Bank of Albania

FINANCIAL STABILITY REPORT

2016/II

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INTRODUCTION

This is the seventeenth 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 to 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. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the developments over the second half of 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-December 2016, banks operating in Albania are divided into the following peer groups by their share:

- Peer Group 1 (each bank 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 4.6% of the sector's total assets.

- Peer Group 2 (each bank sharing 2-7% of total banking 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 26.6% of the sector's total assets.

- Peer Group 3 (each bank sharing over 7% of total banking assets): National Commercial Bank (NCB), Raiffeisen Bank (RB), Credins Bank (CB), Intesa Sanpaolo Bank –Albania (ISBA).
  They account for around 68.7% of the sector's total assets.

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

- Banks with foreign capital[1]: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank - Albania, Veneto Bank (Italy); Alpha Bank - Albania, Tirana Bank, National Bank of Greece (Greece); National Commercial Bank (Turkey); Société Générale (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 82.6% of the sector's total assets.

- Banks with Albanian capital: Credins Bank, Union Bank, American Bank of Investments.
  They account for around 17.4% of the sector's total assets.

At the end of December 2016, the National Commercial Bank has a branch abroad in Kosovo.

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

FINANCIAL STABILITY STATEMENT FOR 2016 H2

Pursuant to provisions under Article 69 of the Law No. 8269, dated 23.12.1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18.12.2006 "On banks in the Republic of Albania", as amended, to inform the Assembly and the Council of Ministers of the Republic of Albania, and promote the awareness of financial institutions and of the public at large on the situation of the Albanian financial system 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 the Statement prefacing it assess the exposure of the banking sector to risks arising from its interaction with the external and internal economic developments, real economy agents, financial markets in Albania, as well as operational risk in the activity of the banking sector. In addition, these risks face 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 the activity of the banking sector and of the overall financial system has been stable during 2016 H2. Overall, the banking sector's exposure to various risks remains contained and the main activity indicators related to capitalization, liquidity and profitability show its full capacity to withstand operational risks under normal conditions, and show good resilience against stronger shocks.

HIGHLIGHTS IN ECONOMIC AND FINANCIAL DEVELOPMENTS

Developments in the **global economy** over the period were overall positive, despite differences across major regions and in economic policies. This performance was driven mainly by more favourable financing conditions in the markets, continuation of growth promoting policies in most advanced and emerging economies, and the rise in commodity and oil prices. The latter's performance has contributed to the upward inflationary pressures, although they remain overall below central banks' targets. In global financial markets, fluctuations in interest and exchange rates have been more notable in the last months of the year, mirroring primarily certain significant political and economic developments in advanced economies. Euro area economy expanded at a moderate but steady pace during the period. Economic activity expanded in most countries of this region, driven mainly by the improvement in domestic

demand and positive contributions from inventories in the private sector. The economies in the Western Balkan countries grew at positive rates in 2016, accompanied with an improvement in labour market conditions. The financial situation of European banking groups that operate in Albania remains overall stable. For some of them, the activity contracted over 2016, following the processes for lowering debt and cleaning balance sheets from non-performing loans.

The positive performance of the global economy is expected to persist over 2017-2018[2], driven by the continuing gradual economic growth in advanced economies and intensification of the positive contribution by emerging economies. In the euro area, the positive effect from the accommodative monetary policy on private consumption and investments will continue to support economic growth. However, political developments in advanced economies and the possibility for them to be accompanied by changes in economic policies are considered currently as the main factors that may contribute to the global economy outlook.

As a result of a further improvement of the global economy, including the euro area and the Balkan region countries, the positive contribution by the external sector to the performance of the Albanian economy will edge upwards. In fact, this contribution appeared stronger in the performance of the balance of payments for 2016 Q4, when the current account deficit decreased following the increase in the positive surplus in the services account and a better performance of exports. Overall, Albania's economic growth in 2016 Q4 accelerated, recording almost 4% growth rate. By sector of the economy, services and production provided positive contribution to economic growth. The growth in economic activity was accompanied by a further drop in unemployment, both in annual and quarterly terms, to 14.2% at the end of the year. At the end of the period, the consolidating fiscal policy resulted in a significant narrowing of the budget deficit for 2016. The deficit was mainly funded with foreign funds, thus reducing the Government's need for borrowing in the domestic market, compared to the previous year. During the period, the Bank of Albania continued to implement an accommodative monetary policy stance, in response to contained inflationary pressures.

In financial markets, the average yield on government debt securities, both long and short-term, shifted slightly upward, but resulted lower than in the previous year. In the interbank market, banks traded lower volumes at interest rates constantly below or close to the policy rate, reflecting a stable liquidity situation. In the currency exchange market, during the period, the Albanian lek appreciated against the European currency and depreciated slightly against the US dollar. In annual terms, the lek appreciated against both major currencies. Following the lowering of the policy rate and improvement of the quality of credit for real estate, the conditions for obtaining this credit have become more favourable and have supported better the housing market. This is evidenced

[2] *According to the IMF's outlook, global growth over 2017-2018 is projected around 3.4-3.6 per cent.*

in house prices; surveys show an increase in the price index and a somewhat more optimistic outlook for developments in this market.

During the period, **households and enterprises** continued to be inclined towards net savings, thus conducing to an expansion of the households' credit position and narrowing of the enterprises debt position. This performance was driven by the faster growth in foreign currency deposits. Households borrowing accelerated to 3.7% in annual terms, realised totally in Albanian lek. The credit quality for households improved during the period. Improvement was most notable in the foreign currency credit and unhedged credit from unfavourable volatility in the exchange rate. Loans to enterprises, which represent almost 67% of the total credit, expanded by 2.4% in annual terms, directed mainly towards non-resident entities. In the structure of loans to enterprises, lek credit as well as a preference of small and medium-sized enterprises both increased. The credit quality for enterprises also improved during the period. Overall, the process of cleaning the banks' balance sheets from lost loans contributed to the improvement of the credit quality.

During the period, the activity of the **financial system** expanded and the other indicators were overall stable. The banking sector accelerated the expansion of its activity, increasing its share to 94.9% of the Gross Domestic Product (GDP). It resulted in profit and adequate capital and liquidity ratios. In the banking sector activity, in annual terms, the transactions in securities (increase), other investments (increase) and reserve funds, contributed most to change in balance assets, whereas treasury and interbank transactions (increase), deposits (increase) and permanent resources (increase) contributed most to change in balance liabilities. From a year earlier, the banking sector expanded the credit position with non-residents and increased the loans outstanding by 2.5% and the deposit stock by 5.2%. The non-banking sector maintained its share in GDP and its performance has contributed to the expansion of activity in non-bank financial institutions and insurance companies. For the non-banking sector, investments in Albanian government securities are significant, although in 2016 such investments recorded a decline. Direct exposure of the non-banking sector to the banking sector is assessed as low, whereas the banking sector's stability remains a critically important factor for the activity and stability of the non-banking sector.

BANKING SECTOR'S EXPOSURE TO OPERATIONAL RISKS

In relation to operational risks to the banking sector, the Bank of Albania deems that:

a) *Credit risk scaled down during the period*; however, it remained close to levels recorded in the previous year. The absolute value of non-performing loans fell by 8% and the ratio of non-performing loans fell

by 1.7 percentage points, to 18.3%. The banks' actions to collect, restructure and write off (lost loans) from their balance sheets contributed to the reduction of non-performing loans. The reduction of non-performing loans showed a better distribution in terms of sector, currency, and bank. This reduction was accompanied by an improvement in their coverage with reserve funds and capital, whereas the level of loan collateralisation has remained stable.

The reduction in the value of non-performing loans during the period, their better distribution and improvement of provisioning indicators are positive and encouraging developments. The reduction of non-performing loans in the banking sector will gain more stability if expectations materialise for an improvement of both economic growth and functioning of the relevant institutional and legal infrastructure in this process. However, taking into account that determinant factors in this process are diverse and contain uncertainties about the way they develop, the Bank of Albania urges banks to keep their focus on this critical process for a steady growth of their activity, engaging the necessary financial resources and expertise for reducing non-performing loans. A professional analysis at the phase of granting the credit, the effective monitoring and due restructuring are fundamental actions for lowering the probability of a borrower's default (and reduction of non-performing loans flows), whereas the actions related to provisioning, execution of collateral and lost loans write off should, in parallel, contribute to the early recognition and reduction of the stock of non-performing loans.

b) *Liquidity risk in the banking activity is assessed as low*. The low credit-to-deposit ratio, the continuation of credit growth and the high presence of liquid assets above minimum requirements of the regulatory framework point to a good liquidity situation of the banking sector, both in general and by main currency. During the period, the coverage of current liabilities with liquid assets fell slightly, but as long as they remain significantly above the minimum requirements set out in the regulatory framework, this development should reflect a better utilisation of financial resources by the banking sector. The good liquidity situation of the sector was proven also by a special stress test, based on data for November 2016.

The liquidity capacity of the banking sector by currency, in addition to the adequacy of liquid assets of the banks, should be also assessed in accordance with its ability to convert liquid assets into cash, quickly and without any significant cost. For the national currency, if needed, this process is facilitated through relevant central bank operations with banks, in accordance with the legal stipulations and best standards. If these instruments were to be adjusted for the foreign currency as well, this process would require increasing foreign currency resources

of the central bank. Yet, in the case of an emerging economy, such as Albania, this process bears costs for the central bank. As a rule, while not taking into account other factors, the liquid capacities of the banking sector are better in the national currency versus the foreign currency; therefore, the liquidity risk is higher for the foreign currency versus the national currency. For these reasons, it is necessary for it to be introduced in the requirements for banks for a higher level of liquid assets in foreign currency than in the national currency. From a longer-term perspective, the reduction of banks' foreign currency activity would diminish this source of risk and contribute positively to financial stability.

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

While the open foreign currency position in the balance sheet remains close to the historic levels and the foreign currency credit unhedged against unfavourable exchange rate volatility has a lower share in credit outstanding, the latter is considered to be at high levels and the banking sector's exposure to exchange rate risk is significant. The increase in foreign currency deposits of the banking sector, against the narrowing of the spread in the average interest rate on lek and foreign currency ones, bears the potential for it to be channelled into foreign currency credit (where a considerable part would be again unhedged against the exchange rate), if credit demand picks up. This would reverse the downward trend of foreign currency credit in recent years. The process is in itself a reinforcing one because, through the currency creation process, foreign currency credit contributes to the expansion of foreign currency deposits, and so on. If this trend materialised, the narrowing of the national currency credit channel and the increase of the banking sector and economic agents' sensitivity to exchange rate volatility would affect the ability of the central bank's monetary policy to use its transmission channels effectively.

Therefore, in this case, when taking into account factors that have led to higher euroisation levels in the banking sector and assessing with priority the risks it poses to financial stability and monetary policy effectiveness, it is necessary, in addition to the attention to maintain balanced foreign currency positions in the banks and economic agents' balance sheets, to aim through a sustainable strategy and realistic long-term objectives, at lowering the euroisation level in the financial system at more appropriate levels. In this context, the Bank of Albania is assessing the need for concrete actions which will aim at maintaining an appropriate positive spread between the average rate between the Albanian lek and major currencies, and raise the awareness of borrowers about risks accompanying unjustified foreign currency borrowing. Aware of the complexity of the phenomenon, the Bank of Albania will seek the

cooperation of other public authorities for this purpose.

Regarding the interest rate risk, it appears more mitigated but remains nonetheless present in the banking activity in both its direct and indirect form. In the direct form, the risk is transmitted through the gap that exists between assets and liabilities of the banking sector by repricing periods, and sensitivity of certain assets to interest rate fluctuations. This gap is negative, but it has narrowed somewhat during the period. The risk would materialize in case of an increase in the interest rate which due to the negative gap would affect faster the operational costs of the bank, compared to its revenues. In addition, the assumed increase in the interest rate would affect negatively (and initially) the value of bank assets sensitive to interest rate fluctuations, such as long-term securities. This risk has an indirect component which is related to the negative effect from the increase in interest rates on borrowers with variable interest rate loans. Also in this case, it is necessary for banks to quantitatively assess the impact of adverse scenarios and work towards containing the exposure to risk. In the meantime, the interest rate risk remains especially necessary to be assessed in the activity of life insurance companies, investment funds and private supplementary pension funds.

ç) *Banks' systems in place for assessing and controlling operational risk need improving.*

While banks reporting show an improvement of coverage with capital of overall operational risks, the supervisory activity of the Bank of Albania has identified the need to further improve the process for the identification and reporting of operational losses in accordance with the profile of the bank's activity. Also, in response to the infringement of the physical security in the activity of transporting cash funds during the previous year, the Bank of Albania has strengthened the minimum requirements in the relevant regulatory acts, mainly with regard to planning, preparing, monitoring and supervising the compliance with the relevant procedures by the special security units in banks. In the framework of this matter, during 2016, the Bank of Albania has cooperated constantly with the Albanian State Police, contributing to improving the sub-legal acts about the transportation of monetary values. Looking forward, the Bank of Albania will strengthen the focus for assessing the adequacy of banks systems for controlling operational risk, as part of regular inspections at supervised institutions.

d) *The contraction of the activity in some of the European banking groups that operate in Albania keeps the stimuli for restructuring the activity, including the change of their network in countries outside the EU.*

This phenomenon has been more notable in Central European and Balkan countries, but Albania has not been affected insofar, in relative terms, by this phenomenon. The experience of other countries shows that if the process is well coordinated among all the stakeholders, the exit of a banking group from a certain market may be accompanied by the entry of other valuable investors, who may introduce additional capacities and other priorities in the local banking sector. These changes may yield a positive effect on the banking sector and financial system structure and increase its contribution to bolstering economic growth. The process contains also uncertainties related to the actual phase of the economic and financial cycle in the European Union and the region, as well as the potential of the regional countries to stir the interest of new and valuable investors. It is difficult to determine to what extent and way this process may affect the Albanian subsidiaries of European banking groups. In any case, the Bank of Albania and other authorities in Albania will strengthen their monitoring and evaluating capacities as well as cooperation, in order for the processes to take place in accordance with the legal requirements and the ultimate objective of safeguarding the stability of the financial system in Albania.

RISKS TO FINANCIAL STABILITY

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

Overall, the indices do not show an increase in risks to the financial stability during the period. The lower profit of the banking sector and the slight fall in liquidity indicators (yet, they remain at high levels) are offset by more positive developments in the real economy, with an improvement of economic growth and economic situation for both households and enterprises. The accumulation of risks has been weaker due to the contraction in foreign currency credit, improvement of public debt indicators, and the more positive performance of the real estate market. On the other hand, the probability of materialisation for the systemic risk has reduced, given that the credit quality has improved, unemployment has fallen and exchange rate volatility has been low.

THE BANKING SECTOR'S ABILITY TO WITHSTAND RISKS

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

At the end of the period, the capital adequacy ratio for the banking sector stood at 15.7%, notably above the 12% required minimum for this indicator. This performance was determined by the increase in risk-weighted assets by almost 4.3% (downward impact on the indicator) and the regulatory capital appreciation by almost 3.8% (upward impact on the indicator). Financial leverage, measured as the ratio of total assets to shareholders' equity was 10.3 times and is considered to be at good level. Maintaining a good capital position is determined also by the performance of the sectors' financial result. In 2016, the banking sectors profit amounted to around ALL 9.3 billion, standing lower on a year earlier. The fall in net interest income and the increase of the provisioning for credit risk contributed to the decline in profit. The fall in net revenues from interests reflected the fall in return from investments, for financial instruments both in foreign currency and in lek, at a faster pace than the fall in expenditure for them. The increase in provisioning for credit risk reflected the shift of non-performing loans toward more extreme classes. Sector profitability indicators, return on assets (RoA) and return on equity (RoE) were 0.7% and 7.2%, 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 2017-2018 period. In the adverse scenario, the contraction of the economy, contraction of credit, rapid growth of interest rates and strong depreciation of the exchange rate, were included as part of the extreme assumptions, but with a low probability of occurrence. The results of the stress test showed that in the baseline and the moderate scenarios, the banking sector remains capitalized, but would need a capital raise 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 capitalization and profitability of banks is adequate for coping with operational risks. Nonetheless, the sensitivity to risks is specific for each bank, depending on its profile and capacities to cope with risks. Therefore, the Bank of Albania reiterates the need for regularly assessing such risks by each bank, undertaking the necessary risks for mitigating them and maintaining capitalisation indicators.

The next sections of the Financial Stability Report 2016 H2 analyse the stability of the financial system in Albania in greater detail.

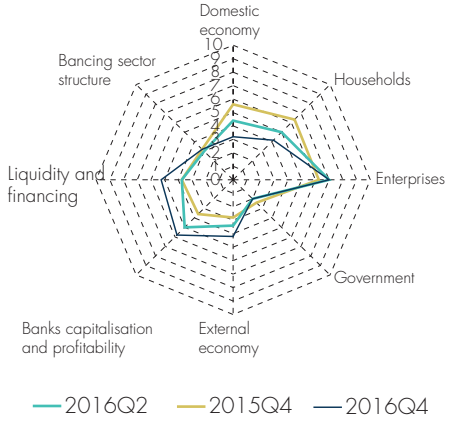
1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

The Financial Stability Map shows the allocation of risk among factors that determine the stability of the financial system, which include the activity of the banking sector, and the surrounding external and internal environment.

(1) As at end 2016, the financial stability map shows a slight increase in the risk of banking activity and decrease for risks that may arise from the surrounding economic environment. In the analyses of separated developments, the indicators' value suggests that the risk to "households" and "domestic economy" categories, as part of the surrounding economic environment, has been downward due to the positive developments of macroeconomic and financial indicators over the period under review. Conversely, banking activity indicators related to "capitalisation and profitability" and "liquidity and funding" fell slightly, suggesting higher risk.

(2) Nevertheless, by considering the interaction of the map constituent categories, the performance of banking sector indicators may reflect more the shift towards the improvement of its activity efficiency. The indicators of banking sector activity, in particular of liquidity fell, while they stand at high levels, and mainly reflect an improvement of banking sector's efficiency, as a result of a more active role in lending to economy. Assuming this trend will continue, the further improvement of the surrounding economic environment reflected, for example, in the acceleration of economic growth and further decrease of unemployment, will be accompanied by the increase of banking sector's willingness to commit more financial resources to lending by increasing the pressures on a further fall of its liquidity indicators. On the other hand, the more effective use of banking sector's resources in the intermediation process should positively contribute to the financial performance of the sector in the long term and to maintaining steady activity capitalisation levels.

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.
Source: Bank of Albania.

Compared to December 2015, following are assessments for the real economy components:

- domestic economy: risk is assessed as "low". Risk fell for all the sub-categories. The fulfilment of funding needs from external sources, the narrowing of the output gap and the low volatility of the exchange rate provided the main contribution in this regard;
- households: risk is assessed as "average" and "downward", driven by the fall in unemployment, increase of remittances, and the improved credit developments and quality.
- enterprises: risk is assessed as "moderate" and "upward" again, over the period under review, given the fall in the "production volume index";
- government: risk continues to be assessed as "low", trending downward, mainly attributable to the considerable narrowing of the budget deficit;
- external economic environment: risk is assessed as "average", but upward, over the period under review, reflecting the increase in both oil prices in international markets, and short-term interest rates at international level.

For the banking sector:

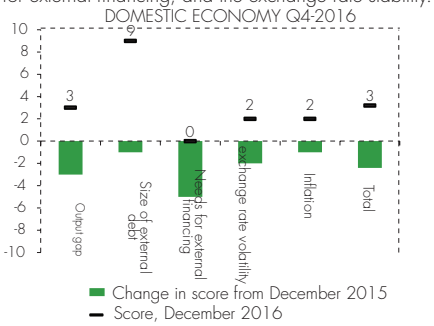
- capitalization and profitability: risk is assessed as "moderate" but upward, due to the decrease of the net income from interests and the financial result of the banking sector;
- liquidity and financing: risk is assessed as "average" and again upward, reflecting the deepening of the gap between banks' assets and liabilities with maturities up to three months[3];
- banking sector structure: risk remains low, following the better diversification of funds for financing the banking sector and the improved CAR indicator for banks, which have a capitalisation rate below the average level of the sector. However, credit concentration in the enterprises sector is somewhat higher.

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

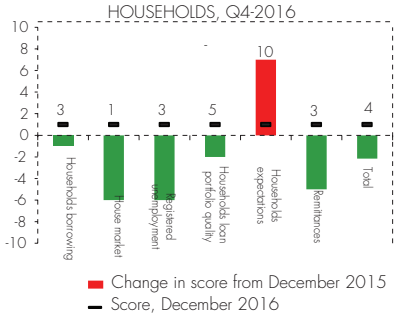
[3] *Within this category, which, overall is assessed with low risk, this is a result of the change in the definition of the proper term, for purposes of more detailed analyses by the supervisory authority.*

BOX 1.1 FINANCIAL STABILITY MAP COMPONENTS

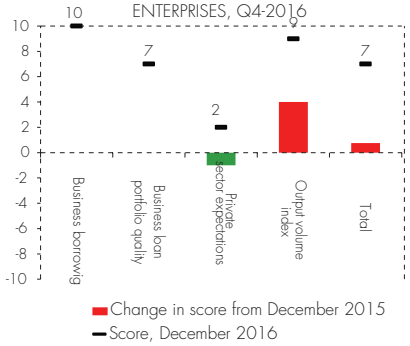
Risk from "domestic economy" is rated as "low" and downward, following the improvement of the output gap, needs for external financing, and the exchange rate stability.



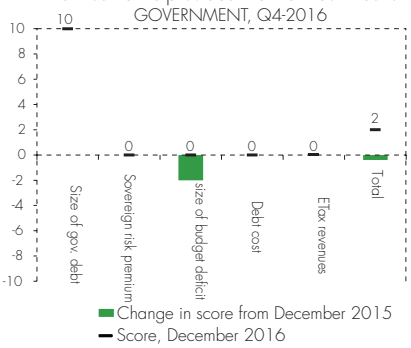
Risk to "households" is rated as "average" and downward, due to the improvement in their economic and financial indicators.



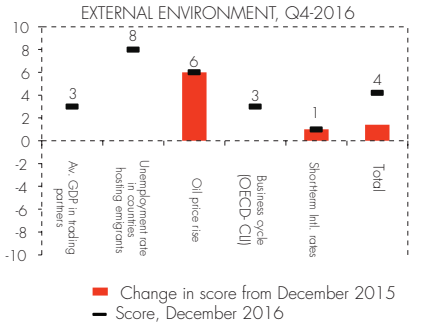
Risk to "enterprises" is rated as "moderate" and upward, reflecting the deterioration of the production volume index, below the long-term trend.



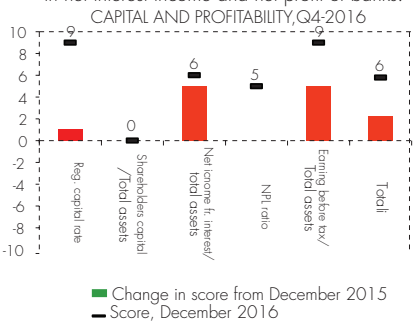
Risk from "government" is rated as "low" and downward; the narrowing of the budget deficit in annual terms provided the main contribution



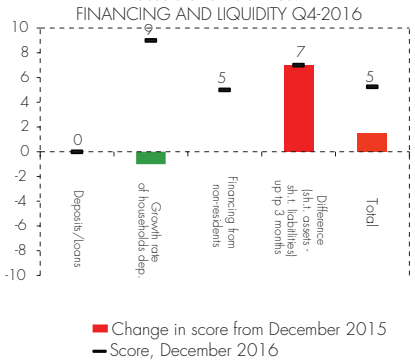
Risk from "external environment" results increased from the end of 2015, affected by the oil prices and performance of international short-term rates.



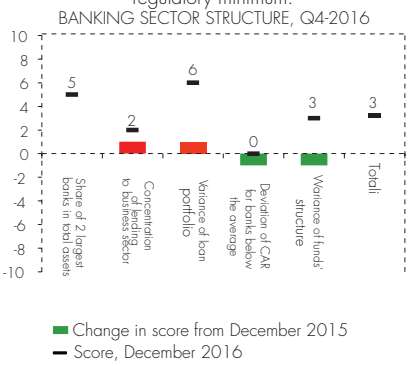
Risk from "capital and profitability" is assessed as "moderate" and upward, due to the decline in net interest income and net profit of banks.



Risk from "financing and liquidity" was again "average", but trending 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" continued to be low, given the increase in the diversification of its financing funds and CAR level against regulatory minimum.



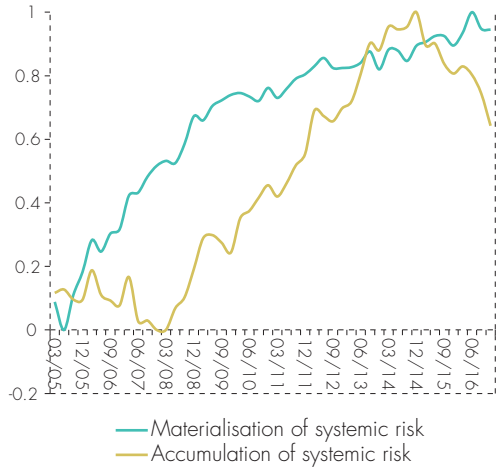
Source: Financial Stability Department, Bank of Albania.

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 its activity exposure to systemic risks is analysed. The materialisation index of the systemic risk assesses the actual risk level, whilst the risk accumulation indices of financial stress and the banking industry perception on it, focus mainly toward the future.

