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. Furthermore, these risks are emphasised through the stress test and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

The Bank of Albania estimates that in 2018 H1 (hereinafter, the period), the banking sector activity was stable, with good indicators of performance and financial resistance. The decline in the value of foreign currency assets of the banking sector, as a result of the significant appreciation of exchange rate of lek, affected the slight contraction in the value of total assets of the banking sector for the period. Economic developments and the performance of financial markets fully supported the activity of the financial system. During the period, the exposure of the banking sector to the risks of the activity did not experience significant changes. Banking sector’s capability to withstand these risks in circumstances of high levels of liquidity, capitalisation and profitability is assessed as strong.

HIGHLIGHTS IN ECONOMIC AND FINANCIAL DEVELOPMENTS

During the period, the global economic activity continued to expand driven by the generally favourable financing conditions, despite signals for a further tightening of the monetary policy stance by the central banks of major economies. Global inflationary pressures remained, overall, steady. At times, they showed an upward trend driven also by the recovery in oil prices. In securities and capital markets, developments were generally in opposite directions. In the Balkans region, economic developments were positive. The global economic growth is expected to continue, but the growth pace will be
subject to certain risks related to the further tightening of financing conditions, uncertainties surrounding the global trade due to the increase of cases of the application of trade tariffs and continuation of geo-political tensions in certain regions. Emerging countries are assessed to be more vulnerable to these risks.

In Albania, the economy accelerated the growth pace to 4.45% at the end of the first quarter of the year. Production and services sectors - notably the branches of the extracting industry, trade, transport and construction - contributed to such growth. Aggregate demand grew, sustained by the expansion of the final consumption of the population and investments. The expansion of the current account deficit contributed in the opposite direction to the balance of payments, where the narrowing of the positive balance in the services sector concurred with the expansion of the deficit in the trade of goods. The continuation of positive developments in the labour market was confirmed with the drop of the unemployment rate to 12.4%, recording the lowest level in the last two decades. For the rest of the year, expectations for employment remain positive and above the average values. During the period, the Bank of Albania lowered further the policy rate and intervened in the foreign exchange market to decelerate the effect of the Albanian lek’s appreciation in view of achieving its inflation target. At the end of the period, the inflation rate grew to 2.4%. The fiscal policy has maintained the consolidation trend, although the positive budget balance, at the end of the period, resulted at lower values.

**HOUSEHOLDS AND ENTERPRISES**

During the period, the creditor position of households and the debtor position of enterprises decreased slightly. For households, this performance was driven by the faster growth of credit, primarily in lek, than deposits. For enterprises, the faster growth of deposits in all currencies concurred with the contraction of credit. Although households showed added preference for investments in long-term debt securities during the period, their financial wealth in the form of deposit, securities and quotas in funds decreased. The credit quality for households improved, leading to the decline in the non-performing loans ratio to 7.5%, although for the unhedged credit against the indirect foreign exchange risk, the change was insignificant. Survey results for the financial condition and debt burden of households show that overall they remain at adequate levels and more concentrated in households with higher income. For the majority of the borrowing households the value of debt servicing account up to 30% of the income level. For enterprises, the credit contraction was present mostly in

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5 Data for 2018 Q2, published on 10 September 2018, show a significant improvement in the balance of the current account, suggesting an increase in the positive contribution of external trade to the economic growth of the period.

6 The significant appreciation of the lek during the period contributed to the lowering of the value of reported assets and liabilities in foreign currency for the banking sector and real economy agents (households, enterprises, government). The overall effect of this factor on the balance sheet of the banking sector is assessed in this report, and should be further kept in consideration in the interpretation of various indicators.
the euro currency and concentrated in resident enterprises. During the period, the credit quality for enterprises did not show notable changes in the non-performing loans ratio, at 17.1%, but shows a better performance in annual terms. Survey results on the financial condition and debt burden of enterprises show that this burden did not change during the period and is assessed as affordable. For most enterprises, the debt value is assessed at half the capital value, although this indicator for the larger enterprises and those operating in the industry sector tends to be higher. Most borrowing enterprises state that the debt servicing accounts for around 20% of the enterprises’ income; but, this indicator rises to around 30% for small enterprises. According to survey results, the households and enterprises credit demand for the short-term period is likely to remain moderate.

FINANCIAL SYSTEM ACTIVITY

The financial system assets to GDP ratio was at 107.8%, around 2.7 percentage points lower than in the end of 2017. The fall in the share of the banking sector by 2.3 percentage points, at 97.1% of GDP, provided the main contribution to this performance. Banking system assets were ALL 1.427 billion, contracting by 1.3%. The decline in the balance sheet values was mainly driven by the treasury and interbank transactions, credit and deposits, which were considerably affected by the diminishing effect of the exchange rate appreciation. The banking sector maintained high levels of net crediting positions in the relation with non-resident entities. In terms of financial soundness indicators, the banking system was characterised by the increase of capitalisation levels, mainly driven by the fall in risk-weighted exposures’ value, due to the regulatory changes. The profitability and liquidity ratios are estimated at high levels. The direct exposure of the banking sector to the non-banking sector is estimated as low, whereas the banking sector performance remains critical for the activity and stability of the non-banking sector.

