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FINANCIAL STABILITY REPORT
2015 H2

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

C O N T E N T S

B O X E S

T A B L E S

C H A R T S

INTRODUCTION

This is the fifteenth 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 public authorities with the possibility to identify the relevant measures for adjustments, as necessary. The Financial Stability Statement, whose half-yearly release is a legal requirement, prefaces the Report.

In producing this Report, we have used data available at the Bank of Albania, and information from other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the developments over the second half of 2015 (hereinafter, "the period"). 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 analyses the latest developments in international financial markets, and in advanced and regional economies. We have also assessed their impact on the financial system and the 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 banking sector borrowers.

The report provides a summary of stress-testing exercise results, which now reflect the regulatory changes in the calculation of capital adequacy and has included liquidity stress test scenarios.

NOTES

As at the end of December 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), American Bank of Investments (ABI)
  They account for around 6.5% 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 Bank (SGAB), Alfa Bank – Albania (ABA), Union Bank (UB), Tirana Bank (TB).
  They account for around 24.1% 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 69.3% of the sector's total assets.

As at the end of December 2015, by capital origin, the banks operating in Albania were categorised as follows:

- **Banks with foreign capital**[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; 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 84.1% of the sector's total assets.

- **Banks with Albanian capital**: Credins Bank, Union Bank, American Bank of Investments. They account for around 15.9% of the sector's total assets.

As at the end of December 2015, the National Commercial Bank had its branches network extended to Kosovo.

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

FINANCIAL STABILITY STATEMENT FOR 2015 H2

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

Economic activity expanded over the second half of 2015, driven mainly by the positive contribution of private investments and net exports. The performance of public investments and private consumption was weaker. Economic growth has not been translated in lower unemployment as yet. Fiscal policy continued its consolidating trend. Budget deficit was mainly financed through external sources.

The accommodative monetary policy was reflected in the fall of the average interest rates applied to the borrowing in the interbank market, money market, banking products and the government debt securities. Volatility of the domestic currency exchange rate was low, reflecting the developments in the international markets and the changes in the demand and supply for foreign currency in the domestic market. Both the primary market of government debt securities and the interbank market performed in line with expectations, supported by the necessary operations for liquidity management by the Bank of Albania. Worldwide, authorities continued the efforts to boost crediting and economic growth amid low interest rates and ample liquidity conditions. Nevertheless, international markets reflect instability, attributable to the sluggish economic growth in the advanced economies and the weakness in the emerging economies.

Financial system's activity in Albania was stable during the year, accounting for 101.3% of the Gross Domestic Product. Albeit the total banking sector assets expanded by 1.9%, during 2015, their share to GDP fell at 91.3%. The interbank investments sustained the expansion of the activity in the banking system. The sector's deposits rose by 2.6% in annual terms, driven by the increase in foreign currency deposits. Although businesses provided the main contribution to the increase of deposits during the period, the share of households' deposits in total deposits remains high. Households further expanded their investments in government debt securities, especially in the long-term debt. Credit dynamics was substantially impacted by the loan write-off process, estimated at around ALL 27 billion. This process mainly consisted in the foreign currency-denominated credit and in the credit to businesses. Consequently, total outstanding credit of the banking sector contracted by 1.5%, in annual terms. During the year, outstanding credit denominated in the Albanian lek increased by 2.6%, whereas that in foreign currency fell by 4%. At the end of the year, the ratio of non-performing loans to total loans dropped at 18.2%. All segments of the credit portfolio improved the quality. During the period under review, the banking sector's financial performance improved compared to the previous year, due to the control over activity costs. The largest banks provided the main contribution in the financial result of the sector.

Indices that seek to summarise different risks and to assess the systemic risk, show that they eased during the period under review, thus indicating an improvement in the stability of the financial system. Nevertheless, developments in the domestic and external economic and financial environment, point to some challenges, in particular:

a) *Banking system exposure to activity risks, such as credit and market risks remains similar to the previous periods, calling for continuous attention.* Notwithstanding the fall in non-performing loans and their improved coverage with provisions and capital, issues related to their concentration and the slowdown of lending show that the banking sector's perception for credit risk is considerable. Lending recovery, particularly in lek, is a desired feature that is better supported by the lowering of the average interest rate. Meanwhile, the contraction of foreign currency credit reflects the need for a better balance of the credit portfolio structure and the additional risks accompanying foreign currency credit. The latter remains the main channel through which unfavourable fluctuations of the exchange rate may jeopardise the solvency of borrowers and further threaten the quality of the banks' credit portfolio.
Overall, the Bank of Albania assesses that the banking industry should focus on the accurate identification as well as the timely and complete provisioning of non-performing loans. In this regard, the Bank of Albania shall intensify the supervisory activity, while maximally contributing to the inter-institutional action plan for the resolution of non-performing loans. Also, the Bank of Albania assesses that the support of lek credit products to the private sector should be appropriately provided, in order to balance the credit portfolio structure and control market risk. The support of crediting in the Albanian currency remains one of the alternatives to strengthen banks income generation amid low interest rates environment. Credit recovery will require, among others, the realisation of a more favourable structure of the financing sources of banks, regarding the extension of their term to maturity. Continuous attention should be paid to the assessment and treatment of operational risk in the banking activity, where the focus should be on the completion and perfection of the control systems.

b) *Due to the collateral execution related to NPL collection, the volume of real estate transferred to the banks' balance sheet has increased.* The inclusion of these assets in the banks' balance sheet is an indicator of the process difficulty, which does not appear to adequately stir the interest of potential buyers of these assets during the respective auction. The rise of these assets' volumes in the balance sheet of the banking sector shows, on one hand, that the functioning of the real estate market has problems and on the other hand, highlights the need for banks to invest more for the profilisation, marketing and identification of mechanisms that facilitate the finding of potential buyers and provide for the swift sale of these assets. The management over a long period of such assets is not a typical activity for commercial banks, and adds human and financial costs to their activity.

Although the current level of these assets in the balance sheet of the banking sector is affordable, the Bank of Albania considers that the authorities need to continue efforts to improve the collateral execution process, focusing on the identification and implementation of mechanisms that attract a high number of potential buyers in auctions. In general, instruments to improve the functioning of the real estate market should be found, and the legal framework for the expansion and validity of other assets securing bank credit must be improved. Banks should steadily continue the efforts for the sale of these assets and undertake the necessary measures to establish the internal infrastructures that help this process. As long as these assets are in the balance sheet of the banking sector, banks should value them regularly according to the respective standards and provision against the possible movements in the value of these assets. Because the management of these portfolios is not a proper activity of a commercial banks, banks should assess continuously the need and the benefit of transferring this process to more specialised non-bank financial institutions in accordance with all forms stipulated in the legal framework. The Bank of Albania shall support this process based on the bank analysis on a case by case basis, and within its legal responsibilities.

c) *The overall fall of interest rates in the domestic market will increase the pressure on the financial performance of the banking sector and of the financial institutions, in general.* So far, the fall in the return rates from banks' investments (in the asset side) is offset by the fall, to a large extent, in operational expenses, related mainly to interest ones (in the liabilities side). Nevertheless, the space for the further decrease of the latter is considerably limited and in the event the fall in the average return rate from investments continues, the net interest margin for the banking sector will decrease, and negatively affect the net financial result. The possible fall of the financial result weakens the banks' ability to support their activity with own sources, thus increasing the burden to shareholders for raising bank capital.

Although this is not an immediate process, the Bank of Albania assesses that in their development strategies banks should include using the profit made in 2015 mainly to bolster their capital position. They should also accelerate the operations to boost lending at home, when the return rate and risk are at acceptable levels.

d) *The international economic and financial developments remain unstable.* Notwithstanding measures taken by the central banks and other authorities, the euro area economy remains considerably below its growth potential, lending is weak and the cleaning of banks' balance sheets is still unconsolidated. Thus, the restructuring of the activity of European banking groups, aiming to strengthen the capital position and focus in high return markets or products, is expected to continue. In practice, this process will include operations to alter their network in various countries, cease certain activities that have a relatively high cost, and merge to establish synergies that ensure a more efficient market activity. During the first years of the global financial crisis, these processes affected Albania, mainly regarding the withdrawal of some banks from specific activities. Actually, the degree and form by which this process can affect the region or our country, in the future, remains unclear.

Due to the fact that the concrete information on these issues is rather scarce, the Bank of Albania will attentively monitor the situation to identify how our banking sector and financial system may be affected by these developments. The Bank of Albania shall strengthen the cooperation with the central banks and supervisory authorities in the region and in the euro area, for sharing information and undertaking harmonised actions. In Albania, there will be a continuous communication with banking industry and other public authorities, to undertake all the necessary measures that safeguard the stability of our financial system.

Overall, the Bank of Albania assesses that the financial situation and stability of banking sector are good. The withstanding capacities against different shocks remain resilient, during the period under review, as both capitalisation and liquidity indicators are at good levels. Nevertheless, the present risks suggest for the positive financial result of 2015 to be used for their further strengthening. Stress-tests also confirm the good situation of the banking sector and its resilience against assumed shocks, according to the macroeconomic scenarios and various risks to the liquidity situation.

In the following chapters, the Financial Stability Report analyses in greater detail the macroeconomic environment in which the banking activity operates, and the main financial indicators of the banking sector for the second half of 2015.

1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

(1) Overall, risks to financial stability were downward, compared to the end of 2014. All components in the banking activity, as well as the "Government" item in the real economy, improved.

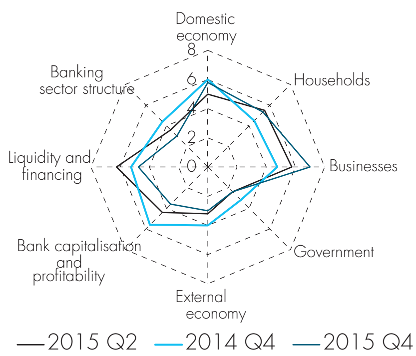
Compared to December 2014, for the real economy components, we note:

- For "domestic economy", risk is assessed as "moderate" and trending down, attributable to the performance of the exchange rate and the needs for external financing.
- For "households", risk is assessed as "average" and upward. The non-positive developments in the "housing market" and "remittances" contributed to this risk score.
- For "businesses", risk is assessed as "moderate" and upward, given the contraction in "business borrowing", the fall in the "production volume index" and the " private sector expectations"
- For "government", risk is assessed as "low" and trending down, mainly supported by the fall in the "budget deficit".
- Risk arising from the "external economic environment" was down. This risk is assessed as "low", compared to the assessment ("average") at the end of 2014. The growth of the Gross Domestic Product 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 contributing most to this risk reduction.

Compared to end-2014, for the banking sector components, we note:

- For "capitalisation and profitability", risk is assessed as "average" and downward. The good performance in the shareholders' equity and in net interest income, in addition to the increasing and improved loan portfolio quality, contributed to the fall in this risk.
- For "liquidity and financing", risk is assessed as "average" and slightly down, attributable to the fall in the reliance on financing from non-residents.
- For "banking sector structure", risk fell at "low" rate, following the diversification in financing funds of banking sector and the diversification of lending to businesses.

Chart 1.1 Financial Stability Map*

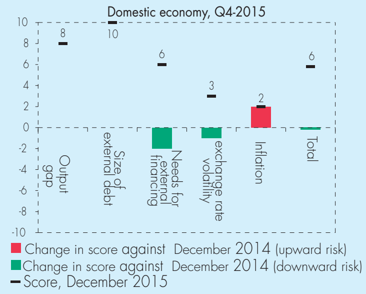


*This map assesses the exposure of financial system to risks stemming from the domestic and external economy, economic agents and the banking sector.
Risk is rated: low for scores 0-3 in the map, average for scores 4-5, moderate for scores 6-8, and high for scores 9-10. The farther from the centre, the higher the risk is.
Source: Bank of Albania.

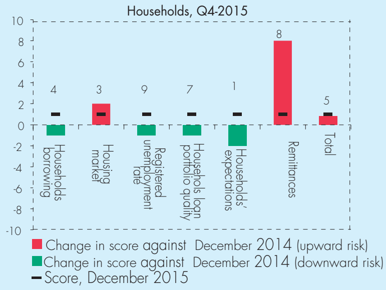
Box 1.1 shows the Financial Stability Map components over 2015, the score for each risk level and the comparison with the scores for 2014

BOX 1.1 FSM COMPONENTS

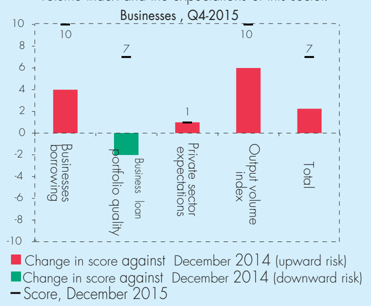
Risk from "domestic economy" is assessed as moderate and trending downward, attributable to the performance of the exchange rate and the needs for external financing.



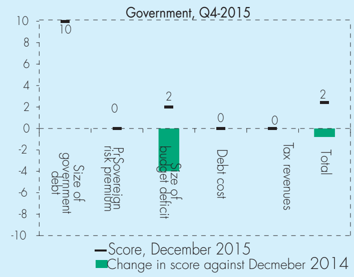
Risk for "households" is assessed as "average" and upward, due to the developments in the housing market and in remittances.



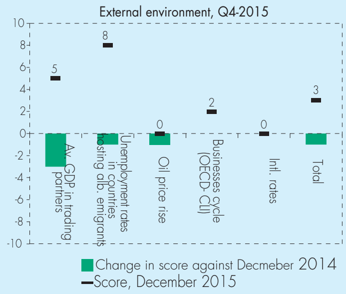
Risk to "businesses", is rated as moderate attributable to the contraction of private sector's borrowing, fall in the production volume index and the expectations of this sector.



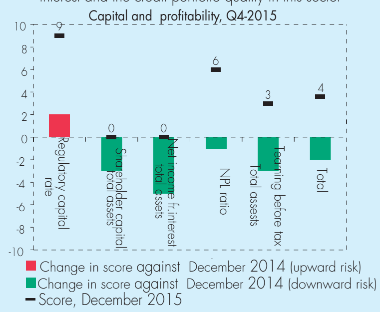
Risk from "Government" rated as low, given the reduction of t the size of the budget deficit.



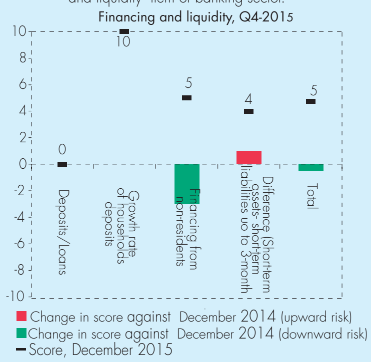
Risk from "external environment" reduced attributable to the improved economic indicators in trading partners and the fall in oil price.



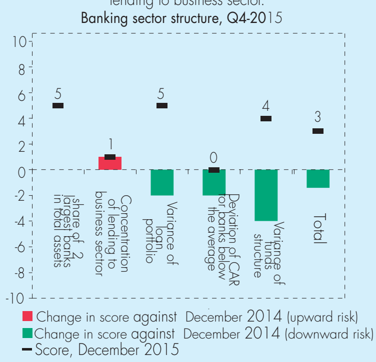
Risk from "capital and profitability" rated as downward due to positive developments in shareholders' equity, net income from interest and the credit portfolio quality in this sector



The fall in the dependence of financing from non-residents provided the keeping of the same risk rate for the "financing and liquidity" item of banking sector.



Risk related to the "structure of banking sector" fell given the increase in the diversification of its financing funds in lending to business sector.



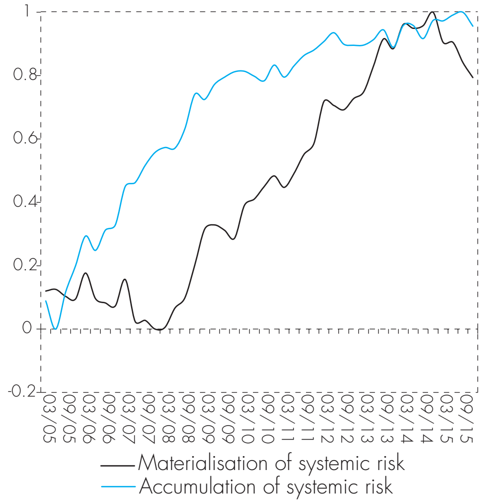
Source: Bank of Albania.

1.1 SYSTEMIC RISK

(2) **During 2015, the accumulation of the systemic risk[2] arising from factors relating to the banking sector and the real economy fell by reflecting the positive developments in both the housing market and in public debt.** At the same time, the contraction of foreign currency credit has mitigated the accumulation of systemic risk.

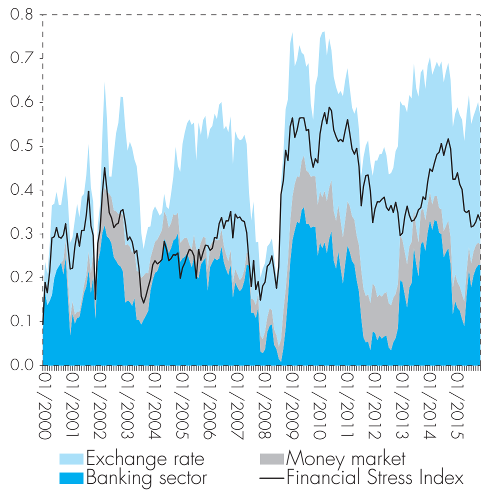
(3) **Against this backdrop, the materialisation of the systemic risk fell compared to the previous year, reflecting the improvement of credit quality for businesses and households, attributable to the written off loans from balance sheets and the reduction of exposure to exchange rate risk (see Chart 1.2).** During the period under review, financial stress is assessed as downward, mainly due to the exchange rate stability and the normal functioning of the money market (see Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk



Source: Financial Stability Department.

Chart1.3 Financial Stress Index

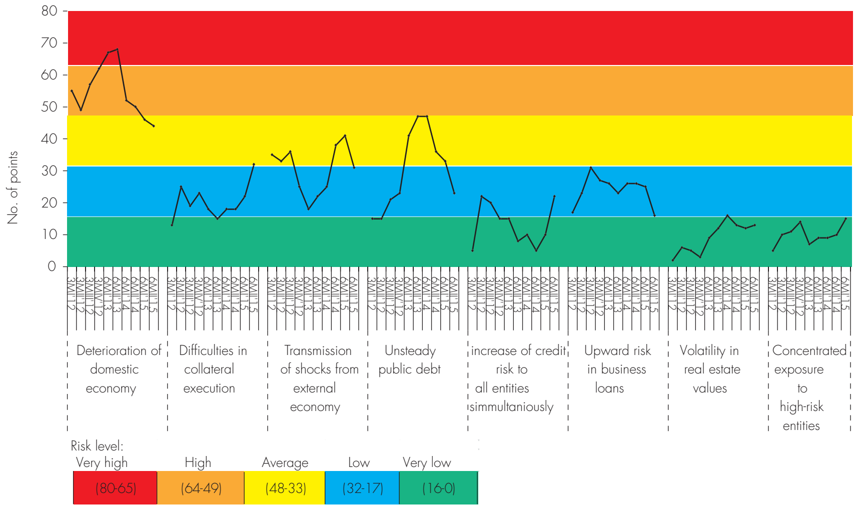


Source: Financial Stability Department.

(4) **Banks identify the same risks to their activity as in previous periods, albeit the perception on the exposure to these risks and the probability of occurrence are rated as downward.** The "worsening of the domestic economy" remains the most significant systemic risk, according to the perception of the banking sector for this risk, which continued to be mitigated, remaining at "average" level. Banks' attention to the risk arising from the "difficulties in the execution of collaterals" was up, given the considerable share of collaterized loan. In contrast to the last two years' trend, the risk from "shocks from the external economy" was mitigated, mainly affected by the stabilisation of the financial situation in Greece, after the signing of the agreement with the international creditors, in the summer of 2015.

2 *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 1.4 Bank assessment of main systemic risks



Source: Financial Stability Department.

Banks' perception on the probability of the systemic risk materialisation in the short term (up to 12 months) and long term (1-3 years) was down and below the "average" level, in 2015 H2. To mitigate systemic risk in the short run, banks continue to rely on strengthening the internal controls and reducing specific exposures; in the medium run, they focus on the orientation toward strategic sectors and the increase of diversification.

After the overview of risks to the financial stability in Albania, following are presented in greater detail the developments in the global and domestic economy, and in the financial system, especially in the banking sector.

2. INTERNATIONAL DEVELOPMENTS

(5) **The global economic activity recovered slowly and varied across countries and regions.** The better economic growth in advanced economies was somewhat offset from the weak economic activity in emerging economies, due to the decline in oil prices, the tightening of financing standards and the increase of geopolitical tensions. Global trade rebounded after the pronounced fall in 2015 H1, while global inflationary pressures remained low. Conditions in financial markets were volatile, particularly affected by the economic developments in China and the expectations for monetary policy tightening in the US.

(6) **Economic activity increased at a slow pace in advanced economies, while the performance of emerging economies was weak and varied across countries.** Overall, inflationary pressures remained weak. The pace of economic growth in advanced economies continued to improve gradually and steadily over 2015 H2, supported by the low oil prices, the strengthened domestic demand and the completed consolidating processes of both public and private sectors. On the other hand, the accommodative monetary policies, particularly in Europe and Japan, continued to support the favourable conditions of liquidity in financial markets. Among advanced countries, the US economy continues to record a stable growth, albeit at a slower pace in the last quarter of year, due to the weak domestic demand and exports. On the other hand, labour market conditions improved considerably and unemployment fell to 5%. These positive developments provided the conditions for the Fed to raise the policy rate at the end of 2015, thus signalling the change of the monetary policy direction.

In emerging economies, the performance was weak due to the internal and external macro-financial imbalances, increase in geopolitical tensions and negative effect of the fall in oil prices in the producing and exporting countries. However, economic dynamics within this group were heterogeneous. The emerging economies in Europe performed better. In financial markets, economic slowdown in China drove to the tightening of financing conditions and unfavourable movement of capital. The global economic activity is expected to grow at slow rates, mainly supported by the positive performance of advanced regions[3]. On the other hand, the further deceleration of economic growth in large emerging regions, the reaction of capital markets against the USA monetary policy and of the appreciation of USD, and the escalation of geopolitical tensions in certain regions, are currently considered as the main risks to the medium-term perspective of global economy.

[3] *Global growth is estimated at 3.1% in 2015 and projected to be 3.4% in 2016, and 3.6% in 2017 (According to the latest IMF World Economic Outlook, January 2016).*

(7) **Euro area economy continued to recover gradually during 2015 H2, driven by the increase in private consumption and the improvement of financing conditions.** Real GDP in the euro area recorded a positive annual growth, mainly supported by the increase of both domestic demand and private consumption. This development reflects the improved conditions in the labour market and the positive effect of the decline in oil price. Euro area exports increased during the last months of the year, mainly reflecting the effect of euro depreciation against main currencies during the first half of year. Financial conditions in this region were very accommodative, due to the expansionary policies and the non-conventional measures implemented by the European Central Bank (ECB) in the effort to meet its inflation target by promoting growth. On the other hand, the downward oil and primary commodity prices and the weak inflationary pressures continued to subdue inflationary pressures during the second half of year. Lending dynamics improved gradually in the banking sector. The euro area bank lending survey in January 2016 showed the easing of credit standards and increase of lending to the private sector. Nevertheless, the uncompleted consolidation process of banks' balance sheets and the high rate of non-performing loans, continue to hamper credit recovery.

(8) **Regardless of the risks, euro area economy is expected to continue to grow driven by favourable financial conditions.** Domestic demand will continue to be supported by the monetary policy stance and the progress achieved from fiscal consolidation and structural reforms. The low oil prices will keep the positive impact on households and enterprises' financial situation, favouring the growth of consumption and investments. Notwithstanding the overall positive expectations, the euro area economy may be adversely affected by the unstable global economic activity, in particular in emerging economies, and the possible escalation of geopolitical tension in certain regions. Also, the considerably low inflation, amid a weak economic growth environment, remains a dangerous combination to the outlook of the euro area economy.

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

	GDP change (annual %)				Inflation (annual %)		Unemployment (annual %)		Gross Government debt (as % of GDP)	
	2015 Q3	2015 Q4	2015 exp	2016p	Sept. 15	June'15	Sept'15	Dec'15	2015 Q2	2015 Q3
USA	2.1	1.8	2.5	2.6	-0.2	-0.1	5.1	5.0	101.3	100.5
Euro area	1.6	1.5	1.5	1.7	-0.1	0.2	10.6	10.4	92.3	91.6
- Germany	1.7	1.3	1.5	1.7	-0.2	0.2	4.5	4.5	72.5	71.9
- France	1.1	1.3	1.1	1.3	0.1	0.3	10.4	10.2	97.7	97.0
- Italy	0.6	1.0	0.8	1.3	0.2	0.1	11.6	11.4	136	134.6
- Greece	-1.9	-1.9	:	:	-0.8	0.4	24.6	:	168.9	171.0

Source: European Central Bank, Bureau of Economic Analysis (BEA), IMF
P - IMF projections, January 2016.
: no available data.

BOX 2.1. MOVEMENTS IN THE MAIN POLICY RATES OF MAJOR CENTRAL BANKS

Table 2.2. Movements in the main policy rates of major central banks (June 2015- December 2015)

Institution	Type of rate	Change (in basis points)	Rate value after the change	Period of change
European Central Bank	Main Refinancing Operation	10 bp ↓	0.05%	June 2015
	Marginal Lending Facility	35 bp ↓	0.30%	June 2015
	Deposit Facility	10 bp ↓	-0.20%	June 2015
		10 bp ↓	-0.30%	December 2015
Federal Reserve	Federal Funds Rate	Unchangedr	0%-0.25%	June-December, 2015
		25 bp ↑	0.25% - 0.5%	December 2015
Bank of Eengland	Bank Rate	Unchanged	0.50%	The rate has remained unchanged since March 2009
Bank of Japan	Official Interest Rate	Unchanged	0.0%	June-December 2015
		10 bp ↓	-0.10%	January 2016
People's Bank of China	Base Interest Rate	25 bp ↓	4.85%	June 2015
		25 bp ↓	4.60%	August 2015
		25 bp ↓	4.35%	October 2015

(9) **Economic growth in Central and Eastern European (CEE) countries was stable and positive.** The economic activity in the large CEE countries was driven by the steady growth of domestic demand, and investments and the economic improvement in the euro area. Meanwhile, lending in this region remained sluggish due to the problems of assets quality and the clean-up of the non-financial private sector's balance sheets.

(10) **The increase in investment expenses and exports contributed at different extents to economic growth in Western Balkans, but private consumption and lending remain subdued.** Regional continued economies to grow positively during 2015 Q3, mainly driven by the growth in exports and in expenses for investments in some sectors of economy. External factors, such as decline in oil price and the strengthening of demand from euro area countries contributed positively to the increase of exports. On the other hand, private consumption in these countries remains sluggish, due to the difficult conditions in labour market and the unsteady confidence of consumers. Inflationary pressures are low and frequently downward, by reflecting the performance of

oil price, the weak economic growth and the stability of exchange rate. Bank lending shows recovery signs, mainly in loans to households, while loans to enterprises remained subdue. The public sector continues to be a concern to the regional countries, due to the fast increase of public debt during the last years.

Table 2.3 Selected macroeconomic indicators for Central, Eastern and South-East European countries

CESEE	GDP change (annual %)		Unemployment (% annual basis)		Sovereign debt (% of GDP)	
	T3'15	T4'15	T2'15	T3'15	T2'15	T3'15
Bulgaria	2.9	3.1	8.7	8.8	28.3	26.9
Romaniai	3.8	3.6	6.9	6.7	38.0	37.2
B&H	3.1	:	43.0	43.0	43.8	43.1
Western Balkans						
Macedonia	3.5	:	26.8	25.5	36.1	36
Kosovo	3.4*	:	:	:	11.5	12.7
Monte Negro	4.2	:	17.7	16.5	59.0	58.8
Serbia	2.2	:	17.9	16.7	72.8	73.5

Source: European Central Bank, Eurostat, European Commission, respective central banks. 2015 Q2.
:- no available data.