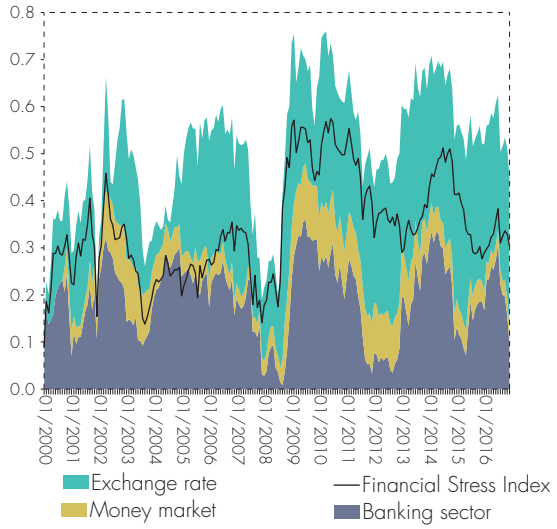
(3) The systemic risk accumulation and materialisation as well as financial stress indices show decreased levels of the systemic risk. Thus, the contraction of foreign currency credit and the reduction of public debt and external debt drove to the decline of systemic risk accumulation, given the moderate increase of housing prices at the end of 2016. Improvement of credit quality to both enterprises and households, decline of unemployment and reduction of exchange rate volatility have contributed to reducing the materialisation of systemic risk, compared with a year earlier (Chart 1.2). The decrease of depreciating pressures in the exchange rate and the positive developments in deposits' performance contributed to the lowering of the financial stress index (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



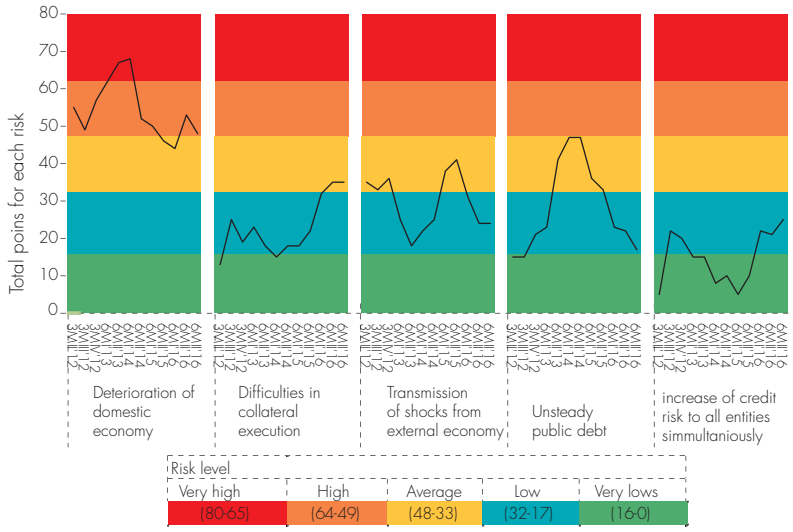
Source: Bank of Albania, Financial Stability Department.

(4) Banks' perception on the operational risks is similar to the previous period. Hence, the "Deterioration of the domestic economy" remains the most important systemic risk at home, but in the bank's perception, its importance

[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".*

has decreased from "high" to "average", during the period. Banks' attention to the risk arising from the " collateral enforcement" continues to be high, and the perception on it has not changed, during the period. This reflects the importance of the legal process of collateral enforcement, as an indispensable instrument to address the non-performing loans, also the banks' assessment on the problematic that accompanies it. The banks' assessment regarding risk from "external shocks" has been upward for certain banks, mainly affected by the developments in the Italian banking sector during the period. Nevertheless, at sector level, the perception on this risk has remained low (Chart 1.4).

Chart 1.4 Banks' assessment of main systemic risks



Source: Bank of Albania, Financial Stability Department.

2. INTERNATIONAL DEVELOPMENTS

(5) During the period, global economic developments were generally positive, notwithstanding the differences across regions and larger economies, due to differences in economic policies. Oil prices recovered during the end of year, providing better support to the exporting countries' economies. Global economic activity grew positively and at a more improved pace in 2016 H2, mainly driven by improved conditions in the financial markets, continuation of incentive policies in most advanced economies and in some emerging economies, and the stabilisation of oil prices. The International Monetary Fund (IMF) has assessed a global growth of 3.1% for 2016, which is expected to gradually improve in the next two years[5]. Nevertheless, differences across regions were considerable. The economic performance of advanced economies was more positive than expected, while pressures on a part of emerging economies were upward, driven by both domestic and external factors. Developments in financial markets reflected monetary policies divergences in advanced economies[6] and expectations for a change in the US fiscal policy after the elections in November 2016. The turn in the US monetary policy drove to the tightening of financing conditions at the end of the year, in particular, in financial markets in emerging regions. Inflationary pressures, at global level, increased somewhat, affected by the stabilisation of oil and commodity prices.

(6) Economic activity in advanced economies recovered at a better pace than expected, whereas in emerging countries it was varied. Among advanced economies, the US economy improved considerably over 2016 H2, compared to the weaker performance in 2016 H1. Economic growth was mainly driven by the increase in consumer spending and the positive contribution of net exports. Conditions in the labour market continue to stabilise and the unemployment rate fell at 4.7%, as at the end of year. The UK economy, notwithstanding the pessimistic expectations triggered by Brexit, recorded positive growth driven by the increase in consumption and in exports. Nevertheless, the uncertainty surrounding the new trading relationships between the United Kingdom and the European Union after the eventual Brexit and British pound depreciation, has a significant impact on the performance of investments and domestic demand. Economic performance, across emerging markets, was varied, due to both external and internal economic factors, geopolitical tensions in certain regions and the performance of oil and commodity prices.

[5] *(Forecast, January 2017).*

[6] *As expected, in December 2016, the Federal Reserve raised its key interest rate by 25 basis points for the federal funds, signalling a turn regarding the ultra-accommodative monetary policy, whereas the largely accommodative monetary policy in other advanced economies remained unchanged.*

Thus, economic activity in China was better than expected, mainly due to the simulating economic policies. In other countries, such as in Latin America (Argentine, Brazil, Mexico), Turkey, etc, economic activity was downward. On the other hand, oil producing countries, such as Russia, were positively affected by its stable price in markets.

(7) Euro area economy expanded at a moderate but stable pace over 2016 Q3, and preliminary data suggest the same trend for the last quarter. Economic activity in euro area expanded in most countries in this area, mainly supported by the improved domestic demand and the positive contribution of inventories in the private sector. On the other hand, trade provided a negative contribution by reflecting the weak external demand. Nevertheless, euro depreciation since 2016 Q3 is expected to provide a positive contribution to the euro area exports in the period ahead. Labour market conditions improved positively supporting consumption. Employment increased further approaching to the pre-crisis levels, while the unemployment rate stood at 9.6%, at the end of year.

(8) Lending in the euro area banking sector continues to recover at a moderate pace, responding to the performance of credit demand. The European Central Bank (ECB) accommodative monetary policy promoted the easing of lending standards over 2016 H2. Lending to enterprises and households recorded positive growth in annual terms. Credit demand was strengthened, supported by some factors, including: the interest rates at low historical levels, the increase in the activity of loan refinancing from banks, positive developments in the real estate market and the increase of consumers' confidence. On the other hand, European banks improved the capital positions and decreased the debt levels. Nevertheless, the prolonged process of balance sheet consolidation and the still high level of non-performing loans in some of euro area countries, continues to slow down credit recovery.

(9) Global economy is expected to continue to perform positively during 2017-2018[7], supported by the continuing gradual economic growth in advanced economies and the strengthened positive contribution of economic performance in emerging economies. Yet, political developments, particularly in USA and Europe, currently are the main factors that may affect the outlook for the global economy. Emerging regions, whose economies are forecasted to improve over the next two years, are expected to have the main share in the global economic growth. Advanced economies will continue to recover gradually. Nevertheless, the possible political changes in USA in euro area countries, and the Brexit process may dictate a shift in economic policies, which coupled with volatility in trade and currency exchange rates, could intensify protectionist pressures. Increased restrictions on global trade and migration would hurt productivity and incomes at global level, and take an immediate toll on markets and investors' expectations. On the other hand,

[7] *IMF outlook for global growth over 2017-2018 is 3.4 - 3.6%.*

the structural macroeconomic weaknesses in some emerging economies and the still uncompleted consolidation process of financial system balance sheets in some advanced economies represent possible additional risks to the global economy.

(10) Euro area economy is expected to continue to expand at a moderate but stable pace. The ECB monetary policy pass-through to real economy will support the domestic demand and ease the consolidation process of both private and public sectors. On the other hand, the favourable financing conditions and the increase of profitability in the private sector will promote the growth of investments. Also, the improvement of labour market conditions will continue to contribute positively to the growth of private consumption, through the increase in household disposable income. Currently, risks to expectations for the euro area economic performance are related to both internal and external factors, such as: the policies of the new US administration; the agreement with the United Kingdom about the Brexit process; and the uncertainties related to the political elections in some euro area countries.

Table 2.1 Selected macroeconomic indicators for the US and euro area

	GDP change (annual %)				Inflation (annual %)		Unemployment (annual %)		Gross government debt (as a % of GDP)	
	2016 Q3	2016 Q4	2016f	2017f	June '16	Dec'16	June '16	Dec'16	2016 Q2	2016 Q3
U.S.	1.7	1.9	1.6	2.3	1.1	1.8	4.9	4.7	105.05	104.81
Euro area	1.8	1.7	1.7	1.6	0.1	1.2	10.1	9.6	91.2	90.1
- Germany	1.7	1.8	1.7	1.5	0.2	1.7	4.2	3.9	70.2	6.9.4
-France	0.9	1.1	1.3	1.3	0.3	0.8	10.0	9.6	98.3	97.5
-Italy	1.1	1.1	0.9	0.7	-0.2	0.5	11.6	12.0	135.5	132.7
-Greece	2.2	0.3	:	:	0.2	0.3	23.4	23.0*	179.8	176.9

Source: European Central Bank, Eurostat, BEA (Bureau of Economic Analysis), Bureau of Labour Statistics, IMF;
*f-IMF estimates, January 2017; *October 2016 data;: no available data.*

(11) Western Balkans economy grew positively over the three quarters of 2016 and labour market conditions improved. Annual economic growth of regional countries and Turkey increased at 2.5% in 2016 Q3. Serbia, Kosovo and Bosnia&Herzegovina improved, whereas in Montenegro and Macedonia, the growth rate slowed somewhat down. Economic activity in Macedonia reflected the fall in consumption and investments due to the prolongation of the political crises there.

Table 2.2 Selected macroeconomic and financial indicators for Western Balkans

	GDP (real, annual %)			Unemployment (annual %)		Sovereign debt (% of GDP)		Credit growth (annual %)		Non-performing loans ratio	
	2016 Q2	2016 Q3	2016f	2016 Q2	2016 Q3	2016 Q2	2016 Q3	2016 Q2	2016 Q3	2016 Q2	2016 Q3
B&H	1.2	2.4	:	42.4	41.0	41.1	41.2	1.6	2.0	12.1	12.1
Macedonia	3.1	2.4	2.1	24.0	23.4	37.0	41.9	5.8	2.8	7.2	7.1
Montenegro	2.7	2.4	2.7	17.5	16.9	61.7	60.8	-0.2	-1.5	12.6	11.0
Kosovo	3.3	3.8	:	26.2	:	13.8	14.3	8.4	9.6	5.3	5.1
Serbia	1.9	2.6	2.7	15.2	13.8	71.5	71.3	13.3	13.9	20.2	19.5

Source: EU Candidate and Potential Candidate Countries' Economic Quarterly (CCEQ) - 2016 Q4 Release.
f- ECFIN's forecast, January 2017.

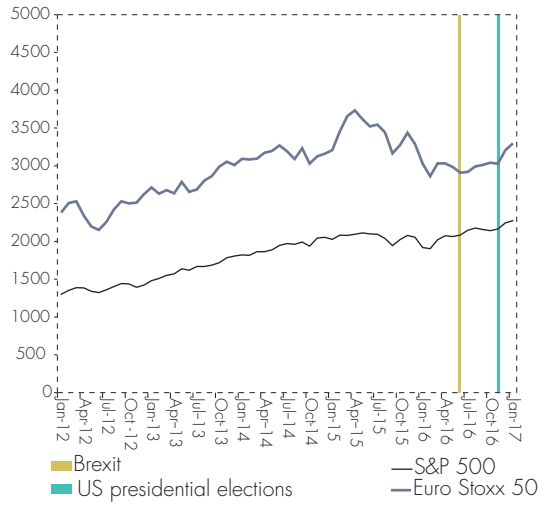
Notwithstanding specific problems, the labour market conditions improved through the increase in employment and decrease of unemployment in all the countries. Inflationary pressures, throughout the region, remain low, reflecting the low price of primary commodities and the stability of exchange rate. Inflation rates in Bosnia&Herzegovina, Macedonia and Montenegro were at negative values or close to zero, over 2016 H2. Inflation was positive in the rest of the countries, but overall, below the central' banks target. Fiscal performance in the public sector of regional countries improved considerably over 2016. The continuation of consolidating programmes and economic recovery contributed to the further reduction of fiscal deficits and public debt in most regional countries. In the banking sector, lending showed positive signs supporting economic growth in the region. Except for Macedonia and Montenegro, lending in the other regional countries was positive and upward. Notwithstanding the reduction of non-performing loans portfolio over 2016, this indicator remains above the pre-crisis levels for most countries, thus hampering credit recovery in the region.

2.1 HIGHLIGHTS IN FINANCIAL AND PRIMARY COMMODITY MARKETS

(12) Overall, developments in global financial markets were positive over 2016 Q3. The shock from the referendum result of the United Kingdom on Brexit was short-lived, in particular after the further accommodative monetary policy stance implemented by Bank of England and the European Central Bank and the commitment for new easing facilities in case of need. For the same period, the major part of values in capital markets of advanced economies recovered and spreads narrowed, returning to the values before June 2016. Financing conditions in emerging markets eased in some segments and capital flows returned in search of higher profits.

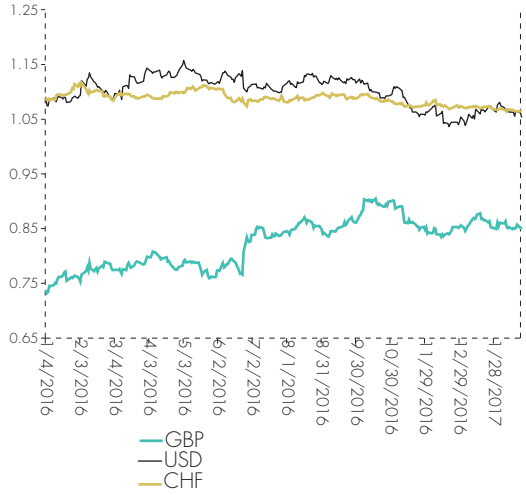
(13) Over the last months of 2016, financing conditions in global markets were tightened, partially reflecting the turn in the US monetary policy and the expectations for a fiscal policy shift. In advanced markets, long-term rates trended up during the last quarter, particularly in markets of long-term securities of United Kingdom and of USA. These developments were mainly promoted by the expectations for a shift in US economic policies after the presidential elections in November 2016. In European markets of sovereign securities, interest rates rose, more notably in Italy, reflecting political and financial uncertainties. In capital markets, prices were also up, mainly for non-financial corporates, while in money markets the interest rates remained in negative territory, reflecting the ECB monetary policy and the ample liquidity. The tightening of financial conditions in global markets drove to outflows of capital in Latin America and in European emerging countries, and added depreciating pressure on the domestic currencies.

Chart 2.1 Main indices stock market



Source: ECB.

Chart 2.2 Exchange Rate euro versus main currencie



Source: ECB.

(14) As a result of higher capital flows, foreign exchange markets were notably more volatile, driven by the combination of political and economic factors.

Thus, overall, euro appreciated significantly against the British pound over 2016 H2, but it depreciated against the other main currencies: the US dollar, the Japanese yen and the Swiss franc. Capital flows fluctuations from some emerging markets increased in particular the pressures on their currencies. The currencies of Turkey and Mexico depreciated considerably, due to heightened political and economic uncertainties. On the other hand, the currencies of oil and primary commodity exporting countries appreciated, reflecting the stabilisation of their prices in markets.

(15) Oil prices have trended up over 2016 H2, particularly driven by supply-side factors. After the agreement among the main producers[8] to reduce the oil production quota over 2016 H1, oil prices in markets picked up rapidly. In December 2016, the crude oil price was USD 52.6/barrel, up from USD 29.9/barrel in January 2016[9]. Nevertheless, the very high level of accumulated stock has somewhat offset the effect of limits on oil production supply. Primary commodity prices, in particular of metals, picked up at the end of year, mainly the due to upward demand from China and the expectations for investments in infrastructure by the new US administration.

[8] *The agreement (signed in June 2016, and ratified on 30 November 2016) among OPEC and non-OPEC countries sets out the cut of oil production quota by 1.27 and 0.6 million bpd, respectively.*

[9] *Source: IMF.*

2.2 HIGHLIGHTS OF FOREIGN BANKING GROUPS OPERATING IN ALBANIA

(16) Overall, foreign banking groups operating in Albania closed 2016 at stable capitalisation levels, although the financial result for some of them was negative. The lowering of debt levels and the need to write off non-performing loans from balance sheets continue to affect their downward activity. Nevertheless, stress-test results of the European Banking Authority (EBA, July 2016) showed good capacities to withstand macroeconomic shocks, notwithstanding the increased sensitivity in some of the banking groups. The share of the Albanian subsidiaries in the activity of the banking group, over 2016, performed at different directions, reflecting the specifics of their individual activity.

Table 2.3 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	Veneto Group
Assets	-0.5%	9.1%	-4.5%	-6.1%	-26.5%	2.2%	-11.2%
Credit	2.1%	5.0%	-2.8%	-4.6%	-2.3%	3.0%	-16.8%
Deposits	-0.4%	2.0%	1.9%	-15.0%	-0.9%	8.0%	-12.0%
Loan-loss provisions	-36.7%	6.3%	-63.4%	...	-80.6%	13.7%	...
Net profit	-6.9%	-14.3%	...	...	-36.5%	15.3%	58.3%
Ratios							
Non-performing loans	10.2%	4.1%	38.3%	38.8%	-	5.0%	22.5%
Net interest margin	2.8%	-	2.7%	-	-	-5.6%	56.4%
Capital adequacy ratio	12.6%	12.8%	16.8%	17.4%	21.9%	11.5%	...
Bank' s share in Albania to the group	1.7%	0.4%	0.7%	0.2%	0.3%	0.1%	0.8%

Note: (...) shows pronounced change of this indicator (higher than 100%), while (-) shows unavailable data for this indicator in the publications of the respective bank.
Source: Official websites of banking groups.

(17) The contraction in the activity of some European banking groups operating in Albania maintains the stimulus for restructuring the activity, including the change of the network in non-EU countries. This process is based on a complete analysis of costs and profits at group level as a ratio to its short and long-term objective, and is oriented on the current and potential performance for the activity of each unit of the network in the jurisdiction where they operate. The experience of other countries shows that if this process is well coordinated among all stakeholders, the exit of one banking group from a certain market may be accompanied with the entry of other valuable investors, who may introduce additional capacities and priorities in the local banking

sector. These changes may provide a positive effect on the banking sector and financial system's structure in a given country, and increase its contribution to the economic growth of that country. The process contains uncertainties as well, related to the current phase of the economic and financial cycle in EU and in the region, with the potential of the regional countries to generate interest among new valuable investors. It is difficult to determine the degree and the way this process may affect the Albanian subsidiaries of these European banking groups. In case it materialises, this process should be assessed in the framework of new opportunities that may be generated with a view to improving the activity of the banking sector. On the other hand, the Bank of Albania and other authorities in Albania shall strengthen the monitoring and assessing capacities as well as mutual collaboration , in order for the processes to take place in compliance with the legal requirements and with the ultimate objective to safeguard the financial system's stability.

3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

(18) The Albanian economy grew in 2016 Q4, at 3.97%, in annual terms. The positive contribution from construction, industry and agriculture in the production sector was added to the significant positive contribution of services. Aggregate demand was supported by the increase in the final consumption of population and Government, and the increase in the formation of the stable capital. The reduction of current account deficit in the balance of payments, mainly as a result of the improved exports and the positive surplus in the services account[10] provided a notable contribution to the expansion of the domestic demand. Economic growth in Albania was accompanied by a further fall in unemployment, both in annual and quarterly terms[11], at 14.2%. Expectations for employment in 2017 H1 are determined by the positive assessments from all sectors of the economy and the somewhat lower expectations of consumers.

(19) The monetary policy stance of the Bank of Albania remained accommodative during the period, although the Bank of Albania did not change the policy rate. This approach was dictated by the need to consolidate the positive developments related to the improvement of economic and lending activities, the decline in unemployment and the gradual rise of annual inflation toward the medium-term target. Annual inflation stood at 2.2% in December 2016. While this rate was similar to that in the previous year, it was up in the fourth quarter of 2016[12]. In line with expectations for further improvement of the economic activity in Albania and abroad, the Bank of Albania expects inflation to converge to the target within 2018.

(20) At the end of the period, the consolidated fiscal policy resulted into a considerable narrowing of the budget deficit for 2016. The budget balance deficit was around ALL 27 billion, from ALL 58.2 billion in the previous year. Budget was mainly financed by external funds, reducing the need of the government to borrow in the domestic market. The value of budget deficit dropped due to the surge in budget income by 6.8%[13] and the fall in budget spending by 1.4%, with the fall in capital expenditure providing the main contribution. Budget spending, in particular capital one, in compliance with the objectives and evenly throughout the financial year, remains one of the challenges of the budget planning and realisation.

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[10] *Exports of goods and services increased by 15.9%, while imports of goods and services increased by 0.45%.*

[11] *Unemployment rate was 14.7% in 2016 Q3 and 17.3% in 2015 Q4.*

[12] *In December 2015, this rate was 2.0% and in September 2016 at 1.8%.*

[13] *Annual income recorded an accumulative value of ALL 405.1 billion, while general expenditure was ALL 432 billion.*

(21) **In 2016 Q4, the current account deficit in the balance of payments decreased considerably, attributable to a better performance of exports and increase in positive surplus in the services account**. Current account deficit was EUR 240 million, shrinking by 40% in annual terms. This performance was determined by the narrowed deficit in goods account due to the rapid growth of exports[14], increase of positive surplus in services account[15] affected by the inflows for travel services[16], the increase of the inflows in the secondary income account[17] mainly due to the growth of remittances[18], and reduction of outflows in the primary income account. The expansion in the export of goods was attributable to: (i) increase in the export of mineral products in "Ores, slag and ash" and (ii) increase of the export in "base metals and their articles (cast iron and stainless steel)". The flow of financial liabilities of Albania to the world is assessed at EUR 221 million, recording an annual drop of 34%. Financial liabilities were at the highest degree created from foreign direct investments, which stood at EUR 276 million, around 70% higher than in the previous year. Energy and hydrocarbon sectors provided the main contribution to the growth of foreign direct investments. Liabilities in the form of other investments recorded a negative value of EUR 59 million, against the positive value of EUR 43 million in the previous year.

[14] *Exports grew 29%, while imports increased only 1%, compared to the same period in the previous year.*

[15] *In the services account, the positive surplus of EUR 230 million was EUR 89 million higher than in the same period in the previous year.*

[16] *Incomes from travel services were twice higher than in the same period in the previous year, at EUR 96 million.*

[17] *The surplus in this account was EUR 224 million, up around EUR 23 million from the same period in the previous year.*

[18] *In annual terms, remittances grew by 8%, standing at EUR 160 million.*

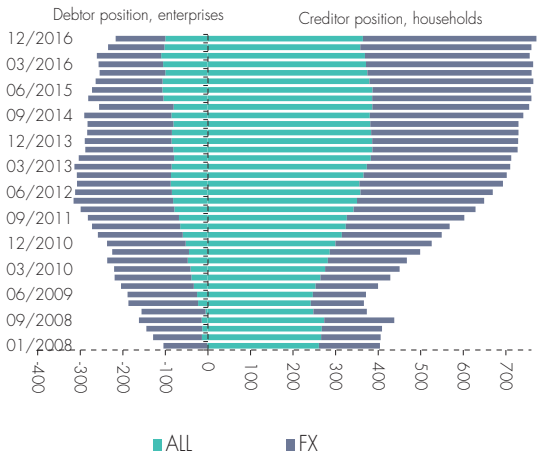
4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND ENTERPRISES

(22) Households and enterprises were inclined toward saving, over 2016. While lending to households accelerated, their deposits increased at a higher pace, reflecting the expansion of households' creditor position. Lending to enterprises fell in the same period, while deposits expanded more rapidly, mainly in foreign currency. Thus, enterprises reflect a narrowing of the debtor position. The loss loans write off from banks' balance sheets contributed to the improvement of credit quality to households and enterprises, which was more evident compared to the developments in the previous year, mainly for the unhedged foreign currency loans.

4.1 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

(23) During the period, the creditor position[19] of households expanded, whereas the debtor position of enterprises narrowed[20]. Households' creditor position rose to ALL 772 billion, totally supported by the expansion of the creditor position in foreign currency through the increase of such deposits. The orientation of credit to households in the domestic currency drove to the narrowing of the creditor position in ALL. By contrast, enterprises narrowed their debtor position against the banking sector by around ALL 38 billion, at ALL 217 billion. The narrowing of the debtor position is more notable in the foreign currency segment, mainly due to the considerable growth of deposits in foreign currency.

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



Source: Bank of Albania.

(24) During the period, households increased savings in the form of deposits mainly in foreign currency and decreased investment in other assets of the financial system. The share of investments in treasury bills, bonds and investment funds fell slightly during the period, while the share of deposits in foreign currency increased at 42.3% of households' total assets in the financial system.

