Bank of Albania

FINANCIAL STABILITY REPORT

2016 H1

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C O N T E N T S

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T A B L E S

C H A R T S

INTRODUCTION

This is the sixteenth issue of Bank of Albania's Financial Stability Report, which is published half-yearly. The purpose of this Report is to identify and assess risks facing the financial system and its infrastructure, in order to provide the public authorities with the possibility to identify the relevant measures for adjustments, as necessary. The Financial Stability Statement, whose half-yearly release is a legal requirement, prefaces the Report.

In producing this Report, we have used data available at the Bank of Albania, and information from other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the highlights over the first half of 2016 (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 highlights 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 enterprises and households' financial situation, and the impact on the solvency of the banking sector borrowers.

The report briefly includes the results of the stress test, which includes liquidity stress scenarios.

NOTES

As at end- June 2016, banks operating in Albania are 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);*
  They account for around 4.7% of the sector's total assets.

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

- **Banks Peer Group 3** *(each sharing over 7% of total banking sector assets): National Commercial Bank (NCB), Raiffeisen Bank (RB), Credins Bank (CB), Intesa Sanpaolo Bank –Albania (ISBA).*
  They account for around 69.1% of the sector's total assets.

As at end-June 2016, by capital origin, the banks operating in Albania were divided as follows:

- **Banks with foreign capital** [1]*[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 (France); ProCredit Bank (Germany); First Investment Bank (Bulgaria); International Commercial Bank (Malaysia); United Bank of Albania (Islamic Development Bank -Saudi Arabia); Credit Bank of Albania (Kuwait).*
  They account for around 83.4% of the sector's total assets.

- **Banks with Albanian capital:** *Credins Bank, Union Bank, American Investment Bank;*
  They account for around 16.6% of the sector's total assets.

At the end of June 2016, from all the registered banks, headquartered in the Republic of Albania, only the National Commercial Bank has a branch abroad, in Kosovo.

The 'period' in this report refers to 2016 H1. 'Previous period' refers to 2015 H2, and 'future period' refers to the 2016 H2.

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

FINANCIAL STABILITY STATEMENT, 2016 H1

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

The Financial Stability Report and in the statement that prefaces it assess the banking sector's exposure to risks arising from its interaction with external and internal economic developments, real economy agents, financial markets in Albania as well as risks related to the way the baking sector conducts its activity. In addition, these risks are faced with the financial situation of the banking sector and are stressed through the stress test to assess the banking sector's resilience.

The Bank of Albania considers that the activity of the banking sector and of the financial system has been stable during 2016 H1. The main financial indicators of the banking sector- including capitalization, liquidity and profitability -attest to its full capacity to withstand the operational risks at normal conditions, as well as to show endurance against strong shocks.

Economic and financial highlights

During 2016 H1, the international economic and financial developments have been in line with expectations. Incentivising policies, particularly in the advanced economies, have supported the moderate growth of the world economy. Raw material and oil prices have settled at low levels and the signals for their recovery need consolidating. Overall, inflationary pressures remained weak, despite a relative improvement in the labour market in more advanced economies. Liquidity in the financial markets appears better, attributable to the easing monetary policies of central banks in the larger countries. Foreign exchange markets were overall stable, despite the volatility at the end of the period following the unexpected Brexit referendum result. In the sovereign debt markets of the advanced economies, the yields curve continued to be close to or below zero for all maturities. In the capital markets, the value of bank's share, especially the European banks, declined mainly due to concerns related to the assets' quality, uncertainties regarding the impact of regulatory changes, and profitability levels. However, the stress test conducted on European banks for this year, showed their resilience attributable to better capitalization. Overall, during the period, international developments had no significant impact on the performance of the financial system and the banking sector in Albania.

During the period, economic developments in Albania were positive. Economic growth, driven mainly by the domestic demand, accelerated during Q1 to 2.96% (annual growth) and employment indicators improved. Inflationary pressures remained weak and the Bank of Albania deepened the easing monetary policy stance by lowering the policy rate two times by 0.25 percentage point to 1.25%. Fiscal policy maintained its consolidation trend through the increase in revenues and the decrease in budget expenditures. The shift to a positive budget surplus was accompanied with declining needs for funding, which were fulfilled almost entirely with foreign sources. In the domestic financial market, interest rates on lek financial products, declined during the period, due to monetary and fiscal policy actions. During the period, liquidity in the interbank market was stable and trading volume has slightly increased. The foreign exchange market reflected developments in international markets, and lek appreciated slightly against major currencies.

Households and enterprises appear to have stable financial balance sheets. During the period, the notable credit financial position of households declined slightly as a result of the faster growth of credit, especially in lek, compared with the growth of their deposits. On the other hand, the enterprises debt financial position deepened somehow due to the decline of deposits and growth of credit. Regarding quality, the non-performing loans decreased for households but increased for enterprises.

During the period, the banking sector and financial system activity expanded even further, but the growth pace slowed down and the financial system's share in GDP fell to 100.7%. The sluggish growth of the banking sector activity was the main contributor to this performance. Banking sector's assets make up 90.8% of the financial system's assets. In annual terms, in the banking sector activity, securities (increase) and reserve funds (decrease) in the assets side of the balance sheet, and treasury and interbank transactions (decrease) and permanent resources (increase) in the liabilities side experienced the biggest change.

During the period, the banking sector expanded the credit by 1.9% and increased the investments in debt securities. The activity was funded again through deposits, which make up 82.3% of the banking sector's assets, and showed steady value during the period. Despite the slight increase during the period, the relationship between the banking sector and non-residents remained stable during the last year.

Banking sector exposure to operational risks

Regarding the banking sector operational risks, the Bank of Albania assesses as follows:

a) **Credit risk increased during the period.** The value of non-performing loans rose by 11.7% and the ratio of non-performing loans in the banking sector rose to 20%, from 18.2% at the end of 2015. Credit to enterprises, foreign currency credit and medium-term credit gave the main contribution to this increase. The increase in non-performing loans is associated with the slight reduction of their coverage with reserve and capital funds, albeit these indicators remained at the same levels as a year ago.

The increase in non-performing loans points to the difficulty for their resolution and the need to closely monitor this process. The Bank of Albania expects the NPLs curve to trend down, although their value may fluctuate over time. In this regard, the Bank of Albania will carefully monitor the banks proactive approach to timely identify, and to provision non-performing loans, as well as the way they implement the regulatory requirements for writing off lost loans from the balance sheet. In addition, it will be important to verify the impact that the approval of the draft law "On Bankruptcy" will have in the relationship between banks, debtors and other parties that interact in the resolution of problematic debt. As evidenced by the Albania Financial Forum IV proceedings in June 2016, in cooperation with the banking industry and the government, the Bank of Albania will assess the need for taking additional measures that reduce the uncertainty in the financial intermediation process and improve the implementation of legal requirements in this field.

b) **Liquidity risk in the banking activity is assessed as low.** The low value of loans to deposits ratio, continuation of deposits growth and the high presence of liquid assets above the minimum regulatory requirements, show a very good situation of liquidity in the banking sector. This situation shows the space and need for improving the financial intermediation, as a necessary phenomenon to contribute, among other things, to improving the efficiency of banking activity. However, it must be taken into account that the share of very short-term sources of the banking sector in the form of current accounts and demand deposits continues to grow. This performance dictates maintaining high levels of liquid assets and negatively affects the performance of income from interests. The good liquidity situation was also proven through a special stress test exercise, which took place in June.

c) **The banking sector is significantly exposed to the market risk (including the exchange rate risk and interest rate risk) regardless of the reduction of exposure size during the period.**

As previously assessed, the direct exchange rate risk in the banking activity is limited, as foreign currency assets and liabilities have approximate values. However, risk increases when the assessment includes the indirect impact from the exchange rate, transmitted mainly through foreign currency loans to resident entities, whose main income is in lek. Despite the decline in this loan category during the period, it accounts for about 26.5% of the total outstanding loans, which is considered as a high share. Banks as well as borrowers should carefully evaluate the risks stemming from foreign currency lending, where the parties are exposed to adverse fluctuations of the exchange rate. Transparent communications between parties regarding the recognition of risk and the implementation of concrete procedures by banks for its quantitative assessment should be part of this careful assessment.

Interest rate risk is present in the banking activity in both its direct and indirect forms. In its direct form, the risk is transmitted through the gap between assets and liabilities of the banking sector according to repricing periods. This gap is negative and has widened somewhat in the short term. The risk would materialize in the case of an increase of the interest rate, which, due to the negative gap, would have a faster impact on the banking activity costs compared with its revenues. This risk has an indirect component related to the negative effect from the increase of interest rate on borrowers who have variable interest rate loan. It such case, it is necessary for banks to quantitatively assess the impact of adverse scenarios and work on reducing the exposure.

d) **The events that affected the transport security and safeguarding of monetary values point to the necessity of strengthening the procedures that banks apply for operational risk management.** This should not only include the physical security but also the electronic and IT-related security, which are of critical importance for a secure banking activity. In this regard, the Bank of Albania promotes cooperation between banks and law enforcement authorities to resolve concrete cases and take measures to eliminate loopholes. More generally, regarding the operational risk management, the Bank of Albania emphasizes the need of a holistic approach, where the assessment of operational risk is based on its impact on the reputation, strategy, and finances of the institution, as well as on a full analysis on risk likelihood. Thus, the control system should be established and implemented on such basis, while the procedures' quality and compliance, and the suitability of the whole supportive infrastructure of the process is part of the periodic test and regular evaluation by special bank structures. The Bank of Albania notes that it will strengthen its supervisory and regulatory activity in terms of the verification and evaluation of the operational risk management systems by banks, inter alia, by increasing the significance of this process on the banks' overall evaluation, and in particular, on their management structures.

e) **The significant presence of foreign banks in Albania and the exposure of the banking sector to non-residents, underpins the need for close**

monitoring of international developments. In this regard, the stress tests conducted on the biggest European banks were of particular interest. The results, which were published in June, confirmed that none of the banks operating in Albania, part of the stress test, had any problems regarding activity sustainability. In general, the stress test showed that European banks have much better conditions of capitalization and liquidity than in previous years.

The European financial markets showed an increase of their activity volatility by the end of the period, following the somewhat unexpected "Brexit" referendum result. The foreign exchange markets were the most volatile, with the British currency depreciating rapidly. The depreciation of the British currency could, in short term, be accompanied by a decreasing value of the Albanian banking products in this currency. Based on the performed analysis, the Bank of Albania considered that this was a minimal effect, since public's loans and deposits denominated in the British currency were negligible. Also, the Albanian banking sector investments in British currency in the form of placements (account, deposits) or securities were quite limited. In a longer term, Brexit impact on the Albanian economy would be determined by the volume of trade relations. The analysis showed that exports, imports, foreign investments and remittances to/ or from the UK, were in each case less than 1% of the GDP, thus considerably limiting the adverse impact of Brexit. It should also be noted that the Brexit process will require time and is surrounded by uncertainties. However, the measures taken by the monetary and fiscal authorities in the UK and Europe, to ensure a smooth process, without causing dramatic volatility in the respective economic and financial indicators, will mitigate the potential effects from this process on other countries.

Risks to financial stability

To assess systemic risks, we analysed the performance of indicators related to the materialization and accumulation of the systematic risk, with the stress level in the financial system and with the banking industry perception regarding the banking activity exposure to systemic risks. Also, the financial stability map, aims to achieve a consolidated approach of risks to financial stability.

In general, the indices show a slight increase of risks to financial stability over the period. In the banking sector, the increase of non-performing loans, relative decrease of profitability indicators, slowdown of deposits' growth and banks' perception on risk levels have made the main contribution. In the real economy, the increase of the external debt of Albania and the still-volatile expectations of the private sector for the economy's performance contributed to the increase of risks. In general, economic growth, fiscal performance of the government and decline of foreign currency loans in the banking sector, contributed positively in the reduction of risks evaluation.

Banking sector's ability to cope with risks

The banking sector's ability to cope with risks is assessed by analysing its capitalization and profitability situation, as well as by stressing these indicators using the stress test.

At the end of the period, the banking sector's capital adequacy ratio was 16.1%, about 0.1 p.p. higher compared to the end of 2015, about 0.6 p.p. higher than a year ago, and significantly above the minimum required level for this indicator, at 12%. Despite the increase of risk-weighted assets coefficient by almost 3.9%, the increase of the regulatory capital by 4.2% retained the indicator's upward trend. Financial leverage indicator, measured as the ratio of total assets to shareholders' equity was 10.4 times and is considered to be at a good level. The maintenance of a good capital position is determined by the performance of the sectors' financial result. During the period, the banking sector resulted at a profit, albeit lower than a year ago. The decrease in income from interests and the increase of the provisioning for credit risk drove to the profit decline. The decrease of income from interests has reflected the fall in return rates from investments for financial instruments both in foreign currency and in lek. Increased provisioning for credit risk, has reflected the growth of non-performing loans during the period. Sector profitability indicators, Return on Assets (RoA) and Return on Equity (RoE) were 0.8% and 8%, respectively.

The adequacy of the above indices has been proven during the stress test with scenarios that assumed adverse changes in macroeconomic and financial indicators for the 2016-2017 period. As part of the extreme assumptions, but with a low probability of adverse scenario likelihood, the contraction of the economy and of credit, and the rapid increase of interest rates and the strong depreciation of the exchange rate were included. The results of the stress test showed that in the baseline and the adverse scenario, the banking sector remains capitalized, whilst it would need a capital increase in the adverse scenario. Additional capital requirement for specific banks is evident in the adverse scenario.

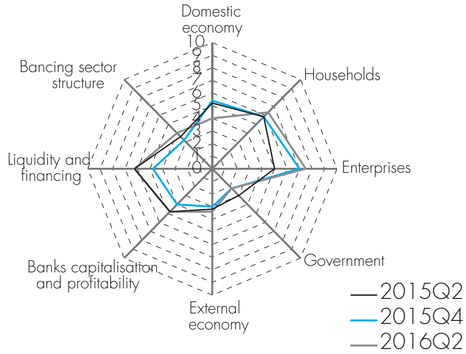
Based on this analysis, the Bank of Albania considers that banks capitalization and profitability is sufficient to cope with operational risks. Banking sector activity, in the short term, will benefit in the case of an acceleration of economic growth, by improving the revenues' structure and consolidating the positive performance of the financial result. But, in a shorter-term period, the banking sector's profitability may continue to feel the pressure of the low interest rates and the volatility in the level of activity cost. Thus, the Bank of Albania assesses that banks should continue to efficiently use the revenues, and maintain the indicators of the activity capitalization.

The following sections present the Financial Stability Report 2016 H1 in greater detail.

1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

(1) Risks to the banking sector were slightly upward during the period for certain categories. The Financial Stability Map shows the performance of the sector's and real economy indicators in the last 18 months. Specifically, the banking sector marks a slight increase exposure to the risk of "liquidity and funding" and "capitalization and profitability" categories, mainly as a result of the decline in profitability. For the real economy, the risk is increased for "households" and "enterprises", mainly following their volatile expectations regarding the second half of the year.

Chart 1.1 Financial Stability Map*,**



* 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.
**This map assesses the exposure of financial system to risks stemming from the domestic and external economy, economic agents and the banking sector.
Source: Bank of Albania,INSTAT, ECB, IMF.

Compared to December 2015, for the real economy components[2]:

- for the **'domestic economy'**, risk is assessed as 'average' and downward, as a result of the fulfilment of needs for funding , particularly from external sources, the exchange rate stability and the low inflation rate;
- for **households**, risk is assessed as **'moderate'**, with an upward contribution only from weaker expectations;
- for **'enterprises'**, risk is assessed as **'moderate'** and upward, given the fall in the **'production volume index'** and the volatility in **'private sector expectations';**
- for **'government'**, risk continues to be assessed as 'low', unchanged from the end of the previous period, for the components of this category;
- lastly, risk stemming from **'external economic environment'** is assessed as below 'average' largely unchanged from the end of last year. Risk growth as a result of the economic slowdown in the trade-partner countries is mitigated by the reduction of unemployment in countries that are sources for remittances.

[2] *Due to lack of data, data from 2016 Q1 is used to assess the risk of the real economy categories.*

'Banking sector' components[3]:

- for **'capitalization and profitability'**, risk is assessed as 'average' but slightly upward due to the decrease of the net interest income and financial result of the banking sector;

- for **'liquidity and financing'**, risk increased to 'average', reflecting the deepening of the gap between assets and liabilities of banks with maturities up to three months;

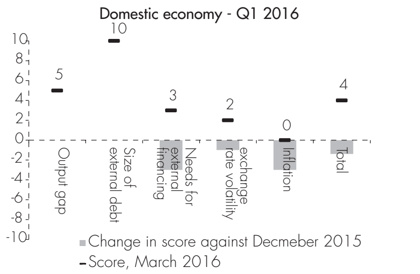
- lastly, for **'banking sector structure'**, risk is low, following the better-diversification of funds for financing the banking sector and lending, although credit concentration in the business sector is somewhat higher.

Box 1.1 shows the Financial Stability Map components over 2016 H1, the score for each risk level and comparison with the scores from the end of 2015.

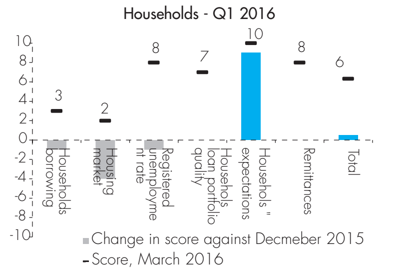
3 Data from 2016 Q2 are used for the risk assessment for the three categories of the banking sector.

BOX 1.1 FINANCIAL STABILITY MAP COMPONENTS

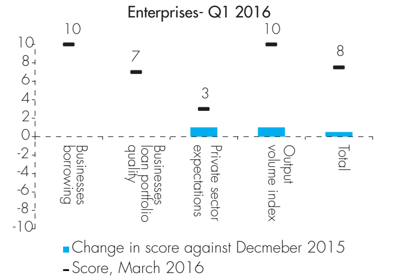
*Risk to **"domestic economy"** is rated as "average" following the improvement of needs for external financing, exchange rate stability and inflation.*



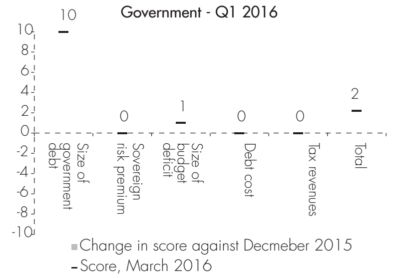
*Risk to **"households"** is rated as "moderate" due to the deterioration of expectations of this economic agent.*



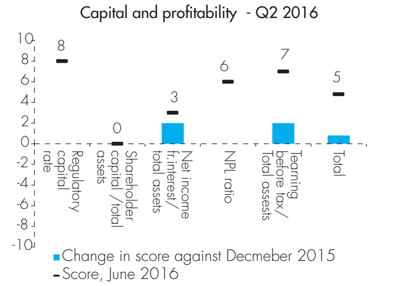
*Risk to **"enterprises"**, is rated as moderate given the fall in the "production volume index" and the private sector expectations.*



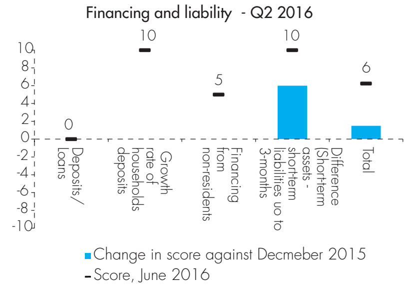
*Risk from **"government"** is rated as "low", maintaining the same levels for all the main indicators.*



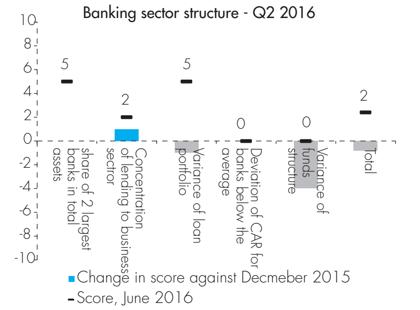
*Risk from **"external environment"** results to be almost unchanged from the end of 2015, when the slowdown of the economic growth in some of trading partner countries was mitigated by improved labour market in countries originating major remittance flows.*



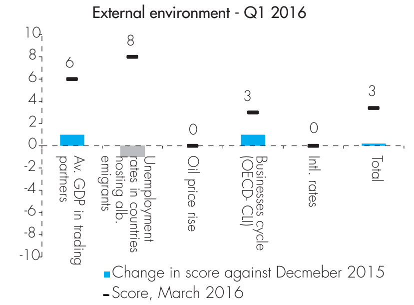
*Risk from **"capital and profitability"** is assessed as upward, due to the decline in net interest income and net profit of banks, amid declining interest rates in Albania.*



*Risk from **"financing and liquidity"** was upward due to the deepening of the gap between short-term, up to three months, assets and liabilities.*



*Risk related to the **"banking sector structure"** fell, given the increase in the diversification of its financing funds and lending to enterprises.*



Source: Bank of Albania, Financial Stability Department.

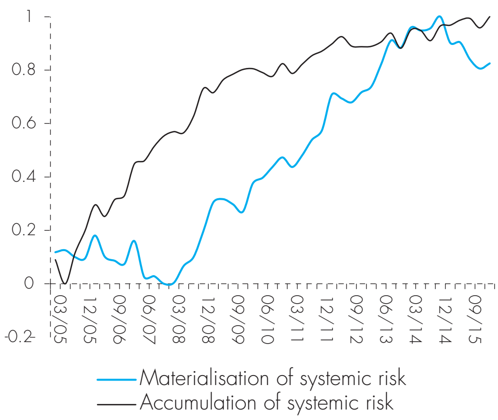
1.1 SYSTEMIC RISK[4]

To assess the banking sector's exposure to systemic risk, the performance of indicators related to the materialization and accumulation of the systemic risk with stress level in the financial system and the banking industry perception regarding the banking activity exposure to systematic risks, is analysed. Materialisation index of the systemic risk assesses the actual level of the risk, whilst the risk accumulation indices of financial stress and the banking industry perception on it, focus mainly toward the future.

(2) Materialisation of systemic risk has been downward. Improvement of credit to enterprises and households, due to the loss loans write-off from the banks' balance sheet, decline of unemployment and of exchange rate volatility have contributed to reducing the materialisation of systemic risk, compared with a year earlier (see Chart 1.2)

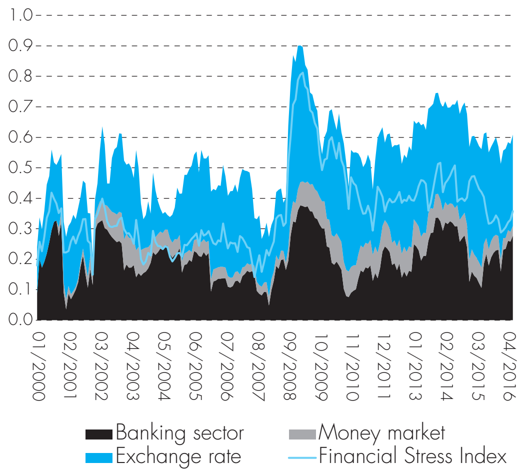
(3) The accumulation of systemic risk[5] and financial stress index increased over the past year. Regarding the systemic risk accumulation index, the contraction of foreign currency credit has mitigated risk accumulation; on the other hand, the housing market performance, increase in credit to enterprises as well as in external debt had an opposite effect. The lower increase in deposits and the decrease in the net margin of interest rate in the banking sector contributed to the increase of the financial stress index (see Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk



Source: Bank of Albania, Financial Stability Department.