2.1. HIGHLIGHTS IN FINANCIAL AND PRIMARY COMMODITY MARKETS

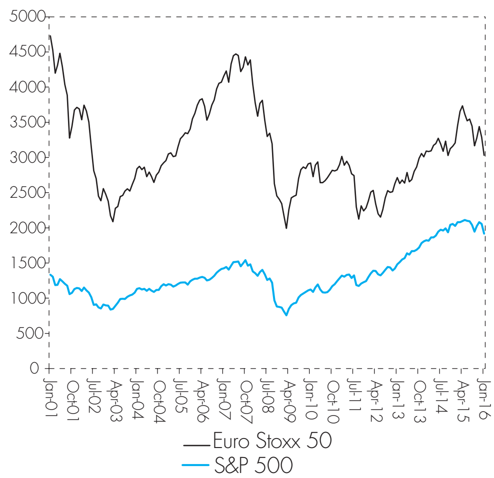
(11) During 2015 H2, global financial markets saw pronounced fluctuations. Capital and primary commodity markets in developing regions, recorded strong fluctuations and considerable losses, arising from the weakening economic growth in China and the expectations on the changes of Federal Reserve monetary policy stance. The markets performance was more stable in advanced economies. In primary commodity markets, oil prices fell, reflecting the mismatch between the weak demand and the ample supply.

(12) Global capital markets are characterised by an overall decline of prices and high fluctuation, due to the uncertainty about the global economy outlook. Summer 2015 was dominated by two episodes that drove to the increase of tensions in capital markets: first, the political and financial developments in Greece that had temporary effects and were limited to certain segments; and second, the depreciation of the Chinese currency[4] in mid -August 2015, which was followed by a pronounced fall of prices in the stock markets and heightened uncertainty for investors, at global level. Coupled with the fast fall of oil price, these developments were perceived as a signal of the global economy weakening. Therefore, capital flows shifted and financing conditions were tightened, particularly in the emerging markets. In autumn,

4 *In the middle of August 2015, the Chinese authorities changed the methodology of calculating the fixed exchange rate of the currency, which drove to the depreciation of the currency by 1.9% within the day. Global markets reacted considerably, by perceiving this movement as a weakening of Chinese economy.*

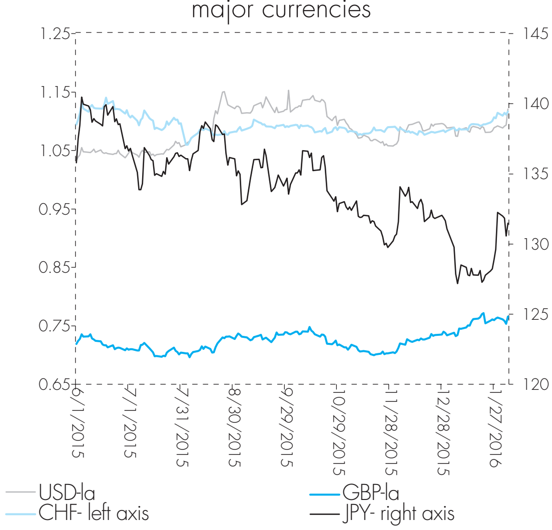
market tensions were mitigated and stock exchanges recovered somewhat, attributable to the ECB's supporting monetary measures. Nevertheless, the concerns related to economic performance in emerging economies and the direction of monetary policy in advanced economies, maintained the impact on the performance of capital markets.

Chart 2.1 Main indices in stock markets



Source: European Central Bank.

Chart 2.2 Euro exchange rate against major currencies



Source: European Central Bank.

(13) The movement of investors toward stable markets was followed by the fall of yields in public debt securities. In the euro area, the down trend of yields on public debt securities reflected the weak economic growth, the weak inflationary pressures and ample liquidity conditions. ECB's unconventional measures of quantitative easing further supported the demand for public debt securities.

(14) In foreign exchange markets, movements of currencies have reflected not only the economic outlook, but also the role that central banks are placing on the exchange rate to boost economic growth and contained inflationary pressures. During 2015 Q3, the economic slowdown in emerging economies and the exposure degree of advanced economies to this phenomenon drove to a depreciation of the US dollar and a relative appreciation of the euro. This trend changed in 2015 Q4, when the euro depreciated against the currencies of the main trading partners, mainly reflecting the ECB's quantitative easing effects, amid weak inflationary pressures in the euro area and expectations for a tightening monetary policy stance in the USA.

(15) The low oil prices worsened the financial position of exporting countries. Overall, gross oil prices have been downward during 2015 H2, in primary commodities markets, except in September and October, when these prices were somewhat stabilised. While oil demand was upward during this period, the ample supply exerted pressure on the further decline of the price.

For the medium term, market participants expect oil prices to increase slightly, owing to the adjustment of the supply against the demand level.

BOX 2.2. DEVELOPMENTS IN BANKING GROUPS OPERATING IN ALBANIA

Table 2.4 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 good capitalisation of these banking groups. The share of banks operating in Albania in total assets of the respective foreign banking groups remains low.

Table 2.4 Developments in banking groups operating in Albania

Change (%)	Raiffesen Bank International[I]	Intesa San Paolo[II]	Alpha Bank[III]	Piraeus Bank[IV]	National Bank of Greece[V]	Societe Generale[VI]
Assets[VII]	-5.8%	4.5%	-5.0%	-2.0%	2.9%	2.0%
Credit	-10.3%	3.2%	-6.8%	-7.0%	-9.1%	9.4%
Deposits	4.4%	3.0%	-26.7%	-29.0%	-15.1%	8.6%
Provisions	-27.8%	-27.6%	-	10.0%	-	15.6%
Net profit	…	…	…	-	…	27.4%
Operating income	-7.9%	1.9%	-3.9%	-1.0%	-3.0%	4.0%
Net interest income	-12.2%	-6.5%	0.6%	-4.0%	-5.1%	-
Net commission income	-4.2%	10.8%	-5.8%	-3.0%	-3.0%	-
Operating expenses	-3.6%	2.4%	-16.0%	2.0%	-0.3%	3.0%
Net operating result	-13.4%	1.4%	-	-	…	5.8%
Ratios						
Non-performing loans	11.9%	-	36.8%	39.5%	-	5.3%
Net interest margin	3.0%	-	2.7%	2.69%	2.75%	-
Capital adequacy	16.8%	13.1%	16.7%	16.6%	16.8%	10.9%
Bank' s share in Albania to the group	1.82%	0.15%	0.66%	0.62%	0.22%	0.04%

*Note: *(…) shows pronounced change of this indicator (higher than 100%), while (-) shown non-available data for this indicators in the publications of the respective bank.*

I *Annual report 2015: http://investor.rbinternational.com*
II *Financial statements for 2015: http://www.group.intesasanpaolo.com*
III *Financial results for 2015: http://www.alpha.gr*
IV *Financial results for 2015: http://www.piraeusbankgroup.com*
V *Financial results for 2015: https://www.nbg.gr*
VI *Financial information for 2015: http://www.societegenerale.com*
VII *Change from end of the previous year for balance sheet data.*

3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

(16) During 2015, economic activity in Albania expanded, but at a slower pace in the last quarter. In 2015 Q4, the economic activity grew by 2.15% in annual terms, from around 3% in 2015 Q3. During 2015, the Albanian economy accumulated a growth rate at 2.61%. By sector, economic growth is mainly driven by the positive performance of services and less by the production sector. Agriculture shrank during the period under review. Aggregate demand was mainly driven by the positive contribution of private investments and net exports, during 2015. Both private and public consumption provided a negative contribution. Economic growth in 2016 will be mostly driven by the low interest rates. Unemployment rate in 2015 Q4 was again up, at 17.7%, from 17.3% in June and 17.4% a year earlier. Expectations about employment in 2016 H1, overall, remain more positive for all sectors.

(17) The monetary policy of the Bank of Albania has maintained its accommodative trend, amid low inflationary pressures. Following the low inflationary pressures, on 4 November 2015, the Supervisory Council of the Bank of Albania reduced the policy rate by 25 basis points, (the second reduction in 2015) to 1.75%. Annual inflation stood at 2.0% in December 2015, a similar rate to that recorded in the previous quarter (1.8%), but higher than that recorded in the same period in the previous year (0.7%). Inflation at the lower bound of the targeted band of the Bank of Albania continues to reflect the spare production capacities, the low prices in international markets and the moderate inflationary pressures. Based on the above, the Bank of Albania's monetary policy will maintain the accommodative stance, supporting consumption and investments, and the return of inflation to the 3% target in the medium term.

(18) Fiscal policy maintained its consolidating trend, recording lower budget deficit and having it financed almost entirely through external sources in 2015 H2. According to the Ministry of Finance, revenues amounted to ALL 378.5 billion cumulative, recording an annual growth of 3.2%. General expenditure dropped 1.9% in annual terms, reaching ALL 430.62 billion. The decline in the value of arrears and the fall in capital expenses and (domestic) interest expenses provided the main contribution. Budget deficit stood at ALL 52.15 billion or 27.7% lower than a year earlier. Starting from July, it was entirely financed through external sources. The issue of the Eurobond in this period has changed the financing structure of the budget deficit.

(19) Net position of capital flows has fully financed the current account deficit. At the end of 2015 Q4, the current account deficit was EUR 413 million, around 8% higher in annual terms. The increase of trade deficit in goods by EUR 44 million, the increase in the negative surplus in the primary income account by EUR 3 million and the fall in the positive surplus of the secondary income account by EUR 4 million provided the main contribution to the current account deficit. Trade deficit expanded around 7%, compared with the previous year, reaching EUR 705 million. By contrast, services recorded around EUR 141 million surplus, or around EUR 21 million higher than in the same period in the previous year. Remittances stood at EUR 154 million in 2015 Q4, down 10% in annual terms. A downward trend in remittances is recorded throughout 2015. Capital inflows recorded a net positive position of EUR 493 million and provided the full financing of current deficit.

4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

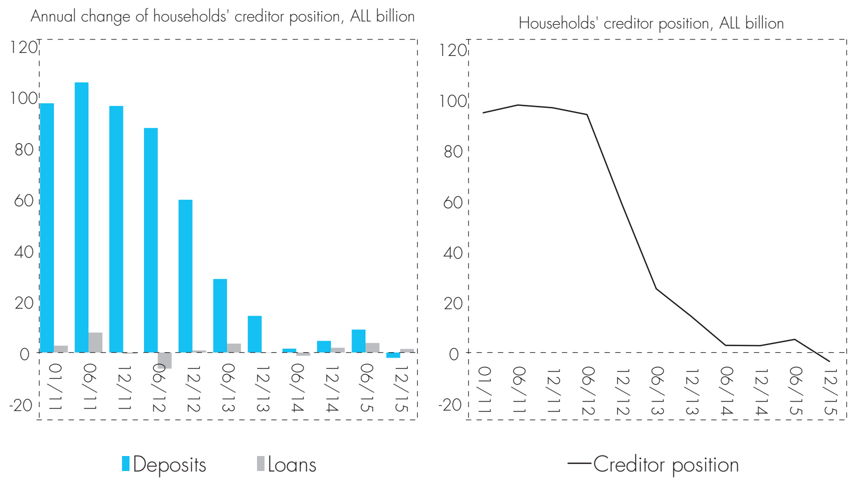
(20) During 2015 H2, households remained oriented towards savings, as shown by the expansion of deposits in the financial system. *Loans to households expanded 1% in annual terms, remaining oriented in the national currency, whose share in the outstanding loans to households stood at 52.2%. For the same period, loans to enterprises were down, mainly driven by the loss loan write offs from banks' balance sheets, mainly in foreign currency.*

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

4.1. HOUSEHOLDS

(21) During 2015, households increased further the savings, mainly in foreign currency. The resident households' creditor position[5] amounted to ALL 687.9 billion. This position narrowed in annual nominal terms, albeit it remains above the values recorded in the previous half of the year[6].

Chart 4.1 Households financial position in financial system



Source: Bank of Albania.

[5] *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; conversely, if the difference is negative, they are debtors to the system.*

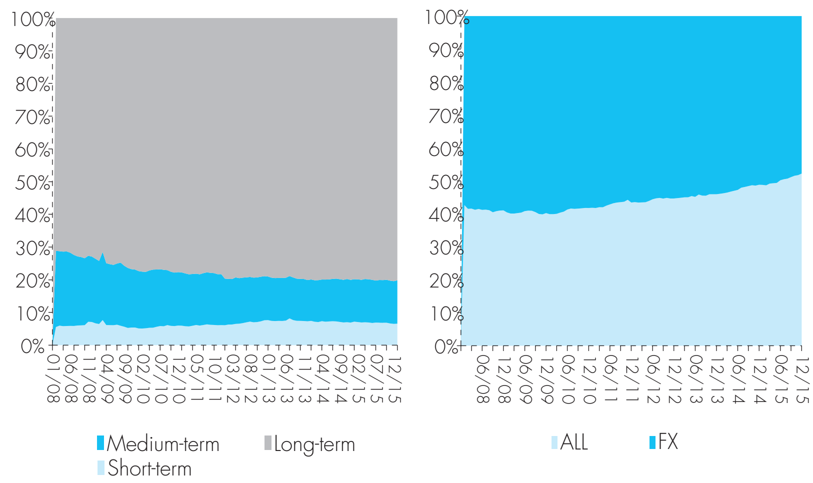
[6] *This position recorded an annual fall of ALL 3.44 billion, compared to the semi-annual growth around ALL 1.26 billion.*

By currency, resident households are creditors of ALL 342.1 billion in the national currency and ALL 345.8 billion in foreign currency. The creditor position in lek narrowed - both in annual and half-yearly terms - whereas the position in foreign currency expanded. Annual developments in foreign currency reflect a positive performance of deposits against the contracted credit; related to lek, deposits fell against the increase in credit.

4.1.1 CREDIT RISK - HOUSEHOLDS

(22) In total credit to households, the share of lek credit increased for the second consecutive six-month period. Bank loans to resident households expanded only 1% in annual terms. The expansion reflected the increase in the Albanian lek by 8.1%, whereas lending in foreign currency fell by 5.7%.

Chart 4.2 Structure of credit to households by maturity (left) and currency (right)



Source: Bank of Albania.

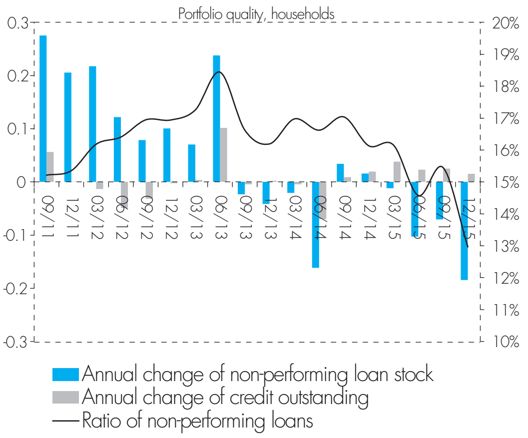
Hence, the share of lek credit rose to 52.2%, in annual terms growing 3.4 percentage points. By term to maturity, long-term credit to households' accounts for 80.2% of the portfolio, short-term credit fell at 6.6% of the portfolio, and medium-term credit accounts for 13.3% of portfolio.

(23) The loss loans write off from banks' balance sheet is accompanied by the improvement of the portfolio quality for loans to households. The outstanding non-performing loans to households dropped around 18.4%, during the previous year, attributable to the loss loans write off from banks' balance sheet. The non-performing loan ratio for households dropped at 12.96%, as at end-2015, from 14.58% in June 2015 and 16.13% in December 2014.

4.1.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

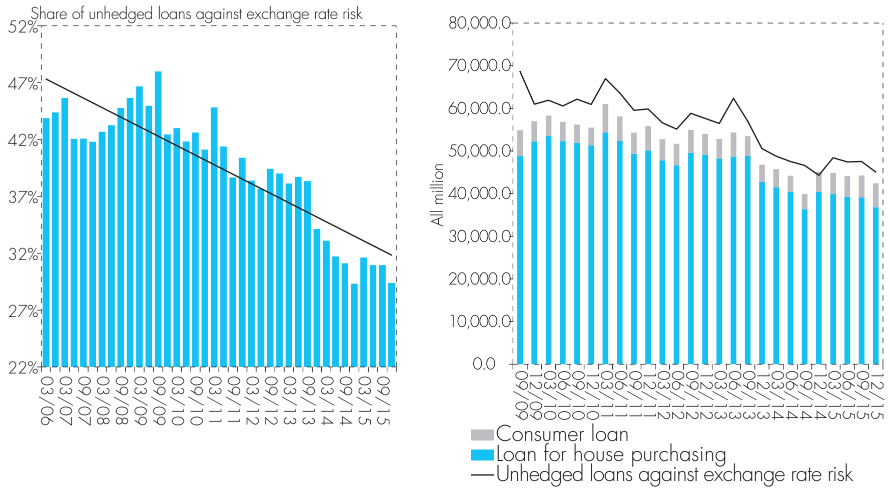
(24) **During 2015, foreign currency credit, unhedged against the exchange rate risk[7], fell in absolute value, and its quality improved.** In December 2015, the credit unhedged against the exchange rate risk stood at 29.4% of total household outstanding loans, from 31% in June 2015 and 29.3% in December 2014. Around 82% of household loans unhedged against exchange rate consisted in "House purchase loans", which was down by 9.5 percentage points during the period under review.

Chart 4.3 Households portfolio quality



Source: Bank of Albania.

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



Source: Bank of Albania.

(25) **During the period, the credit portfolio quality to households in foreign currency, overall, improved.** The ratio of non-performing loans in foreign currency fell at 15.3%, down by 4.1 and 2.4 percentage points, respectively, in annual and half-yearly terms. Also, the quality of credit unhedged against the exchange rate risk to households improved at 15.1%, from 17.8% in June 2015 and 17.5% in December 2014. The considerable fall in loans classified as "loss loans ", attributable to their write off from balance sheet, and the fall in the value of "sub-standard loans" in the balance sheet provided the main contribution to the improvement of the credit quality in foreign currency.

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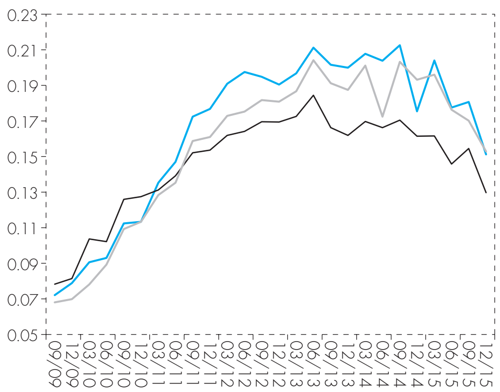
7 *When the loan is received in a currency different from that of the borrower's income; for example, when the loan is received in foreign currency and the income is mainly in lek.*

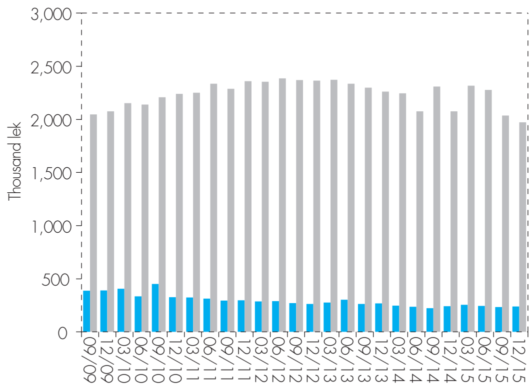
The average level of foreign currency credit for house purchase fell during 2015, standing at ALL 1.973 million.

Chart 4.5 Households credit portfolio quality



Source: Bank of Albania.

Chart 4.6 Average value of foreign currency loans

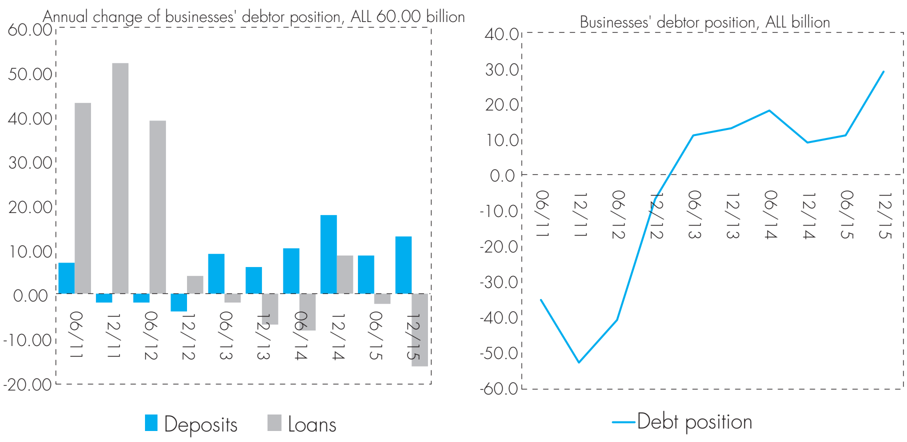


Source: Bank of Albania.

4.2. ENTERPRISES

(26) Owing to the increase in deposits and contraction of credit, particularly in foreign currency, resident enterprises narrowed considerably their debt position to the financial system[8]. The debt position amounted to ALL 237.1 billion, narrowing around ALL 18.9 billion, during the period under

Chart 4.7 Businesses' debtor position to the financial system

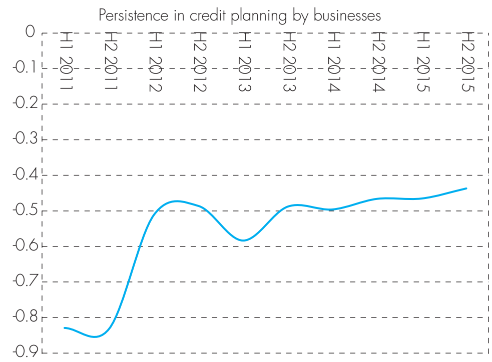


Source: Bank of Albania.

[8] *Enterprises' financial position is measured as the difference between their deposits and loans in the Albanian financial system (which includes all bank and non-bank financial institutions in Albania). When the difference is negative, enterprises are "debtors" to the system.*

review, and around ALL 29.3 billion, during the year. The annual performance mostly reflects the expansion of resident enterprises' deposits by ALL 12.9 billion, whereas the credit contracted by ALL 16.4 billion. By currency, enterprises are debtors of ALL 76.9 billion in the national currency and ALL 160.1 billion in foreign currency. Relative to the previous year, the debtor position narrowed by ALL 2.5 billion in lek, and and ALL 26.7 billion in foreign currency. This trend is reflected also in the half-yearly developments.

Chart 4.8 Persistence in credit planning by businesses



Source: Financial Stability Department.

BOX 4.1. ASSESSMENT OF PERSISTENCE IN CREDIT PLANNING BY ENTERPRISES

This box seeks to assess the persistence of credit planning by firms. Based on the survey data of the financial situation and borrowing, related to firms that have declared their intention to take a loan in the forthcoming period, their declaration is subject of verification to see whether they have succeeded to receive the loan. The data belong to 2010 H2 - 2015 H2, considering 10 periods. For each successive pair of periods, those firms which are active in replying in both samples are selected based on their unique business registration number (NUIS). For each of them, the submitted reports are surveyed for each firm in period t on the plan to receive a bank credit in the next half of year, and it is compared to the report in the period t+1, if the firm has eventually received a loan. Around 500 firms are analysed in each period.

The following table shows a matrix of possible alternatives of two questions on the planning of borrowing in period t and its realisation in the period t+1. The possible values of assessment rate from "-1" if the firm plans to borrow and does not realise it, to "1" if it does not plan to borrow, albeit it takes a loan.

Table 4.1 Summarised matrix of borrowing planning

Current / *Expectations*	The firm has received a loan in the current half of year	The firm has not received any loan in the current half of year
Plans to take a loan in the next half of year	0.5	-1
Does not plan to take a loan in the next half of year	1	-0.5

For each period, the average of coefficients' assessment is constructed according to the table, by attaining the Persistence in Credit Planning Index for the period 2011-2015.

The results show that, overall, the average indicator remains negative. In the first survey period, during 2011, the indicator is around -0.8 (close score -1), implying that firms that had planned to take a loan, have not taken it. Based on Lending Activity data, at the beginning of 2011, banks tightened lending standards tending to keep them tight till the end of the year. Related to the second period, after 2012, *overall, the indicator improved, albeit remaining negative. At the end of the period, during 2015, its value was around -0.4 (close to -0.5), implying that, overall, firms did not plan and have not taken any loan. This development reflects the presence of a weak credit demand, and the assessment for an important part of firms, that the current debt level is sufficient to conduct the activity.*

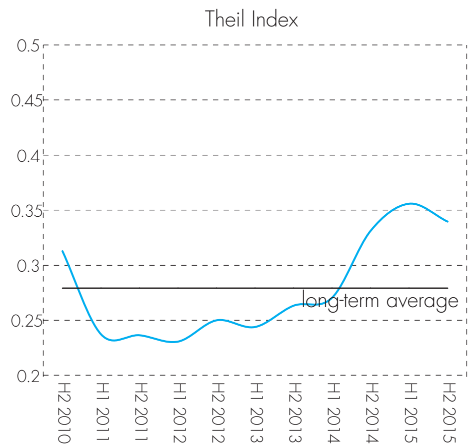
Theil Index is constructed to assess the distribution of firms answers within the period. This Index is used to measure the distribution degree of answers between the possible alternatives of borrowing, and provides information on the concentration of the firms answers in one of the provided alternatives.*

Theil index is calculated according to the following formula:

$$T_T = T_{\alpha=1} = \frac{1}{N}\sum_{i=1}^{N}\left(\frac{x_i}{\overline{x}} \cdot \ln \frac{x_i}{\overline{x}}\right)$$

Where **N** *is the number of alternatives to the question and* x_i *is the part of answers to one alternative.*

Chart 4.9 Theil Index



Source: Financial Stability Department.

Theil Index takes values from 0 to 1. The lowest value 0 implies an equal distribution of answers according to all alternatives of the question, showing a high insecurity. The highest value 1 is obtained if all firms have chosen only one alternative, thus stating the lowest possible uncertainty.

As shown in chart 4.9, the average of this index stands at 0.28, by reflecting heterogeneity in response to the presence of firms uncertainty in assessing the possibility to borrow. Overall, the index ranges close to its historical average, almost across all the timespan, in particular in the period 2014 H2 - 2015 H2, when firms expressed lower uncertainty than the historical average. These results are in line with the persistence indicator of the borrowing plan, constructed above, which improved in the same period.

** In the survey, the enterprises are asked: What is the probability your enterprise receives a bank credit in the next six month (chose one alternative)?*

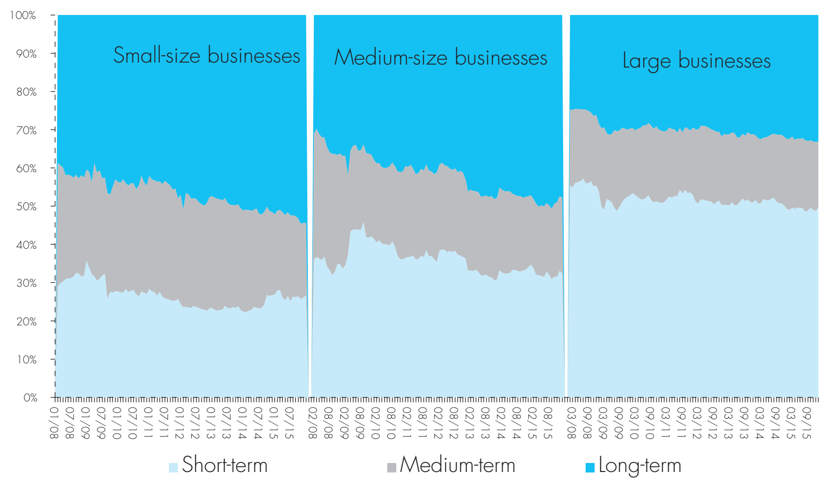
1 None
2 Little possibility
3 Strong possibility
4 It is sure.

