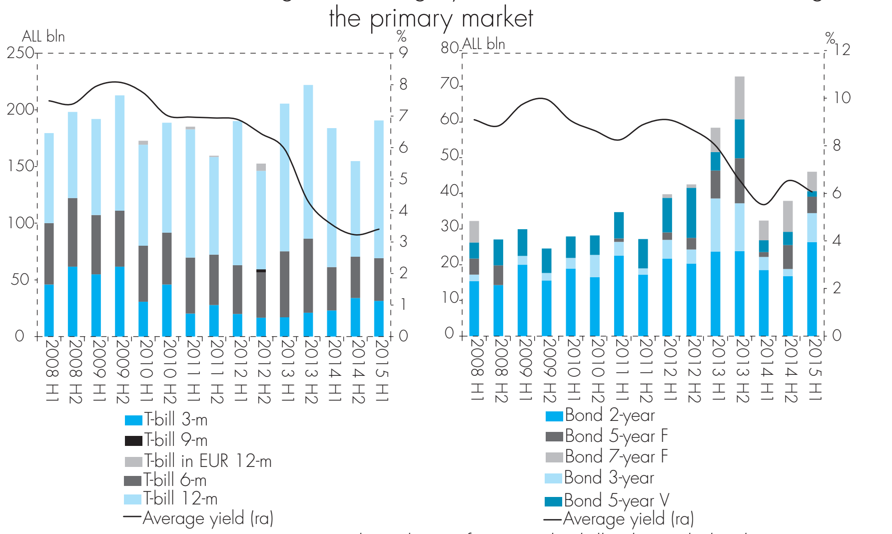


Source: Bank of Albania.

5.1 PRIMARY MARKET FOR GOVERNMENT DEBT SECURITIES

(36) **Rates of return in the primary market auctions of government debt securities fluctuated around the levels of the previous period following the reduction of the key interest rate[16] at the beginning of the year.** Overall, the increase in yields on treasury bills and their decrease on bonds retained the average interest rate of the government debt at the level of 4%.

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



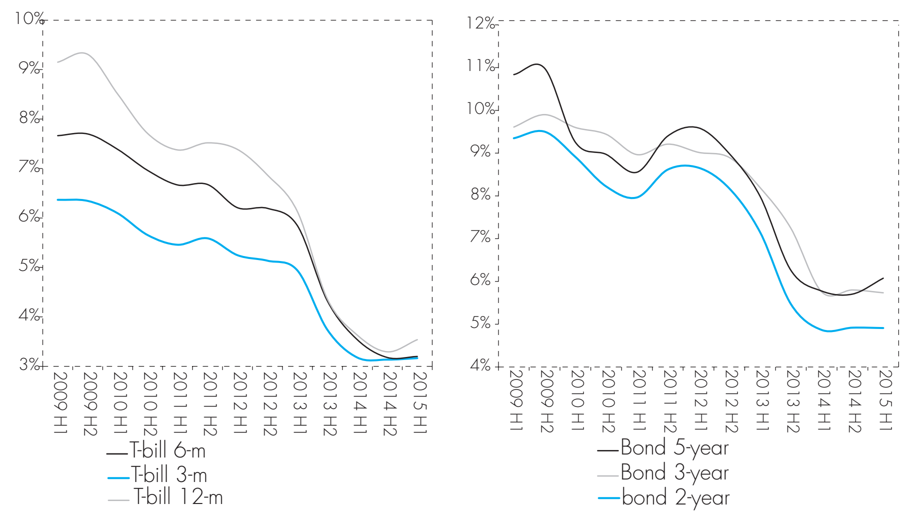
Note: The volume of 12-month T-bills also includes the issues in euro.
Source: Bank of Albania.

[16] *The Bank of Albania cut the key interest rate by 0.25 percentage points in May 2015, to a record low of 2%.*

(37) Despite the rise in issues in treasury bills, their yields have been stable. During the period, around ALL 190 billion were issued in treasury bills' auctions compared to ALL 154 billion issued during the previous half of the year. Bidders' interest in auctions remained higher for the 12-month maturity T-bills, whose share in the total treasury bills reached 64%. At the end of the period, the average yield on treasury bills resulted 3.4%, up by 0.2 percentage points against the previous period, but decreased slightly from the same period a year earlier. Overall, the yields show a downward trend since 2009 H2.

(38) The government's demand for borrowing and the preference of investors underlied the increase in the volume of bond issues. Government bonds increased to ALL 55.9 billion, up by around ALL 7.2 billion from the previous half. This increase is impacted positively by the expansion of securities with maturities of 2 and 3 years (for about ALL 15.5 billion), and negatively by the contraction of securities of maturities of 5, 7 and 10 years, which fell by more than ALL 8 billion. During the period, the weighted rate of return on bonds fell by 0.4 percentage point, to 6.1% level

Chart 5.3 Average yield on debt securities in the primary market

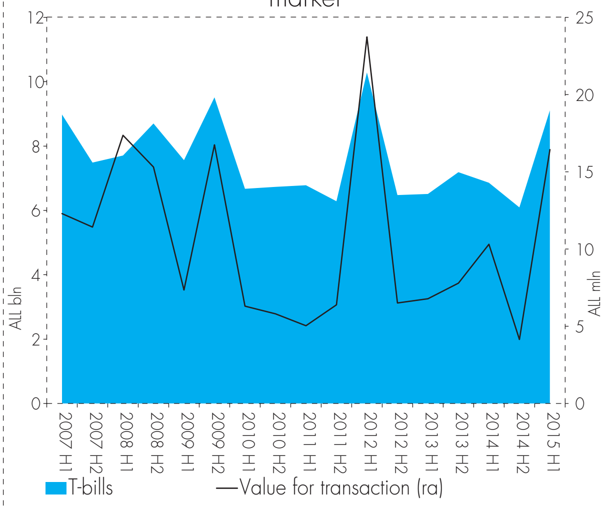


Source: Bank of Albania.

(39) In some Treasury bill and bond auctions, government demand for borrowing was not met. Thus, in some 3, 6 and 12 months auctions, the bid failed to meet the demand, reflecting the decline in preference for such issues against the backdrop of low yields. Even in the case of longer-term government debt securities, in some auctions the bid has not fully met the demand, exerting pressure for the increase of yields. This phenomenon evidences an increase in the investors' reluctance to finance government borrowing, especially the long-term one. It may be due to the investors' perception of the debt level as "high", and reflects their decision on the allocation of funds and risk management.

5.2 SECONDARY MARKET FOR DEBT SECURITIES

Chart 5.4 Trading volume of T-bills in the secondary market



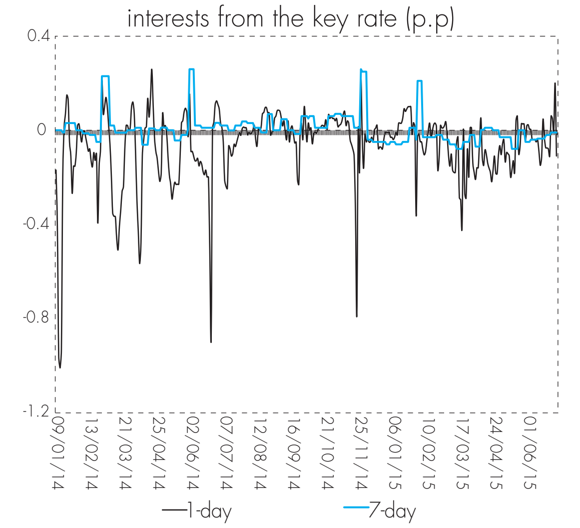
Source: Bank of Albania.

The secondary market continues to be characterized by a low number and volume of transactions, reflecting a generally passive management of portfolio securities by investors.

(40) During 2015 H1, the market continued to operate smoothly and did not show any structural changes. During the period under review, the volume of transactions of Treasury bills in the secondary market rose to 9.1 billion, from about 6 billion in the previous six-month period. Compared to the previous period, the number of transactions in the market was 266 less, but the average transaction value quadrupled, up about ALL16.4 million. Bonds of 12 months maturities dominated the trade volume. Maturities of 3 and 6 months had an insignificant share.

5.3 INTERBANK MARKET

Chart 5.5 Deviation of interbank transactions' interests from the key rate (p.p)



Source: Bank of Albania.

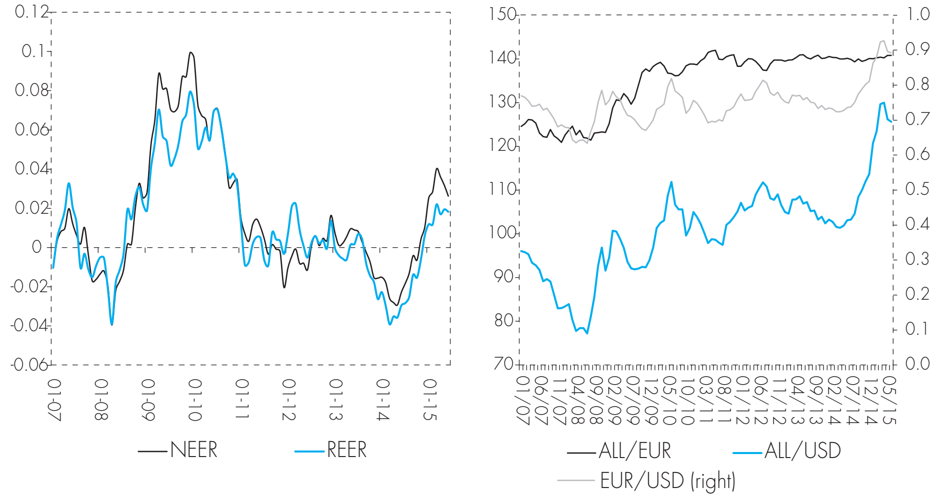
In the interbank market, trading volumes of daily, weekly and monthly transactions as well as the respective levels of interest rates have reflected common transactions of banks and adequate liquidity conditions. Interbank market transactions increased during 2015 H1. During the period, the average volume of overnight borrowing increased to ALL 2.4 billion; yet, it remained below the level of the previous year. The average 1-week volume of borrowing fell slightly, from ALL 6.1 to ALL 5.6 billion a day. The 1-month maturity borrowing is used less frequently and its volume is lower. The average weighted rate fell to 1.97%, from 2.44% at the end of 2014, reflecting the key rate cut in January 2015. Banks have almost always traded below but close to the key interest rate reflecting a stable liquidity situation in the banking market.

5.4 FOREIGN EXCHANGE MARKET

(41) During the period under review, lek weakened in nominal and real terms, driven by the depreciation against the US dollar. Lek was steady against the euro, supported by seasonal effects (remittances) and trade deficit narrowing. In annual terms, the Albanian lek appreciated around 0.3%

against the euro and depreciated around 23% against the U.S. dollar. During 2015 H1, the ALL/EUR exchange rate averaged 140.4, slightly down from the previous period. The ALL/USD exchange rate averaged 125.9, from 108.6 in the previous period. In the same-stated period, the Nominal Effective Exchange Rate (NEER[17]) rose on average terms, reflecting an appreciation of the lek by around 3.1%, in annual terms. In real terms (REER), the local currency depreciated on average by 1.7% on an annual basis, reflecting the change in the inflation rates in euro area countries.

Chart 5.6 Annual change in NEER and REER (left), and the exchange rate in the domestic foreign exchange market (right)



Source: Bank of Albania.

[17] *NEER is calculated against the currencies of Albania's five main trading partners: Italy, Greece, Germany, Turkey and China. An increase in NEER implies lek's depreciation.*

6. PAYMENT SYSTEM DEVELOPMENTS

(42) **During 2015 H1, the technical infrastructure supporting the banking sector activity operated effectively.** AIPS and AECH payment systems have 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.

(43) **During January - June 2015, the number of AIPS transactions increased by 43% and the value decreased by 5% compared to the same period in 2014.** As a result, the average value per transaction fell by ALL 28.6 million. In daily terms, in AIPS around 475 payments are settled, with a daily average volume of about ALL 27 billion.

Table 6.1 AIPS transactions

AIPS	2014 H1-	2015 H1
Number of transactions	41.317	59.000
Value of transactions (in ALL billion)	3,533.41	3.355
Average value per transaction (in ALL million)	85.51	56.87

Source: Bank of Albania.

(44) **During the period, AECH activity reflected an increase in number and value respectively by 10.4% and 4.2%, compared with the same period a year ago.** The payments cleared in the AECH increased due to the combined effect of the increased payments by the Ministry of Finance (accounting for approximately 54% of the number and 49% of the value of transactions) and the payments cleared by banks for the account of their clients. The continuation of increased payments cleared by banks for the fourth consecutive year reflects the effect of measures taken by the Bank of Albania in March 2011[18].

Table 6.2 AECH transactions

AECH	2014 H1	2015 H1
Number of transactions	195,985	216.302
Value of transactions (in ALL million)	37,477.45	39,046.34
Average value per transaction (in ALL million)	0.19	0.18

Source: Bank of Albania.

[18] *Bank of Albania Supervisory Council in its Decision No 12, dated 23.02.2011, stipulated the following: increase to 1.5 million (from 1 million) the limit value for processing in AECH, addition of a third clearing session in AECH, differentiation of tariffs by session, and lowering commissions and fees for this system as well as defining a maximum ALL 500 commission, which may be applied by banks for lek payments cleared in AECH.*

(45) **Banks reports for 2015 H1 highlight an increase in payments for clients by 10% in number and by 12% in value.** Thus, during January-June 2015, some 5.4 million payments are resulted to be carried out with a total value of ALL 2.25 billion. The distribution of payments per clients according to the type of instrument indicates that despite the prevalence of credit transfers, and mainly of those in paper form, the relative importance of this instrument against the total number of payments has decreased. At the same time electronic payments, such as home banking (subcategory of credit transfers not paper), bank card payments and direct debit have shown an upward trend in volume. Beyond the total increase in the use of various payment instruments, during this year, the use of electronic payment instruments increased faster.

7. FINANCIAL SYSTEM

7.1 FINANCIAL SYSTEM STRUCTURE

(46) The main activity indicators of the financial system improved and the financial intermediation deepened in H1. Amid a stable economic environment, banks improved further the profitability indicators and maintained strong positions in capital and liquidity. At the same time, the activity and the number of entities in other segments of the financial system expanded. Thus an electronic money institution and a micro credit one began operating. The share of non-bank financial institutions rose to 10% of financial system assets, wherein private investment funds give the main contribution. These funds provide a relatively higher interest rate against the backdrop of low interest rates and have shown a dynamic increase. A direct spillover of risks to the banking sector from other segments of the financial system remains generally low. On the other hand, non-bank financial institutions' exposure to the banking sector is considerable. In June 2015, in Albania the financial intermediation deepened. The ratio of the system's assets[19] to Gross Domestic Product[20] rose to 102.8%. Banks continue to dominate the structure of the financial system assets, accounting for 90.2% of financial system assets and 92.7% of the GDP.

Table 7.1 Share of financial system segments in GDP, in years

Licensing and Supervisory Authority	Financial system	2008	2009	2010	2011	2012	2013	2014	2015 H1
Bank of Albania	Banking sectorr	76.7	77.5	80.9	84.7	89.6	90.5	91.7	92.7
	Non-bank institutions	1.7	2.2	2.7	2.5	2.7	2.5	2.7	2.7
	SLAs and their unions	0.7	0.8	0.8	0.7	0.8	0.8	0.8	0.8
Albanian Financial Supervisory Authority	Insurance companiesi	1.4	1.5	1.4	1.5	1.6	1.6	1.7	1.8
	Pension funds	-	0.01	0.01	0.01	0.02	0.03	0.04	0.05
	Investment fundsi					1.21	3.7	4.5	4.8
Financial Intermediation		80.5	82.01	85.81	89.41	95.93	99.13	101.44	102.8

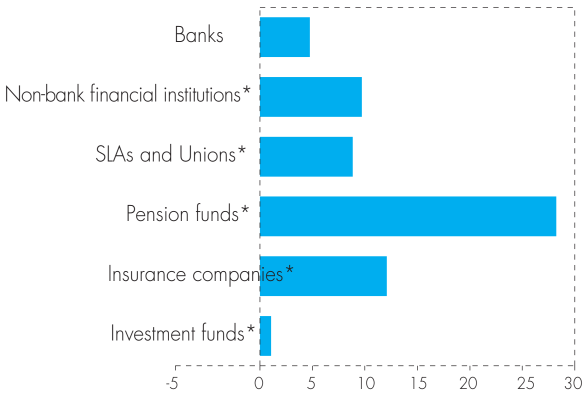
(47) Mutual exposures between segments of the financial system emphasize the importance for the proper functioning of the banking sector, for the entire financial system. As at December 2015, banking sector exposure to other segments of the financial system in Albania was low, accounting for about 1.5% of assets' value. This exposure was mainly in the form of loans and participation in capital in non-bank financial institutions on the assets side, and in the form of funds collected by them (various accounts) on the liabilities side.