Chart 1.3 Financial Stress Index



Source: Bank of Albania, Financial Stability Department.

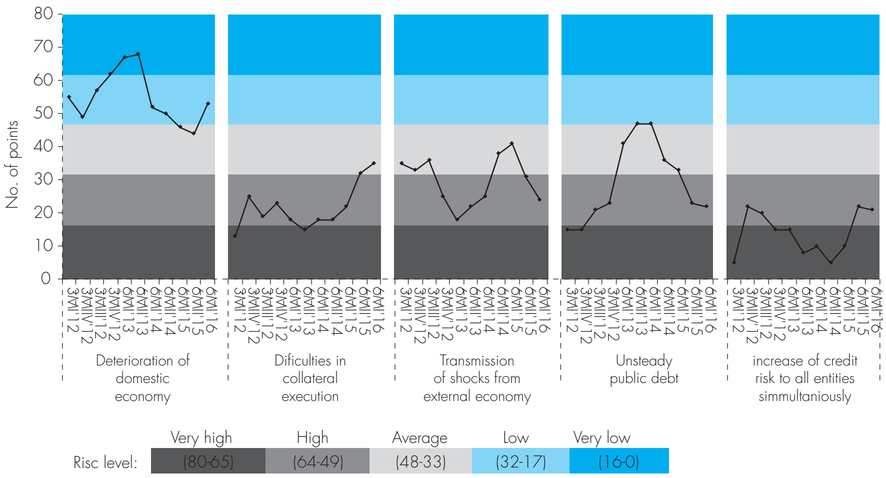
(4) During the period, bank's perception on certain risks increased, but the probability of materialisation in short and medium term is assessed as "below average". The deterioration of the "domestic economy" remains the

4 *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"*

5 *Data refer to 2016 Q1.*

most important systemic risk and, in the bank's perception, its importance has increased from "average" to "high". Banks' attention to the risk arising from the "difficulties in the execution of collaterals" continues to be up, given the considerable share of collateralized loan. On the other hand, the concern regarding "external shocks risk" continues to be mitigated, mainly as a result of the stabilization in European economies and financial situation in Greece.

Chart 1.4 Bank assessment of main systemic risks



Source: Bank of Albania, Financial Stability Department.

2. INTERNATIONAL DEVELOPMENTS

(5) During the period, global economic highlights were generally positive, although in the end, the Brexit referendum result was followed by shocks in the financial markets and uncertainty over the global economy outlook. Global economic activity recovered at a moderate pace, driven by improved conditions in the financial markets and incentive policies, in advanced economies and in some emerging regions. The Brexit result on 23 June was accompanied with significant volatility in equity and foreign exchange markets. This shock was short lived and the majority part of prices recovered in the following months. However, the decision of UK to exit EU and the uncertainty regarding the start and duration of the process (which occurs for the first time), has negatively affected the expectations of investors, and may have consequences for the European and global economic perspective in general. Global inflationary pressures remained subdued, reflecting the weak demand and a lack of adequate recovery in oil and commodity prices.

(6) Economic activity in advanced economies expanded at a slow pace, supported by monetary and fiscal stimulating policies. Economic performance in emerging economies has shown significant volatility among different countries, but generally remained weak. Among advanced economies, the US economic growth pace moderated in the first quarter of this year, due to the fall of private expenditures and investments by non-residents. Data on macroeconomic indicators show a positive trend in the second quarter of the year and following, supported by strengthening of domestic demand. On the other hand, net exports are expected to contribute negatively due to the appreciation of the dollar and the weakening of external demand. Conditions in the labour market showed signs of stability and the unemployment rate in May-June stood at 4.9%. In developing countries, the economic performance remained weak, affected by the internal and external financial imbalances, geopolitical tensions and the negative effect of oil prices on producing/exporting countries. However, the economic dynamics between the countries are heterogeneous, with countries like China and India registering a steady positive growth, while countries such as Brazil and Russia remaining in economic recession.

(7) Global economy is expected to continue its gradual recovery, supported by expansionary policies in advanced economies, improved labour market conditions and expectations for a reduction of economic recession in some of the major emerging economies. Given the still unclear situation regarding "Brexit" and the possible consequences for the global economy, the International Monetary Fund (IMF) reduced by 0.1 p.p. the outlook for the global economic growth for 2016 at 3.1%, and at 3.4% for 2017. The outlook revaluation for advanced economies contributed to this reduction, whilst the forecast for emerging economies remained the same[6].

(8) Possible "Brexit" effects are considered as the main threats to the outlook for the global economy and the financial markets. The uncertainty related to this process has prompted a surge in economic, political and institutional uncertainty. In a positive scenario, the new arrangements between the UK and the European Union would avoid economic barriers between the two regions, thus minimizing the consequences of this transition. However, in case of the materialization of a more negative scenario, macroeconomic consequences in the European advanced economies may be significant, whereas the impact is expected to be limited outside the EU. On the other hand, the potential economic slowdown of emerging economies, in particular the uncertainty surrounding the economic transition of China, escalation of geopolitical tensions, and the adverse effect of low oil prices in the fiscal and financial balances of some of the producing countries continue to pose a risk for the medium-term perspective of global economy.

BOX 2.1. BREXIT AND THE BANKING SECTOR EXPOSURE TO THE UK AND BRITISH CURRENCY (POUND)

The impact of Brexit at European level is still unclear and will require time. More direct and short-term risks for the financial system assets are mainly related to the possibility of the decline in value of these assets invested in GBP, as a result of its depreciation. Longer-term and most difficult risks to be determined are related to the impact of Brexit on the economy of continental Europe and the UK, and the way this may spill over in trade relations with other countries.

By focusing on shorter-term risks for investments in the financial system in Albania, banking sector's exposure to the UK and GBP is considered low. At the end of 2016 H1, claims in the form of placements in non-resident institutions (not only in the UK) in GBP account for only 0.86% of banking sector assets, with an absolute value of ALL 11 billion. By banking groups, G3 group has a relatively high share. Exposure only to the UK is even lower, at 0.32% of the sectors' assets.

Table 2.1 Resident placements in GBP and UK

	G1	G2	G3	Sector
Placements in GBP (ALL mln)	17.39	1,025.4	9,187.5	1,0230.3
Securities in GBP (ALL mln)	0	0	1,911.1	1,191.1
Total Exposures % to assets	0.03%	0.29%	1.13%	0.86%
Total placements in UK	296.91	387.32	1,318.64	2,002.87
Securities in UK	0	1,251.85	954.99	2,206.84
Total Exposures % to assets	0.48%	0.47%	0.25%	0.32%

Source: Financial Stability Department.

Because of the low exposure, even if it is assumed that banks will lose all placements in the UK or in GBP, the impact on the capital adequacy ratio is quite low. In this case, the capital adequacy ratio decreases by 0.1-0.3 p.p., by bank's size.

[6] *According to the latest forecast of the IMF in July 2016-World Economic Outlook update.*

Table 2.2 Effects of the banking sector's exposures in the UK in the capital adequacy ratio

	Total exposure in UK	Current CAR	50% loss of the exposure value	100% loss of the exposure value
G3	2,273.63	15.4%	15.2%	15.1%
G2	1,639.17	17.2%	16.8%	16.5%
G1	296.91	20.1%	19.7%	19.5%

Source: Financial Stability Department.

Regarding trade relations, the Albanian economy exposure to the UK is low. Trade with the UK, the direct foreign investments stock of this country and remittances account for a small share in the GDP. As a result, their limitation would have a very low impact on the Albanian economy and its development pace.[i]

[i] *For more information, read the quarterly Monetary Policy Report 2016/III at: https:///www.bankofalbania.org/web/Monetary_Policy_Report_5794_2.php?kc=0,22,18,0,0.*

(9) The economy of Euro area recorded a positive growth during 2016 Q1, driven by the strengthening of domestic demand and investments. This growth is positively supported by the strengthening of private consumption, improved labour market conditions and increased investments as a result of accommodative conditions in the financial markets. On the other hand, export contributed negatively, due to the weakening of global trade and decline in demand from developing regions. The effects of the significant decline in oil prices over the past year, and the weakness of external demand continued to subdue the inflationary pressures in the euro area. The decline of inflation rates to negative values, prompted the European Central Bank (ECB) to undertake new measures for the further accommodation of the monetary policy. These measures included the reduction of the interest rate on the main refinancing operations down to 0.0%, new programs of quantitative easing and the extension of deadlines and increase of existing programs' limit.

(10) In the euro area banking sector, lending continues to gradually improve. Banking credit to private sector recorded positive growth, in annual terms, driven by the easing of standards, amid further accommodation of monetary policy by ECB, and upward credit demand. Nevertheless, the uncompleted consolidation of banks' balance sheets and the high rate of non-performing loans, continue to decelerate credit recovery. On the other hand, European banks' profitability remains low in terms of a weaker macroeconomic environment and a very low level of interest rates, resulting in significant volatility of the stock prices in the capital markets. Capitalization of European banks is good, verified by the stress test for 2016, whose results were published on 29 July 2016 by the European Banking Authority (see Box 2.2)

(11) Euro area economic recovery is expected to continue at a modest pace, driven by favourable financial conditions. Domestic demand will continue to be driven by accommodative monetary policy, improvement of labour market conditions and low oil prices. The easing of financial conditions is expected to boost investment growth. Currently, risks to the economic outlook of the euro area are mainly related to the Brexit referendum result consequences, the weakening of the economic outlook in the developing regions and the possibility of escalation of geopolitical tensions in certain regions.

Table 2.3 Selected macroeconomic indicators for the U.S. and Euro area

	GDP change (annual %)				Inflation (annual %)		Unemployment (annual %)		Gross government debt (as a % of GDP)	
	Q1'16	Q2'16	2016f	2017f	Mar.'16	Jun.'16	Mar.'16	Jun.'16	Q4'15	Q1'16
U.S.	1.6	1.2	2.2	2.5	0.9	1.0	5.0	4.9	103.8	105.4
Euro area	1.7	1.6	1.6	1.4	0.0	0.1	10.2	10.1	90.7	91.7
- Germany	1.8	1.7	1.6	1.2	0.1	0.2	4.3	4.2	71.2	71.1
-France	1.3	1.4	1.5	1.2	-0.1	0.3	10.1	9.9	96.2	97.5
-Italy	1.0	0.7	0.9	1.0	-0.2	-0.2	11.5	11.6	132.7	135.4
-Greece	-0.8	-0.7	:	:	-0.7	0.2	23.7	23.3*	176.9	176.3

Source: European Central Bank, Eurostat, BEA (Bureau of Economic Analysis), Bureau of Labour Statistics, IMF
*IMF estimates, January 2016; *April 2016 data;: no available data.*

(12) In the Western Balkans, increased private and public investments positively contributed to economic growth in the region, while consumption remains subdued. Countries of the region, during 2016 Q1, continued to positively grow, but some of them (Macedonia and Montenegro) at a slower pace compared to the previous quarter. The activity is positively driven by private and public investments, but consumption remains subdued reflecting wages and pensions stagnation as well as low consumer confidence. Labour market conditions continue to be challenging, although economic recovery has helped, at various degrees, improving employment rates. Inflationary pressures remain low throughout the region, reflecting the effect of low oil prices, stability of exchange rate and the weakness of domestic demand. In the public sector, the implementation of consolidated programmes and economic recovery contributed to the reduction of fiscal deficits and public debt in all countries. In the banking sector, credit annual growth is generally positive, driven by the decline of interest rates. In some countries such as Macedonia, Kosovo and Serbia, credit growth was significant, while in Albania and Montenegro this growth was weaker. Except for Albania and Macedonia, in the other countries of the region non-performing loans declined at the end of Q1. However, it should be noted, that despite the positive efforts, the cleaning of bank's balance sheet- remains the main challenge of the banking sector in this region, affecting thus lending and financial performance.

Table 2.4 Selected macroeconomic and financial indicators for Western Balkan

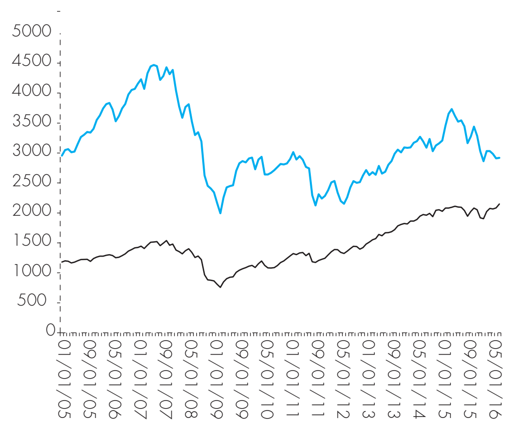
	GDP (real, annual %)			Unemployment (annual %)		Sovereign debt (% of GDP)		Credit (annual %)		Non-performing loans ratio	
	T4'15	T1'16	2016f	T4'15	T1'16	T4'15	T1'16	T4'15	T1'16	T4'15	T1'16
B&H	2.1	:	:	42.9	42.4	42.3	:	2.4	3.0	13.7	13.2
Macedonia	3.9	2.0	3.5	24.6	24.5	38.4	36.8	8.6	8.6	10.3	10.9
Montenegro	1.4	1.1	3.6	17.9	19.1	63.3	59.3	0.8	1.4	13.4	12.9
Kosovo	0.9*	:	:	32.9**	:	13.2	13.6	7.9	8.2	:	:
Serbia	1.2	3.5	2.0	17.7	19.0	75.4	73.7	7.6	11.4	21.6	20.9

*f- ECFIN's forecast, 2016; * Data of 2014;** Data of 2015.*
Source: European Commission.

2.1 HIGHLIGHTS IN FINANCIAL AND PRIMARY COMMODITY MARKETS

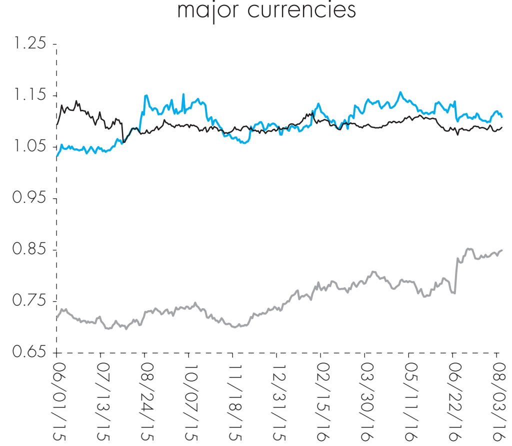
(13) Global financial markets improved their performance during February-June 2016. The shocks that characterized financial markets at the end of the previous year and earlier this year, normalized during the following months, due to positive expectations on the global economy performance, signals for a recovery of oil prices and expectations for further easing of ECB's monetary policy. In the capital markets of advanced economies, these developments led to the recovery in stock prices, from the fall at the beginning of the year, and narrowing of the spread in sovereign credit markets. In emerging markets, in some segments, financing conditions eased and capital flows returned in search of higher profits. In European money markets, developments have been stable, with negative rates and a downward trend, reflecting the ECB's accommodative policy and ample liquidity.

Chart 2.1 Main indices in stock markets



Source: ECB.

Chart 2.2. Exchange rate of euro against major currencies



Source: European Central Bank.

(14) The Brexit referendum results surprised financial markets, triggering their strong and immediate reaction. Increased investor's uncertainty relating this process and the future of UK and EU relationship, led to the overall decline of values in stock markets, especially European and British ones. European banks' stock prices recorded significant fluctuations compared with other segments of the market, reflecting thus concern over their profitability and related events with banks or specific countries. In the sovereign markets, the relocation of investors towards markets with more sustainable return and expectations for further easing of monetary policy of the ECB, led to the decline in yields on European debt securities, especially of highly rated countries. However, the shock resulted short-lived and some of the values gradually picked up during July. Meanwhile, the Brexit referendum impact on UK, US and developing economies' capital markets was limited.

(15) Currency markets fluctuated during 2016 H1, reflecting the economic performance between regions and market expectations. In the first months of the year, euro appreciated against the US dollar, reflecting the expectations of the economic performance of the two regions and a gradual transition toward the tightening of monetary policy by the Federal Reserve of the United State. After "Brexit" results, euro appreciated significantly against the British pound. At the end of the period, euro depreciated against the US dollar, the Japanese yen and the currencies of most developing regions, reflecting market expectations for a further easing of monetary policy by the ECB.

(16) Prices in oil markets stabilized and seemed to recover during February-June 2016. The decline in oil supply, mainly due to the production slowdown by OPEC countries and the interruption of supplies from several other producing countries (like Nigeria and Canada) exerted pressure to raise the prices during the period. From the beginning of June onwards, prices in oil markets and commodities declined moderately, driven by increased supply from producing countries, against a still subdued demand.

BOX 2.2 HIGHLIGHTS OF FOREIGN BANKING GROUPS OPERATING IN ALBANIA

During 2016 H1, foreign banking groups in Albania showed good capitalization and good capacities to withstand macroeconomic shocks, as reflected by stress-test results of the European Banking Authority (EBA). The share of the banking activity of these European banking groups operating in Albania against the total group activity, remains low and almost at the same levels as at the end of 2015.

Table 2.5 Highlights of foreign banking groups operating in Albania

Change (%)	Raiffesen Bank International	Intesa San Paolo	Alpha Bank*	Piraeus Bank*	National Bank of Greece*	Societe Generale
Assets**	-0.40%	6.00%	-6.60%	-2.00%	-4.30%	9.40%
Credit	1.30%	3.70%	-7.80%	-3.00%	-11.50%	3.70%
Deposits	-0.10%	3.90%	-14.00%	-3.00%	-7.60%	5.50%
Loan-loss provisions	-33.30%	33.00%	-25.00%	-1.00%	-55.10%	-
Net profit	-23.80%	-14.80%	...	...	...	7.50%
Ratios						
Non-performing loans	10.40%	9.00%	37.40%	40.00%	-	5.10%
Net interest margin	2.76%	-	2.81%	2.81%	2.80%	-
Capital adequacy ratio	17.60%	12.90%	15.90%	16.70%	16.70%	16.70%
Bank' s share in Albania to the group	1.73%	0.15%	0.68%	0.63%	0.29%	0.04%

**The data refer to the end of 2016 Q1.*
*** Change from the end of the previous year for balance sheet items.*
*Note: *(...) shows pronounced change of this indicator (higher than 100%), while (-) shows non-available data for this indicator in the publications of the respective bank.*
Source: Official websites of banking groups.

At the end of July 2016, the European Banking Authority (EBA) published the results of the stress-test, conducted on the banks of the European Union for 2016. This exercise assesses the resilience of the largest banks in the European banking sector (51 banks in total) against adverse economic shocks. The exercise this year, did not assign a minimum ratio of required capital to pass the stress test, but the results can be compared with minimum regulatory requirements, established for this purpose in every EU country. Only three of the banks participating in the stress test operate in Albania, namely: Raiffeisen Bank, Intesa SanPaolo and Societe Generale.

In general, for the European Banking sector, stress testing results show stability improvement due to improved capital position (after its constant increase). Except for an Italian Bank that does not operate in Albania[1] and which had inadequate capital due to the adverse scenario at the end of 2018, capitalization rate for *all participating banks is above the minimum regulatory requirements for capital constituent components.*

For banks operating in Albania, the results show a capitalization rate of the first level, above the regulatory minimum (4.5%) for both scenarios. For Intesa San Paolo bank, this positive difference is significant for both scenarios. For Raiffeisen Bank, results estimate a capitalization growth in the baseline scenario, and a value close but above the regulatory minimum for the adverse scenario. According to the RZB group statement, strengthening of the capital position remains a main objective and, therefore, starting from 2015, Raiffesen Bank International has developed a specific programme aiming to increase the capital adequacy ratio up to at least 12% by the end of 2017. Lastly, Societe Generale has adequate capitalization rates for the both stress-test scenarios, significantly above the regulatory minimum.

Table 2.6 Outcomes of the stress-test for banking groups that operate in Albania

	Transitional Common Equity Tier 1 (CET1)		
Bank	2015	Baseline scenario 2018	Adverse scenario 2018
Raiffesen	10.47%	12.36%	6.14%
Intesa SanPaolo	12.98%	12.83%	10.24%
Societe Generale	11.42%	11.94%	8.03%

Source: European Banking Authority.

[1] *The oldest bank in the world, Monte Dei Paschi di Siena.*

3. MACROECONOMIC DEVELOPMENTS

(17) Albania's economic activity continued to expand during 2016 Q1, by 2.96% yoy and by 1.2% qoq. Economic growth is driven by the positive performance of the services sector[7], whilst production sector contributed negatively. Aggregate demand was driven by the growth of private investments, net exports and private consumption, whilst public consumption contributed negatively. Positive developments were also recorded in the labour market; the unemployment rate declined yoy and quarterly, at 15.5%[8].

(18) The monetary policy of the Bank of Albania remained accommodative during 2016 H1, in order to boost credit, consumption and private investments, given the low inflationary pressures. Annual inflation stood at 1.2% in June 2016. Although this rate was similar to that of the previous year, it is significantly higher than the previous quarter[9]. In addition to these developments, the Supervisory Council of the Bank of Albania has lowered the policy rate two times by 0.25 p.p, to 1.25%. For the remainder of the year, Albanian economy is expected to continue the positive trend, with an economic growth improving thus contributing to the return of inflation close to Bank of Albania's target in the medium term.

(19) Fiscal policy has reinforced its consolidation trend during the period, recording a positive budged surplus for the first time since 2007; but failure to realise capital expenditures should be assessed carefully. According to the Ministry of Finance's preliminary data, the increase in revenues by about 8.7%[10] was followed by a decline of total expenditures by about 7.9%. Decline of capital expenditures, interest expenditures and subsidies, mainly for the local government, gave the main contribution to the realisation of lowest expenditures. Positive budget surplus, reached ALL 17.9 billion against the deficit of ALL 13.3 billion, a year ago. Budget surplus drove financing needs to be lower. Foreign sources completely matched these needs. The change in the structure of financing budget needs continues to be attributed to the

[7] *Branches that contributed positively are: "Trade Hotel and Restaurants" and "Transport" (0.85 p.p); "Public Administration, Education and Health" (0.60 p.p); "Construction" (0.55 p.p); "Information and Communication" (0.37 p.p); "Real Estate" (0.23 p.p). Branches that contributed negatively are: "Industry, Energy and Water" (0.30 p.p); "Agriculture, Forestry and Fishing" (0.05 p.p).*

[8] *During 2016 Q2, unemployment rate reached 15.5% against) 17.3% in December, and 17.0% a year ago. According to the International Labour Organization definition, unemployment includes individuals of 15 years of age and above.*

[9] *More specifically, in June 2015, this rate stood at 1.4% and in March 2016 it stood at 0.3%. For the remainder of the year, expectations regarding employment are also considered positive for every sector of the economy.*

[10] *Annual revenues recorded a cumulative value of ALL 198.116 billion, while total expenditures amounted to ALL 180.130 billion.*

Eurobond issue, last year. Non-realisation of capital expenditures according to the plan needs to be carefully analysed and evaluated in order to limit it over the time. Realisation of capital expenditures and their best distribution throughout the financial year is important not only to support economic growth and the performance of macroeconomic indicators, but to also manage the needs for liquidity in interbank market.

