

FINANCIAL STABILITY STATEMENT FOR 2021 H1

Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18.12.2006 "On banks in the Republic of Albania", as amended, to inform the Assembly of the Republic of Albania and the Council of Ministers, and promote awareness among financial institutions and the public at large of the situation in the Albanian financial system and potential risks to 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 environment, real economy agents, financial markets in Albania, as well as operational risks in the activity of the banking sector. Furthermore, these risks are assessed through the stress test and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

The Bank of Albania deems that in 2021 H1 (hereinafter 'the period'), operations of the banking sector were stable. Deposits and loans grew, credit quality improved considerably, and other financial stability indicators remained at appropriate levels. The overall risk exposure of the banking sector was contained. The improvement of the healthcare situation supported the fast recovery of the economic activity. This development shows that the acceleration of the vaccination process is vital in mitigating the uncertainties of the pandemic on the economic and financial outlook. At the same time, these uncertainties evidence that the economic, financial and prudential policies preserve the flexibility in order to react if necessary. As regards banks, the regular assessment of the degree of exposure to risks and maintaining a proactive stance for taking measures to mitigate and withstand them, is currently pertinent. In this regard, Bank of Albania stands ready to undertake all necessary actions according to the law, in order to support banking activity and contribute to the stability of the financial system.

Developments in this period revealed the following:

The improved healthcare situation and the relaxation of containment measures supported the recovery of the economic activity at a global level.

The improvement was more evident in the second quarter of the year as the vaccination process accelerated and the number of new coronavirus cases entered a downward trajectory in the Northern hemisphere. Developments varied across the regions, reflecting, among others, also the access and different



scales of vaccination. Overall, the financing conditions remained favourable and many countries continued to support the economy with favourable fiscal and financial policies. The performance of employment indicators was overall positive. For the same reasons, the economy in the euro area and the Western Balkans significantly improved during this period. The fast economic recovery, on one hand, and the bottlenecks in the chains of production and trade on the other hand, have highlighted the impact of base effect in the temporary growth of inflationary pressures. The developments during the period and the presence of favourable economic policies underpin the optimistic expectations of the global economic performance in the second half of 2021 and beyond. On the other hand, the latest coronavirus variants, inadequate access and the slow vaccination pace in emerging countries, geopolitical conflicts and climate change effects, induce uncertainties to both public health situation and global economic developments.

The economy of Albania grew significantly by 5.53% in annual terms in 2021 H1. The improved healthcare situation, the acceleration of the vaccination process and accommodative economic policies reflected the recovery in consumption and investments. As regards economic sectors, it is assessed that the economic growth was broadly-based, including the production and services sectors. The negative contribution of the external sector on economic growth was mitigated by the good performance of exports of goods and services and remittances. Nevertheless, economic growth still is not reflected in the labour market and inflationary pressures have remained contained. Some early-warning indicators signal that the economy will continue its positive performance in 2021 H2, as well. Despite these expectations, the coordination of adequate economic policies will be necessary to address the lingering uncertainties of the pandemic on the economic performance and in parallel to preserve the stability of macroeconomic indicators in the longer-term period.

Markets carried on their activity as normal, without strong fluctuations. During the period, the level of government debt securities issued in the primary market was around 26% higher than in the previous six months, but around 2% lower than in the same period of the previous year. The average interest rate remained unchanged, at around 2.3%, maintaining similar levels with the average of the last 18 months. Activity in the secondary market of government debt securities did not show significant changes during the period, but the value and volume of transactions were lower than in the previous year. Investors continue to show a preference for holding securities to maturity. The volume of transactions in the interbank market remained stable during the period, but was significantly lower than the same period in the previous year. Interest rates fluctuated close to the policy rate, reflecting the unlimited liquidity injection by the Bank of Albania. In the foreign exchange market, lek reflected lower volatility against the foreign currencies, by facilitating the activity of economic agents. In the real estate market, supply and demand are assessed as upwards. House prices, calculated according to the Fischer House Price Index for sales



conducted during the period, were up by 0.5% compared to the previous six-month period, and by 6.7% compared with the same period in the previous year. Real estate agents remain optimistic for the long-term future of this market.