[19] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. In the analysis of this chapter, consider that only the database of insurance belongs to 2015 Q1, while the analysis of the activity of the other segments of the financial system, is based on the data belonging to 2015 H1.*

[20] *GDP is estimated at about ALL 1,416.9 billion, and refers to annual economic growth estimates, published by INSTAT and IMF.*

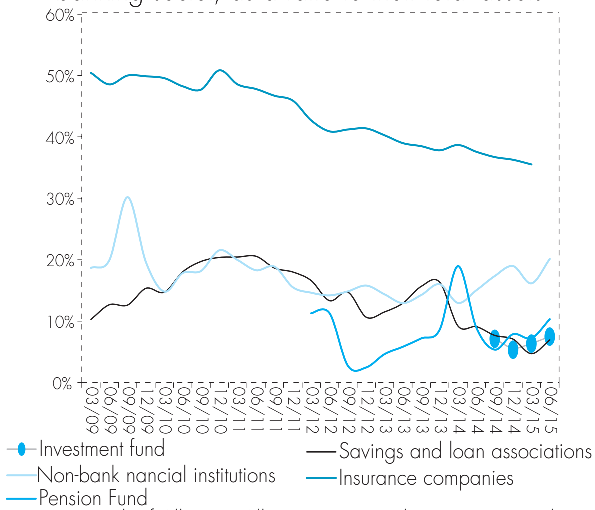
These low levels of exposure to non-bank financial segments limit the direct financial risk that may spill over by a stress situation in the non-bank financial sector. However, there are also non-financial indirect risks, whose effect is difficult to measure. On the other hand, non-bank financial institutions' exposure to the banking sector was significant for their activity, highlighting the importance of the proper functioning of the banking sector for their performance. Insurance companies (ICs), savings and loans associations (SLAs) and non-bank financial institutions (NBFIs) have the most sensitive exposures of the banking sector. ICs' deposits in the banking sector accounted for around 36% of their assets, (decreasing) while SLAs and NBFIs investments' share in the banking sector accounted for 6.9% and 20.1%, respectively, of their assets. Except for insurance companies, exposures of other financial segments of the banking sector show an increasing trend, a phenomenon concentrated in 2015 Q2. Chart 7.2 shows the exposure in years of non-bank financial system segments to banking sector, calculated as the ratio of the size of these exposures to the total assets.

Chart 7.1 Activity expansion rate by institution



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 7.2 Performance in years of exposures (as placements) of non-bank financial segments to banking sector, as a ratio to their total assets



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Box 7.1 Performance of financial sector segments

In 2015 H1, non-bank financial institutions (NFBIs) expanded their activity as an electronic money institution and a micro credit one started operations. Financial result is positive, capitalisation is adequate and assets' quality appears improving. Savings and loan associations (SLAs) expanded their activity and narrowed their financial loss; meanwhile, the loan portfolio quality improved. Insurance companies expanded their activity due to a higher number of concluded contracts and gross written premiums. The balance of assets increased based on investments in bank deposit and accounts and expansion of technical provisions. Supplementary private pensions and investment funds show positive performance.

The activity of NFBIs expanded by 6.3% in annual terms, up to ALL 38.9 billion. The entrance of two new financial institutions has increased the assets of non-bank assets. Also, lending has supported the activity of NBFIs, increasing the level to ALL19.9 billion, about 0.9% higher compared with the end of 2014. Businesses have the main share in the credit portfolio, around 92.3 %. Trade and agriculture have the highest concentration, 25.3% and 11.4%, respectively. Credit risk remains the main risk to NFBIs' activity. "Non-performing loans/total loans" improved in Q2 to 12.9%, from 13.7% at the end of 2014 and from 14.2% at the same period in the previous year, after the narrowing of the stock of non-performing loans. Financial result remains positive as a result of the expansion of income from interest and commissions.

Table 7.2 Financial indicators of NFBIs' activity

	2012	06/2013	2013	06/2014	2014	06/2015
Total assets (in ALL billion)	35,348	34,363	35.03	36,546	39,484	38,861
Loan portfolio (in ALL billion)	20.04	19,501	19,646	19,685	19,743	19,937
Non-performing loan ratio, in %	8.37	14.15	13.21	15.05	13.73	12.90
Capital adequacy, in %	38.9	39.78	40.94	44.79	41.94	44.60
Profit, in ALL billion	1,244	0.52	1,502	0,426	0,976	0,820

Source: Bank of Albania.

Activities of SLAs expanded by 9.1% compared with the previous year, but the pace of expansion fell to 0.6% during 2015 H1. The credit portfolio quality improved to 10.4%, from 11% at the end of 2014. The "provisions/non-performing loans" ratio stood at 83%. SLAs narrowed the financial loss compared with previous year.

Table 7.3 Activity indicators of SLAs and their unions

	2012	06/2013	2013	06/2014	2014	06/2015
Total assets (in ALL billion)	10.6	10.292	9.75	9.83	10.65	10.72
Loan portfolio (in ALL billion)	7.12	6.77	6.39	6.32	6.6	6.7
Total assets	67.44	65.82	65.53	64.26	61.99	62.42
Non-performing loan ratio, in %	6.42	11.12	11.95	12.91	11.06	10.41
Profit, in ALL billion	-0.04	-0.19	-0.23	-0.05	0.09	-0.02

Source: Bank of Albania.

Insurance companies. As at June 2015, there were 12 (8 non-life, 3 life and 1 reinsurance) licensed insurance companies.

During 2015 Q1, insurance companies' assets expanded to ALL 25.5 billion, with an annual growth of 12.1%. Insurance liabilities (or technical provisions) grew considerably by 24%, in annual terms, standing at ALL 2.9 billion, whereas total capital grew annually by 1.2%, standing at ALL 10.4 billion. Insurance companies expanded slightly their share in GDP, at 1.8%. Gross written premiums, the main indicator of insurance company activity - expanded by 20.9%, y-o-y, to ALL 6.4 billion. The indicator of insurance* *penetration in the market - the ratio of premiums to GDP - was 0.45%.*

Loss indicator measured as the ratio of paid claims to gross written premiums, improved to 22.7%, from 24.4% 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 12.6% in annual terms, to ALL 1.5 billion.

Investment portfolio of the insurance sector toward low risk assets provides for maintaining a low risk level for investments. At the end of 2015 Q1, investments were mainly in the form of time deposits with commercial banks (around ALL 3.9 billion) and Albanian government treasury bills (around ALL 2.7 billion). Exposure of insurance companies to sovereign debt expanded to 10.5% of total assets.

*Investment funds**. In 2015 H1, two investment funds operated in Albania, with a net value of assets around ALL 67.5 billion, up by 5.8% from end-2014 . Funds have 34,000 investors, majorly households. This participation expanded about 4.4% during the period. Their activity is dominated by investments in government debt securities, accounting for 90% of total funds' assets and about 4.8% of GDP.*

*Private supplementary pensions*** . In 2015 H1, three voluntary private pension funds operated in Albania. Data analysis shows that pension funds' activity increased by 41%, compared to a year earlier - at an assets level of ALL 756.8 million. Their activity is dominated by investments in Government debt securities, about ALL 672.9 million, up by about 21.8% from end-2014. The number of pension funds members is increased by about 27.1% compared to the end of 2014, although this segment holds a small share in financial intermediation in Albania.*

* AFSA, "Insurance Market Statistical Report: Year 2015", published on 24 July 2015.

** AFSA, Market Developments Investment Funds, 31 March 2015", published on 15 May 2015.

***AFSA, Statistical Report "Developments in the private supplementary pensions", 31 March 2015.

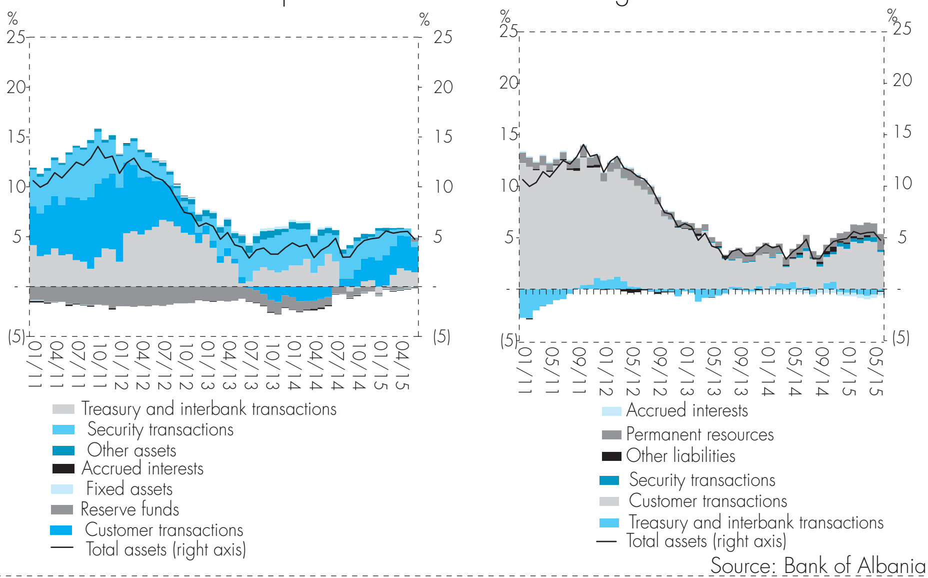
8. BANKING SECTOR

(48) During 2015 H1, the volume of banking sector's activity expanded based on the interbank and loan investments. Financial performance improved. Liquidity and capitalization indicators of the sector stood at satisfactory levels. The loan portfolio quality improved, although the level of non-performing loans is still assessed as high. Exposure to market risks remains subdued, but it should be monitored and assessed regularly.

8.1 BANKING ACTIVITY

(49) During the period, the Albanian banking sector assets expanded by 1.5%, rising to ALL 1,313 billion, representing about 92.7% of GDP. Assets expanded in the form of interbank investments mainly in non-resident entities. The loan portfolio also saw a slight expansion. At the same time, the sector contracted the portfolio of investments in securities, both for non-resident entities and the government. This development reflects the preference shown by the government for financing the deficit through foreign resources. In annual terms, banking sector assets increased 4.8%, from 4.1% in the previous year. The expansion of the loan portfolio provided the highest contribution to this performance, around 6%. Interbank investment portfolio and securities portfolio expanded 4.4% and 2%, respectively.

Chart 8.1 Annual expansion of assets and financing contribution of assets



Source: Bank of Albania.

(50) **As at end of June 2015, the balance in "Transactions with clients"[21] in the balance sheet of the banking sector was estimated at ALL 593.7 billion, expanding ALL 2.4 billion compared to the end of 2014. Lending to non- resident entities provided the main contribution to the growth of credit, during the period, similar to last year.** The loan portfolio represents approximately 45.5% of total assets of banks, being at the average levels of two past years. On the other hand, improvement of the loan portfolio quality as a result of the non performing-loans write off[22] is reflected in the reduction of provisions for credit risk. During the period, this fund fell by about ALL 5 billion, or 5.5%, to ALL 89 billion.

(51) **The annual growth rate of bank investments in securities, consisting mainly in governments securities, slowed down.** In June 2015, this portfolio was estimated at ALL 321.4 billion, annually up 2% (from 8.7% a year earlier) and represents 24.5% of total assets. The banking sector owns about 57% of total domestic debt issued by the Albanian Government. This amount reflects the parties interdependence on their performance, and highlights the need to assess the potential risks from this exposure.

(52) **Banking activity is funded mainly by deposits, which account for about 82% of total assets, and cover nearly two times the loan portfolio.** Deposits' base[23] expanded in annual terms by around 4.4%, from 3.5% a year earlier. Both lek and foreign currency deposits contributed positively to deposits growth. By maturity structure, deposits up to a year account for around 68% of the total, whereas current accounts around 21%. Overall, the short-term structure of deposits reflects and, at the same time, increases the difficulties of the banking sector to transform the sources of funding into long-term investments in economy. On the other hand, given that 86% of them are corporate deposits, the low concentration improves the deposits' sustainability. Banks maintained the capital utilisation ratio to finance their operations, respecting the requirements for regulatory capital framework.

8.2 BANKING SECTOR POSITION TO NON-RESIDENTS

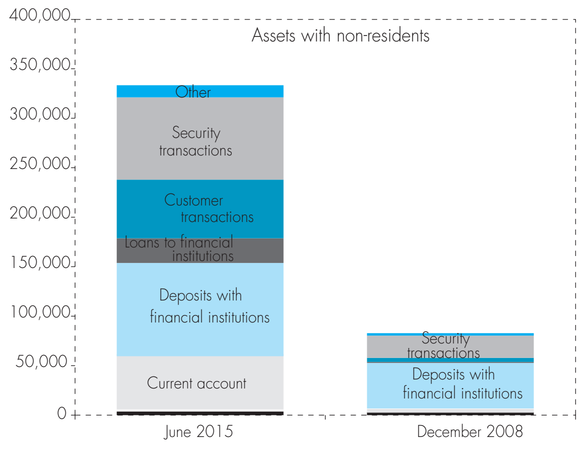
(53) The banking sector's reliance on external sources of financing remains limited. Net position of banking sector to non-residents remained on the crediting side and continued to increase during the period. Borrowing from parent banking groups reached its historical lowest level. In June 2015, assets with non-residents accounted for 25% of assets and liabilities to non-residents accounted for 6.6%. As a result, the net position of credit to non-residents has expanded by 12.5% in half-yearly terms, up to ALL 246.5 billion. The investment in non-resident instruments is represented by investments in securities

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

[22] *Starting from January 2015, banks are obliged by the Supervisory Authority to undertake the process of balance cleaning and the write off loans under the category "lost" for 3 years. It is estimated that the amount of written off loans during the first half of 2015 is about 11 billion.*

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

Chart 8.2 Risk-weighted assets



Source: Bank of Albania.

(those in the EU account for 38.6% of the portfolio), in loans to non-resident entities, and in deposits or current accounts in financial institutions.

(54) **Countercyclical measures taken by the Bank of Albania in May 2013 contributed to reducing the growth pace of investments abroad by the banking sector.** During the period, the average expansion of the annual investments in non-residents slowed down to 10% from 13.3% in 2014 and 22.7% in 2013.

(55) **On the liabilities side, the use of credit lines from parent banking groups has dropped to historic low levels.** For the most part, liabilities to non-residents are represented by liabilities to banking groups (parent banks), mainly in the form of credit lines. During the period, banks' borrowing in the form of credit lines have recorded the highest decrease in history. They fell to ALL 8.8 billion, from ALL 25.6 billion at the end of 2014.

EXPOSURE TO NON-RESIDENTS

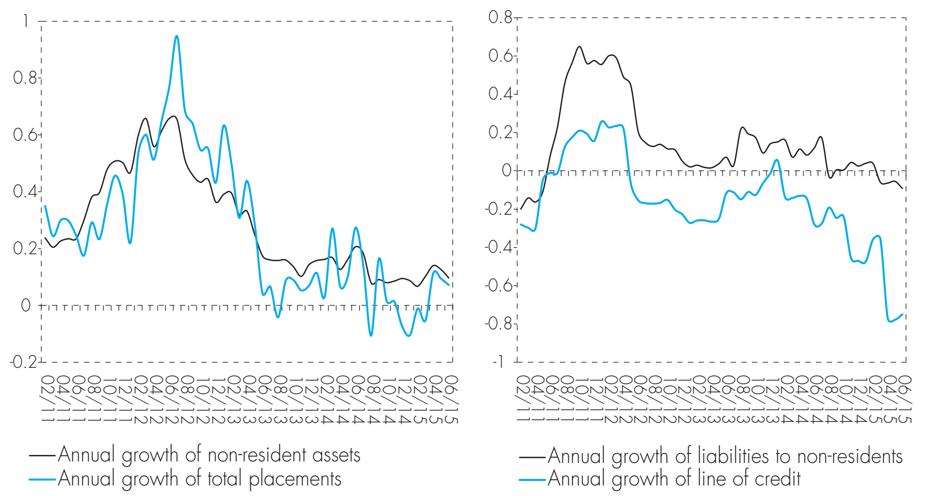
Box 8.1. Banking sector exposure to non-resident institutions

Asset of non-residents' placements. *The main share of placements at non-resident institutions in assets was in the form of time deposits, 46.7% of total. Placements appear in euro at the rate of 64.9% and in US dollars at the rate of 15.1%; while placements at the parent banking groups in euro shared a higher percentage, 83.3% of the total. Placements in non-residents assets continue to focus mainly in the euro area with 81.2% of the value of placements. By banking-groups, 75.2% of placements to non-residents in assets belongs to G3, 19.5% to G2 and the rest of 5.3% to G1. By origin, the group of banks with Greek capital placements shared 12.4%, group of banks with Italian capital placements shared 12.9%, group of banks with Albanian capital placements shared 23.1% and the group of banks with French capital placements shared 3.3%.*

Liability of non-residents' placements. *Liability placements are mainly in the form of term loans borrowed from the banks, about 43.6%, and time deposits of about 43.5%. Placements on the liability side were mainly denominated in euro, 55.8% of the total and 96.7% of liabilities to parent banking groups. Liabilities to euro area countries accounted for 57.7% of total non-resident placements on the liability side. The rest are placements in countries outside the European Union, with an increasing share. By banking groups, G3 banks account for 43.5% of liabilities to non-resident institutions, G2 banks 0.7% and G1 banks 55.8% The major part of liabilities to non-residents consists of the the Italian group placements with 55.8% followed by the Albanian one with 42.3%. Banks of the Greek group have narrowed significantly the share of the non-residents liabilities, with only 0.7%. Banks of the French group continue not to have such liabilities.*

* *This Box is based on operational data as reported by the banking sector and does not include banking sector investments in securities with non-resident institutions.*

Chart 8.3 Exposure to non-residents



Source: Bank of Albania.