(20) In 2016 Q2, net position of financial account enabled the funding of more than 2/3 of foreign currency needs in Albania. During this period, the current account deficit expanded about two times yoy, reaching EUR 354 million. This development is entirely attributable to the further deepening of trade deficit in goods, which expanded by about EUR 189 million, reaching EUR 677 million. Exports fell by 22% annually, down to ALL 194 million, whereas imports of goods grew by 18% at EUR 871 million. From a year earlier, expansion of the trade deficit by about 39% is attributed mainly to: (i) expansion of goods imported for investment in the energy sector: (ii) adverse developments in oil export due to the decline in production and oil prices in international markets; and (iii) import growth for "machinery, equipment and vehicles", mainly related to the direct foreign investments. While recording a surplus of EUR 122 million, the services account, resulted about ALL 6 million less than a year earlier. "Travel services" and "Manufacturing Services on Physical Inputs Owned by Others" gave the main contribution to this performance[11]. Primary income account closed with a negative surplus of EUR 15 million, about EUR 2 million more than a year earlier. Secondary incomes were assessed at EUR 217 million, about EUR 6 million more than a year earlier. Remittances make up about 71% of secondary incomes and according to the Bank of Albania estimations, during the period, they accounted for EUR 154 million, approximately 5% lower than a year earlier.

During 2016 Q3, the capital account recorded a positive surplus of about EUR 7 million, down by EUR 14 million compared with the previous year. This performance is attributed to the decline of grants for capital investments.

The financial account recorded a debtor position in foreign assets of EUR 254 million or EUR 76 million more compared to the same period a year earlier. This account funded about 73% of the foreign currency needs arising from the joint performance of the current and capital account[12].

[11] *The volume of transactions conducted in the textile industry and textile items, and footwear, (re-exporting industry in Albania).*

[12] *The amount of the current and capital account balance is perceived as the level of exposure of the Albanian economy to the rest of the world, according to the sixth edition of the IMF's Balance of Payments Manual – BPM6).*

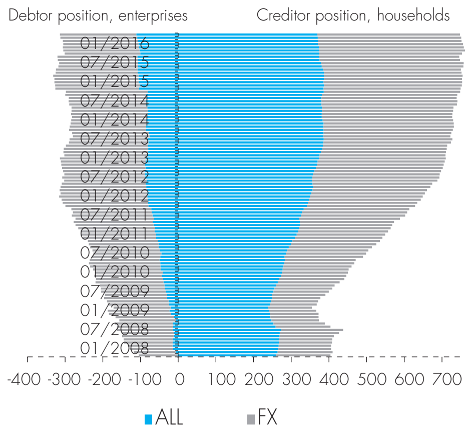
4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND ENTERPRISES

(21) Households remained oriented to saving, but trending down, over 2016 H1. Annual growth of credit to households at a higher pace than their deposits is a positive development, reflecting the orientation to borrowing in lek. Credit to enterprises slightly increased while deposits expanded more rapidly in the same period. Hence, households narrowed the creditor position, while enterprises showed deepening of debtor position. 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, and mainly the unhedged loans in foreign currency.

4.1 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

(22) Households' creditor positions decreased; while enterprises' debtor positions increased. Notwithstanding households maintain the savings trend, the creditor position13, narrowed by around ALL 5 billion, at ALL 748 billion, during the period. This development reflects the more rapid expansion of credit to households against their deposits, mainly in the domestic currency. In contrast, households expanded their deposits in foreign currency, by increasing the trend of savings in foreign currency. On the other hand, enterprises deepened their debtor position to the banking sector, by around ALL 13 billion, during the period, at ALL 313 billion, given the slow expansion of credit and the decrease in deposits. The deepening of enterprises' debtor position was more evident in the domestic currency due to the accelerating of credit. Debtor position in foreign currency narrowed somewhat from the more rapid increase of deposits.

Chart 4.1 Financial positions of households and enterprises, in ALL billion



Source: Bank of Albania.

(23) Households expanded their investments in other assets in the financial system, in research of higher return rates of investment. Share of investments in securities increased rapidly after 2010, at 12.4% of households' total assets, followed by the purchase of quotes in investment funds by 6.4% of total.

[13] *Spread between deposits and credit of households in the banking sector.*

Table 4.1 Households' assets in the financial system, ALL billion

	2010		2013		2016 H1	
	ALL billion	Weight, %	ALL billion	Weight, %	ALL billion	Weight, %
Lek deposits	357.6	49.8	449.5	43.7	450.4	40.3
Foreign currency deposit	304.0	42.3	418.4	40.7	455.6	40.8
T-bills	56.7	7.9	70.6	6.7	72.4	6.5
Bonds	0.37	0.05	39.8	3.9	66.4	5.9
Investment funds	-	-	50.3	4.9	71.7	6.4
Voluntary private pension funds	0.12		0.43	0.04	1.1	0.1
Households' portfolio	718.8	100.00	1,029	100	1,117.6	100

Source: Bank of Albania.

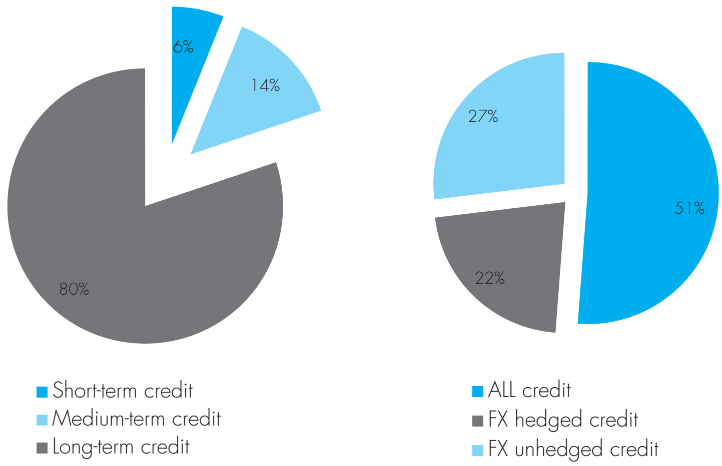
4.1.a. Lending to households and credit risk

(24) Credit to households expanded by about 3.1% compared to the end of 2015, and 3.0% compared to the previous year, standing at ALL 159.4 billion at the end of June 2016. The expansion of credit to households, over one year, reflected the increase of new credit, mainly for "investments in real estate", following the cut of interest rate. The average interest rate applied to this credit recorded the lowest historical level of 3.74%, the annual fall of 1.3 p.p., at the end of June 2016. The process of loans write off by about ALL 4.2 billion during the last 12 months, drove to the decrease of credit outstanding to households. If written-off loans were still in bank's balance sheets, the annual credit growth would have been 5.7%.

(25) Credit to resident households (accounting for about 94% of total credit to households) expanded by 2.3%, during the period, at ALL 149.5 billion. The expansion of credit for real estate and for the consumption of durable goods provided the main contribution to this expansion. The decrease of new "Overdraft" credit to households drove to the narrowing of credit outstanding for this item by 10.7%. Credit to resident households expanded by 1.7%, over one year, supported by the expansion of consumption loan by 5.5%. Credit to non-resident households accounted for about 15.2% of total credit to non-residents. It expanded considerably during the last years. This credit outstanding, increased by about ALL 1.5 billion (or 19.5%), in 2016 H1, and by ALL 2.4 billion (or 36.5%), compared to a year earlier.

(26) Credit expansion to households mainly reflected the growth of credit in lek, by about 6%, in addition to the slight increase of credit in foreign currency, by about 0.5%. Unhedged credit in foreign currency to households has fallen in absolute value and its quality improved, recording a fall of exposure to unfavourable volatilities of the exchange rate. Its share to credit to households fell at 26.9% of total credit outstanding, compared to 29.4% at the end of 2015. Around 82.4% of household credit unhedged against exchange rate consisted in "House purchase loans", which remained almost at the same level, over one year period. Hence, credit share in lek increased at 51%, about 1.4p.p. more than in June 2015. By maturity, long-term credit to households did not change and accounted for 80.2% of credit portfolio; short-term credit was down at 6.1%, and medium-term credit accounted for 13.7% of credit portfolio.

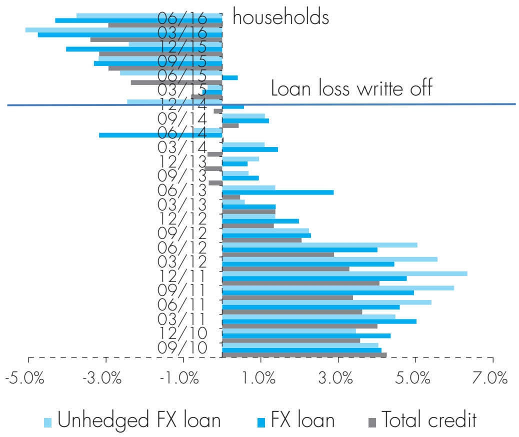
Chart 4.2 Structure of credit to households by maturity (left) and currency (right)



Source: Bank of Albania.

(27) The loss loans write off from banks' balance sheet is accompanied by the improvement of portfolio quality for credit to households. Non-performing loans ratio to households fell at 12%, about 2.9 p.p, lower than in the previous year. The improvement of credit quality was more considerable for the credit in foreign currency, and for its part that is unhedged against the fluctuations in the exchange rate. The ratio of non-performing loans in foreign currency fell at 13.3%, down by 4.3 p.p annually. Also, the quality of credit unhedged against the exchange rate risk to households improved at 14.0%, from 17.8% in June 2015.

Chart 4.3 Annual change of NPLR for households, in p.p.



Source: Bank of Albania.

BOX 4.1 SURVEY RESULTS ON HOUSEHOLDS' FINANCIAL AND BORROWING SITUATION

The survey of households' financial and borrowing situation is conducted half-yearly for the sixth consecutive year. The survey is based on an occasional sample of 1,209 households, across around 54% urban areas and 44% rural areas.

***In 2016 H1, the number of employed persons increased** supported by the employment in the private sector. Nevertheless, the financial balance (income-expenses) of households narrowed, due to the more rapid increase in expenses, compared to income.*

***About 30% of households state to have a loan to pay.** This share is slightly lower from 2015 H2, but higher from the previous year.*

*94% of borrowing is in lek. 43% of borrowing households had borrowed from formal sources (banks and non-bank institutions), and 57% of borrowing households had borrowed from informal sources, mainly in cash. **This allocation has shifted to formal borrowing from informal one**, as a result of the increase of borrowing from banks. "Consumption" (35%), "Purchasing/renovating a property" (31%) and "business development" (13%) remained the top three purposes for borrowing. Unlike the trend of the last years, the allocation of credit by purpose of loan has shifted to "Purchasing/renovating a property" loans over the surveyed period, in line with the developments in the credit outstanding to households.*

Total of the reported credit outstanding was down compared to the previous survey, but higher than the previous year.** About 84% of total credit outstanding is provided from formal sources and 16% from informal sources, by reflecting a considerable shift towards formal loans from banks. By currency, 71% of credit outstanding is in lek, and 29% in euro. By purpose of use, **about 61% of credit outstanding was for "Purchasing/renovating a property", 21% for "business development" and only 5% for "consumption";

*The borrowing households assessed **the fall of credit instalment** during the referring period, by reflecting the decrease of weighted credit rate to households. **Solvency improved slightly in annual and half-yearly terms.** Expectations for the rest of the year are optimist. Credit demand remained weak, but it slightly increased in the first part of year. The possibility to receive a loan increased slightly in 2016 H1, but it remained below the long-term average.*

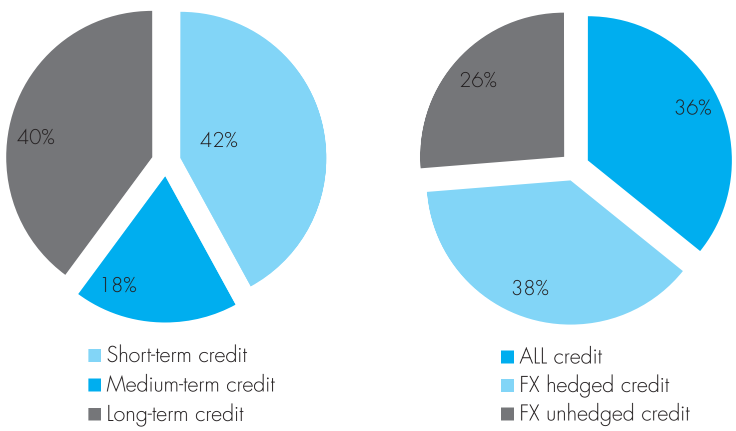
4.1.b. Lending to enterprises and credit risk

(28) Credit to enterprises, accounting for about 69% of total credit (ALL 409.9 billion) provided the main contribution in the development of credit. It expanded by about ALL 7.9 billion, or 2.0%, compared to the end of 2015. Credit to enterprises fell by ALL 3.9 billion, or 0.94%, compared to the previous year, by reflecting the write-off of non-performing loans, at about ALL 14.4 billion. Adjusted for this effect, credit outstanding to businesses would have expanded by 2.5%.

(29) Credit expanded to both resident and non-resident enterprises, during the period. Credit to resident enterprises, expanded by 0.6% during 2016 H1, at ALL 391.2 billion. "Overdraft" credit outstanding, which has the main share of credit to resident enterprises (about 32.0%), expanded at a more rapid pace, by 1.6%. "Investments for real estate" credit preformed positively, up by 1.3%, or ALL 1.3 billion. Credit to resident enterprises narrowed by about ALL 2.9 billion, or 0.7%, compared to a year earlier, due to the fall in the credit stock to enterprises for investments in real estate" over the process of loan loss write offs. Credit outstanding to non-resident enterprises expanded considerably, during the period, by about 9.7%, or ALL 4.5 billion. Credit to non-resident enterprises, also, increased by about 1%, or ALL 0.6 billion, compared to the previous year.

(30) Lending to enterprises increased both in lek and foreign currency, over 2016 H1. Credit in lek to enterprises expanded more rapidly, by 2.6%, while in foreign currency increased slightly by 0.8%. Share of credit in foreign currency to total credit to enterprises continue to fluctuate at the interval 64-65%, slightly down by 0.4 p.p. from the end of 2015. Unhedged credit outstanding fell at 26.3% of total credit to enterprises, from 27% at the end 2015. In the structure of unhedged credit to enterprises, the share of "for trade" loans increased at 47.0% of this portfolio, while "Business development loans" and "Real estate development loans" accounted for 15.1% and 10.6% of the portfolio, respectively.

Chart 4.4 Structure of credit to enterprises by maturity (left) and currency (right)



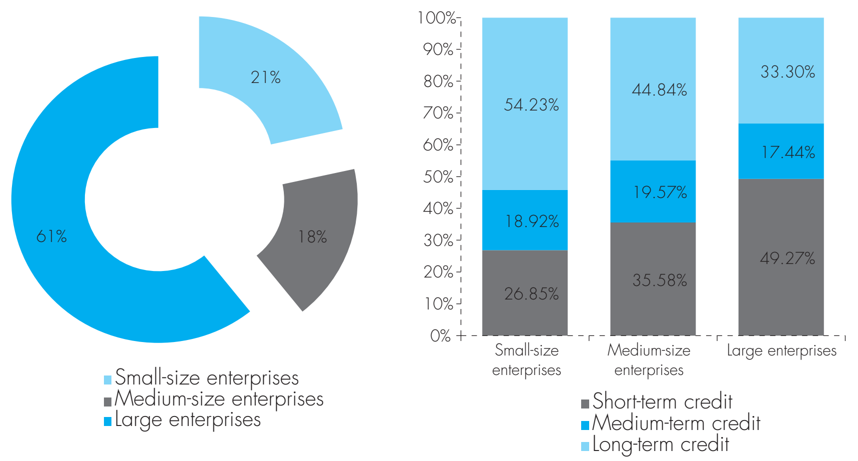
Source: Bank of Albania.

(31) By activity size[14], the share of loans to large and medium-sized enterprises fell, accounting for 60.7% and 17.7% to total, respectively. Loans to small enterprises increased to 21.6% of the total. During the first half of the year, the small and medium-sized enterprises increased the share of short-term

14 Resident enterprises.

credit, whereas the larger enterprises are oriented towards the medium-term and long-term credit. By currency, the small and large enterprises expanded the foreign currency credit, whereas this credit for medium-sized enterprises contracted.

Chart 4.5. Structure of creditto enterprises by size



Source: Bank of Albania.

BOX 4.2. ENTERPRISES' EXPOSURE TO EXCHANGE RATE RISK

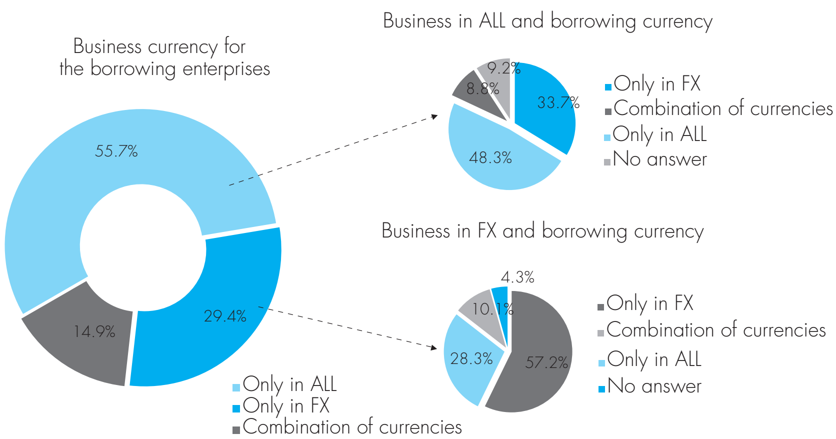
According to the survey results on enterprises financial situation and borrowing for 2016 H1, enterprises are exposed to the indirect credit risk and exchange rate volatility. Of total 469 borrowing enterprises (in the total of 1,209 surveyed enterprises), around 60% conduct their activity only in lek, 29% in foreign currency, and the remaining of15% in both currencies.

The exchange rate volatility exposes the enterprises that conduct their activity in a currency other than that of the credit. Of the enterprises that conduct their activity only in lek, 42.5% are exposed to the depreciation of the exchange rate, having borrowed only in foreign currency or in several currencies. Of the enterprises that conduct their activity only in foreign currency, 38.4% have borrowed only in the domestic currency, or combined currencies, thus exposing them to the risk of exchange rate appreciation.

In total, about 65% of borrowing enterprises are hedged from the exchange rate risk, due to borrowing in the same currency as their activity or a combination of currencies. The remaining 35% of borrowing businesses is exposed to exchange rate volatility. Of the exposed enterprises, 23.6% have an instalment that exceeds 20% of revenues, compared to 22.5% for unexposed enterprises.

Moreover, attention should be paid to non-borrower enterprises, which may potentially borrow in the future. Of them, 58.6% conduct the activity only in lek, 26.8% only in foreign currency, and 14.5% in a combination of currencies.

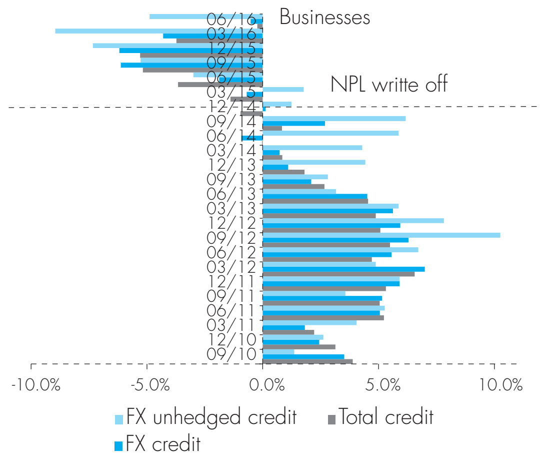
Chart 4.6 Business currency and enterprises'exposure to exchange rate



Source: Bank of Albania.

(32) The portfolio quality of loans to enterprises improved slightly in annual terms, but fell during the period. In June 2016, the non-performing loan ratio was 24.4%, from 21.4% in December 2015, and 24.7% in the previous year. The ratio of non-performing loans for foreign currency loans stood at 25.3% at the end of the period, only 0.5 p.p. lower than in the previous year. The portfolio quality for unhedged foreign currency loans to enterprises improved significantly in annual terms, mainly due to the lost loan write off. At the end of the period, the ratio of non-performing loans for this credit category fell to 26.3% from 31.2% in June 2015, but higher than the 25.5% at the end of the year.

Chart 4.7 Annual change of NPLR for enterprises, in p.p.



Source: Bank of Albania.

BOX 4.3. SURVEY RESULTS OF ON ENTERPRISES FINANCIAL AND BORROWING SITUATION

The survey of enterprises financial and borrowing situation is conducted half-yearly for the sixth consecutive year. During 2016 H1, the survey was conducted on a sample of 1,209 enterprises of all sizes, across the country, operating in major sectors of the economy.

