FINANCIAL STABILITY STATEMENT FOR 2017 H2

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

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. In addition, these risks face the financial situation of the banking sector and are stressed through stress tests to assess the banking sector's resilience.

The Bank of Albania assesses that developments in the real economy and financial markets in 2017 H2 (hereinafter "the period") sustained the expansion of the financial system's activity in Albania. The banking sector's exposure toward activity risks was more restrained, highlighting the significant improvement in the loan portfolio quality across all its components. Exposure to other risks is at manageable levels, but needs to be evaluated carefully on continuing basis. Hence, the banking sector's ability to further expand financial intermediation and improve its efficiency indicators has improved. Banking sector's capability to withstand activity risks, in view of high levels of liquidity, capitalization and profitability, remains robust. In the light of these developments, the Bank of Albania deems that the banking sector remains resilient.

HIGHLIGHTS IN ECONOMIC AND FINANCIAL DEVELOPMENTS

During the period, global economic developments were positive and stable. The expansion in economic activity was broad-based and harmonised across regions. Economic growth was driven by the favourable financing conditions and the continuation of stimulating policies; while oil price recovery contributed to boosting the economies of oil-exporting countries. Conditions in financial markets were favourable, notwithstanding the divergences among the monetary policies of the main central banks. Overall, global inflationary pressures were subdued, but showed an upward trend occasionally, supported also by the recovery in oil prices. In financial markets, the capital securities continued to increase; meanwhile, debt securities were more volatile. The Balkans region showed faster economic growth and improved employment indicators. Overall, lending remains low, in spite of the considerable progress in reducing the non-performing loans level. The accommodative monetary policy stance and investments, mainly private ones, are expected to support the global economic growth in 2018. The main risks to global economic growth arise from the geopolitical tensions, the possibility of implementing protectionist trade policies particularly in advanced economies, and the possibility that markets may face fast and unexpected corrections.

In Albania, the economic growth pace recorded positive levels throughout 2017. As at 2017 Q4, the annual growth reached 3.36%. Services and production provided positive contribution in this regard. The expansion of the final consumption of the population and gross fixed capital formation continued to support aggregate demand. In 2017 Q4, the positive contribution stemming from the narrowing of the current account deficit during the three previous quarters was halted. In the labour market, the unemployment rate dropped further, at 13.4%. The monetary policy implemented by the Bank of Albania remained accommodative, throughout the period, as the inflationary pressures remained moderate. Although the fiscal deficit in 2017, in absolute terms, was higher than in the previous year, the share of public debt to gross domestic product (GDP) decreased. In *financial markets*, the interest rates generally reflected the stable liquidity situation. In the primary market, although the average yield on government debt securities recorded slight changes over the period, it stood at somewhat higher annual levels by end of the year. The performance of average interest rates on T-bills provided the main contribution in this regard. Notwithstanding the increase of volumes in the interbank market, the average interest rate stood close to the monetary policy rate. In the real estate market, surveys show a more optimistic outlook of market participants. The average interest rate on real estate loans fell slightly. In the foreign exchange market, lek appreciated against the US dollar and slightly depreciated against the euro, over the period.

Liquidity situation of *households* and *enterprises* improved over the period. The net creditor position of households increased, given the faster growth of deposits in foreign currency; meanwhile, the net debtor position of enterprises decreased due to the faster growth of deposits in lek. In annual terms, unlike the half-yearly trend, households show a slight narrowing of the creditor position attributable to the creditor position in the domestic currency. Meanwhile, enterprises recorded again a narrowing debtor position, mainly attributable to the fall of foreign currency loan portfolio. Regarding households, credit growth over the period is realised almost only in lek, and credit quality improved in both domestic and foreign currencies. Non-performing loans ratio for households fell by 2.6 percentage points on annual basis, standing at 7.6% at the end of 2017. Regarding enterprises, loan portfolio recorded a slight annual fall, imposed by the lost loans write off from banks' balance sheets, mainly in foreign currency. Hence, the share of loans in domestic currency to total loan portfolio outstanding increased. Credit quality improved considerably over the period, also for enterprises. Non-performing loans ratio for enterprises fell at 16.9% at the end of year, around 6 percentage points lower on annual basis. To fully assess the financial situation and borrowing of households and enterprises, the Bank of Albania conducts two specific 6-monthly surveys, in collaboration with the Institute of Statistics. For the period, large and medium-sized enterprises report an improvement in their access to financing, while it continues to be a more difficult process for small enterprises. Overall, both enterprises and households show to currently have a moderate appetite for borrowing.