The core infrastructure for the clearing and settlement of payments in lek continued to operate effectively and securely. During the period, it is noted that there was an increase in the number and volume of small- and large-value transactions and in the use of payment instruments, with a positive contribution from payments made with cards and through direct access to banks' apps and webpages.

Households and enterprises continued to expand their savings. As a result, over the past year, household's financial position as net creditors expanded while enterprises tightened their debtor position. Foreign currency provided the main contribution in the saving instruments of both households and enterprises, while domestic currency dominated borrowing for both groups. Survey data suggest that around 24% of households have a debt to pay, and the debt payment for $\frac{3}{4}$ of them does not exceed 30% of the monthly income. Households' solvency improved compared with the previous year. However, households' credit demand in the upcoming months remains weak and concentrated on those that do not have a loan to pay. Banks' data show that despite the high number of loan applications, the rejection rate by banks remains high for households as compared with enterprises. The survey data on enterprises show that the pandemic has continued to affect their activity, by triggering more difficulties to market preservation and competition. Around 40% of total responding enterprises declare that they currently have loans to settle. This share has decreased by 1 percentage point (pp) compared to the previous six months, but has slightly increased compared with the previous year. The total value of loans resulted approximately at half of the enterprises' equity, for around 74% of total borrowing enterprises, and almost equal to the value of equity for 13% of them. Analysed by size, the "debt/equity" ratio was higher for small and medium-sized enterprises. Most of borrowing enterprises (76%) declare that the loan repayment amounts to 20% of their income, and this share has decreased slightly compared with the previous survey. Debt payment seems to be more burdensome on medium-sized enterprises. In relation to credit demand in the next six months, the borrowing plan index appears lower for all enterprises, but it is more pronounced for small and medium-sized enterprises. Among the group of banks by capital origin, it is observed that when compared with banks with domestic capital, banks with foreign capital have lower rejection rates for loan applications from enterprises.

A slight increase in the share of financial system assets³ to Gross Domestic Product (GDP) was observed during the period. At the end of 2021 H1, this share reached 122.4%. This performance was mainly driven by the expansion

³ The financial system consists of the banking sector and non-banking sector (non-bank financial institutions, credit savings associations, pension funds and investments funds). The database for the non-banking sector and GDP data are from 2020 Q3.



of the financial system activity, where the banking sector provided almost the only contribution by 4.4 pp.

The non-banking segment of the financial system had an overall good performance, slightly expanding its share by around 13% of the GDP. The growth of share was concentrated on the segment of non-bank financial institutions, investments funds and pension funds. Loan quality granted by these entities until the end of the first quarter was relatively good, despite declining somewhat compared with last year. The exposure of the banking sector to the non-banking sector remains limited and unchanged during this period. The exposure of the non-banking sector to the banking sector continues to remain high, as placements of non-banks in the banking sector in forms of deposits and capital instruments account for around 20% of non-banks' balance sheets.

The banking sector's activity expanded significantly and the main contribution to this expansion was from the investment in securities and lending. The share of activity in foreign currency has not shown considerable changes, remaining balanced on both sides of the banking sector's balance sheet. The statistical effect of the exchange rate on the equivalent value of the foreign currency balance had an insignificant impact. Deposits and own funds continued to be the main funding source of the banking sector's activity. Reliance on external funding sources remains at low levels. Assets placed with non-resident entities increased during the period, in the form of placements, loans and current accounts with banks and financial institutions and in the form of securities investments. This has driven to the expansion of the net creditor position of the banking sector against non-residents, by 1 percentage point.

The banking sector maintained a good level of capitalisation during the period. The Capital Adequacy Ratio recorded around 18% (17.95%), downwards in the last two periods. The performance of the indicator during the period was mainly affected by the increase of risk-weighted assets which exceeded the effect of the increase of regulatory capital. Banks with European capital and systemically important banks show the highest level of Capital Adequacy Ratio. During the period, the banking sector recorded a positive financial result of around ALL 10.5 billion. This result was 47% higher compared with the previous year. Activity in lek contributed around 2/3 to the growth of the net financial result. The growth in net interest income and other activities income coupled with the decrease of expenses for loan provisions provided the main contribution to the increase of the banking sector's profit. The banking activity's expenditures increased during the period, but their ratio to banking activity's income declined to 57% from the previous year. The increase in the profit of the sector is also reflected in the performance of the average profitability indicators of the banking sector: RoA and RoE climbed to 1.3% and 12.8%, respectively.