Overall, enterprises hold that difficulties from competition are ***the main limiting factor to their activity****. Access to finance and cost of financing are difficulties for small enterprises, whereas availability of qualified staff limits the activity for large enterprises.*

Compared to end- 2015, small enterprises, and less medium-sized enterprises, assess as downward the level of sales and financial result, whereas large enterprises assess them as improved. *As a result, small enterprises have contracted their activity, whereas medium-sized enterprises continued to expand their activity, despite the fall in sales. Larger enterprises expanded their activity significantly. For 2016 H2, all enterprises* ***expect expansion of activity and positive performance for the overall sales and financial result.***

In 2016 H1, more than half of respondent enterprises financed their activity only through sales, irrespective of division by size. *The activity was financed only through sales for 56.7% of small enterprises, 56% of medium-sized enterprises, and 56.5% of large enterprises. Borrowing as a separate or combined source was used by 29.8% of large enterprises, 27.2% medium-sized enterprises, and 23.3% small enterprises.*

Around 46.4% of total (469) enterprises state that they have a loan to repay. *For small enterprises, the share of borrowers is 39.5%, for medium-sized enterprises the share is 46.6% and for large enterprises the share is 51.1%. Enterprises state that they have addressed mainly the banking sector for borrowing. Respectively, 92.2% of small enterprises, 92.7% of medium-sized enterprises and 96.1% of large enterprises have obtained loans only from banks, whereas the rest have combined a number of financing sources.*

Enterprise loans are aimed at covering current expenditure *(48.5% of small enterprises, 38.1% of medium-sized enterprises and 40.9% of large enterprises), and long-term investments (34.8% of small enterprises, 36.5% of medium-sized enterprises and 38.5% of large enterprises). Over 70% of enterprises, irrespective of their size, consider as adequate the level of borrowing for financing the activity.*

The outstanding credit is dominated mainly in the domestic currency for the small and medium-sized enterprises; for large enterprises the foreign currency credit has a larger share. ***Most enterprises have taken a loan in the past 1-5 years,*** *whereas new loans over the half of the year accounts for only 16.2% for small enterprises, 11.2% for medium-sized enterprises and 14.5% for large enterprises.*

The overall value of the loan is about half the value of the enterprise's capital, for the majority of enterprises *(over 70%, regardless of size). For 76.9% of small enterprises, 67.2% of medium-sized enterprises, and 82.8% of large enterprises,* ***the loan payment to total revenues amounts up to 20% of revenues.*** *For all enterprises, the debt burden is assessed as slightly higher than the "average burden".*

Bank borrowing is assessed between "normal" and "difficult" for all enterprises. *The possibility of new borrowing in the next half of the year is assessed as "little likely" and stands slightly lower for small enterprises. The low credit demand reflects mainly the stance that the actual borrowing level is considered as adequate. However, of enterprises that wanted more loans, 23.5% of small enterprises state that it is certain or very likely that they will borrow in the next period, 19.1% of medium-sized enterprises and 31.8% of large enterprises.*

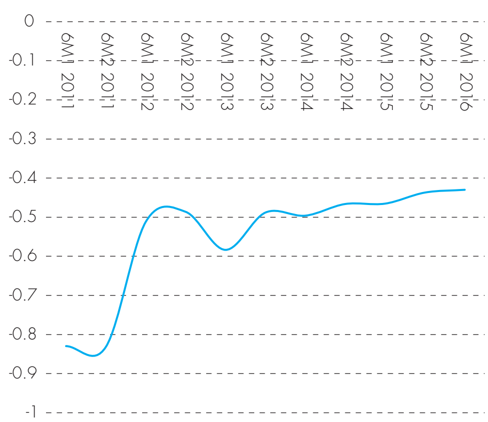
The aggregate assessment of the persistence in enterprises' borrowing planning, aims at verifying whether specific enterprises that have sought (planned) to take a loan for period t have realised or not in period t+1. Possible combinations for this case is, are given in Table 4.2.

Table 4. 2 Summarised matrix of borrowing planning

Period t \ Period t+1	The firm has received a loan in the current half of year (t+1)	The firm has not received a 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

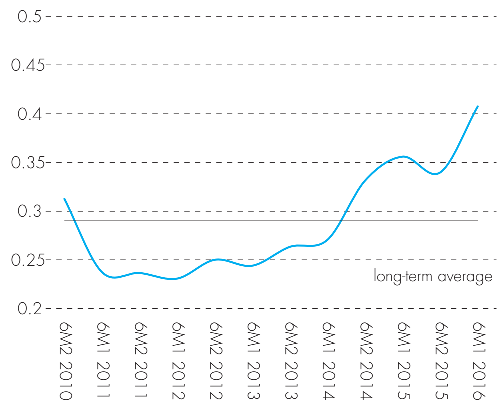
According to values from the verification the persistence index in borrowing planning is built (Chart 4.8). The performance and values of the index show that during the period, enterprises loan demand (plan) has lacked (value of index is close to -0.5). The Theil Index (Chart 4.9) assesses the concentration of enterprises' repsonses by existing alternatives in the summary matrix of borrowing plan. The index has 0 and 1 values, where 0 shows an even distribution among all alternatives, whereas 1 shows full concentration. The values of the Theil index show upward concentration in bank responses that reinforces the assessment for a weak credit demand.

Chart 4.8 Persistence in credit planning



Source: Financial Stability Department.

Chart 4.9 Theil Index



Source: Financial Stability Department.

4.2 REAL ESTATE MARKET

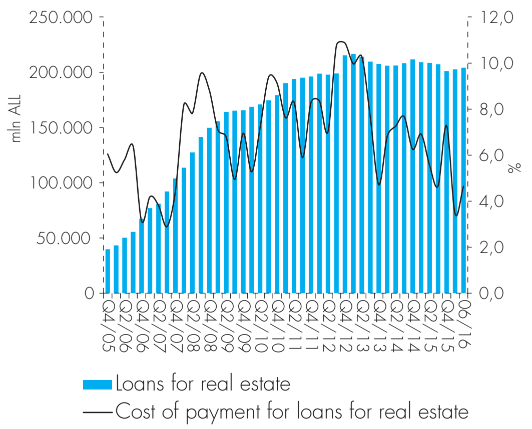
(33) The banking sector is exposed either directly or indirectly to the real estate market[15]. For this reason, the sensitivity to fluctuations in real estate prices, is considerable. In June 2016, 50.6% of loans are real estate-collaterised, or around 67% of loans to households and around 44.7% of loans to enterprises. During the period, the households loan demand for real estate is assessed as

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

upward, although credit conditions are reported as unchanged for households and tightened for enterprises[16].

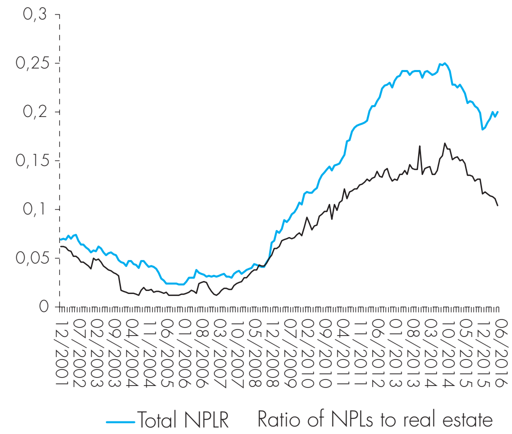
(34) Credit outstanding for real estate expanded by about 1.2% during the period amid downward interest rates on credit and is accompanied by a slight improvement in its quality. The ratio of non-performing loans for this category fell to 10.4% from 11.6% at the end of the year, and 13.5% a year earlier. The share of credit outstanding for construction stood at 12.6% of credit outstanding to enterprises, showing no significant changes during the period (compared to the 20% average over 2007-2011).

Chart 4.10 Mortgage loans



Source: Bank of Albania.

Chart 4.11 Non-performing loans ratio



Source: Bank of Albania.

(35) The weighted interest rate on real estate loans[17] stood at 6.1%, in line with the downward trend in recent years. Along the same lines, the relative repayment cost[18] of real estate purchase continued to lower, reflecting more favourable conditions for real estate purchase from the borrower's perspective.

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16 *According to the Bank Lending Survey 2016 Q2, banks report that households credit demand has improved significantly for house purchase (the balance resulted 11.4% from -9.8% in the previous quarter).*

17 *The interest rate is weighted for households for credit for real estate purchase, and for enterprises for real estate investment.*

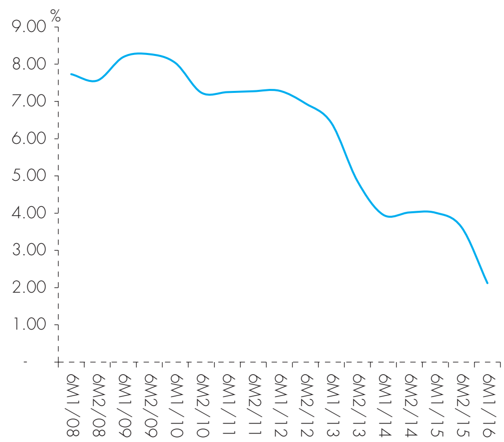
18 *The relative repayment cost of credit real estate purchase is measured as the difference between the interest rate on real estate loans and the average house price rise rate for the four previous quarters. The increase in this difference implies higher relative costs.*

5. FINANCIAL MARKETS

5.1 SECURITIES MARKET

(36) Yields on government debt securities continued to fall, during the period. Yields in the primary market auctions on government debt securities fell for all maturities, reflecting the reduction of the policy rate, twice, by the Bank of Albania, and the developments in both demand and supply for debt securities in 2016 H1. The average aggregate interest rate of government debt reduced at 2.1%, about 1.5 p.p. lower than in the previous year. In 2016 H1, the Government increased the domestic debt financing at 24%, ALL 202.9 billion. Treasury bills, which shares 74.2% of total, continue to dominate the issue structure.

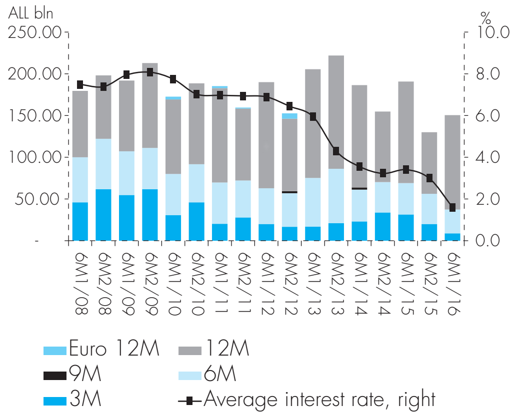
Chart 5.1 Average yields on debt securities, in per cent



Source: Bank of Albania.

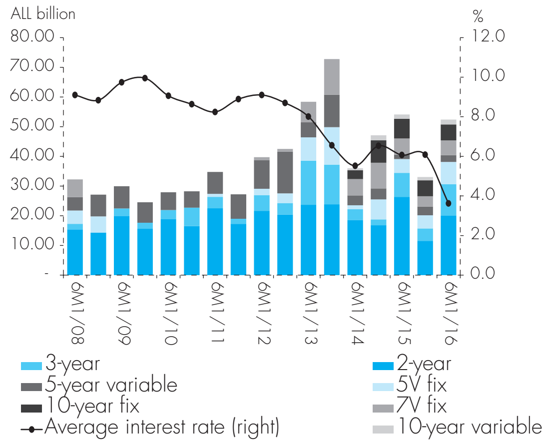
(37) 12-month T-bills were the most demanded among the debt securities in the form of treasury bills. Government debt securities issued in the form of treasury bills were about ALL 150 billion, up by 15% from 2015 H2, although lower than in 2015 H1. Bidders' showed higher interest in auctions for the 12-month T-bills. Investment supply matched the borrowing demand. In 2016 H1, the share of 12-month T-bills in the total T-bills increased at 75%, compared to the previous period. The average yield on T-bills continued to trend down since 2009 H2, standing at 1.6%.

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



Source: Bank of Albania.

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



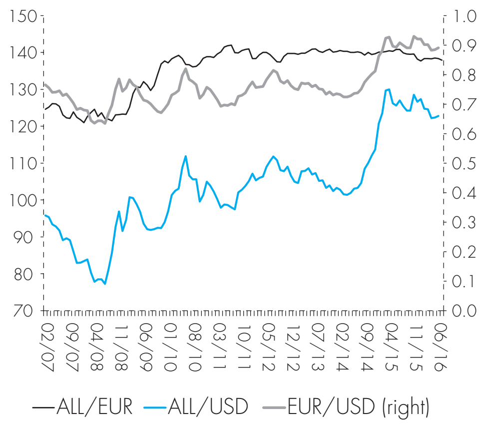
Source: Bank of Albania.

(38) The demand for government debt securities in the form of bonds was high as well. This demand supported the fall of their yield. Government's debt securities issued in the form of bonds increased at ALL 52.4 billion, 56% higher from 2015 H2, but somewhat lower from the same period in the previous year. The 2-year and 3-year bonds shared about 80% of total issued bonds[19]. In aggregate, the weighted yield on bonds fell at 3.6%, from 6.1% in 2015 H2. Notwithstanding the lower yields, investors' demands were higher than the announced values for borrowing, thus reflecting the investors' demand for higher rates of return on investments.

5.2 INTERBANK MARKET

(39) Transactions in interbank market increased in during the period. Liquidity situation in the market was stable. The average value of overnight loan and one-week loans increased compared to 2015 H2. One-month loans increased as well, although occurring rarely and at lower volumes, compared to short-term transactions. In 2016 H1, the transactions' weighted average interbank rate was 1.51%, from 1.91% in 2015 H2. The interest rates applied by banks showed that banks have continuously traded at rates close to the policy rate level, thus reflecting a stable liquidity situation in the interbank market.

Chart 5.4 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

5.3 FOREIGN EXCHANGE MARKET

(40) In 2016 H1, lek appreciated slightly against euro and US dollar. In annual level, the domestic currency showed almost the same appreciation of about 1.5%, against both main foreign currencies. In 2016 H1, the exchange rate averaged ALL 138.28 for one euro and ALL 124 for one US dollar.

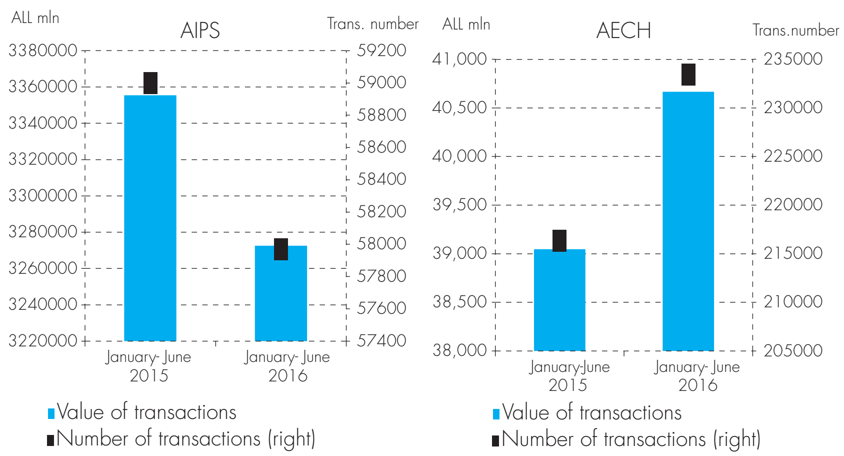
[19] *The issuance of 5-year bonds at variable rates and 10-year bonds at fix rates fell slightly. No 7-year bonds at variable rates were issued during the period. These bonds shared 14.5% in total bonds.*

6. PAYMENT SYSTEM DEVELOPMENTS

(41) The basic infrastructure for the clearing and settlement of payments in the domestic currency continued to operate in an effective and secured manner, thus supporting the financial stability and the implementation of monetary policy. In 2016 H1, the operation of the system did not reflect any operational, financial (credit and liquidity) and legal risk, which jeopardise the availability of the system.

In terms of the activity, AIPS recorded a fall in the number and value of the processed transactions by 1.75% and 2.47%, respectively, compared to 2015 H1. This system processed about 58 000 transactions during the period under review. The average settlement value per transaction was ALL 54.5 million. In AECH, 233.4 thousand payments were cleared, and the average value per transaction amounted to around ALL 0.17 million, during the period under review. In 2016 H1, the activity of AECH increased, both in number and value, by 8% and 4.2%, respectively, from the same period in the previous year.

Chart 6.1 AIPS and AECH activity in 2015 H1 and 2016 H1



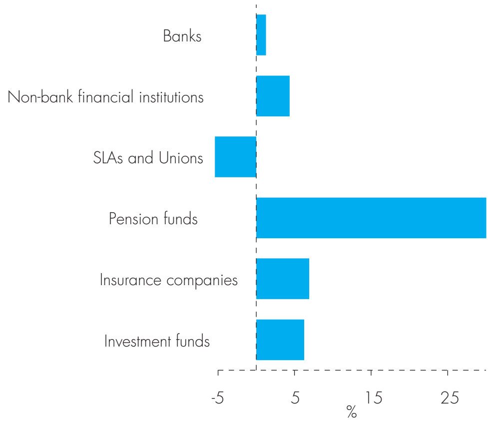
Source: Bank of Albania.

(42) The payments conducted through specific instruments: credit transfers, credit and debit cards, direct debiting, etc., increased during the period. During the period, 3.8 million payments were processed, totalling ALL 2.14 billion. Notwithstanding the dominance of credit transfers in paper form, the relative share of this instrument against the overall number of payments was down. At the same time, the number of electronic credit transfers (such as "home banking"), use of bank cards and direct debiting increased from a year earlier.

7. FINANCIAL SYSTEM

(43) In 2016 H1, the indicators of the financial system activity were stable. The banking system closed the activity at a profit and the indicators of capital and liquidity were at good levels. The other financial system segments expanded their activity. The share of non-bank financial institutions to the total financial system assets stood at about 10%, of which, private investment funds have the highest share. By size of mutual exposure, the direct risk of spill-over to the banking sector from other segments of the financial system is low; while the stability of the banking sector is of critical importance to non-bank financial institutions as well.

Chart 7.1 Annual growth of financial system components



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

(44) The main indicators of the financial system activity were stable, during the period, but the financial intermediation expanded at a slower pace. The financial intermediation in Albania, estimated as the ratio of the system assets[20] to Gross Domestic Product (GDP) stood at 100.7%, down from the levels in the last two years. The activity of the banking system, which expanded at a slower pace than the growth of GDP, provided the main contribution to this fall. Banks continue to dominate the structure of the financial system assets, accounting for 90.8% of financial system assets or about 90.5% 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	2016 H1
Bank of Albania	Banking sector	84.7	89.6	90.5	91.7	91.3	90.5
	Non-bank institutions	2.5	2.7	2.5	2.7	2.7	2.7
	SLAs and their Unions	0.7	0.8	0.8	0.8	0.7	0.6
Albanian Financial Supervisory Authority	Insurance companies	1.5	1.6	1.6	1.7	1.9	1.9
	Pension funds	0.01	0.02	0.03	0.04	0.1	0.1
	Investment funds		1.21	3.7	4.5	4.7	4.9
Financial Intermediation		89.41	95.93	99.13	101.44	101.3	100.7

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

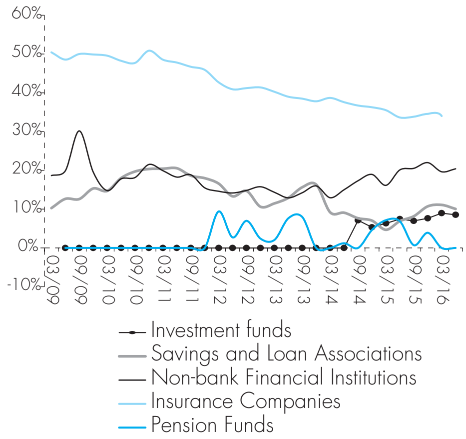
(45) The banking sector's exposure to other segments of the financial system in Albania remained low. This exposure was mainly in the form of loans and participation in the capital of non-bank financial institutions on the assets side

[20] *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 the only database of insurance belongs to 2016 Q1, while the analysis of the activity of the other segments of the financial system, is based on the data belonging to 2016 H1.*

of banks, and in the form of funds collected by them (various accounts) on the liabilities side. In total, this exposure accounted for about 1.9 % of banking sector's total assets, considerably limiting the direct financial risk that may spill over to the banking sector by the cross-sectorial interaction.

(46) On the other hand, the above values of exposures to the activity of the non-bank financial institutions are considerable. Insurance companies (ICs) and non-bank financial institutions (NBFIs) were more significantly exposed to the banking sector (See chart 7.2). Their deposits in the banking sector accounted for 34.0% and 20.4%, respectively, of their assets, as at end of 2016 Q2. In the last years, ICs exposure to the banking system has been downward. NBFIs exposure has increased by about 8 p.p., since the beginning of 2014. Notwithstanding the low exposure rates, the exposure of investment funds and SLAs has been upward. Exposure of "Pension funds" does not show a clear trend and stands at a low rate.

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.

Box 7.1 PERFORMANCE OF FINANCIAL SECTOR SEGMENTS

In 2016 H2, the Non-Bank Financial Institutions (NBFIs) expanded their activity, due to the increased number of entities operating in the market. The NBFIs' financial result was positive, capitalisation was adequate and asset quality improved. Savings and loan associations (SLAs) narrowed their activity driving to the contraction of lending. The balance of assets increased based on investments in banks' deposit and accounts and on the expansion of technical provisions. In addition, supplementary private pensions and investment funds expanded their assets.

The activity of NFBIs, measured through the overall value of assets, increased about 2%, compared to end -2015, and by 2.5% in annual terms, at ALL 40.3 billion. The main developments in non-bank structure related to the entry into market of four financial institutions, which conduct the activity of money and payment transfers, lending and factoring activities. This development drove to a slight expansion in the credit portfolio, by about ALL 0.8 billion (or 4.1%) compared to end-2015, at ALL 19.7 billion. Enterprises continued to have the main share in the credit portfolio, 90.5%. Trade and agriculture have the highest concentration, 22.8% and 11.5%, respectively. Credit risk remains the main risk to NBFIs' activity. The ratio of "non-performing loans to total loans" improved in 2016 H1, at 12.1%, from 12.7% at end- 2015. Financial result continues to be positive, albeit lower from the previous year.

Table 7.2 Financial indicators of non-bank financial institutions

	2012	2013	2014	2015 H1	2015	2016 H1
Total assets (ALL billions)	35.348	35.03	39.484	39.278	39.471	40.265
Credit portfolio (ALL billions)	20.04	19.646	19.743	19.937	18.959	19.736
Non-perform.loans ratio (%)	8.37	13.21	13.73	12.86	12.71	12.14
Capital adequacy %	38.9	40.94	41.94	43.66	42.2	42.57
Financial result (ALL billions)	1.244	1.502	0.976	0.738	0.721	0.676

Source: Bank of Albania.

(SLAs assets narrowed, driven by the contraction in lending. The indicator of credit quality improved at 7.7%, from 8.7% at end-December 2015. The "Provisions to non-performing loans" ratio stood at 77%. SLAs reported a minimal positive financial result, at ALL 0.01 billion, after the financial loss in the previous year.

Table 7.3 Selected indicators of SLAs and their unions

	2012	2013	2014	H1-2015	2015	H1-2016
Total assets (ALL billions)	10.6	9.75	10.65	10.72	10.56	8.42
Outstanding loan (ALL billions)	7.12	6.39	6.61	6.69	6.37	5.48
Outstanding loan/Total assets (%)	67.44	65.53	61.99	62.42	60.29	65.2
NPL/Outstanding loans (%)	6.42	11.95	11.06	10.41	8.69	7.69
Financial result (ALL billions)	-0.04	-0.23	0.09	-0.02	-0.27	0.01

Source: Bank of Albania.

Assets of Insurance Companies (ICs) share about 1.9% of GDP and of the entire financial system. There were 12 licensed ICs in 2016 H1 (8 non-life, 3 life and 1 reinsurance). ICs assets of amounted ALL 27.9 billion, at the end of 2016 H1, somewhat lower from 2015 H2. They expanded by about 9.6%, in annual terms. Insurance liabilities (or technical provisions) expanded by about 2.7%, compared to the end of 2015, standing at ALL 3.4 billion, while total capital fell by 0.2%, standing at ALL 10.6 billion. Gross written premiums[I], the main indicator of ICs activity - expanded by 2.97%, in annual terms, standing at ALL 6.6 billion. The indicator of insurance penetration in the market, measured as the ratio of premiums to GDP was 0.45%.

Loss measured as the ratio of paid claims to gross written premiums, increased considerably, standing at 28.7%, from 22.7% a year earlier, attributable to the higher paid claims compared to the growth in gross premiums income. This ratio shows that about 1/4 of claims were covered by written premiums. The indicator of gross paid claims was up 29.9%, in annual terms, to ALL 1.9 billion.