4.2.1 CREDIT RISK TO ENTERPRISES

(27) Lending to resident enterprises fell in annual terms and half -yearly terms, by 4.2% and 1.5%, respectively. While credit in lek remained almost at the same levels compared to the previous year, the considerable fall in outstanding loan reflects the considerable contraction of credit in foreign currency driven by the loss loans write off from banks' balance sheets. The credit in foreign currency shrank by 6.6% in annual terms, while credit in lek recorded a minimum expansion only 0.3%. By size, credit to large enterprises accounted for 63.8% of credit portfolio, up by 2.1 percentage points during the year. Credit to medium-sized enterprises accounted for 17.8%, down by 1.6 percentage points during the year, and credit to small enterprises accounted for 18.4%, down by 0.5 percentage point during the same period.

(28) **Both the credit in foreign currency and short-term credit continued to dominate the structure of credit portfolio to enterprises, during the period under review.** Nevertheless, both, large and small enterprises narrowed the medium-term credit in favour of long-term credit. Meanwhile, medium-sized enterprises narrowed the short-term credit, in favour of medium-term credit. By currency, the three types of enterprises narrowed the credit in foreign currency. Lending in lek was higher to large and small enterprises, by mitigating the contraction effect of credit in foreign currency. On the other hand, credit in the domestic currency to small-sized enterprises was also down.

Chart 4.10 Structure of credit to businesses by maturity (left) and currency (right)



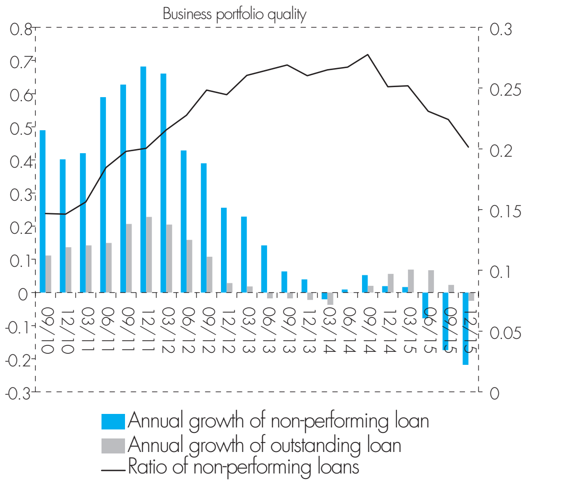
Source: Bank of Albania.

(29) **The portfolio quality of loans to enterprises improved. In December 2015, the non-performing loans ratio was 20.1%, from 23.1% in June 2015 and 25.1% in December 2014.** The fall in the outstanding non-performing loans in annual terms, around 22%, driven by the loss loans write off, provided the main contribution to this development.

4.2.2 INDIRECT CREDIT RISK TO ENTREPRISES ARISING FROM EXCHANGE RATE VOLATILITY

(30) **During 2015, the exposure of businesses to credit risk arising from the exchange rate volatility was down.** The business outstanding loans, unhedged against the exchange rate risk fell to 27% of total credit to businesses, from 27.6% in June 2015 and 31.9% at the end of 2014. Although 66% of new loans to enterprises was in foreign currency during

Chart 4.11 Business portfolio quality



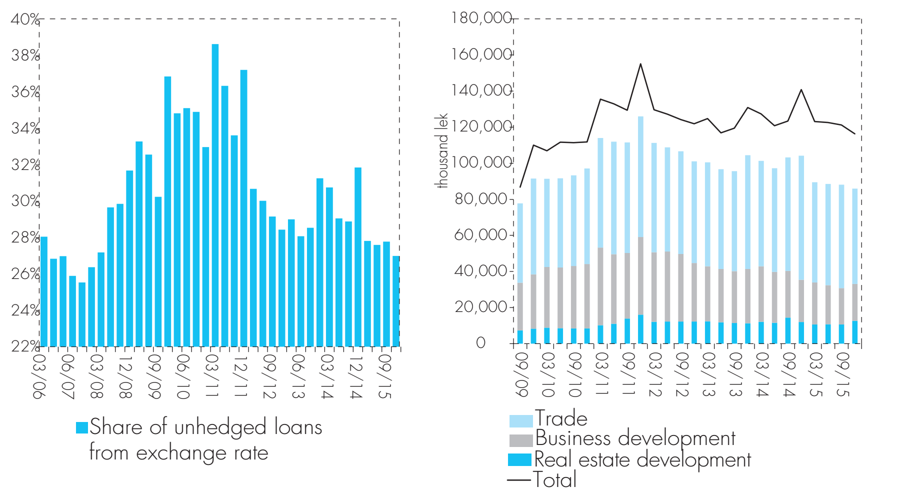
Source: Bank of Albania.

the period under review, the write off of foreign currency loss loans from the balance sheet drove the share of foreign currency loans in total loans to enterprises down to 64.6% as at end-2015, from 65.5% in December 2014.

The structure of loans to enterprises showed fall in "Commercial-related loans" to 45.4% of this portfolio, while "Business development loans" and "Real estate development loans" accounted for 17.6% and 10.9% of the portfolio, respectively.

(31) The quality of credit portfolio unhedged against exchange rate volatility improved. The ratio of non-performing loans for unhedged loans to enterprises stood at 25.5% at the end of the period, from 31.2% in June 2015, 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 31.6% from 51.8% in the previous year. Also, the ratio of non-performing loans for "Commercial-related loans" was down. This ratio was 22% in December

Chart 4.12 Business exposure to indirect credit risk arising from the exchange rate

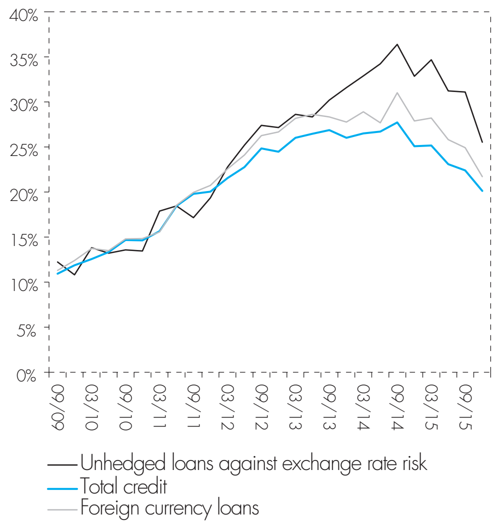


Source: Bank of Albania.

2015, from 25.3% in December 2014.

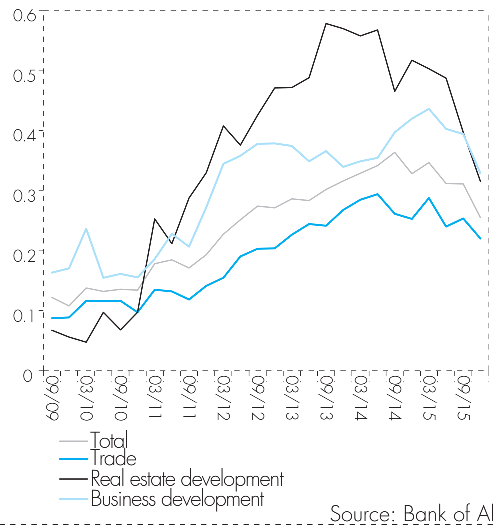
The loss loans write off provided the most considerable impact in this improvement.

Chart 4.13 Business loan quality



Source: Bank of Albania.

Chart 4.14 Quality of unhedged credit against exchange rate



Source: Bank of Albania.

BOX 4.2. SURVEY ON HOUSEHOLDS AND FIRMS FINANCIAL SITUATION AND BORROWING

For an elaborate assessment of Albanian households and firms' financial situation and borrowing, the Bank of Albania conducts, besides other analyses, a half-yearly specific survey. The latest survey was conducted in November-December 2015 and focused on developments during 2015 H2, while the expectations refer to 2016 H1.

SURVEY RESULTS OF HOUSEHOLDS' FINANCIAL SITUATION AND BORROWING

The survey is based on a sample of 1212 households across 16 districts of Albania, with 92% of respondent households answering the questions either completely or partially.

- *Financial situation*

The total number of income-earning members was up, due to the increased number of employed persons, mainly in the private sector. Broken down by income and expenditure level, the structure has shifted to the level of somewhat higher income and expenditure, returning to the levels at the end of the previous year.

- *Borrowing*

The total number of households reporting to have one or more than one loan to repay at the moment of interview, despite the type, source, or value, was 334 households or around 31% of respondents. This share is higher from 2015 H1 and the previous year. About 39% of borrowing households had borrowed from formal sources (such as banks and other non-bank financial institutions) and 61% of borrowing households had borrowed from informal sources (such as natural persons and stores), mainly in cash. The structure of outstanding loan distribution is oriented to "formal sources" 71%, and to "informal sources" 25% of outstanding loan. "Purchasing/renovating a property" (24%), "Consumption" (39%) and "Business development" (15%)

remained the three main purposes for borrowing. This distribution continues to shift to the borrowing for consumption. On the other hand, the allocation of outstanding loan by the purpose of use appears different: "purchasing/renovating a property" 40%, "business development" 38%, and consumption only 8%.

- *Household solvency*

The net balance of responses on household solvency was -27.2%, improving from the first half of year and the previous year. Of households reporting "Worsened solvency" (33% of borrowing households), 43% of cases attributed it to "lower income", while 41% to "higher living costs". Concerning the expectations for solvency in the next six months, around 77% of respondents stated they "do not expect any changes", whereas the net balance of responses for those that expect changes was 12.2%, worsening compared to the previous year.

SURVEY RESULTS OF ENTERPRISES FINANCIAL SITUATION AND BORROWING

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

Financial situation

In 2015 H2, the overall sales and financial result of enterprises improved compared to the end of 2015 H1, in all sectors. The expansion of the activity and increase in investments showed positive signals. The importance of sales as the only one source of financing was down, while enterprises were mostly supported in combining the sales with borrowing, by signalling the finding of somewhat more favourable conditions of borrowing in the financial system. The sales as the only source of financing the activity were mostly used by the enterprises operating in industry and services. Those operating in construction preferred most a combination of several sources.

Borrowing

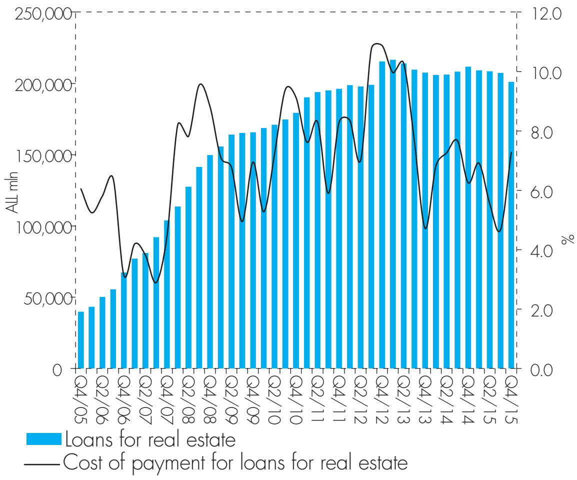
More than half of respondent enterprises (54% or 346 enterprises in total) stated that they actually had a loan to repay, up by 1.9 percentage points from the previous half of year. Around 90% of enterprises have borrowed only from banks, whereas the rest has combined alternative borrowing sources, such as "non-bank financial institutions", "borrowing from natural persons", or from "other companies". Main borrowing purposes remain the short-term expenditure and long-term investments (mainly services sectors). The share of enterprises having used the loan for short-term expenditure purposes fell in half-yearly terms. Around 44% of enterprises borrowed in the national currency, up by 2 percentage points, 45% in foreign currency and 11% combined both in the domestic currency and foreign currency. Around 18% of enterprises state they have to repay the loan within 12 months, down compared to the previous survey. The main form of loan payment remains mainly through equal amounts at monthly frequency. Most enterprises (84.1%) state they have collateralised their loan, by pledging real estate (including combined forms of collateralisation). For 91.7% of enterprises, the loan value did not exceed the firm's capital value. Around 95.3% of enterprises spend less than 50% of their income to service the loan; the share has shown a downward trend. For 2016 H1, enterprises expect a further decline in loan repayment.

- *Relations with banks*

The relation with banks continues to be considerably important, while borrowing remains somewhat difficult. Almost half of the responding enterprises (of 714 businesses) do not plan any borrowing in the next half of year. Around 78% of borrowing enterprises consider the current borrowing level as adequate for the development of the activity.

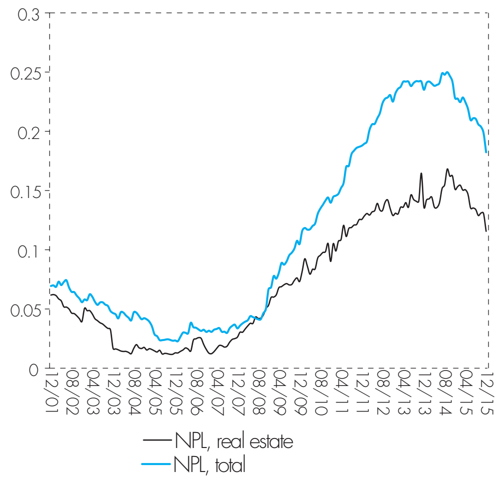
5. HOUSING MARKET

Chart 5.1 Housing market developments



Source: Bank of Albania.

Chart 5.2 Non-performing loans ratio, for real estate and in total



Source: Bank of Albania.

(32) The fall in interest rates and the eased bank lending standards, sustained the credit demand for real estate, during the period under review. During 2015 H2, the House Price Index in Tirana increased by 1.9%, from the same period in the previous year, reflecting the improved credit demand in the second part of year and the easing of lending standards. In the same period, outstanding loan for real estate purchase dropped around 3.5% from 2015 H1, and 5% from 2014 H2.

This performance reflects the written off loss loan, by around ALL 4.2 billion. The mortgage loan, adjusted to this effect, was up by 3% in annual terms.

The weighted interest rate on real estate loans was 6.8%, within the downtrend of the last years, while the relative repayment cost of real estate purchase loans was mitigated, reflecting more favourable conditions for real estate purchase from the borrower's perspective. The outstanding loan for construction contracted close to 12.7% of total loans to businesses (compared to the average value of 20% during the period 2007-2011.)

(33) The quality of real estate loan portfolio improved. The non-performing loans ratio for real estate purchase fell to 11.6% as at end-December 2015, from 13.5%, as at end-June 2015, and around 15.1% 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.

(34) Banking sector is exposed to the real estate market[9], either directly or indirectly and the sensitivity to fluctuations in real estate prices is considerable. In December 2015, 52% of loans are real estate-collaterised,

[9] *In this case, the exposure is represented by the loan for real estate or collateralised by real estate; loans to firms operating in construction; and the real estate loans portfolio that is established in banks as e result of taking the collateral following the execution of the obligation.*

or around 67.5% of loans to households and around 46.6% of loans to enterprises. Collaterised loans, which also show performance problems, account for around 10.6% 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. An ineffective collateral execution, combined with downward real estate prices, provides negative impact on the financial result of banks.

BOX 5.1. "REAL ESTATE MARKET" AND PERFORMANCE OF HOUSE PRICE INDEX, 2015 H2 SURVEY*

The questionnaire on the real estate market was conducted on October 2015. A total of 230 real estate agents and construction firms were interviewed, representing around 75-80% of the population. Some 179 entities or around 77.8% of sample responded for this period. The questionnaire provided information for the period July-December 2015 (2015 H2), and contains also the questions on the expectations for the future.

House prices

Overall, the assessment about the situation in the real estate market was negative for 2015 H2. The net balance between agents' share assessing the situation as "worse" and those assessing the situation as "better", was -36% lower than the average of net balances in the previous periods -28.7%, but in line with the first part of 2015 (-40%). In general, an increase is noted in the number of agents assessing the situation as worsened, while the number of responses for a "better situation" remains unchanged.

During 2015 H2, Fischer's House Price Index, on a national level, fell by 9.6% from the base period (year 2013), thus discontinuing the upward trend noted during the periods since the beginning of this questionnaire. Tirana provided the main contribution to this performance, reporting almost unchanged prices against the base period, compared to the increase stated in the first part of year, also from the other areas reporting lower prices.

Sales of properties

During 2015 H2, agents reported, in aggregate terms, less registered properties in real estate agencies' books, during the period under review; net balance continues to remain negative, at -7%. For commercial properties, net balance recorded positive terms, similar to the previous period (1.6% from 1.9% in 2015 H1).

Number of unsold properties is reported as downward, discontinuing the trend since the beginning of this questionnaire. For properties, the net balance was (-19.2%), from 10.5% in the previous period, or 9.4% as a long-term average. The number of unsold commercial properties shows the same trend. Notwithstanding these developments, in aggregate terms, agents assess the average time of sale in the referring period has fallen, driven by the sales in Tirana. In the coastal and other areas, the average time of properties sale is assessed as upward.

Real estate purchase financing

Agents assessed that around 70% of the sold real estate are purchased with loans, similar to the previous period. This indicator is the highest rate reported since the start of this questionnaire. In average terms, the loan-to-value ratio accounts for 51% of the house value, showing slight fluctuations since the start of the questionnaire. The results are similar regarding trading properties for both the above indicators.

Agents' expectations

In the last survey, agents were pessimistic for the short-term period for the territory they operate in. For Tirana, the expected negative expectations was (-12.4%), narrowing from (-22%) in the previous period. The relative improvement in the responses balance in total reflects the stability of responses that do not report any change, the increase of optimistic responses and the fall of pessimistic responses.

Country wide, related to the number of properties expected to be newly recorded, agents do not show important changes; net balance remains negative, at -9.3%. Around 33% of agents expect a fall of prices in the short run, (mainly referred to 2016 H1), from 24% in the previous period. These agents assess that the price will fall averagely by 3%, maintaining the same assessment as in the previous periods.

The balance of agents' opinions on the market performance in the short run, was again negative (-5%), and the percentage of those expecting stability remained almost the same, 49%. Expectations for the medium term (two years) remain optimistic. Net balance of responses stood at 28%, without significant changes from the previous period.

* Commissioned by the Bank of Albania since 2013 Q1, INSTAT conducted a survey on the performance of real estate market, till 2014 at quarterly basis. In 2015 INSTAT conducted this survey on half-yearly basis. The survey targets the real estate agencies and construction firms in some districts of the country, and collects both qualitative and quantitative information about the performance of housing market and commercial properties (excluding the land).

6. FINANCIAL MARKETS

(35) The Albanian financial markets showed a stable performance in 2015 H2, sustained by the accommodative monetary policy of the Bank of Albania. Following the reduction in the domestic borrowing of the Government, after the issue of Eurobond and the further cut of the key interest rate, the yileds on government securities fell considerably. Lek's exchange rate was steady against the US dollar, and slightly appreciated against the euro.

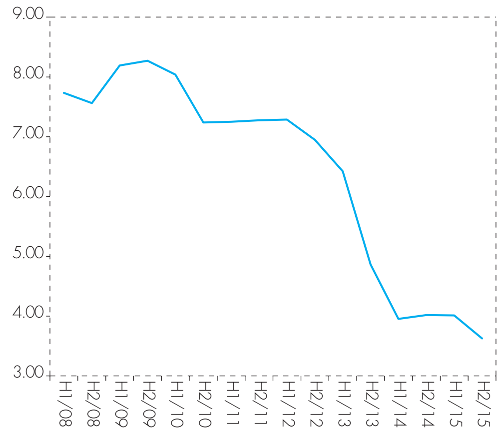
6.1. PRIMARY MARKET FOR GOVERNMENT DEBT SECURITIES

(36) Yields in the primary market auctions of government debt securities fell for all maturities, reflecting the transmission of the reduction of key interest rate by the Bank of Albania, and the changes in the demand and supply ratios. During 2015, the Bank of Albania cut the key interest rate twice, at a total value of 0.5 percentage point, down to 1.75%. In the second part of the year, the Government increased the foreign borrowing through the reissue of the Eurobond and the financing programmes with the World Bank and the International Monetary Fund. Thus, the reduction of the government demand for financing the domestic deficit drove to the change of the demand to supply ratio for borrowing, in both short and medium-term segments. For these reasons, the average interest rate of the government debt fell at 3.6% at the end of year.

(37) Despite the fall in the volume of debt issue through T-bills, the investors' interest on the later was lower.

During the period under review, the Government issued ALL 130 billion in T-bill auctions, from ALL 190 billion in 2015 H1 and ALL 155 billion in 2014 H2. Bidders' showed higher interest in auctions for the 12-month maturity T-bills, whose share in the total reached 57%. The indicators on the deepening of this market - the ratio of financing demand covering with the investment supply for different issues - show that for all three maturities, some auctions resulted with an incomplete demand for financing, reflecting a lower interest of participants due to the low yields.

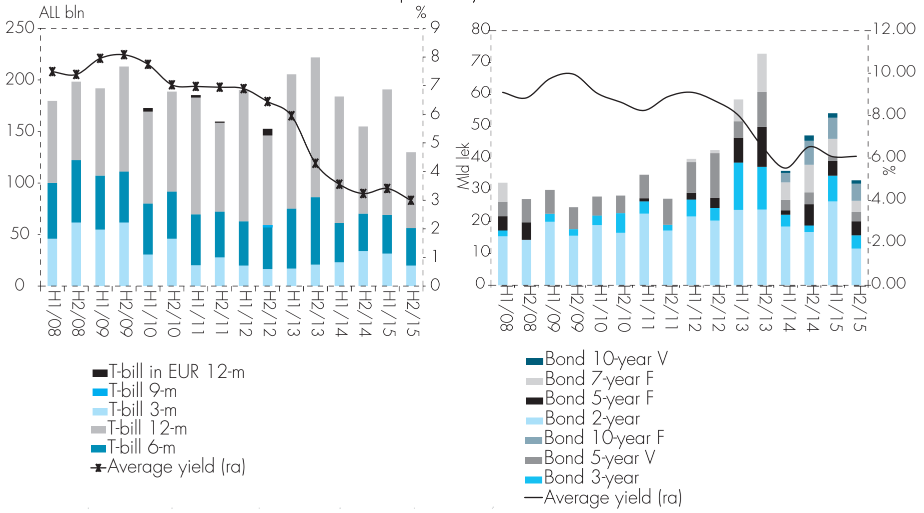
Chart 6.1 Average yield on debt securities, in per cent



Source: Bank of Albania.

At the end of the period, the average yield on treasury bills was 3%, down by 0.4 percentage points against 2015 H1, at a slight fall from end 2014.

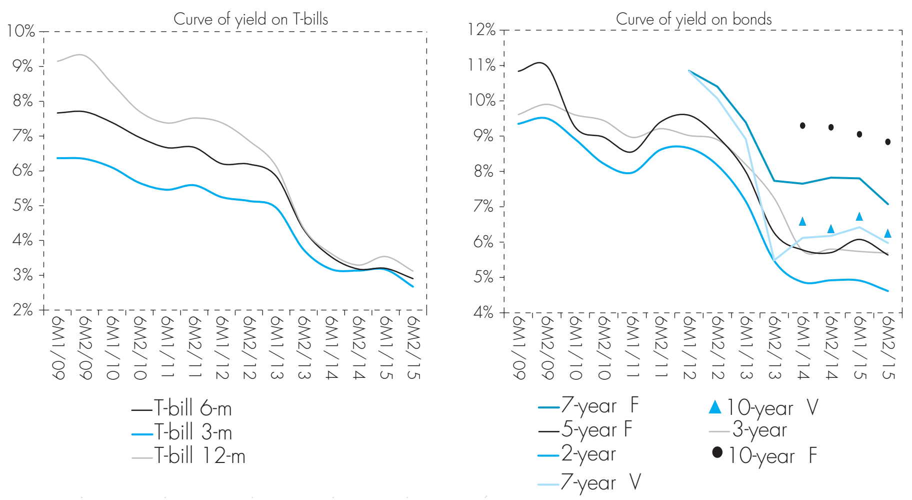
Chart 6.2 Volume and weighted average yield on T-bills (left) and bonds (right) in the primary market



Source: Bank of Albania.

(38) **Interest rate on borrowing through bonds was more stable, notwithstanding the fall in their volume.** The securities issues of government's debt in the form of bonds fell at ALL 33.6 billion, from ALL 55.9 billion in 2015 H1, mainly reflecting the reduction of bonds with 2-year maturity (ALL 15 billion). Issue of bond recorded a total fall around ALL 15 billion, from the end of 2014. Overall, the yields on bonds show slight decrease, across the majority of maturities. Nevertheless, the weighted rate of yields on bonds remained unchanged from the previous half of year, around 6.1%. The following shows the yields on Government debt securities by maturity.

Chart 6.3 Average yield on debt in the primary market



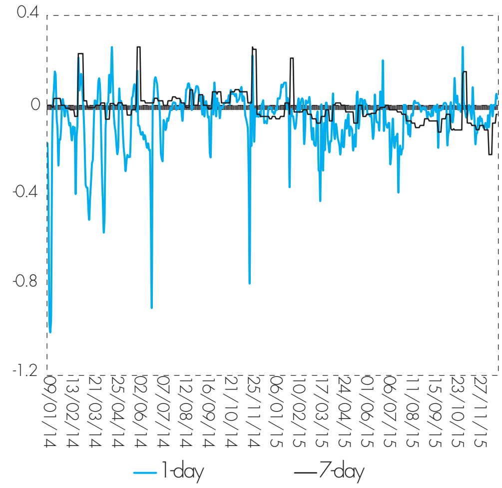
Source: Bank of Albania.

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.

6.2. INTERBANK MARKET

(39) Transactions in the interbank market reflected normal liquidity conditions and usual interbank operations. During 2015 H2, the average volume of overnight borrowing was ALL 1.9 billion a day, lower from 2015 H1 that was around ALL 2.4 billion a day, and almost unchanged from 2014 H2. The average volume of 1-week borrowing fell slightly, from ALL 5.6 billion to ALL 4.7 billion a day. At the same time, the 1-month borrowing is used less frequently and its volume is lower. Nevertheless, in 2015 H2, the average rate stood at 1.87%, from 1.97% in 2015 H1, reflecting the key rate cut in November 2015, at 1.75%. As shown in Chart 6.4, banks have traded close to the key interest rate, reflecting a stable liquidity situation in the banking market

Chart 6.4 Spread between interbank rates and the key rate, by maturity

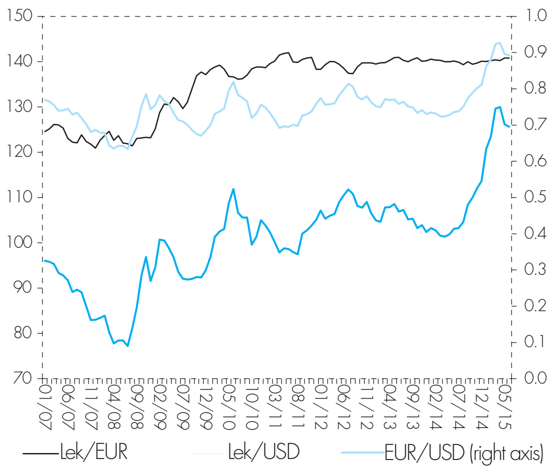


Source: Bank of Albania.

6.3. FOREIGN EXCHANGE MARKET

(40) Although the Albanian lek depreciated against the US dollar in H1, it appeared stable against the US dollar and slightly appreciated against euro, in 2015 H2. This performance reflected the exchange ratios of main foreign currencies in international markets, in particular lek's exchange rate against the US dollar and the relative dominance of foreign currency inflows in the market during the period. During 2015 H2, the exchange rate averaged for the euro ALL 139.05, and for the US dollar ALL 126.