8.3 OUTSTANDING LOANS

(56) The pace of credit growth slowed down during 2015 H1, mainly driven by the write off process of non-performing loans from bank balance sheets. Lending continued to perform below the historical level, due to demand and supply factors, and probably reflecting the shifting at a lower average growth rate for the future. Structural supply-side restrictions persist and are related to: (i) the more withdrawn position of banking groups[24] following requirements by EU and euro area regulatory authorities; (ii) still-high level of non-performing loans and the need to strengthen lending standards[25] and (iii) short-term structure of funding sources, which weakens banks' willingness to finance the private sector in long-term maturities. On the demand side, restrictions on lending are associated with the presence of continued negative output gap, as the economy operates below its potential, and business and consumers expectations for economic growth remain unsteady.

(57) In 2015 H1, outstanding loans[26] of the banking sector rose to ALL 597.9 billion, increasing by 0.5% during the period and by 5.5% year on year. The considerably low pace of credit growth in this period reflects the acceleration of the writing off of non-perfroming loans from the banks balance sheet, about ALL 11 billion. Adjusting the expansion of credit for this effect, nominal credit growth during the period would be around 2.4% and the annual growth would be 7.5%. The share of foreign currency loans and the exchange rate mainly of lek against the US dollar have a significant impact on reporting of nominal loan balance. For the six-month period, this effect has negatively affected the reported amounts of credit for about ALL 2.4 billion.

(58) In terms of currency, the lek credit portfolio, 38% of the total, was the main source of the lending growth, 7.2% in annual terms. In the same period of the previous year, the annual growth rate was 3.3%. Lek lending is supported by the downtrend of interest rates. Since the beginning of the monetary policy easing cycle by the Bank of Albania, in September 2011, the average interest rate of lending in the domestic currency has fallen by 3 percentage points, averaging 8.3%, during 2015 H1.

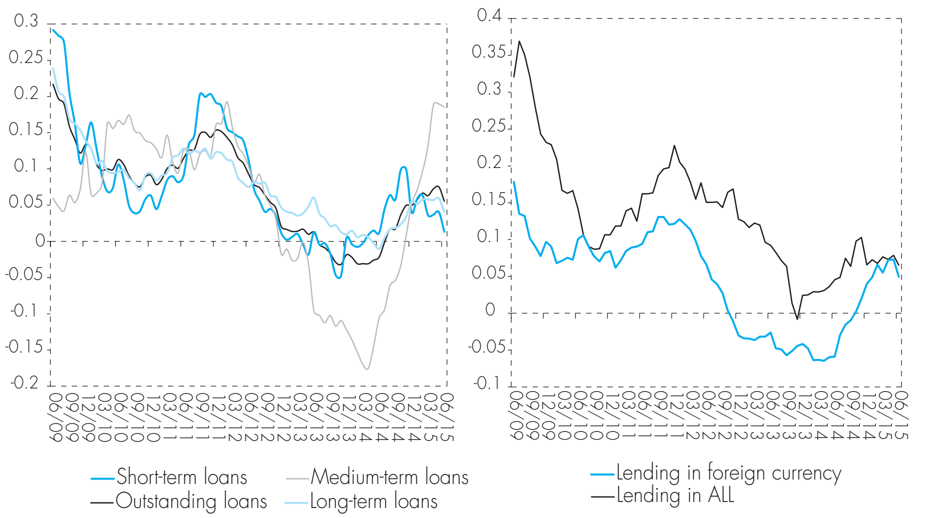
24 By origin, 58.6% of the capital originated from European countries. These banking groups saw deep structural changes upon the entry into force of new requirements by CRDIV/CRR – to ensure compliance with Basel III and address the results from the Asset Quality Reviews and stress testeve by EBA and ECB, respectively.

25 Irrespective of the short-term improvement, lending standards appear volatile; especially for businesses, they remain tight compared to four years earlier. (Quarterly Monetary Policy Report 2015 Q3).

26 Outstanding loans is taken as a value from banks' balance sheet, consisting in the loan to residents and non-residents, and including the loan principal and the accrued interest.

(59) **Credit outstanding in foreign currency fell slightly by 0.7% compared with December 2014, marking, however, an increase in annual terms by nearly 5%.** Annual growth was mainly driven by lending to non-residents. The shrinking in foreign currency loans is attributed to the change of the business model of credit institutions in the framework of reducing unhedged credit exposure against exchange rate fluctuations.[27] Starting from late 2012, the share of foreign currency loans fell by nearly 8 percentage points to 62% in June 2015. For 2015 H1, the performance of foreign currency loans is influenced by the writing off of loss loans from bank balance sheets.Undo edits

Chart 8.4 Annual growth rate of lending by maturity and currency



Source: Bank of Albania.

(60) **By maturity, medium-term credit has determined the performance, up 5.8% during the period and about 18.5%, compared with the previous year.** During the period, short and long-term loans fell by 1% and 0.5%, respectively.

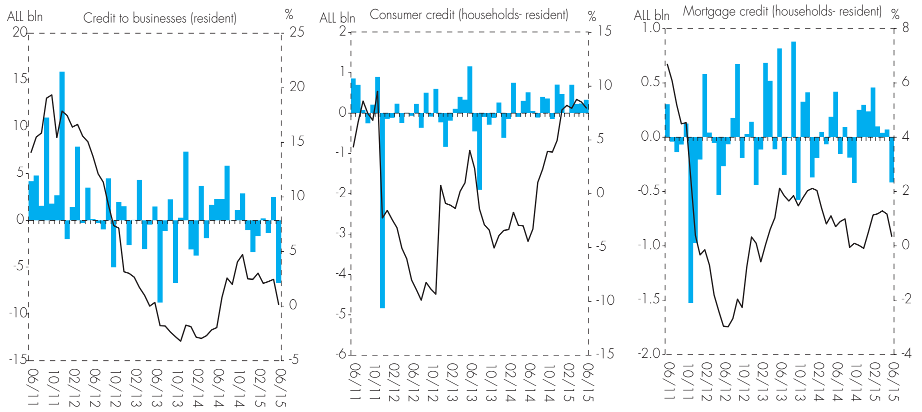
(61) **Credit for the private sector[28] (households and businesses) increased by 5.3 in annual terms, compared with the contraction of 2.5% in the same period in the previous year.** Business loans, which represent nearly 70% of the total were the main direction of lending and oriented to non-residents. Compared to June 2014, this loan increased 6.3% while compared to the end of 2014, this credit shrank 0.1%. Outstanding loans to "resident" businesses narrowed by 2.6% in semi-annual terms, reflecting the loans writte off. Outstanding loans for "investment in real estate", which represents approximately 27.0% of the total loan to resident businesses, has shown the largest decline by 3.4%. "Overdraft" outstanding loan, which accounts for approximately 31.5% of the total credit to resident businesses, fell by 2.1%. During the period, credit for household extended by 2.2%. Resident households' credit increased by 1.7%. Credit for households extended by 2.2% during the period of, when lending to

[27] *This performance is also related to the implementation of the regulatory requirements of the supervisory authority EU, which impose on Member States of the EU, among others, to implement the strict conditions of lending in foreign currency for vulnerable borrowers so to restrict exposures to credit risk and market.*

[28] *Private sector credit accounts for around 95% of the loan portfolio.*

resident individuals increased by 1.7%. Loans to resident households for "real estate purchase", which constitutes the major share of credit to households with around 70% of the total, slightly expanded by 0.5%.

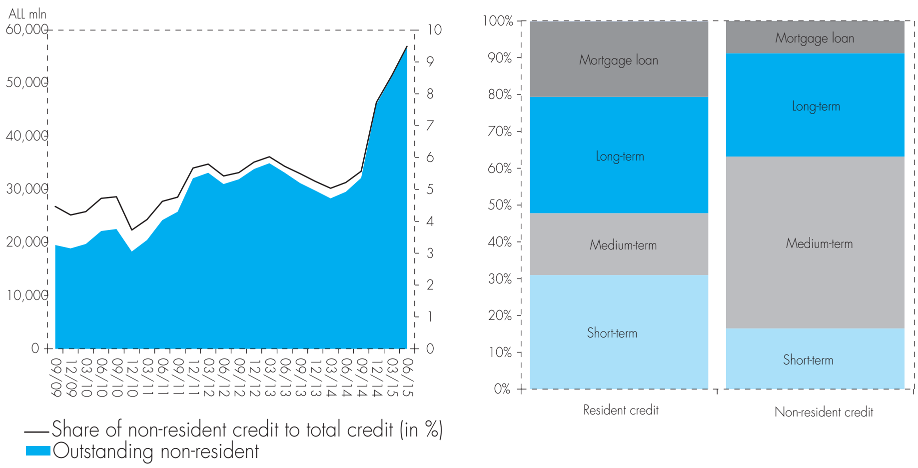
Chart 8.5 Resident loans to businesses, consumer loans to households and mortgage loans to households - absolute monthly change and annual performance



Source: Bank of Albania.

(62) In June 2015, the share of loans to non-residents in the credit outstanding of sector loan rose to 9.46%, increasing faster during 2015 Q1. Overall, non-resident credit is oriented toward longer term maturities with the main share in the medium and long term.

Chart 8.6 Loans to non-residents and structure as at June 2015



Source: Bank of Albania.

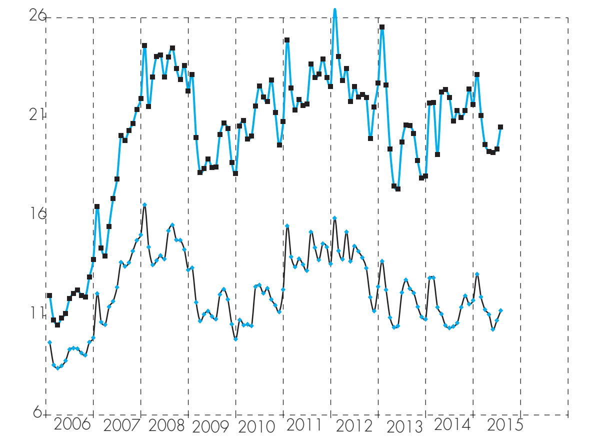
8.3.1 NEW LENDING[29]

The new loan to residents shows signs of improvement although it remains below its potential and is concetrated in a small number of banks.

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

(63) **During the period under review, the number of new loans remained below the potential and concentrated in big banks.** The banking sector new credit for the economy amounted to ALL 112.96 billion, of which the restructured loan accounted for ALL 10 billion. Excluding the restructured loan, the new loan decreased by 15.2% during the period, and by 8.1% against the same period a year ago. Over the same stated period, the banking sector's loan collection amounted to ALL 120.9 billion. The loan use ratio, measured as the ratio of repaid to new loans, rose to 107%, from 91% in June 2014, and 100.4% a year earlier.

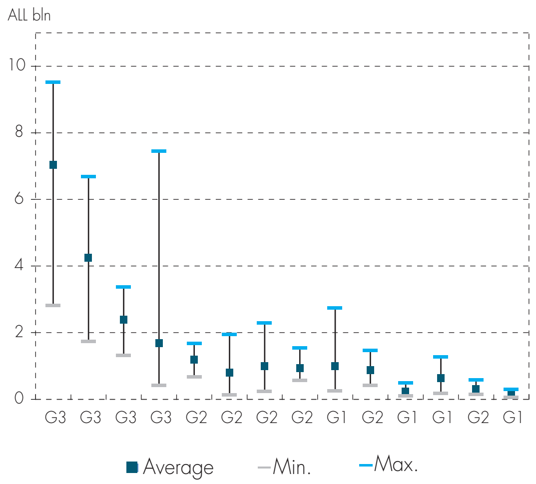
Chart 8.7 New lending*



*Exponential weighted moving average of new lending, alpha=0.03

Source: Bank of Albania.

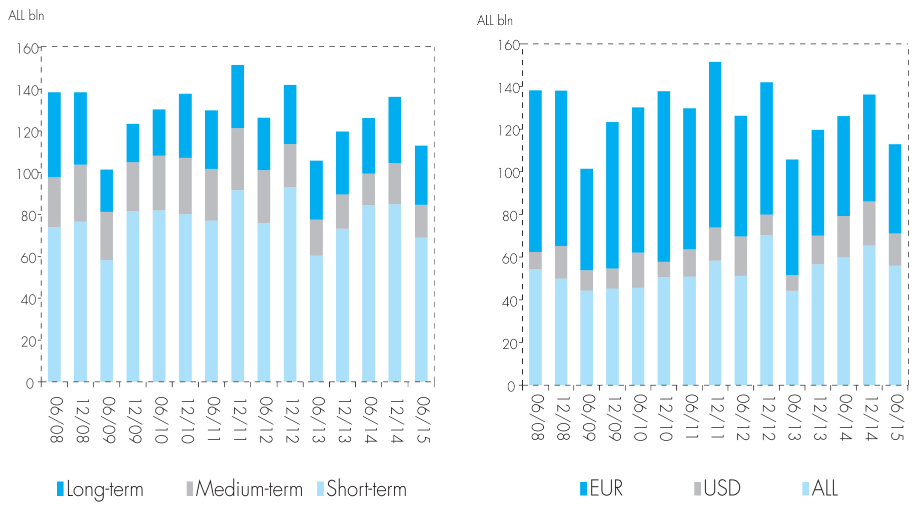
Chart 8.8 New loan monthly flows by banks (June 2014-June 2015)



Source: Bank of Albania.

(64) **During the period and compared with a year earlier, the new loan fell for lek, euro and US dollar.** The new loans in lek accounted for around 50% of total new loans. By maturity, the new loan slightly expanded in medium and long term maturities but the short-term maturity continues to have the highest share, 61%.

Chart 8.9 .Distribution of new lending by maturity (left) and currency (right)

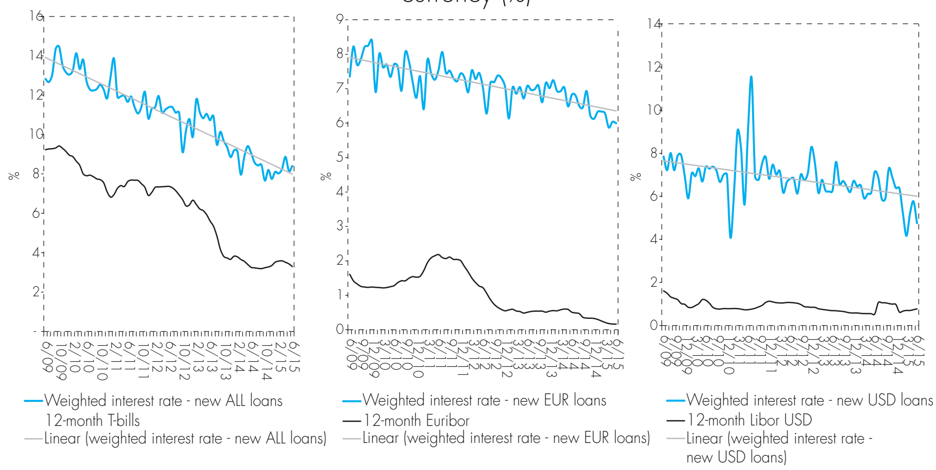


Source: Bank of Albania.

- *INTEREST RATES ON NEW LOANS*

(65) **During the period the interest rate on new loans in euro and US dollar continued to trend down, while the interest rate of new loans in lek trended up**. In June 2015, the weighted average interest rate on new loans stood at 6.77% or 0.1 percentage point lower than in December 2014. The weighted average interest rate on new loans in euro and US dollars fell by 0.13 and 1.63 percentage points, to 6 % and 4.8%, receptively. For new lek loans, the weighted average interest rate recorded 8.4% expanding with 0.7 percentage point compared to the level in December 2014. This expansion was concentrated in Q2, driven by increased business loan for "overdraft" by one bank.

Chart 8.10 Performance of interest rates on new loans and the reference rates by currency (%)



Source: Bank of Albania.

8.4 DEPOSITS

(66) Volume of deposits in the banking sector has increased despite the decline in the average interest rate. Foreign currency has given the main contribution. Households have expanded the total investments in financial instruments in the form of deposits in the banking system and government debt instruments. Household preference towards longer-term investments in government debt securities remained the same whilst their movement towards the edges of the maturity structure of deposits in the banking sector has continued.