Insurance sector continued to maintain a low risk level, by concentrating the investments in low risk assets. ICs investments were mainly in the form of time deposits at commercial banks (about ALL 6 billion) and in the form of Albanian government treasury bills (about ALL 3.9 billion). Exposure of ICs to sovereign debt expanded at 14.0% of total assets, from 10.5% in the previous year.

Investment fund highlights[II] Two investment funds operate in the Albanian financial system, whose net assets (about ALL 72 billion) accounted for about 5% of GDP. The assets of investment funds increased by 7.3%, compared to the end of 2015. Funds list about 32,435 investors, whose major part are households. Their investments are denominated by those in Government debt securities, accounting for 83.8% of total funds' assets and about 4.1% of GDP.

Private supplementary pensions highlights[III]. In 2016 H1, three voluntary private supplementary funds operated in Albania. Data analysis shows that pension funds' activity increased by 19.8%, compared to the end of 2015, at ALL 1.1 billion. Their activity is dominated by investments in Government debt securities, about ALL 1 billion, up by 18.6% from end-2015. The number of their members was about 14.840, at the end of 2016 Q2. This number increased compared to the end of 2015, and considerably up by about 38% compared to the previous year. Nevertheless, this segment has a small share in financial intermediation in Albania.

[I] *AFSA, "Insurance Market Statistical Report: January-June 2016", published on 26 July 2016.*
[II] *AFSA, Market Developments Investment Funds, 30 June 2016"*
[III] *AFSA, Statistical Report "Developments in the private supplementary pensions", 30 June 2016, published on 23 August 2016.*

8. BANKING SECTOR

(47) The Albanian banking sector showed stable performance in 2016 H1. The activity of the banking sector expanded at a slower pace than a year earlier, mainly driven by the investments in securities. In terms of solvency, liquidity and establishing reserve funds for respective risks, prudential indicators were at adequate levels, in accordance with the regulatory requirements. The quality of credit portfolio has been decreasing, notwithstanding the continuous process of loan loss write offs from the banks' balance sheets. Exposure to market risks remains subdued, but it should be monitored and assessed regularly.

8.1 BANKING ACTIVITY

(48) "Customer transactions", representing the lending activity, "Treasury and interbank transactions" and "Security transactions" are the main items in the assets' structure. "Security transactions" recorded the fasted increase, during the last year, mainly reflecting the stagnation in the lending activity and the channelling of funds from the banking system to the investments of relatively higher return. Reserve funds, mainly created for the quality of assets, were down, overall, due to the loan loss write off.

(49) "Customer transactions", which represent the depositing activity and "permanent resources", which represent the banks' capital, continue to remain the main items on the liabilities side.

Table 8.1 Structure of banks' balance sheet

Asset	% of assets	Annual change, %	Liabilities	% of liabilities	Annual change, %
I. Treasury and interbank transactions	31.7	-2.1	I. Treasury and interbank transactions	4.4	-9.6
II. Customer transactions (credit)	44.6	0.0	II. Customer transactions (deposits)	82.3	2.1
Of which: public sector	0.14	-8.2	Of which: to public sector	1.2	42.5
Of which: private sector	42.5	0.3	Of which: to private sector	81.2	1.7
III. Securities transactions	25.4	5.5	III. Securities transactions	0.05	-91.2
IV. Created Reserve funds	5.9	-9.0	IV. Other liabilities	0.8	0.4
V. Other*	4.3	0.7	V. Permanent sources	11.9	6.1
			of which: Subordinated debt	1.7	1.8
			of which: Shareholders' equity	9.6	6.7
			VI. Accrued interests	0.5	-23.0
Total assets	100	1.3	Total liabilities	100	1.3

**"Other" in the balance sheet refers to "Other assets", "Fixed assets" and "Accrued interests" .*
Source: Bank of Albania.

(50) The Albanian banking sector assets expanded by 0.9%, rising to ALL 1,329 billion, accounting for about 90.5% of GDP, in 2016 H1. In annual terms, the banking sector assets increased by 1.3%, from 4.8% in the previous year. The expansion in assets was evidenced in the form of securities investments,[21] mainly in government debt securities, also in securities of non-resident entities[22]. The banking system own holdings of government debt securities increased at 23.1% of total assets, form 22.3% in 2015 H2[23].

(51) Credit portfolio[24] of banking sector increased by 1.9% in half-yearly terms, standing at ALL 593.4 billion. Notwithstanding the continuous process of loan loss write off from banks' balance sheets, the deterioration in credit portfolio is reflected in the increase of provisioning fund for the period under review. Provisioning fund increased at ALL 79 billion, about ALL 2.4 billion (or 3.2%) higher compared to the fund surplus at the end of 2015. The narrowing in treasury[25] and interbank investments [26] decelerated the expansion of assets.
(52) Banking activity was mainly funded by deposits, which accounted for about 82.3% of total assets. Loan/deposits ratio was 54.3%. Deposits' base[27] fell slightly in half-yearly terms (about 0.04%), due to the fall in lek-denominated deposits, but expanded in annual terms by 2.1%. In terms of maturity, there is a shift towards demand deposits and current accounts[28]. 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, and overall, the remained maturity of liabilities was up due to the increased value of deposits of higher than one-year maturity. Banks maintained the capital utilisation ratio to finance their operations, in compliance with the regulatory capital requirements.

(53) The Albanian banking system is characterised by a high concentration for some of its activities. Chart 8.1 (left) shows some of the banking products (in the bank's assets and liabilities) for which the banking system shows a moderate or lower concentration. Deposits of the public and credit (in particular for some of its sub-items) are more evident. Chart 8.1 (right) shows the banking sector's activities with a higher concentration, mainly on the asset side of the banking

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[21] *Investment portfolio in securities increased by about ALL 29.5 billion compared to the end of 2015, up at ALL 337.2 billion. These investments mainly consisted in the form of securities of placement (resident) at ALL 144.7 billion, or 19.1% higher from the end of 2015.*

[22] *Investments in securities of non-resident entities increased at half-yearly terms by about ALL 11.3 billion, at ALL 84.2 billion.*

[23] *The increase of investments on government debt securities was totally derived from the expansion of bonds portfolio. In 2016 H1, T-bills portfolio narrowed by ALL 4 billion. At end 2015 at ALL 70.9 billion, while bonds portfolio increased considerably by about ALL 17.2 billion, standing at ALL 235.5 billion.*

[24] *Not including accrued interests.*

[25] *In 2016 H1, transactions with the central bank, in the form of "current accounts" fell considerably by about ALL 30.6 billion, at ALL 22.8 billion.*

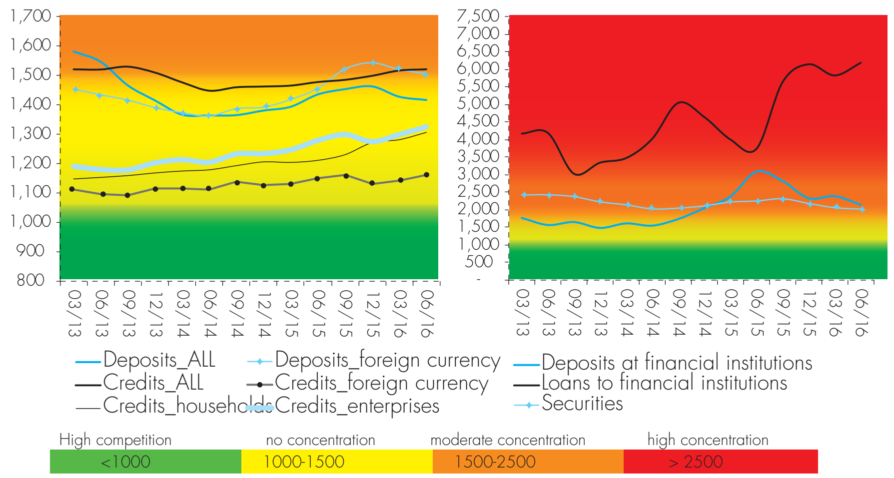
[26] *Interbank investments increased in half-yearly terms by about ALL 3 billion, at ALL 208.1 billion. These investments were mainly in the form of "Loans to banks, credit and other financial institutions" to non-residents, at ALL 7.5 billion, up at ALL 53.1 billion.*

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

[28] *In June 2016, the share of current accounts was 28.5%, from 27.0% in December 2015, and 22.4% in the previous year.*

sector's balance sheet. They consist in lending and investments transactions, mainly with non-resident financial entities.

Chart 8. 1 Herfindahl indicator for the main banking products



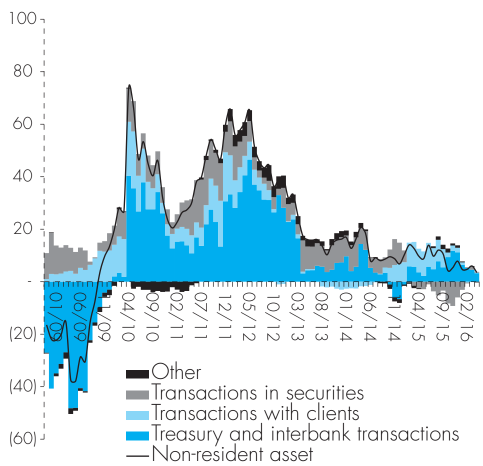
Source: Bank of Albania.

8.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

(54) The banking sector's reliance on external sources of financing remains limited. Net position of banking sector to non-residents remained on the crediting side and continued to increase during the period. Borrowing from small banking groups remained low.

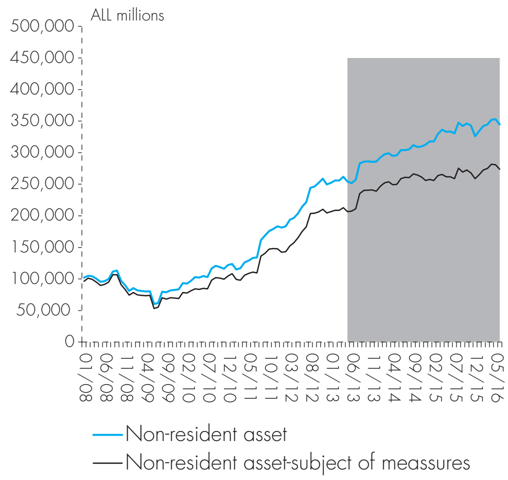
(55) The relationship of banking sector with non-resident entities appeared stable and its lending position increased. At the end of June 2016, assets with non-residents accounted for 25.9% of total assets, and liabilities to non-residents accounted for 6.1%. As a result, the net position of credit to non-residents expanded by 7% year on year, at ALL 263.6 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 foreign financial institutions. The highest expansion of transactions with non-residents (by 67.3% yoy) was evidenced in "Treasury and interbank transactions", in the form of loans granted to banks and financial institutions.

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



Source: Bank of Albania.

Chart 8.3 Performance of non-resident assets



Source: Bank of Albania.

(56) The countercyclical measures taken by the Bank of Albania, in May 2013, contributed to the deceleration of growth of banking sector investments in non-resident entities. The annual growth pace slowed considerably down, at 3.4% in June 2016, compared to 25% in May 2013. The share of assets with non-residents, subject to macro-prudential measures, lowered at 79.4% of total assets with non-residents. Within the group of assets with non-residents, subject to macro-prudential measures, loans to financial institutions and securities expanded considerably, while current accounts contracted. Assets with non-residents, which are not subject to macro-prudential measures (mainly transactions with customers), expanded by 11.1% as at end-2015, although they remained almost unchanged from the previous year.

*BOX 8.1 BANKING SECTOR RELATIONSHIP TO NON-RESIDENT INSTITUTIONS**

Asset of non-residents' placements. *The main share of placements (excluding investments in securities) at non-resident institutions in assets was in the form of time deposits, 48.4% of total, followed by current accounts by 28.1%. These placements appear 76.9% in euro and 16.7% in US dollars; while placements at the parent banking groups in EUR share 71.5% in the total. Placements in non-residents assets continue to focus mainly in the euro area with 69.1% of the value of placements. By banking-groups, 73.4% of placements to non-residents in assets belong to G3, 22.8% to G2 and the rest of 3.8% to G1. By origin, the group of banks with Greek capital placements shared 17.7%, group of banks with Italian capital placements shared 16.5%, and the group of banks with Albanian capital placements shared 8.9% of the total.*

Liability of non-residents' placements*. Liability placements were mainly in the form of time deposits from banks, about 69.3% of total. Placements on the liability side were mainly denominated in euro, 85.5% of total and 92.2% of liabilities to parent banking groups. Liabilities to euro area countries accounted for 23% of total non-resident placements on the liability side. The rest are placements in countries outside the European Union (70.6%), with an increasing share to total. By banking groups, G3 banks accounted for 77.3% of liabilities to non-resident institutions and G1 banks possess 22.7%. Banks of the Italian Group hold 20.1% of these non-resident liabilities, while banks of the Albanian group placements hold 9.7% of these liabilities.*

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

8.3 CREDIT

(57) Banking sector credit outstanding increased in 2016 H1, driven by the expanded credit to enterprises in the domestic currency. The write off of non-performing loans from banks' balance sheet continued, but at a slower pace than in 2015. The share of credit to non-residents in the sector's credit outstanding was up. The new lending[29] to resident entities fell compared to the end of 2015, affected by the foreign currency credit and the new credit to enterprises.

(58) At the end of the period, credit outstanding was ALL 597.4 billion, 2% higher from the end of 2015. About ALL 5.9 billion loans classified under "lost" were written off from the balance sheets during the period. Excluding the loan loss write off, the increase in credit outstanding would have been 3%, during the period. In annual terms, credit outstanding contracted by 0.3% at the end of the period,affected by the writing off process of loan loss [30]. Adjusted by the value of written off loans, the annual growth of credit outstanding would have been 3.1%.

Table 8.2 Credit performance

	Indicator and unit	Value (ALL billions)	Share to total	Share to total	Change Against	Change Against
	Period	06/2016	06/2016	06/2015	12/2015	06/2015
By foreign currency	Lek loans	238.6	39.9%	39.2%	3.9%	4.2%
	Foreign currency lending	358.9	60.1%	60.8%	0.7%	-2.7%
	Foreign currency lending, excluding the exchange rate effect	361.0	60.4%	61.4%	1.3%	-2.1%
By institution	Public sector	28.1	4.7%	5.0%	-4.4%	-3.8%
	Businesses	409.9	68.6%	68.6%	2.0%	-0.9%
	Households	159.4	26.7%	26.4%	3.1%	3.0%
By maturity	Short-term	197.6	33.1%	18.1%	-0.5%	-0.4%
	Medium-term	112.0	18.7%	9.7%	4.6%	-0.9%
	Long-term	287.9	48.2%	25.5%	2.8%	0.5%
	Credit outstanding	597.5	100.0%	100.0%	2.0%	-0.1%
	Credit outstanding, excluding the exchange rate effect	599.6	100.0%	100.0%	2.3%	0.3%

Source: Bank of Albania.

(59) Credit outstanding was mainly supported by the expansion of credit in lek. Since the beginning of 2012, the share of foreign currency loans has fallen by about 8 p.p., at 60%, in June 2015. In addition to the trend of banks to credit in the domestic currency, this development reflects the highest share of credit in foreign currency in total written off loans as "loss" from banks (about 74%). Lending in the domestic currency expanded by 3.9%, while in foreign

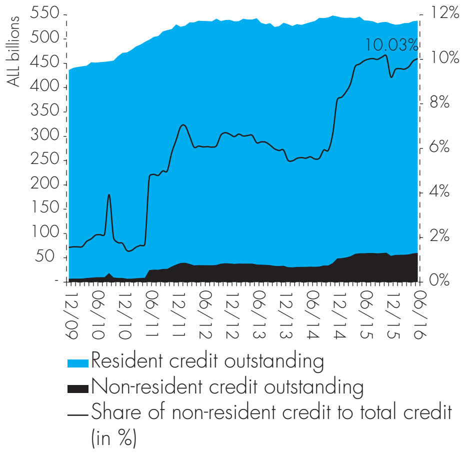
[29] *The data for the new loan are taken from SRU forms, constructed for the purposes of monetary policy. These forms consider lending to residents, without the accrued interest, adding the loan granted to non-bank financial institutions.*

[30] *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 line with this requirement, the banking sector wrote off the balance sheet ALL 14.1 billion loans falling under the category "lost" in 2015 H1, ALL 12.9 billion in 2015 H2 and ALL 5.9 billion in 2016 H1. In total, ALL 32.9 billion loans falling under the category "loss" are written off the balance sheet in 18 months.*

currency increased only 0.7% during the period. By maturity term, long-term credit provided the main contribution to the expansion of credit, during the period under review, and at the same time manifests a slight expansion in annual terms. By entity, lending to households maintained a positive pace during the period.

(60) Attributable to the considerable share of credit in foreign currency, the performance of lek exchange rate affects the nominal value of credit being reported in the domestic currency. Related to the credit outstanding calculated as at the end of June 2016, the exchange rate performance has negatively impacted the reported value of credit, mainly due to the depreciation of the European currency against the domestic currency. Credit outstanding, excluding this effect, during the period under review, would have expanded by 2.3%.

Chart 8.4 Performance of credit to non-residents and its share

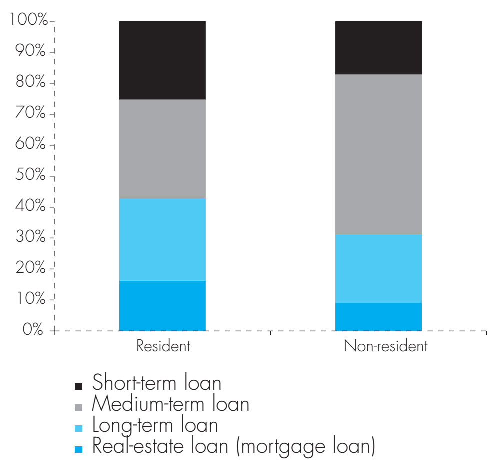


Source: Bank of Albania.

BOX 8.2 CREDIT OUTSTANDING TO NON-RESIDENT ENTITIES

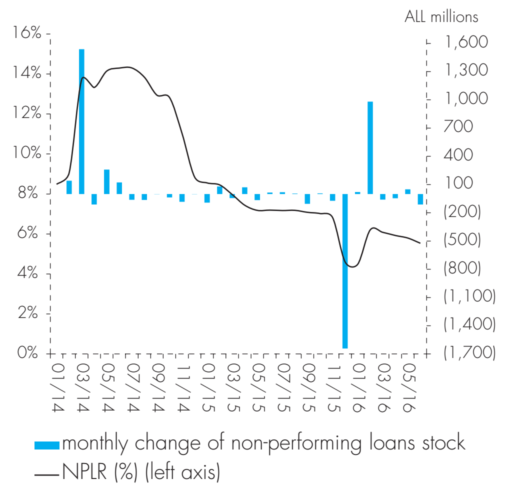
Share of non-resident credit in credit outstanding of the sector increased to 10.0%, in June 2016, from 9.2% in December 2015, although, it remained unchanged from the previous year. Credit outstanding to non-residents stood at ALL 59.9 billion, up by 11.1% from the end of 2015. Credit to enterprises, up by 9.7% in 2016 H1, provided the main contribution to this growth. It accounted for 85% of total credit outstanding to non-residents. Non-resident credit to households has a low share, and expanded both in annual terms and during the period under review. Overall, credit to non-residents was oriented toward longer-term maturities, with the main share in the medium term (52%). Share of medium-term credit expanded, while long-term credit narrowed, over the past year.

Chart 8.5 Credit outstanding by maturity term



Source: Bank of Albania.

Chart 8.6 Credit quality



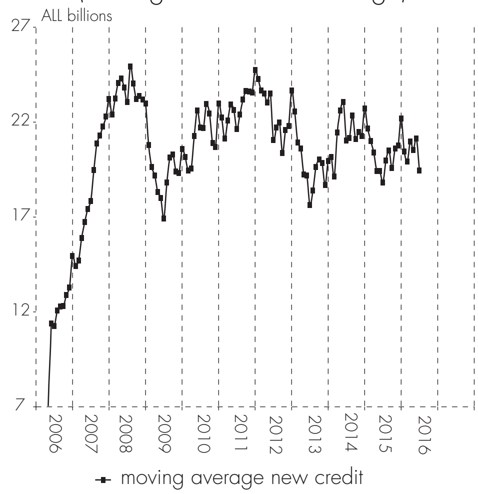
Source: Bank of Albania.

Credit quality to non-resident entities was considered at relatively good levels, as "non-performing loans to credit outstanding ratio" was 5.5% and has been falling over the last two years. Nevertheless, the non-performing loans ratio expanded around 0.9 p.p. compared to the end of 2015, notwithstanding the annual contraction by 1.7 p.p.

(61) In 2016 H1, new loans granted by banking sector accounted for ALL 116.7 billion, 12.6% lower than in 2015 H2, but 3.3% higher than in the previous year. In 2016 H1, the banking sector's loan collection amounted to ALL 110.9 billion, 20.7% lower than in the previous period. The loan use ratio, measured as the ratio of repaid to new loans, fell to 95%, from 104.7% in December 2015, mainly due to the fall in the value of the paid loans.

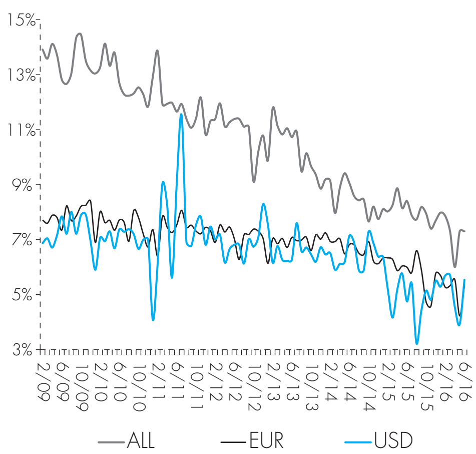
(63) The downward trend of interest rates on credit, in particular lek credit, supported the performance of the new lending. In June 2016, the average weighted interest rate on new credit, as a whole, stood at 6.42%, unchanged from December 2015. The average weighted interest rate on credit stood at 7.3%, down by 0.4%, over the period, reflecting the policy rate cut. The interest rate on euro and US dollar credit stood at 5.3% and 5.5%, respectively.

Chart 8.7 New credit
(moving semi-annual average)



Source: Bank of Albania.