Chart 6.5 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

6.4. PAYMENT SYSTEM DEVELOPMENTS

(41) During 2015, AIPS and AECH payment systems increased the volume of their activity. The volume of transactions processed in AIPS amounted 123,578 transactions, and the circulated liquidity totalled ALL 6,329 billion. The volume of the processed transactions in AIPS increased considerably, compared to the previous year, about 43%, meanwhile the value of the processed transactions fell by 12.7%.

Table 6.1. AIPS activity

AIPS	2014	2015
Number of transactions	86,430	123,578
Value of transactions (in ALL billion)	7,253,748	6,329,598
Average value per transaction (in ALL million)	83.93	51.22

Source: Bank of Albania.

In AECH, 466,708 payments were cleared, and the average value per transaction amounted to around ALL 180,000, during 2015. The volume of payments cleared in the AECH increased by 5.12% and their value increased slightly by 1.53%, from the previous year.

Table 6.2. AECH activity

AECH	2014	2015
Number of transactions	443,977	466,708
Value of transactions (in ALL million)	83,133.08	84,404.99
Average value per transaction (in ALL million)	0.19	0.18

Source: Bank of Albania.

(42) Banks' reports for 2015 show an increase in payments for clients, 7.8% in number, and 7.6% in value. During this period, 11.3 million payments were processed, totalling ALL 4.6 billion. Credit transfers accounted for 67.6% of total payments of clients, 81.6% of which are payments in paper form. During the recent years, paper credit transfers contracted, meanwhile non-paper credit transfers (home banking) and card payments increased.

7. FINANCIAL SYSTEM

7.1. FINANCIAL SYSTEM STRUCTURE

(43) Overall, the indicators of the financial system activity improved, during 2015 H2. The banking system closed the activity at profit and maintained strong positions in capital and liquidity. The other financial system segments expanded their activity. Electronic money and micro-credit institutions were added to the activity of the non-bank financial institutions. Saving and loans associations slowed down the activity due to the contraction in lending. Insurance companies and pension funds maintained a good pace of their activity growth. The share of non-bank financial institutions to the total financial system assets stood at 10%. Private investment funds have the highest share. A direct spillover of risks to the banking sector from other segments of the financial system remains low. On the other hand, non-bank financial segments' exposures to the banking sector are considerable.

(44) The main indicators of the financial system activity improved and the financial intermediation was stable during 2015. In December 2015, the financial intermediation in Albania, estimated as the ratio of the system assets[10] to Gross Domestic Product[11], was 101.3%. Banks continue to dominate the structure of the financial system assets, accounting for 90% of financial system assets(around 91.3% of the GDP).

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

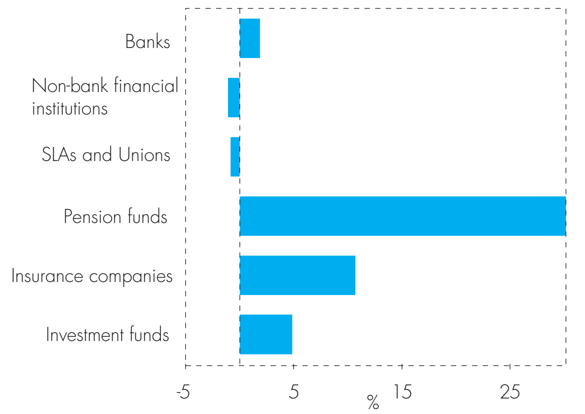
Licensing and Supervisory Authority	Financial system	2011	2012	2013	2014	2015
Bank of Albania	Banking sector	84.7	89.6	90.5	91.7	91.3
	Non-bank institutions	2.5	2.7	2.5	2.7	2.7
	SLAs and their unions	0.7	0.8	0.8	0.8	0.7
Albanian Financial Supervisory Authority	Insurance companies	1.5	1.6	1.6	1.7	1.9
	Pension funds	0.01	0.02	0.03	0.04	0.1
	Invetstment funds		1.21	3.7	4.5	4.7
Financial Intermediation		89.41	95.93	99.13	101.44	101.3

Source: Bank of Albania, FSA.

[10] *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 data on insurance belongs to 2015 Q3, whereas for the other segments, the analysis is based on the data as at 2015 Q4.*

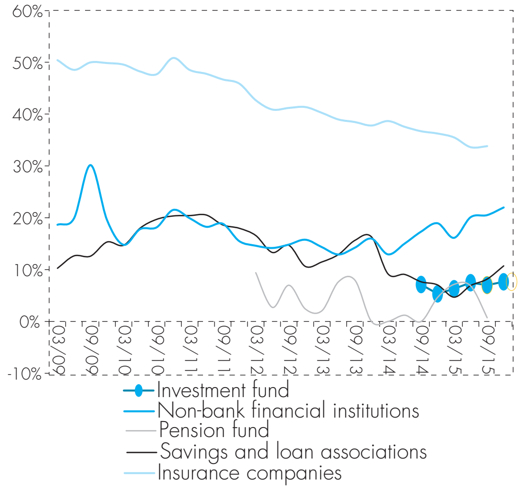
[11] *GDP is estimated at about ALL 1,443.7 billion, and refers to annual economic growth estimates, published by INSTAT and IMF.*

Chart 7.1 Annual growth of financial system components



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 7.2 Exposures (as placements) of non-banking financial institutions to the banking sector, as a ratio to their total assets



Source: Bank of Albania, Albanian Financial Supervisory Authority.

(45) **The banking sector exposure to other segments of the financial system in Albania remained low.** This exposure was mainly in the form of loans and participation in the capital of non-bank financial institutions on the assets side, and in the form of funds collected by them (various accounts) on the liabilities side. In December 2015, this exposure accounted for around 1.7% of banking sector's total assets, by limiting the direct financial risk that may spill over by the cross-sectoral interaction.

(46) **On the other hand, non-bank financial institutions' exposure to the banking sector was significant for their activity, thus highlighting the importance of the proper functioning of the banking sector for their performance.** In 2015 H2, insurance companies (ICs), savings and loan associations (SLAs) and non-bank financial institutions[12] (NBFIs) were more significantly exposed to the banking sector. Insurance companies' deposits in the banking sector accounted for around 33.8% of their assets, while SLAs and NBFIs investments' share in the banking sector amounted to 10.7% and 22%, respectively, of their assets. Exposures of other financial segments of the banking sector showed a dropping trend, a phenomenon concentrated in 2015 Q3. Chart 7.2 shows the exposure in years of the financial system segments to banking sector, calculated as the ratio of portfolio they hold with banking sector to the respective total assets.

[12] *Data for 2015 Q3.*

BOX 7.1. PERFORMANCE OF FINANCIAL SECTOR SEGMENTS

In 2015 H2, the Non-Bank Financial Institutions (NBFIs) narrowed their activity, due to the acquisition of a non-bank financial institution by a bank. Financial result was positive, capitalisation was adequate and assets' quality appears improving. Savings and loan associations (SLAs) narrowed their activity due to the contracted lending. 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, which expanded their activity, showed a positive performance.

The activity of NFBIs narrowed by 1.1% in annual terms, at ALL 39 billion. The main developments in non-bank structure related to the entry into market of an electronic money institution and two micro credit institutions and the acquisition of a non-bank institution by a bank, during 2015 H2. This change in structure drove to the narrowed lending activity around 4% in annual terms, at ALL 18.9 billion. Enterprises continued to have the main share in the credit portfolio, 92%. Trade and agriculture have the highest concentration, 27% and 12.9%, respectively. Credit risk remains the main risk to NBFIs' activity. The ratio of "non-performing loans to total loans" improved as at end-2015, standing at 12.7%, from 13.7 % at end-2014, after the narrowing in the non-performing loans stock by 11%[1]. Financial result continues to be positive, albeit lower from the previous year.

Table 7.2. Financial indicators of non-bank financial institutions

	2012	06/2013	2013	06/2014	2014	2015
Total assets (in ALL billion)	35.348	34.363	35.03	36.546	39.484	39.053
Loan portfolio (in ALL billion)	20.04	19.501	19.646	19.685	19.743	18.959
Non-performing loan ratio (in %)	8.37	14.15	13.21	15.05	13.73	12.71
Capital adequacy, in %	38.9	39.78	40.94	44.79	41.94	42.1
Profit, in ALL billion)	1.244	0.52	1.502	0.576	0.976	0.624

Source: Bank of Albania.

In the activity of Savings and Loan Associations, assets narrowed, compared to the previous year, around 0.84%. The quality of the lending portfolio improved at 8.7%, from 11% at end-December 2014. The "Provisions to non-performing loans" ratio stood at 84%. The Savings and Loan Associations closed the year 2015 at a negative financial result.

Table 7.3. Selected indicators of SLAs and their unions

	2012	06/2013	2013	06/2014	2014	06/2015	2015
Total assets (in ALL billion)	10.6	10.29	9.75	9.83	10.65	10.72	10.73
Outstanding credit (in ALL billion)	7.12	6.77	6.39	6.32	6.6	6.7	6.5
Outstanding credit/ total assets (%)	67.44	65.82	65.53	64.26	61.99	62.42	60.28
Non-performing loans/ outstanding credit	6.42	11.12	11.95	12.91	11.06	10.41	8.28
Profit (in ALL billion)	-0.04	-0.19	-0.23	-0.05	0.09	-0.02	-0.36

Source: Bank of Albania.

Insurance companies. There were12 licensed insurance companies in 2015 (8 non-life insurance companies, 3 life insurance companies and 1 reinsurance company).

During the 9-month period of 2015, insurance companies' assets expanded at ALL 27 billion, with an annual growth of 10.7%. Insurance liabilities (or technical *provisions) expanded by 21%, in annual terms, standing at ALL 3.1 billion, while total capital recorded an annual growth of 2.2%, standing at ALL 10.9 billion. Insurance companies expanded slightly their share to GDP, at 1.9%. Gross written premiums[II] - the main indicator of insurance company activity - expanded by 21.2%, y-o-y, standing at ALL 14.1 billion. The indicator of insurance penetration in the market - the ratio of premiums to GDP - was 0.97%.*

Loss indicator measured as the ratio of paid claims to gross written premiums, grew at 25.9%, from 24.4% a year earlier, attributable to the higher pace of damages compared to gross premiums. This ratio shows that around 1/4 of claims were covered by written premiums. The indicator of gross paid claims was up 28.3%, in annual terms, to ALL 3.6 billion.

Investment portfolio of the insurance sector toward low risk assets provides for maintaining a low risk level for investments. In the period under review, investments were mainly in the form of time deposits at commercial banks (about ALL 5 billion) and Albanian government treasury bills (about ALL 3.4 billion). Exposure of insurance companies to sovereign debt expanded at 12.6% of total assets.

Because of the conservative structure of insurance companies' investment portfolio, the insurance companies are less exposed to price volatility in the financial market. Exposure of insurance companies to liquidity risk is relatively low, given that their premium incomes are evenly distributed in time and claim payments are occasional.

Investment funds[III] In 2015 H2, two investment funds operated in Albania, with a net value of assets around ALL 67 billion, up by 4.8% as at end-2015. Funds list around 32,149 investors, whose major part are households, and this participation narrowed by 1.6%, in annual terms. Their investments are denominated by those in Government debt securities, accounting for 92% of total funds' assets and about 4% of GDP.

Private supplementary pensions [IV]. In 2015 H2, three voluntary private supplementary funds operated in Albania. Data analysis shows that pension funds' activity increased by 45%, compared to a year earlier - at an assets level of ALL 840.2 million. Their activity is dominated by investments in Government debt securities, about ALL 807.4 million, up around 46.1% from end-2014. The number of their members increased during the year, by 32.2%, while pension funds have a low share in the financial intermediation in Albania.

I Due to the acquisition of Credins Leasing by Credins Bank.
II AFSA, "Insurance Market Statistical Report: January - December 2015", published on 25 January 2015.
III AFSA, Market Developments Investment Funds, 31 December 2015"
IV AFSA, Statistical Report "Developments in the private supplementary pensions", 30 September 2015, published on 11 November 2015.

BOX 7.2. IMPACT OF LOW INTEREST RATES ON THE ACTIVITY OF INSURANCE COMPANIES, PENSION FUNDS AND INVESTMENT FUNDS

In the structure of insurance market assets, investments in the form of deposits in banks and in the form of Albanian Government treasury bills have a considerable share, around 46%. The liabilities in the insurance market, technical provisions to counter possible risks arising from the insurance activity, have the main share, around 48% of liabilities in September 2015, followed by the capital by 40%.

Around 89% of the established technical provisions belong to non-life activity.

The main income from insurance market activity is obtained from the gross written premiums based on the agreed contracts, mostly in non-life insurance. Income from premiums is evenly distributed in time, while payments of damages are occasional. The coverage ratio of damages of life activity results 18.4%, while non-life activity 26.5%.

- *Possible risks arising from the continuous fall of the interest rate*

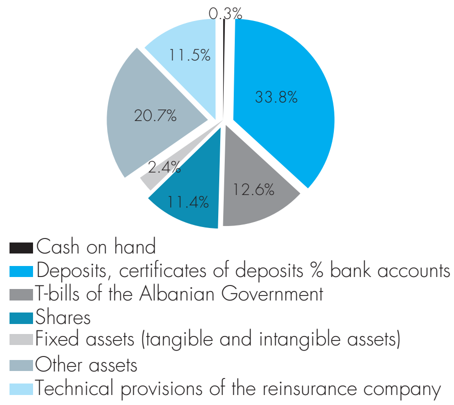
The continuous fall of the return rate of investment, affects both banking and insurance activities. Interest rate risk is an important factor to determine profitability of the insurance companies.

In theory, changes in the interest rate affect both sides of the insurance companies' balance sheet. In terms of assets, investments in Treasury bills and deposits in banks will drive to a lower return. In terms of liabilities, the fall in interest rates reduces the liabilities of companies, reducing their future liabilities to holders of insurance policies. Nevertheless, this behaviour would make the products of insurance companies less attractive, by affecting the level of insurance policies sales and consequently lower levels of premiums income.

The return rates of time deposits and treasury bills recorded a further fall during 2015. Hence, income of insurance companies appear exposed to a further reduction of the interest rate, while 34% of investments are in the form of deposits in the banking sector and 13% are in the form of treasury bills. Given that investments in Government treasury bills generate fixed income, the exposure to interest rates fluctuations is expected to be lower. Nevertheless, the short-term investments, overall, implies re-investment at lower interest rates and fall in income.

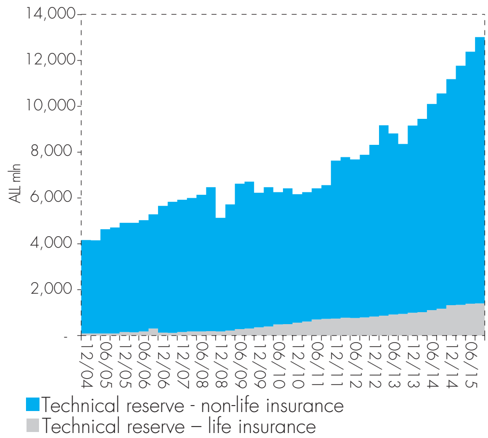
The impact of a low-interest rates environment on the activity of insurance companies depends on the structure of assets and liabilities. The insurance companies, which

Chart 7.3 Structure of assets in the insurance market



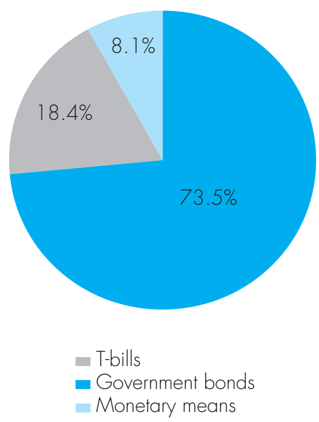
Source: Albanian Financial Supervisory Authority.
**The latest report submitted to the Bank of Albania related to the insurance companies' activity corresponds to 2015 Q3.*

Chart 7.4 Technical reserves in the insurance market



Source: Albanian Financial Supervisory Authority.
**The latest report submitted to the Bank of Albania related to the insurance companies' activity corresponds to 2015 Q3.*

Chart 7.5 Structure of investments of funds



Source: Albanian Financial Supervisory Authority.

have guaranteed payments to be performed in future, but hold a portfolio mainly consisting in short and medium-term securities of fixed income, will be more affected from the re-investment risk, compared to an insurance company which has a better duration match between assets and liabilities. Thus, the impact of the fall in interest rates is different for the life and non-life companies, due to the different structure of assets and liabilities for both sectors.

The major part of non-life insurance contracts consists in short-term ones, up to one year. On the other hand, insurance companies have long-term liabilities, which may extend for decades, and are rather sensitive to long-term interest rates (bonds), based on which they make projections on the technical provisions necessary to counter various losses. The remaining maturity of liabilities is long in time, thus it could not avoid the creation of mismatches between assets and liabilities, which need higher reserves. In an environment of low interest rates, the interest earned from existing premiums declines, thus other income sources are needed to cover the requirements for technical provisions and profit, which consist in: a) increase of technical provisions, which absolutely will corrode the capital, b) increase of premiums, or c) the combination of a) and b).

Nevertheless, due to the current structure of insurance in Albania, mainly oriented to non-life activity, income from premiums and the established reserves appears to sufficiently cover the risks arising from their activity.

Investment funds. The effect of cutting the interest rates considerably affects the activity of investment funds, given that investments in Government bonds, with a higher sensitivity to the movement of the interest rate, have the main share in the total of their investments.

The private supplementary pension funds are based on pension plans with definite contributions, meaning with no commitments for the value of pension payments in the future. Thus, the fall of the return on investments in assets, is not accompanied with the obligation to increase the investment value in order to meet the future commitments. Anyway, the fall of interest rate would drive to lower return on investments and less profits. Meanwhile, in the schemes of determined contributions, that may cause stress to meet the obligation to the employee and/or employer, as only if the employer or employee contribute more in the fund, would the level of pension profits be the same as that in case of normal performance of interest rates.

8. BANKING SECTOR

(47) Banking sector maintained its structure[13]and stability during 2015. The activity of banking system sector expanded at a slower pace than a year ago. In terms of solvency, liquidity and establishing reserve funds for respective risks, prudential indicators were at appropriate levels, in accordance with the regulatory requirements. Loan portfolio quality improved, supported by the loan loss write offs and other measures taken for the solution of non-performing loans. Exposure to market risks remains subdued, but it should be monitored and assessed regularly.

8.1 BANKING ACTIVITY

(48) During 2015 H2, the Albanian banking sector's assets expanded slightly by 0.4% at ALL 1,318 billion, accounting for about 91.3% of GDP[14]. In annual terms, the banking sector assets increased by 1.9%, from 4.8% in the previous year. Assets expanded in the form of interbank investments mainly in non-resident entities[15], during the period under review. On the other hand, the sector contracted the portfolio of investments in securities, both for non-resident entities and the government[16]. In the view of the government's strategy to reduce the domestic debt[17], banking system own holdings of government debt securities fell to 22.5% of total assets, from around 25% in 2015 H1[18]. In semi-annual terms, banking sector contracted the credit portfolio by 1.9%, reflecting the loan loss write offs from banks' balance sheets. The balance sheet was around ALL 27 billion, during 2015. If written off loans were still in the banking sector's balance sheets, outstanding credit would have increased by 2.9% during 2015.

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[13] *There are 16 banks: 3 Albanian banks (total assets stand at 15.5%) and 13 banks with foreign capital. None of the banks with foreign capital functions as a branch.*

[14] *This report is based on the estimations (INSTAT, IMF) of GDP for 2015 H2, of ALL 1,444 billion.*

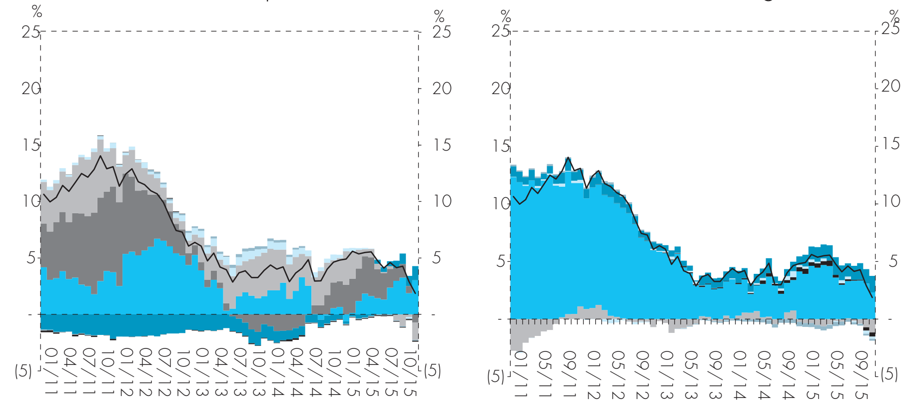
[15] *These were mainly in the form of loans and deposits. Placements in the form of loans to non-resident financial institutions are mainly concentrated in a bank. On the other hand, three banks of the sector have the highest increase of placements in the form of deposits, compared to the first half of the year. Meanwhile, the "current account with non-residents" shrank considerably in the second half of the year, down by ALL 7 billion from June 2015, and ALL 5 billion compared to the end of 2014. The combination of the above transactions drove to the expansion of "Relation with banks, credit institutions and other financial non-resident instituttions" by ALL 4.2 billion (or 2.4%) up to ALL 182 billion*

[16] *Currently this portfolio represents about 4% of total assets.*

[17] *With the issuance of the Eurobond at the end of November and during December, there have been several auctions for early purchase of securities by the Government, as well as matured securities aiming to reduce domestic debt. This resulted in a lowering of the public domestic debt.*

[18] *In 2015 H2, bank's portfolio in treasury bills shrank by ALL 19 billion whilst bank's portfolio in bonds shrank by All 6 billion.*

Chart 8.1 Annual expansion of assets and contribution to financing of assets



Source: Bank of Albania.

(49) **In December 2015, the surplus in "Customer transactions"[19] was estimated at ALL 582.2 billion, shrinking around ALL 9 billion, or 1.5% compared to a year earlier.** Lending to non-resident entities was determinant in the majority of lending activity in annual terms, but in 2015 H2 this portfolio shrank by ALL 5.4 billion or 9.1%. The credit portfolio represents approximately 44.5% of total assets of banks, being below the average of the past two years. On the other hand, improvement of the credit portfolio quality as a result of the non performing-loans write off[20] is reflected in the reduction of provisions for credit risk. During this period, the fund fell by around ALL 10 billion or 11.8%, and by ALL 16.3 billion in annual terms or 17.5%, down to ALL 75.5 billion.

(50) **The annual growth rate of bank investments in securities, consisting mainly in governments securities, slowed down in December 2015, this portfolio was estimated at ALL 296.5 billion, annually down by around ALL 28 billion or 9%, accounting for 22.5% of banking sector's assets.** The banking sector owns about 56.2% of the total domestic debt issued by the Albanian government, 0.83 percentage points lower than the end of 2014. However, credit risk stemming from this investment portfolio is low, considering that the government debt that is classified as "held to maturity" by banks is estimated to be higher than 80% of the entire portfolio. The average term of government debt is low[21].

[19] On the asset-side in the balance sheet of banks, 'Customer transactions' represents banking sector lending to residents and non-residents, excluding accrued interests.

[20] 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 second half of 2015 is about 12.8 billion. In total, around ALL 26.6 loan loss were written off from the balance sheets, during 2015.

[21] The latter exposes the Government to the non-renovation risk of debt by its holder.

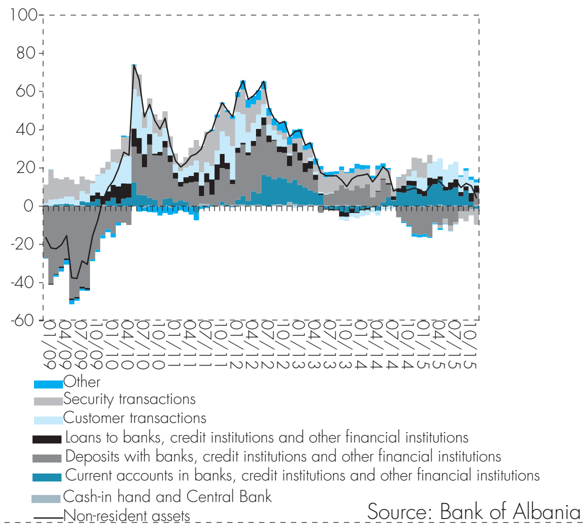
(51) Banking activity was funded mainly by deposits, which account for about 83% of total assets. Loan/deposits ratio is 53.2%. Deposits' base[22] expanded by around 2.1%, in semi-annual terms and by around 2.8% in annual terms, despite the fall of the average interest rate. Only the expansion of foreign currency deposits contributed positively to the growth of deposits. Distribution by maturity shows the shift towards the shorter term deposits. Deposits up to one year account for around 65% of total deposits, whereas current accounts around 27%. This phenomenon poses a potential weakness in terms of the structure of banking sector financing, which however is mitigated by the fact that 85% of deposits belong to households. Banks maintained the capital utilisation ratio to finance their operations, respecting the requirements for regulatory capital framework

8.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

(52) 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. During 2015, the borrowing from parent banks fell at historic levels. In December 2015, assets with non-residents accounted for 24.7% of total assets and liabilities to non-residents accounted for 6%. As a result, the net position of credit to non-residents expanded by 12.6% in annual terms, to ALL 246.6 billion. The investment in non-resident instruments is represented by investments in securities, in loans to non-resident entities, and in deposits or current accounts in financial institutions. The highest expansion of transactions with non-residents was in the form of loans and deposits at banks and financial institutions, by 49% and 27% in annual terms, respectively, up to ALL 34.2 billion and ALL 95.6 billion. Meanwhile, investment in securities of non-resident entities, which are mainly in the European Union at 44.1%, fell by 26.4% in annual terms, down to ALL 73 billion

(53) Countercyclical measures taken by the Bank of Albania, in May 2013, contributed to the mitigation of the growth pace of investments of the banking sector at non-resident entities. The annual expansion pace in non-residents slowed considerably down at 4.2% in December 2015, compared to 25% in May 2013.

Chart 8.2 Contribution to the annual growth of assets with non-residents in p.p.



Source: Bank of Albania.

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

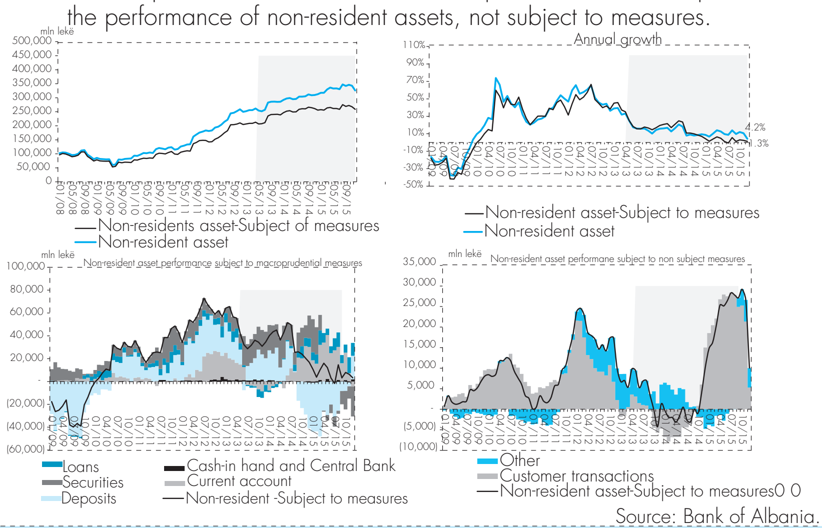
BOX 8.1. IMPACT OF MACRO-PRUDENTIAL MEASURES ON THE NON-RESIDENTS' ASSET

In May 2013, the Bank of Albania introduced a measure on the requirements for bank capital for investments in non-resident financial institutions. The purpose of this measure is to limit the increase of assets in non-resident entities for treasury and interbank operations as well as securities. Transactions, which are not part of targeted measures, include costumer transactions, other assets and fixed assets.