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

[20] *In annual terms, creditor position of households expanded by around 2%, against the narrowed debtor position of enterprises by around 15%.*

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

	2010		2013		2016, June		2016, December	
	ALL billion	Weight, %	ALL billion	Weight, %	ALL billion	Weight, %	ALL billion	Weight, %
Lek deposits	357.6	49.8	449.5	43.7	450.4	40.3	454.3	40.3
Foreign currency deposits	304	42.3	418.4	40.7	455.6	40.8	476.4	42.3
T-bills	56.7	7.9	70.6	6.7	72.4	6.5	65.2	5.8
Bonds	0.37	0.05	39.8	3.9	66.4	5.9	64.5	5.7
Investment funds*	-	-	50.3	4.9	71.7	6.4	65.4	5.8
Voluntary private pension funds*	0.12		0.43	0.04	1.1	0.1	1.2	0.1
Households' portfolio	718.8	100	1.029	100	1,117.6	100	1.127	100

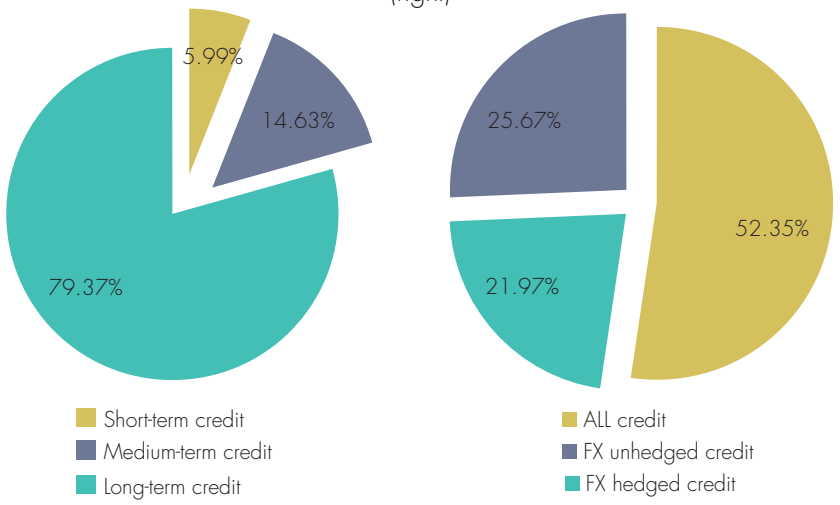
Source: Bank of Albania.

4.1.A LENDING TO HOUSEHOLDS AND CREDIT RISK

(25) During the period, households accelerated the borrowing from banking sector, at 3.7% in annual terms. This expansion reflects the increase of credit for "consumption of non-durable goods" followed by credit for "house purchase". New credit for "investments in real estate" recorded a positive pace supported by low historical levels of the interest rate.

(26) Credit expansion to households[21] is recorded entirely in the domestic currency, while credit in foreign currency narrowed. Unhedged loans to households in foreign currency fell in absolute value and its quality improved, recording a fall of exposure against the unfavourable movements of the exchange rate. Its share in households' credit fell at 25.7% of total outstanding credit, compared to 29.4% at the end of 2015. Around 79.8% of household unhedged credit consists in "House purchase loans", which fell slightly by 2 percentage points, over one year period. Hence, credit share in ALL picked up at 52.4%, around 2.6 percentage points higher than in December 2015. By maturity, long-term credit to households increased slightly by 1.1%, reaching at 79.4% of portfolio; short-term credit fell at 6.0%, and medium-term credit accounted for 14.6% of the portfolio.

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

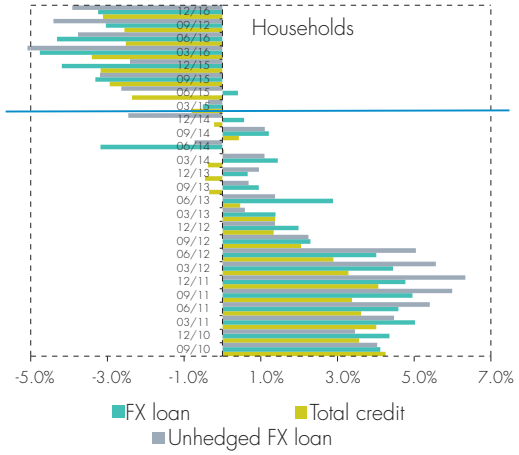


Source: Bank of Albania.

[21] Resident households.

(27) The quality of credit portfolio to households continued to improve, attributable to the loss loans write off from banks' balance sheet. Non-performing loans ratio for households fell at 10%, around 2.9 percentage points lower than in the previous year. The credit quality improved more considerably for the foreign currency credit, and for its part that is unhedged against fluctuations in the exchange rate. The ratio of non-performing loans in foreign currency to households dropped at 11.9%, recording an annual fall of 3.4 percentage points. Also, the quality of credit unhedged against the exchange rate risk to households improved. The non-performing loans ratio for this category fell at 11.2%, from 15.1% in December 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. The survey is based on a randomly selected sample of 1,209 households, across around 55% urban areas and 45% rural areas.

In 2016 H2, the number of employed persons increased in annual terms, supported by the employment in the private sector. *The financial balance (income-expenses) of households expanded, due to the increase in income and the almost unchanged expenses.* ***About 29% of households state to have a loan to pay.*** *This share is slightly lower from both 2016 H1 and the previous year.*

In 95% of cases, borrowing is in lek. This share has been increasing. Around 38% of borrowing households had borrowed from formal sources (banks and non-bank institutions), and 62% from informal sources, mainly in cash. Compared with 2016 H1, ***this allocation has shifted in favour of the non-formal against the formal borrowing****, as a result of the increase of borrowing from natural persons. "Consumption" (42%), "Purchasing/renovating a property" (29%) and "business development" (12%) remained the top three purposes for borrowing. During the surveyed period, the allocation of credit by purpose of loan has shifted to "consumer loans".*

Total reported outstanding credit was down compared to both the previous survey, and the previous year. *About 80% of total outstanding credit is provided from formal sources and 20% from informal sources, shifting somewhat toward informal loans. By currency, 97% of outstanding credit is in lek, and 3% in euro. By purpose of use,* ***around 57% of outstanding credit was for "Purchasing/renovating a property", 24% for "business development" and only 10% for "consumption";***

The borrowing households say ***credit instalment during the referring period has fallen****, reflecting the reduction of the weighted credit interest rate to households.* ***Solvency improved in annual and half-yearly terms****. Expectations for the rest of the year are optimistic.*

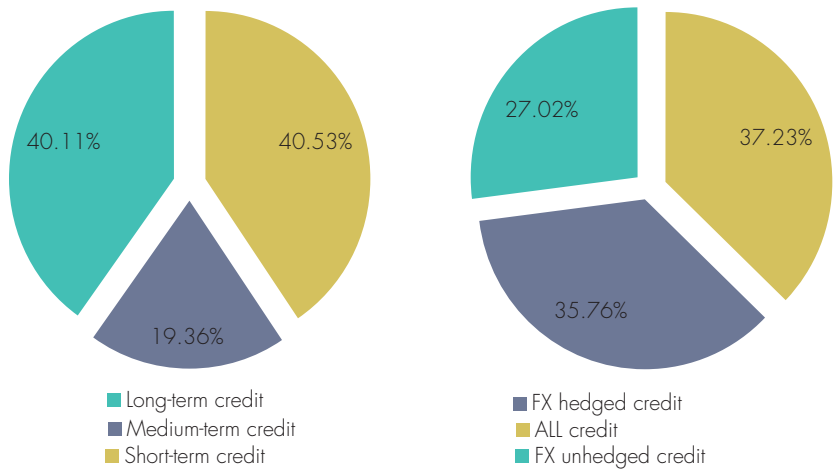
*Although **credit demand remained sluggish, it trended up** throughout the year. The possibility to receive a loan increased slightly in 2016 H2, approaching the long-term average.*

4.1.A LENDING TO ENTERPRISES AND CREDIT RISK

(28) Credit to enterprises, accounting for about 67% of total credit, expanded by 2.4% in annual terms, oriented mainly to non-resident entities. Credit to resident enterprises recorded a negative pace, narrowing by 0.8% from the previous year. Credit outstanding to residents contracted for all the purposes of use, except of credit for "equipment purchase" accounting for 29% of total (which increased by 4% in annual terms) and "credit to start up a business", which accounted for only 1.4% of total. Outstanding credit to non-resident enterprises expanded by 25.6% from the previous year, or around 14.4% during the period.

(29) In the structure of credit to enterprises, the share of credit in the domestic currency increased. The share of credit in foreign currency in the total credit to enterprises dropped at 61.6% or 3.1 p.p. lower from the end of 2015. However, outstanding credit unhedged against unfavourable volatilities in the exchange rate remains at the same levels with the previous year, accounting for around 27% of total credit to enterprises. In the structure of unhedged credit to enterprises, the share of loans "for trade" fell at 44.4% of this portfolio, while loans for "business development" and "real estate development" accounted for 15.8% and 8.6% of the portfolio, respectively.

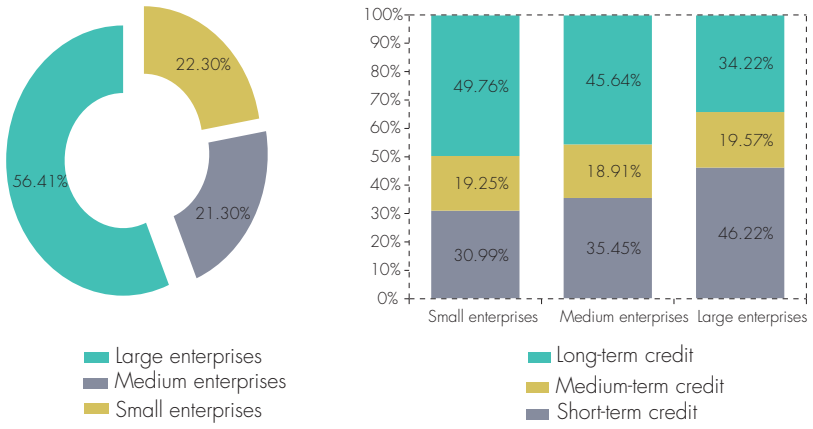
Chart 4.4 Structure of credit to enterprises by maturity (left) and currency (right)



Source: Bank of Albania.

(30) The share of credit to large enterprises dropped at 56.4% of total; while the share credit to small and medium-sized enterprises increased, accounting for 22.3% and 21.3% of total, respectively. Over 2016, the small and medium-sized enterprises continued to increase the share of short-term credit, whereas the larger enterprises were oriented towards the medium-term and did not recorded any change in the long-term credit. By currency, the small and medium-sized enterprises expanded the credit in lek, whereas larger enterprises narrowed slightly the credit in foreign currency in favour of the one in lek.

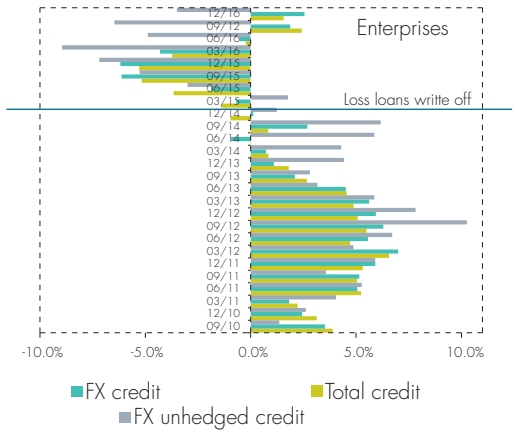
Chart 4.5 Structure of credit to enterprises by size



Source: Bank of Albania.

(31) While the portfolio quality of credit to enterprises deteriorated slightly in annual terms, it trended down throughout the period. In December 2016, the non-performing loan ratio was 21.4%, from 23.0% in June 2016, and 20.1% in the previous year. The ratio of non-performing loans for foreign currency credit stood at 24.3% at the end of the period, or 2.6 p.p. higher than in the previous year. The portfolio quality for unhedged foreign currency credit to enterprises improved significantly annually, mainly affected by the lost loan write off. At the end of the period, the ratio of non-performing loans for this credit category fell to 22.2% from 26.3% in June 2016, and from 25.7% at the end of 2015.

Chart 4.6 Annual change of NPLR for enterprises, in p.p.



Source: Bank of Albania.

BOX 4.2 SURVEY RESULTS ON ENTERPRISES FINANCIAL AND BORROWING SITUATION

The survey of enterprises financial and borrowing situation is conducted half-yearly. During 2016 H1, the survey was expanded on a sample of 1,209 enterprises (small, medium-sized, and large enterprises), across the country, operating in major sectors of the economy.

Competition and finding a market are assessed as the main limiting factors to the activity for all enterprises, in particular, to small and medium-sized enterprises. All the three group of enterprises assessed problems related to access to finance and cost of financing as downward.

Small enterprises continue to assess as downward both the level of sales and the financial result, during 2016 H2, but at a decreased trend from 2016 H1. The situation for medium-sized and large enterprises appears more positive. They assessed the sales and financial result upward during the referring period. All the three groups of enterprises declared expansion of their activity. This expansion was more notable for the medium-sized and large enterprises. For 2017 H1, all enterprises expect expansion of their activity and positive performance for the sales and financial result. Nevertheless, these expectations decreased during the period.

During the reporting period, more than half of respondent enterprises financed their activity only through sales. Compared to the previous period, the use of sales as the only financing source fell for small and larger enterprises, relying on the use of reserve funds. On the other hand, borrowing as a separate or combined source was used by around 25 % of enterprises.

Around 44% of total enterprises state that they have a loan to repay, and this share dropped compared to 2016 H1, for all the three groups of enterprises. For small enterprises, the share of borrowers is 38%, for medium-sized enterprises the share is 44% and for larger enterprises the share is 48%. Around 96% of borrowing enterprises state that they have turned mainly to the banking sector for borrowing, up compared with the previous period. This increase was noted across all the three groups of enterprises, but it was more highlighted for the medium-sized enterprises.

Enterprises borrowed primarily to cover current expenditure (37% of small enterprises, 41% of medium-sized enterprises and 43% of large enterprises), and to conduct a long-term investment (40% of small enterprises, 37% of medium-sized enterprises and 38% of large enterprises). Around 76% of total borrowing enterprises (irrespective of their size) consider the level of borrowing for financing their activity as adequate. Around 17%

of enterprises states that they wished to have received more loans, and this share increased from the previous half-yearly period, mainly driven by small and larger enterprises.

Borrowing is reported ***mainly in the domestic currency for small and medium-sized enterprises,*** *and* ***mainly in foreign currency for larger enterprises.*** *Nevertheless, the share of borrowers in lek against those in foreign currency increased for all the three groups of enterprises. Most enterprises (around 50%) have taken a loan in the past 1-5 years. On the other hand, only 14% of small enterprises, 12% of medium-sized enterprises and 14% of large enterprises reported new borrowing over 2016 H2.*

The overall value of the loan is about half the value of the enterprise's capital, for the majority of borrowing enterprises (78%), *and almost the same for 12% of enterprises. Over 70% of enterprises state that the loan payment to total revenues amounts up to 20% of revenues, resulting into a debt share at the "above 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, overall, 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.*

4.2 REAL ESTATE MARKET AND REAL ESTATE CREDIT

(32) The banking activity, financing conditions and real estate market interact closely with each other[22]. On the one hand, the rapid and unjustified increase by market conditions of credit for real estate purchase may drive to overheating or strong surge of prices in the real estate market. On the other hand, an immediate drop in real estate prices, in addition to the negative effects on the economy, may drive to instability in financial markets in the form of contraction of demand for credit collateralised with real estate, receding demand and repayment rate by the construction sector and fall in the value of real estate portfolio obtained by banks as a result of collateral enforcement.

(33) Credit outstanding for real estate[23] fell by 1.7% over the period, although the quality of this credit improved slightly and the interest rate was down. The non-performing loans ratio for this category of credit fell at 8.8%, from 10.4% in June, and around 11.5% in the previous year. The share

[22] *In this case, the exposures is represented by the loan granted 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.*

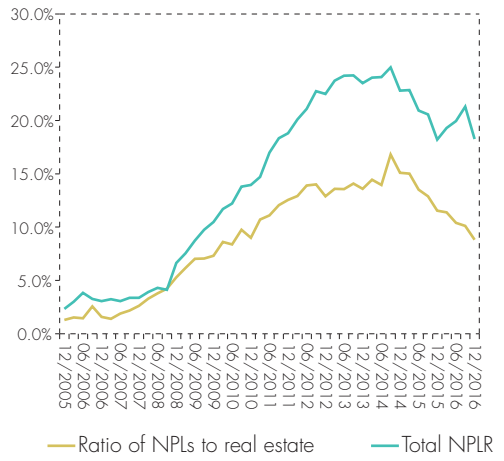
[23] *It includes the credit granted for house construction and purchase.*

of outstanding credit for construction fell slightly at 13.7% of credit outstanding to enterprises, showing no important changes during the period and reflecting somewhat more tight standards from the banking sector. The share of this category of credit to outstanding credit was around 20% in 2007-2011. Meanwhile, households' demand for credit for real estate has firmed up, and banks report that standards for this category, overall, remained unchanged.

Chart 4.7 Credit for real estate purchasing

Source: Bank of Albania.

Chart 4.8 Non-performing loans ratio



Source: Bank of Albania.

The weighted interest rate on real estate credit[24], at the end of 2016, stood at 4.2%, in line with the downward trend in recent years. Along the same lines, the relative repayment cost of credit for real estate purchase continued to lower, reflecting more favourable conditions for real estate purchase from the borrower's perspective.

(34) The share of collaterised credit for real estate fell during the period. At the end of 2016, around 49% of loans granted by the banking sector were real estate collaterised, while for households and enterprises they were 65% and 43%, respectively. The three figures were down compared with 2016 H1 and with the previous year. At the end of 2015, real estate collaterised credit accounted for around 52% of the total credit stock.

(35) Survey results on real estate market and house price index performances for the period, on a national level, suggest an increase in both the number and price of sales. The interviewed entities, real estate agents and construction companies improved their perception for the market situation, although, overall it is assesses as difficult. According to the respondents , the Fisher's House Price Index, on a national level, increased by 12.8%. This development is affected by the increase of sales price and volume in both the central areas of the capital and other areas[25]. In the coastal area, the agents reported a decline in

[24] *Households and enterprises.*

[25] *"Other areas" include all the areas, except for Tirana and the coastal area.*

the average price and volume of sales. The average price index for Tirana is assessed 3.3% higher compared with 2016 H1. Overall, the performance of the reported inventories and the drop in the number of unsold properties support a more optimist situation of this market, as affirmed by the expectations of the respondent entities for the forthcoming period. Nevertheless, the prolongation of the average sale period of properties shows that, overall, transactions still are selective ones, and this will reflect the performance of prices.

BOX 4.3 REAL ESTATE MARKET AND HOUSE PRICE INDEX, 2016 H2 SURVEY

The situation in the real estate market is assessed through the field survey of a sample consisting in 230 real estate agents and construction firms, representing around 75-80% of the sample of these entities by size of activity. The Bank of Albania compiles the questionnaire and the data entry and processing, while the Institute of Statistics performs the field interviews, the main processes of sampling and the physical check of the filled questionnaires.

The net balance of responses of - 8.2% for the question "How do you assess the market situation compared with the previous period", shows a higher number of agents providing negative response (worse) than the positive response (better). Although, the overall assessment remains pessimistic, the balance of responses is less negative than in 2016 H1 (-33%), showing an improvement in the overall assessment of the respondent entities. It should be mentioned that, the same indicator assessed only for the entities reporting sales during the period, shows more negative values; the net balance of responses on the overall situation by the entities reporting sales is -16%.

Fischer House Price Index, on a national level, rose by 12.8%, over the second half of 2016, determined by the increase in the sales volume in the central areas of the capital and the increase in the price and volume of sales in other areas. In the coastal areas, the agents reported a fall in the average price and volume of sales. The average price index for Tirana is assessed 3.3% higher compared with 2016 H1.*

Agents report the number of houses recorded in their books is largely unchanged; the net balance between those reporting increase and those reporting decrease in the number of the houses recorded in their books is almost neutral. Related to commercial properties, the net balance of the number of properties returned to positive values (2.6%), while in 2016 H1, the net balance was -17%. Number of unsold properties, both for residential and commercial buildings fell considerably compared to the previous period. It is worthy to mention that since the beginning of 2013, this is the first case reporting a drop in the number of unsold properties.

The average time of sale for real estate, on a national level, is 13.7 months, or two months longer compared with 2016 H1. For Tirana, the respondent entities reported an average time of sale of 13.8 months, almost the same as 2016 H1. For the coastal area, the average sale time fell from 10 months to around 8.4 months, while for the other areas, the entities reported almost the same sale time with the previous period (15 months).

The real estate agents reported 68% of the sold real estate is purchased with loans. This figure is slightly up compared with 65% in the previous period. The loan-to-value ratio accounts for 53% of the house value, somewhat higher compared with the previous period.

Agents are optimistic about the market performance in the territory they operate in the short-term future and considerably more positive for the long-term period (up to two years). The number of properties expected to be registered for sale during the forthcoming period is assessed as downward, while agents do not expect considerable changes related to the further performance of real estate prices.

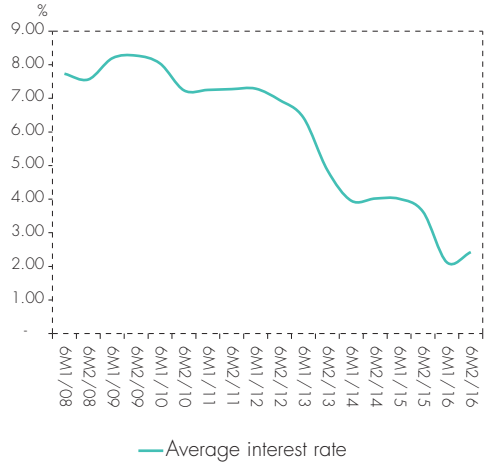
** "Other areas" include all the areas, except for Tirana and the coastal area.*

5. FINANCIAL MARKETS

5.1 SECURITIES MARKET

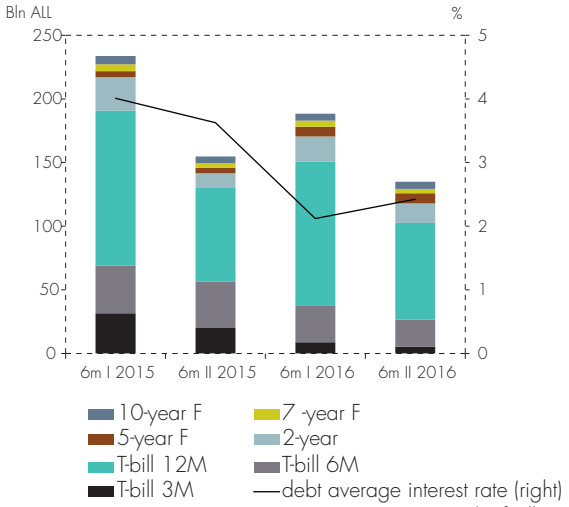
(36) During the period, the average interest rates of government debt securities increased slightly, but were lower than a year earlier. At the end of the year, the average interest rate of government debt was 2.4% or 0.3 percentage point higher compared with the end of 2016 H1, but 1.2 percentage points lower compared with a year earlier. The yields rose at auctions in the primary market of debt securities, especially of those with maturity over one year, reflecting developments in the demand-supply ratio for these instruments. During the period, the government reduced the need for domestic debt financing at 32%, at ALL 137 billion. Treasury bills, which share 75% in total issued domestic debt, continue to dominate the issue structure.

Chart 5.1 Average yield on debt securities, in per cent



Source: Bank of Albania.

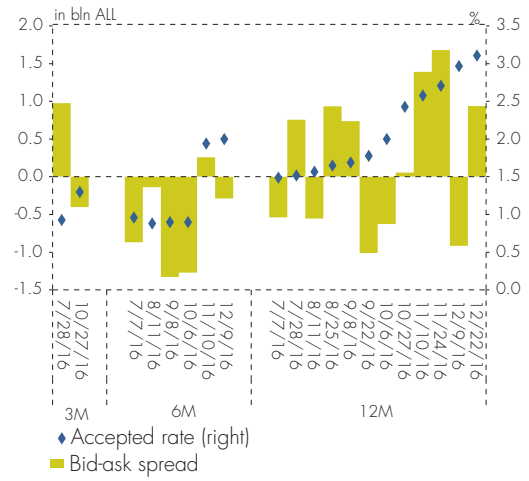
Chart 5.2 Composition of debt issued during 2015-2016



Source: Bank of Albania.

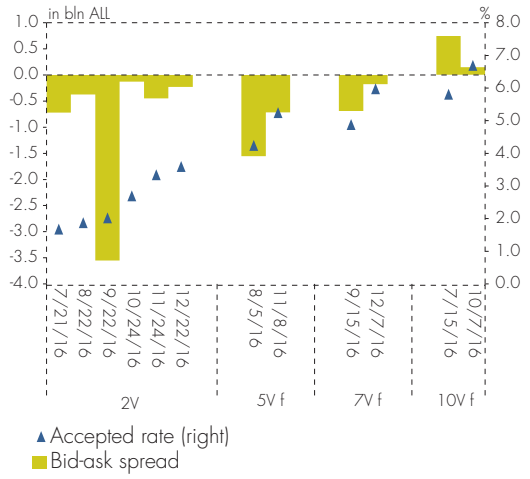
(37) Issues of short-term government debt declined during the period, but the average yield increased. During 2016 H2, issues of government debt securities in the form of treasury bills were ALL 100 billion, down by 32% from 2016 H1 and by 21% from the previous year. In short-term debt issues, those with 12 months maturity, shared 74.0% of the total volume. The average yield on Treasury bills increased by 0.3 p.p., reaching 1.9%. In some auctions, mainly for 3 and 6 month-bills, the bid to invest was lower than the demand for borrowing or the amount announced by the government, thus favouring a rise in yields. Although with a lower frequency, the phenomenon is also observed in the auctions for 12-month bills, whose yields rose from 1.5% at the beginning of the period to 3.1% at the end of the year.