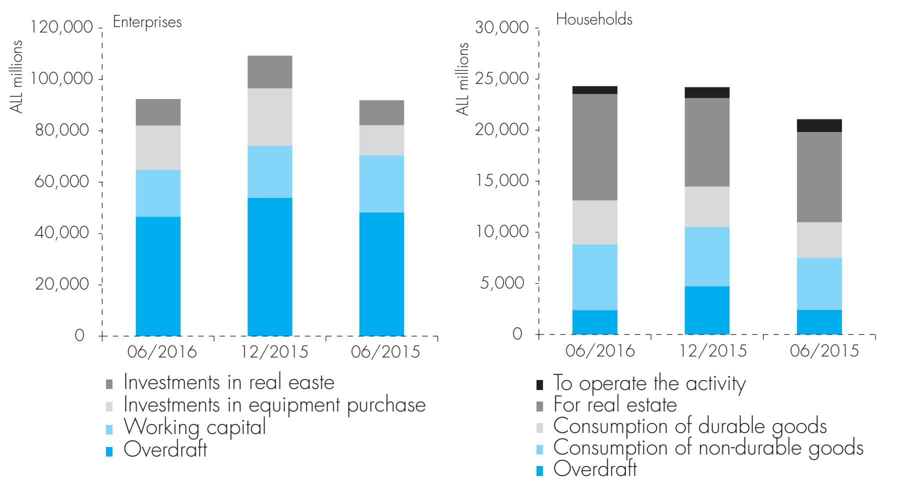
Chart 8.8 Weighted interest rate on new credit



Source: Bank of Albania.

(64) By sectors, businesses provided the main contribution to the performance of new credit over the period. Enterprises received 79% of the new credit, during the period, while households about 21%. New credit to enterprises narrowed by 12.6%, mainly due to the narrowing of the "Overdraft" credit, which has the main share in the new credit to enterprises (about 50%). New credit to enterprises slightly expanded by 0.5%, in annual terms, attributable to the considerable of 48% increase of new credit to "Investment for equipment purchase", which accounted for about 19% of total. New credit to households performed positively in 2016 H1, as well as compared to the previous year. In 2016 H1, the new credit to households slightly expanded by 0.4%, driven by the increase in real estate credit[31], sharing 43% of the new credit flow, from 36% in December 2015. In annual terms, the credit to households provided the main contribution to the positive performance of new credit. It increased by 15.4% or ALL 3.2 billion. Half of this amount was credit for real estate purchase.

Chart 8.9 Lending by purpose of use



Source: Bank of Albania.

(65) By currency and maturity term, credit in lek provided the main contribution in the credit performance during the period, in both medium and long term. New credit in lek accounted for 52% of total and continued the upward trend of the recent years pointing at 14.3% in 2016 H1. The share of new credit in foreign currency of 48%, fell by 12 p.p. in 2016 H1. By terms of maturity, short-term credit accounted for 54% of the total (down by 3.4 p.p., during the period under review), medium-term credit accounted for 17% of the total (up by 2.3 p.p.during the period), and long-term credit accounted for 28% of the total (up by 1.1 p.p., during the period under review).

8.4 DEPOSITS

(66) In 2016 H1, the deposits' value at ALL 1,100 billion was almost equal to the value of the end 2015, but about 2% higher, compared to the previous year. The annual growth pace of deposits slowed down considerably and was below the long-term average. Foreign currency deposits, on average up

[31] *The new credit to households "for real estate" expanded by ALL 1.8 billion during the period, at ALL 10.4 billion.*

by 5.4%, continue to dominate the structure of deposits and the annual growth rate. Time deposits contracted and the share and level of current accounts increased considerably driven by the fall in interest rates.

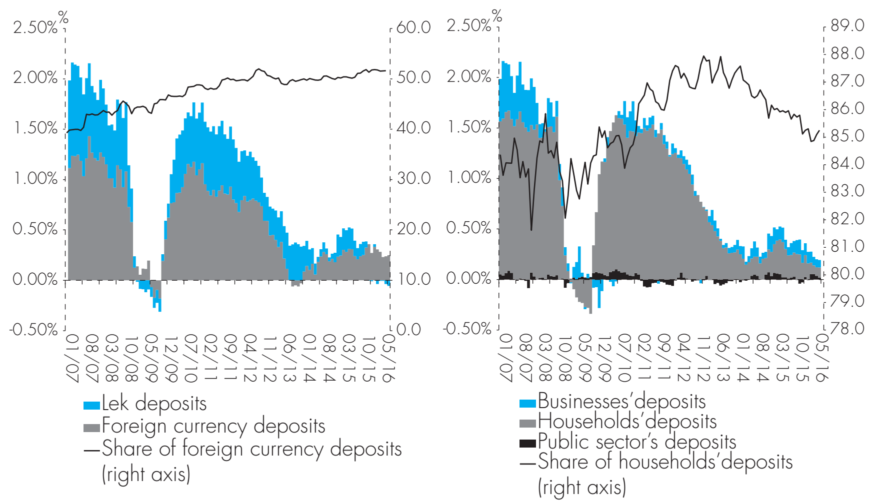
Table 8.3 Main indicators of deposits in the banking system

	Indicator and unit	Value (in ALL bn)	Share to total deposits (%)		Change	
	Period	06/2016	06/2016	06/2015	Against 06/2015	Against 12/2015
By foreign currency	Lek deposits	532	48.4%	49.9%	-1.1%	-0.7%
	Foreign currency deposit	568	51.6%	50.1%	5.0%	0.6%
	Foreign currency lending, excluding the exchange rate effect	573	51.8%	50.5%	5.9%	1.4%
By institution	Public sector	31	2.8%	2.7%	7.2%	17.4%
	Enterprises	131	11.9%	11.4%	6.5%	-4.5%
	Households	938	85.3%	85.9%	1.2%	0.1%
By product	Current account	314	28.5%	22.4%	29.6%	5.6%
	Demand deposits	76	6.9%	6.9%	3.1%	9.5%
	Time deposits	690	62.8%	68.9%	-7.1%	-3.2%
	Total deposits	1.100	100.%	100.%	1.9%	0.0%
	Total deposits, excluding the exchange rate effect	1.105	100.%	100.%	2.4%	0.4%

Source: Bank of Albania.

(67) Foreign currency deposits increased their contribution in the growth of banking sector's deposits. The average annual growth of foreign currency deposits was 5.4%; while lek deposits fell by 0.4%, in 2016 H1. Thus, foreign currency deposits accounted for about 52% of total deposits, as at end 2016 H1. Their share has been increasing during the last years, most rapidly in 2007-2012[32]. Excluding the effect of changes in the exchange rate from the value of deposits, the annual growth of foreign currency deposits would be 5.9% and of total deposits 2.4%, at the end of June 2016.

Chart 8.10. Contribution in the growth of deposits



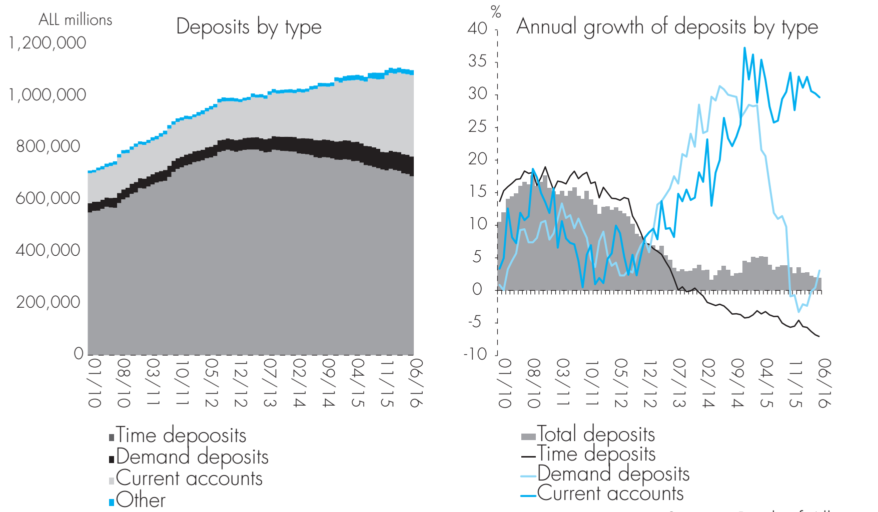
Source: Bank of Albania.

32 *The share of deposits in foreign currency against the total deposits was 39% at the beginning of 2007, and about 51% at the end of 2012.*

(68) The increase of households' deposits and the fall of businesses' deposited contributed to the stability of deposits during the period under review. Households' deposits, which share about 85% of banking sector's deposits, increased on average 1.5%, in 2016 H1, standing below the annual average[33] of the last three years (of 2.6%). Enterprises' deposits fell by 4.5% from their level of December 2015, although they were 8.6% higher than their value in the previous year. Between the households' deposits in lek and in foreign currency and the enterprises' deposits in lek and in foreign currency, the enterprises deposits in foreign currency recorded the most rapid increase, while households' deposits in lek recorded the highest fall. At the end of 2016 H1, foreign deposits accounted for about 50% of households' deposits and about 63% of businesses' deposits.

(69) Current accounts and time deposits provided different contribution in the performance of deposits' value. The value of current accounts at the banking sector increased further in 2016 H1, and was about 31.2% higher at the end of 2016 H1, compared to the previous year. On the other hand, time deposits fell both in value and share (against the total deposits) in 2016 H1, although they dominated the value of deposits at the banking sector. Time deposits fell by ALL 22.7 billion, or 3.2%, compared to the end of 2015; their share fell at 63% of total deposits.

Chart 8.11 Deposits by currency



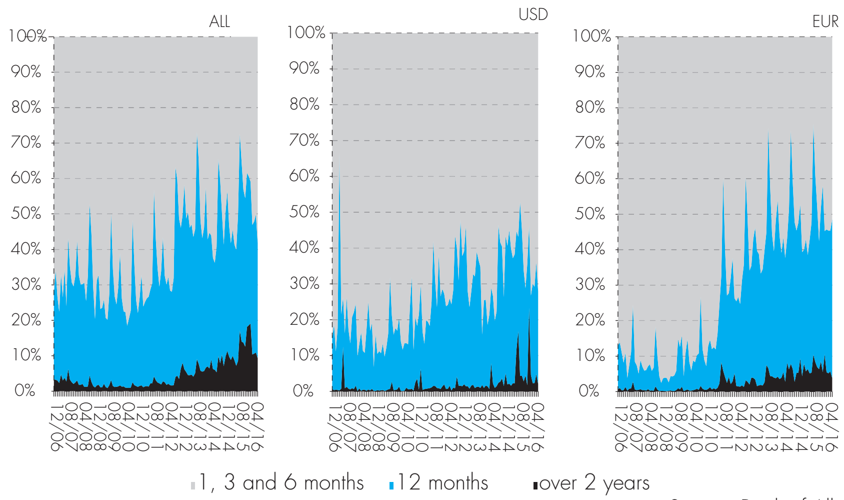
Source: Bank of Albania.

(70) By size of the activity, deposits increased for medium-sized banks, and fell for larger and small-sized banks. For larger banks, deposits fell by 1%, but these banks manage 69% of the sector's deposits. Movements in deposits increased by 11% for the group of medium-sized banks, and fell by 25% for small-sized banks. These movements were mainly caused by the re-classification of a bank, from a small-sized to a medium-sized bank.

33 *Starting from July 2013.*

(71) Banking sector had a new flow of new time deposits (new placements and replacements) for about ALL 274.7 billion. There was a slight shift of deposits to longer-term maturities within the structure of deposits. By currency, the new flow of deposits in lek fell by 21.5%, in US dollar fell by 35%, while in euro increased by about 6%. The average interest rate on new time deposits in lek continued to trend down, at 0.14%, while in main foreign currencies were about 0.1%, in 2016 H1.

Chart 8.12 New time deposits by currency and maturity



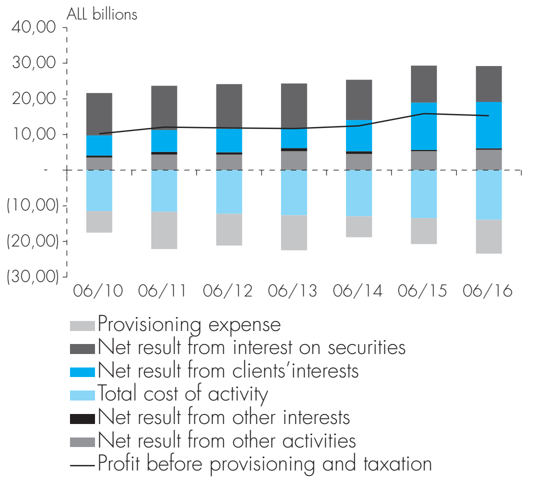
Source: Bank of Albania.

8.5 FINANCIAL RESULT AND RESOURCES EFFICIENCY

(72) Net financial result of the banking sector was positive, although down, during the period. The most rapid fall of income from interest compared to the fall of financing costs drove to the lowering in the net income from interest and the net interest margin. The costs in the form of provisions for the credit risk, and the whole expenses, increased considerably, becoming the main factor contributing to the fall in banking sector profitability. Other activities provided low impact on the profitability. The Return on Equity (RoE) and Return on Assets (RoA), for the sector, fell in annual terms.

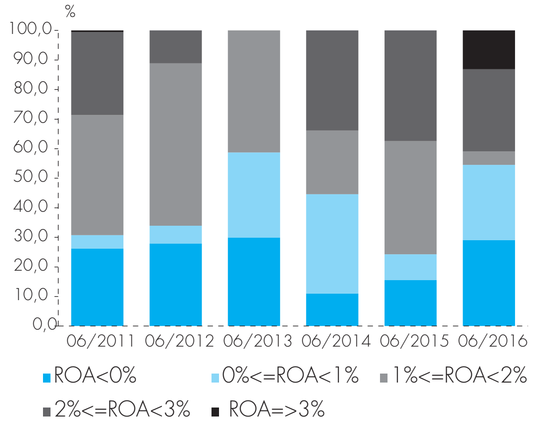
(73) In June 2016, the banking sector reported a positive financial result of about ALL 5.1 billion, or about ALL 3.2 billion lower compared to the previous year. Notwithstanding, the increase in provisioning costs was the main factor that drove to the reduced profit, the main banking activity was down as well, thus affecting the fall in the income from interest. The main profitability indicators, Return on Assets (RoA) and Return on Equity (RoE), were assessed at 0.8% and 8%, respectively, down by 0.5 and 6.2 p.p., respectively, from the previous year.

Chart 8.13 Financial result components



Source: Bank of Albania.

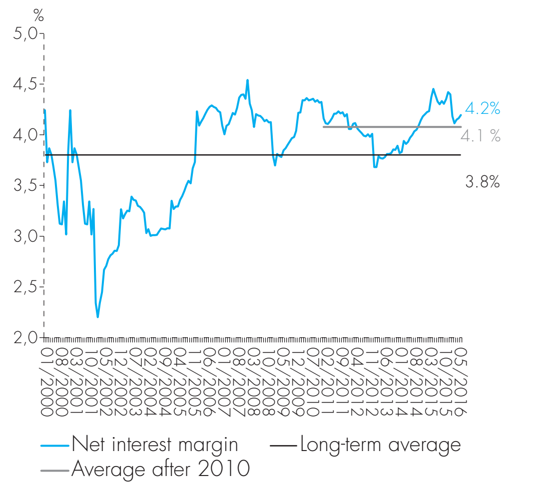
Chart 8.14 ROA by banks' share in the assets of the sector



Source: Bank of Albania.

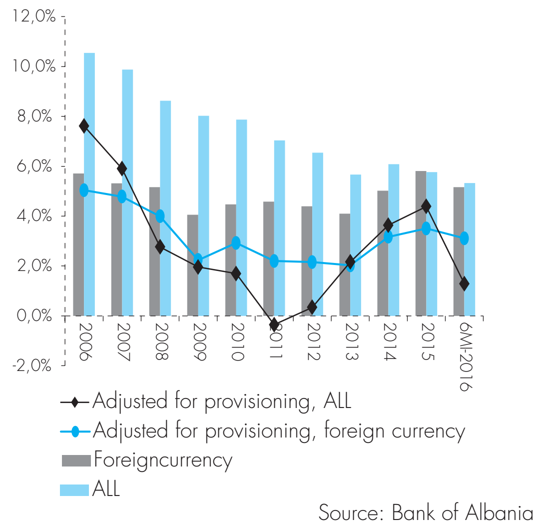
(74) The continuous lowering of the financing costs did not sufficiently offset the fall of income from the main banking activity. Interest income shrank by ALL 2.3 billion, driving to the fall of net interest result by about ALL 0.5 billion, due to the slighter fall in interest expenses. Hence, net interest margin narrowed at 4.2%, from 4.4% over the previous year.

Chart 8.15 Net interest margin



Source: Bank of Albania.

Chart 8.16 Effective interest rate of credit



Source: Bank of Albania.

(75) The fall in credit interest rates and the stability in provisioning affected the fall in the net effective rate of return of credit stock[34]. The effective rate of return on credit stock fell by 0.3 p.p. in 2016 H1, standing at 5.7% at the

[34] *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. This assessment is an approximation of the factual performance of interest rate on outstanding credit and deposits, and does not consider the operational, capital costs commissions and other elements in determining the credit or deposits interest rate.*

end of 2016 H1. When corrected for the provisioning costs realised by banks, then the net effective return on credit stock in lek falls at 1.3%, while of credit in foreign currency at 3.1%. This result mainly reflects the increase in provisioning expenses on credit in 2016 H1.

(76) Provisioning expenses for credit risk, and overall provisioning, reflect considerable increase compared to the previous year, by 15.8% and 30.4%, respectively. For individual banks, the increase in provisioning expenses for credit in 2016 H1, affected the establishment of the financial loss, although the net result from banking activity has not changed considerably. As a result, the share in the assets of the banking sectors and banks that recorded a financial loss, increased at 29.1%, higher compared to the two previous years.

(77) Expenses for other activities decreased at a higher pace than the income from these activities, thus affecting positively the net result, by about ALL 0.4 billion. Also, activity costs, even though slightly up, were covered adequately by the activity income, providing a positive impact on the operative profitability (prior to provisioning).

By size, the profit was positive for the three banking groups, unlike the previous year, when the small-sized banks reported financial loss. For the medium-sized and larger banks, RoA and RoE were down, albeit positive.

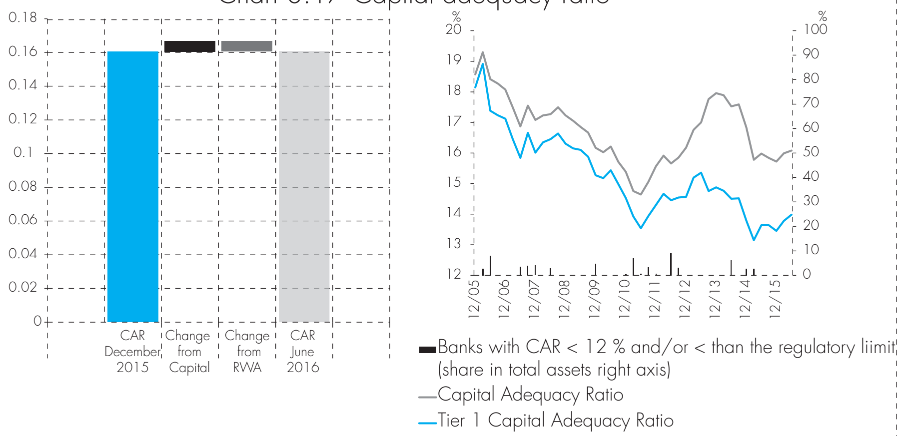
8.6 BANKING BUSINESS CAPITALIZATION

(79) In 2016 H1, banking business capitalisation is assessed at good levels and banks have maintained the minimum required levels of capital adequacy ratio. Capital injection and the good level of banking sector's profit, affected positively the performance of the regulatory capital. On the other hand, capital requirements for credit risk and investments in non-resident entities drove to the increase of risk-weighted assets of the banking sector.

(80) At end of June 2016, the capital adequacy ratio stood at 16.1% from 16.0% at the end of 2015, and 15.9% in the previous year. Risk-weighted assets expanded by about 3.9%, compared to December 2015, thus contributing in the reduction of capital adequacy ratio by 0.6 p.p.. On the other hand, regulatory capital increased by 4.2%, attributable to capital injection and the continued positive financial result, thus improving the capital adequacy ratio by 0.64 p.p.

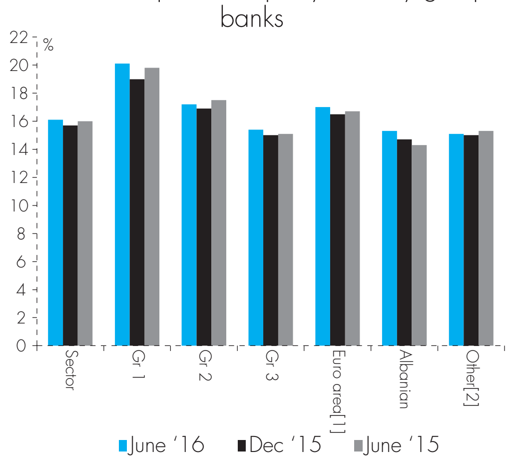
(81) By group level, Group 3 banks present a lower capitalization rate; while by the origin of capital, banks of Albanian origin show lower capitalization rates than banks of origin from the euro area. The major part of individual banks maintains capital adequacy rates at the interval 14-16%.

Chart 8.17 Capital adequacy ratio*



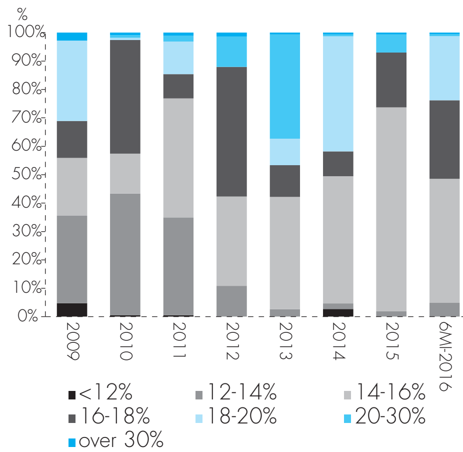
* The Capital Adequacy Ratio (CAR) is measured as the ratio of "Regulatory capital to Risk-Weighted Assets" (RWA); The Tier 1 Capital Ratio is measured as the ratio of "Tier 1 Capital to Risk-Weighted Assets".
Source: Bank of Albania.

Chart 8.18 Capital adequacy ratio by group of banks



[1] Austria, Germany, Italy, France, Greece and Bulgaria.
[2] Turkey, Saudi Arabia, Kuwait and Malaysia.
Source: Bank of Albania.

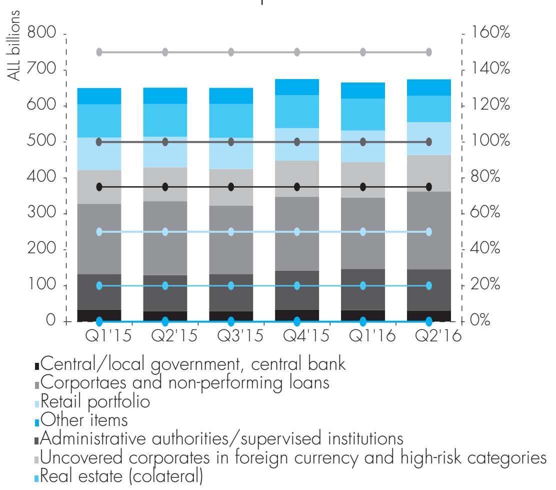
Chart 8.19 Asset allocation of banking sector, by Capital Adequacy Ratio



Source: Bank of Albania.