In May 2013, 81.2% of non-resident assets consisted of "Subject to macro-prudential measures'' assets, extending up to 86% at the end of October 2014. In December 2015, this share stood at 79.4%. These developments reflect the significant slowdown of the growth of non-resident assets, subject to the measures, extending by only 1.3% in annual terms, in December 2015. Related to non-resident assets, subject to the measures, loans to financial institutions and deposits expanded considerably, while current accounts and securities portfolio contracted.

Non-resident assets which are not subject to measures, mainly customer transactions, expanded by 17.6% in annual terms.

Chart 8.3 Developments in non-resident assets subject to measures compared with the performance of non-resident assets, not subject to measures.



Source: Bank of Albania.

(54) On the liabilities side, the use of credit lines from parent banking groups dropped to the lowest historic 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. At the end of the period, the utilized credit lines were ALL 1.7 billion, from ALL 3.3 billion in the previous year.

*BOX 8.2. 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, 53.7% of total. These placements appear 79% in Euro and14.8% in US dollars; while placements at the parent banking groups in EUR have a share of 74.6% of the total. Placements in non-residents assets continue to focus mainly in the euro area with 74.7% of the value of placements. By banking-groups, 74.3% of placements to non-residents in assets belong to G3, 19.5% to G2 and the rest of 6.2% to G1. By origin, the group of banks with Greek capital placements shared 15.8%, group of banks with Italian capital placements shared 14.7%, and the group of banks with Albanian capital placements shared 11.9%.

Liability of non-residents' placements. Liability placements are mainly in the form of time loans borrowed from the banks, of around 43.6%, and time deposits of around 41.5%. Placements on the liability side were mainly denominated in euro, 62.2% of total and 98.8% of liabilities to parent banking groups. Liabilities to euro area countries accounted for 41.5% of total non-resident placements on the liability side. The rest are placements in countries outside the European Union, with an increasing share to total. By banking groups, G3 banks account for 58.5% of liabilities to non-resident institutions; G2 banks possess 0.5% and G1 banks 41%. The major part of liabilities to non-residents consists of the Albanian group placements with 58.5% followed by the Italian one with 41%. While Greek banks continue to have obviously a very small share in liabilities to non-residents with only 0.5%.

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

8.3 CREDIT OUTSTANDING

(56) The write off process of non-performing loans from banks' balance sheets has affected the indicators of lending activity. In concrete terms, the credit outstanding, overall, contracted during the period under review and in 2015, mainly attributable to the foreign currency credit and the credit to resident businesses. The structure of credit maturity term changed slightly.

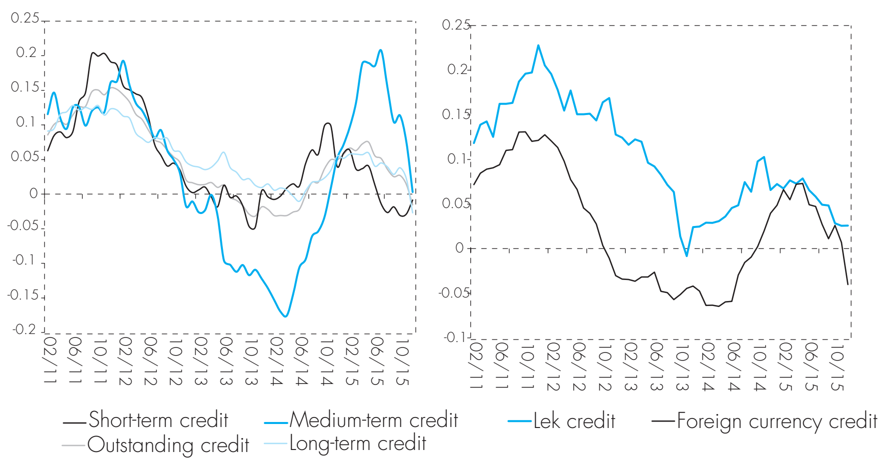
(57) The write off process of non-performing loans dictated the dynamics of credit in 2015. At the end of 2015, credit outstanding fell to ALL 586 billion, shrinking by 2% in 2015 H2 and 1.5% compared with the previous year. This performance reflects the write off process of loan loss[23]. If we avoid the effect of written-off loans from banks' balance sheets, credit outstanding of the banking sector would record an annual growth of around 2.9%. In a more general point of view, credit continues to be affected by both supply and demand-side factors, which are determined by the expectations for the economic growth, the quality of banking sector's assets and access of banks to risk, the decisions of banking groups and the effectiveness of the process of non-performing loans collection.

[23] *Starting from January 2015, banks are obliged under the regulatory requirements to undertake the process of balance sheets cleaning - the write off of loans falling under the category "lost" for more than three years. In 2015 H2, the volume of written off loans stood at ALL 12.8 billion, while the value of written off loans was around ALL 26.6 billion throughout 2015.*

(58) Bank of Albania actions supported the lending activity of banking sector. Lowering of the interest rate supported the lending in the domestic currency[24]. On the other hand, the countercyclical measures supported the lending activity of the banking sector, as shown by the effect they had on the capital adequacy ratio of the sector. Banking sector improved its capital adequacy ratio attributable to the expansion of credit outstanding within the determined interval, by 0.17 percentage points. If we include the value of written-off loans from the banking sector's balance sheet in 2015, the sector's profit in the value of capital adequacy ratio for credit growth would be 0.39 percentage points.

(59) The share of credit denominated in lek increased during the period. Credit outstanding in the domestic currency was ALL 229.6 billion at the end of the year, up by 0.3% compared to June 2015, and by 2.6% in annual terms. Adjusted for the written-off loans, annual growth rate of credit in the domestic currency would have been higher, around 4.8% or ALL 10.8 billion. At the end of 2015, credit outstanding in foreign currency stood at ALL 356.3 billion, narrowing by ALL 12.5 billion or 3.4% during the period, and by 4% in annual terms. In addition to the tendency of banks to lend in the national currency, this development reflects a more rapid written-off process of loans denominated in foreign currency. If not considering the effect of written off loans, credit in foreign currency would show an annual growth of 1.8% or ALL 6.7 billion. Because of the significant share of foreign currency loans, the exchange rate performance of the lek against the main foreign currencies, have a significant impact on the reporting of the nominal loan balance. For credit outstanding at the end of December 2015, this effect has negatively affected the reported amount of credit, for around ALL 3.3 billion. Overall, starting from the beginning of 2012, the share of foreign currency loans fell by 7.3 percentage points and currently shares 60.8% of the outstanding loan.

Chart 8.4 Annual credit growth by maturity and currency



Source: Bank of Albania.

[24] *The key rate was lowered twice during the year, down to 1.75, from 2.25% at the end of 2014.*

(60) The structure of the loan maturity has slightly changed. During the period, medium-term loan (affected by the outstanding to residents) and the long-term loan (affected by the settlement of non-resident outstanding[25]) contracted by ALL 5.9 billion (or 5.2%) and ALL 6.3 billion (or 2.2 %), respectively. Short-term loan expanded slightly by 0.1%, supported by the expansion of credit to non-residents. During 2015, the medium-term loan portfolio grew by 0.3%[26], while short-term and long-term loans contracted by 0.9% and 2.7%, respectively.

(61) The process of written off loans has mainly affected the credit to business. This credit, which accounts for about 69% of credit outstanding, narrowed by about ALL 11.8 billion or 2.9% during the period, and contracted by ALL 12.3 billion or 3% during the year. During 2015, banks have written off about ALL 21 billion of business' loans from their balance sheets. Adjusted for this effect, credit outstanding to businesses would have expanded by 2.1%, in annual terms.

Outstanding credit to resident businesses contracted by 1.4%, down to ALL 388.8 billion. Credit for "investment in real estate", which represents around 26.0% of total credit to resident business[27], declined by 5.4% during the period. Credit for "Investment for equipment purchase" extended during the period. Referring to the end of 2014, lending to resident business narrowed significantly, by ALL 16 billion or 12.4%, impacted by the written-off of non-performing loans, where around ALL 12 billion were loans to resident businesses for investments.

For non-resident business, credit outstanding narrowed by around 11.9% or ALL 6.3 billion[28], during the period. Credit to non-resident businesses expanded by around ALL 4 billion, or around 10%, during the year.

(62) Credit to households remained almost unchanged during the period, around ALL 155 billion, but increased by 2% compared to the previous year. Loan written-off process reduced the credit outstanding to households by around ALL 5.7 billion. If written-off loans were still in bank's balance sheets, the annual credit growth would have been around 5.8%. During the period, credit to resident households contracted by 0.7%, at ALL 146.1 billion, remaining around 1% higher than in the previous year. During the year, consumer credit to resident households expanded by 6.4%, while credit for real estate contracted by 1.1%. This performance is dictated by the written-off process, which led to the contraction of both, credit for real estate (mortgage) by around ALL 4.2 billion, and consumer credit by around ALL 1.1 billion. Excluding the write-offs, mortgage credit expanded by 3% y-o-y and consumer credit by 9.1%. Credit to non-resident households accounts for around 18% of credit outstanding granted to non-residents. Given the relatively low base, this credit expanded by 50% during the period and by around 60% during the year.

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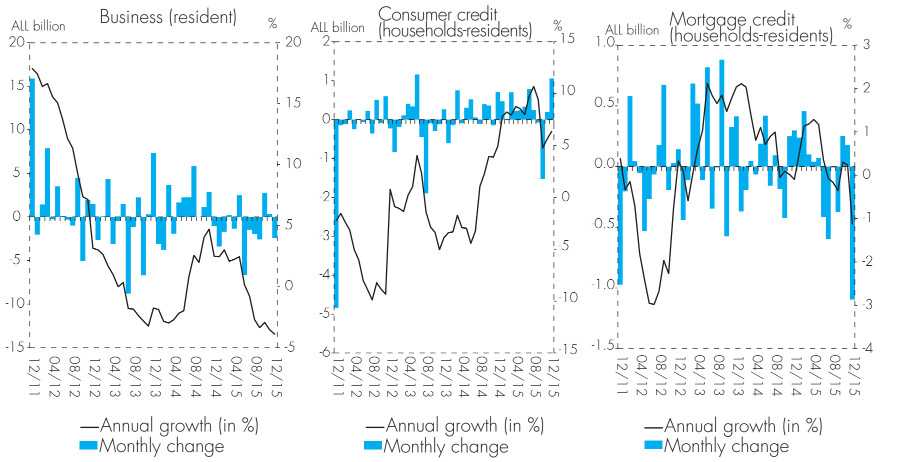
[25] *A loan of ALL 5.4 billion, granted by a large bank to non-residents was repaid in December 2015.*

[26] *In June 2015, the annual growth of medium-term credit stood at + 18.5%.*

[27] *Large banks are the major contributors to the narrowing of credit outstanding granted to resident businesses for "real estate".*

[28] *This shrinkage was a result of repayments in credit stock in euro of a large bank.*

Chart 8.5 Performance of resident credit to businesses, consumer credit to households and mortgage credit to households - absolute monthly change and annual performance



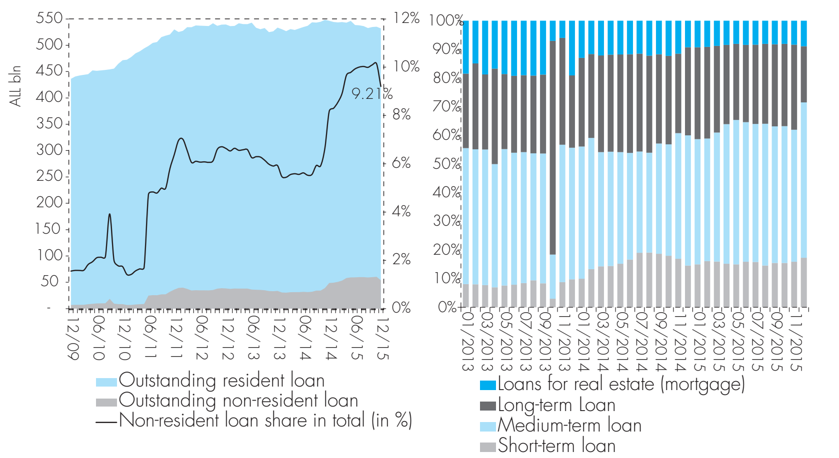
Source: Bank of Albania.

Box 8.3. CREDIT OUTSTANDING TO NON-RESIDENT ENTITIES

Share of non-resident credit in credit outstanding of the sector fell to 9.2% in December 2015, from 9.9% in June 2015. 82% of this credit was granted to business entities. Although down during the period (11.9%) due to the repayment of a part of portfolio, this outstanding continues to remain higher, referring to the end of 2014, by around 10%. Meanwhile, credit to households expanded during the period, albeit it has a small share of credit outstanding to non-residents.

Overall, credit to non-residents is oriented toward longer-term maturities, with the main share in the medium term (54.3%). Share of medium-term credit expanded while medium-term credit narrowed during the last year.

Chart 8.6 Loans to non-residents and respective components



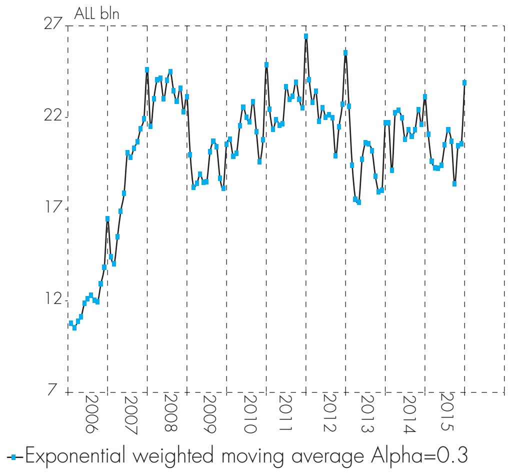
Source: Bank of Albania.

8.3.1 NEW LENDING[29]

(63) **Despite its good performance during the period, new loan has declined during the year**. Businesses have profited the major part of new loan. Foreign currency loans (mostly in EUR) and the short and long term loans provided the main contribution to the new loan.

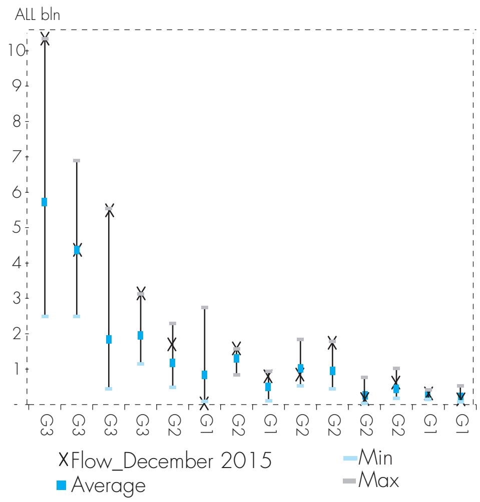
(64) **Despite the good performance during the period, new loan declined during 2015.** New loans granted by banking sector accounted for ALL 133.5 billion, around 18% higher than in 2015 H1[30]. In 2015, the banking sector granted new loans to the extent of ALL 246 billion, around 6% lower than in 2014. During the period under review, the banking sector's loan collection amounted to ALL 139.8 billion, about 16% higher than the previous period, and 13% higher than in 2014 H2. The loan use ratio, measured as the ratio of repaid to new loans, fell to 104.7%, from 107% in June 2015.

Chart 8.7 New loans and exponential weighted moving average of new loans (alpha=0,03)



Source: Bank of Albania.

Chart 8.8 New loan monthly flows by bank (December 2014-December 2015)



Source: Bank of Albania.

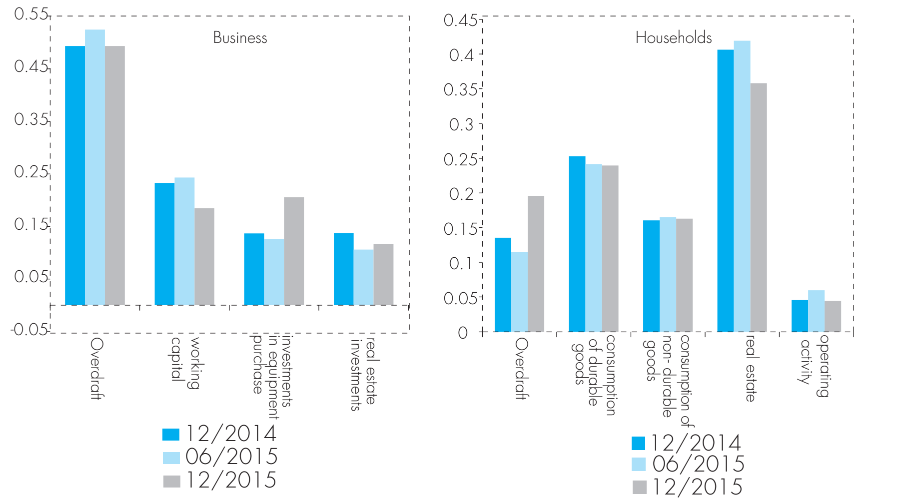
(65) **By group of users, the business sector obtained 82% of new loan whereas households around 18%.** During the period, new credit to business sector expanded by 18.9%, or ALL 17.4 billion. The growth of new loans for "investments in equipment purchases" contributed by around 62% to the added value of new loans. The loan granted in the form of "Overdraft" continued to have the main share of new loan granted to business, by around 49%. The loan in this form expanded by ALL 5.7 billion, or 11.8%, during the period. New loans to enterprises contracted by 5% in annual terms, mainly driven by the narrowing of the new loan for both, "working capital" and the "real estate investments", by respectively 24.8% and 19.3%. New loan to households expanded by 14.9% or ALL 3.1 billion, mainly driven by the expanded

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

30 *Larger banks provided the main contribution to the expansion of new loans during the period under review.*

"Overdraft" loan[31], whose share grew at 20% of the new loan flow, from 12% in 2015 H1. The new loan granted for "real estate" to households continues to have the main share in new lending to households, despite its contraction, from the two previous periods. The loan in this form shares 36% of the new lending to households and fell by around 1.8% during the period.

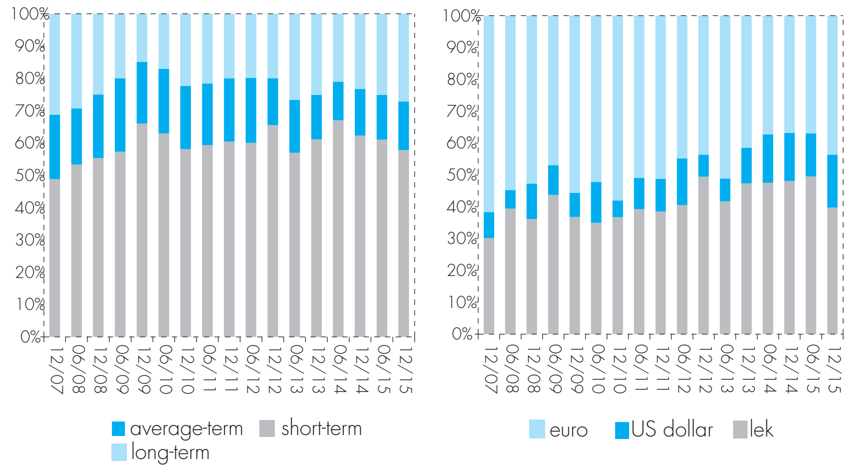
Chart 8.9 Distribution of new loans to businesses (left) and households (right) by purpose of use, in per cent.



Source: Bank of Albania.

(66) Foreign currency and the short and long term maturity loans provided the main contribution in the new loan performance. By currency, the share of new loan in foreign currency[32] accounted for 60% of new lending during the period, 72.5% of loans in EUR expanded during the year. The new loans in lek contracted by 5.1%, during the period, and by 19% from

Chart 8.10 New loans by maturity (left) and currency (right)



Source: Bank of Albania.

[31] New loan for households in the form of "Overdraft" expanded by ALL 2.3 billion during the period, thus contributing by 74% in the expansion of new loan to households, to ALL 4.7 billion.

[32] The new loan in foreign currency accounted for 60% of total new loans.

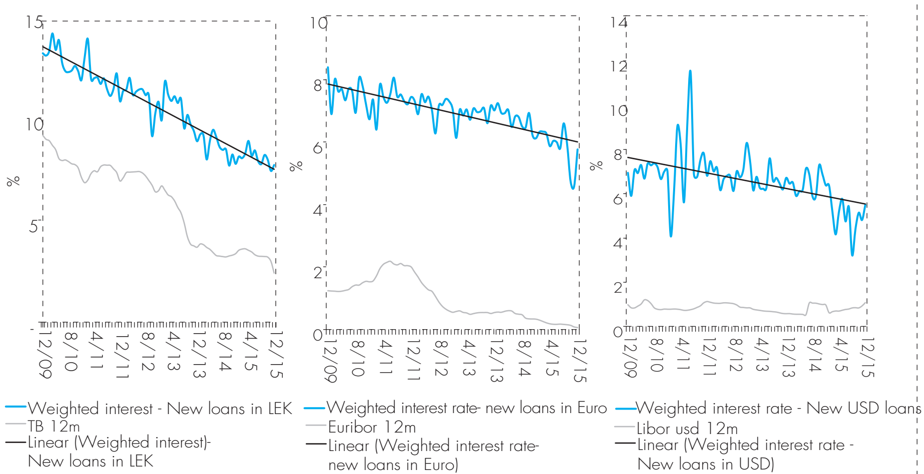
the previous year. The largest share of new loan reflects the largest share of loan in foreign currency in the overall credit outstanding and responds to the settlement process or the restructuring of loans. By terms of maturity, new loan is mainly granted in the short and long term and lending increased by respectively 12% and 28.3%. In annual terms, the narrowing of new loan was attributable to the poor performance of the short-term loan, which accounted for 58% of the total.

- Interest rates on new loans

(67) **The interest rate on new loans in euro and lek trended down during the period.** The interest rates on new loans in US dollar trended slightly up, being concentrated in the last three months of 2015.

(68) **The average interest rate on new loans in all currencies declined.** In December 2015, the weighted average interest rate on new loans stood at 6.46% or 0.33 percentage points lower than in June 2015. During the period, the weighted average interest rate on new loans in euro fell by 0.23 percentage points, to 5.57%, while in US dollar expanded by 0.75 percentage points, to 5.50%. Within 2015 H2, the lowest weighted interest rate on new loans in US dollars was reflected in August, due to the significant decline in the interest rate on short-term loans granted by a bank. The weighted average interest rate on new loans in domestic currency was 7.69%, narrowing by 0.71 percentage points in June 2015 and also reflecting the downward trend of the interest rate.

Chart 8.11 Interest rates on new loans and reference rates by currency (in %)



Source: Bank of Albania.

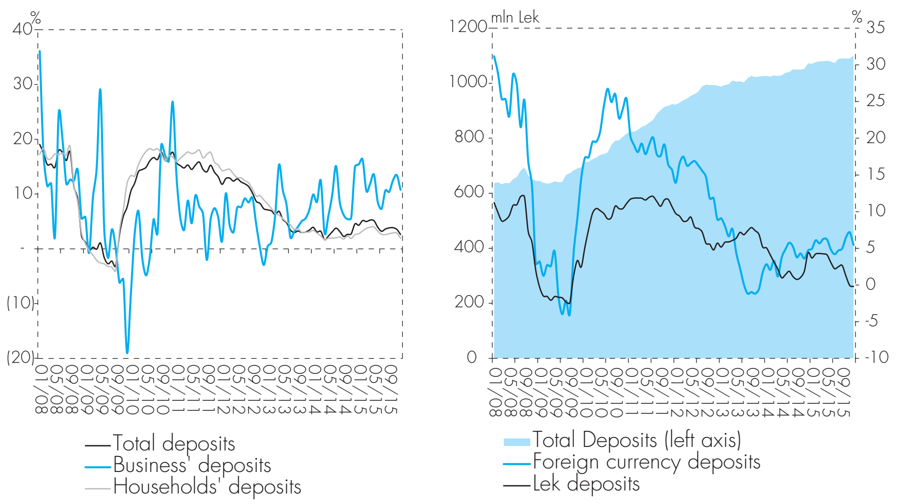
8.4 VOLUME OF DEPOSITS

(69) Volume of deposits in the banking sector increased despite the decline in the average interest rate and the impact of the Greek crisis in the summer of 2015. Foreign currency deposits provided the main contribution in deposits

growth. Businesses provided the main contribution to the increase of deposits during the period; however, the share of households' deposits in total remains high. The decline in households' deposits in lek in the banking sector was fully offset by the increased investment in government debt securities, especially towards bonds.

(70) **During the period, deposits in banks grew, and foreign currency deposits provided the main contribution.** In December 2015, deposits [33] in the banking sector amounted ALL 1,100 billion, expanding by 2% compared to 2015 H1. All deposits in lek fell by ALL 2.3 billion or 0.4%, while foreign currency deposits increased by ALL 23.5 billion or 4.3%. Deposits in Euro provided the main contribution in the growth of foreign currency deposits, expanding by 5%, while deposits in US dollar fell by 4%. Around 51% are foreign deposits; therefore the statistical effect of change in the exchange rate is important. Mainly due to exchange rate movements of lek against the US dollar, the effect was negative by around ALL 11 billion, while in annual term this effect was negative by around ALL 3.9 billion. Without the exchange rate effect, the annual growth of foreign currency deposits would be 1 percentage point higher, around 6.4%, and the annual growth of total deposits would be around 3.1%. In annual terms, banking sector deposits grew by 2.6% and the accrued interest fell by around 26%. A decline of 0.2% was recorded for lek deposits in 2015, whereas foreign currency deposits grew by 5.4%

Chart 8.12 Deposits



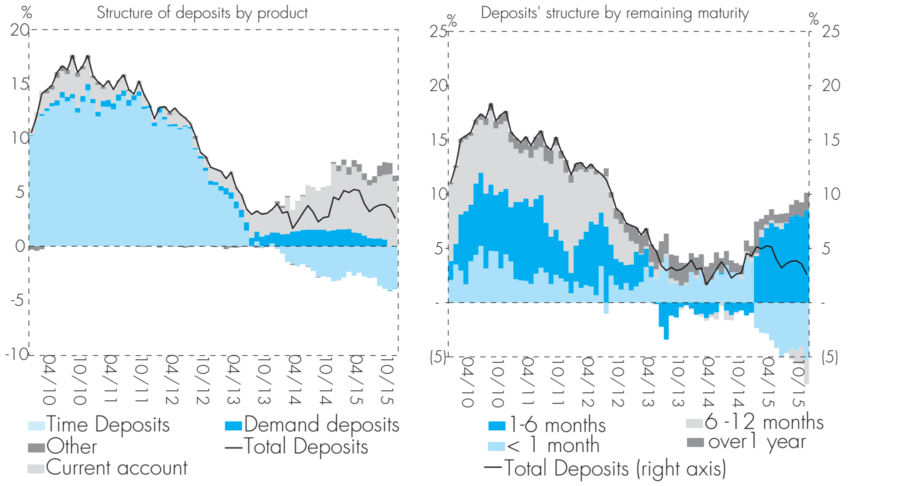
Source: Bank of Albania.

(71) **Values remain concentrated in the period up to one year in the structure of deposits.** Time deposits, which account for around 65% of public's deposits, fell during the period under review by about ALL 29.8 billion or 4%. Also, the demand deposits fell by ALL 4.4 billion or 5.9%. Current accounts have increased significantly by 22.8%. Other saving products (e.g, deposit certificates) have been expanding, although by very low volumes, increasing by around 1% during 2015 H2 (See Chart 8.13 left). According to remaining maturity, the structure of deposits continues to expand for the over a year

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

maturity, but at a slower pace. 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 8.6%.Time deposits with remaining maturity below 1 month provided a negative impact, by about 5.2%.