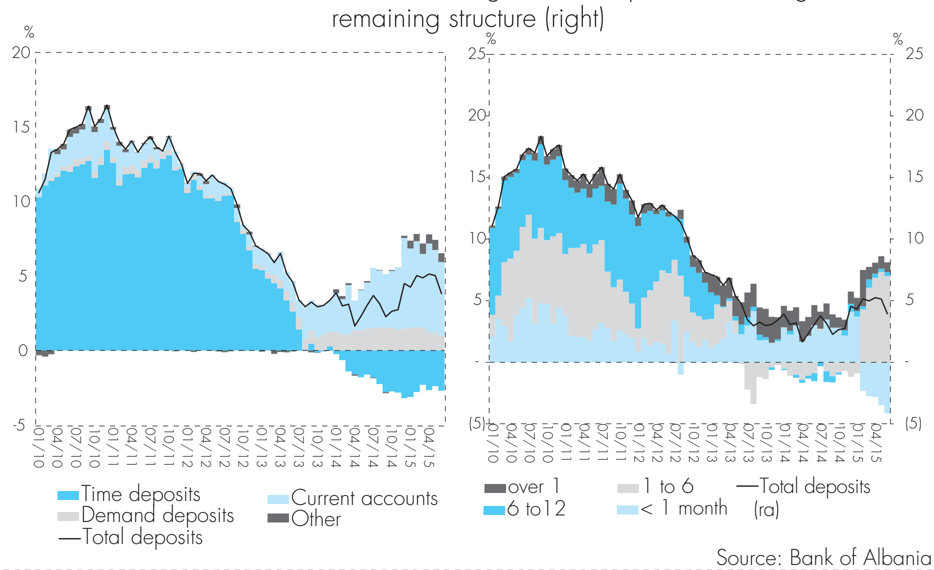
(67) **During 2015 H1, deposits[30] in the banking sector reached ALL 1,079 billion, up by 0.6%, thanks to the major contribution of foreign currency deposits**. In annual terms, banking sector deposits expanded by 4% and the accrued interest fell by 36%. Deposits in lek grew 3.1% annually whereas those in foreign currency grew 4.8%. Around 50% of sector deposits are in foreign currency, therefore the statistical effect of exchange rate change

[30] *Deposits' stock with the accrued interest.*

was present. During the period, the effect of exchange rates in the reported amounts of deposits was negative for about ALL 3.75 billion.

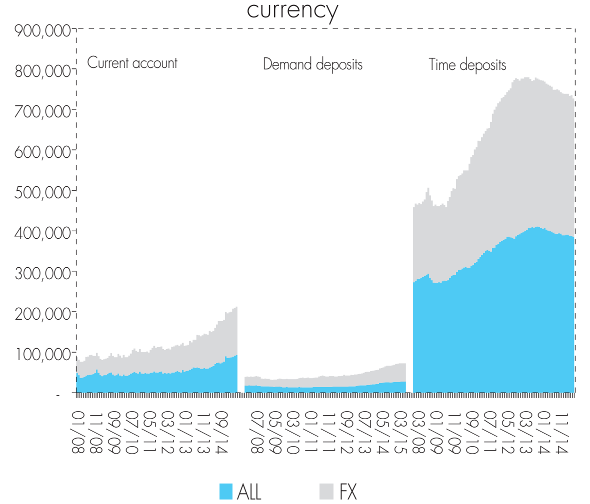
(68) **Regarding to the structure of the deposits, the shifting continues toward current accounts and deposits**. Time deposits, which account for 69% of public's deposits, fell during the period under review by about ALL 11.6 billion or 1.5%. Current accounts and deposits increased respectively by 3.9% and 5.5% during the period. Other saving products (e.g, deposit certificates) have been expanding, although by very low volumes (Chart 8.11 left). According to remaining maturity, the structure of deposits continues to expand for the over a year maturity but at a slower pace compared to the previous year. In the meantime, deposits with remaining maturity of 1-6 months provided the main contribution to the annual expansion of the deposit base, by about 7%.

Chart 8.11 Contribution to the annual growth of deposits according to the remaining structure (right)



Source: Bank of Albania.

Chart 8.12 Structure of deposits by product and currency



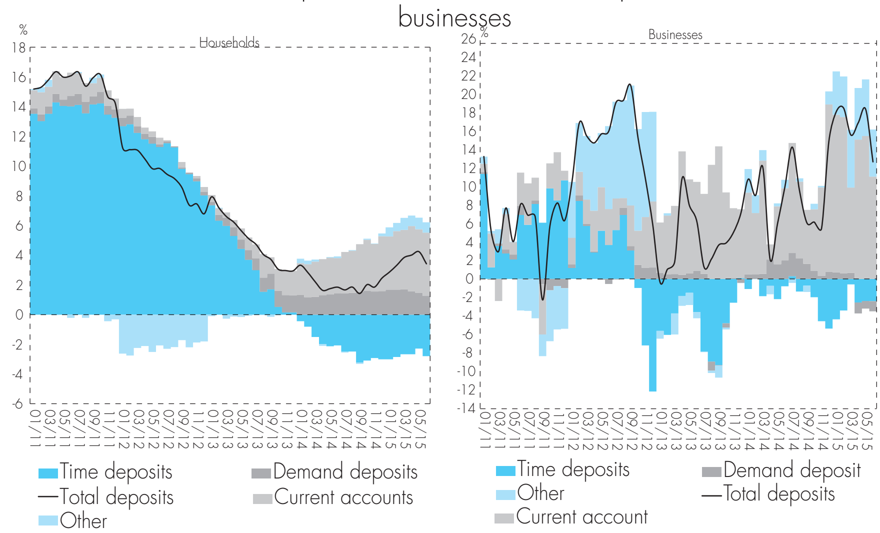
Source: Bank of Albania.

(69) **Foreign currency has an important role in the composition of deposits**. In current accounts and demand deposits, the foreign currency stood respectively at 56.4% and 62.3% in June 2015. Time deposits in the local currency had the major share by about 53%, but with a down trend. Also, around 48.8% of households' deposits and nearly 60% of businesses' deposits are dominated in foreign currency.

(70) Households' deposits represent 86% of deposits in the system. During the period, households expanded the deposits by 0.9%, whereas businesses reduced them slightly by 0.6%. However, annual business deposit growth remains high by about 8.5%. Compared to the second half of the previous year, the deposit base

of the public sector has expanded albeit it maintains a low share in total deposits by about 3%. The foreign currency component provided the main contribution to the annual deposits' expansion for households and businesses. Households' foreign currency deposits increased by 3.5% in annual terms, compared with 2.4% in the local currency. For businesses, foreign currency deposits increased by 12.6%, while those in lek by 3.1 %.

Chart 8.13 The annual expansion of the structure of deposits for households and businesses



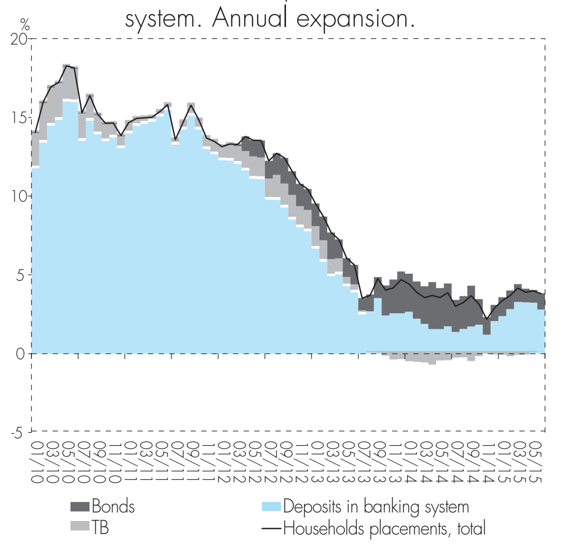
Source: Bank of Albania.

Box 8.2 Total Households' placements

During the period, households expanded the total investments in the form of deposits in the banking system and government debt instruments. At the end of June 2015, households' investments in deposits and debt securities of government in total are expanded by 4.0% in annual terms, with 1.2% from the expansion of investments in government debt securities and 2.8% of deposits in the banking system.

Households' participation in government debt instruments portfolio expanded by ALL 11.5 billion or 9.7% in annual terms. Public preference appears for government bonds, which offer the highest rate of return. These are expanded by ALL 10.6 billion compared with the previous year or with 21%. On the other hand, the treasury bonds portfolio, owned by households slightly expanded by 1.4% in annual terms, after a period of decline.

Chart 8.14 Households' placements in financial system. Annual expansion.



Source: Bank of Albania.

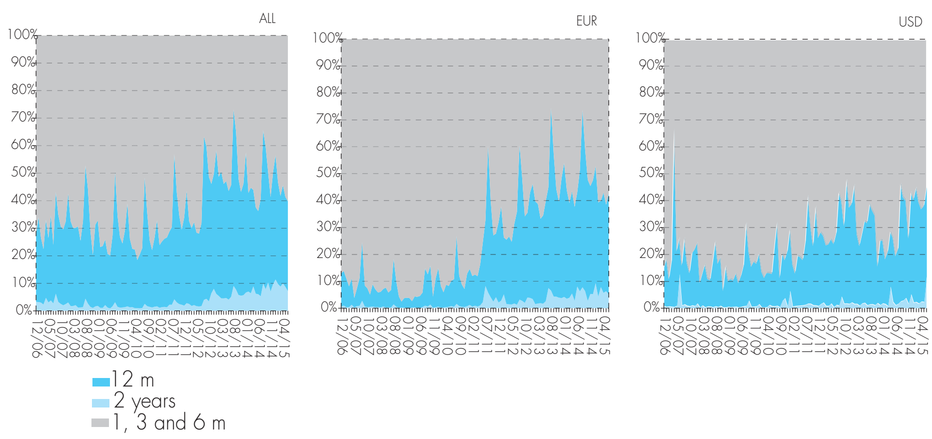
(71) Big banks' group of Group 3 continues to provide the main contribution to the expansion of the deposits' base. Deposits of this group's banks grew to ALL 736.2 billion, up ALL 27.2 billion, or 3.8% from the end of 2014. At the same time, medium-sized banks of Group 2 decreased in volume by about ALL 18.3 billion or 6.2%, down to ALL 276.6 billion, mainly influenced by the contraction of deposits in banks with Greek capital. Small banks of Group 1 slightly expanded their deposits' base.

8.4.1 NEW DEPOSITS

(72) During 2015 H1, banking sector had new flow of deposits (replacements and new placements) with about ALL 853 billion. New time-deposits share 19% of the total, and in annual terms decreasing by about 15%. Time deposits shifted towards longer-term maturities. During the period, the share of deposits with over 2 years maturity has extended with 1.5 percentage points, to 7.9% of the total, while the share of the 12 months deposits shrank by 5.6 percentage points to around 36.6% of the total. New deposits with 6, 3 or 1 month maturity continue to hold the highest share by 55.5% of the total, narrowing by 4 percentage points. The latter are presented mostly in one month maturity.

(73) By currency, new time-deposits decreased for all three currencies. Compared to 2014 H1, during the period under review, the flow of new deposits in lek fell by 12%, in US dollar by 20% and in euro by 22%. For all three currencies, the flow of new deposits with maturity of over 2 years increased 18% for lek, 22% for the US dollar and 11% for euro.

Chart 8.15 New time deposits by currency and maturity

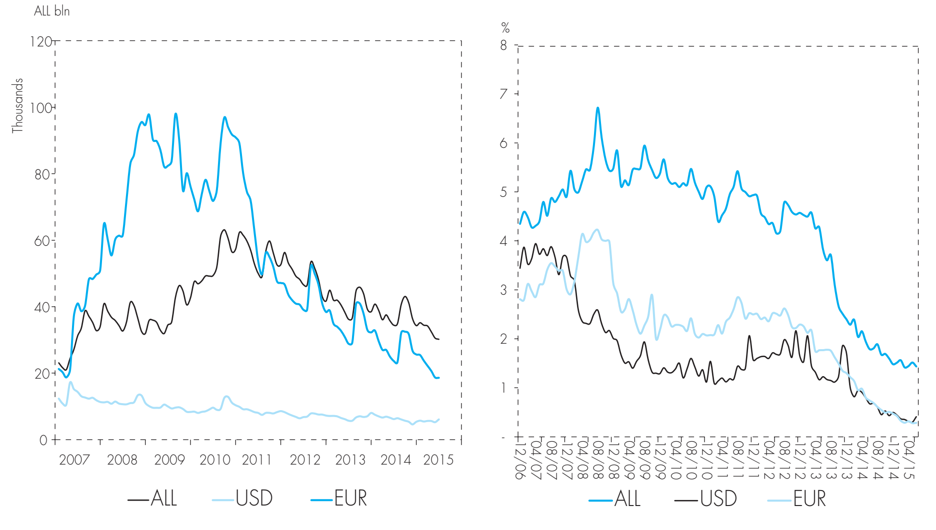


Source: Bank of Albania.

(74) In 2015 H1, the average interest rates of new term deposits continued the downward trend in total, for the three currencies. Average weighted rate of new time deposits was estimated at 0.98%, from 1.36% in 2014. For lek, this interest rate fell to 1.48% from 1.9% in 2014. The euro and the US dollar, average interest rate results respectively at 0.32% and

0.36% from 0.76% and 0.69% at the end of 2014.

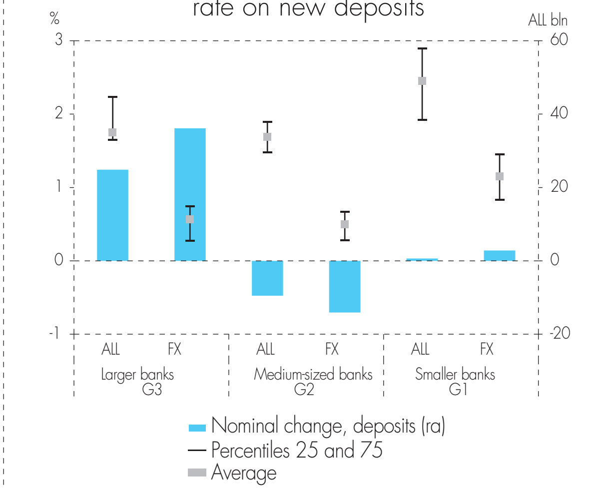
Chart 8.16 Moving average of new deposits and time interest rates (right)



Source: Bank of Albania.

(75) **Interest rates of new time deposits decreased during the period for banks of three groups by size.** The positive deposits' flow continues to be limited to major banks followed by a lowering in average interest rate by 0.44% from 0.82% at the end of 2014. For medium-sized banks, the average interest rate on deposits fell to 0.32% from 0.84% at the end of 2014. For medium-sized banks, the average interest rate on deposits fell to 0.9% from 1.48% at the end of 2014. But they continue to offer the highest rates of interest in the market for local as well as for foreign currency.

Chart 8.17 Expansion of the deposits base (the annual absolute expansion) by currency and banking groups and the distribution of the weighted interest rate on new deposits



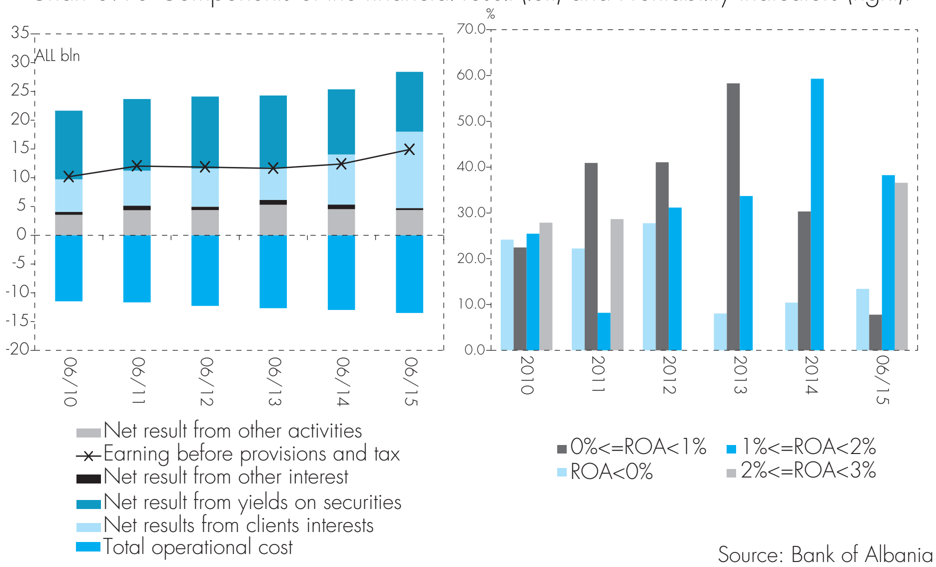
Source: Bank of Albania.

8.5 PROFITABILITY AND EFFICIENCY IN USING RESOURCES

(76) Net outcome of the banking sector improved significantly during the period. The most rapid fall of financing costs has influenced in improving the net income from interest. Also net interest margin increased. The expansion of costs in the form of provisions for the credit risk negatively affected the financial result of some banks. For the sector, indicators of Return on Equity (RoE) and Return on Assets (RoA) improved in annual terms.