Chart 5.3 Balance on the bid for investment and the yields on T-bills for 2016 H2



Source: Bank of Albania.

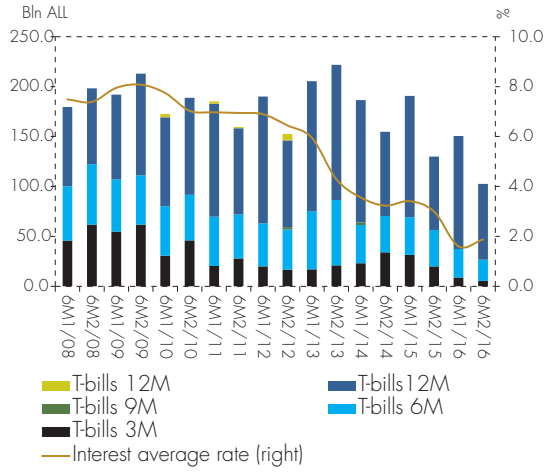
Chart 5.4 Balance on bid for investment and the yields on bonds for 2016 H26



Source: Bank of Albania.

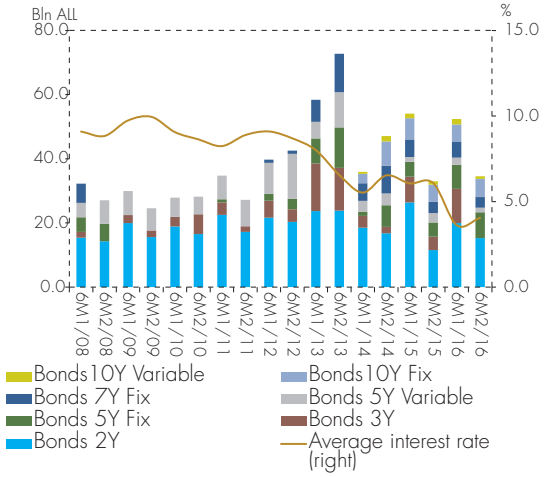
(38) In terms of issues and yield performance, a similar phenomenon was noted for long-term government debt securities. Debt securities issued in the form of bonds were ALL 35 billion during 2016 H2, about 34% less than in 2016 H1, but almost unchanged from a year earlier. About 70% of the volume of issued bonds consists of 2 and 5-year fixed rate bonds. The rapid decrease of the weighted yield of bonds in lek during 2016 H1 was reflected in reduced demand for investments in such securities in 2016 H2. Indeed, in some bond auctions, the bid amount was below the amount asked for borrowing. As a result, the average yield for long-term government securities increased slightly at 4.1%. However, this level was significantly lower compared to the end of 2015.

Chart 5.5 Volume and weighted average yield on treasury bills in the primary market



Source: Bank of Albania.

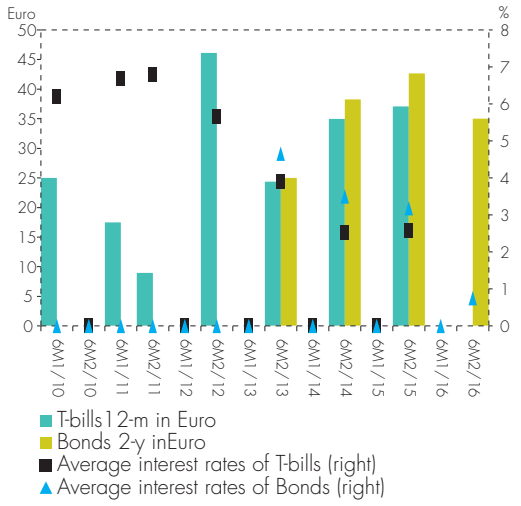
Chart 5.6 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

(39) At the end of the period, the government reissued medium-term debt in euro for the domestic market, and also decided to mature the short term securities in this currency. In December 2016, the government matured 12 months debt securities and reissued 2-year euro bonds. This was the only issue in euro for 2016 and made up 3.4% of total issues during the period. In the absence of short-term debt in euro, the total debt in euro issued for the domestic market fell by 57% compared to the end of 2015. The contraction of borrowing supply in euro, in the presence of a high demand of investors for this instrument was reflected with the decline of the yield on securities to 0.75%, compared to 3.23% in the similar issue a year earlier.

Chart 5.7 Domestic borrowing in euro

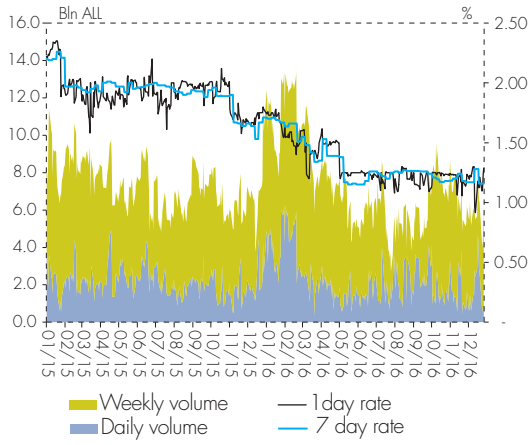


Source: Bank of Albania.

5.2 INTERBANK MARKET

(40) The volume of transactions in the interbank market decreased, during the period, and the interest rates stood close to the policy rate. Keeping the policy rate unchanged during the period, favoured low interest rates in the interbank market. Banks traded less in volume, at rates constantly below or close to the policy rate level, thus reflecting a stable liquidity situation. At the end of the year, the average interest rate for 1 and 7-day interbank transactions was 1.2% or 0.3 p.p. lower, compared to 1.5% at the end of 2016 H1. Despite low interbank interest rates, the average volume of overnight loans and one-week loans fell compared to the end of the previous period. One-month loans decreased as well, although this instrument is rarely used and at lower volumes, compared to shorter-term instruments.

Chart 5.8 Interest rates in the interbank market

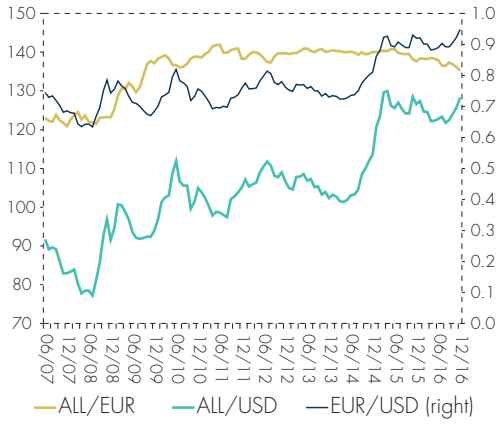


Source: Bank of Albania.

5.3 FOREIGN EXCHANGE MARKET

(41) During the period, the Albanian lek appreciated against the euro and depreciated slightly against the US dollar. In average terms, lek appreciated against euro by 1.3% compared to 2016 H1. During the period, lek depreciated against the US dollar reflecting the appreciation of the US dollar

Chart 5.9 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

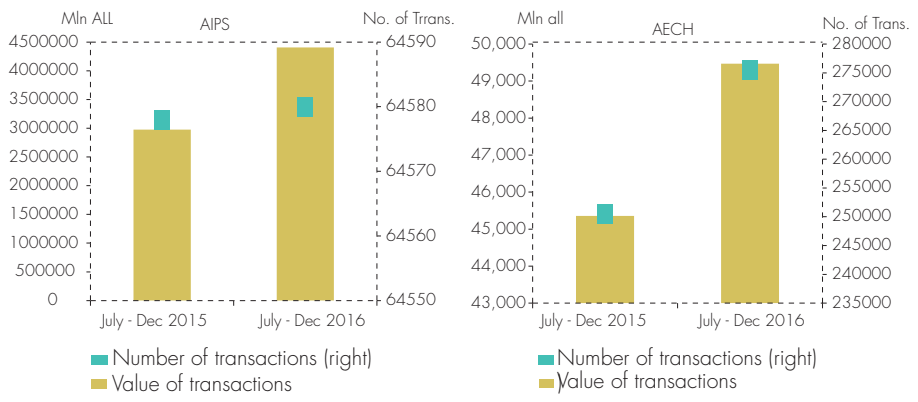
against the euro. Compared to a year earlier, the domestic currency appreciated by 1.9% against the euro and 1.3% against the US dollar.

6. PAYMENT SYSTEM DEVELOPMENTS

(42) The underlying infrastructure for the clearing and settlement of payments in the domestic currency continued to operate effectively and securely, thus supporting the financial stability and the implementation of the monetary policy. During the period, the operation of the system did not pose any operational, financial (credit and liquidity) and legal issues, which might jeopardise the availability of the system. In terms of the activity, AIPS (Albanian Interbank Payment System) recorded an increase in value about 48% from the same period in the previous year, whilst the number of transactions amounts to around 65 thousand. Hence, the average settlement value per transaction rises to around ALL 68 million compared to ALL 46 million in the previous year.

In AECH (Albanian Electronic Clearing House), during the period, 275.5 thousand payments were cleared, and the average value per transaction amounted to around ALL 0.18 million. Compared to the same period a year earlier, the activity of AECH increased, both in number and value, by 10.0% and 9.1%, respectively.

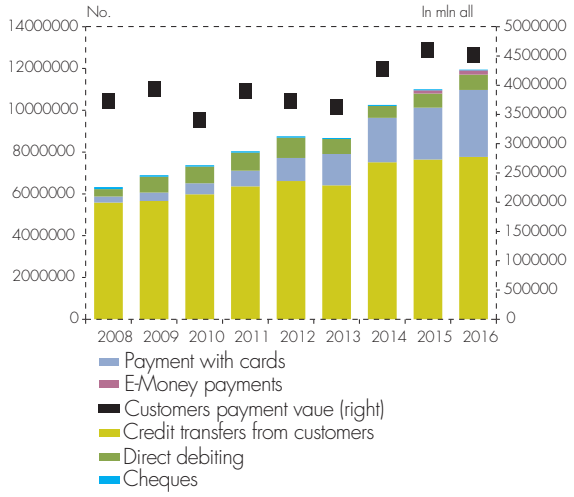
Chart 6.1 AIPS and AECH activity in 2015 H2 and 2016 H2



Source: Bank of Albania.

(43) The number of payments conducted through specific instruments such as credit transfers, credit and debit cards, and direct debiting, increased during the period, but the value was lower than a year earlier. In concrete terms, 11.9 million payments were conducted in total during 2016, about 8.5% more payments compared to 2015. Credit transfers in paper form are the most used payment instrument (65%) Overall, the use of payment instruments

Chart 6.2 Performance of payment instruments in quantity and value



Source: Bank of Albania.

increased during 2016, excluding cheques, whose use decreased by about 31%. Despite the upward trend in using payment instruments, their total value decreased by 1.9% from 2015 to ALL 4,512 billion, driven mainly by the decline in the value of credit transfers in paper form.

7. FINANCIAL SYSTEM

(44) During the period, the financial system activity expanded and the other indicators were generally stable. The banking system expanded its activity, rising to 94.9% of the GDP, and resulted profitable and with good capital and liquidity indicators. The non-banking sector maintained its share to GDP, and non-bank financial institutions and insurance companies contributed positively to its activity. Direct exposure of non-banking sector to the banking sector is considered as low, whilst the stability of the banking sector remains a critical factor for the activity and stability of the non-banking sector. Investments in debt securities of the Albanian government are highly important for the non-banking sector, even though these investments declined during 2016.

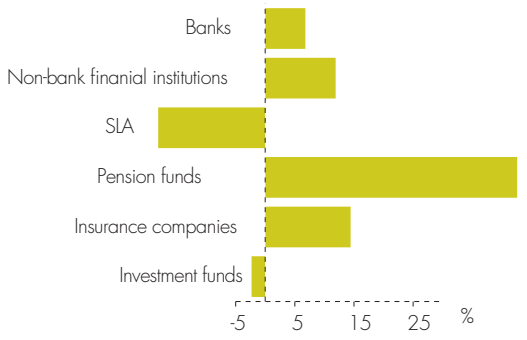
(45) The financial system expanded its activity during the period at faster rates. Thus, the ratio of financial system assets[26] to GDP increased to 105.1%, up 4 p.p. after stagnating for two years. The activity of the banking sector, which expanded faster than the GDP growth, provided the main contribution to this increase. Banks continue to dominate the structure of the financial system assets, accounting for 90.4% of the system assets or 94.9% of the GDP. This dominance rose further during the period.

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

Licensing and Supervisory Authority	Financial system	2011	2012	2013	2014	2015	2016
Bank of Albania	Banking sector	84.7	89.6	90.5	91.7	91.3	94.9
	Non-bank institutions	2.5	2.7	2.5	2.7	2.7	2.9
	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	2.1
	Pension Funds	0.01	0.02	0.03	0.04	0.1	0.1
	Investment Funds		1.21	3.7	4.5	4.7	4.4
Financial intermediation		89.41	95.93	99.13	101.4	101.3	105.1

Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 7.1 Assets' annual growth of financial system components



Source: Bank of Albania, Albanian Financial Supervisory Authority.

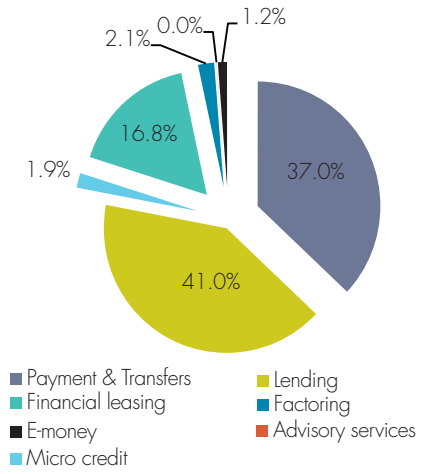
[26] *The financial system consists of banks, non-bank financial institutions, saving and loan associations (SLAs), insurance companies, supplementary pension funds and investment funds. In the analysis of this chapter, consider that the data of insurance companies, and pension funds belong to 2016 Q3, while the analysis of the activity of the other segments of the financial system, the last reporting on their activity are from 2016 Q2.*

7.1 NON-BANKING SECTOR DEVELOPMENTS

INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA

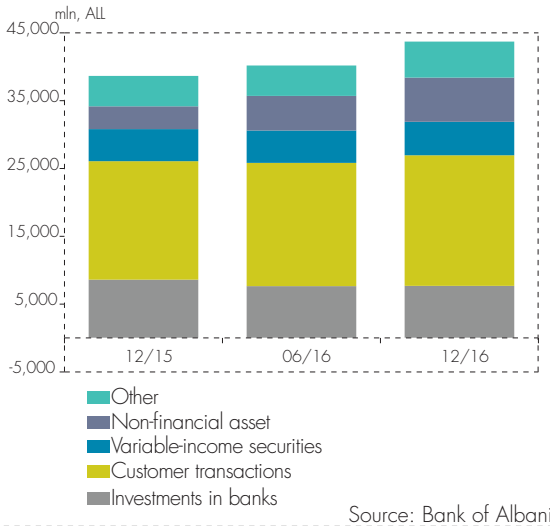
(46) During the period, non-bank financial institutions (NBFIs), expanded their activity and showed better indicators of their financial performance. Assets increased supported by the expansion of lending activity and investments in the form of deposits in the banking sector. The financial result of NBFIs was positive, capitalisation was adequate and asset's quality has been increasingly improving. At the end of 2016, the financial system had 28 NBFIs, engaged mainly in the field of: micro-credit, lending, leasing, factoring, electronic money, etc. NBFIs that engage in lending dominate, followed by those that conduct payments and transfers. The NBFI assets amounted to ALL 44 billion, up by 8.7% compared to June 2016 and 10.7% compared to a year earlier. Transactions with customers have the biggest share in the structure of assets. They represent lending, followed by non-financial assets, which have been a major contributor to the expansion of assets. About 87.6% of the NBFI loan portfolio consists of firms that operate mainly in trade (24%) and agriculture (14%). NBFI's financial result improved to ALL 1.3 billion from ALL 0.7 billion a year earlier.

Chart 7.2 Structure of non-bank financial institutions by type of activity



Source: Bank of Albania.

Chart 7.3 Assets structure of NBFIs



Source: Bank of Albania.

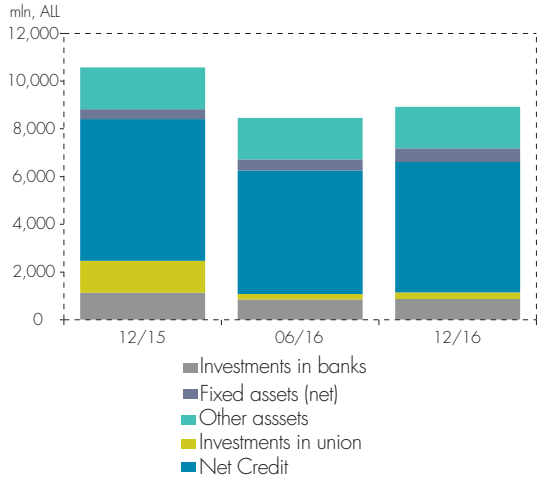
(47) The savings and loan associations (SLAs)performed better during the period, but their activity shrank compared to the previous year. This result reflects the process of restructuring their activities, following the requirements of the new law that regulate their activity and inclusion in the deposit insurance scheme. The main activity of these institutions reflects the same trend as the overall activity. SLAs financial result returned to positive terms (ALL 5 million) compared to financial loss in 2015 (ALL 274 million). Loans to customers, other assets (mostly investments in shares) and fixed assets represent the main items of their assets. At the end of 2016, there were nine active SLAs in the market.

INSTITUTIONS SUPERVISED BY THE FINANCIAL SUPERVISION AUTHORITY

(48) Insurance companies expanded their activities during the period. In 2016 H2, there were 12 licensed insurance companies[27]. Assets of these institutions expanded to 14.4%[28] in annual terms, and focused on investments in the form of time deposits in banks, in shares, government debt securities and technical provisioning. Insurance companies significantly expanded the total capital, with about 11.5% in annual terms.

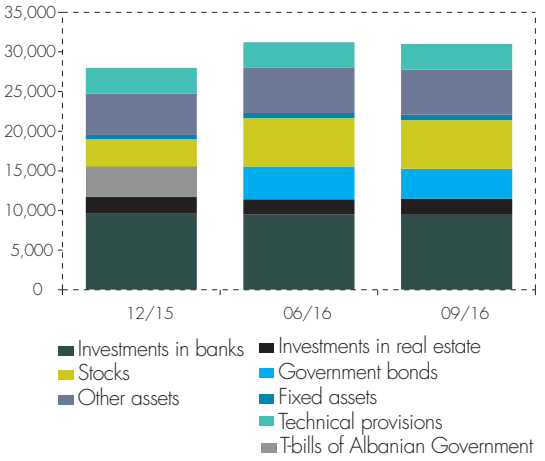
In insurance activity, income from premiums (paid in advance) are used for paying claims and covering costs that may arise from an insurance occurrence. Gross written premiums[29], which represent the main financing source for the insurance activity, expanded by 9.6% in annual terms. The indicator of insurance penetration in the market, measured as the ratio of premiums to GDP increased at 1.04% from 0.97%, a year earlier. Loss indicator or the ratio of paid claims to gross written premiums increased at 27.7% from 25.8% a year earlier, attributable to the higher paid claims compared to the growth in gross premiums income. The value of gross paid claims was up by 17.5%, in annual terms, to ALL 4.3 billion.

Chart 7.4 Structure of assets in the savings and loan associations



Source: Bank of Albania.

Chart 7.5 Structure of assets of insurance companies



Source: Financial Supervisory Authority.

(49) The activity of investment funds[30] **slowed down as a result of the decline of investments in government debt securities.** The investment fund is an open-ended undertaking , established by a contract, offering units to the public[31] that represent the investors' rights and interests. Yields from investors' participation in the investment funds are usually higher than rates on bank deposits, reflecting the higher risk profile[32] of investing in a fund. In

[27] *8 non-life insurance companies, 3 life insurance companies and 1 life reinsurance company.*

[28] *The level of insurance company assets refers to September 2016, as the final report of their balance at the Bank of Albania.*

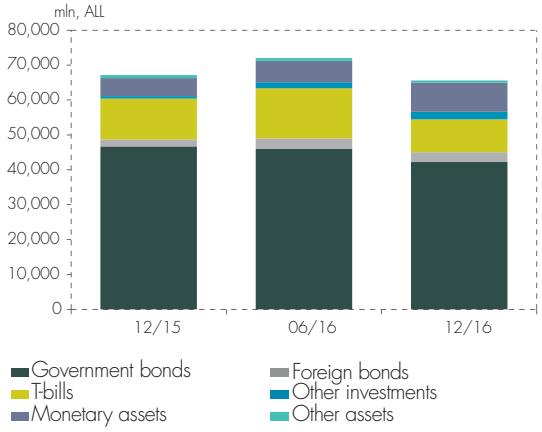
[29] *AFSA, "Insurance Market Statistical Report: January - December 2016", published on 25 January 2017.*

[30] *AFSA, "General data of Investment Funds, 31 December 2016".*

[31] *Law No.10 198, dated 10/12/2009 on "Collective Investment Undertakings", AFSA*

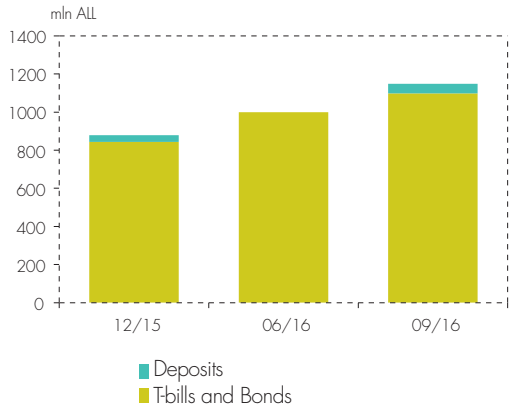
[32] *In an extreme case related to adverse movements in market and / or mismanagement of a fund, the entire amount invested by the investor in a fund can be lost. In a similar case in banks, depositors' savings are protected at least up to the value of ALL 2.5 million (according to the law "On Deposit Insurance). In any case, both investment funds and banks are subject to the regulatory requirements for the financial indicator of their activity, aiming to prevent the possibility of default.*

Chart 7.6 Structure of assets of the investment funds



Source: Financial Supervisory Authority.

Chart 7.7 Structure of supplementary private pension funds



Source: Financial Supervisory Authority.

the Albanian financial system, there are three active investment funds, one of which started to operate in mid-2016. The funds' assets are invested mainly in treasury bills and bonds issued by the Government of Albania in lek and in euro.

In 2012, investment funds had 7,149 members, while in 2016 this number was about four times higher (29267 members). The net asset value, in September 2012, was ALL 16.9 billion, while in 2016, it was ALL 65.4 billion (4.4% of the GDP)

(50) The Supplementary Private Pension Funds[33] expanded their activity during the period. As at the end of 2016, three voluntary private supplementary funds operated in Albania. At the end of 2016 Q3, the assets of these funds amounted to ALL 1.2 billion or 29% higher than a year earlier. The activity of pension funds is dominated by investment in government debt securities. The value of these investments was about ALL 1.1 billion or 30% higher from the end of 2015 Q3. According to the latest reports, the pension funds had about 16000 members.

7.2 ASSESSMENT OF THE NON-BANKING SECTOR RISKS AND EXPOSURES

(51) The exposure of the banking sector to the non-banking sector in Albania remains low. This exposure, on the asset side, is represented by loans and participation in the capital of non-bank financial institutions, and on the bank's liabilities side in the form of funds collected by them (various accounts). In total, the exposure accounts for only 1.8% of the banking sector's assets value.

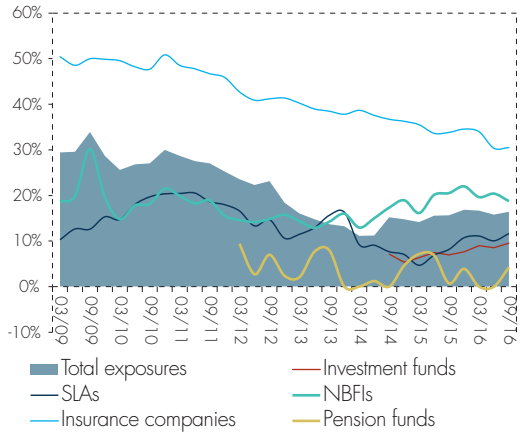
(52) On the other hand, the non-banking sector exposure to the banking sector remains considerable. In total, this exposure represents 16.4% of non-banking sector assets, up by 0.8 percentage point from a year earlier[34]. Insurance companies and non-bank financial institutions (NBFIs) show greater sensitivity to the banking sector, since their placements in the form of deposits account for 31% and 19%, respectively, of their assets. For insurance companies, the share of these deposits in the total of their activity has been declining in

[33] *AFSA, Statistical Report "The Voluntary Private Pensions Market", 30 September 2016, published on 21 November 2016.*

[34] *The data refer to 2016 Q3.*

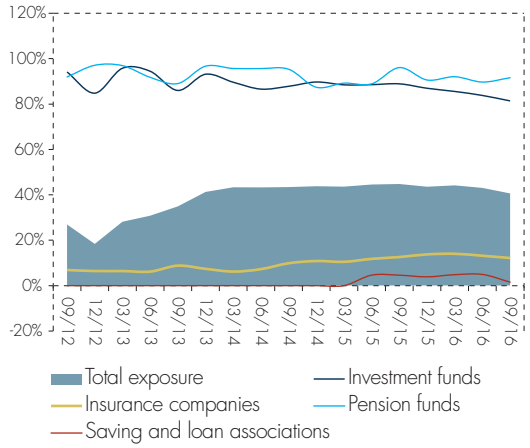
the last 5-6 years. Investment funds and pension funds exposure show also upward exposure, albeit such exposure is low. The exposure of savings and loan associations has trended upward over the last two years.