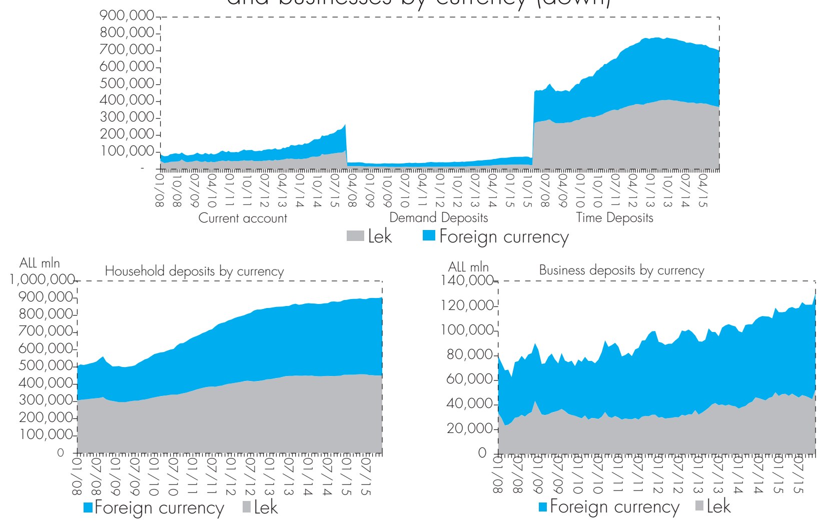
Chart 8.13 Contribution to deposits annual growth by product (left) and remaining maturity (right)



Source: Bank of Albania.

(72) **Reduction of the average maturity term, has also affected the composition of deposits by currency.** In December 2015, foreign currency has the main share in current accounts and demand deposits, respectively by 58.1% and 64.9% of the value. Time deposits in the local currency had the major share by 52.4%, albeit at a down trend. In total, foreign currency represents about 50.2% of the deposit base for households and 60% of the deposit base for businesses.

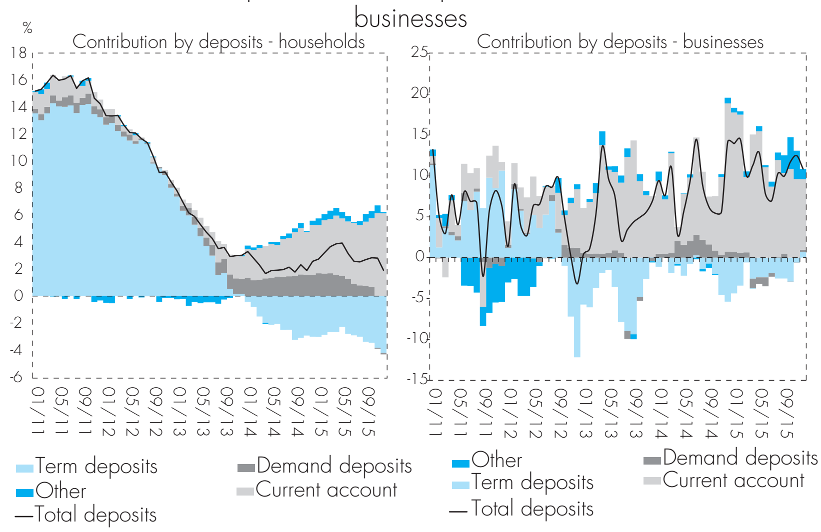
Chart 8.14 Deposits' structure by product and currency (above) and for households and businesses by currency (down)



Source: Bank of Albania.

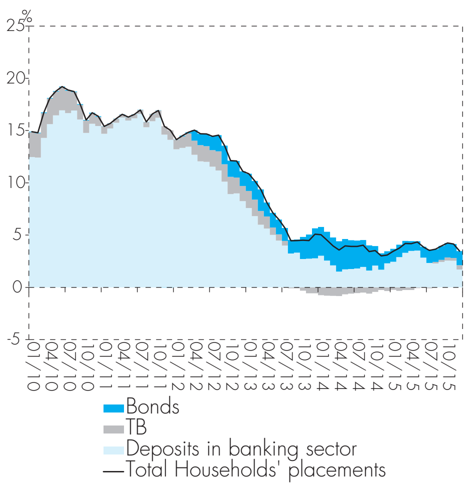
(73) Businesses provided the main contribution in the increase of deposits during the period; however, the share of households' deposits in total deposits remains high. Households' deposits represent 85% of deposits in the sector. During the period, households' deposits expanded by ALL 9.7 billion or 1%. Business' deposits have contributed to the growth of the deposit base during the period, as they increased by ALL 14.1 billion or 11.5%. By currency, foreign currency households' deposits increased by ALL 18.1 billion or 4% during the period, while those in lek fell by ALL 7.3 billion or 2%. During the period, foreign currency businesses' deposits increased by ALL 7.5 billion or 11%, while deposits in lek increased by ALL 5 billion or 11%. Deposits of public sector have e negligible share in the total of deposits, by 2.4% and they decreased by ALL 2.5 billion or 8.7%, during the period. In annual terms, business' deposits increased by around 10.8% or ALL 13.4 billion, while households' deposits increased by 1.9% or ALL 17.8 billion.

Chart 8.15 Annual expansion of the deposits' structure for households and businesses



Source: Bank of Albania.

Chart 8.16 Households' placements in the financial system, annual expansion



Source: Bank of Albania.

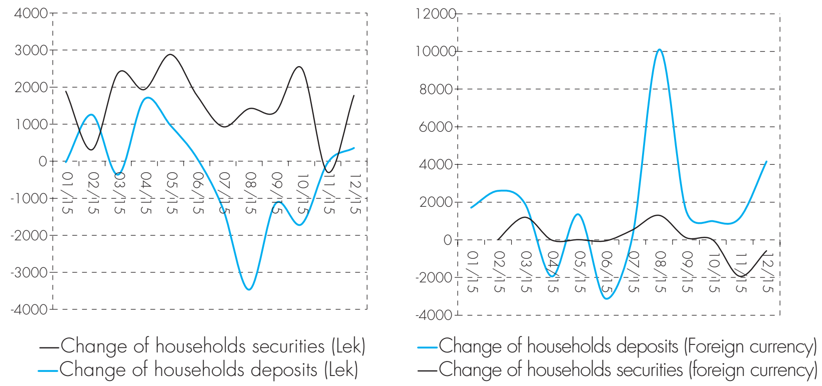
BOX 8.4 TOTAL HOUSEHOLDS' PLACEMENTS

During the period, households expanded the investments in debt securities of government. The annual growth of investments in debt securities of government was around ALL 18.3 billion or 15%. By instrument, investments growth in bonds and treasury bills was 27% and 6%, respectively, or ALL 14.1 and ALL 4.2 billion, respectively. Public preference appears for government bonds, which offer the highest rate of return.

At the end of 2015, households' investments in deposits and debt securities of government in total expanded by approximately 3.5% in annual terms, around 1.8% arising from the expansion of investments in debt securities of government and around 1.7% from deposits with the banking system.

Households' shift from deposits toward investments in securities, looking for higher return rates, is more visible in the domestic currency. During H2 2015, households' deposits in lek decreased by over ALL 7 billion, while their investments in securities in lek rose around ALL 7.7 billion.

Chart 8.17 Change of deposits in lek (left), in foreign currency (right) and of securities, mln lek



Source: Bank of Albania.

Regarding foreign currency deposits, the trend is not the same. During the period, foreign currency deposits of households, increased by around ALL 18 billion, while their investments in foreign currency securities, fell insignificantly, around ALL 0.6 billion. Households would prefer to invest their funds in foreign currency deposits rather than in foreign currency securities.

(74) **The larger banks (G3) provided the main contribution to the expansion of the deposits base, as these banks have the highest share to total deposits in the banking sector.** Bank's deposits of this group increased to ALL 764.6 billion, up by around ALL 28.4 billion or 3.9% during the period under review. It's noteworthy that small-sized banks of Group 1, in relative terms, reflected the highest growth rates, by 6.7% or ALL 4.5 billion, reaching ALL 70.7 billion, at the end of 2015. Medium-sized banks of Group 2 recorded a fall in the volume of deposits by around ALL 11.6 billion or 4.2%, down to ALL 264.9 billion, mainly affected by the contraction of deposits in banks with Greek capital, by around 7.7% or ALL 12.1 billion, during the period.

(75) **The highest increase of deposits in the G3 banks is associated to the increased indicators of deposits concentration.** Based on the concentration measurement of deposits, according to the Herfindahl's index[34], which is 1.495 points, the banking sector appears to be in the segment of "low" concentration. However during the period, the indicator rose by 56 points and its getting closer to the classification of the "moderate" index (over 1,500 points).

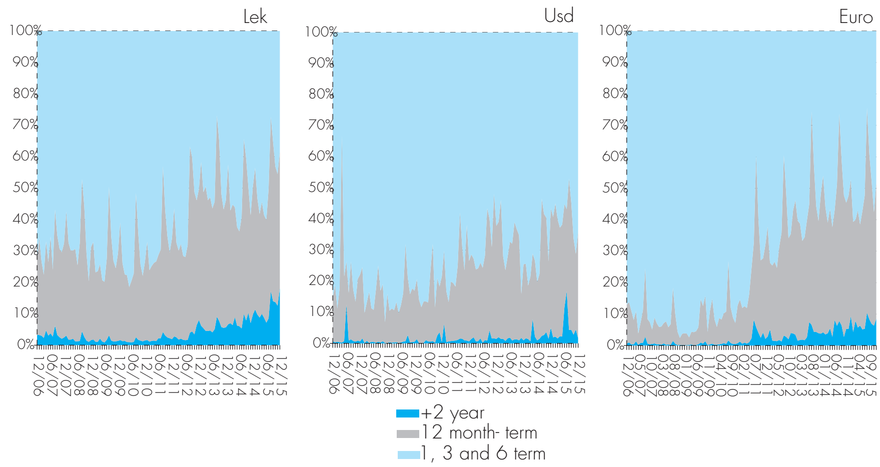
[34] *Index resulted in 10 points from 9 points in the previous period for G1 and 109 points from 125 points for G2. Concentration of deposits for G3 according to the Index increased by 70 points, from 1.305 to 1.375.*

8.4.1 FLOW OF DEPOSITS

(76) During 2015 H2, banking sector had a new flow of deposits (replacements and new placements) with around ALL 978 billion. New time-deposits share 18% of the total of the period and decreased by around 14% in annual terms. In the structure of time-deposits, there is a shift towards longer terms of maturity, mainly towards 12-month maturity. They increased by 12 percentage points, sharing 48% of new time deposits. Time deposits of 1, 3 and 6 months, fell by around 15 percentage points and their share fell by around 41% of the total time-deposits. The share of 1-5 year deposits increased by 3 percentage points, up to 9%. Finally, time deposits of over 5 years rose by 1 percentage point, sharing only 2% of the total.

(77) By currencies, new time deposits increased for lek and Euro, and contracted for the US dollar, with an inclination for longer-term maturities. During the period, the flow of new deposits in lek increased by 12%, in US dollar fell by 30% and in Euro increased by 51%, compared to 2015 H1. The flow of new deposits showed an upward trend for all the three currencies, for longer -term of maturity.

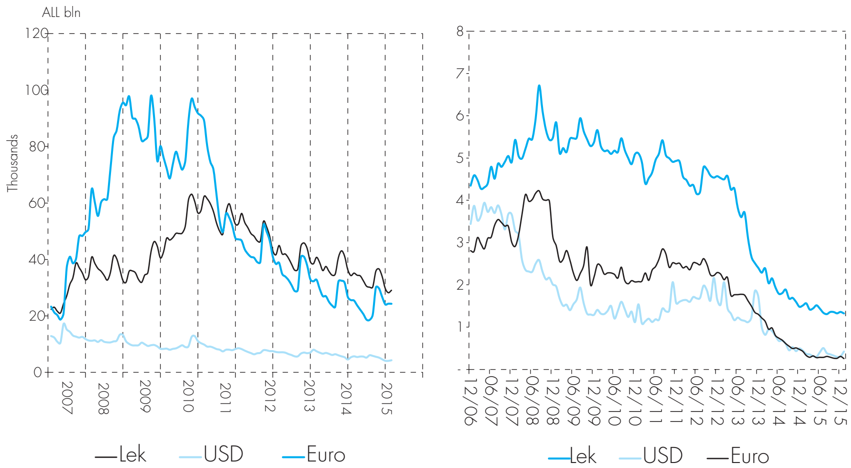
Chart 8.18 New time deposits by currency and maturity



Source: Bank of Albania.

(78) In 2015 H2, the average interest rates of new time deposits both, in lek and in main foreign currencies, continued to trend down. For the period, the average weighted rate of new time deposits was estimated at 0.46%, down by 1.3% percentage points compared to the previous year. For the US dollar and Euro, the average interest rate on new time deposits, was 0.20%, down by 0.36 percentage points compared to the end of 2014. Average interest rate of lek was close to 1.3%.

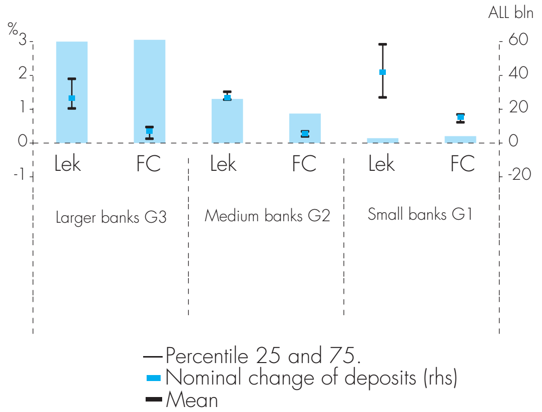
Chart 8.19 Moving average of new time deposits (left) and monthly average interest rates (right)



Source: Bank of Albania.

(79) The flows of news deposits increased for all bank groups, despite the cut of the interest rate on new deposits. The positive flow of deposits positive continues to be concentrated in large banks, despite the lowering of the average interest rate at 0.55%, from 1.28% at the end of 2014. For medium-sized banks, the average interest rate of deposits fell to 0.72%, from 1.50% at the end of 2014. For small-sized banks, the average interest rate of new deposits fell to 1.14%, from 1.85% at the end of 2014, but they continue to offer the highest interest rates in the market.

Chart 8.20 Annual (absolute expansion) of the deposit base by currency and banking groups and distribution of weighted interest rates on new deposits



Source: Bank of Albania.

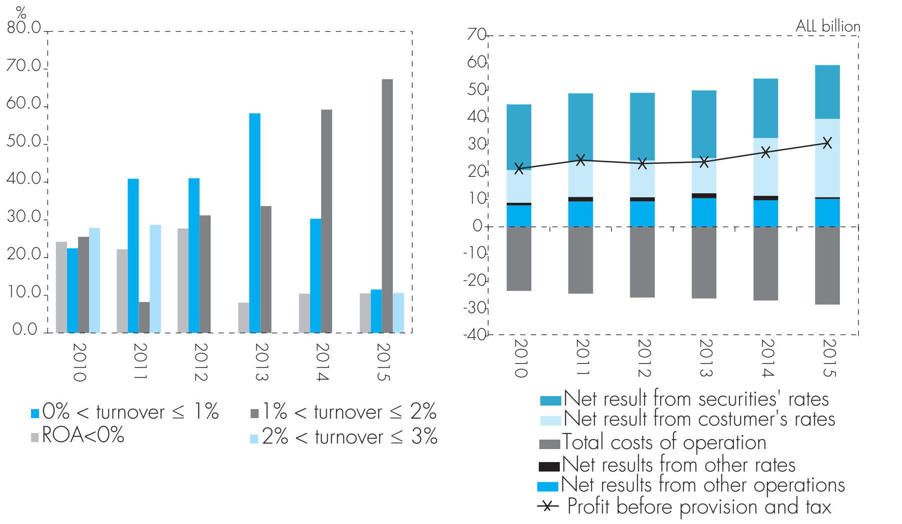
8.5 PROFITABILITY

(80) Net outcome of the banking sector improved significantly during the period. The most rapid fall of financing costs has influenced in the improvement the net income from interest and the increase of net interest margin. The costs in the form of provisions for the credit risk have not affected the financial result of the banking sector, by recording an insignificant fall compared to the end of 2014. However, the increase in the provisioning costs for credit has negatively affected the financial results, in certain banks. For the sector, indicators of Return on Equity (RoE) and Return on Assets (RoA) improved in annual terms.

(81) As reported by banks, in accordance with the stipulations laid down in the supervisory regulatory framework, in December 2015, the banking sector reported a positive financial report of ALL 15.7 billion or

ALL 4.5 billion higher compared to the previous year. Expansion of the net interest income provided the main contribution to this improvement. The main profitability indicators, RoA and RoE were assessed at 1.2% and 13.2%, respectively, up by 0.3 and 2.5 percentage points, from the end of 2014.

Chart 8.21. Financial result components (right) and profitability indicators (left)



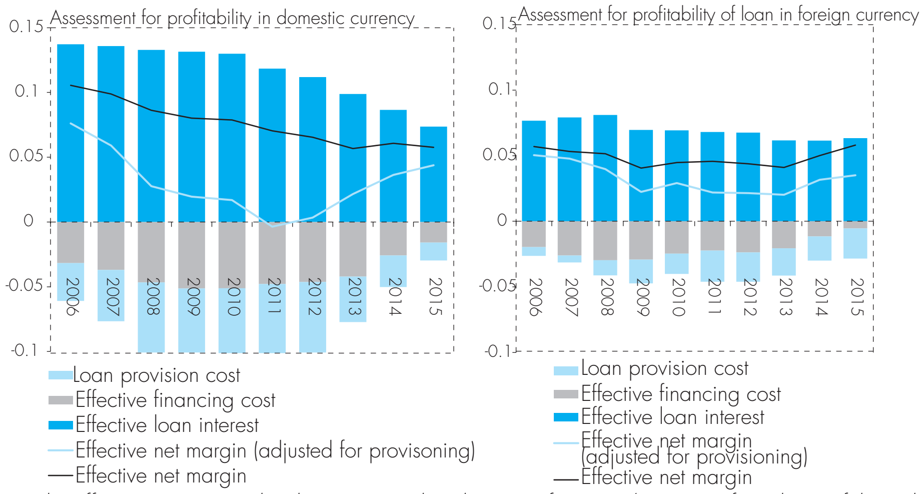
Source: Bank of Albania.

(82) **Interest income contracted by around ALL 3.7 billion, but the net result from the interest rate reflected the highest fall in interest expenses by around ALL 8 billion.** Despite the decline by 0.25 percentage points of the spread of interest rates on credit-weighted and new deposits base, to 6.32%[35], the fall in interest expenses reflects the contraction of time deposits (more costly to banks), down to 64.8% of total deposits, from 70.4% last December.

(83) **Profitability of the banking sector lending, adjusted for the cost of provisioning improved in 2015 H2.** During the period, the effective interest rate on the loans' stock fell by 1.3 percentage points, to 7.4%, while effective interest of funding fell by 1 percentage point, down to 2%. By currency, banks maintained the effective net margin in domestic currency and increased the net effective margin in foreign currency, mainly by lowering of the financing cost. As a result, the net effective margin adjusted for the cost of provisioning of banks, resulted 4.4% at the end of 2015, from 3.6% in December 2014. For almost two years, the decline in interest income for the banking sector is offset by an even faster decline in interest expenses.

[35] *In December 2015, the weighted average rate of credit interest rate stood at 6.46%, downward by 0.41 percentage points compared to the end of 2014. On the other hand, the average weighted interest rate on new deposits (including current accounts) stood at 0.14%, down by 0.05 percentage points compared to the end of 2014.*

Chart 8.22 Assessment of the effective profitability from lending



*The effective interest rate has been assessed as the ratio of income/ expenses from the portfolio with clients against the average portfolio value for each period.
Source: Bank of Albania and Financial Stability Department estimations..

Table 8.1. Profitability indicators from the main activity, in per cent (cumulative)

Indicators	2012	2013	2014	2015
Interest income/average earning assets	7.73	7.32	6.28	5.72
Interest expenses/average expending liabilities	3.71	3.31	2.14	1.29
Net Interest Margin (Net interest income/average earning assets)	4.01	3.89	4.18	4.42

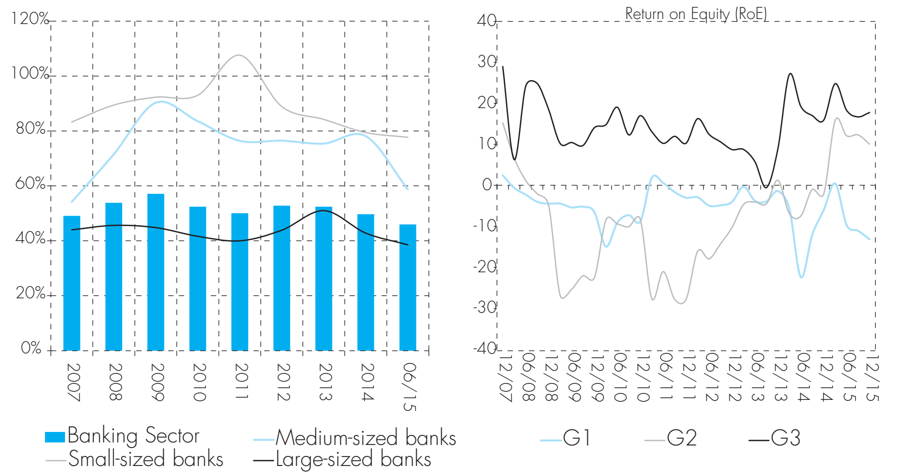
Source: Bank of Albania.

(84) **Provisioning expenses for credit risk, and the overall provisioning, reflect slight decline compared to the previous year, by 3.9% and 1.4%, respectively.** During the period, the increase of expenditures for provisioning among banks, contributed to the creation of a negative net financial result, while net income from the rest of the activity were positive. As a result, the share of the assets of the banking sector which registered a financial loss was 10.5%, lower than its average of recent years.

(85) **The net income from other activities improved slightly, providing a low impact on the net result.** The activity costs were slightly up, but they were covered adequately by the activity income, providing a positive impact on the operative profitability (before provisioning).

(86) **According to banking groups, profit is deepened in large banks (G3) and medium-sized 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.

Chart 8.23 Costs in relation to income and return on equity for banking groups



Source: Bank of Albania.

Box 8.6. NET INTEREST INCOME

During 2015, the expansion of net interest income provided the main contribution to the financial result of the banking sector. Meanwhile, the time deposits' weighted rate fell at 0.79%, the lowest historic level, and the weighted rate of total deposits base marks only 0.14% .Further reduction of financing costs aiming at maintaining the profit, is limited.

The following analysis assesses the sensitivity of net interest income of banking sector, against the possibility of further lowering of the interest rate, according to two scenarios:

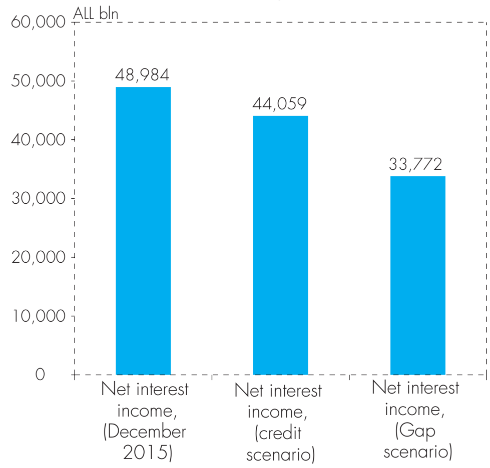
a. *In "credit scenario", we assume that the banking sector is limited to further reduce the financing cost to 0.8 percentage point, reaching at 0%. On the other hand, in line with the expansion of lending activity and easing of lending standards in an environment of low interest rates, the banking sector shall lower the new loan rate, to 2 percentage points, compared to the current level of 6.46%.*
b. *In "gap scenario", we assume a reduction of 0.8 percentage points of the financing cost, while in an environment of low interest rates and lower demand for government financing, the return rate on other assets which are sensitive to the interest rate, would decrease by 2 percentage points.*

Loan scenario current structure of banking sector balance, in terms of loans and deposits that mature within 12 months, results in a negative gap of around ALL 188,796 million. Its presence and the high share of loan to be re-estimated (89% of total credit), which exposes the sector to a more rapid fall in the return rate of loan compared to the fall of the financing cost. In total, the reduction of net interest income stood at ALL 4,924.48 million. The impact on the capital adequacy ratio of the sector is assessed downward, by 0.6 percentage points, compared to December 2015.

Gap scenario: If we assess the aggregated level of assets and liabilities, which have a residual maturity to 12 months, the negative gap would expand at ALL 299,547.75 million. As a result, the exposure of banking system to a more rapid *lowering of the return rate on assets is higher. This impact is somewhat mitigated from the lower level of assets' share that are re estimated within one year, at an average level of 66% (compared to 89% of the credit). In total, the reduction of net interest income is expanded at ALL 15,211.79 million. The impact on the capital adequacy rate is assessed at -1.9 percentage points against the value in December 2015.*

Results of the analysis show that banking sector has a limited space to continue to maintain the level of the financial result through the further lowering the financing costs. Even in case of expanding the total cost of time deposits, followed by the reduction in the return rate on credit or other assets, the net interest income would fall. Large banks that provided the main contribution in the expansion of net interest income are more exposed to the difficulty of maintaining their high contribution to the financial result.

Chart 8.24 Assessment net income from interest for the banking sector



Source: Bank of Albania and Financial Stability Department estimations.

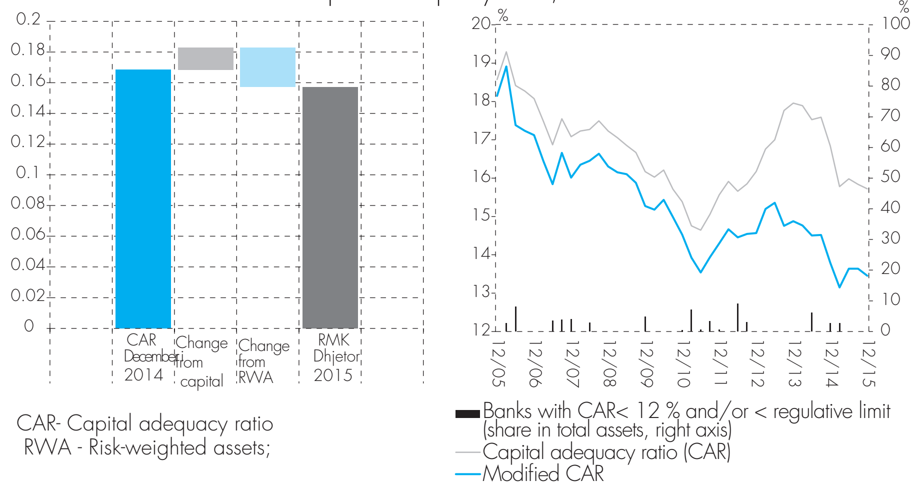
8.6 BANKING BUSINESS CAPITALISATION

(87) Banking business capitalisation is assessed at good levels and banks have maintained the minimum required levels of capital adequacy ratio, albeit the fall compared to the previous year. At the end of 2015, the capital adequacy ratio fell to 15.7%, from 15.9% in 2015 H1 and 16.8% a year earlier. During 2015 H2, the risk-weighted assets expanded by 2.8% compared to 2015 H1, up to ALL 817 billion. The entry into force of the new Regulation on the capital adequacy[36] increased the risk-weighted assets by 18% in annual terms. The increase of risk-weighted assets impacted negatively the performance of capital adequacy ratio, by 2.6 percentage points. On the other hand, the regulatory capital increased by 1.1%, up to ALL 128.5 billion, attributable to the capital injection. The increase of regulatory capital impacted positively the performance of capital adequacy ratio, by 1.4 percentage points. The capitalization of profit further increased the presence of the core capital in the structure of regulatory capital, up to 86%.

[36] *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, banks can release capital in certain categories of risk-weighted assets from one side, by providing additional capital requirements for market and operational risk.*

Table 7.2 summarises the capital adequacy ratios for the banking sector and banking groups, by business size and origin of capital. Referring to group levels, Group 3 banks present a lower capitalization rate than other groups.