(77) **In June 2015, banking sector reported a positive financial result of about ALL 8.3 billion, or about ALL 2.9 billion higher compared with the previous year. Expansion of the net interest income was the main factor that contributed to this performance. The main profitability indicators, ROA and ROE were assessed at 1.3% and 14.2%, respectively.**

Chart 8.18 Components of the financial result (left) and Profitability indicators (right).



Source: Bank of Albania.

(78) **Interest income shrank due to the contained pace of lending and the decrease of interest income from securities. But, the rapid decline of financing costs, contributed to the increase by 15% in annual terms of net interest.** The income from other activities, mainly from foreign exchange operations and commissions remained almost unchanged from the previous year. Also, activity costs, even though slightly up, were covered adequately by the activity income, providing a positive impact on the operative profitability (before provisioning). The performance of net interest margin reinforces the developments described above. Interest incomes mark a decline for two years while interest expenses are reduced with a faster rate. As a result, net interest margin increased to 4.4%.

Table 8.1 Profitability ratios, in per cent (cumulative)

Indicators	06/11	06/12	06/14	06/15
Interest income/average earning assets	7.74	7.76	6.41	5.77
Interest expenses/average expending liabilities	3.78	3.74	2.40	1.36
Net Interest Margin (Net interest income/average earning assets)	4.21	4.04	3.97	4.39

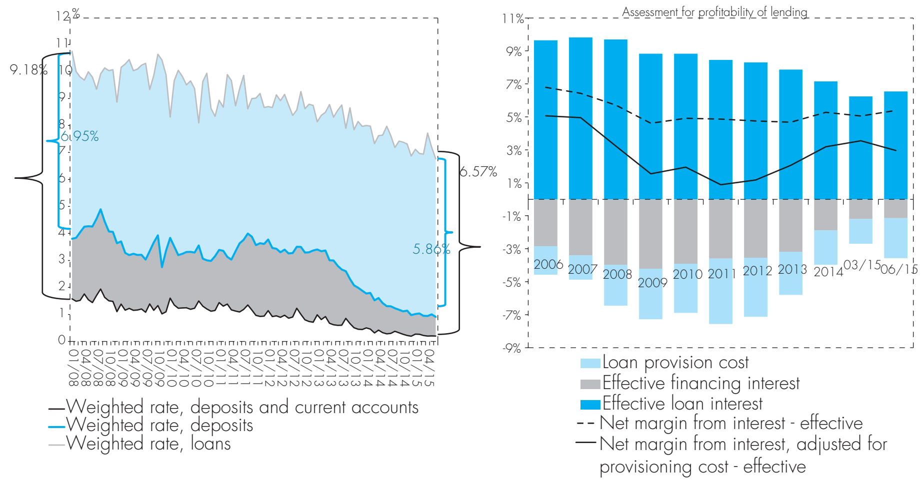
Source: Bank of Albania.

(79) **During the period, the banking sector has increased provisioning expenses for credit.** The latter, in particular banks contributed to the financial loss, although net result of banking marked an increase. As a result, the share in the assets of the banking sectors and banks that recorded a financial loss, rose up to 15.5%, but remains significantly lower compared with the 2010-2011 period.

(80) **Profitability of the banking sector lending, adjusted for the cost of provisioning has decreased slightly in 2015 H1 (Chart 8.19, left).** During the period, the effective interest rate on the loans' stock fell by 0.6 percentage point, at 6.5%, while effective interest of funding fell by 0.73 percentage point to 1.1% level. The fastest decrease of the effective interest of funding, besides reducing the interest rate on time deposits, reflects the change of their

structure towards the share of the current accounts and demand deposits. As a result, the effective net interest margin marks 5.4% with an increase of 0.1 percentage point during the period. Adjusted for the cost of provisioning, assessed as 2.4% in June 2015, this margin has decreased to 2.96% (0.23 percentage point lower than at the end of 2014). During the period, banks have reduced the spread of interest rates on credit-weighted and new deposits (including current accounts) by 0.11 percentage point to 6.57%.

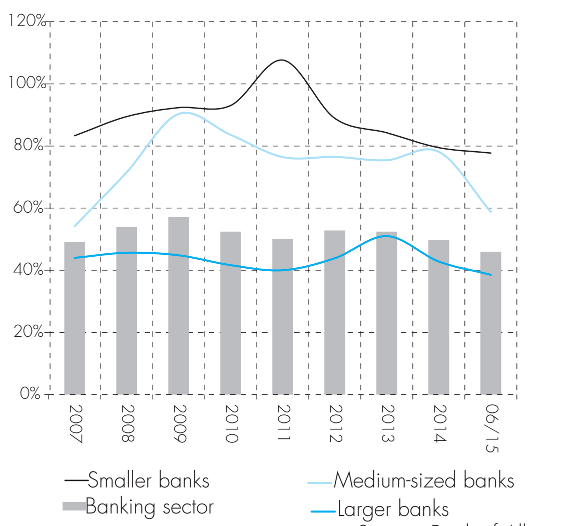
Chart 8.19. Assessment for profitability of lending (right) and performance of the weighted interest rate on new loans, deposits and new current accounts. (left).



Source: Bank of Albania and Financial Stability Department estimations.

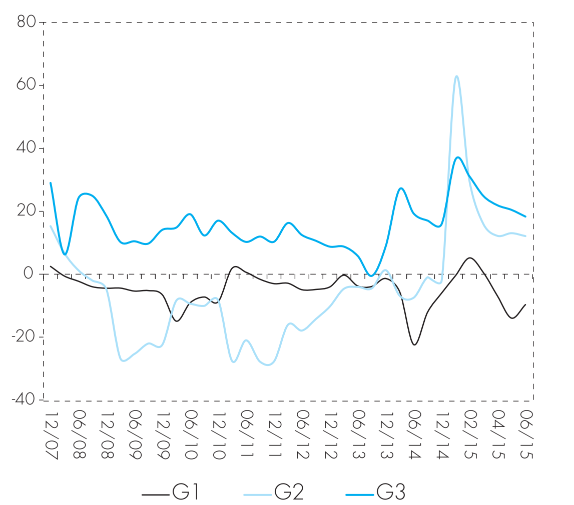
The effective interest rate[31] has been assessed as the ratio of income/ expenses from the portfolio with clients against the average portfolio value for each period. Values of 2015 Q1 and and Q2 annualized

Chart 8.20 Cost in relation to income



Source: Bank of Albania.

Chart 8.21 Return on equity



Source: Bank of Albania.

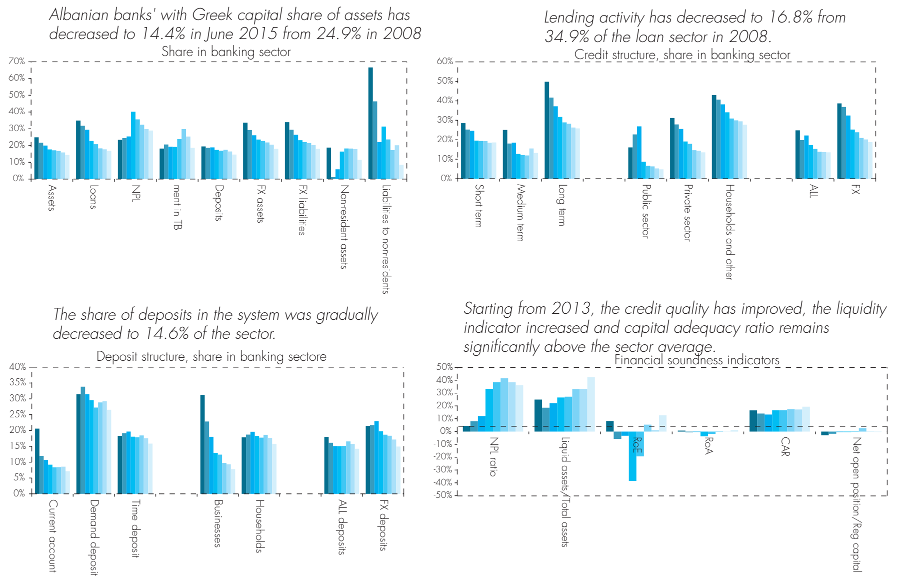
[31] *Assessment of the profitability of lending activity that is presented on the chart is an approximation of the factual performance of the interest rate for the balance of the loan and deposits. This estimation does not take into account the operating cost, capital, commissions cost or other elements in determining the loan and deposits' interest rate.*

(81) **According to banking groups, profit is deepened in large banks (G3) and medium ones (G2),** where cost has declined much more rapidly than income. In the banks of these groups, RoE and RoA showed positive performance. Small banks resulted to have a financial loss.

*Box 8.3 Albanian banks with Greek capital**

Albanian banks with Greek capital represent a significant part of the banking sector in Albania. Despite the relatively small share in parent banking groups (in total 2.32% in June 2015), at the end of June 2015 they represent 14.4% of the Albanian banking sector assets and 30% of the paid in capital. Since the beginning of the so-called "Greek crisis", the share of Albanian banks with Greek capital in the market has decreased (see Chart 8.21).

Chart 8.22 The share of Albanian banks with greek capital for the period 2008-June 2015



Source: Bank of Albania.

Risks associated with the fulfilment of financing needs of Greece in 2015 H1 were exceptional. Greek authorities' decision to summon a referendum regarding the terms of the loan proposed by the institutional creditors, led to the failure of negotiations and the end of the existing financing agreement through the European Financial Stability Facility on 30 June 2015. In addition, the European Central Bank decided not to increase the ceiling of the Emergency Liquidity Assistance any further by which it helped the Greek banking group activities. Shortly afterwards, Greek authorities shut the banks down and introduced capital controls. This meant that all customers of Greek banks, including "institutional" ones, would have very limited access to the accounts and the investments they held in these banks, for an indefinite period.

Although exceptional, these developments were not unexpected for the authorities in the region. In Albania, the legal changes of November 2011 enabled the transformation into a "subsidiary" two (of the three) banks with Greek capital which up to then acted as a "branch" of Greek banking groups. This change, ensured that now all three banks would be subject to full compliance with the requirements *of the Bank of Albania for the respective levels of capital, liquidity, for means of organization and management etc. From that period, the Albanian banks with Greek capital have strengthened their capital position and have also taken important actions to restructure their activity, which have improved liquidity position and reduced costs of operation. For these reasons, they have been able to meet, without any difficulty, the requirements of the Bank of Albania, for higher levels of capitalization and liquidity operations.*

The main channel of stress spilling over from Greek banking groups to their subsidiaries would be the restriction of access in accounts that these branches could hold with parent banking groups. For this reason, the Bank of Albania, in cooperation with the subsidiaries, worked to reduce the size of this exposure over time, especially in 2015 H1. As a result, at the end of June 2015, the exposure of Albanian banks with Greek capital in parent banking groups, and in general in the Greek market instruments, descended to insignificant levels. This fact, as well as the very good liquidity and capitalization indicators, minimized the financial channel of stress spillover from Greece.

Basically, banking is a confidence-based activity, where bank depositors choose to invest their savings. What was happening in Greece, had the potential to shake the confidence of depositors in Albanian banks with Greek capital. In fact, these banks experienced net withdrawals of their obligations, more prevalent in July. Withdrawals were handled without difficulty, thanks to the high level of liquid assets of these banks. The majority of drawn funds, shifted into the rest of the banking sector. Starting from the end of July, net withdrawals in these banks decreased greatly, and in August Albanian banks with Greek capital have resumed growth (entrance) of their net liabilities. As a result, during this period, banking sector deposits were stable.

Bank of Albania has closely followed the activity of the Albanian banks with Greek capital. This is accomplished through constantly communicating with them, as well as focusing on supervisory activities. The Bank of Albania has cooperated closely with national authorities, particularly with the Ministry of Finance, the Deposit Insurance Agency and the Financial Supervisory Authority, as institutions that are part of the Financial Stability Advisory Group. Regular and constant communication has been maintained also with international financial institutions, particularly with the IMF and the World Bank, which have helped in assessing and strengthening of the capacities for the management of financial stress situations. In this context, institutional and inter-institutional plans of action for the management of financial stress situations are reviewed and tested. Pulic communication of Bank of Albania's assessment of the situation is considered an important instrument for its administration. For this purpose, press releases and various media interviews have helped.

* *Currently, in the Albanian banking sector, three Albanian banks with Greek capital are operating, in the form of the subsidiary. This means that they are subjected to full regulatory and supervisory framework of the banking activity in the Republic of Albania.*

8.6 BANKING BUSINESS CAPITALIZATION

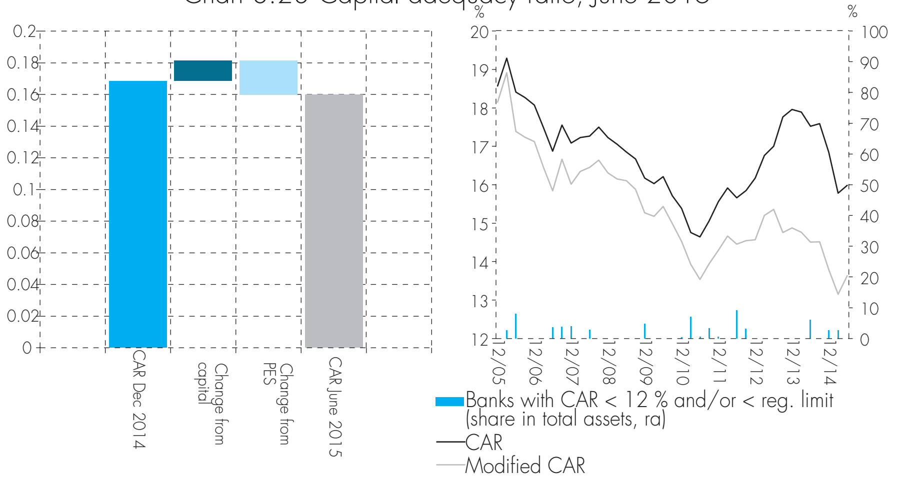
(82) Good capitalization remains a feature of the banking sector and its stability is confirmed by good levels of capital adequacy ratio and financial leverage. Banks have maintained the minimum required levels, by passing to the new rules on capital adequacy assessment, according to the Basel II approach.

(83) Starting from January 2015, banks have shifted to a new standard in terms of calculating the capital requirements for monitoring of the main risks in accordance with Basel II methodology. In pursuance of the new regulation provisions "On capital adequacy ratio" that makes aligning with this standard, capital banks can release capital in certain categories of risk weighted assets from one side, but should plan for additional capital requirements for market and operational risk.

(84) The quick growth of risk-weighted assets (RWA), contributed to the decrease in the capital adequacy rate. In June 2015, the capital adequacy ratio fell to 16.0% from 16.8% at the end of 2014 and 17.5% a year ago. During the period, RWA expanded by about 15%, to ALL 794.7 billion. This development contributed to the decline of capital adequacy rate by 2.2 percentage points. On the other hand, regulatory capital increased during the period by 8.8% to ALL 127 billion. This development has positively contributed to the growth of capital adequacy by approximately 1.3 percentage points.

(85) The composition of the capital in the banking sector is dominated by the core capital. The capitalization of profit has increased the presence of the core capital in the structure of regulatory capital, further at 85.3%. During the first half of 2015, capital injections stood at ALL 5.7 billion[32], expanding the paid-in capital of the banking sector at ALL 111.8 billion, about 5.4% more than at the end of 2014.

Chart 8.23 Capital adequacy ratio, June 2015



Note: The capital adequacy ratio (CAR) is measured as the ratio of "Regulatory capital to risk-weighted assets" (PES); The modified Capital Adequacy Ratio is measured as the ratio of "Core Capital to Risk Weighted Assets".
Source: Bank of Albania.

32 *Only a big bank of the banking sector (share in the system 25.4%) injected capital in the first quarter of 2015.*

(86) Referring to group levels, Group 3 banks and those of Albanian and French origin present a lower capitalization rate than other groups. Table 8.2 summarises the capital adequacy ratio for the banking sector and banking groups, by business size and origin of capital.

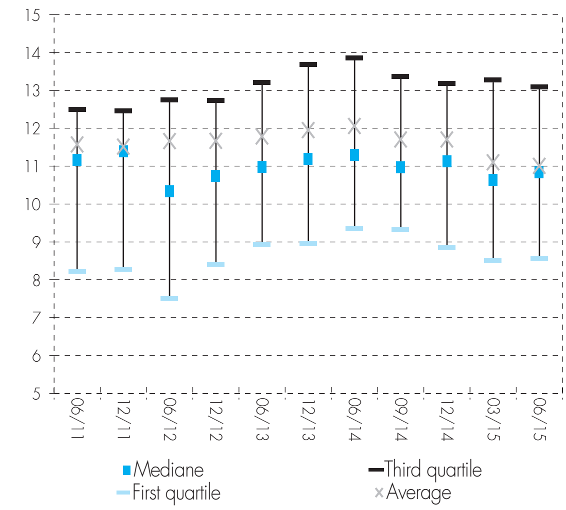
Table 8.2 Capital adequacy ratio, in per cent.