Chart 7.8 Exposure of main non-banking institutions to the banking sector, in relation to their total assets



Source: Financial Supervisory Authority, Bank of Albania.

Chart 7.9 Investments of non-bank institutions in government securities, against total assets



Source: Financial Supervisory Authority, Bank of Albania.

(53) Investments of non-bank financial institutions in government debt securities[35] are considerable. The share of these investments in the assets of the non-banking sector decreased during 2016 down to 41% compared to 44% at the end of 2015. Regarding their assets, pension funds and investment funds have the highest exposure to government debt.

(54) Credit risk affects largely the activity of active non-bank financial institutions in lending and the activity of savings and loan associations. In December 2016, the ratio of non-performing loans to total loans for these two segments decreased, at 11.6% and 6.7%, respectively, from 12.7% and 8.7% a yearearlier.

(55) Market risks, mainly the risk relating to the level and volatility of interest rates, pose a greater concern regarding the activity of the insurance companies, investment funds and pension funds. The impact from this risk is determined by both the size of shock and the structure of assets and liabilities of each institution.

Thus, life insurance companies that offer guaranteed payments to be made in the future, but have a short-term investment portfolio, are faced with decrease of income from reinvestment, especially over a prolonged period of decreasing interest rates. This risk is significantly lower for non-life insurance companies, since they have a better match between assets and liabilities (both generally

[35] *Data on investments in government securities for pension funds belong to 2016 Q3.*

short-term). The same applies in the case of rising interest rates, where the insurance companies that have long-term investments will initially face a loss of their market value.

In investment funds[36], sensitivity to the interest rate volatility risk reflects the need for regular assessment with the market value of the participation units in the fund, as a result of the possibility to withdraw them at any time. The funds' assets are invested in financial instruments, which are freely traded and their price can constantly change. When interest rates increase, the price of financial instruments decreases. As a result of this decline, the value of the investment portfolio drops, consequently, the return on investment falls, reflected in turn in lower unit price and higher possibility for withdrawal. The fund might be obliged to change the structure and composition of its assets' portfolio, in order to meet the demand for repayment. This action might negatively affect the fund's performance since selling of financial instruments prematurely may result in losses and further decrease of the unit price. Regarding the exchange rate, the funds' risk is low, given a better match of the balance sheet items by currency. Investment funds may be exposed to the reputational risk associated with the performance of the company that manages the fund. Also, the inability to repay large amounts in cases where there is a considerable withdrawal of units by fund members is a potential risk.

Supplementary private pension funds generally rely on defined contribution plans. Interest rate volatility would cause fluctuations on the return levels from investments and perhaps less profit. This risk can be mitigated only if the employee or the employer contributes more to the fund.

[36] *Prospectus "Raiffeisen Prestige and Raiffeisen Invest Euro " - February 2017, official website of Raiffeisen Invest.*

8. BANKING SECTOR DEVELOPMENTS

(56) During 2016 H2, performance of the banking sector was stable. Compared with a year earlier, the activity expanded faster, based mainly on the increased stock of investments in securities. Prudential indicators in terms of solvency, liquidity and provisioning for respective risks were at adequate levels, in accordance with the regulatory requirements. The continuous loan write off from bank balance sheets slowed down the growth pace of non-performing loans. Despite this development, the banking sector remains exposed to credit risk. Exposure to market risks remains subdued, but it requires a regular monitoring and assessment.

8.1 BANKING SECTOR ACTIVITY

(57) The banking sector activity expanded faster during the period. In annual terms, the total assets of the banking sector expanded at 6.8%, against 1.9% a year earlier. On the asset side of the balance sheet, "Transactions with securities" expanded faster followed by treasury[37] and interbank transactions[38] as well as positive developments in lending. "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. Only during the period, the banking sector assets expanded by 5.8%, reaching ALL 1,407.3 billion. The expansion in assets during the period was supported by investments in securities[39], mainly in government debt securities, as well as in securities of non-resident entities. The holdings of the banking sector in the Albanian government debt securities account for 22% of total assets, from 23% in the previous period, determined mainly by the faster growth of assets[40].

[37] *In 2016 H2, transactions with the central bank, in the form of "current accounts" increased considerably by about ALL 27.7 billion, at ALL 50.6 billion.*

[38] *Interbank investments increased in half-yearly terms by about ALL 5.3 billion, at ALL 213.4 billion. These investments were mainly in the form of "Current Accounts for banks, credit institutions and other financial institutions" and "Loans to banks, credit institutions and other financial institutions" to non-residents, increasing respectively ALL 11.2 billion and ALL 9.4 billion, up to ALL 60.8 billion and ALL 62 billion. Only interbank investments in the form of "Deposits in banks, credit institutions and other financial institutions" mainly to non-residents fell by ALL 15.6 billion, to ALL 88.1 billion.*

[39] *Investment portfolio in securities increased by about ALL 31.2 billion or 9.2% compared to 2016 H1, up at ALL 368.4 billion. These investments mainly consisted in the form of securities of placement, of investment and REPO (non- resident) at ALL 108 billion, or 28.2% higher than in June 2016.*

[40] *The increase of investments on government debt securities was totally derived from the expansion of bonds portfolio. In 2016 H2, T-bills portfolio narrowed by ALL 1.9 billion compared to June 2016 at ALL 68.9 billion, whilst the bond portfolio increased by ALL 5.2 billion at ALL 240.7 billion.*

Table 8.1 Structure of banks' balance sheet, December 2016

Asset	% of assets	Annual change, %	Liabilities	% of liabilities	Annual change, %
I. Treasury and interbank transactions	32.9	3.1	I. Treasury and interbank transactions	4.4	26.4
II. Customer transactions (credit)	42.4	2.5	II. Customer transactions (deposits)	81.9	5.4
Of which: public sector	2.04	-2.8	Of which: public sector	2.1	11.6
Of which: private sector	40.6	2.8	Of which: private sector	80.2	5.1
III. Securities transactions	26.2	19.7	III. Securities transactions	0.4	807.71
IV. Created Reserve funds	-5.6	3.7	IV. Other liabilities	0.9	37.7
V. Other*	4.2	4.6	V. Permanent sources	11.9	6.1
			of which: Subordinated debt	1.6	-1.7
			of which: Shareholders' equity	9.7	9.01
			VI. Accrued interests	0.3	-26.1
Total assets	100	6.8	Total liabilities	100	6.8

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

(58) Loan portfolio[41] of the banking sector expanded by 0.6% in half yearly and 2.5% in annual terms, reaching to ALL 596.9 billion at the end of 2016. Despite the ongoing process of loss loans write off, the provisioning fund increased reflecting a new flow in non-performing loan classes, over the year, and its shifting between classification categories.

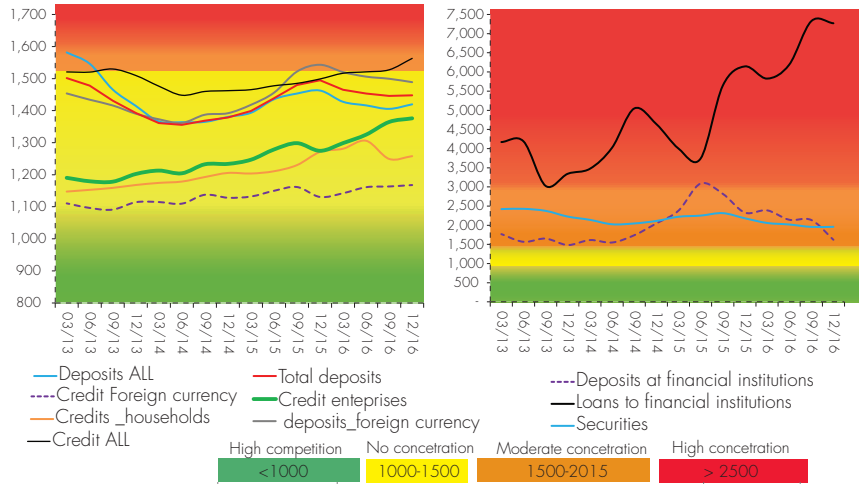
(59) Banking activity was mainly funded by deposits, which accounted for about 82% of total assets. The loan-to-deposit ratio was 52%. The deposit base[42] increased at similar levels both half yearly and annually (5.2%), driven by foreign currency deposits. In terms of maturity, deposits have shifted toward current accounts[43]. This phenomenon poses a potential weakness in terms of the structure of banking sector financing, which, nonetheless, is mitigated by the fact that 83% of deposits belong to households, and overall, the remaining maturity of liabilities was up, due to the increased value of deposits with higher than one-year maturity. Banks maintained the capital utilisation ratio to finance their operations, in compliance with the relevant regulatory requirements.

(60) The Albanian banking sector is characterised by a high concentration for some of its activities. Chart 8.1 (left) shows some of the banking products (in bank's assets and liabilities) for which the banking system shows a moderate or lower concentration. However the concentration for lending in lek and lending to enterprises increased. Chart 8.1 (right) shows the banking sector's

[41] *Excluding accrued interests.*
[42] *Here we refer to" customer transactions", at banks' balance sheet excluding the accrued interest.*
[43] *In December 2016, the share of current accounts was 32.3%, from 28.5% in June 2016, and 27.0% in the previous year.*

activities with a higher concentration, mainly on the asset side of the banking sector's balance sheet. They consist in lending transactions, mainly with non-resident financial entities.

Chart 8.1 Herfindahl indicator for the main banking products



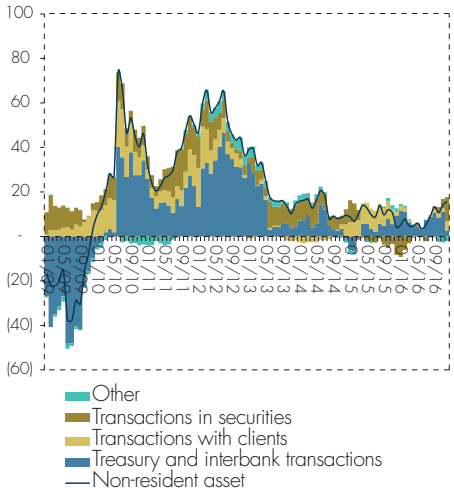
Source: Bank of Albania.

8.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

(61) 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 expand during the period. Borrowing from banking groups remained low.

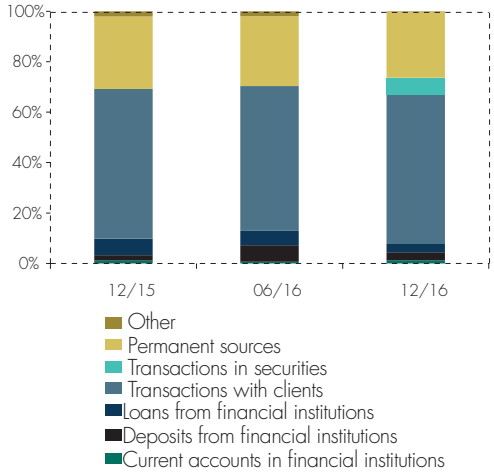
(62) The banking sector expanded the credit position in non-resident entities. In December 2016, assets with non-residents accounted for 27% of total assets and liabilities to non-residents accounted for 6%. As a result, the net credit position expanded by 11% in half yearly and about 19% in annual terms, reaching ALL 293 billion. On the assets side, "Transactions with securities" increased the most in transactions with non-residents (by 48% yoy). Liabilities to non-residents are composed largely by "Transactions with customers" (the placement of non-resident deposits in domestic banks), as well as by "permanent resources" or own funds. During the second half of the year, unlike the first half, "interbank transactions" fell. They include deposits and loans received from non-resident financial institutions, which indicates a further reduction of reliance on external funding sources.

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



Source: Bank of Albania.

Chart 8.3 Components of non-resident liabilities



Source: Bank of Albania.

(63) Claims in the form of placements[44] in parent banking groups account for a low share, about 2.8% of the banking sector assets, while liabilities account for only 0.02%. Placements in the parent banking groups increased by 2.7%, in annual terms. In total, 48.1% belong to G3 banks, 41.1% to G2 and 10.8% to G1. By capital origin, the Italian peer group accounts for 39.8% of the total, while the Greek peer group account for 22.7% of placements in parent banking groups.

(64) The countercyclical measures taken by the Bank of Albania, in May 2013, contributed to the deceleration of the growth of banking sector investments in non-resident entities, but this influence weakened during the period. During 2016 H1, the annual growth rate of investments in the banking sector to non-residents was 3.4%, significantly lower compared to the growth rates of these investments at the time when the implementation of these measures started, by about 25%. During 2016 H2, the rapid growth of financing resources in foreign currency and the reduction of the penalizing effect on these measures, is reflected in the expansion of assets with non-residents by about 15.6% in annual terms, due to lack of adequate investment alternatives in Albania. The share of assets with non-residents, subject to macro-prudential measures, rose at 80.3% of total assets with non-residents compared to 79.4% a year earlier. Within the group of assets with non-residents, subject to the above-mentioned measures, investments in securities expanded significantly. Throughout 2016, the growth rate in non-residents assets of the sector, which are not subject to such measures, was lower and stable, reaching at 10.9% in December 2016. For 2017, the Bank of Albania will continue to implement measures addressing the reduction of investments in non-resident entities from the banking sector, but the way these measures are implemented has changed. Starting in March 2017, the Bank of Albania will require higher capital for the

[44] *Investments in securities and loan to non-financial, non-resident entities are excluded.*

extent of change regarding the placements with non-residents, but the base period of comparison will change according to a two-year moving period. Changing the way the measure is implemented, addresses the need to avoid unlimited growth of demand for additional capital.

8.3 TRENDS IN LENDING

(65) At the end 2016 H2, outstanding loans in the balance sheet of the banking sector stood at ALL 600.4 billion, expanding by 2.5% in annual terms. The credit portfolio benefited from the granting of new loans during the period to the amount of ALL 140.4 billion. Over the same stated period, the banking sector's recovered loans amounted to ALL 150.2 billion, about 8.4% more than a year earlier. Lending is supported by the continuous decrease of the new loan interest rate, down to 5.32%, about 1.1 percentage point lower compared with June 2016.

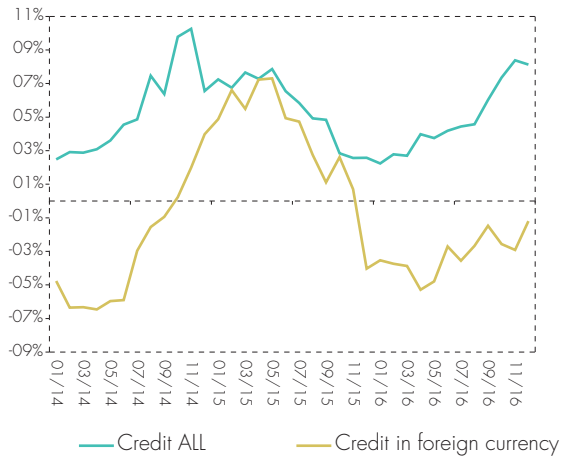
Table 8.2 Credit performance

Indicator and unit	Value (in ALL bln)	Share to total loans (%)	Share in total loans:	Change 6-M	Annual change
Lek loans	248.3	41.4%	39.9%	4.1%	8.2%
Foreign currency lending	352.1	58.6%	60.1%	-1.9%	-1.2%
Public sector	28.7	4.8%	4.7%	1.6%	-2.82
Enterprises	403.0	67.1%	67.4%	0.04%	2.4%
Households	168.7	28.1%	27.9%	1.4%	3.7%
Short-term	190.9	31.8%	33.1%	-3.4%	-3.9%
Medium-term	121.5	20.2%	18.7%	8.5%	13.6%
Long-term	287.9	48.0%	48.2%	0.0%	2.8%
Credit outstanding	600.4	100.0%	100.0%	0.5%	2.5%

Source: Bank of Albania.

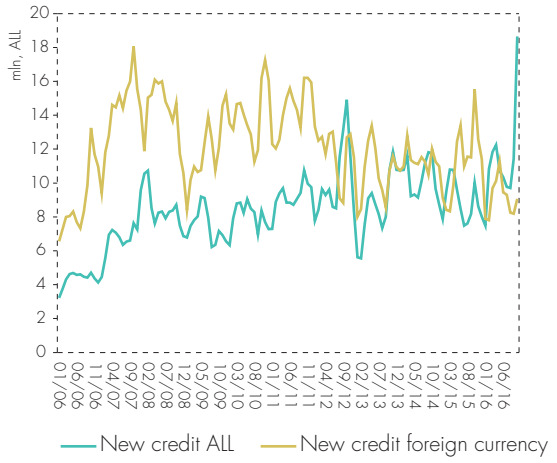
(66) The share of loans in lek continued to grow in the structure of the loan portfolio. In the one year horizon, outstanding loans in the domestic currency expanded by 8.2%, and narrowed in the foreign currency by 1.2%. New loans in lek granted during the period, increased by 21 p.p. and account for 61% of the total of new loans. It continuous the upward trend of the recent years, expanding by 62% from the same period a year earlier. New loans in foreign currency, during the period, decreased by 31% from a year earlier. In the framework of supporting lending in domestic currency, the banking sector lowered the interest rates for the new loans in lek by 1.8 p.p. down to 5.5%. The interest rate on new loans in euro is 4.6%, declining more slowly by 0.73 p.p., during the period.

Chart 8.4 Outstanding loan, annual growth



Source: Bank of Albania.

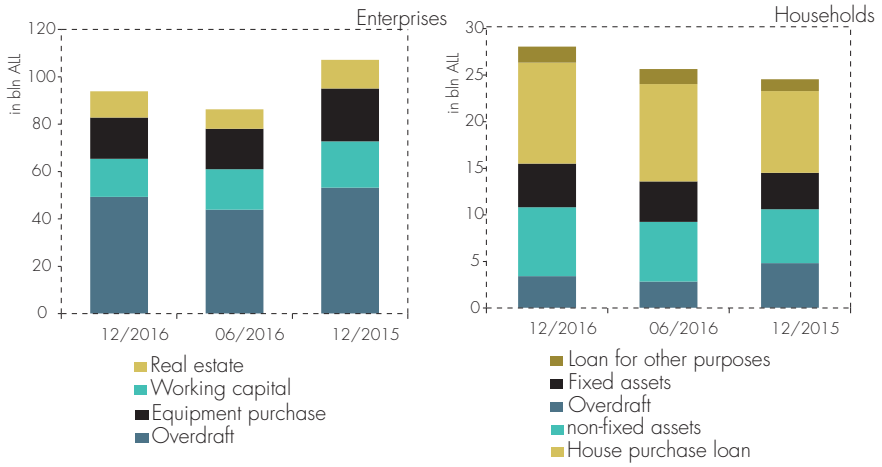
Chart 8.5 New loan, Moving average, 3 months



Source: Bank of Albania.

(67) Banking sector accelerated lending to households, but reduced lending to enterprises. In annual terms, outstanding loans to households expanded by 3.7% while that to enterprises expanded by 2.4%[45]. During the period, new loans to households grew by 14.3% over the same period a year earlier, where the loan for real estate purchase gave the main contribution to this expansion. From a year earlier, its share in the new loans to households grew by 3 p.p., up to 39%. Conversely, during the period, new loans to enterprises shrank by 12.2%, as a result of tightening of credit for "equipment purchase" for "working capital" and "overdraft". Outstanding loans to the public sector accounts for a low share, 4.8% in the total, but the new loans to this sector during the period account for 12.6% of the total.

Chart 8.6 New loans by purpose of use

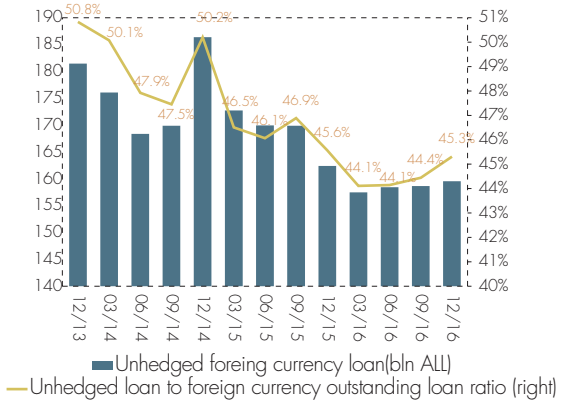


Source: Bank of Albania.

[45] *Referring to the results of "Lending activity Survey 2016 Q4", the banking sector eased the lending standards to households and tightened lending standards to enterprises, reflecting thus for the latter, specific issues of the sector, non-performing loans and banks perception on macroeconomic situation.*

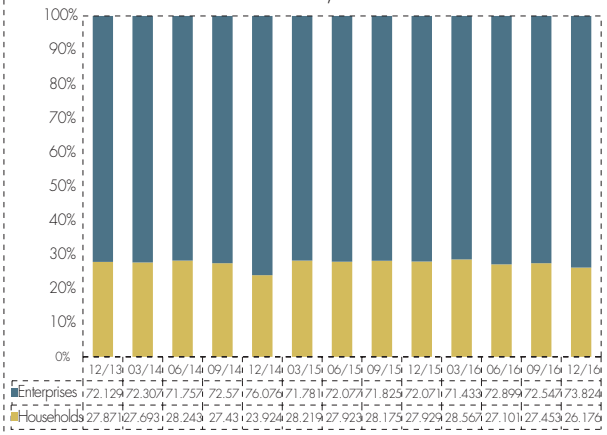
(68) Banking sector exposure to loan indirect risk remains high, especially for the business. In December 2016, the unhedged foreign currency loans from the adverse fluctuations of exchange rate (unhedged foreign currency loans) account for 45.3% of the total foreign currency loans (1.2 p.p. higher than in June 2016) and 26.6% of the total outstanding loan (almost unchganged from the previous period). By entities, the outstanding unhedged foreign currency loans to enterprises account for 74% of the total of such loans. Outstanding unhedged loans, during the period, expanded by 0.7%, to ALL 159.5 billion, driven by the considerable expansion of unhedged loans in the US dollar by about 37.3%[46]. By entities, unhedged loans expanded during the period, reflecting the increase of this loan to enterprises by 2.6%. In annual terms, the contraction of the unhedged foreign currency loans by 1.8% reflects the reduction of the outstanding unhedged loans to households; for enterprises ,this loan expanded by 1.3%.

Chart 8.7 Unhedged foreign currency loans



Source: Bank of Albania.

Chart 8.8 Unhedged foreign currency loans, by entities, %

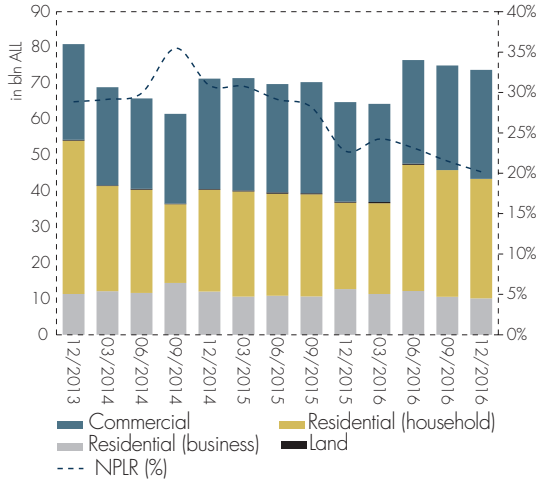


Source: Bank of Albania.

(69) The unhedged foreign currency loans for investment in real estate accounts for 46% of total unhedged loans, contracting, compared to the previous year. The rest of the unhedged foreign currency loans was granted mainly for trading and business development purposes (Chart 9.12).

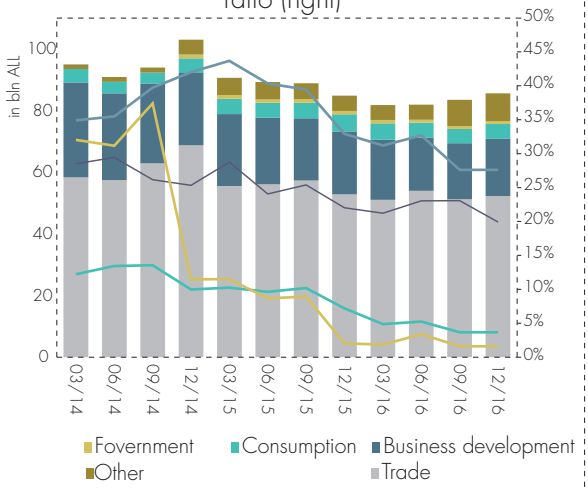
[46] *Outstanding US dollar loan , when the borrower's income is in Albanian lek, accounts for 18.1% of the outstanding unhedged foreign currency loans.*

Chart 8.9. Unhedged foreign currency loans for immovable property and its quality (right)



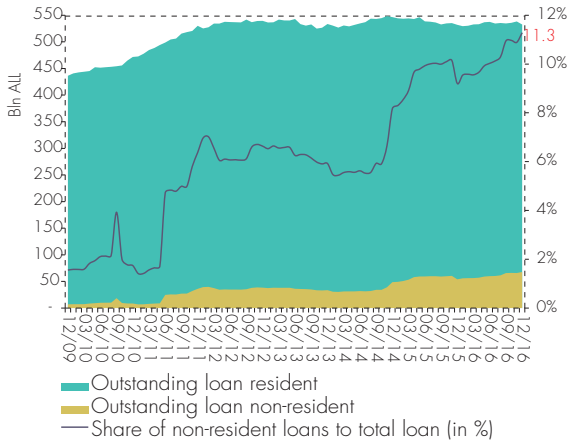
Source: Bank of Albania

Chart 8.10 Unhedged foreign currency loans (not for immovable property) and non-performing loan ratio (right)



Source: Bank of Albania

Chart 8.11 Lending to households



Source: Bank of Albania

(70) The banking sector increased its exposure to credit in non-resident entities. The share of loans to non-resident entities rose to 11.3% of outstanding loans in December 2016, from 9.2% a year earlier. Outstanding loans to non-residents stood at ALL 67.8 billion, up by 25.6%, yoy, and 13.1% during the period. Up by 25.5% yoy and 14.4% during the period, loans to enterprises provided the main contribution to this growth. It accounted for 86% of the total. Overall, loans to non-residents were oriented toward longer-term maturities, with the main share in the medium term (52%), followed by the long-term loan (30%).