Chart 8.25 Capital adequacy ratio, December 2015



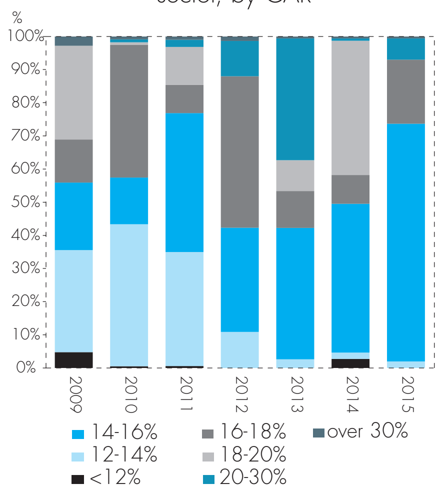
Note: The capital adequacy ratio (CAR) is measured as the ratio of "Regulatory capital to risk-weighted assets" (RWA); The ratio of modified capital adequacy ratio is measured as the ratio of "Core capital to Risk-weighted Assets".
Source: Bank of Albania.

Table 7.2. Capital adequacy ratio, in per cent

Period	Sector	G1	G2	G3	Euro area*	Albanian	Other**
December 2015	15.7	19.0	16.9	15.0	16.5	14.7	15.0
June 2015	16.0	19.8	17.5	15.1	16.7	14.3	15.3
December 2014	16.8	22.5	15.1	17.0	17.3	14.5	17.0

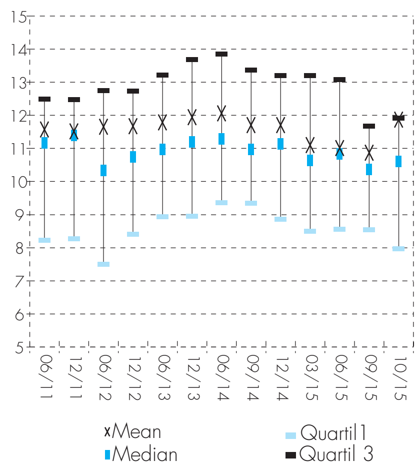
Source: Bank of Albania.
** This group includes banks of Austrian, Italian, Greek, French, German and Bulgarian capital.*
*** This group includes banks of Turkish, Arabian, Kuwaiti and Malaysian capital.*

Chart 8.26 Asset allocation of banking sector, by CAR



Source: Bank of Albania.

Chart 8.27 Financial leverage ratio



Source: Bank of Albania.

The major part of individual banks maintains capital adequacy rates at the interval 14-16%.

(88) **Albanian banking sector is characterized by a low and stable financial leverage ratio.** At the end of December 2015[37], the financial

[37] *Leverage indicator, is an additional indicator that reflects the position of banks' capital, and is calculated as a ratio of assets to equity.*

leverage ratio was estimated at 10.5 times, from 11.0 in June 2015 and 11.7 times in the previous year. Individual banks did not differ significantly in terms of financial leverage.

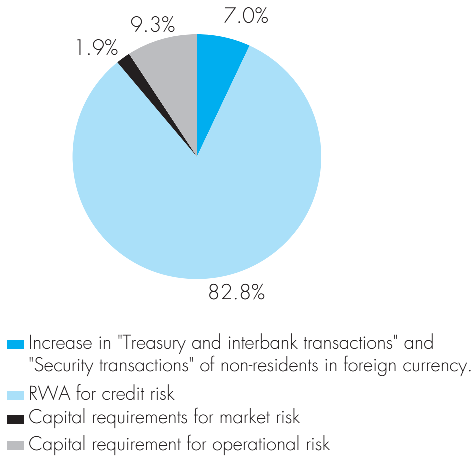
Box 8.7. RISK-WEIGHTED ASSSETS- EXPOSURE BY CREDIT RISK, MARKET RISK AND OPERATIONAL RISK.

In December 2015, risk-weighted assets (RWA) increased at ALL 817 billion, from ALL 794.7 billion in June 2015. RWAs for the credit risk account for 83% of total, additions to increase investments in non-resident entities 7% and RWAs for operational risk account for 9.3% of total.

RWAs for credit risk expanded by around ALL 25.2 billion compared to the first part of year, up to ALL 676.7 billion. The highest exposure of banking mainly relates to three classes of credit risk, which are weighted by a higher risk coefficient: a. "Exposure to high risk classified categories" class, which includes lending activity to non-residents and foreign currency lending when the borrower's income is in lek; b. "Exposure to non-performing loans", and c. "Possible exposure or exposures to corporates".

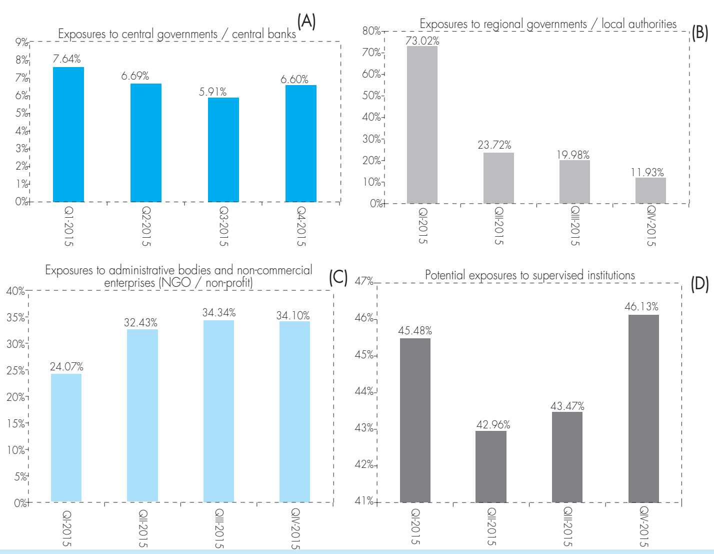
Chart 8.29 shows the performance of average risk-weighted coefficient related to various exposures' classes as reported by banks. Related to banking sector exposures to businesses and households (see Chart 8.29. "E"), which have the highest values in the balance sheet, the average risk-weighted coefficient slightly increased during 2015, showing that banks have shifted somewhat to higher risk lending. Also, Chart 8.29, "G", shows that the average risk-weighted coefficient of fixed assets, included in "other items", has been increasing during 2015. This phenomenon relates to the increase of real estate that banks take in their balance sheet at the conclusion of the mandatory execution process, and their weighting at a high risk coefficient.

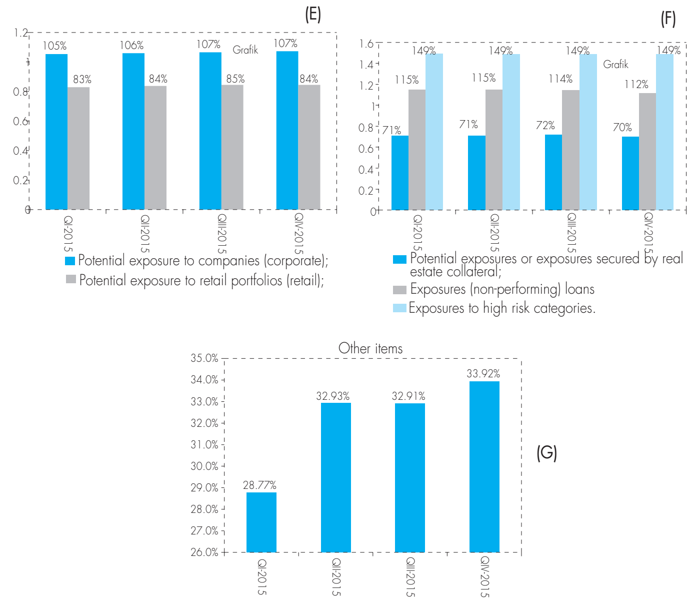
Chart 8.28 Structure of total risk-weighted assets for the banking sector



Source: Bank of Albania.

Chart 8.29 Average risk weighted coefficients, by credit categories





Source: Bank of Albania.

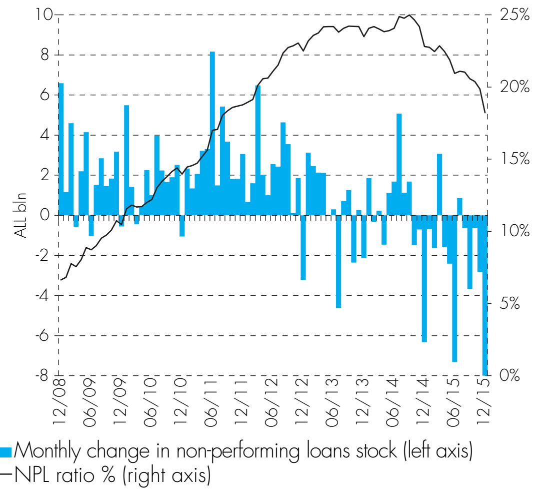
On the other hand, capital requirement on market and operational risks were down compared to the first part of year. They fell by ALL 3.6 billion and ALL 6.6 billion, respectively, to ALL 15.3 billion and ALL 75.6 billion, respectively. The item "additions for investments to non-residents" shows the highest expansion, by ALL 5.4 billion, up to ALL 57.3 billion. The sluggish lending drove to the fall of profit in the demand for capital to increase credit portfolio. This item fell by around ALL 2 billion, from 2015 H1, down to ALL 7.8 billion.

9 MONITORING BANKING SECTOR RISKS

9.1 CREDIT RISK

(89) Loan portfolio quality improved, supported by the loan loss write-offs and other measures taken for the resolution of non-performing loans. During the period, non-performing loans continued to migrate to "loan loss" category. At the same time, the sector increased the level of credit risk provisioning. Credit risk remains high, albeit improving. In this regard, Bank of Albania has been active in the process for the resolution of non-performing loans, by strengthening the collaboration with public authorities and banking sector, to reduce the credit risk. An action plan to reduce the non-performing loans was finalised in September 2015 and consist in some legal and regulatory measures, which will facilitate the management processes of credit risk from the banking sector.

Chart 9.1 Non-performing loans ratio

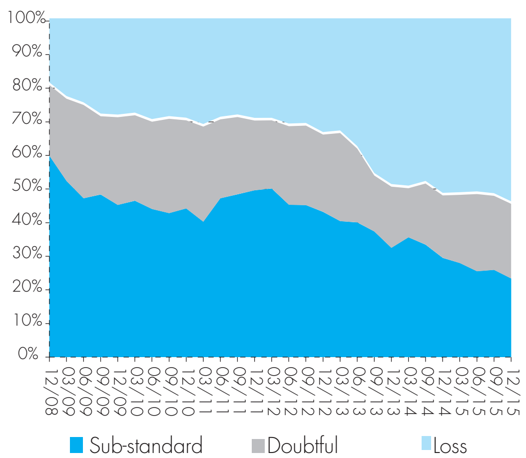


Source: Bank of Albania.

9.1.1 LOAN QUALITY

(90) During the period, the stock of non-performing loans[38] fell by around 15%, to ALL 106.7 billion, contributing to the fall in the non-performing loan ratio. This performance was mainly supported by (i) mandatory loan loss write off process and (ii) bank actions-plans for loan restructuring. The payment of Government's arrears to private sector helped to decrease the credit risk. The value of written off loans amounts to ALL 26.6 billion across 14 banks. As a result, at the end of December 2015, the non-performing loans ratio (NPLR) stood at 18.2%, down by 2.7 percentage points from June (see Chart 9.1). The structure of the non-performing loans shows a shift of loans to "loan loss" category. Thus, the share of "sub-standard loans" fell to 23%, while the share of "loan loss" increased to 54.4%.

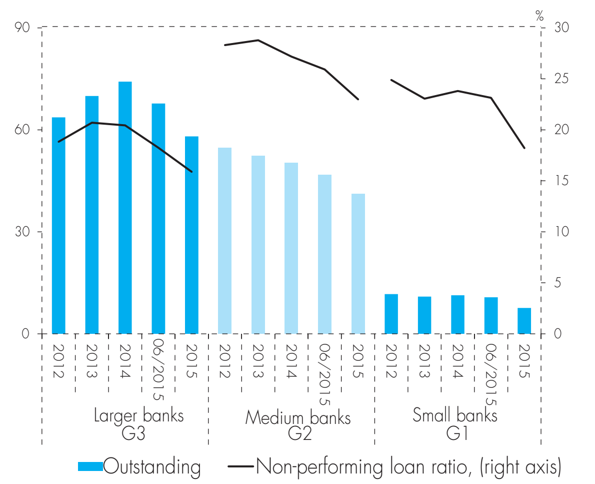
Chart 9.2 Non-performing loan structure



Source: Bank of Albania.

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

Chart 9.3 NPL portfolio by bank groups

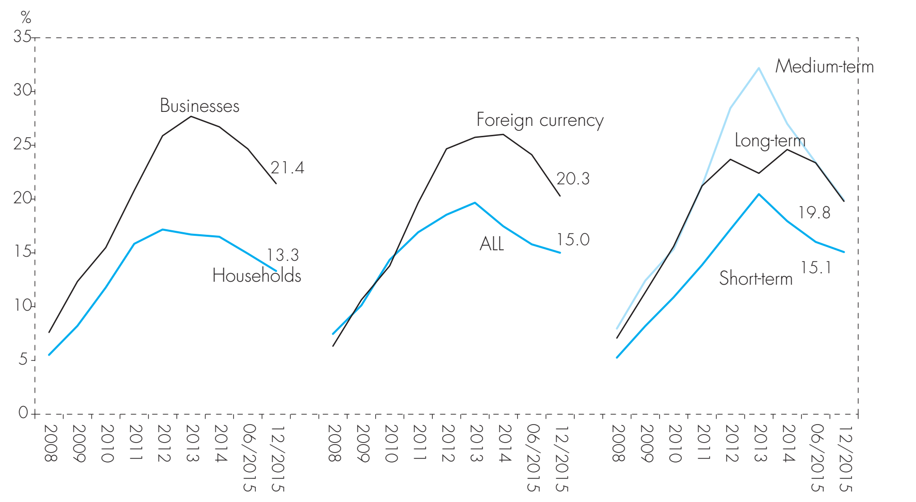


Source: Bank of Albania.

(91) **Loan qua lity improved in each of the three bank groups.** Loan quality improved mostly for the small-sized group banks (G1), with the average NPL ratio dropping 4.9 percentage points, down to 18.2%. The NPL ratio for medium-sized and larger banks was 23.0% and 15.9%, improving by 2.9 and 2.4 percentage points, respectively, The larger banks of Group 3, dominate the stock of non-performing loans by around 54.5%, but they have the lowest ratio of non-performing loans in total loans. At the same time, these banks have written off the majority of loans from the balance sheet, representing approximately 48% of total loans written off the balance sheet during 2015.

(92) **The banking sector's exposure to credit risk remains high in foreign currency credit portfolio for businesses and long-terms loans.** In December 2015, credit quality represented by NPL ratio for credit in foreign currency, was 20.3%, for loans to enterprises was 21.4%, and for medium and long-term loans 19.9%.

Chart 9.4 Non-performing loans in the Albanian banking sector

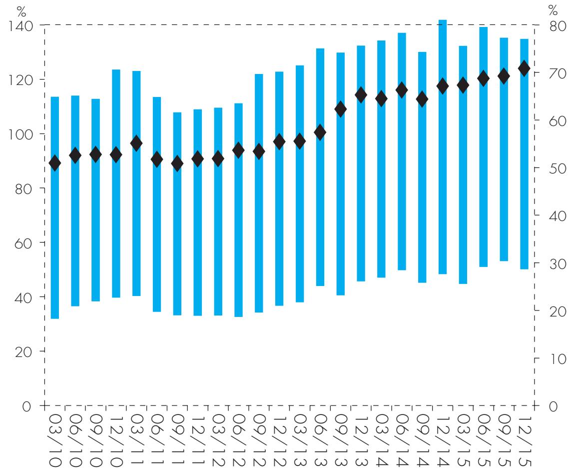


Source: Bank of Albania.

9.1.2 PROVISIONING

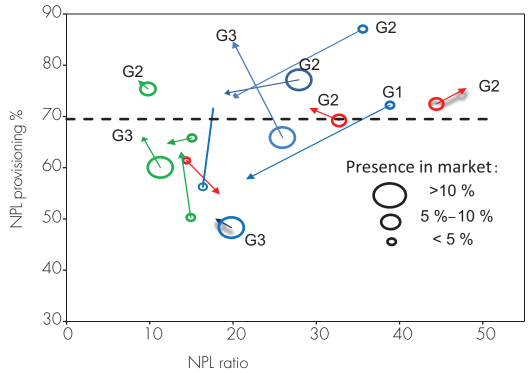
(93) **Credit risk is mitigated by the good levels of provisions created by the sector.** Overall, banks have increased provisioning for non-performing loans. In December 2015, the provisioning ratio stood at 70.8%, up by 2 percentage points, from June 2015, and 3.7 percentage points from a year earlier (see Chart 9.5). Only in four banks of the sector, which together account for around 18% of its total assets, we note a fall in provisioning during the period. The narrowed stock of credit provisions provided the main effect on the fall of provisioning for these banks.

Chart 9.5 Provisioning over the years



Source: Bank of Albania.

Chart 9.6.* Annual change of the provisioning ratio for banks - arrows show changes in December 2014 – December 2015



*Note: This includes banks sharing more than 1% in total assets. Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows the average ratio of non-performing loan provisioning at sector level, 71% at end of December 2015.
Source: Bank of Albania.

(94) **During the period, the banking sector improved the coverage of non-performing loans with capital.** During 2015 H2, at sector level, the ratio of net non-performing loans to outstanding credit narrowed by 1.2 percentage point, down to 5.3%. In the previous year, this ratio stood at 7.5%. At the same time, owing to the lower exposure to credit risk through the fall in net non-performing loans stock, the ratio of "net non-performing loans/regulatory capital" fell to 24.3%, from 30.8% at the end of June, and 38.2% a year earlier.

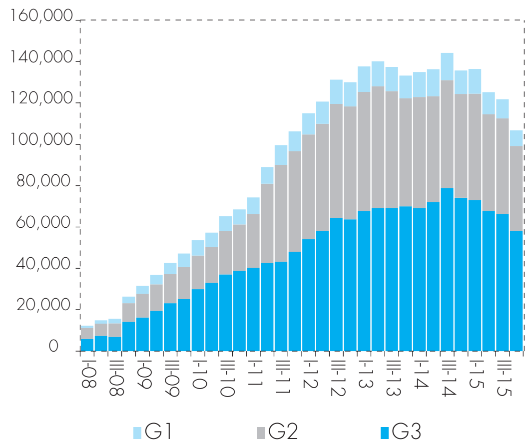
*BOX 9.1. CREATION OF PROVISIONS TO CREDIT RISK BY THE SECOND TIER BANKS**

Global financial crisis after 2008 and the high lending prior to the crisis, were materialised into the increase of non-performing loans of banking sector. Non-performing loans ratio increased from 6.6% in December 2008, to 25% at the end of 2014. Non-performing loans recorded the highest historic ratio in 2014, at ALL 144 billion. At group level, by size of activity, G3 banks have the highest ratio of non-performing loans stock, while G2 banks have the most rapid expansion of these loans.

In parallel with the fall of loan portfolio quality, banks expanded the provisioning ratio of the non-performing loans. The highest ratio of provisioning was recorded in 2014 Q4, while the non-performing loans ratio to outstanding loan recorded the highest level.

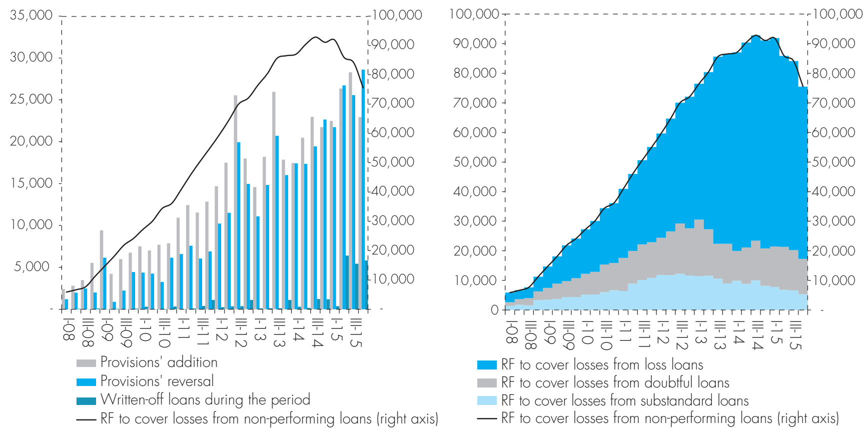
In the calculations of the reserve funds balance (at the end of the period), banks consider the reserve funds at the beginning of the period, the increase in provisions (+) during the period, reversal of provisions due to credit restructuring (-), stock of written off loans (-) and other

Chart 9.7 Non-performing loans for the banking sector and groups by size of activity (ALL mln)



Source: Bank of Albania.

Chart 9.8 Dynamics of reserve funds for credit risk (provisioning)

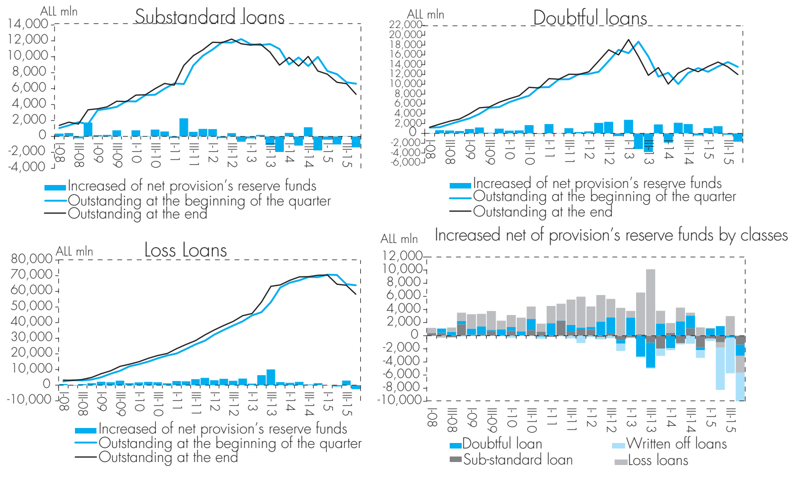


Source: Bank of Albania.

corrections (+/-). In recent years, the increase and reversal of provisions have been developed considerably. The increase in provisions in September 2015, recorded the highest level, by around ALL 5 billion higher than a year earlier (up to ALL 28 billion), due to the increase of provisions in the two last classes of non-performing loans.

In December 2015, the increase in the net provisions' reserve fund was negative,

Chart 9.9 Addition of provisions, re-assumption and provisions by classes



Source: Bank of Albania.

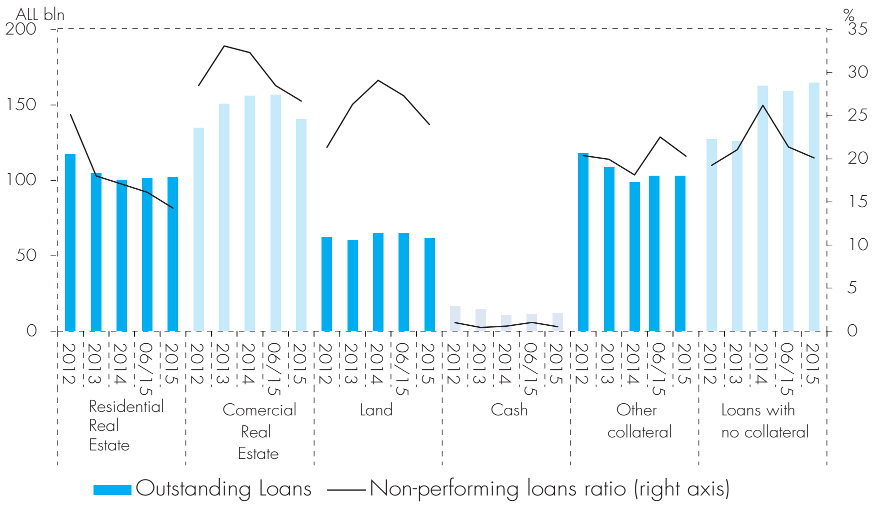
by reflecting the non-performing loans written offs and the provisioning reversal in all classes of credit. Chart 9.9 shows all the changes in the provision value, by all classes of non-performing loans. In 2015, the impact that the process of written off loans from the balance sheet had in determining the net provision changes, increased.

* *The 17 form, URS is used for the short analysis, with a quarterly report of banks.*

9.1.3 COLLATERAL COVERAGE

(95) Credit collateral coverage, an important hedging for credit risk, remains at stable levels. Collateral in the form of real estate continues to dominate. At the end of December 2015, collateral coverage[39] stood at 71.8%, from 73.3% in June 2015. The write off process of non-performing loans from banks' balance sheet helped improve the credit portfolio quality for all collateral classes (see Chart 9.10). 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 57.8% of the total collateralised loans. At the same time, the loans that are collaterised with a commercial real estate have the highest level of non-performing loans, by around 25.1% in December 2015.

Chart 9.10 Outstanding loan and non-performing loans ratio by collateral



Source: Bank of Albania.

9.1.4 INDIRECT CREDIT RISK[40]

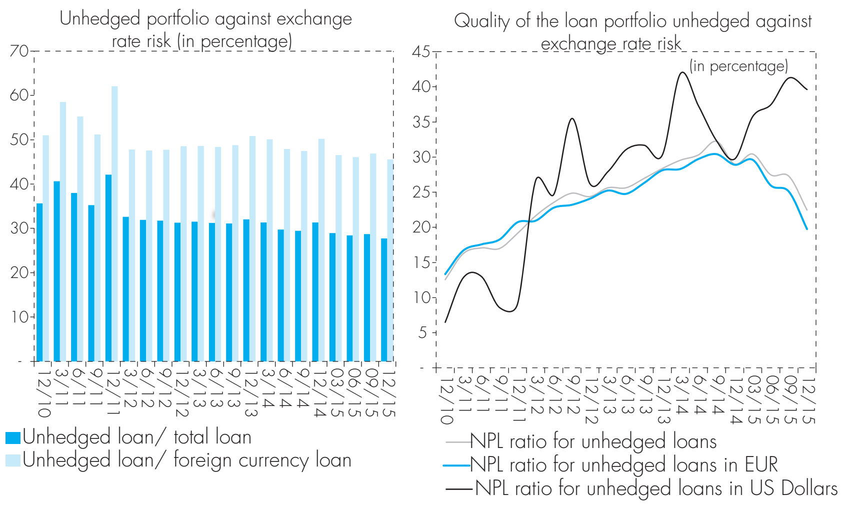
(96) Exposure to indirect credit risk remains high. Notwithstanding the reduced bank lending in foreign currency, within this portfolio, the share of loans unhedged against exchange rate volatility remains at considerable rates. In December 2015, this share of loans accounted for 45.6% of foreign currency outstanding credit, (0.5 percentage points lower from June 2015) and 27.7% of total outstanding credit. This development reflects the contraction of unhedged loans during the period by 4.4%, mainly in euro[41].

(97) Portfolio quality for unhedged foreign currency credit improved over the period, by 5 percentage points, down to 22.5%, mainly 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 6.2 percentage points,

[39] *Collateral in the form of real estate (residential, trade or land), cash etc.*
[40] *The analysis in this section includes credit data for the economy.*
[41] *Outstanding credit in euro, when the borrower's income is in the national currency, accounts for around 84.6% of the outstanding unhedged foreign currency credit.*

amounting to 19.8%, whereas for unhedged US dollar loans, it deteriorated by around 2.2 percentage points, amounting to 39.6%.

Chart 9.11 Quality of the unhedged loan portfolio against exchange rate risk



Source: Bank of Albania.