Period	Sector	G1	G2	G3	Italian	French	Greek	Albanian
June 2015	15.9	19.8	17.5	15.1	16.6	13.5	19.4	14.3
December 2014	16.8	22.5	15.1	17.0	17.4	14.5	17.2	14.4
June 2014	17.5	23.7	14.7	18.2	19.7	14.1	16.3	14.9

Source: Bank of Albania.

(87) Albanian banking sector is characterized by a low and stable financial leverage ratio. In the end of June 2015[33] the financial leverage ratio was estimated (11.0 times) from 11.7 times in the previous year. Individual banks did not differ in terms of financial leverage.

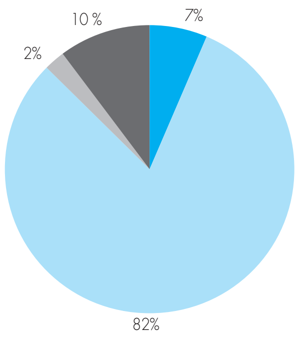
Chart 8.24 Financial leverage ratio



Source: Bank of Albania.

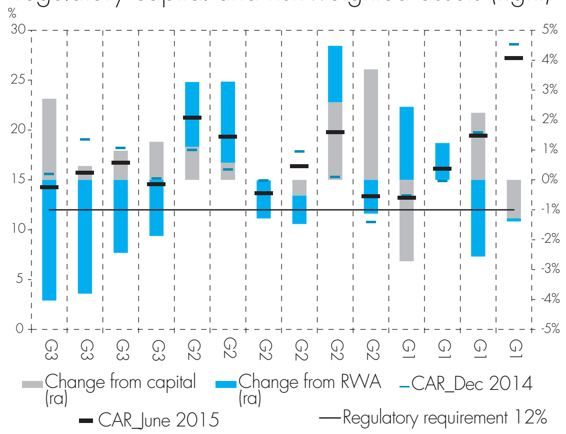
[33] *Financial leverage is measured as the ratio of assets to equity.*

Chart 8.25 Structure of total risk-weighted assets for the banking sector, June 2015



Source: Bank of Albania.

Char 8.26 Capital adequacy ratio and the effect in percentage points derived from the changes in the regulatory capital and risk-weighted assets (right)



Note: In the chart, 2 small banks both at 0.7 of total assets are not included.At the end of their period their CAR level were respectively 36.1% and 73%.

Source: Bank of Albania.

Box 8.4 The impact of the new regulatory framework "On capital adequacy ratio" in the banking sector.

Upon entry into force of the new regulation on capital adequacy, risk-weighted assets (RWA) came up to ALL 794.7 billion from ALL 693 billion at the end of 2014 at sector level. In this new RWA value, about ALL 153 billion come from the capital requirements for market and operational risk, as well as from the additional capital requirements arising from increased investments by non-residents. The expansion of risk-weighted assets has been more evident in the case of the large banks (G3) causing a decrease in capital adequacy rate. To mitigate this impact these banks have expanded the regulatory capital via the injection and / or generation /capitalization of profit. Minimum capitalization levels required by the Bank of Albania have been maintained for all banks in the system.

In the end of June 2015, 5 banks in the system (which make up approximately 19% of banking sector assets) have expanded the level of the capital adequacy rate , combining the contraction of RWA (chart shows a difference of the result of RWA with positive effect) and the expansion of the regulatory capital. While 11 banks that account for 81% of total assets of the sector, have a decreased rate of capital adequacy, mainly due to the expansion of the RWA in accordance with the new regulation. Financial loss has negatively affected the contraction of the regulatory capital for two small banks in the system (which altogether make up 2.5% of banking sector assets.)

9. MONITORING BANKING SECTOR RISKS

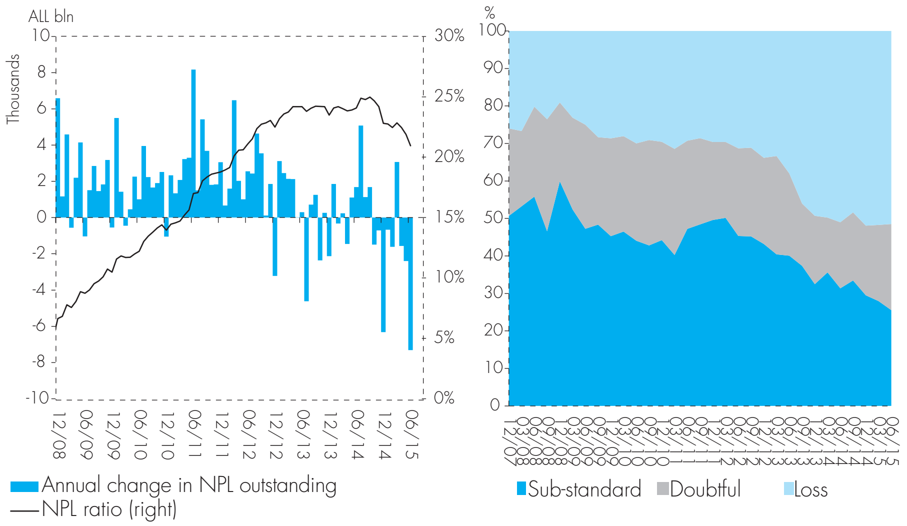
9.1 CREDIT RISK

(88) Loan portfolio quality improved and banks were more active in writing-off the loss loans from their balance sheets. At the same time, the system expanded the level of provisions for the credit risk. However, the credit risk, remains high. The net non-performing loans, in relative terms to the capital, albeit decreasing, stands at around 36%.

9.1.1 LOAN QUALITY

(89) During the period, the stock of non-performing loans[34] fell around 8%, to ALL 125.2 billion, contributing to the fall in the non-performing loan ratio. This performance reflects the acceleration of the write offs from banks balance sheets during the second half of the period. The written off loans amount to ALL 11 billion for 12 banks. As a result, at the end of June 2015, the ratio of non-performing loans (NPLR) stood at 20.9%, down by 2 percentage points against December 2014 (Chart 9.1, left). Within the structure of the non-performing loans, those classified as "doubtful" expanded during the period, by around 4 percentage points, accounting for 23% of the stock of non-performing loans, representing a potential source of risk of being

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

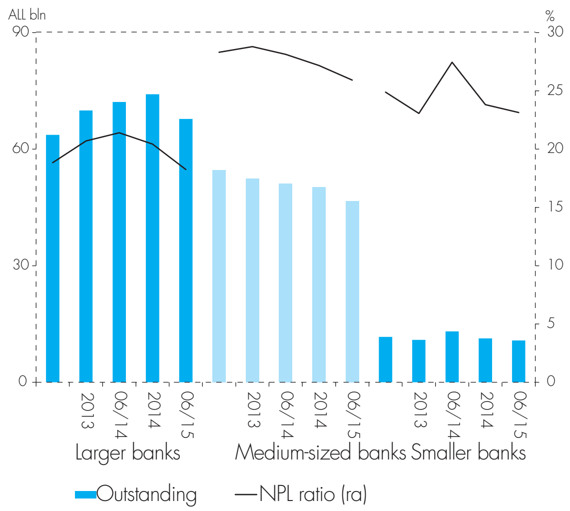


Source: Bank of Albania.

[34] *Non-performing loans include "substandard", doubtful", and "loss"; Criteria to define a loan as "non-performing" is the number of past due days (90 days).*

transformed in "loss" loans. Loans classified as "loss' fell by 7.4%, in annual terms, and continue to account for around 51% of non-performing loans (Chart 9.1, right).

Chart 9.2 NPL portfolio by bank groups



Source: Bank of Albania.

(90) Credit quality improved in each of the three groups of banks. It improved most for the larger G3 banks, with the NLPR dropping 2.2 percentage points, down to 18.2%. The expansion of outstanding credit and shrinking of non-performing loans, attributable to the "write off", have contributed to this performance. For medium-sized and smaller banks, the credit quality improvement reflects mainly the write off process, as the base effect of the portfolio expansion is insignificant. The NLPR for these groups stood at 25.9% and 23.1% respectively, falling (improving) during the period by 1.3 and 0.7 percentage points, respectively. Regulatory amendments that encourage the early restructuring of loans[35] continue to produce effects for individual banks. At sector level, at end-June 2015, the NPLR would have been 0.95 percentage points higher (or at 21.9%), if the impact of the applied measures were excluded.

(91) Banking sector's exposure to credit risk remains high for the medium-term credit, foreign currency credit and business credit. In June 2015, the non-performing loans ratio for each portfolio stood at 23.4%, 24.1%, and 24.7%, respectively.

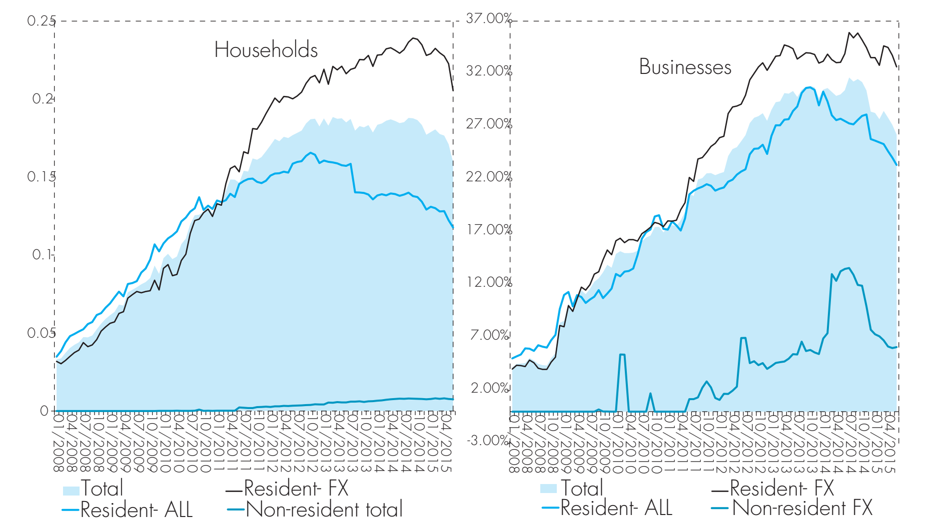
Chart 9.3 Non-performing loans in the Albanian banking sector

Source: Bank of Albania.

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

(92) *The larger banks continued to lend to non-residents, but its relatively better quality is mainly attributable to the "young age" and the limited amount.* Lending to non-residents accelerated, concentrated mainly in the businesses segment. The quality of this portfolio is better than that of the resident portfolio, given that this is a relatively new activity. For businesses, the non-performing loans to non-resident outstanding credit stood at 6.1% from 7.8% at the end of 2014. The ratio marked the highest share during 2014. This development reflects non-resident loans growing faster than the stock of non-performing loans.

Chart 9.4 Credit quality for residents and non-residents

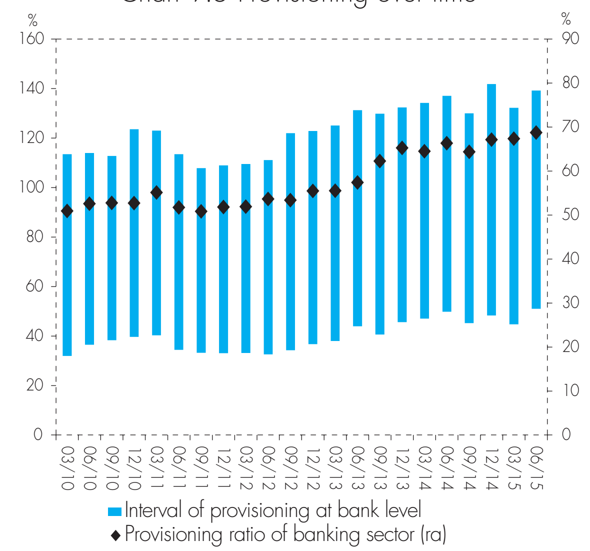


Source: Bank of Albania.

9.1.2 PROVISIONING

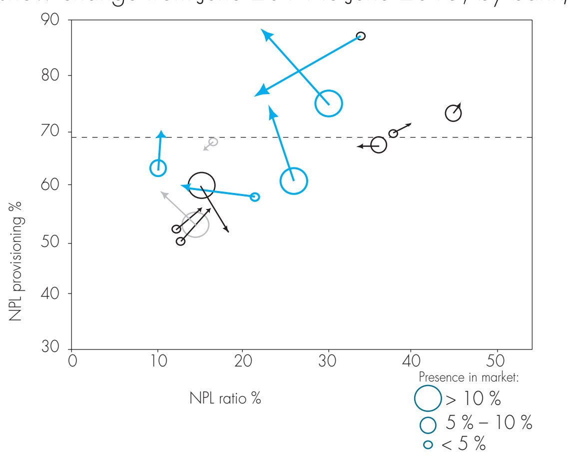
(93) Credit risk is mitigated by the good level of provisions created by the sector. Overall, banks have maintained and/or increased provisioning for non-performing loans. In June 2015, the provisioning ratio stood at 69%, up by 1.6 percentage points, from December 2014 and 2.4 percentage points from a year earlier (Chart 9.5). In three banks of the sector, which together account for around 15% of its total assets, we note a simultaneous fall in provisioning and rise in non-performing loans. This performance is more evident in a larger bank, whose provisions, however, cover more than 50% of the non-performing loans.

Chart 9.5 Provisioning over time



Source: Bank of Albania.

Chart 9.6* Annual change in provisioning levels (arrows show change from June 2014 to June 2015, by bank)



**Note:* This includes banks sharing more than 1% in total assets. Grey shows improvement; black shows deterioration, blue shows combined risk. Dotted line shows the average ratio of NPL provisioning at sector level, 67.1% at end- December 2014.*

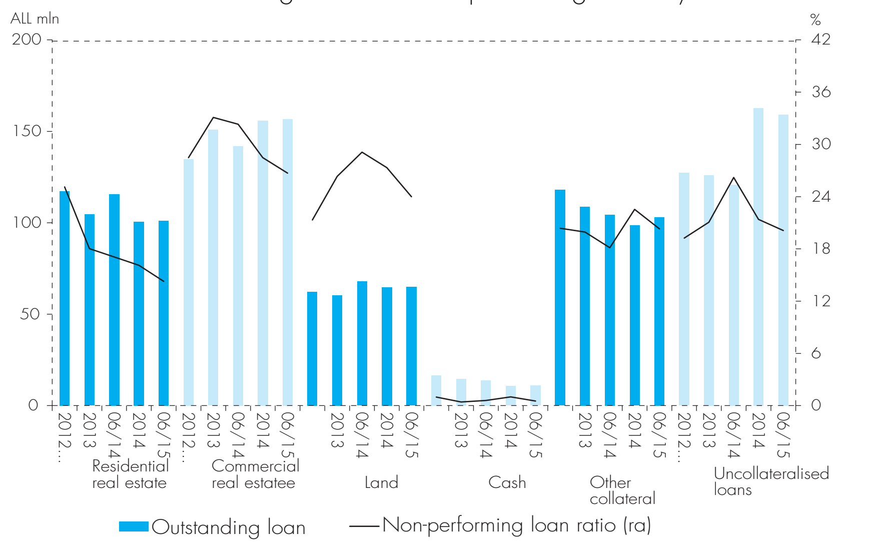
Source: Bank of Albania.

(94) **...and better coverage of net non-performing loans with capital.** During 2015 H1, at sector level, the ratio of net non-performing loans to outstanding credit fell by 1 percentage point, down to 6.5%. In the previous year, the ratio stood at 8.1%. At the same time, the expansion of the regulatory capital, dictated by the new regulatory framework "On capital adequacy ratio" has improved the banking sector's capability to cover non-performing loans with capital. The ratio of "non-performing loans/regulatory capital" fell to 36% from 38.3% at the end of 2014, and 40.5% a year earlier.

9.1.3 COLLATERAL COVERAGE

(95) **Credit collateral coverage, an important hedging for credit risk, remains at stable levels.** At the end of June 2015, collateral coverage[36] stood at 73%, slightly expanding compared to 72.6% at the end of 2014. The write off of non-performing loans from banks' balance sheet has improved the quality of the credit portfolio for all collateral classes (Chart 9.7). However, the banking sector remains dependant on the efficiency of the real estate market and the execution of collateral. Loans covered by real estate collateral account for 59% of the total collateralised loans. At the same time, this class continues to suffer from high levels of non-performing loans (especially when the collateral is a commercial real estate).

Chart 9.7 Outstanding credit and non-performing loans by collateral



Source: Bank of Albania.