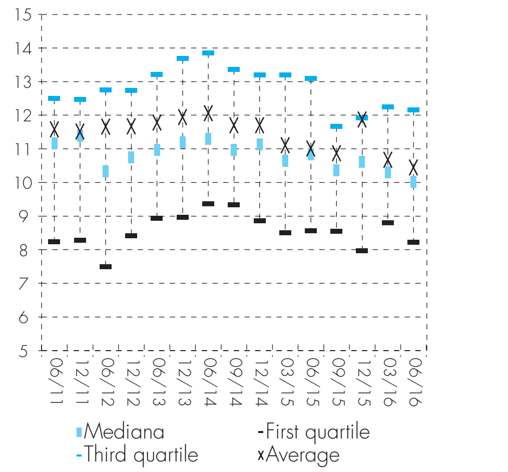
(82)RWAs for credit risk expanded by around ALL 16.8 billion, compared to the end of 2015, up at ALL 677.1 billion. The highest exposure of banking sector mainly relates to three classes of credit risk, which are weighted by a high risk coefficient: a. "Exposure to high risk classified categories", which includes lending 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". On the other hand, capital requirement on market and operational risks was up compared to the end of 2015. They increased by ALL 807.4 million and ALL 8.0 billion, respectively, at ALL 16.1 billion and ALL 83.9 billion, respectively.

Chart 8.20 Risk-weighted coefficients and the size of main credit portfolio classes



Source: Bank of Albania.

Chart 8.21 Financial leverage ratio



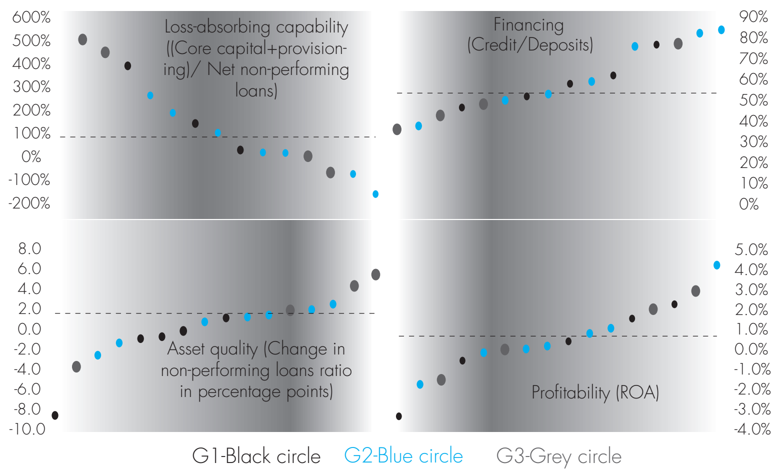
Source: Bank of Albania.

(83) Albanian banking sector is characterized by a low and stable financial leverage ratio, thus affirming the good level of capitalisation. The financial leverage ratio[35] as at end June 2016 was 10.4 times, from 11.9 times a year earlier. Individual banks did not differ significantly in terms of financial leverage.

BOX 8.3 BANKING SOUNDNESS, COMPARISON AMID BANKS

Chart 8.22 shows the listing of 16 banks of the banking sector based on four indicators of banks' balance sheet related to the loss-absorbing capacity, assets quality, profitability and financial sources. The closer the bank is to the centre of chart, the higher is the need to correct the indicator to the sectors' average.

Chart 8.22 Banking soundness at bank level, June 2016



Source: Bank of Albania.

[35] *The financial leverage ratio is measured as the ratio of assets to equity.*

**Note: There are included 16 banks of the system. The arrows in the horizontal axis of the summarising chart show the performance of banks. The darker area shows higher risk. The dotted line (at the middle of the each chart) marks the level of each indicator for the entire sector, in June 2016. The indicators in the chart are:*

- *Loss-absorbing capacity (core capital plus provisioning/net non-performing loans),*
- *Need for financing (Credit/deposits),*
- *Credit quality (non-performing loans/total credit) (semi-annual change in percentage points),*
- *Profitability (ROA).*

At aggregate level, banking sector shows good loss -absorbing capacity, where the covering with core capital of non-performing loans was 93%. However, in 2016 H1, two larger banks and banks with Greek capital, showed lower loss-absorbing capacity, in reflecting the high level of non-performing loans. This development is reflected in the important contribution of credit worsening (1.75 p.p. for the sector) deriving from these two larger banks. The net result of banking sector was down, compared to the end of 2015. The Return on Assets fell at 0.8% (June 2016). Five banks (of which one larger bank and two medium-sized banks) reported losses for the period under review, mainly reflecting the rapid increase in provisioning expenses. Finally, larger banks reported a low financing level, where the deposits/credit ratio was below the average of the sector (54%).

9. MONITORING BANKING SECTOR RISKS

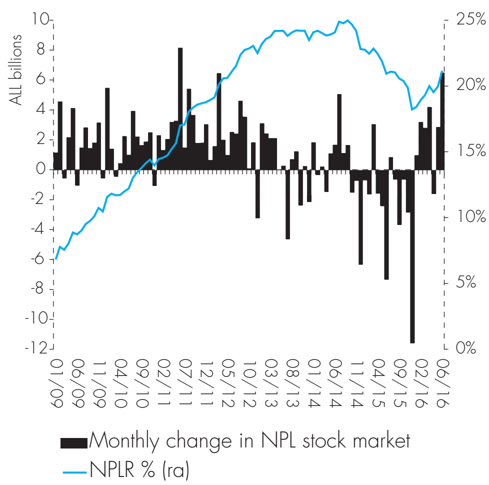
9.1 CREDIT RISK

(84) In 2016 H1, credit quality worsened, mainly from the new flows in the stock of non-performing foreign currency loans to enterprises, concentrated in the larger banks. The credit risk is mitigated by the good level of provisions, although the rate of provisioning for non-performing loans has fallen. The Bank of Albania has been active in the resolution process of non-performing loans, by intensifying the collaboration with public authorities and the banking sector, to reduce the credit risk.

9.1.a. Credit quality

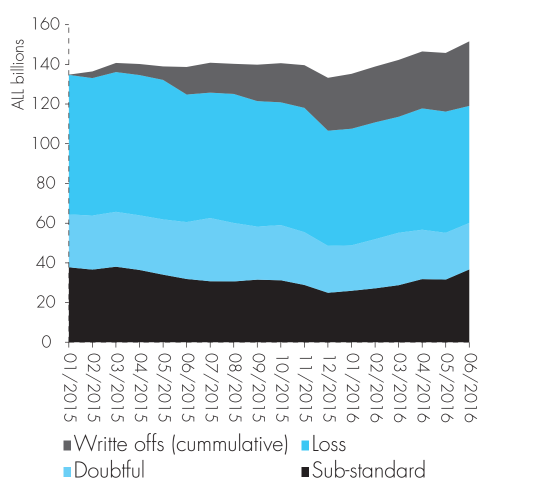
(85) During the period, the outstanding non-performing loans[36] expanded by around 11.7%, to ALL 119.3 billion, reflecting the expansion in the non-performing loan ratio. The new flows in non-performing loans were not able to be covered by the loans written off in the first half of the year, reflecting an expansion of the stock of non-performing loans (NPLR). The loans written off in the first half amounted to around ALL 5.9 billion.

Chart 9.1 Non-performing loans ratio



Source: Bank of Albania.

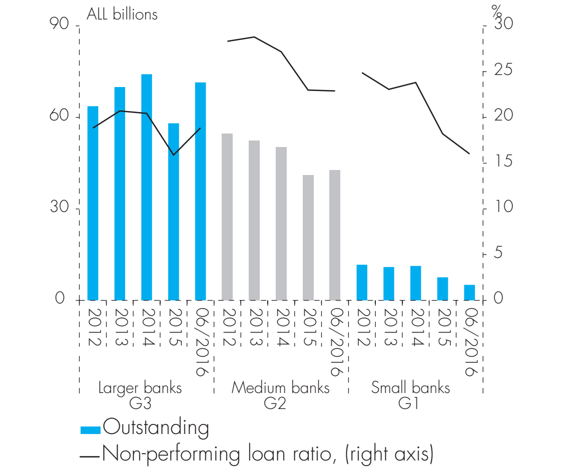
Chart 9.2 Non-performing loans structure



Source: Bank of Albania.

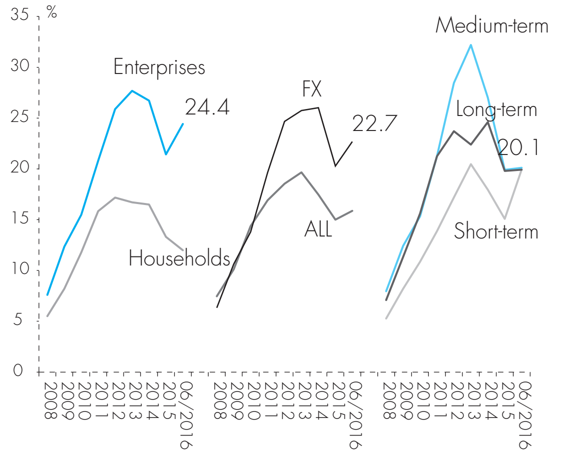
36 *Non-performing loans include "substandard", "doubtful", and "loss" classes; The criteria to define a loan as "non-performing" is the number of past due days (90 days).*

Chart 9.3 NPL portfolio by bank groups



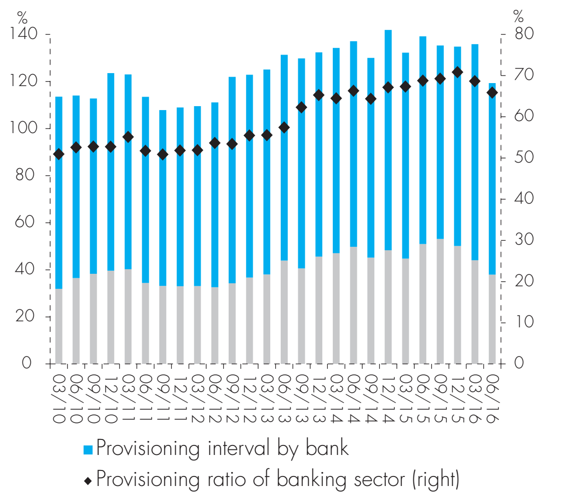
Source: Bank of Albania.

Chart 9.4 Non-performing loans in the Albanian banking sector



Source: Bank of Albania.

Chart 9.5 Provisioning over time



Source: Bank of Albania.

(86) At the end of June 2016, the non-performing loans ratio (NPLR) stood at 19.96%, expanding by 1.7 p.p. from December 2015 (see Chart 9.1). In the NPL structure, the considerable expansion of the substandard class (to 30.8% of the total NPLs, from 23.3% in December 2015) shows that there is a new flow in NPL classes; on the other hand, the transition within the NPL classes shows a migration toward the "loss" class, which expanded by 2% during the period, excluding the effect of written off loans.

(87) The larger banks made the main contribution to the deterioration of the credit quality, together accounting for 60% of outstanding NPLs. The NPLs for this group of banks expanded by 23%, whereas the NPLR increased by 3 p.p. to 18.9%. The smaller G1 banks recorded an improvement in the credit quality, as their NPLR fell by 2.2 p.p. to 16.0% as a result of the contraction in NPLs by 33% during the period. Regardless of the slight improvement by 0.1 p.p. of the NPLR during the period, the medium-sized G2 banks show the highest level of the NPLR, at 22.9%.

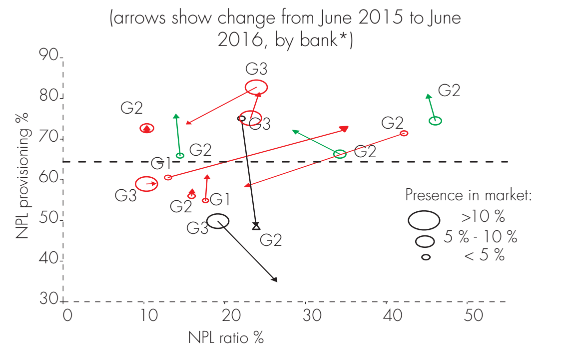
(88) The credit quality appears lower for the foreign currency loans, loans to enterprises, and medium-term loans. In June 2016, the credit quality for each portfolio stood at 22.7% (foreign currency), 24.4% (enterprises) and 20.1% (medium term).

9.1.b Provisioning

(89) The NPL provision coverage ratio has fallen; thus, its performance should be monitored carefully. In June, the provision coverage ratio fell to 65.9% from 70.8% in December 2015 and 68.7% a year earlier (Chart 9.5). The coverage ratio fell during the period, primarily due to the faster expansion of outstanding non-performing loans followed by the contraction in value of the reserve funds due to the write off process.

(90) The increase in the net value of non-performing loans during the period has led to the decrease in their capital coverage. During the period, the ratio of net non-performing loans to outstanding loans expanded by 1.5 p.p., to 6.8%. In the previous year, the ratio stood at 6.6%. At the same time, as a result of the higher exposure to credit risk through the expansion of the outstanding net non-performing loans, the "net non-performing loans/regulatory capital" rose to 30.4% from 24.3% at the end of December 2015. In the previous year, the ratio stood at 30.8%.

Chart 9.6 Annual change in provisioning levels

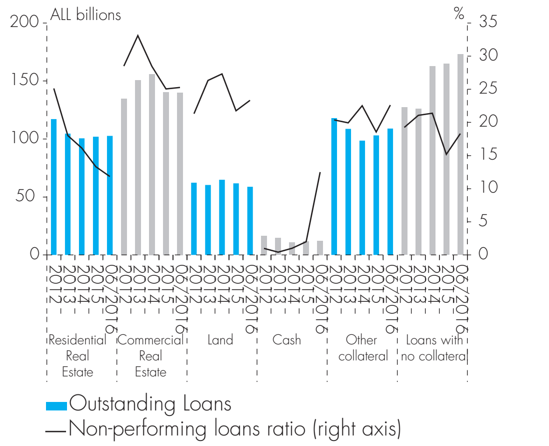


*This includes banks sharing more than 1% in total assets. Green shows improvement, red shows deterioration, black shows combined risk. Dashed line marks the average ratio of non-performing loan loss provisions at sector level, 65.9% as at end- December 2016.
Source: Bank of Albania.

9.1.c Collateral coverage

(91) Loan collateral coverage remains stable and maintains the high concentration in the form of "immovable property". In June 2016, the collateral coverage[37] fell to 71.0% from 71.8% in December 2015. The loans covered with collateral in the form of immovable property account for 71% of collateralised loans and 51% of outstanding credit. Overall, the quality of collateralised loans has fallen during the period, leading to the ratio of non-performing loans rising by 1.2 p.p., to 20.7%. The loans collateralised with residential immovable properties are the only class showing credit quality improvement over the first half of the year, due to the narrowing in the outstanding non-performing loans by 10.4% (see Chart 9.7). At the same time, loans collateralised with commercial immovable property have the highest share in the ratio of non-performing loans, standing at 25.3% in June 2016, expanding by 0.2 p.p. during the period. The high usage of immovable property as collateral to secure credit increases the dependence of the sector on the need for an efficient functioning of this market and well-functioning of the legal process of collateral execution.

Chart 9.7 Outstanding loans and non-performing loans by collateral



Source: Bank of Albania.

9.1.d Indirect credit risk[38]

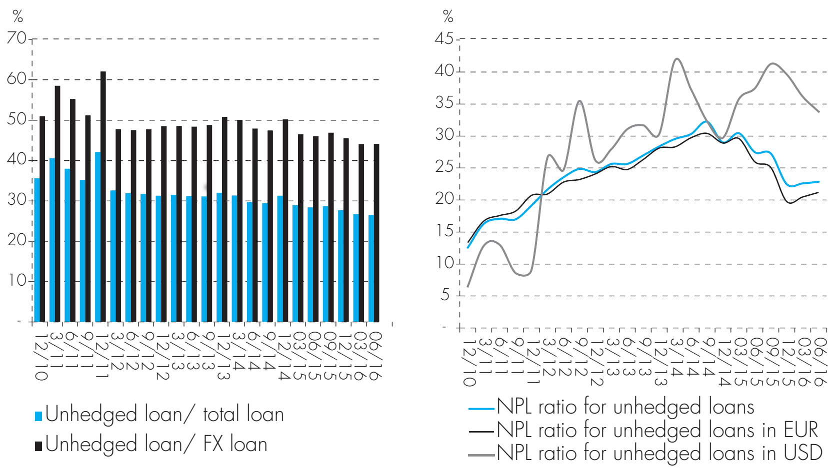
(92) Exposure to indirect credit risk remains high. Although in the last two years the sector has reduced the share of unhedged credit against this risk in total foreign currency loans, it continues to be considerable. In June 2016,

[37] Collateral in the form of immovable property (residential, commercial or land), cash, etc.
[38] The analysis in this section includes credit data for the economy.

unhedged foreign currency loans accounted for 44.1% of outstanding foreign currency loans (1.4 p.p. less than in December 2015) and 26.5% of total outstanding loans (1.2 p.p. less than in December 2015). This development reflects mainly the contraction of unhedged outstanding loans during the period by 2.4%, mainly due to the fall in US dollar unhedged credit[39].

(93) Ratio of non-performing loans for unhedged foreign currency loans increased to 22.9% (+0.4 p.p. from December 2015), due to the faster decrease in the outstanding unhedged credit. This development reflects the orientation of new credit to the domestic currency, and the write off process. By currency, the quality ratio for unhedged euro loans deteriorated by 1.4 p.p., to 21.2%, whereas for unhedged US dollar credit, it improved by around 5.8 p.p., amounting to 33.8%.

Chart 9.8 Quality of the credit portfolio unhedged against the exchange rate risk



Source: Bank of Albania.

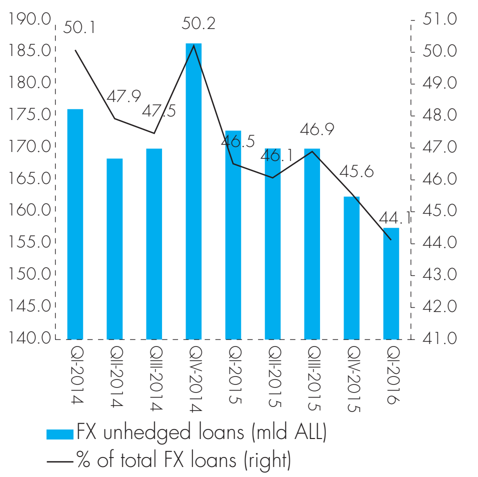
BOX 9.1. BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

Since the end of 2013, the share of foreign currency borrowing has been downward. Foreign currency loans have the main share in the banks' credit portfolio (60.1%), down from the highest 68% level recorded at the end of 2011. The higher inclusion of foreign currency loans in the write off process has reduced the banking sector's exposure to the indirect risk from the exchange rate, while banks and clients have shown higher preference for lek credit, taking into consideration the fall in interest rates. The unhedged credit shares 26.5% in the total credit portfolio. By subject, credit to the private sector has the main share (73%) of outstanding foreign currency loans unhedged against the exchange rate risk. During the period, households provided the main contribution to the narrowing of the "unhedged" outstanding loans (which contracted by 5.3%). In annual terms, the contraction of the unhedged foreign

[39] *Outstanding US dollar credit, when the borrower's income is in Albanian lek, accounts for 13.3% of the outstanding unhedged foreign currency loans.*

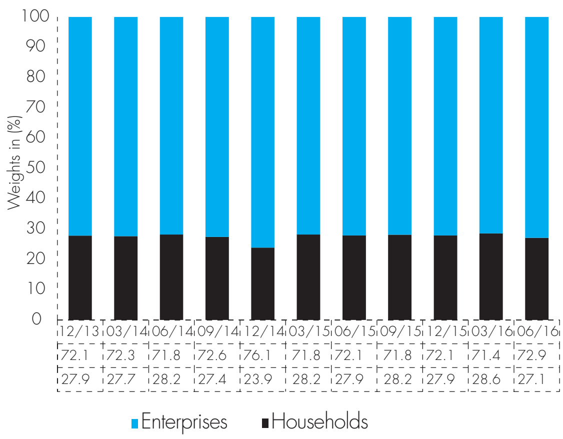
currency loans by 2.4% reflects the reduction of the outstanding unhedged credit to enterprises for 'business development' and 'investment in real estate' purposes.

Chart 9.9 Foreign currency loans



Source: Bank of Albania.

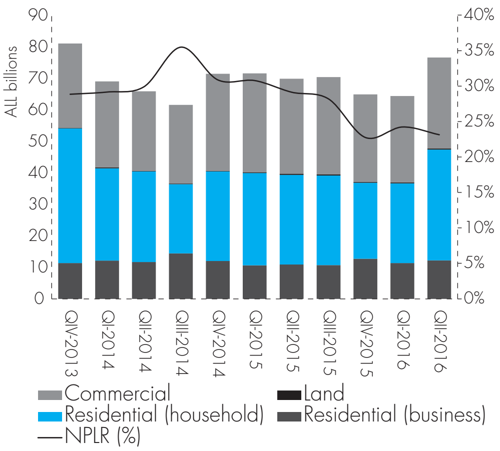
Chart 9.10 Unhedged foreign currency loans, by category, %



Source: Bank of Albania.

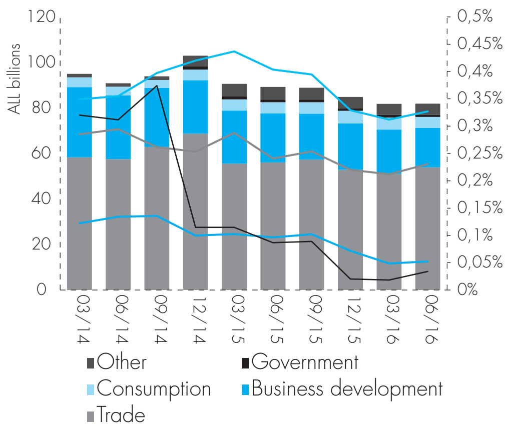
The unhedged foreign currency loans for 'investment in real estate' accounts for 48% of total unhedged credit, contracting during the period, compared to the previous year. Its quality worsened during the period by 0.4 p.p., to 23.1%. The rest of the unhedged foreign currency loans was granted mainly for trading and business development purposes (Chart 9.12). The unhedged credit for 'business development' has the highest ratio of non-performing loans, at 32%, followed by credit for 'trade' purposes, at 21.2%.

Chart 9.11 The unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania.

Chart 9.12 The unhedged foreign currency loans (not for real estate) and the ratio of non-performing loans (right)



Source: Bank of Albania.

In total, the NPL ratio for the unhedged foreign currency loans is at 22.9%, around 0.2 p.p. more than the quality of the foreign currency loans and 2.94 p.p. more than total credit.

9.2 LIQUIDITY RISK

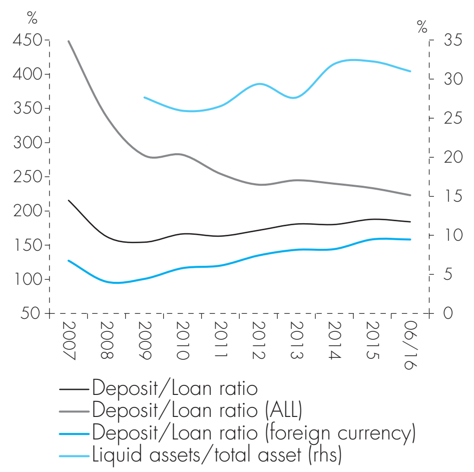
(94) Liquidity position of the banking sector stands at good levels. The liquidity ratios, both in lek and foreign currency, stand above the minimum regulatory level. Deposits remain the main source of funding, covering almost twice the volume of loans for the sector.