BANKING SECTOR’S EXPOSURE TO ACTIVITY RISKS

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

a) Credit quality continued to improve, although at a slower pace. Non-performing loans ratio remained almost unchanged over the period, at 13.3%, but it is 2.2 percentage points lower on annual terms. It reflects the fall at almost the same percentage (around 3%) of both non-performing loans and total outstanding loan portfolio. The following contributed to the fall of the absolute value of non-performing loans: repayments; credit restructuring (shifts to performing classes); and the write off of loss loans. Around ALL 3.1 billion loss loans are written off during the period, driving to the value of ALL 51 billion loss loans
written off from the banking sector’s balance sheet since the beginning of 2015. The reduction of non-performing loans is accompanied by the faster decrease of loan loss provisioning, driving to the fall in their provisioning coverage ratio. Collateral coverage of loans improved due to the expansion of loans collateralized by other than real estate.

The stable economic growth and the experience of banks in loans collection and restructuring facilitated the reduction of non-performing loans. But, the fall in the write off values may suggest a drop in the impact of this factor in the process of credit improvement, and highlights the need to enhance the efforts regarding other ways of solving non-performing loans. In addition, banks should carefully assess and provision pro-actively the credit exposures they might have in external jurisdictions, which face or may face fluctuation of the economic and financial indicators. These factors may turn more challenging the reducing process of non-performing loans in the short run.

b) **Liquidity risk in the banking activity remains low.** The liquidity ratios, both in lek and foreign currency, to short-term liabilities stand significantly above the minimum regulatory requirements. Deposits, sharing almost 80% of liabilities, 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, whereas time deposits fell. Enterprises’ contribution to the growth of deposits increased compared with the households’ contribution. But the current structure of funding sources limits the banking sector’s capacity to finance longer-term projects, which mainly relate to the investments of households and enterprises, by reducing the effectiveness of its activity. This phenomenon is also related to structural factors of the financial market, which make difficult the finding of longer-term funding sources. However, the efforts to provide financial instruments that withdraw such sources should continue.

c) **The banking sector’s exposure to market risks, although down over the period, remains important.** The exposures to both direct and indirect foreign exchange risk did not show considerable change over the period. Loan portfolio in foreign currency unhedged against exchange rate risk dropped at 24.2% of total outstanding loan, while enterprises continue to share around 2/3 of the value. The possibility of exchange rate fluctuation, in both directions, is the main feature of the free exchange rate regime. All economic actors, choosing to be exposed to foreign currencies, should keep in mind this fact, aiming at reducing the eventual risks and their positioning adequately. Regarding the impact of interest rate movements, banking sector remains exposed to interest rate fluctuations. The data show that the direct impact is moderate, given the open balance sheet positions between interest rate-sensitive
assets and liabilities, as a ratio to regulatory capital of the sector, is limited. The indirect effect from the interest rate risk remains important, given that loan portfolio is dominated by variable interest rates loans. When interest rate spread values are at the low historical levels, the impact of a possible correction of interest rates on borrowers’ solvency increases in the medium-term period. 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.

**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 financial stability’s risk assessment.

Overall, the financial stability map, the indices of materialisation and accumulation of systemic risks and the financial stress index, show that risks to the financial stability are contained. The economic growth, the fall of unemployment rate, the performance of exchange rate, the control of public debt levels, and the improvement of some indicators of the banking sector - mainly related with the capitalisation and its liquidity - provided a positive contribution in this regard. On the other hand, the slowdown in deposits growth, contraction of credit and the reduction of net interest margin in the banking sector provided a negative contribution. Banks’ responses in the relevant survey show that there were no considerable changes on the perceived levels of systemic risks over the period and that the expectations, overall, remain positive.

**MACRO-PRUDENTIAL POLICY**

In accordance with the Macro-prudential Policy Strategy document, Bank of Albania has developed the methodologies and has improved the necessary data base, which provide the assessment of signalling indicators on systemic risks performance and support the decision making process in implementing certain macroeconomic instruments. Regarding the latter, the consultations with banking industry and other interested stakeholders has begun, regarding the regulatory framework that enables the use of macro-prudential capital buffers. The compilation of this framework is adapted to the current stage of financial cycle; it helps to determine a mechanism that reduces the financial cycle fluctuation during the future economic development; and it represents an important approximation with the international standards in this field.
**BANKING SECTOR’S ABILITY TO WITHSTAND RISKS**

The banking sector’s ability to withstand risks is assessed by analysing its capitalization levels and profitability, 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 17.9%, 1.0 percentage point higher than at the end of 2017 and notably higher than the 12% regulatory minimum requirement. The fall in the value of risk-weighted exposures mainly led the improvement in the capital adequacy ratio. This fall was driven by one-time event factors related to changes in the regulatory framework. The financial result of the sector was satisfactory. The profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.54% and 15.0%, standing 0.1 percentage points and 1.7 percentage points, respectively, lower than the same period in the previous year. The positive contribution to the financial sector’s performance has come from the decline in credit risk provisions. Meanwhile, the net interest result was overall stable. The net interest margin dropped to 3.8%, over the period, compared with 3.9% in the previous year, by reflecting the impact of a long term low interest rates environment.

The adequacy of the above indicators was assessed through the stress test exercise, with scenarios that assumed adverse developments in macroeconomic and financial indicators for 2018-2019. Similar to before, part of extreme assumptions -but with a low probability of occurrence - in the adverse scenario were the strong contraction of the economy, contraction of credit, rapid growth of average interest rates and strong depreciation of the exchange rate.

In general, the results of the above tests show that the banking sector remains well capitalized and with good performance in scenarios that contain assumptions with a higher probability of occurrence. In the most extreme scenarios, 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 capability to withstand various risks regularly, in compliance with the supervisory and regulatory framework.