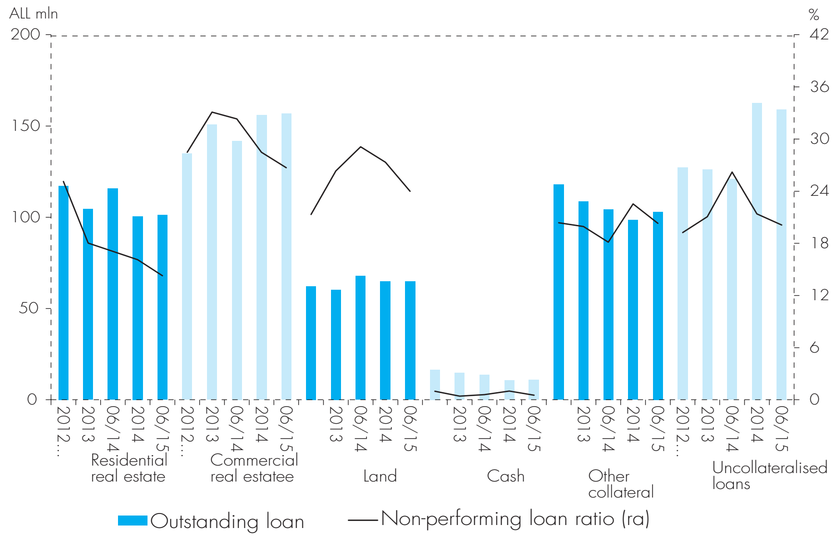
[36] *Collateral in the form of real estate (residential, commercial or land), cash etc.*

9.1.4 INDIRECT CREDIT RISK[37]

(96) Exposure to indirect credit risk due to volatility of market indicators remains high. Notwithstanding the reduced bank lending in foreign currency, within this portfolio, the share of loans unhedged against exchange rate volatility remains at considerable rates. In June 2015, this share of loans accounted for 46.1% of foreign currency outstanding credit, 4 percentage points less from the end of 2014. This development reflects the contraction of unhedged loans during the period by 9%, mainly in euro[38].

(97) Portfolio quality for unhedged foreign currency credit improved over the period, with the NPLR falling 1.5 percentage points, to 27.5%, due to the fall in the absolute value of the non-performing loan portfolio. By currency, the quality ratio for unhedged euro loans improved by 3 percentage points amounting to 26%, whereas for unhedged US dollar loans, it deteriorated by around 7.7 percentage points, amounting to 37.5%. The performance of the US dollar loan portfolio reflects the depreciation of the Albanian lek against the US dollar in the last year, and the sensitivity of the credit portfolio quality to exchange rate volatility. However, the unhdedged US dollar portfolio accounts for only 13.5% of the unheldged loans against this risk.

Chart 9.7 Outstanding credit and non-performing loans by collateral



Source: Bank of Albania.

[37] The analysis in this section includes data on credit for the entire economy.

[38] Outstanding credit in euro, when borrower's income is in lek, accounts for around 86% of unhedged foreign currency outstanding credit.

Box 9.1 Similarity of Banks in Albania: the Application on the Credit Portfolio and Quality

Credit risk may increase in the event of a high similarity of the credit portfolio among banks. For example, if the similarity is high in the form of credit portfolio concentration in the same sectors of the economy, then the sector is sensitive to macroeconomic shocks in these sectors (with a potential systemic effect). The methodology assesses similarities in the credit portfolio for each sector of the economy through individual banks, initially ignoring the risk profile of the assets of these categories**, but then taking into account this risk factor as well.*

Matrix 1. Balance-Sheet Similarity (June 2015)

	G3	G1	G1	G3	G2	G1	G3	G2	G1	G2	G2	G1	G3	G2	G2
G3	1	0.80	0.74	0.65	0.75	0.74	0.84	0.80	0.82	0.43	0.60	0.78	0.85	0.80	0.73
G1	0.80	1	0.87	0.50	0.79	0.61	0.65	0.89	0.85	0.44	0.63	0.77	0.92	0.81	0.69
G1	0.74	0.87	1	0.51	0.83	0.57	0.79	0.85	0.76	0.40	0.56	0.76	0.82	0.73	0.68
G3	0.65	0.50	0.51	1	0.74	0.68	0.70	0.51	0.70	0.77	0.81	0.72	0.59	0.74	0.73
G2	0.75	0.79	0.83	0.74	1	0.69	0.84	0.82	0.86	0.78	0.87	0.84	0.70	0.93	0.80
G1	0.74	0.61	0.57	0.68	0.69	1	0.62	0.67	0.82	0.72	0.74	0.88	0.68	0.81	0.95
G3	0.84	0.65	0.79	0.70	0.84	0.62	1	0.70	0.79	0.57	0.67	0.78	0.64	0.78	0.69
G2	0.80	0.89	0.85	0.51	0.82	0.67	0.70	1	0.88	0.47	0.62	0.82	0.89	0.86	0.69
G1	0.82	0.85	0.76	0.70	0.86	0.82	0.79	0.88	1	0.73	0.84	0.95	0.85	0.95	0.83
G2	0.43	0.44	0.40	0.77	0.78	0.72	0.57	0.47	0.73	1	0.94	0.75	0.38	0.33	0.79
G2	0.60	0.63	0.56	0.81	0.87	0.74	0.67	0.62	0.84	0.94	1	0.83	0.58	0.89	0.81
G1	0.78	0.77	0.76	0.72	0.84	0.88	0.78	0.82	0.95	0.75	0.83	1	0.81	0.92	0.92
G3	0.85	0.92	0.82	0.59	0.70	0.68	0.64	0.89	0.85	0.38	0.58	0.81	1	0.78	0.70
G2	0.80	0.81	0.73	0.74	0.93	0.81	0.78	0.86	0.95	0.33	0.89	0.92	0.78	1	0.84
G2	0.73	0.69	0.68	0.73	0.80	0.95	0.69	0.69	0.83	0.79	0.81	0.92	0.70	0.84	1
Pairs	14	13	12	11	10	9	8	7	6	5	4	3	2	1	0

Source: Bank of Albania.

In Matrix 1, rows and columns represent individual banks in the same order. Each cell thus represents the similarity between the two banks of the corresponding row and column. The darker is the cell, the greater is the similarity between the two banks. The matrix colouring is determined by the percentile distribution.

- Light blue represents pairs with low similarity and coefficient in the 10th percentile, whose value is 0.57. This shows that 10% of the pairs' value is below 0.57.
- Blue represents pairs with relatively high similarity in the 50th percentile, whose value is 0.78. This shows that 50% of the pairs' value is up to 0.78.
- Dark blue represents pairs with the highest level of similarity, which extends to the 90th percentile, whose value is 0.94. We find that 10% of the values of the bank pairs has a higher than 0.94 similarity (very close to 1), which shows that banks are highly similar and are thus exposed at the same level to macroeconomic risks. This development reflects the concentration of lending in similar sectors. According to this methodology, the total banking sector similarity is 0.72.

Matrix 2. Balance sheet similarity taking into account credit risk (June 2015)

	G3	G1	G1	G3	G2	G1	G3	G2	G1	G2	G2	G1	G3	G2	G2
G3	1	0.94	0.76	0.72	0.83	0.85	0.83	0.95	0.94	0.53	0.76	0.87	0.96	0.91	0.81
G1	0.94	1	0.90	0.71	0.87	0.76	0.88	0.95	0.94	0.51	0.77	0.89	0.99	0.86	0.82
G1	0.76	0.90	1	0.66	0.87	0.61	0.93	0.83	0.79	0.46	0.69	0.83	0.86	0.71	0.79
G3	0.72	0.71	0.66	1	0.91	0.87	0.85	0.71	0.85	0.96	0.98	0.87	0.67	0.88	0.93
G2	0.83	0.87	0.87	0.91	1	0.80	0.96	0.88	0.90	0.79	0.92	0.91	0.83	0.92	0.90
G1	0.85	0.76	0.61	0.87	0.80	1	0.77	0.78	0.89	0.78	0.87	0.87	0.78	0.89	0.92
G3	0.83	0.88	0.93	0.85	0.96	0.77	1	0.87	0.89	0.69	0.85	0.94	0.86	0.87	0.91
G2	0.95	0.95	0.83	0.71	0.88	0.78	0.87	1	0.94	0.53	0.75	0.89	0.95	0.92	0.79
G1	0.94	0.94	0.79	0.85	0.90	0.89	0.89	0.94	1	0.72	0.90	0.96	0.94	0.96	0.90
G2	0.53	0.51	0.46	0.96	0.79	0.78	0.69	0.53	0.72	1	0.93	0.75	0.47	0.28	0.83
G2	0.76	0.77	0.69	0.98	0.92	0.87	0.85	0.75	0.90	0.93	1	0.90	0.74	0.91	0.93
G1	0.87	0.89	0.83	0.87	0.91	0.87	0.94	0.89	0.96	0.75	0.90	1	0.90	0.93	0.94
G3	0.96	0.99	0.86	0.67	0.83	0.78	0.86	0.95	0.94	0.47	0.74	0.90	1	0.87	0.81
G2	0.91	0.86	0.71	0.88	0.92	0.89	0.87	0.92	0.96	0.28	0.91	0.93	0.87	1	0.87
G2	0.81	0.82	0.79	0.93	0.90	0.92	0.91	0.79	0.90	0.83	0.93	0.94	0.81	0.87	1
Pairs	14	13	12	11	10	9	8	7	6	5	4	3	2	1	0

Source: Bank of Albania.

The balance sheet similarity taking into account the credit risk (represented by the non-performing loan ratio) measured according to formula 2, results higher for all bank pairs, affirming higher credit risk exposure. Thus, similarity values by pairs, as a percentile, range as follows:

- 0.71 for the 10th percentile (i.e. only 10% of bank pairs show similarity up to the value of 0.71 and 90% of the pairs are above 0.71).
- 0.87 for the 50th percentile
- 0.96 for the 90th percentile

Total similarity for the banking sector according to this methodology is 0.84, being considered as a high similarity in the credit portfolio.

In conclusion, the application of the methodology revealed that banks in Albania have made their investments in the same sectors, which renders them similar. The similarity level results even higher when including the risk factor in the application, represented by the non-performing loans ratio.

* *Based on "Similarity and Clustering of Banks: the Application on the Credit Exposures of the Czech Banking Sector". By J. Brechler, V. Hausenblas, Z. Komárková, M. Plašil- Czech National Bank, 4/2014.*

** *Portfolio similarities between two banks (e.g. bank A and bank B) by selected category "i", which represent lending to businesses by sector, households, divided into consumer credit and mortgage loans, relations with the government, relations with other financial institutions, and relations with non-residents, measured by the cosine similarity Blocher (2011). Thus, the similarity between two vectors is described as the cosine of the angle between the two vectors (a) also adding risk (b) :*

$$\text{Similarity}(a,b) = \cos(\theta) = \frac{\sum a\, i * bi}{\sqrt{(\sum a i^2 * \sum bi^2)}} = (\text{ek. }1) \text{ and Similarity}(a,b) = \cos(\theta)$$

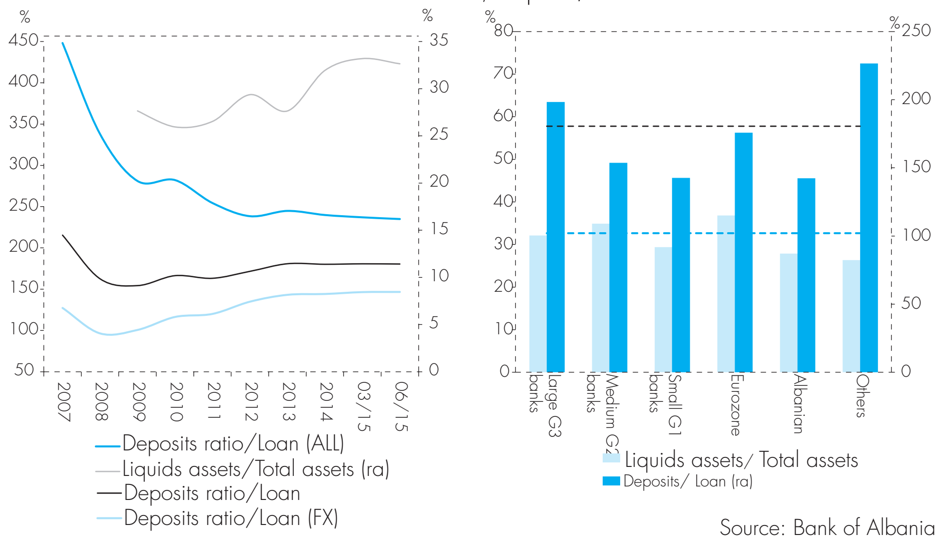
9.2 LIQUIDITY RISK

(98) **Liquidity position of the banking sector stands at good levels. The liquidity ratios, both in lek and foreign currency, are above the minimum regulatory ratios.** 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. Deposits cover almost twice the volume of loans for the sector.

(99) **Banking sector liquidity indicators stood at good levels. Banks improved the liquidity indicators.** The banking sector maintains a good liquiditypositionwithaconsiderableoutsandingclientdepositsoverloans. In June 2015, the deposit/credit ratio stood at 180.5%.

(100) **The slow performance of lending and the shift of funds towards more liquid assets in money and capital markets, maintained high rates of the liquid assets ratio in banks' balance sheets.** At the end of June 2015, liquid assets accounted for 32.6% of total banking sector assets, up 0.7 percentage points during the period. The other liquidity indicator "liquid assets to total short-term liabilities" improved also by 1.7 percentage points, rising to 42%. This liquidity surplus, which banks in Albania may use in the case of a liquidity shock (ensuring, at the same time compliance with the e regulatory thresholds), allows better performance of lending if economic agents' expectations improve.

Chart 9.9 Liquidity situation in the banking sector as at June 2015 - dotted line indicates the sector level; deposit/credit ratio

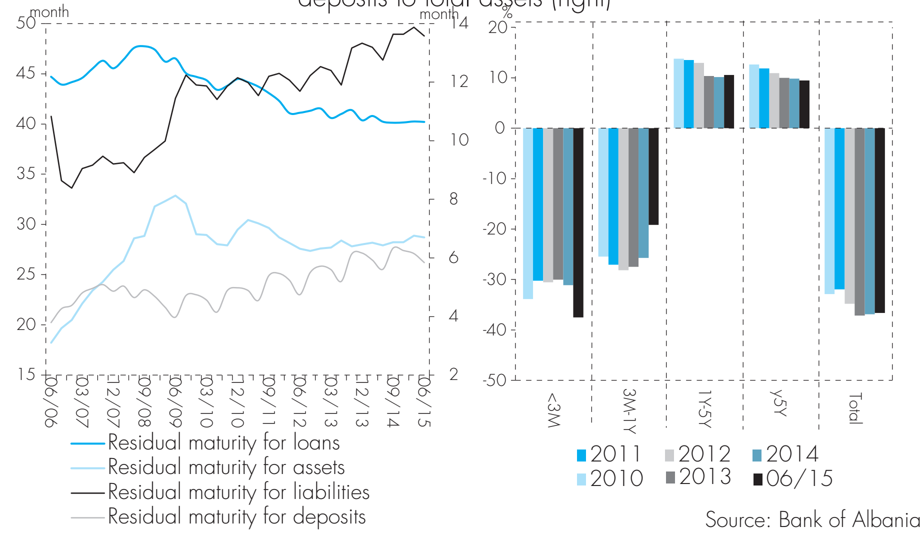


Source: Bank of Albania.

(101) **In banks' balance sheet items, residual maturity for assets expanded by around 0.5 months, whereas this indicator for liabilities remained unchanged.** Thus, the maturity mismatch expanded to 15 months. The residual maturity of deposits, as the most representative item in liabilities, and of credits on the assets side, showed low volatility standing at 5.8 months and 40.2 months respectively (Chart 9.10, left).

(102) Although banks are operating under ample liquidity conditions, the negative gap between the residual maturity for loans and deposits against total assets is considered high, especially for short-term maturities. Public deposits continued to grow in banks, against the backdrop of low interest rates, and were accompanied with the need to accelerate the transformation of maturities towards more profitable investments. This process has its own risks, especially in the case of unfavourable movements in interest rates. The mismatch of funds volume is more problematic for the 3 months – 1 year maturities, as for shorter maturities it may be a result also of a normal behaviour of economic agents given the very low interest rates (Chart 9.10, right). The situation must be assessed also by taking into consideration that the loss loans share around 11% in the outstanding credit, on which the maturity mismatch is calculated.

Chart 9.10 Average residual maturity for assets and liabilities, loans and deposits (left); maturity mismatch between loans and deposits; outstanding credit minus deposits to total assets (right)



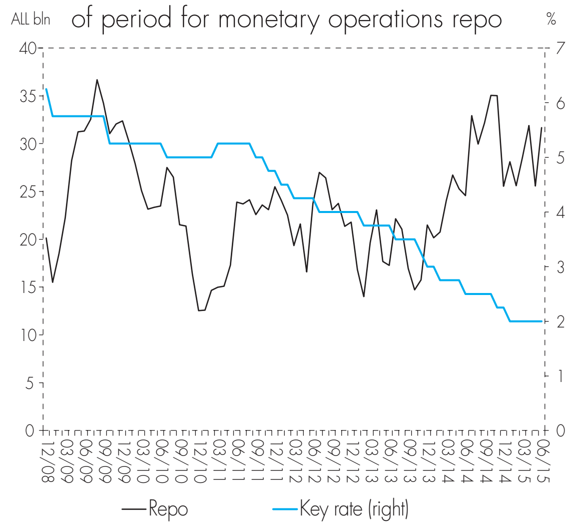
Source: Bank of Albania.

(103) The banking sector continues to be financed by client deposits and does not show dependence on financing from parent banks. At the end of the period, banks having credit facilities with parent banking groups had used 14% of these facilities, and the total of their value fell to ALL 8.8 billion, from ALL 25.6 billion at the end of 2014.