At the end of 2021 H1, outstanding loans totalled approximately ALL 630 billion, higher by 3% over the period, and by 6% from the previous year. The expansion of loan stock was mainly affected by the rescheduling of loan payments in



response to the accommodative measures of the Bank of Albania and the flow of new loans, which was still lower than in the previous six months. A particularly good performance in the credit stock, over the period, was registered for credit portfolio of long-term maturity; loans in domestic currency and loans to enterprises. During the period, loans in foreign currency were 2% higher, but its share to total credit has decreased compared with the previous periods. By residence, credit growth over the period was affected almost entirely by an increase of loans to resident entities, which account for almost 96% of outstanding loans. Loans to enterprises and households increased by 3% and 6%, respectively, with the main contribution from real estate loans and loans in lek. Over the period, loans to non-residents increased by 16% and as a result, its share to the total credit increased by 1 pp, at 4%. The volume of written off loans from the banking sector's balance sheet was low during the period and the share of unhedged loans in foreign currency recorded a slight decrease.

Deposits held in the banking sector recorded high rates of growth over the period. The growth is distributed almost equally between households and enterprises and between lek and foreign currency deposits. The growth of euro deposits was more pronounced in foreign currency deposits. Time deposits grew slightly by 1%, but the largest growth over the period in deposits by maturity was registered in current accounts and demand deposits, by around 6% each. At the end of June 2021, deposits registered around ALL 1,340 billion, up by ALL 50 billion (or 4%) during the period, and ALL 100 billion (or 9%) compared with the previous year. Around 45% of the overall stock of deposits is composed of time deposits, which did not change significantly during the period. The average interest rates for time deposits both in lek and in foreign currency, continue to remain at low levels and their average ratio did not record significant changes during the period.

Overall, the risks to the Albanian economy were contained over the period. The financial stability map shows a lower level of risk in the overall macroeconomic environment and to real economy agents, while risks associated with the banking activity remain at contained levels, despite the unusual situation of the previous year. The main contributor to this performance was the improvement in the financial situation of enterprises, households and the external environment. Meanwhile, other factors related to the overall performance of the economy, fiscal situation and banking activity have shown small and irrelevant changes. In parallel, other indicators, which try to capture systemic risk perception and risk assessments, including the banking industry's assessment, call for an increased attention on the performance of budget deficit and the level of public debt, as well as recognize the positive developments of the period related to economic recovery, credit quality and exchange rate stability. The increase of house prices in the real estate market, which continues uninterrupted for several years, requires an analysis in view of sustainability. In terms of more specific activity risks to the banking sector, the following is observed:



Credit risk recorded a significant decline over the period. The non-performing loans ratio fell by 1 p.p., to 7.1%, the lowest level since 2009. The improvement was present in almost all loan categories, and was driven by both the decrease in non-performing loans stock and the increase in outstanding credit. The absolute value of non-performing loans decreased by ALL 5 billion, standing at ALL 45 billion. Within non-performing loans, the share of “sub-standard” and “doubtful” loans decreased. As a result, given the faster decrease of the stock of non-performing loans compared with the relevant provisions for credit risk, the provisioning ratio increased by 3 pp, to 68%. Net non-performing loans account for 2.3% of total loans and their value is covered 11.1 times by the capital of the banking sector. The collateralisation of the loan value was 80% and almost 2/3 of credit is collateralized by real estate. At the end of the period, the highest amount of non-performing loans was attributed to loans to enterprises (8.4%), foreign currency loans (7.9%) and medium-term loans (7.5%).

The liquidity position of the banking sector is assessed to be in good levels, but it needs attentive monitoring. The liquidity indicators, both in lek and in foreign currency, remained significantly above the minimum regulatory ratios. Liquid assets of the banking system grew by ALL 11 billion, standing at ALL 560 billion. The ratio of liquid assets to total assets in banks’ balance sheets continues to remain high. At the end of the period, its value was 34.1%, while the fall during the period was 0.7p.p.. The ratio of liquid assets to short-term liabilities also decreased by 1 p.p., standing at 46.5%. Deposits, as the main source of funding the banking activity, cover twice the volume of loans of this sector. At the end of period, the “loans/deposits” ratio stood at 46.8%, slightly downwards during the period due to the performance of the foreign currency ratio.