9.2 LIQUIDITY RISK

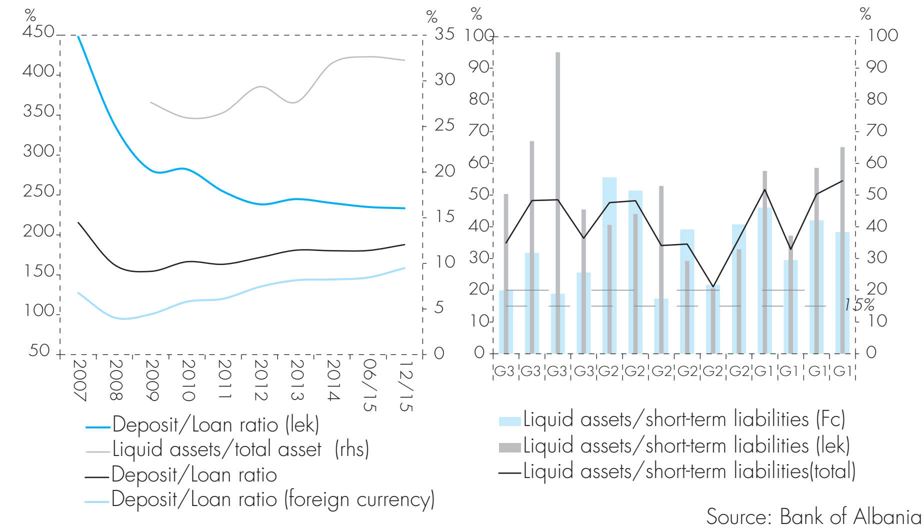
(98) Liquidity position of the banking sector stands at good levels. The liquidity ratios, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source of funding, by covering almost twice the volume of loans for the sector. Bank of Albania, through its monetary operations, has accommodated banks' demands to normalise the continuation of the calm and liquid situation in the sector.

(99) The banking sector continues to maintain a good liquidity position with a considerable outstanding client deposits over loans. In December 2015, the deposit/credit ratio stood at 188% (credit/deposit 53.2%) By currency, this ratio stands at 233% for the domestic currency and 158% for foreign currency.

The liquid assets rates in banks' balance sheets remain high due to the slow performance of lending. At the end of December 2015, liquid assets accounted for 32.3% of total banking sector assets, slightly down by 0.4 percentage points during the period. The other liquidity indicator "liquid assets to total short-term liabilities" fell also by 0.6 percentage points, down to 41%.

On the other hand, to overcome the situation after the crisis' effects of Greece sovereign debt, the liquidity ratios fell in banks with Greek capital, during the second half of the year. In any case, these banks maintained, in every moment, the liquidity ratios, in compliance with the requirements of the regulatory framework.

Chart 9.12. Liquidity situation in the banking sector

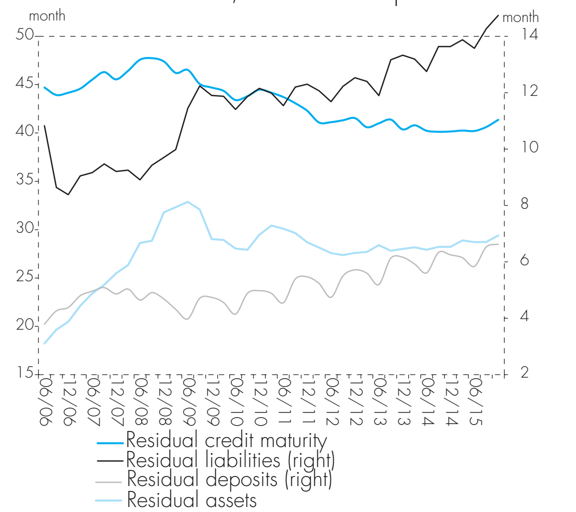


Source: Bank of Albania.

(101) **Developments in balance sheets' items of banks are followed by the expansion of liabilities maturity, by around 1.2 months, and a slight increase of this indicator for assets, by around 0.7 months.** Thus, the maturity spread narrowed to 14.7 months. The residual maturity of deposits, as the most representative item in liabilities, and of credits on the assets side, expanded to 6.6 months and 41.3 months, respectively (see Chart 9.12).

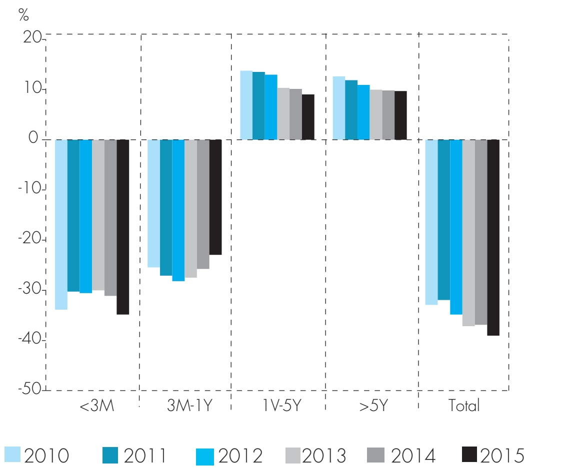
(102) **Although banks are operating under ample liquidity conditions, the negative gap between the residual maturity for loans and deposits, by residual maturity segments, against total assets is considered high, especially for short-term maturities.** The mismatch of funds volumes is more problematic for 3 months – 1 year maturities, because for shorter maturities, the gap may be a result also of a normal behaviour of economic agents given the very low interest rates (see Chart 9.14).

Chart 9.13 Average remaining maturity of assets and liabilities, loans and deposits.



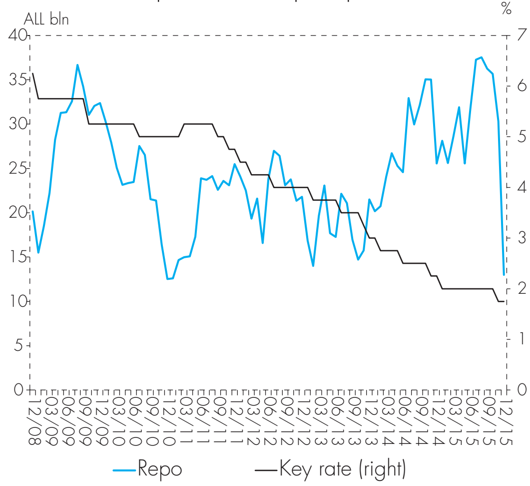
Source: Bank of Albania.

Chart 9.14 Duration gap between loans and deposits: outstanding loans minus deposit



Source: Bank of Albania.

Chart 9.15 Situation in the balance sheet at the end of period for repo operations



Source: Bank of Albania.

(103) Banking sector continues to be financed by client's 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 32% of these facilities, and the total of their value fell to ALL 5.6 billion, from ALL 8.8 billion in June 2015 and ALL 25.6 billion at the end of 2014.

(104) The strategy of the Government to shift the financing of public debt from the domestic market to the international markets, and the consecutive actions to repurchase and mature debt securities, drove to the lowering of the demand for liquidity injection by the Bank of Albania (see Chart 9.15). This action of the Government contributed in the creation of new liquidity balances in banks and is accompanied by the fall in their needs to borrow at the Bank of Albania.

9.3 MARKET RISKS

(105) Banking sector is sensitive to the negative impact on the borrowers' solvency, especially of businesses, unfavourable exchange rate and interest rate fluctuations. 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[42] introduces new capital requirements for the market risk. Banks 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 December 2015, risk-weighted assets for the market risk accounted for 1.9% to the total, from 2.4%, in June 2015. The activity of banks in the tradable book remains at limited levels, accounting for 1.6% of total assets and concentrated in the larger banks[43], from 2% in December 2014. In the tradable portfolio, investments in Albanian government debt securities amount to 88% of the portfolio's value.

9.3.1 EXCHANGE RATE RISK

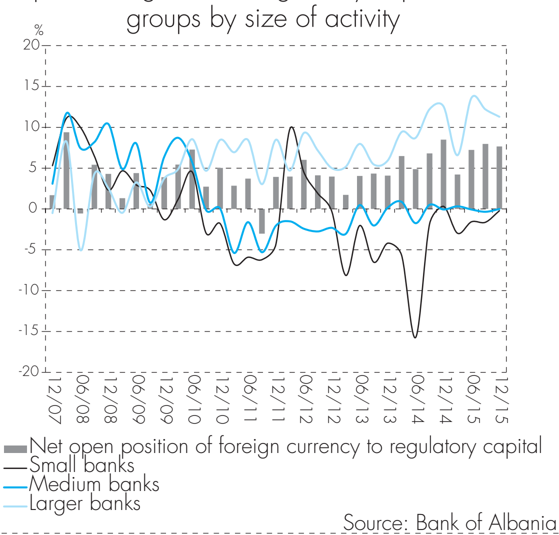
(106) The open foreign currency position to the regulatory capital reflects good resilience against the depreciation of lek. The currency mismatch index shows a downward exposure to the indirect exchange rate risk. In December 2015, larger banks maintained the "long" position, at 11.3% of the regulatory capital; whereas medium-sized banks moved towards closing the position and

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

[43] *Currently there are only two larger banks that own instruments in the trading portfolio.*

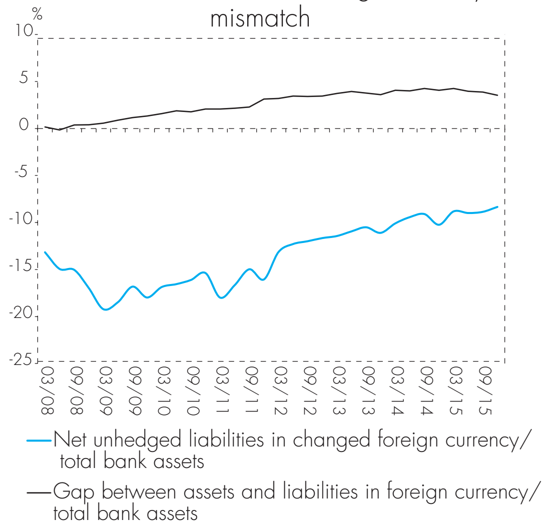
together with the small-sized banks maintain a "short" position, standing at 0.01% and 0.22% of the regulatory capital, respectively (see Chart 9.16). At sector level, the open foreign currency position is assessed as "long" at 7.7% of the regulatory capital. The long position may be considered a strategy of larger banks to have considerable amounts in foreign currency to be protected from a possible negative effect, due to the depreciation of lek against the foreign currency.

Chart 9.16 Net open foreign exchange position against the regulatory capital, for groups by size of activity



Source: Bank of Albania.

Chart 9.17 Index of the foreign currency mismatch



Source: Bank of Albania.

(107) **Banks' exposure to the exchange rate including the unhedged loans from the exchange rate volatilities) continued to be downward during the period**. The Modified Currency Mismatch Index[44] improved, rising to (-8.3%), from (-8.9%) in June 2015, and (-10.24%) at the end of 2014 (See Chart 9.17). This performance reflects the contraction of unhedged loan to both households and businesses during the period. Also, the spread indicator between assets and liabilities in foreign currency on the total assets of banks, has been falling during the period, reaching 3.5% in December 2015, from 3.95 in June 2014 and 4.1% in December 2014. The performance of this indicator mainly reflects the pronounced fall of liabilities to non-residents in foreign currency.

9.3.2 INTEREST RATE RISK

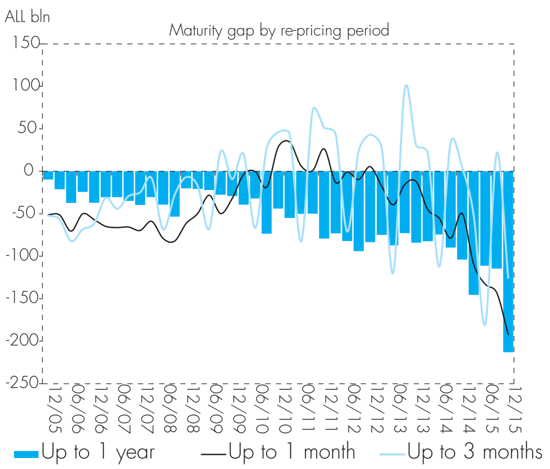
(108) **Banking sector is exposed to interest rate volatility, as evidenced by the negative and increasing spread between interest rate-sensitive assets and liabilities[45]**. During the period, cumulative spread between interest

[44] *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].*

[45] *As at end-December 2015, the spread between rate-sensitive assets and liabilities with maturities of 1, 3 and 12 months to total assets stood at (-14.6%), (-9.5%) and (-16.2 %), respectively and for the total at (-40.3%)*

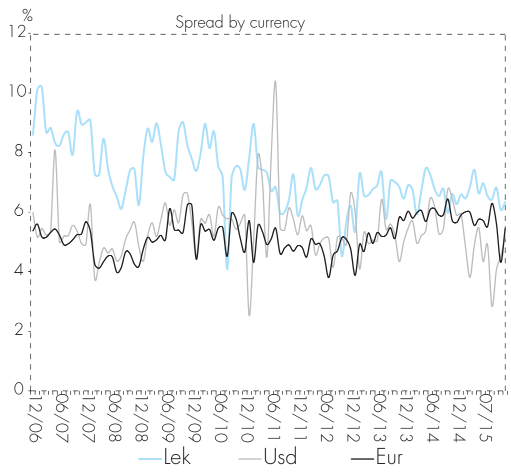
rate-sensitive assets and liabilities, respectively for maturity intervals of 1 and 12 months expanded by ALL 59 billion or by 45% and ALL 102 billion or by 91%, respectively, while the maturity interval of 3 months narrowed by ALL 55 billion, or by 30%. Total cumulative spread expanded by 25% during the period, and doubled during the year. Although deposits finance over 83.5% of liabilities and the sector is characterised by low (still downward) rates (see Chart 9.18), the presence of a high gap in the short term requires a continuous monitoring. On the other hand, the sector appears more hedged against indirect risk arising from the increase of interest rate, given that 90% of credit is at flexible interest rate, although the structure of deposits is at flexible interest rate. In any case, the cut of key interest[46] rate and the maintaining of accommodative monetary conditions for the predicted future, lower the probability of a rapid increase of the interest rate.

Chart 9.18 Maturity gap by re-pricing period



Source: Bank of Albania.

Chart 9.19 Interest rates spread by currency



Source: Bank of Albania.

46 *The key rate was cut twice during the year down to 1.75, from 2.25% at the end of 2014.*

10. ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING[46]

(109) 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 a limited number of medium-sized and larger banks, their exposure to adverse scenarios is higher. Regarding the stress test for the liquidity risk, banks are estimated to have high elasticity to its shocks. Based on the banking sector data, at end of September 2015, it results that banks may afford a high level of deposits withdrawal.

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 2017. 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 two scenarios: baseline scenario and severely adverse scenario. The latter assume a "stressed" situation, but with a low probability of occurrence[48], supported as follows:

1. Baseline scenario

Economic growth is assumed to reach 3.0% at the end of 2016 and improve to 4.1% during 2017. As a result of the non-performing loans write off, the credit portfolio quality will considerably improve by the end of 2017.

2. Severely adverse scenario

In this scenario, the economic growth is assumed to be lower, 1.9% in 2016 and to contract 0.5% in 2017, driven by the depreciation of the lek exchange rate by 20% for each year, increase of interest rates by 3.0 and 2.9 percentage points for each year; and lack of lending to economy in the next two years. These assumptions are reflected in the increase (deterioration) of non-performing loans ratio by 9.6 percentage points at the end of 2016 and 12.1 percentage points at the end of 2017, compared to December

47 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.

48 Bank of Albania calculations.

2015. The credit portfolio quality in this scenario reflects, in addition to the clearing of the balance sheet, the new flows of non-performing loans at the end of the three-year regulatory term. This scenario, following credit quality deterioration, assumes shocks in terms of the market risk and operational risk, as follows:

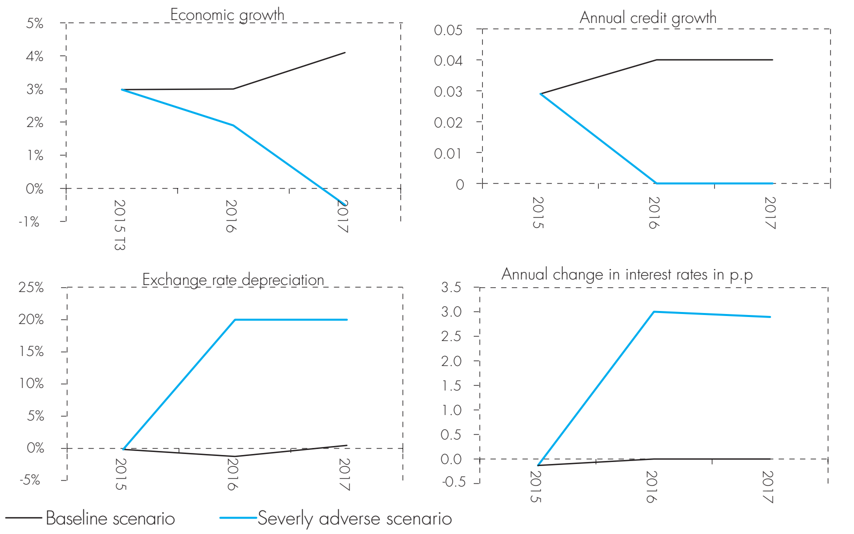
2.a. Interest rate risk- the impact of volatility in the value of instruments included in the banking book, relies on the gap in the value of asset and liability items in the bank's balance sheet (interest earning), and analyses the relevant monetary flows that result from an overall increase in interest 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;

2.b. Market risk- is added 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, and drive to the 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 2% and 5%, respectively, each year.

2.c. Operational risk- in the moderate adverse scenario, RWA for the operational risk increased by 2% in the first year and 5% in the second year.

Grafik 10.1. Assumptions to construct stress test



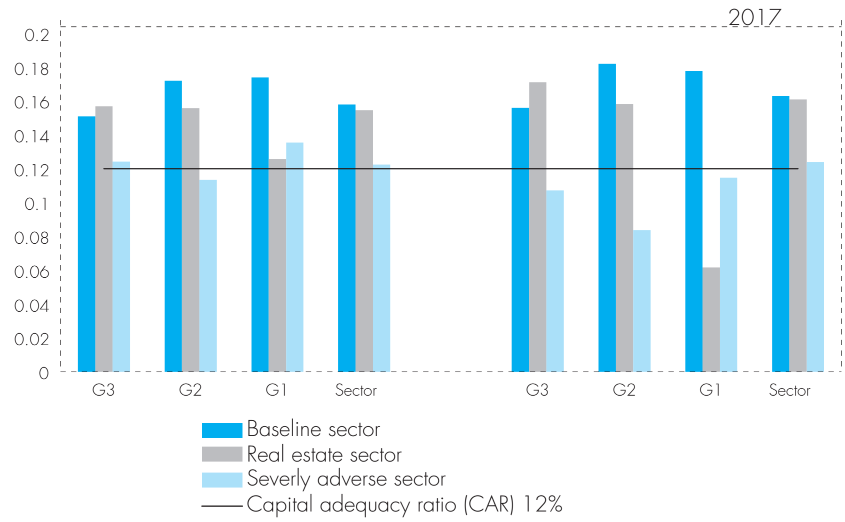
Source:Bank of Albania.

Results in terms of capital adequacy show that:

- in baseline scenario, the capital adequacy ratio of the sector reaches 15.8% at end-2016, and 16.3% at end-2017, following the improvement of loan quality and higher pace of economic growth;
- in the severely adverse scenario, the capital adequacy ratio of the sector reaches 12.2% at end-2016, and maintains 12.4% in 2017. In this scenario, the number of banks falling in under-capitalisation increases compared to the previous scenario, following the deterioration of credit quality, losses in securities portfolio and the increase of exposure to the market and operational risk.

Based on the above information, the need for additional capital ranges ALL 4.5 and 14 billion in 2016 and 2017, in the severely adverse scenario. To place these values in the context of current developments, we point out that during 2015 the banking sector has increased the capital by around ALL 6.9 billion, or around twice the capital injected during 2014.

Chart10.2. Capital adequacy ratio, for each scenario



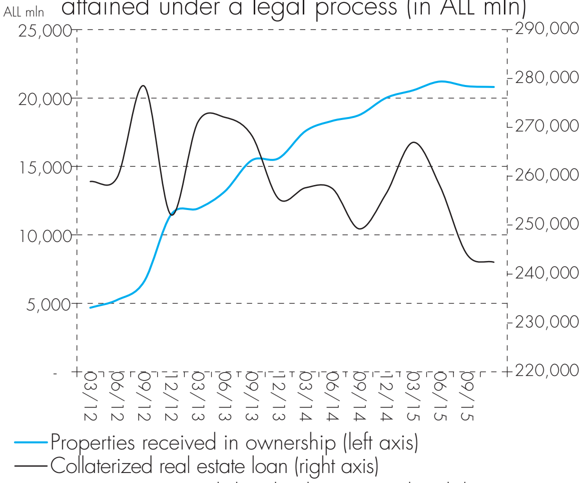
Source: Bank of Albania

BOX 10.1. BANKS' EXPOSURE TO THE RISK RELATED TO THE PROPERTIES RECEIVED IN OWNERSHIP DURING A LEGAL PROCESS

For the purposes of collateral execution, individual banks have become owner of assets in the form of real estate. In the view of supervisory authority, it is important to assess the impact of these collaterals in the balance sheet on the income and capital of the bank. There are eight main types of risk related to the banking activity: credit risk; interest rate risk; liquidity risk; price risk; operational risk; consistency risk; strategic risk and the reputational risk. While price risk is the main risk related to the real estate, the liquidity risk, operational risk, consistency risk and reputational risk are equally important. In concrete terms:

- *a) A fall in real estate price - during the period of maintaining in the balance sheet- may reduce the value of the asset in the balance sheet, also the income that may be realised from the sale of the real estate as collateral. At the same time, a fire sale of these collaterals by banks, on the other hand, may heavily damage the real estate market, not only affecting the bank's income, also the effect of collaterals as real estate accepted during the process of lending, with consequences in the credit portfolio quality and capital adequacy ratio.*
- *b) The high levels of these assets in the balance sheet, accompanied with ineffective strategies of their ownership may negatively impact the liquidity of a bank.*
- *c) Operational policies and procedures related to this types of assets may contribute in the increase of the operational risk, resulting in lower income from collaterals in ownership and high expenses; the inadequate an non-effective effort of sale, splitting/breakdown of collateral/collaterals/ unknown losses, and lower recovery rates.*
- *d) In cases when these collaterals are taken in ownership, banks take the crucial risk of compatibility with the legal framework that regulates the management of properties. A bank is legally responsible related to the ownership, actions and maintenance of these properties, which may arise from definite legal obligations.*
- *e) The risk of bank's failure to comply with the legal obligation on the management of properties may be accompanied with the damage of its reputation to its competitors or clients.*

Chart10.3. Item performance in the asset side of banking sector related to the properties attained under a legal process (in ALL mln)

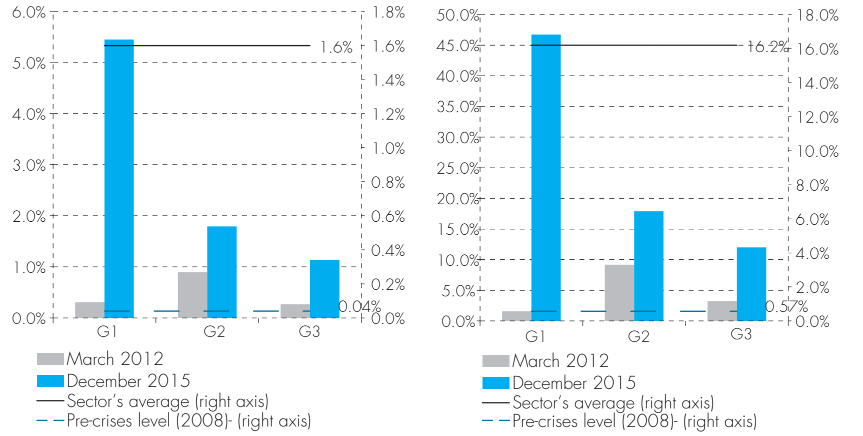


Source: Processed data by the Financial Stability Department

The above data clearly show that till 2008, before the impact of the global financial crisis in Albania, the values of properties received in ownership to the total asset of the balance sheet, and to the regulatory capital stay at ineligible rates, considerably 1%. Meanwhile, in the last four years period (2012-2015), they increase considerably, by recording historic average values, 1.2% and 12.8%, respectively. In December 2015, these values stay averagely at 1.6% to the asset and 16.2% to the regulatory capital. The above view evidences once more the importance of addressing this phenomenon in the framework of individual banks' soundness and of the whole banking sector as well.

The following scenario assesses the exposure of the banking sector to a possible sale resulting in losses of these properties. In this scenario, assumptions on economic growth, exchange rate, the interest rate and increase of credit are equal to those in baseline scenario.

Chart10.4. Property received under a legal process to total assets (left) and to regulatory capital (right axis)



Source: Processed data by the Financial Stability Department

Different from the latter, it is assumed that in case of a subsequent sale of these properties, the sector would suffer a loss calculated from 33-50% of the value in the balance sheet (December 2015) for each year, respectively.

The results show that albeit the sector remains well-capitalised and profitable at aggregate level in both years, in terms of profitability, individual banks have a decrease of the net financial result. In more concrete terms, the number of affected banks is six, and share 21.9% of the banking sector's assets. In this scenario the value of capital adequacy ratio reaches 15.5% and 16.1%, respectively.

10.2 LIQUIDITY STRESS TESTS

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). In this regard it is assessed: (i) risk liquidity in financing (related to liabilities in banks' balance sheets: a bank may incur deposits outflow or the bank encounters difficulties to renovate the deposits) and (ii) liquidity risk in the market (assets: banks' inability to generate the needed liquidity amount when it needs to sale its own asset). The data are taken from the individual bank data, for granular [49] money flows generated by assets and liabilities classified by maturity structure. Based on this data, the inflows and outflows in the bank's balance sheet are included in the exercise, by defined maturity segments, by products and currencies. At the same time, care is taken in the exercise to exclude an asset that is liquidated by the whole assets that generate inflows.

[49] *That means, the cash flows are by individual banks and described really detailed in order to reflect the diversity of sources and the way the funds are used. In concrete terms, the exercise shows the inflows and outflows (of liabilities to clients) by: a) type of product (time and demand deposit); type of depositor (financial institution, business and household). Similarly, are divided the money income (in assets). For example, related to credit, the inflows may be generated by the type of borrower (households, business, financial institution);*

The liquidity stress test assumes that (i) the bank shall fulfil the pronounces withdrawal of deposits through the sale of only liquid assets; (ii) the sale of investments has taken place through the haircut of their value of 10% and 20%. The bank is consider to fail the stress testing exercise only if it is needed the help of central bank via the "loan for liquidity support".

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 two cases of negative liquidity gap (when liabilities are higher than assets) in rather low levels in the domestic currency, which are fully covered by the liquid assets.
- there is one case of negative liquidity gap, when it is rather low in Euro and it is covered by the deposits in assets or securities..
- there are some cases of negative liquidity gap in US dollar,
  but the value is rather limited, and is fully covered by the ample liquidity surplus in other currencies.

ANNEX 1 FINANCIAL SOUNDNESS RATIOS

In per cent	2007	2008	2009	2010	2011	2012	2013	2014	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	15.72
Core capital to risk-weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79	13.45
Shareholders' equity to total assets	7.62	8.57	9.57	9.40	8.69	8.57	8.37	8.58	9.53
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	24.28
Gross non-performing loans tototal loans	3.36	6.64	10.48	13.96	18.77	22.49	23.49	22.80	18.22
Profitability									
Return on Equity (RoE, annual basis)	20.74	11.35	4.58	7.58	0.76	3.78	6.43	10.53	13.16
Return on Assets (RoA, annual basis)	1.57	0.91	0.42	0.72	0.07	0.33	0.54	0.89	1.20
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	7.66
Net open foreign position to core capita	1.80	4.54	4.12	5.33	4.29	4.41	4.92	10.37	8.95
Asset-based indicators									
Liquid assets to total assets	49.77	42.83	27.65	25.95	26.53	29.37	27.64	31.94	32.26
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	41.43
Customer deposits to total loans	215.45	162.60	154.32	166.39	163.20	171.62	180.83	180.16	187.78

Source: Bank of Albania.