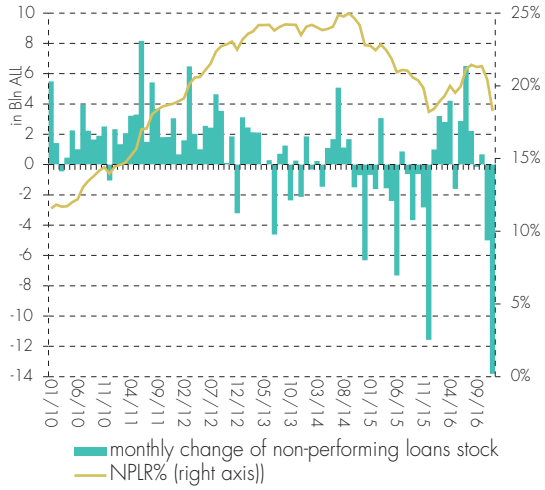
8.3.1 CREDIT RISK

(71) During the period, the outstanding non-performing loans[47] narrowed by around 8%, to ALL 109.7 billion, reflecting the decrease in the non-performing loan ratio. Credit growth for the first classes classified as "non-performing" and mainly write-offs in the "lost" class, led to the reduction of non-performing loans stock. The value of written off loans in 2016 H2 amounted to around ALL 6.7 billion. In the one year horizon, banks wrote off about ALL 12.6 billion lost loans from the balance sheets[48].

[47] *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).*

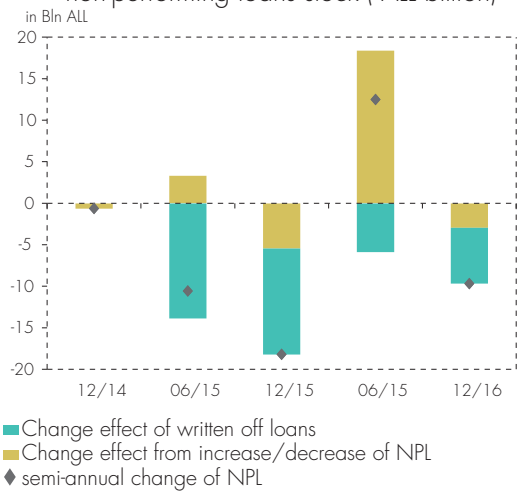
[48] *Starting from January 2015, banks are obliged under the regulatory requirements to undertake the process of balance sheets cleaning - the write off of loans falling under the category "lost" for more than three years. In total, ALL 39.3 billion loans falling under the category "loss" have been written off from the balance sheet over two years.*

Chart 8.12 Non-performing loans ratio



Source: Bank of Albania

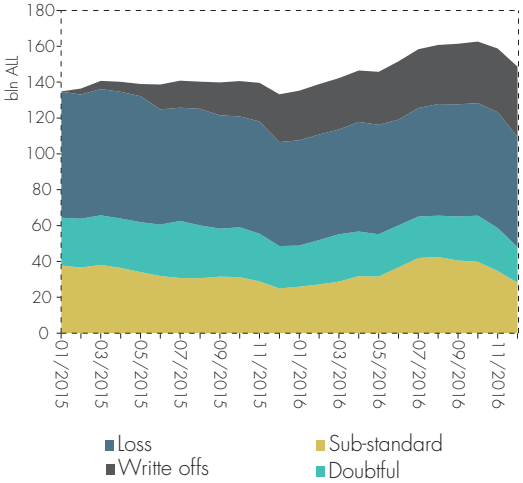
Chart 8.13 Contribution to the change of the non-performing loans stock (ALL billion)



Source: Bank of Albania

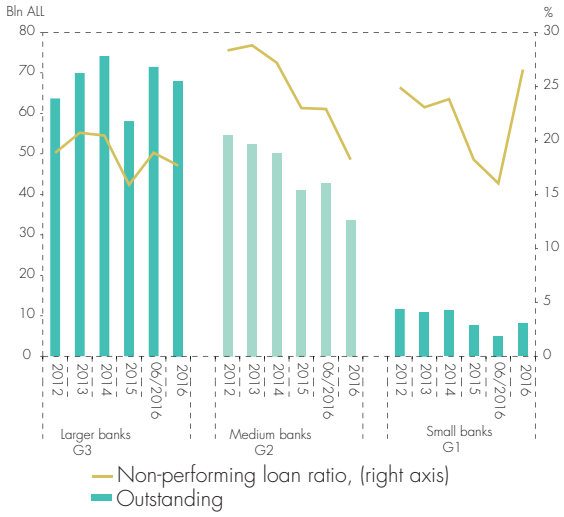
(72) At the end of the period, the non-performing loans ratio (NPLR) was 18.3%, narrowing by 1.7 percentage points from June 2016, but remaining close to the level of the previous year. As a result of repayments, restructuring and write-offs of loss loans, within the structure of non-performing loans, the share of lost loans increased by 6.7 percentage points during the period, accounting for 56% of non-performing loans.

Chart 8.14 Non-performing loans structure



Source: Bank of Albania

Chart 8.15 NPL portfolio by bank groups

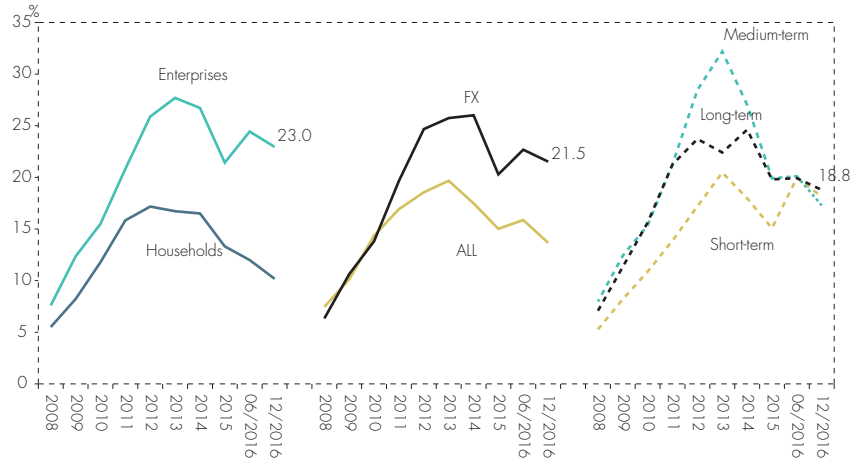


Source: Bank of Albania

(73) The medium-sized banks provided the main contribution to the improvement of the credit quality, together accounting for 31% of the outstanding NPLs. The NPLs for this group of banks narrowed by 21.2%, whereas the NPLR decreased by 4.7 p.p. to 18.2%. Larger Banks (G3) report the lowest level of non-performing loans by 17.7%, down during the period by 1.2 p.p., while Smaller Banks (G1) have the highest level of NPLRs by 26.6%, up by 10.5 percentage points during the period.

(74) The credit quality appears lower for the foreign currency loans, loans to enterprises, and long-term loans. In December 2016, the credit quality for each portfolio stood at 21.5% (foreign currency), 23.0% (enterprises) and 18.8% (long-term).

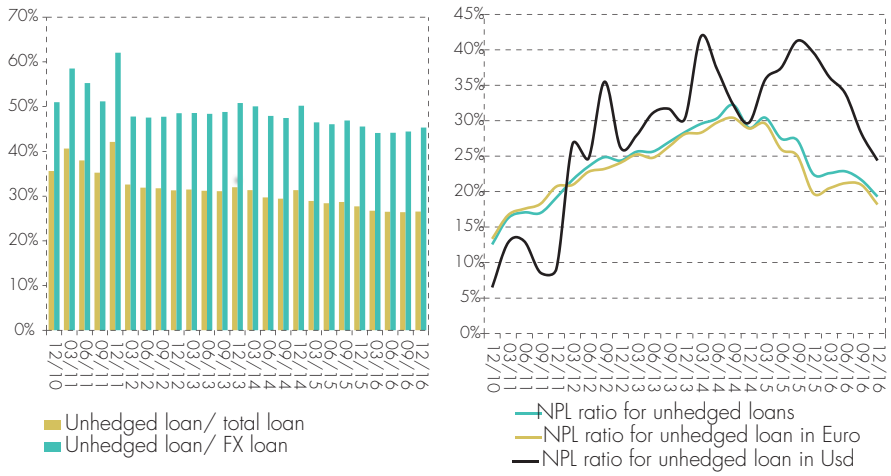
Chart 8.16 Non-performing loans in the Albanian banking sector



Source: Bank of Albania.

(75) Quality of unhedged foreign currency loans has continuously improved since the beginning of 2015. For the unhedged foreign currency loan, the NPL ratio fell to 19.3% (3.6 p.p. lower compared to June 2016). By currency, the quality ratio for unhedged euro loans improved by 3.0 percentage points, amounting to 18.2%, whereas for unhedged US dollar loans, it improved by around 9.4 percentage points, amounting to 24.4%. The unhedged credit for "business development" has the highest NPLR, at 27.6%, followed by credit for "trade" purposes, at 19.9%, which improved during the period.

Chart 8.17 Quality of the credit portfolio unhedged against the exchange rate risk



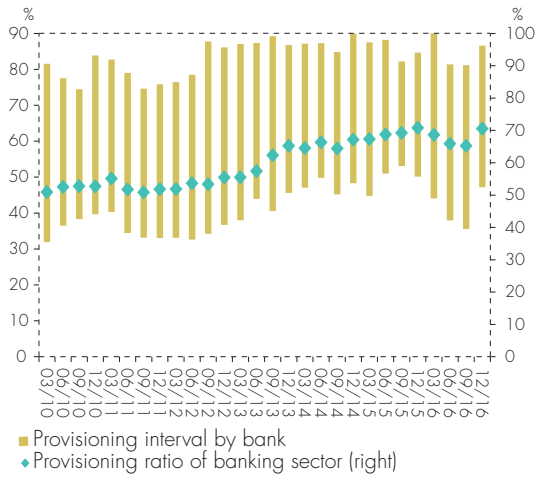
Source: Bank of Albania.

(76) Credit quality to non-resident entities was considered at relatively good levels, as "non-performing loans to outstanding credit ratio" was 3.3% and has been falling since mid-2014. During the period, the NPL stock for these entities narrowed by 31.7%, at ALL 2.3 billion, while the NPLR dropped by 0.2 percentage point. Compared to the end of 2015, the NPLR narrowed by 1.3 p.p., while the NPL stock narrowed by 8.7%. This, however, is a relatively new loan, in recent years, and contains some specifics related with the ability of banks to adequately asses the risks of the borrower who operates in a foreign jurisdiction. Therefore, its quality assessment requires continuous attention and monitoring.

8.3.2 CREDIT RISK MITIGATING FACTORS

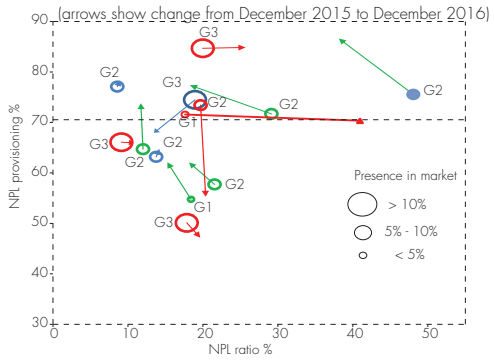
(77) The NPLs provisioning coverage ratio expanded over the period, driven by the rapid reduction of the NPL stock. In December 2016, the provisioning coverage ratio rose at 70.5%, from 65.9% in June 2016. The faster narrowing of the outstanding NPLs provided the main contribution to the expansion of the coverage ratio for the period.

Chart 8.18 Provisioning ratio over time



Source: Bank of Albania.

Chart 8.19* Annual change in provisioning ratios for banks



*Note: This includes banks sharing more than 1% in total assets. Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows the average ratio of NPL provisioning at sector level, 70.5% at end- December 2016.
Source: Bank of Albania.

(78) The decrease in the NPLs net value during the period has contributed to the increase in their capital coverage. During the period, the ratio of net NPLs to outstanding credit narrowed by 1.4 p.p., to 5.4%. In the previous year, the ratio stood at 5.3%. At the same time, as a result of the lower exposure to credit risk through the narrowing of the outstanding net NPLs, the "net NPLs/ regulatory capital" fell to 23.1% from 30.2% at the end of June 2016. In the previous year, the ratio stood at 24.1%.

(79) Loan collateral coverage remains at high levels and maintains the high concentration in the form of collateral as "immovable property". In December 2016, the collateral coverage[49] rose to 71.2% from 71.0% in June 2016. The loans collateralised by immovable property account for 69.4% of collateralised loans and 49% of outstanding credit. The quality of the collateralised loan improved during the period, compared to the previous year, and the NPLR stood at 17.7%. Collateralised loans with "cash" show faster improvement of credit quality. In December 2016, such loans had the lowest level of NPLR, about 0.95%. Despite reporting a significant improvement in credit quality (NPLR dropped by 3.1 percentage points during the period), loans collateralised by commercial immovable property continue to show the highest level of the NPLR by about 22.2%. The uncollateralised loan which accounts for 29% of the total loan shows an expansion the non-performing loans ratio during the period by 1.5 p.p., at 19.8%.

Because immovable property is highly used as collateral to secure credit, the sector is more dependent on the need for an efficient functioning of this market and of the legal process of collateral enforcement.

Chart 8.20 Outstanding credit and non-performing loans by collateral

Source: Bank of Albania.

8.4 DEPOSITS AND LIQUIDITY RISK

(80) In December 2016, the deposits stock in the banking sector amounted to about ALL 1,160 billion, or about 5.3% higher than at the end of 2016 H1. Almost the entire annual deposit growth was realized during the period. Households' deposits prevail in the deposit stock, but expanded at a slower pace compared to enterprises deposits. The decline in interest rates is associated with further contraction of time deposits and significant rise in the share of current accounts and demand deposits.

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

Table 8.3 Main indicators of deposits in the banking system

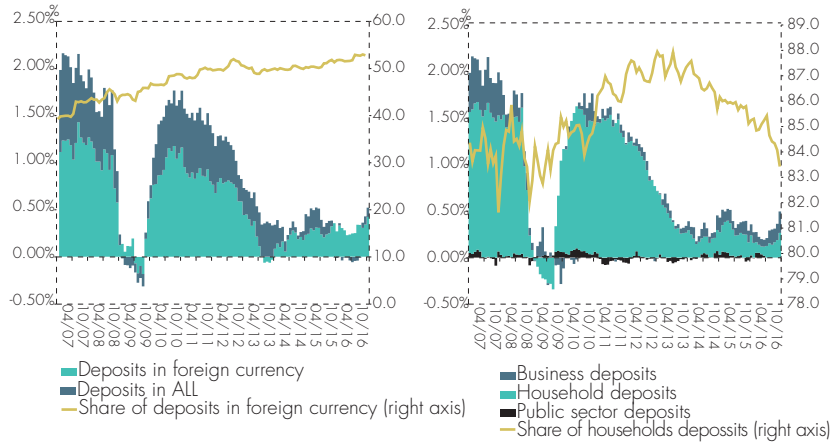
	Indicator and unit	Value (in ALL bln)	Share to total deposits (%)		Change	
	Period	12/2016	12/2016	12/2015	Annual	6-month
By currency	Lek deposits	546	47.2%	48.7%	2.0%	2.7%
	Foreign currency deposits	611	52.8%	51.3%	8.3%	7.6%
By institution	Public sector	29	2.5%	2.4%	11.6%	-4.9%
	Enterprises	163	14.1%	12.5%	18.6%	24.2%
	Households	966	83.4%	85.1%	3.1%	2.9%
By product	Current account	374	32.3%	27.0%	25.8%	19.2%
	Demand deposits	91	7.9%	6.3%	30.8%	19.5%
	Time deposits	669	57.8%	64.8%	-6.1%	-3.0%
	Deposits' stock	1.158	100.%	100.%	5.2%	5.3%

Source: Bank of Albania.

(81) Expansion of foreign currency deposits has been a major contributor to the growth of deposits in 2016. The share of foreign currency deposits increased to 53% of the total, with a positive contribution by foreign currency deposits of both households and enterprises.

(82) During the period, households' deposits grew by 2.9%, while enterprises grew by 24%. In annual terms, the growth was respectively 3.1% and 18.6%. While enterprises' deposits account for about 14% of the total, their substantial growth over the period provided half of the contribution to the total growth of deposit stock. Foreign currency deposits account for about 51% of households' deposits and about 63% of enterprises deposits, and together they recorded the fastest growth during the period.

Chart 8.21.Contribution in the growth of deposits



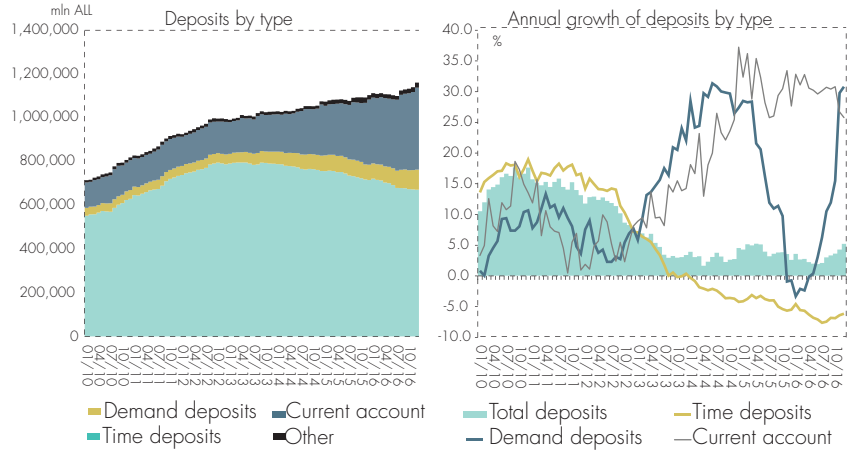
Source: Bank of Albania.

(83) Time deposits continue to have the major share in the total value of deposits, but they narrowed in absolute and relative terms to deposits stock[50]. During the period, time deposits decreased by ALL 21 billion or 3%.

[50] *Since October 2013 (annual growth of term deposits began to register negative rates), time deposits fell by 12.7% and their share to total deposits decreased from 77% to 57.8%. Compared with the end of last year, time deposits fell by ALL 43.8 billion or 6.1%.*

The annual growth of the stock of current accounts (by about 31% during the period) and, to a lesser extent, the increase of demand deposits continued to provide the main contribution to the growth of the deposits stock.

Chart 8.22 Deposits by type



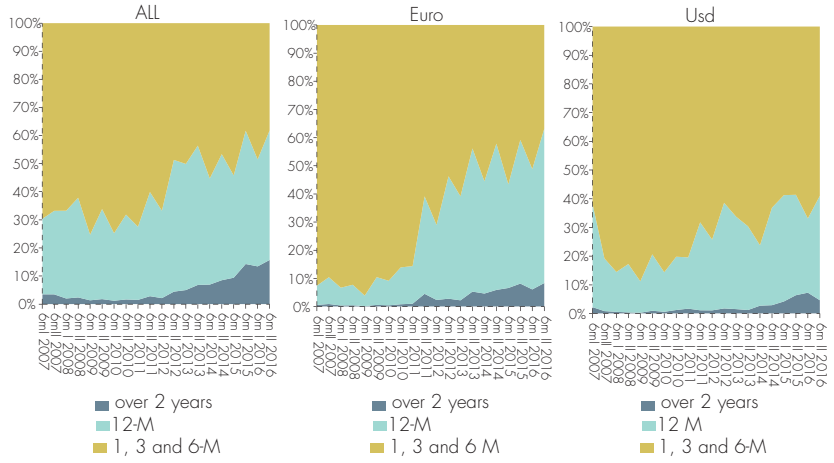
Source: Bank of Albania.

(84) Changes in deposits during the period reflected the way they are distributed by banking groups. Thus, about 66% of the deposit growth is concentrated in the larger banks, and 29% in medium-sized banks. Growth of deposits was also noted in the group of smaller banks. The concentration of deposits according to Herfindahl's Index stands below moderate levels[51] (1.447 points).

(85) During 2016 H2, the flow of new time deposits (replacement and new placement) in the banking sector was ALL 330 billion. Their share in total new deposits (19%) experienced minor fluctuations during the period. There was a slight shift of new time deposits toward longer-term maturities. The flow of new deposits in lek increased by 7.7%, in US dollar increased by 10% and in euro by over 20%. During 2016 H2, the average interest rates on new time deposits in lek continued to fall to 0.8%, while interest rates on new deposits in US dollar and euro remained almost unchanged (0.25 %).

51 If the values of the Herfindahl index are up to 1500, they indicate a competitive market, 1500-2500 moderate competitiveness, and over 2500 high concentration.

Chart 8.23 New time deposits by currency and maturity, 6-month flows



Source: Bank of Albania.

BOX 8.1 THE PRESENCE OF EUROISATION IN THE ALBANIAN ECONOMY AND THE NEED FOR ITS TREATMENT

The term dollarization/euroisation implies the use of a currency or currencies from entities resident in a country (mainly the US dollar or the euro) as an alternative to the local currency. The literature generally distinguishes these forms of euroisation: a) financial euroisation, which represents the assets and liabilities in foreign currency held by the resident entities and are reflected mainly in the balance sheets of the financial institutions; b) real euroisation, which implies the indexing of transactions, prices and wages with the exchange rate of a particular currency; and c) the euroisation of transactions, or the replacement of the local currency through the executions of transactions in foreign currency. An economy may have one or more of the above-mention euroisation forms.

The presence of the euroisation in the economy has important implications on the effectiveness of the monetary policy. In terms of macro-economic policies, the euroisation decreases the effectiveness of the monetary policy; limits the free exchange rate as an automatic stabiliser in case of macro-economic shocks, in the conditions of higher sensitivity of the economic entities to large fluctuations of the exchange rate; and weakens the effectiveness of fiscal policy through potential increase of the debt service cost and changes to its structure. In terms of financial stability, euroisation increases the exposure of the financial system and the economic agents to unfavourable developments in the exchange rate and stress situations of liquidity in the foreign currency. On the other hand, a high level of euroisation is usually associated with costs for the central bank in the form of opportunity cost for maintaining a relatively higher level of foreign currency reserves, as well as the loss of earnings (seigniorage) that accompany the substitution of the local currency by the foreign one.

Euroisation in Albania is present in both sides of the banking sector balance sheet. The narrowing of the positive spread of the average interest rate of loans in lek and that of loans in foreign currency, as a consequence of the accommodative monetary policy of the Bank of Albania, as well as e more passive attitude of the foreign banking groups on loans in foreign currency, have contributed to the decrease of the share of loans in foreign currency at around 60% of total loans (from around 72% in 2008), although this share continues to be considered as high.*

On the liabilities side, deposits in foreign currency constitute 53% of the total, trending upward from 43% registered in 2008. The narrowing of the positive spread between the average rates of saving in lek and in foreign currency, this time has supported savings in foreign currency. The euroisation of assets and the euroisation of liabilities of the banking sector are related close to each other. In accordance with the principles and the requirements for the exchange rate risk mitigation, the banking sector aims to maintain a balanced position in the composition of the balance sheet items according to currency. As a consequence, the increase of financing sources in foreign currency is reflected over time on the assets size. On the other hand, foreign currency lending is reflected on the banking system foreign currency liabilities, in the conditions when the use of credit by the borrower for making investments or different acquisitions from other entities, increases the value of the placements of these entities in the banks.

In this regard, the Bank of Albania considers that the increase of euroisation in the banking sector liabilities exposes the banking sector to the possibility of lending recovery in foreign currency for resident entities (which also had the more rapid deterioration of credit quality) and to investments in assets abroad, which reinforces the vulnerability of the banking sector and the agents in the real economy, to unfavourable developments in the exchange rate, and, at the same time, narrows the necessary monetary policy transmission channels. Hence, the identification of measures to control and decrease the level of euroisation improves the implementation of the Bank of Albania policies and financial stability as a whole, as long as it serves to reduce the systemic risk.

It is clear that de-euroisation cannot be only a target of the financial system for as long as foreign currency is widely used by the public for various transactions. For this reason, the de-euroisation approach must be all-encompassing where other national authorities may identify and undertake various measures to encourage both the public and economic agents to increase the utilisation of the domestic currency. In this case, the target must be realistic: decreasing the euroisation to zero would be objectively very difficult to realize, and can even be economically unjustifiable. On the other hand, undertaking strong actions that aim at a quick result may be accompanied by considerable cost for the entities subject to these measures, and may cause undesirable effects on certain economic and financial indicators. The target in this context should be the control of the current levels of euroisation and its decrease in the long term

to more appropriate levels, comparable with that in peer economies.
The Bank of Albania aims to approach this phenomenon strategically by seeking to collaborate with other national authorities. For this purpose, Memorandum of Cooperation has been prepared, which will be proposed for approval to the Ministry of Finance and the Financial Supervision Authority. The Memorandum encourages each authority, within its field of competence and in a coordinated manner to identify the necessary actions toward de-euroisation, including the communication with the public. The document will also include monitoring mechanisms to assess and report regularly on the effect of the measures undertaken by the authorities on various financial and economic indicators.

The Bank of Albania has started the process of identification and assessment of measures that may be undertaken initially to address the levels of euroisation in the banking system. These measures will be aimed at reducing the risks associated with high levels of euroisation, on both sides of the banking sector balance sheet.