(104) Deceleration of lending, contributed to creating liquidity surplus in the banking sector, which faces obstacles for an efficient distribution among banks. Often, liquidity is concentrated and the restrictions that some banks apply in terms of exposure[39] in the interbank market hamper the efficient distribution of funds in this market. Against this backdrop, through its monetary operations, the Bank of Albania has normalised the situation and provided for business continuity in a calm and liquid situation in the system.

[39] *Also due to parent bank policies for exposures in peripheral countries.*

Chart 9.11 Situation in the balance sheet at the end of period for monetary operations repo



Source: Bank of Albania.

9.3 MARKET RISKS

(105) Banking sector is sensitive to the negative impact on the borrowers solvency, especially of businesses, the unfavourable exchange rate and the interest rate volatility. 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.

The new Capital Adequacy Regulation[40] introduces new capital requirements for the market risk. Banks shall calculate capital requirements in accordance with the conditions for the position risk and the risk of concentration in the tradable book, exchange rate risk, and positions in financial investments in commodity markets. In June 2015, risk-weighted assets for the market risk accounted for 2.4% to the total, and their contribution in terms of capital adequacy stood at 0.25 percentage point.

The activity of banks in the tradable book remains at limited levels, accounting for 2% of total assets and is concentrated in the larger banks. In the tradable portfolio, investments in Albanian government debt securities amount to ¼ of the portfolio's value.

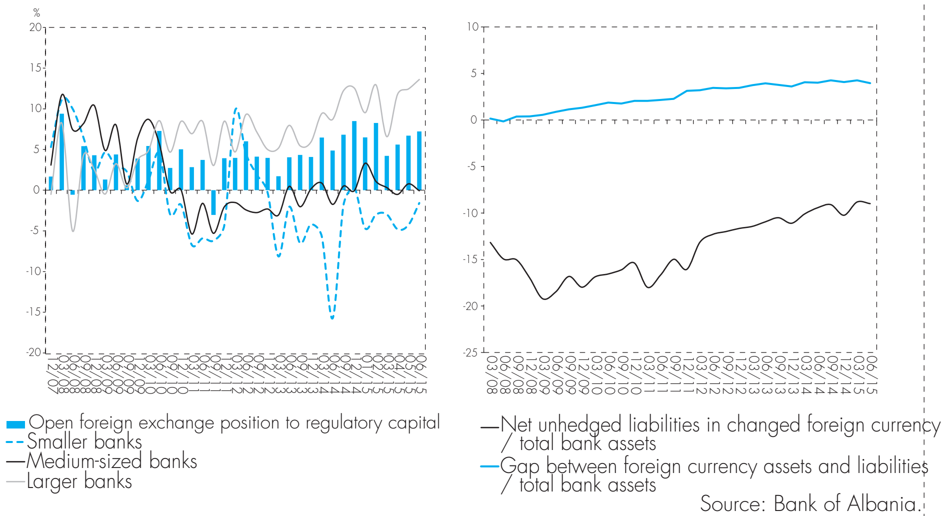
9.3.1 EXCHANGE RATE RISK

(106) The open foreign currency position to the regulatory capital shows good resilience against the depreciation of lek. The currency mismatch index shows a downward exposure to the indirect exchange rate risk. In June 2015, larger banks maintained the "long" position, at 13.6% of the regulatory capital, whereas smaller banks moved towards closing the position and, together with the medium-sized banks, maintain a "short" position, at 1.6% and 0.1% of the regulatory capital, respectively (Chart 9.10) At sector level, the "long" open foreign currency position is assessed at 7.2% of the regulatory capital.

(107) The "long" position of larger banks reflects to some extent the structure of their balance sheet and the active role in the foreign exchange market. It also provides an instrument to prevent the depreciation of the Albanian lek and/or offset the resulting negative impact on the borrowers' solvency.

40 *The new Capital Adequacy Regulation, which entered into force on 1 January 2015, included additional capital requirement for the market risk and operational risk, in accordance with the Basel II methodology.*

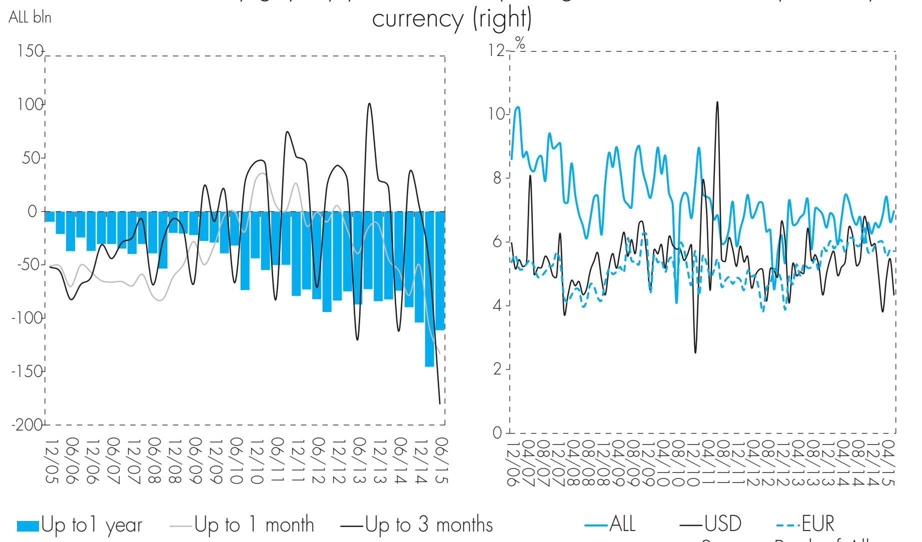
Chart 9.12 Open foreign exchange position to regulatory capital for groups by size in percentage (left) and Currency Mismatch Index (right)



Source: Bank of Albania.

(108) **Banks exposure to the exchange rate including the unhedged loans, was downward.** The Modified Currency Mismatch Index[41] improved, rising to (-8.9%) from (-10.24%) at the end of 2014 and (-9.4%) a year earlier. This performance reflects the expansion of non-resident foreign currency assets and the downward unhedged business loans.

Chart 9.13 Maturity gap by period and repricing and interest rate spread by currency (right)



Source: Bank of Albania.

[41] *The index is calculated as follows: Transformed foreign currency net unhedged liabilities/ Total assets = {[Foreign currency assets] – [Foreign currency liabilities] - [Foreign currency unhedged loans (households + firms]} / [Total assets].*

9.2.2 INTEREST RATE RISK

(109) Banking sector is exposed to interest rate volatility, as evidenced by the negative spread between interest rate-sensitive assets and liabilities[42]. During the period, cumulative spread between interest rate-sensitive assets and liabilities, respectively for maturity intervals of 1, 3 and 12 months expanded by ALL 83 billion, ALL 184 billion and ALL 7 billion. Although deposits finance over 80% of liabilities, and while the sector is characterised by low (still downward) rates (Chart 9.13 right), the presence of a wide gap in the short term dictates ongoing monitoring, given the considerable fall of interest rates in the domestic and international markets, and the possibility for their increase in the future.

(110) The size of banking sector investment in Government securities dictates that the characteristics of markets where these securities are traded, need to be improved, for a good management of respective risks. Banking sector's investments in Government debt securities, accounts for around 60% of the domestic debt, and around 25% of their asset's value. This considerable concentration exposes the parties to each-other's financial performance and sustainability. The measures to control debt levels and to expand this market with other non-banking participants will contribute to lowering this dependence. Also, the still short average debt maturity evidences the risk of the non-renewal of investment in debt securities by the investing entities. The continuing shift of Government debt securities in longer-maturities, and the continuous communication between the parties, helps mitigate this risk. On the other hand, the prolongation of the debt maturity term, if not accompanied with a proportional increase of liabilities maturity term, exposes banks to the risk of interest rate increase and encourages their hesitation to expand investments in securities. This risk would fall if the absorbing capacity of the secondary market, where these securities are traded after the issue, improved. The shift of government's borrowing to foreign currency in external market limits the banking system's exposure to the Government. Since borrowing mainly occurs with international financial institutions, and generally at low interest rates, it may affect the improving of government's debt cost and structure. Nevertheless, this borrowing exposes the government to fluctuations in lek exchange rate and highlights the need for careful planning and use of its foreign currency assets.

[42] *As at end-June 2015, the spread between rate-sensitive assets and liabilities with maturities of 1, 3 and 12 months to total assets stood at -10.1%, -13.7% and -8.5%, respectively.*

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

(111) Stress-test results reveal that the banking sector remains resilient to macroeconomic shocks. Because of the lower initial level of the capital adequacy ratio for medium-sized and larger banks, their exposure to adverse scenarios is higher. As regards the stress test for the liquidity risk, banks are estimated to have high elasticity to its shocks.

10.1 ASSESSMENT OF THE RESILIENCE TO MACROECONOMIC SHOCKS

The stress test exercise assesses the banking sector resilience and capital adequacy until the end of 2016. This 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. The exercise is conducted by applying three scenarios: baseline scenario and two adverse scenarios, moderate and severely adverse scenarios. The latter assume a "stressed" situation, but with a low probability of occurrence[44], as follows:

1. Baseline scenario

Economic growth is assumed to reach 2.6% at the end of 2015 and improve to 3.6% during 2016. As a result of the non-performing loans write off, the credit portfolio quality will improve by the end of 2016.

2. Moderate adverse scenario

Macroeconomic developments will remain the same as in the baseline scenario. The credit portfolio quality will reflect not only the cleaning of the balance sheets, but also the new flow of non-performing loans, following the trend in the past three years. On average, during 2012-2014, provisioning in the banking sector amounted to ALL 15,636.30 million. For 2015 H1, the

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

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

banking sector increased provisioning ALL 7,214.41 million. In this scenario, it is assumed that banks will continue to increase provisioning expenditures at the same pace until the end of 2015, to ALL 14,428.8 million. For 2015, it is assumed that provisioning will slow down to ALL 9,991.97 million.

3. Severely adverse scenario

This scenario supposes that the depreciation of the lek exchange rate by 20% for each year, increase of interest rates by 2.6 and 3.8 percentage points for each year and lending slowdown by 1.5% and 2.8%, respectively, results in economic growth of around 1.89% for 2015 and only 0.03% for 2016. The assumptions are reflected in the increase (deterioration) of non-performing loans ratio by 6.4 percentage points at the end of 2015 and 10.2 percentage points at the end of 2016, compared with the baseline scenario. This scenario, following credit quality deterioration, assumes shocks in terms of the market risk and operational risk, as follows:

3.a Interest rate risk- the impact of volatility on the value of instruments included in the banking book, relies on the gap in the value of asset and liability items in the bank's balance sheet (interest earning), and analyses the relevant monetary flows that result from an overall increase in interest rates. Changes in the interest rate will reflect macroeconomic scenarios for both years. Maturity gaps are recalculated for each period assuming that all interest-earning assets and liabilities are expanded with the growth rate of assets and liabilities, adjusted by the losses of each year.

3.b Market risk- is added recently in the structure of the stress test, in the framework of the entry into force of the new Capital Adequacy Regulation. This risk includes some shocks to the capital:

1. Exchange rate risk, which is based on shocks of the exchange rate on open foreign currency positions.
2. Securities repricing risk, which assesses potential loss due to changes in the value of the securities portfolio, applied in the form of haircut. The securities portfolio includes domestic public debt securities, foreign sovereign debt securities, and commercial (private) debt securities. Losses arising from the securities repricing are reflected at the same size in the regulatory capital.
3. Deterioration of the portfolio quality for the market risk. In this case, it is assumed that the Risk Weighted Assets (RWA) will increase due to the assumption for the deterioration of the classification of assets by 10% each year.

3.c Operational risk- in the moderate adverse scenario, RWA for the operational risk increased by 10% each year.

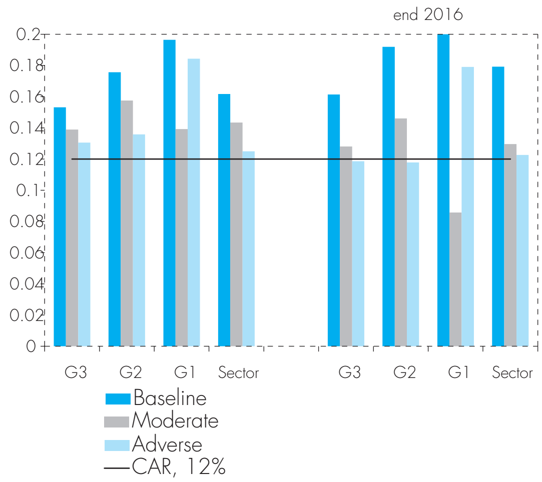
Chart 10.1 Macroeconomic assumptions for baseline and adverse scenarios

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

Results in terms of capital adequacy for the three scenario are presented in the following chart.

In the baseline scenario, the credit quality improvement following the write off of non-performing loans from bank balance sheets, results in an improved capital adequacy ratio, up to 17.7% at the end of 2016. In the case of the moderate adverse scenario, the new flow of non-performing loans increases expenditures for provisioning thus eroding the financial result. As at end 2016, the capital adequacy ratio falls to 12.95%. In the case of the severely adverse scenario, increase in interest rates, securities repricing and credit quality deterioration result in loss for the banking sector. The open foreign currency position, however, mitigates the effect of the exchange rate depreciation. At the end of 2015, the capital adequacy ratio falls to 12.33%, whereas at the end of 2016 it falls to 11.9%.

Chart 10.2 Capital adequacy ratio, by scenario



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

By bank, in the moderate adverse scenario, four banks that account for 17% of the sector's assets, show undercapitalisation at the end of 2015. For the second year, five banks, accounting for 23% of the sector's assets, show undercapitalisation. In the case of the severely adverse scenario, three banks that account for 23% of the sector's assets show undercapitalisation at the end of 2015. At the end of 2016, five banks, accounting for 45% of the sector's assets, show undercapitalisation.

Based on the above information, the need for additional capital ranges ALL 1.3 - 10.1 billion. To place these values in the context of previous developments, we point out that during 2015 H1 the banking sector has increased the capital by ALL 5.2 billion, against ALL 0.14 billion it injected in 2014 H1.

10.2 LIQUIDITY STRESS TEST

The purpose of the liquidity stress test is to assess the capability of banks to settle their liabilities, only through the assets they administer (without outside liquidity assistance/support). The analysis is built based on the liquidity structure of the sector in March 2015. The data are taken from the individual bank data, for granular money flows generated by assets and liabilities classified by maturity structure. The various scenarios assume some shocks from the unexpected deposit withdrawal due to the sudden loss of depositor's confidence and assess the adequacy of liquid assets available for financing them. In concrete terms:

(i) The exercise assumes that banks will cover the pronounced withdrawal of deposits by selling only liquid assets;
(ii) Sale of investments in securities is done through a haircut of their value by 10% and 20%.
(iii) Each of the banks is considered as failing the stress test exercise only if liquid assets shrink to the level when additional liquidity is needed by the Bank of Albania in the form of "loan for liquidity".

The exercise results show that the banking sector successfully passes the liquidity stress test. For each of the banks, in the short term:

- there are no cases of a negative liquidity gap (when liabilities exceed assets), in the national currency;
- there are no cases of a negative liquidity gap in euro;
- there is one case of a negative liquidity gap in the US dollar, but the value is rather limited and it is easily covered by the ample liquidity surplus in other currencies.

In conclusion, it is assessed that banks are highly resilient to liquidity shocks. However, the low diversification in liquidity reserves, which consist mostly in government debt securities, reveals the need for deepening and increasing liquidity for these instruments.

ANNEX FINANCIAL SOUNDNESS RATIOS

In per cent	2007	2008	2009	2010	2011	2012	2013	2014	06/2015
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	15.98
Core capital to risk-weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79	13.64
Shareholders' equity to total assets	7.62	8.57	9.57	9.40	8.69	8.57	8.37	8.58	9.09
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	30.82
Gross non-performing loans to loans outstanding	3.36	6.64	10.48	13.96	18.77	22.49	23.49	22.80	20.94
Profitability									
Return on Equity (RoE, annual basis)	20.74	11.35	4.58	7.58	0.76	3.78	6.43	10.53	14.20
Return on Assets (RoA, annual basis)	1.57	0.91	0.42	0.72	0.07	0.33	0.54	0.89	1.27
Net open foreign position to capital									
Net open foreign position to regulatory capita	1.69	4.30	3.89	5.03	3.94	3.98	4.08	8.49	7.23
Net open foreign position to core capita	1.80	4.54	4.12	5.33	4.29	4.41	4.92	10.37	8.47
Asset-based ratios									
Liquid assets to total assets	49.77	42.83	27.65	25.95	26.53	29.37	27.64	31.94	32.64
Liquid assets to total short-term liabilities (up to one year)	73.96	64.86	32.58	30.62	33.15	36.71	34.71	40.36	42.02
Customer deposits to total loans	215.45	162.60	154.32	166.39	163.20	171.62	180.83	180.16	180.48

Source: Bank of Albania