(95) The banking sector maintains a good liquidity position, with a considerable outstanding client deposits to credit. In June 2016, the deposit/credit ratio stood at 184.1% (credit/deposit 54.3%). By currency, this ratio stands at 223.0% for the national currency and 158.2% for foreign currency.

(96) Liquid assets in banks' balance sheets remain high, following the sluggish performance of lending. At the end of June 2016, liquid assets accounted for 31.0% of total banking sector assets, slightly down by 1.3 p.p. during the period. The other liquidity indicator, "liquid assets to total short-term liabilities", fell also by 1.0 p.p., down to 40%.

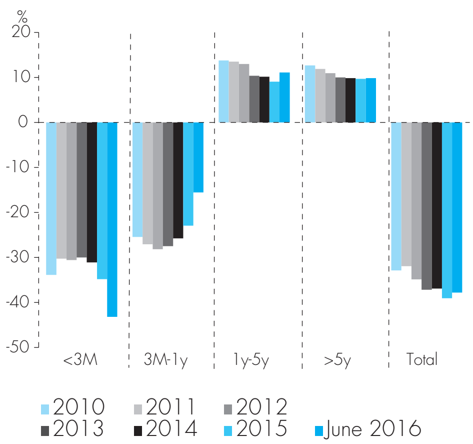
(97) The negative gap between outstanding loans and deposits, by residual maturity segments, against total assets, is considered as high, especially in the short term, although this phenomenon is mitigated by the high presence of liquid assets. The mismatch in fund volumes is more problematic for 3 months – 1 year maturities, because for shorter-term maturities, the gap may be a result also of an expected behaviour of economic agents given the very low interest rates (see Chart 9.14).

Chart 9.13 Liquidity indicators mismatch



Source: Bank of Albania.

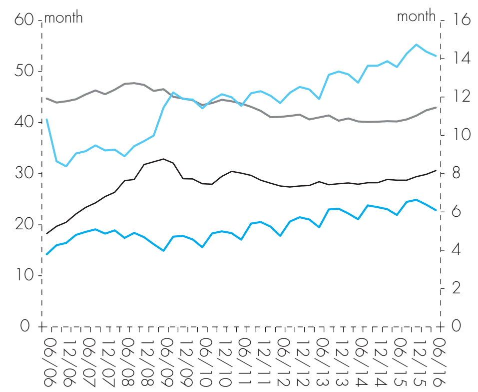
Chart 9.14 Credit and deposits maturity



Source: Bank of Albania.

(98) Developments in balance sheet items of banks are followed by the expansion of the assets maturity, by around 1.2 months, and a slight decrease of this indicator for liabilities, by around 0.6 month. Overall, the average term to maturity is estimated for assets at around 30.6 months, and for liabilities at around 14 months. The maturity gap between the two expanded to 16.5 months. By main balance sheet items, during the period, the residual maturity for deposits, as the main representative item of liabilities, narrowed to 6.1 months (in accordance with the seasonal behaviour), from 6.6 in December 2015. The residual maturity for credit, on the assets side, expanded to 42.9 months, from 41.3 months in December 2015, reflecting the banks inclination to grant credit for longer-term periods.

Chart 9.15 Average residual maturity



Source: Bank of Albania.

(99) The banking sector continues to be financed by client deposits and does not show dependence on financing from parent banks. For banks that have credit facilities with parent groups, at the end of the period, the level of usage fell to 26.9% (from 32.1% in December 2015), whereas the total value of these facilities accounted for ALL 6.7 billion, from ALL 5.6 billion in December 2015.

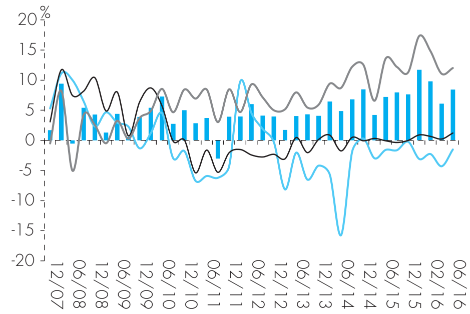
9.3 MARKET RISKS

(100) The banking sector's exposure to the indirect risk from the exchange rate appears downward, as the credit unhedged against this risk has contracted. On the other hand, the low interest rates in the marketplace contributed positively to the borrower's solvency, given that 89.0% of credit is given at variable rates. However, the expansion of the assets and liabilities gap in accordance with repricing periods (segments) expose the banking sector to the direct risk from the interest rate.

9.3.a Exchange rate risk

(101) The open foreign currency position to the regulatory capital reflects good resilience against the volatility in the lek's exchange rate. The currency mismatch index reflects a downward exposure to the indirect exchange rate risk. In June 2016, the larger banks remain in the 'long' position at 12.0% of the regulatory capital; medium-sized banks have moved from the 'short' position in December 2015, to the 'long' position at 1.23%. Smaller banks continue to be in the 'short' position at 1.5% of the regulatory capital. At sector level, the open foreign currency position is assessed as 'long' at 8.4% of the regulatory capital.

Chart 9.16 Open foreign currency position to the regulatory by group and size



Source: Bank of Albania.

(102) Exposure of banks to the exchange rate, including unhedged credit (from exchange rate volatility) fell during the period, mainly due to the contraction of unhedged foreign currency loans.

BOX 9.2. BANKING SECTOR EXPOSURE TO EXCHANGE RATE RISK

The banking sector in Albania is significantly euroised, in both sides of the balance sheet. The euroisation contains risks to both the financial stability (direct and indirect exchange rate risk) and the monetary policy transmission mechanism (weakens the transmission channel of credit and exchange rate). Foreign currency credit for those borrowers that do not have steady income in a foreign currency is associated with the risk of weakening borrowers' solvency in the event of unfavourable exchange rate volatility. In addition, the increase in foreign currency deposits in the banking sector may promote the increase in foreign currency lending, given the fall in yields on alternative investments.

Overall, the currency mismatch for economic agents is one of the systemic risk sources in emerging economies. For the banking sector, we note a positive spread between foreign currency assets and liabilities, which provides, to a certain extent, a natural hedge against the direct risk of unfavourable fluctuations (depreciation) in the exchange rate. To assess, however, the complete risk, the analysis should also include the indirect impact from the exchange rate. To assess the hedging capacity of the banking sector, including the indirect exchange rate risk, we use the foreign currency mismatch index[1], by currency (euro, US dollar, and others) as follows:

$$\text{Foreign currency mismatch index (currency level)} = \frac{\text{Foreign currency mismatch index (currency level)}}{\text{Total assets}}$$

This methodology nets the foreign currency assets with the foreign currency loans for residents (considering the latter as potentially risked). The higher the foreign currency mismatch, the higher the exposure to the exchange rate depreciation risk.

As at June 2016, the currency mismatch index for all the currencies stands unchanged from end- 2015, at around 20.3% of assets, due to the similar increase in both foreign currency assets and foreign currency liabilities. In annual terms, the index improved by 0.7 p.p., reflecting the faster growth in foreign currency assets. Foreign currency credit to residents grew slower in annual terms, by 0.7%. The downward trend of the index in recent years has improved the banking sector's resilience to the exchange rate risk.

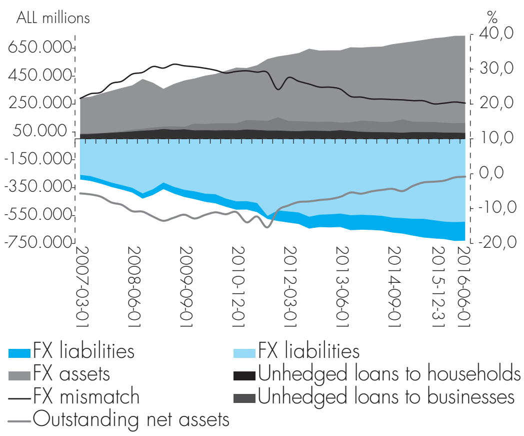
By currency, banks show higher sensitivity to the euro, since around 90% of their transactions are made in this currency. In half-yearly terms, the euro currency mismatch is slightly up, exposing thus the banking sector to this currency. This effect is mitigated by the reduction in the US dollar foreign currency mismatch for the period (see Chart 9.18).

In practice, however, not all the foreign currency credit to residents is exposed to the indirect exchange rate risk. If we readjust the above-stated formula with precisely the values of the unhedged credit to households and enterprises, the following formula allows us to recalculate the net outstanding assets, by currency. The higher the net outstanding assets, the more hedged the bank against exchange rate depreciation.

$$\text{Net outstanding assets (by currency)} = \frac{\text{(FC assets – FC liabilities) - (Unhedged FC loans to households + Unhedged FC loans to enterprises)}}{\text{Total assets}}$$

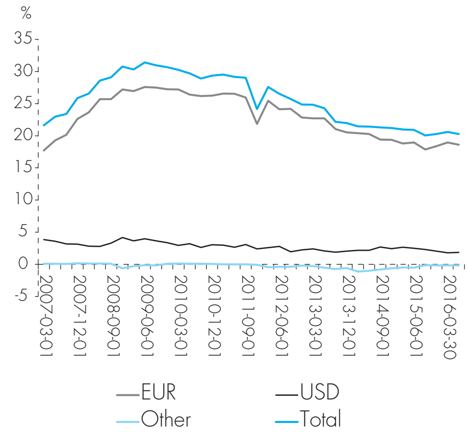
Chart 9.17, shows that during the period, net outstanding foreign currency assets reduced the negative value, accounting for -0.8% of total assets. This is a positive performance and reflects mainly the reduction of the *unhedged credit to both households and enterprises, for the period, by 10.1% and 6.3%, respectively, thus mitigating the exchange rate risk for the banking sector.*

Chart 9.17 Foreign currency mismatch and net outstanding assets



Source: Bank of Albania.

Chart 9.18 Foreign currency mismatch by currency



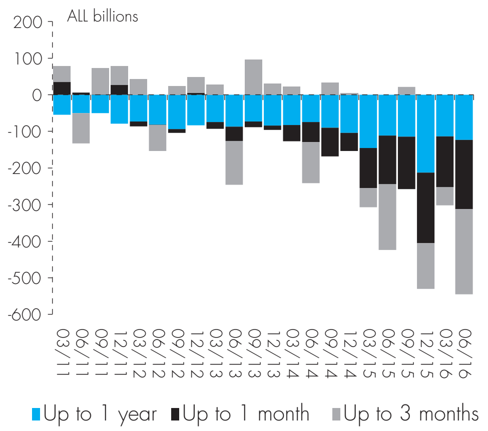
Source: Bank of Albania.

[1] Yeşin P. "Foreign currency loans and systemic risk in Europe", May 2013.

9.3.B INTEREST RATE RISK

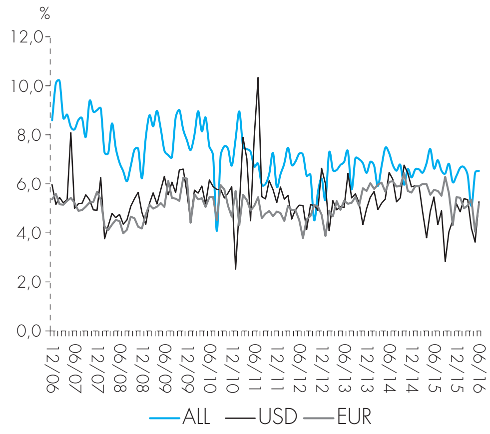
(103) The banking sector is exposed to the interest rate volatility, as the spread between interest rate-sensitive assets and liabilities, by repricing periods, is negative. During the period, the sector has increased its exposure to interest rate volatility for the short-term period up to three months, expanding the cumulative negative spread between interest rate-sensitive assets and liabilities, to 17.5% of total assets (from 9.5% at end- 2015). But, for the residual maturity up to 1 year, the share of the negative asset-liability spread shrank by 7 p.p., to 9.3% of assets, thus reducing the sector's exposure to an increase in the interest rate. Although deposits finance over 83% of liabilities and the sector is characterised by low rates, insofar downward, (see Chart 9.19), the presence of a high gap in the short term requires on-going monitoring. On the other hand, the sector mitigates its exposure to the direct risk from an increase in the interest rate, given that 89.0% of credit is granted at variable rate, although the structure of deposits is also at a variable interest rate. Nonetheless, the effect of the indirect risk from the interest rate should be also taken into consideration, with a possible increase in the interest rate causing a negative effect on the borrowers' solvency and may be accompanied by problems in the credit quality.

Chart 9.19 Maturity gap by repricing periods



Source: Bank of Albania.

Chart 9.20 Interest rate spread by currency



Source: Bank of Albania.

9.4 OPERATIONAL RISK

(103/1) Security is the underlying basis for a sound banking activity. The events during the period that jeopardised the transport security and safeguarding of the monetary values underpin the necessity of strengthening the procedures that banks apply for operational risk management. This should include not only the physical security but also the electronic information security, which are of a critical importance for a sound banking activity. In this regard, the Bank of Albania urges cooperation between banks and law enforcement authorities to resolve concrete cases and take measures to eliminate loopholes.

(103/2) A holistic and well-structured approach is necessary for operational risk management. More broadly, regarding operational risk management, the Bank of Albania emphasizes the need of a holistic approach, which would assess operational risk based on its impact on the reputation, strategy, and finances of the institution, as well as on a full analysis of risk likelihood. On such basis, the control system should be established and implemented, with the quality and compliance procedures, and the suitability of the entire supportive infrastructure of the process being part of the periodic testing and regular evaluation by specific structures of banks. The Bank of Albania notes that it will strengthen its supervisory and regulatory activity for the verification and evaluation of the operational risk management systems by banks, inter alia, by increasing the share of this process in the banks' overall evaluation and in particular on their management structures.

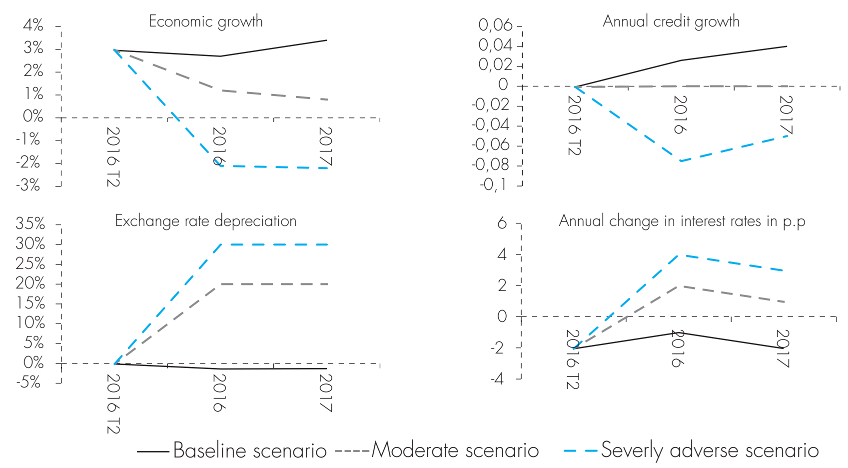
10. ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING[40]

(104) Stress test results on the banking sector's resilience to macroeconomic shocks show that the sector remains stable, regardless of expected economic and financial developments over the two year horizon. The banking sector appears more exposed to more extreme assumptions of the adverse scenario, where the results show a need of additional capital injection in certain banks. The stress test for the liquidity situation corroborates the assessment for a strong liquidity position in the banking sector.

10.1 ASSESSMENT OF THE RESILIENCE TO MACROECONOMIC SHOCKS

(105) The stress test exercise assesses the banking sector's resilience and capital adequacy for the period 2016-2017. The assessment of the impact from macroeconomic situations on the financial situation of the banking sector excludes the possibility of the increase in paid in capital during the period.

Chart 10.1 Assumptions to construct the stress-testing



Source: Bank of Albania.

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40 *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.*

The exercise is conducted by applying the baseline, moderate and adverse scenario, albeit the stressed scenarios have a much lower probability of occurrence.

(106) In the baseline scenario, economic growth is assumed to be improving until the end of 2017. In this scenario, up until the end of the period, economic growth is accompanied by credit growth, driven also by the improvement of the credit quality as a result of measures for the treatment of non-performing loans.

(107) In the moderate scenario economic growth is assumed to be at positive but lower pace, whereas in the adverse scenario a contraction of the economy is assumed. These developments, combined with a depreciation of the exchange rate, increase of interest rates and shortage and/or contraction of lending, affect the banking sector's capitalisation indices. The portfolio quality for these scenarios reflects, in addition to cleaning the balance sheets, the new flows in non-performing loans. Thus, the ratio of non-performing loans appears worsened until the end of 2017, by up to 14.2 p.p. (moderate scenario) and 24.8 p.p. (adverse scenario) against the level of the baseline scenario. The adverse scenarios, in addition to the reduction of the credit quality, suppose also shocks in terms of the market risk, respectively the interest rate risk, securities repricing list, exchange rate risk, and operational risk.

(108) Stress test results in terms of capital adequacy show that:

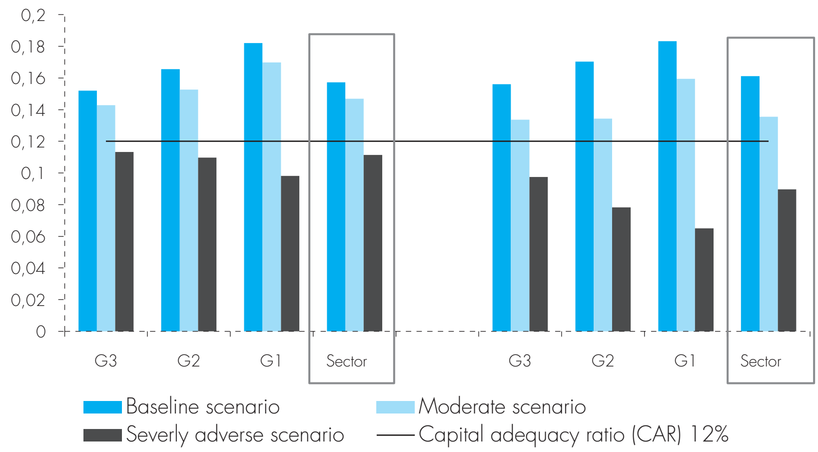
a. in the baseline scenario, the capital adequacy ratio (CAR) of the sector hits 15.7% at end- 2016, and 16.2% at end- 2017, following the improvement of the credit quality and higher pace of economic growth; Also, developments by banking groups attest to stability and capitalisation levels above the regulatory minimum requirement.

b. in the moderate scenario, the sector's CAR reaches 14.7% at end-2016 and 13.6% at end- 2017. This rate is driven by assumptions for a lower growth rate of economic activity; shortage of lending to the economy; increase in interest rates; and, depreciation of the national currency. Based on the above information, one and four banks fall in undercapitalisation for 2016 and 2017, respectively. They account for 20.3% and 28.8%, respectively, of the sector's assets. In this case, the needs for additional capital amount up to ALL 9.7 billion until the end of 2017;

c. in the adverse scenario , the sector's CAR drops even further, based on even more adverse assumptions in the scenario. The sector's CAR reaches 11.2% at the end of 2016, and around 8.0% in 2017. In this scenario, the number of banks falling in under-capitalisation increases compared to the previous scenario, as the assumed macroeconomic developments contribute to the deterioration of credit quality, levels of losses in the securities portfolio, and the increase of exposure to the market and operational risks. In such case, the need for additional capital is four times higher than in the moderate scenario.

(109) To place these values in the context of current developments, we point out that only during 2016 H1, the banking sector has added capital by around ALL 5 billion, almost two thirds of the capital injected throughout 2015.

Chart 10.2 Capital adequacy ratio, by stress test scenarios



Source: Bank of Albania.

10.2 LIQUIDITY STRESS TESTS

(110) Liquidity stress tests measure the ability of individual banks and of the banking sector to withstand extreme but possible shocks to their financing. These tests aim at revealing weaknesses in the sector and help the supervisory authority to set priorities for intervention with policies - including those aimed at reducing specific exposures or creating reserves - and assessing the readiness to face a financial stress.

The analysis, in this case, is built based on the liquidity structure of the sector in May 2016. The data are taken from individual bank data, for granular money flows generated by assets and liabilities, by maturity structure. The various scenarios assume some shocks from the unexpected deposit withdrawal due to the sudden loss of depositor's confidence and assess the adequacy of liquid assets available for financing them. In concrete terms:

(i) The exercise assumes the banks will handle the pronounced deposit withdrawal through the sale of only liquid assets (without asking for additional liquidity by the Bank of Albania);
(ii) Sale of investments in securities is done through a haircut of their value by 10% and 20%.

(111) The bank is considered as failing the stress test exercise only if liquid assets shrink to the level when additional liquidity is needed by the Bank of Albania in the form of 'loan for liquidity support'.

(112) Results show that the banking sector successfully passes the liquidity stress test. In the case of the domestic currency, one bank shows a negative liquidity gap, which is closed with BoA's support. In the case of the foreign currencies, banks have ample liquidity in euro and only two banks show a narrow negative liquidity gap, which may be covered by the securities portfolio. The negative gap for the US dollar in the short term is quite limited and may be easily covered by the ample liquidity surplus in other currencies.

(113) In conclusion, banks are assessed as highly resilient to liquidity shocks. However, the low diversification in liquidity reserves, which consist mostly in government debt securities, evidences the need for deepening and increasing liquidity for these instruments.

ANNEX FINANCIAL SOUNDNESS RATIOS OF THE BANKING SECTOR

In per cent	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016/H1
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	16.08
Core capital to risk-weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79	13.45	13.98
Shareholders' equity to total assets	7.62	8.57	9.57	9.40	8.69	8.57	8.37	8.58	9.53	9.58
Asset quality										
Net non-performing loans to regulatory capital	10.05	21.74	28.24	35.95	52.01	55.62	40.22	38.25	24.28	30.41
Gross non-performing loans to loans outstanding	3.36	6.64	10.48	13.96	18.77	22.49	23.49	22.80	18.22	19.96
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	8.01
Return on Assets (RoA, annual basis)	1.57	0.91	0.42	0.72	0.07	0.33	0.54	0.89	1.20	0.76
Net open foreign position to capital										
Net open foreign position to regulatory capital	1.69	4.30	3.89	5.03	3.94	3.98	4.08	8.49	7.66	8.44
Net open foreign position to core capital	1.80	4.54	4.12	5.33	4.29	4.41	4.92	10.37	8.95	9.70
Asset-based ratios										
Liquid assets to total assets	49.77	42.83	27.65	25.95	26.53	29.37	27.64	31.94	32.26	30.99
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	40.03
Customer deposits to total loans	215.45	162.60	154.32	166.39	163.20	171.62	180.83	180.16	187.78	184.10

Source: Bank of Albania.