** Recommendation on foreign currency loans, 2011, European Systemic Risk Board.*

8.4.1 LIQUIDITY RISK

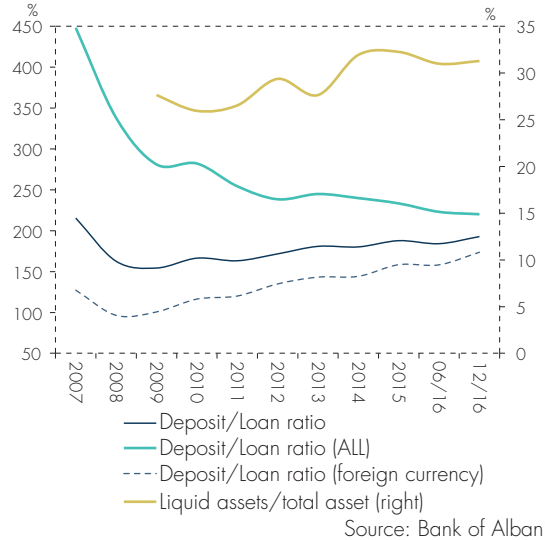
(86) Liquidity position of the banking sector stands at good levels. The liquidity indicators both in lek and foreign currency stand above the minimum regulatory level. Deposits remain the main source of financing, covering almost twice the volume of loans for the sector.

(87) The banking sector maintains a good liquidity position with a considerable outstanding ratio of client deposits to loans. In December 2016, the deposit-to-loans ratio registered 192.8% (loans-to-deposits 51.9%). By currency, this ratio registered 220.1% for the domestic currency and 173.6% for foreign currency.

Liquid assets in banks' balance sheets remain high, while lending performed below potential. At the end of 2016, liquid assets accounted for 31.3% of total assets of the banking sector, slightly downward during the period, by 0.3 p.p. The other liquidity indicator, "liquid assets/total short-term liabilities", trended also down, by 0.5 p.p., to 40.6%.

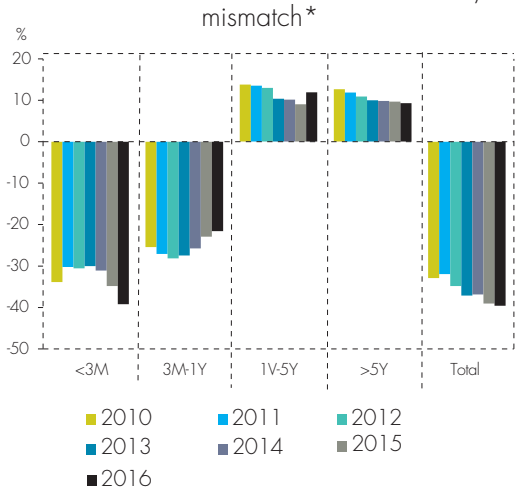
Although banks are operating in conditions of ample liquidity, the negative gap between assets and liabilities, by residual maturity segments, against total assets is considered as high and upward from the previous year, in the short term.

Chart 8.24 Liquidity indicators



Source: Bank of Albania.

Chart 8.25 Assets and liabilities maturity mismatch*

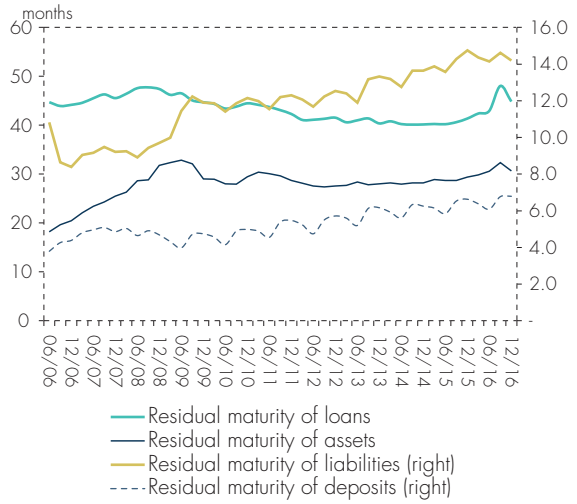


*Out of balance sheet assets and liabilities are included as well.
Source: Bank of Albania.

(88) During the period, the difference between medium-term assets and liabilities was maintained. This difference was around 16.5 months. Deposits residual maturity, as the most representative item of liabilities, expanded to 6.8 months, in accordance with the seasonal behaviour, from 6.1 months in June 2016. Credit residual maturity from the assets side expanded to 44.8 months (from 43 months in June 2016) reflecting the trend of the banks to increase crediting for longer term periods.

(89) The value of financing lines by parent bank groups has a very low share in the banking sector's financing sources. During the period, the total value of these lines registered ALL 6.3 billion, from 6.7 billion in June 2016. For banks that have a credit line with the parent bank groups at the end of the period, the level of their usage was 29.6%, from 26.9% in June 2016.

Chart 8.26 Average residual maturity



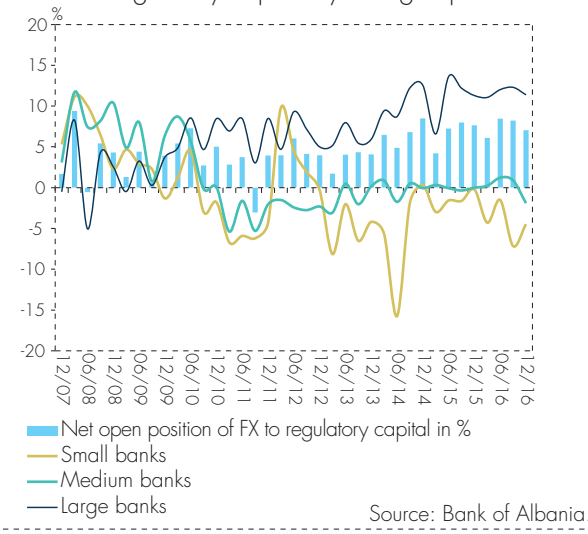
Source: Bank of Albania.

8.5 MARKET RISKS

8.5.1 EXCHANGE RATE RISK

(90) The sector's open foreign currency position to regulatory capital does not present important differences from the previous periods. In December 2016, at the sector level, the open foreign currency position is "long" at 7% of the regulatory capital, being 1.4 p.p. lower than June 2016 and 0.6 p.p. lower than the previous year. Larger banks continue to maintain a "long" position at 11.4% of regulatory capital, while smaller and medium-sized banks are positioned "short" at 4.5% and 1.9% of the regulatory capital, respectively. In general, these levels of open foreign currency positions represent a limited exposure of the banking system to the direct impact of exchange rate volatility on balance sheets.

Chart 8.27 Open foreign currency position to regulatory capital by size groups

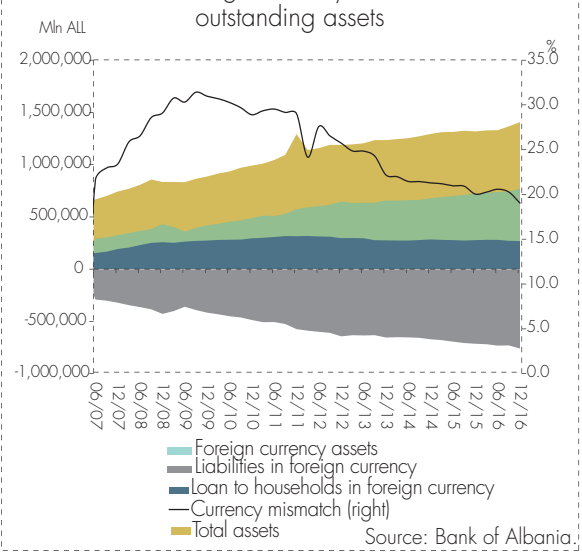


Source: Bank of Albania.

(91) The banking sector has decreased the exposure to indirect exchange rate risk, through the contraction of credit in foreign currency to residents. In December 2016, the foreign currency mismatch indicator[52] for all currencies stood at 18.4% of the assets. The contraction of credit in foreign currency for resident entities (by 3% annually) has contributed to the improvement of the foreign currency mismatch indicator by 1.8 p.p. in annual terms. By specific currencies, foreign currency mismatch in euro decreased by 1.2 p.p. during the period, at 17.4%; while in US dollars it decreased slightly at 1.3%.

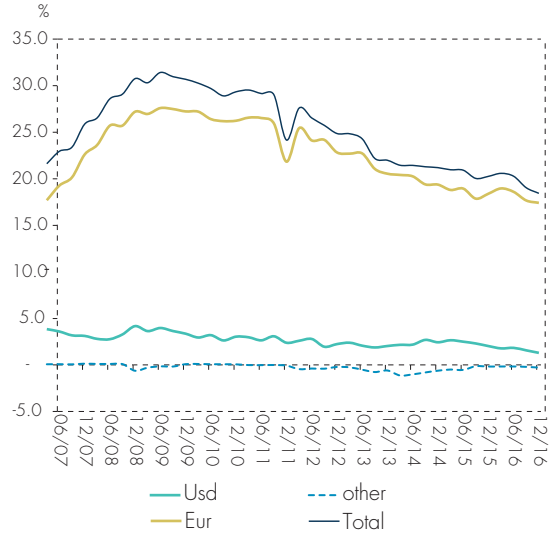
[52] *The foreign currency mismatch indicator measures the level of coverage of banking system liabilities in foreign currency with foreign currency assets in net foreign currency resident credit. A low value of the ratio of this indicator against assets shows low exposure to exchange rate fluctuations. For the calculation of the foreign currency mismatch indicator refer to the Financial Stability Report 2016H1.*

Chart 8.28 Foreign currency mismatch and net outstanding assets



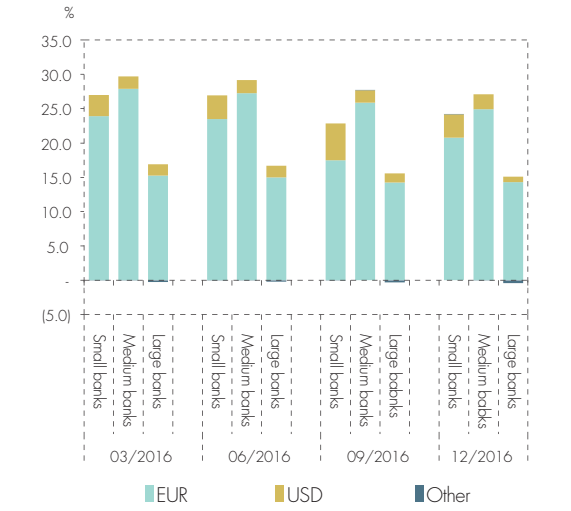
Source: Bank of Albania.

8.29 Foreign currency mismatch by currency



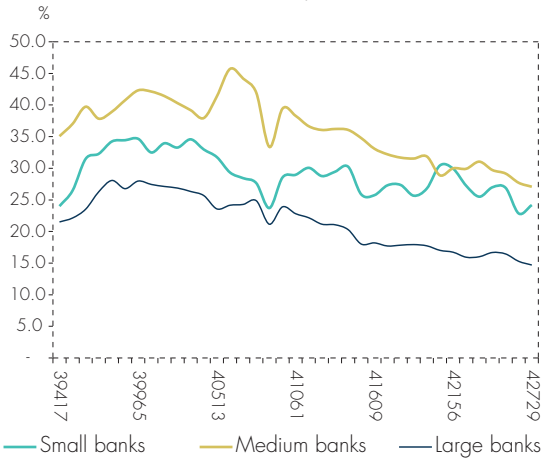
Source: Bank of Albania.

Chart 8.30 Foreign currency mismatch by currency



Source: Bank of Albania.

Chart 8.31 Foreign currency mismatch by groups



Source: Bank of Albania.

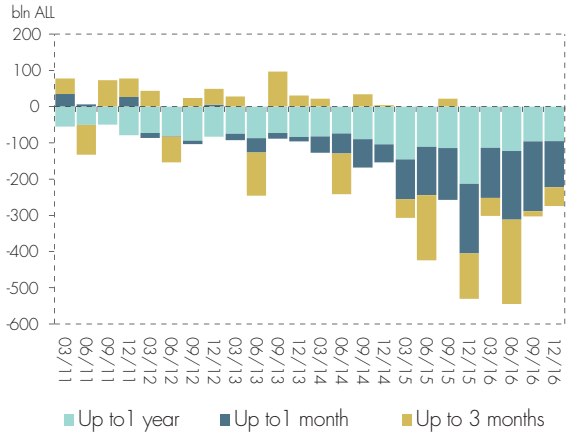
(92) The three peer banking groups registered a reduction of the exposure to exchange rate indirect risk. Larger banks, G3 group, reflect a higher coverage of foreign currency liabilities with foreign currency assets, where the foreign currency mismatch indicator decreased at 14.7%. Medium-sized banks registered the higher exposure to indirect exchange rate risk, although downward, with the foreign currency mismatch indicator at 27.1%. For smaller banks, this exposure decreased at 24.2%.

8.5.2 INTEREST RATE RISK

(93) The banking sector is exposed to interest rate volatility when the spread between interest rate-sensitive assets and liabilities, by re-pricing periods, is negative. During the period, the sector has significantly reduced the exposure to interest rate volatility for the short-term period up to three months, narrowing the negative cumulative spread between interest rate-sensitive assets and liabilities at 3.6% of the total assets from the 17.5% in 2016 H1. It contracted as a result of the growth of the interest rate-sensitive assets, while the liabilities have registered a decrease. A similar trend was observed in the spread of one month maturity of interest rate-sensitive assets and liabilities, which decreased at 9% from 14% in June 2016. For the residual maturity up to one year, the assets-liabilities spread decreased by 2.5 p.p. during the period and by 9.4 p.p. compared with the previous year, at 6.8% of the sector's assets.

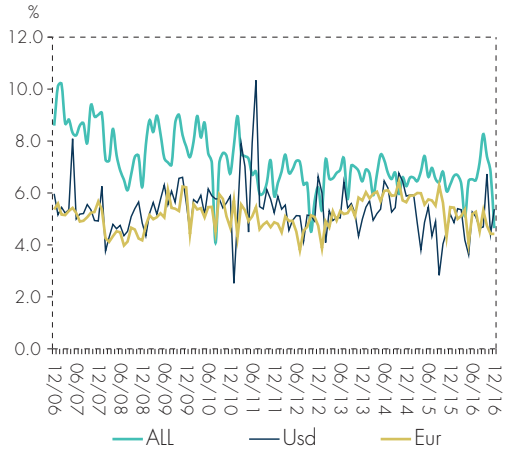
The narrowing of the spread between interest rate-sensitive assets and liabilities reduces the risk that the banking sector and specific banks will face costs in case economic developments suggest an increase of interest rates in the market. The assessment of the risk that may result from fluctuation in the interest rates should also keep into account the indirect impact from interest rate volatility on borrowers' solvency, in addition to monitoring the direct impact in the financial results of the banks (through the impact on net income from interests and income from revaluation). A potential increase of the interest rate may affect negatively borrowers' solvency and may be associated with problems in credit quality.

Chart 8.32 Maturity gaps by re-pricing periods



Source: Bank of Albania.

Chart 8.33 Interest rates spread by currency



Source: Bank of Albania.

8.6 OPERATIONAL RISK

(94) To assess the operational risk during the period, the Bank of Albania has paid increasing attention to the physical security of banking activity. This approach has also reflected the events of the previous year, where banks'

monetary values were robbed, generally during their transportation. On this issue, the Bank of Albania, in the context of improving security measures of financial entities, has organised the work for the revision of the Regulation, "On minimum security requirements on the premises where financial activities are carried out and on values' transportation", approved by Decision of the Supervisory Council No 67, dated 01.06.2016, which lays down some amendments focusing on strengthening security measures, planning, drafting, monitoring and supervising the implementation of the measures by commercial banks' security units. For the transportation of monetary values, subject to the obligation to be insured by insurance companies, the Regulation refers to the Law No 75/2014 "On Private Physical Security Services", an activity that is supervised by the State Police. In this context, the Bank of Albania has continuously collaborated with the State Police during 2016, contributing to preparing regulatory acts on the transportation of monetary values, in line with European Union's standards.

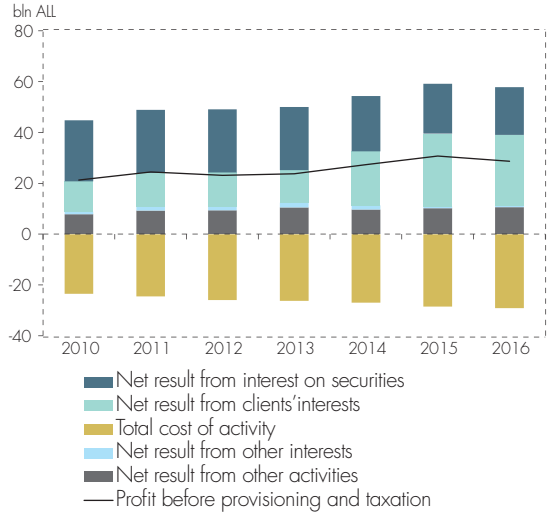
(95) A comprehensive assessment of banks' capacities to address operational risk shows a relative improvement, since the reported capital coverage of gross operational loss has improved significantly. However, the key risk indicators present a more varied picture. The trend of the indicators shows the need for further improvement of the process of identification and reporting of operational losses by business lines to reflect better the profile of the activity of the bank.

8.7 FINANCIAL RESULTS AND EFFICIENCY OF RESOURCES

(96) The banking sector closed 2016 with a positive financial result, but lower compared with the previous year. Due to the faster decline in interest income compared with the declining rate of financing costs, net interest income and interest net margin decreased. Expenses in the form of provisions for credit risk increased significantly and represent the main factor of the decrease of income in the banking sector. Other activities have had a lower impact on the financial result. The banking sector's return on equity (RoE) and return on assets (RoA) indicators registered a decrease in annual terms.

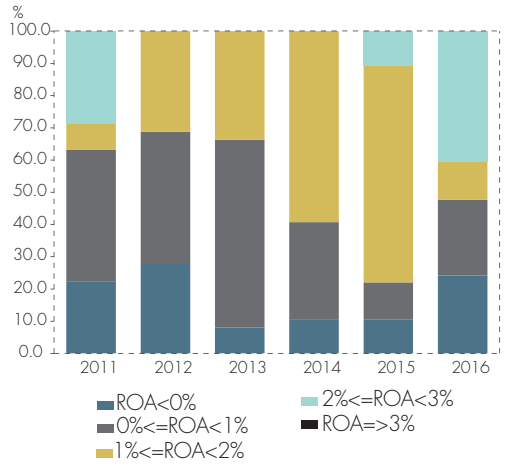
(97) At the end of 2016, the banking sector reported a positive financial result of ALL 9.3 billion, or about ALL 6.4 billion less than in the previous year. Although the increase of provision costs gave the main contribution in the decrease of income, net interest income also registered a decrease in annual terms. The main indicators of profitability, return on assets (RoA) and return on equity (RoE) registered 0.7% and 7.2%, respectively, being 0.5 p.p. and 6 p.p., respectively, lower than the end of 2015. By peer bank groups, medium-sized banks G2 group is the only group whose RoE and RoA show a slight increase.

Chart 8.34 Financial results components



Source: Bank of Albania.

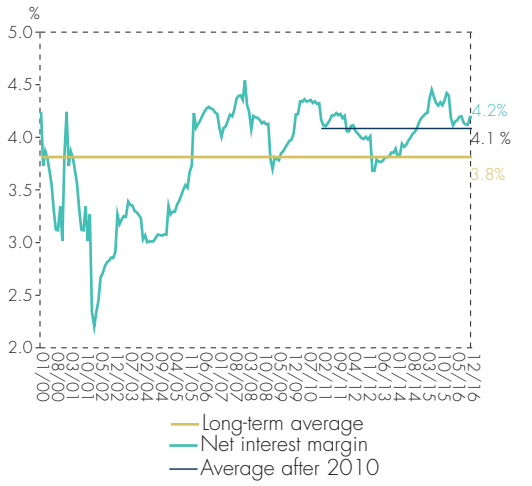
Chart 8.35 RoA by banks' share in the sector's asset



Source: Bank of Albania.

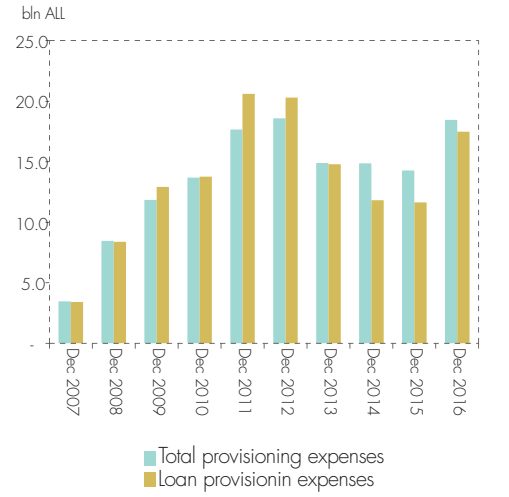
(98) The continuous lowering of financing costs did not sufficiently offset the fall of income from the main banking activity. Thus, net interests results decreased by ALL 1.8 billion, at ALL 47.2 billion, since the decrease of income from interests resulted higher than the decrease of expenses for interests. Consequently, the net interest margin decreased at 4.2%, from 4.4% in the previous year.

Chart 8.36 Net interest margin



Source: Bank of Albania.

Chart 8.37 Provisioning costs



Source: Bank of Albania.

(99) Provisioning costs for credit risk registered ALL 17.5 billion, or ALL 5.8 billion higher than the end of 2015, being the main contributor to the

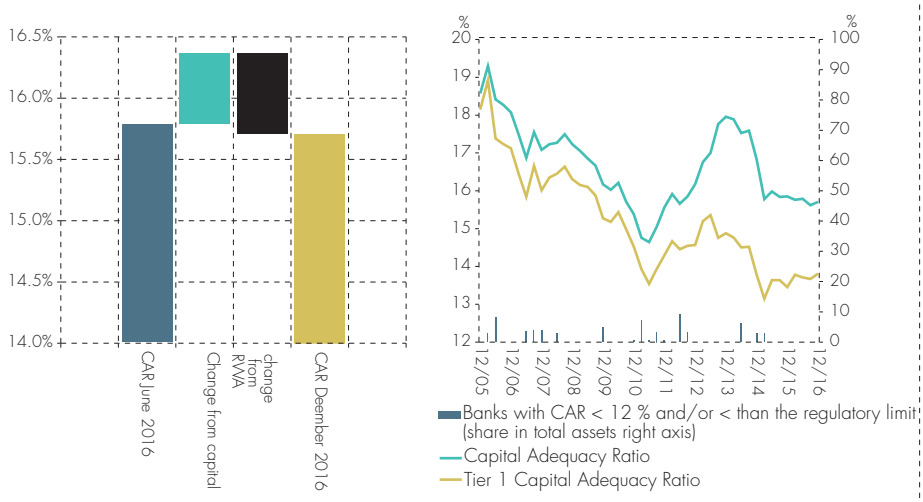
decrease of the sector's financial result. For individual banks, although the banking activity's net result did not register significant changes, the increase of provision costs gave the main impact in the decrease of the financial result. The share in banking sector assets of banks that registered financial loss increased to 24.2%, in comparison with the 10% average of the previous two years.

(100) **Lastly, the financial result from other activities increased by about ALL 0.4 billion, as a consequence of increased income from transactions with securities.** At the same time, the activity costs, although slightly up, were covered better by the activity income, thus registering a positive impact on gross operational income (before provisioning).

8.8 ACTIVITY CAPITALISATION

(101) **Banking sector capitalisation in December 2016 was estimated to be good and resulted stable, despite increased capital requirements for credit risk and investments in non-resident entities**. Good levels of capitalisation were supported by capital injection as well as the positive financial result. Banks have complied with the required regulatory level of the capital adequacy ratio.

Chart 8.38 Capital adequacy ratio

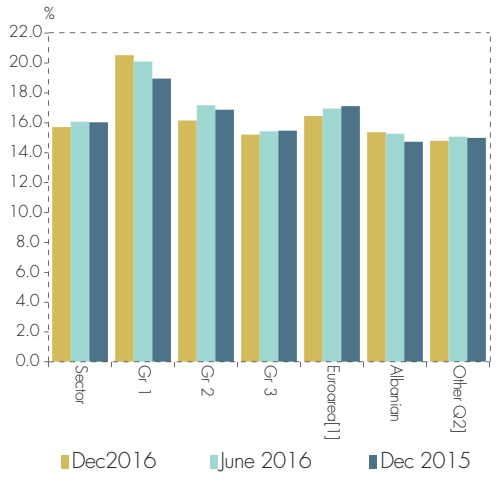


Source: Bank of Albania.

(102) **In December 2016, the capital adequacy ratio registered 15.7%, almost unchanged during the last year (15.8%[53] in the previous year)**. At the end of 2016, risk-weighted assets were about 4.3% higher compared with June 2016, contributing to the decrease of the capital adequacy ratio by 0.7 p.p. On the other hand, due to capital injections and maintaining a positive financial result, the regulatory capital increased by 3.8%, improving the capital adequacy ratio by 0.6 p.p.

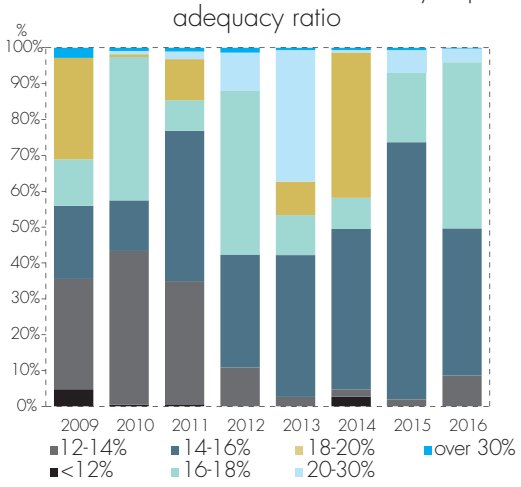
[53] *The capital adequacy ratio for the months December 2015 and June 2016 has been revised after the last certifications done by banks.*

Chart 8.39 Capital adequacy ratio by groups and capital origin



Source: Bank of Albania.