The negative gap between assets and liabilities by residual contractual maturity segment, as a ratio to total short-term assets, remains at high levels. For the period up to 3 months, the negative gap between short-term assets and liabilities by residual contractual maturity segments rose to 27% of assets. During the period, an increase was observed in the average maturity mismatch between assets and liabilities, due to an increase of the average maturity of assets. At the end of the period, this mismatch was around 25 months, from 24 months at the end of the previous six months. Deposits’ residual maturity, which represents the most significant category of liabilities, fell to 7.3 months during the period. Meanwhile, the residual credit maturity increased to 50.7 months, reflecting the banks’ propensity to grant credit for longer-term periods. Similar to the previous six months, the banking sector did not report the use of funding lines by parent groups.

The presence of both high-valued liquid assets and extended values of short-term maturity gap, are two sides of the same coin. This signifies that due to changes in the liabilities structure of the banking sector and their orientation towards demand instruments, banks have a propensity to invest in assets with



a higher quality of liquidity. This approach allows the liquidation of these assets when a stressful situation in fulfilling obligations arises. However, in a hypothetical liquidity stress situation, the quality of liquidity for selected assets may be challenged by the depth of markets where they may be traded or other previously untested factors. Given these reasons, it is necessary for each bank to assess its capacities and framework for creating the necessary liquidity resources in stressful situations, and to undertake the adequate structural steps in order to gradually mitigate the maturity gap in the short run.

Market risks did not show significant changes during the period, but their careful management remains necessary. At the end of the period, the ratio of open foreign currency position to the regulatory capital of the banking sector was 4.5%, the lowest ratio during the last year and considerably below the maximum limits required by the regulatory framework. The performance of this indicator has been determined by the group of systemic banks, which have maintained a long open position. The exposure of the banking sector to the indirect exchange rate risk slightly decreased compared to the first six months and to the previous year. The foreign currency mismatch index for all currencies declined. The exposure of the banking sector to interest rate risk has increased. The weighed total net position in the banks' balance sheet against regulatory capital of the banking sector stood at 5.6% at the end of the year, up by 1.3 p.p. from the previous period.

Both the weighted spread of assets with fixed interest rate (FIR) liabilities and the net position on variable interest rate (VIR) assets and liabilities provided the main contribution to the increase of this indicator. Given that the total net position is positive, the sector has a relative exposure to changes in interest rates, but this impact is assessed as relatively low, as it is significantly below the upper regulatory limit. At the end of the period, regulatory capital coverage of the total net position of the banking sector is 17.5 times, whereas 5 times is the minimum coverage provided for in the regulatory framework. Similar to other risks, the exposure of specific banks to market risks needs to be assessed and monitored regularly. Results show that despite a diverse distribution, the determined regulatory limits are observed in this case as well.

To assess the banking sector's resilience against the real economy or financial markets shocks in the medium-term horizon, the Bank of Albania carries out regular stress testing exercises. Stress tests on capital adequacy show individual banks' degree of resilience in terms of capital and aims to identify its adequacy to withstand assumed shocks on economic growth, credit, exchange rate levels and interest rates.

Overall, the stress-testing exercises carried out at the end of 2021 H1 and spanning over 2021-2022 period, show that the banking sector appears resilient to the possible macroeconomic shocks. Results demonstrate that specific banks are more exposed to assumed shocks and need to strengthen their capital positions.



In conclusion, the Bank of Albania assesses that the financial system and the banking sector continued to have a stable performance despite the activity risks. The improved healthcare situation and the recovery of economic activity in the second and third quarter of the year, shows the interconnectedness between these elements and identifies the importance of accelerating the vaccination process and the understanding of this process by the public. In parallel, the events of the latest months reflect the uncertainty of the pandemic situation, and the need of economic, financial and prudential policies to remain oriented towards mitigating the effects of these uncertainties on economic performance. The banking sector still needs to conduct regular risk assessments and to maintain a proactive stance as regards taking measures for mitigating and withstanding them.