The activity of the *financial system* expanded over the period. The financial system assets to GDP ratio was at 102.6%, around 0.5 percentage point higher than in June 2017, but lower than in the previous year. The growth of financial system's share in GDP owed to the expansion of the activity in almost all the segments, including banks, non-bank financial institutions, insurance companies and investment funds. Banks continue to dominate the structure of the financial system assets, accounting for 93% of financial system assets. Over the period, the share of the banking sector was up at 92.5% of GDP. The activity increased driven mainly by the expansion of interbank transactions. In terms of financial soundness, banking sector was characterised by high levels of capitalisation, profitability and liquidity. The direct exposure of the banking sector to the non-banking sector is low, whereas the banking sector performance remains a critical factor for the resilience of the non-banking sector. In the structure of non-banking sector assets, the share of investments in Albanian government securities is significant, and has been increasing over 2017.

BANKING SECTOR'S EXPOSURE TO ACTIVITY RISKS

The Bank of Albania assesses banking sector's activity risks, as follows:

a) *The improvement of loan portfolio quality, over the period, led to the decrease of credit risk*. At the end of 2017, the annual fall of non-performing loans was 27.5% or ALL 30.2 billion. As a result, the non-performing loans ratio dropped by 5.1 percentage points compared with the previous year, standing at 13.2%. In the lowering of non-performing loans, the contribution from loan collection and restructuring was higher than the contribution from the write-offs from the banks' balance sheet. Non-performing loans decreased across all the categories, including the unhedged foreign currency loan portfolio from exchange rate fluctuations. Among the existing non-performing loans, the lowest quality is noted in the foreign currency loan portfolio, in the loans to enterprises and loans with longer-term maturity. The reduction of non-performing loans is accompanied by the improvement of their coverage with capital, while provisioning and collateralisation showed insignificant changes.

The increase of contribution from actions related with restructuring, helps to sustain the downward trend of non-performing loans over the period. In its supervision activity, the Bank of Albania shall encourage banks to carry out this process effectively, so that only enterprises with feasible financial projects may benefit from it, and, the fall in concentration of non-performing loans accelerates. In terms of new loans, banks need to carefully monitor the increasing exposure toward certain economic sectors, to ensure compliance with regulatory requirements for sound lending standards, and adequate diversification of the loan portfolio.

b) Liquidity risk in the banking activity is considered as low. The liquidity ratios, both in lek and foreign currency, to short-term liabilities stand significantly above the minimum regulatory requirements. Deposits remain the main source of funding, by covering almost twice the volume of loans, of the sector.

In the funding sources of banks, the growth of demand deposits and current accounts continued, as the time deposits fell. Nevertheless, the risk of this funding structure appears limited, given that banking sector deposits are dominated by well distributed household's savings; time deposits maintain the main share in the structure of banking sector deposits; and their downward pace has slowed down considerably in recent years. Within the time deposits, the value of deposits with maturity over two-years, continues to increase. But, the current structure of funding limits the banking sector's ability to finance long-term projects, mainly related to households and enterprises' investments, hence negatively affecting the effectiveness of its activity.

c) *The banking sector's exposure to market risks, although down over the period, remains important.* The direct exchange rate risk remains restrained, given that the movements in open foreign currency positions in banks' balance sheets show lower volatility against their long-term behaviour. The indirect foreign exchange rate risk shows a slight decrease, given the decrease in the value of the foreign currency credit unhedged against the unfavourable movements in the exchange rate. At the end of the period, this category of loans fell at 24.6% of total outstanding loan portfolio and continues to be dominated by the loans to enterprises. This fall is an encouraging one and is expected to be further positively affected by a better awareness of the public and banks, following the measures approved by the Bank of Albania on 7 February 2018, in the framework of de-euroisation process.

The banking sector remains exposed to interest rate fluctuations.

Nevertheless, the latest data of the period show that this exposure appears relatively more limited. In the current environment of low interest rates, the data on the performance of risk weighted assets and the average maturity of assets indicate that, overall, the banking sector has not shown an increasing appetite for higher risk investments in the last two years. In the light of risks management, this behaviour is positive. Nevertheless, that is imposed, to a large extent, by the considerable slowdown in lending, suggesting that the risks' analysis needs to encompass a longer period and include the impact of such behaviour on the effectiveness of banking activity