Chart 8.40 Sector's asset allocation by capital adequacy ratio

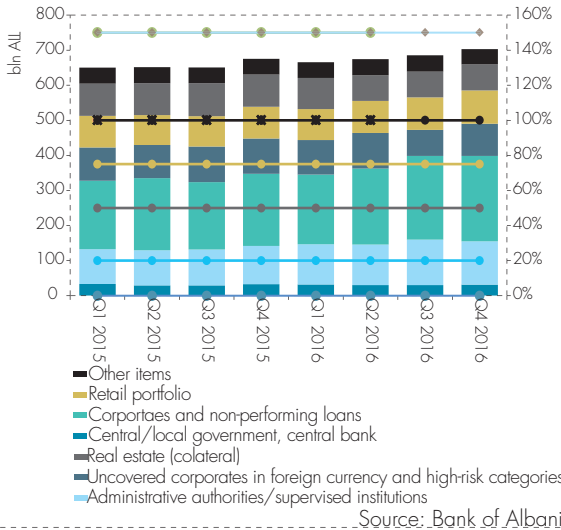


Source: Bank of Albania.

(103) At peer group level, banks of Group 3 registered a lower capitalisation ratio, while by capital origin, banks classified as "Other" and those with Albanian capital have lower capital adequacy ratios. For the most part, individual banks maintained capital adequacy ratios in the range of 14%-16% and 16%-18%.

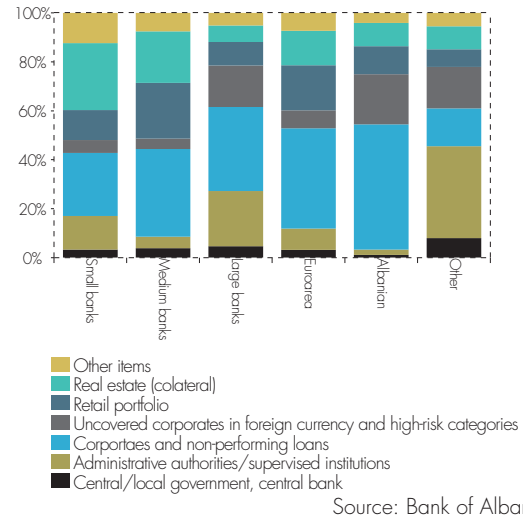
(104) The banking sector registered an increased exposure in terms of credit risk classes. Assets weighted for credit risk increased by about ALL 14.7 billion compared with 2016 H1, to ALL 703.2 billion. Credit categories are weighted with a higher risk coefficient, including credit to non-residents, unhedged credit in foreign currency (Chart 8.41). By peer bank groups, smaller

Chart 8.41 Risk-weighted coefficients and size of the main credit portfolio classes



Source: Bank of Albania.

Chart 8.42 Classes of credit exposures for banks by business size and capital origin

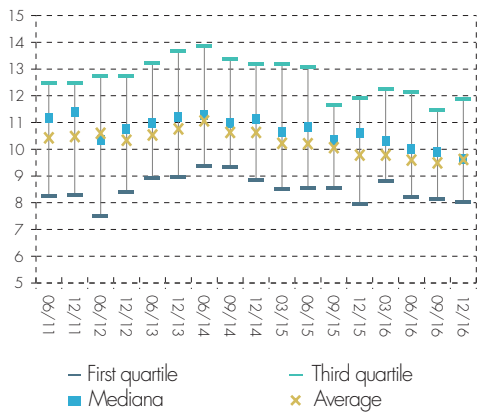


Source: Bank of Albania.

banks register high exposure to credit secured by collateral in the form of real estate; medium-sized banks have a higher exposure to credit to corporations and non-performing loans; meanwhile, larger banks are in addition exposed to managing bodies and supervised institutions. By capital origin, we notice that banks with Albanian capital have a higher exposure to the class "Credit to corporations and non-performing loans" (Chart 8.42).

(105) The implementation of some changes in the weighted assets coefficients, as part of May 2013 countercyclical measures by the Bank of Albania, gave a different impact on the capital requirement for banks. Thus, measures to support credit growth to the economy have had a lower impact on the improvement of the capital adequacy ratio, by only 0.16 p.p. This impact included gradual reduction, until the final closure of this measure at the end of 2016. The reorientation of credit toward the domestic currency, the favourable conditions of the low interest rate environment and the continuous improvement of credit quality as one of the determining factors of the crediting activity, decreased the need for this measure. On the other hand, measures that penalize investments in non-residents, have contributed significantly to the decrease of the capital adequacy ratio, during the period. In December 2016, the requirement for additional capital for those investments registered ALL 93.6 billion. As a result, the increase of non-resident investments has contributed negatively to the lowering of banking sector's capital adequacy ratio by 1.81 p.p., where larger banks continued to be the more affected. In order to establish an upper limit for additional requirement of capital, during 2017, the manner of implementation of this measure will change (see paragraph 64).

Chart 8.43 Financial leverage indicator, in times



Source: Bank of Albania.

(106) Capital requirements for market risk decreased, while those for operational risk remained unchanged compared with 2016 H1. During the period, capital requirements for market risk registered ALL 15.2 billion, decreasing by ALL 1.7 billion or 10.3%. Capital requirements for operational risk did not change. The latter account for approximately 10% of risk-weighted total assets, while the market ones only 1.7%

(107) The Albanian banking sector is characterized by a low financial leverage ratio, which confirms maintaining a good level of capitalisation. At the end of 2016, the financial leverage indicator[54] was 10.3 times, from 10.5 times of the previous year. The extent to which individual banks differ in terms of the level of financial leverage has not shifted significantly.

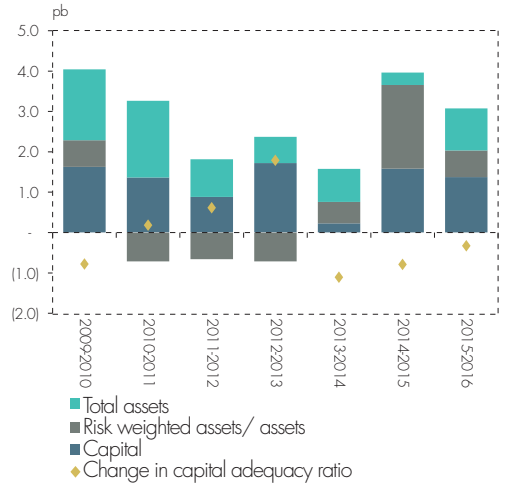
[54] *The financial leverage indicator is measured as a ratio of assets to equity.*

BOX 8.2. INFLUENCING FACTORS IN THE BANKS' CAPITAL ADEQUACY RATIO

The capital adequacy indicator reflects the simultaneous developments in the regulatory capital and in the risk-weighted assets, as well as all the elements that compose these items. In this box we assess the contribution of each element on the performance of the capital adequacy ratio (CAR) in the Albanian banking sector, in the period 2009-2016. Due to the generally small changes, the contribution to the change of the capital adequacy ratio is expressed in basis points (bp).*

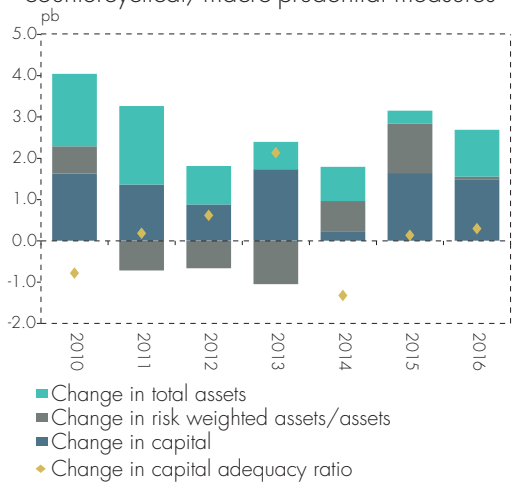
Chart 8.44 shows the contribution of capital indicators and weighted assets in the annual change of CAR. For the period 2009-2012, CAR generally improved, supported by the growth of regulatory capital, the contraction of risk-weighted assets and the performance of total assets. After 2013, CAR contracted reflecting a faster growth of weighted assets compared with regulatory capital growth.

Chart 8.44 Elements' contribution to the capital adequacy ratio, in basis points



Source: Bank of Albania, authors' calculation.

Chart 8.45 Elements' contribution to CAR, in basis points, exclud.the impact of countercyclical/macro-prudential measures

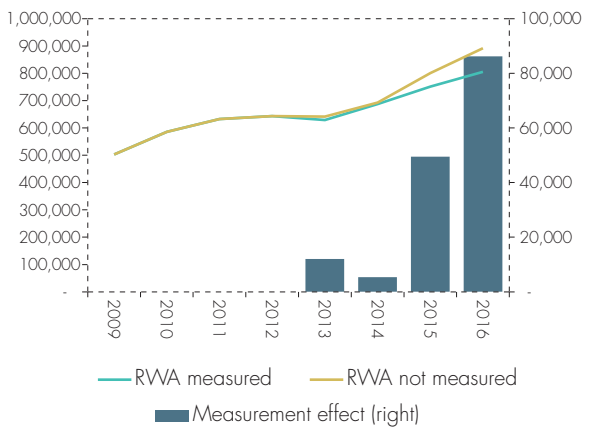


Source: Bank of Albania, authors' calculation.

In fact, developments in risk-weighted assets after 2013 have been significantly affected by the countercyclical measures of the Bank of Albania, reflecting the additional capital requirements for investments in non-residents.

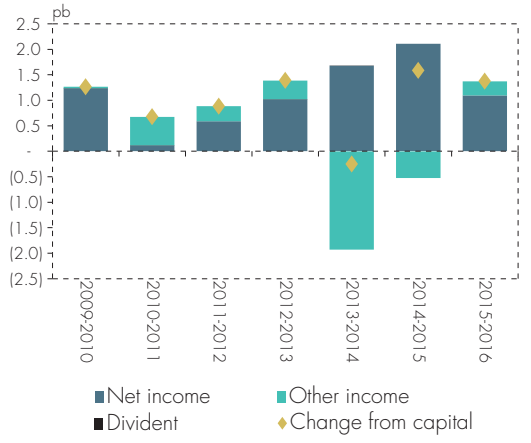
To measure the pure impact (that is not related to the regulatory requirements of the Bank of Albania) of risk-weighted assets in CAR, the contribution of the determinants to CAR is reassessed, if the countercyclical measures were not undertaken. As reflected in Chart 8.45, after 2013, in the absence of these measures, CAR would have improved supported by a faster growth of the regulatory capital compared to the expansion of risk-weighted assets. A more detailed impact of the countercyclical measures on risk-weighted assets is shown in Chart 8.46.

Chart 8.46 Risk-weighted assets (RWA)



Source: Bank of Albania, authors' calculation.

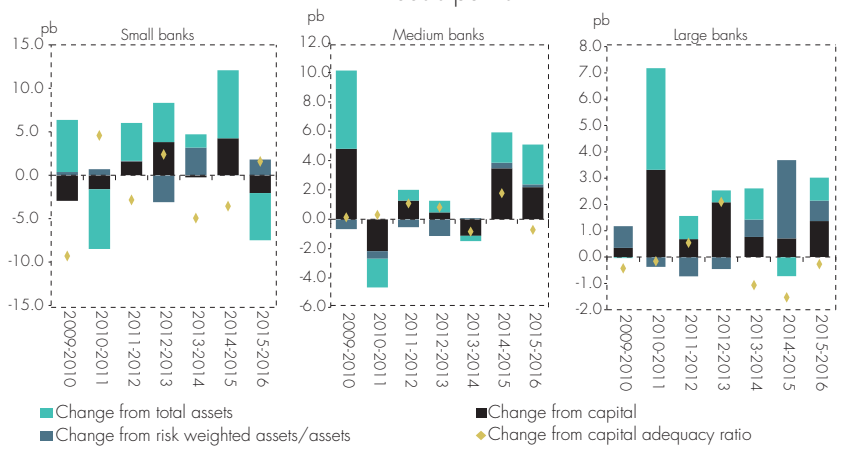
Chart 8.47 Sources of banks' capital growth



Source: Bank of Albania, authors' calculation.

The regulatory capital that directly affects developments in CAR includes several elements: net profit, dividends, retained profit calculated as the difference between net profit and dividends as well as other capital income/sources. The latter represents all those sources such as capital injections (share issue) and the differences of revaluation of fixed assets or securities available for sale. In the Albanian banking system, the distribution of dividends is limited, accounting for about 0.3% of regulatory capital; hence, its contribution is negligible. Further breakdown of CAR contributions from other elements is presented in Chart 8.47. Before 2013, the high contribution to regulatory capital growth came from net profit as well as from capital growth. After 2013, the positive contribution of net profit deepened, constituting the main source of regulatory capital.

Chart 8.48 Contribution in the performance of CAR by business size groups, in basis points



Source: Bank of Albania, authors' calculation.

At group level by business size, CAR for smaller banks is affected mainly by developments in the size of total assets, and less by capital growth. By contrast, for medium-sized banks regulatory capital is the main contributor; whereas for larger banks, the expansion of risk-weighted assets gave the greatest contribution to the contraction of CAR, after 2013.

**1 basis point equals 0.01%.*

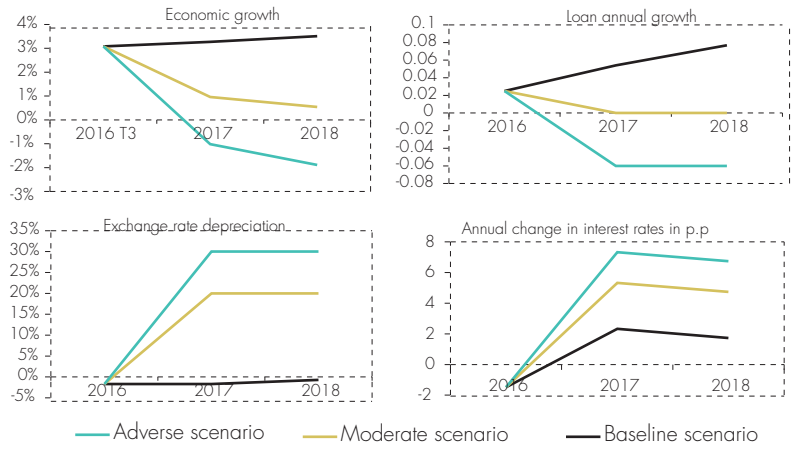
9. ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING[55]

(108) The stress test, which assesses the banking sector resilience against economic and financial developments two years ahead, shows that the sector continues to be stable. The stress test on liquidity also reflects adequate capabilities of the banking sector to withstand a situation of significant deposits withdrawal.

9.1 BANKING SECTOR RESILIENCE TO MACRO-ECONOMIC SHOCKS

(109) The stress test assesses the resilience of the banking sector for the period 2017-2018. This assessment excludes the possibility of increasing the paid in capital during the period and is performed by applying three scenarios, the baseline one and two adverse scenarios and low probability of occurrence.

Chart 9.1 Assumption to construct the stress test



Source: Bank of Albania.

[55] *Stress-testing is not a forecasting method. Intentionally, the scenarios contain adverse and extreme developments, but with a low occurrence probability, to test the resilience of the banking sector to them. Although banks are encouraged to assess their financial situation to withstand the effects from these scenarios, they should not consider these scenarios as events that the Bank of Albania expects to happen in the future. The scenarios vary over time, depending on economic and financial developments. On the other hand, the scenarios do not take into considerations the actions that the banks and the authorities may perform to constantly strengthen the financial situation and the resilience to banks' risks.*

(110) The baseline scenario assumes an improved economic growth until the end of 2018. In this scenario, economic growth is accompanied with credit growth and improvement of the credit portfolio quality until the end of 2018. For the same period, it is assumed a growth of the impact of the measures undertaken by the supervision authority on the treatment of non-performing loans.

(111) The moderate scenario assumes a positive economic growth, but significantly lower than the baseline scenario; while the adverse scenario assumes a contraction of the economy. These developments are assumed to be accompanied with other changes in the macro-economic and financial indicators, such as a depreciation of the exchange rate of lek, interest rates growth, as well as stopping or significant contracting of lending. All these factors affect the capitalisation indicators of the banking sector. Credit portfolio quality in these scenarios reflects, in addition to balance sheet cleaning, the new flows in non-performing loans. As a result, until the end of 2018, the ratio of non-performing loans is presented as worsened (increased) up to 15.6 p.p. in the moderate scenario and up to 32.3 p.p. in the adverse scenario against the baseline scenario level. Furthermore, in addition to worsening of credit quality, these two scenarios also assumes shocks in terms of market risk, including re-pricing securities risk, and operational risk.

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

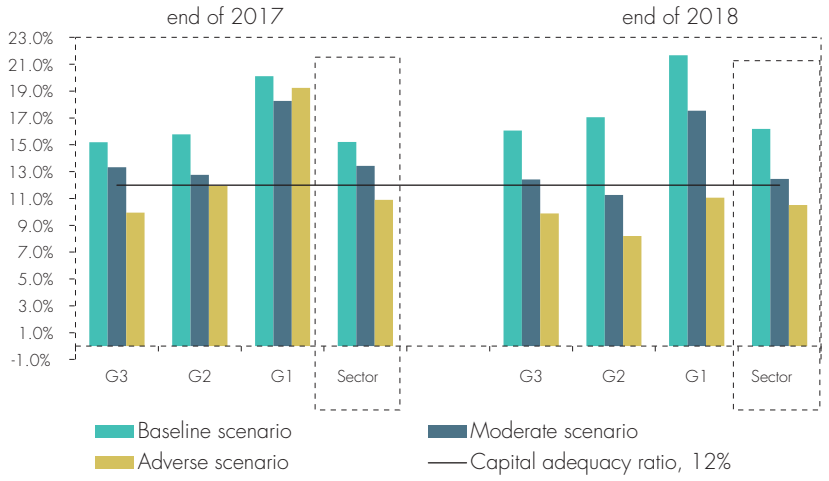
a. In the baseline scenario, the capital adequacy ratio (CAR) of the sector registers 15.2% at the end of 2017 and 16.2% at the end of 2018, following the improvement of credit quality and the higher pace of economic growth. Developments by banking groups as well show resilience and a level of capitalisation significantly above the regulatory minimum requirement.

b. In the moderate scenario, the CAR of the sector reaches 13.4% at the end of 2017 and 12.5% at the end of 2018. Developments in particular banks evidence the need for capital injection in 6 of them, which account for 36.6% of the sector's assets. In this case, the needs for additional capital reach up to ALL 12.1 billion until the end of 2018.

c. In the adverse scenario, the CAR of the sector decreases even further, starting with the more adverse assumptions included in the scenario. The CAR reaches 10.9% at the end of 2017 and about 10.5% at the end of 2018. In this scenario, the number of banks that fall below the capitalisation levels is higher compared with the moderate scenario, where the assumed macro-economic developments affect the significant worsening of credit quality, the level of losses in the securities portfolio and the increase of exposure toward market and operational risk. In this case, the needs for additional capital reach levels around twice higher than the moderate scenario.

(113) To put these values in the context of current developments, we highlight that during 2016 the banking sector augmented the capital by about ALL 10.4 billion, about ALL 3 billion higher than the capital injected throughout 2015.

Chart 9.2 Capital adequacy ratio, by stress test scenarios



Source: Bank of Albania.

BOX 9.1 SENSITIVITY OF THE BANKING SECTOR TO MOVEMENTS IN THE INTEREST RATE

Movements in the interest rate affect directly the banking sector financial result mainly in two items: net interest income and income from securities revaluation (for the purposes of sensitivity analysis, any indirect negative impact of the interest rate growth that is associated, for example, with credit quality decrease is not considered).

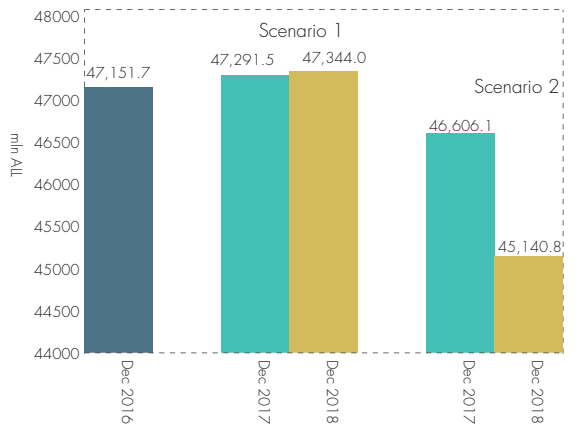
The sensitivity from net interest income is analysed according to two scenarios: Scenario 1, where the interest rates continue to decrease, although slightly compared with 2016; and Scenario 2 where the interest rates rise evenly during each year of the exercise against current rates, by 1 percentage point per year.

To analyse the impact from the increase of the interest rates according to the two abovementioned scenarios, we have to keep into account the structure of the banking sector balance sheet. More specifically, the banking sector structure in Albania registered a negative gap between assets and liabilities sensitive to the interest rate with 12 months maturity, indicating an increased sensitivity of the sector to the liabilities structure in case of an increase of the

interest rates. This is because for the same change in the interest rate, balance sheet liabilities are re-priced more than assets, contributing to the decline of net interest income. In the case of a decrease of interest rates, the contrary is true. Test calculation consider that in December 2016 there is a negative gap of ALL 95.4 billion and the share of re-priced liabilities within a year is considerable (83% of the total and higher than that of assets (76%).

In Scenario 1, when the interest rates show a slight decrease (0.1-0.2 p.p.), net interest income show a slight increase, which at the end of 2018 reaches ALL 192 million, against ALL 47,152 million registered in December 2016. In Scenario 2, when the interest rates start to increase, net interest income contracts by ALL 545.6 million in 2017 and by ALL 2,019 million at the end of 2018, against 2016 level.

Chart 9.3 Banking sector net interest income assessments, by scenarios



Source: Bank of Albania.

But the inverse relation between interest rate and securities value suggests that the assumed increase of the interest rate affect negatively in terms of the revaluation of the securities portfolio held by the banking sector as well, and vice versa. In this case, considering unchanged the entire securities portfolio held to maturity (HTM) and available for sale (AFS) at the end of 2016, the loss from securities revaluation due to the increase of the interest rate by 1% per year, is assessed at about ALL 5.5 billion each year. In case of the assumed increase of the interest rate in this test, the change in the revaluated securities value is negligible.

Given the comparison between the two abovementioned scenarios, we may say that the impact of the potential increase of the interest rates in the financial result (and consequently in the capitalisation indicators) of the banking sector needs to be assessed carefully and continuously by it.

9.2 LIQUIDITY STRESS TESTS

(114) Liquidity stress tests measure the ability of individual banks to withhold extreme but plausible shocks to their financing. These tests aim to identify weaknesses of the sector and to help the supervision authority in setting priorities for interventions with specific policies, including those aimed at reducing specific exposures or creating reserves, as well as assessing the readiness to face a liquidity stress situation.

(115) The analysis in this case is built on the basis of the liquidity structure of the sector in November 2016. The information is taken by individual banks

data, for granular money flows generated by assets and liabilities classified by maturity structure. The various scenarios assume some unexpected deposits withdrawal shocks and assess the adequacy of enlarged liquid assets[56] available for financing them. More specifically:

(i) The test assumes that banks will face significant deposits withdrawal, only through sales of expanded liquid assets (without asking for additional liquidity from the Bank of Albania);
(ii) Investments in securities are sold through the haircut of their value by 10% and 20%.

The bank is considered as failing the stress test only if expanded liquid assets contract to the level where there is a need of additional liquidity by the Bank of Albania in the form of loan for liquidity support.

(116) Results show that the banking sector generally passes the liquidity stress test without problems. Compared with the previous period, we observe a slight worsening of the situation for the lek and a significant improvement of the situation for the euro and US dollar. In the case of lek, the number of banks that did not manage to close the negative liquidity gap even after the sale of expanded liquid assets varies from 2 for short-term maturities, to 3 for long-term ones. For the euro, the negative gap is registered only for the most short-term maturity (up to 1 day) for only 1 bank. For the US dollar, the highest number of banks that register a negative gap is 3, mainly for longer term maturities. For all three currencies, the share of the gap against assets of the banking sector in the respective currency is quite low (0.1-0.3% for lek and 1.2% for euro and the US dollar).

Liquidity stress test results by currency, number of banks that continue to register a negative gap even after the sale of expanded liquid assets (November 2016)

(117) In conclusion, banks are assessed to have a good resilience to liquidity shocks. However, the low diversification level of liquidity reserves, which consists mostly in government debt securities, evidences the need for deepening and increasing liquidity for these instruments.

[56] *Unlike the concept of liquidity assets according to the Regulation of the Bank of Albania, which limits the maturity of securities included as "liquid assets", in this concept, for the purposes of this test, the entire securities portfolio is included.*

ANNEX. BANKING SECTOR FINANCIAL SOUNDNESS INDICATORS

In per cent	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
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	15.71
Core capital to risk-weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79	13.45	13.81
Shareholders' equity to total assets	7.62	8.57	9.57	9.40	8.69	8.57	8.37	8.58	9.53	9.73
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	23.08
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	18.27
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	7.15
Return on Assets (RoA, annual basis)	1.57	0.91	0.42	0.72	0.07	0.33	0.54	0.89	1.20	0.69
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	7.03
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	8.00
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	31.29
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	40.57
Customer deposits to total loans	215.45	162.60	154.32	166.39	163.20	171.62	180.83	180.16	187.78	192.84

Source: Bank of Albania.