d) *The potential of banking market development in Albania needs to be expanded.* This is an important process for the banking sector in order to remain attractive for strategic institutional investors and improve its contribution to country's economic development in the long term. The assessment of banks on the potential of the domestic banking market may be perceived by the survey results that the European Investment Bank conducts regularly with the European banking groups that carry out their activity in the countries of Central, Eastern and South Eastern Europe. The European banking groups are more optimistic for the expansion of their exposure in the region in 2018. Regarding Albania, the banking groups operating in our market, consider the potential of the financial performance as average. Also, most of them assess that their position in the market as fair or optimal. The good assessment for the positioning in the market and the average expectations regarding the performance of the Albanian market suggests a moderate willingness to commit in actions that support the expansion of the activity through the purchase of other banks in the country. Nevertheless, their assessment for the Albanian market improved compared with the previous year. The underlying reasons for this performance may be the improvement in economic growth, the macroeconomic stability, and the improved bank credit quality, against the backdrop of proactive actions by public authorities and banking industry in this regard. As a result, the indicators of the banking sector financial performance improved. It is understandable that the Albanian market will become more attractive to the European banks if these processes continue at an adequate pace. In this case, the acceleration of the adoption of the European standards on banking and financial activities may be important, thus improving the competitiveness of the Albanian market for foreign banks. In this regard, the approval of the Law "On the recovery and resolution of banks in the Republic of Albania" at the end of 2016 was a concrete contribution. Further, the Bank of Albania is working also on adopting some important elements of Basel III standards on supervision processes, and on management of liquidity risk and systemic risk.

RISKS TO FINANCIAL STABILITY

To assess systemic risks, the performance of indicators related to the materialization and accumulation of systemic risk is analysed against the stress level in the financial system and the perception of the banking industry regarding its activities' exposure to systemic risks. Also, the financial stability map provides a consolidated approach of risk assessment to financial stability.

Overall, the financial stability map, the indices for the materialisation and accumulation of systemic risks and the financial stress index, show that risks to the financial stability are more contained. The economic growth, the fall of unemployment rate, the reduction of public debt ratio, the low exchange rate volatility, and the improvement of some indicators of the banking sector - mainly related with the financial result and the improved assets quality - provided a positive contribution in this regard. On the other hand, the increased value of budget deficit at the end of year and the slowdown in deposits growth in the banking sector provided a negative contribution. Banks' responses in the relevant survey show that they perceived lower levels of systemic risks over the period, and that the expectations, overall, are positive.

BANKING SECTOR RESILIENCE

The banking sector's capability to withstand risks is assessed by analysing its capitalization and profitability developments, and by testing the adequacy of these indicators through stress-test scenarios.

At the end of the period, the banking sector's capital adequacy ratio was 16.6%, around 0.6 percentage point higher than at the end of 2016, and notably higher than the 12% minimum regulatory requirement. The higher increase of regulatory capital compared to the increase of risk-weighted assets of the banking sector, led the improvement in the capital adequacy ratio. The financial result of the sector improved over the period. The profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.6% and 15.7%, standing 0.9 percentage points and 8.9 percentage points, respectively, higher than in the same period in the previous year. The performance of the financial sector shows a positive contribution from the downward expenditure for provisioning related to credit risk, reiterating the sensitivity of the banking sector to the continuation of this process. Meanwhile, the financial result from the core activity of financial intermediation, as reflected in net interest income continued to decrease. The net interest income decreased due to return on investments falling faster than the relevant expenditures, against the backdrop of operating in an environment of low interest rates for a relatively long period of time. Notwithstanding the fall by 0.3 percentage point in annual terms, banks maintained the net interest margin around the 3.9% level.

The adequacy of the above indicators was assessed through stress tests, with scenarios that assumed adverse developments in macroeconomic and financial indicators for 2018-2019. Similar to before, as part of extreme assumptions with a low probability of occurrence, the adverse scenario included the contraction of the economy, contraction of credit, rapid growth of interest rates and strong depreciation of the exchange rate. In addition to the stress test with a macroeconomic scenario, some other tests were conducted. In more concrete terms, banking sector's performance indicators were tested against the volatility in the banks' real estate balance sheet value, following the write off of non-performing loans, and the volatility in interest rates. Also, in November 2017, banks provided the necessary data to conduct the stress test on liquidity risk.

Overall, the results of the stress tests show that in the scenario containing assumptions closer to reality, the banking sector remains well capitalized and shows good performance. Liquidity in the banking sector remains ample. In the adverse scenario, individual banks and the banking sector would need to increase capital.

Based on this analysis, the Bank of Albania deems that capitalization and profitability of banks is actually adequate to withstand the activity risks. As previously, banks should analyse and test their capacity to withstand various risks regularly, in compliance with the supervisory and regulatory framework.

The next chapters will present in greater detail the report on financial stability for the second half of 2017.