Bank of Albania

FINANCIAL STABILITY REPORT

2018/HI

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INTRODUCTION

This is the twentieth 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 by public and private, national and international financial institutions. The data and analyses cover mainly the developments over the first half of 2018 (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. Also, 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 presents briefly the results of the stress test, which assesses the banking sector's resilience against macroeconomic and financial shocks, expressed in terms of capital adequacy.

NOTES

As at end-June 2018, the banking sector in Albania shows as following:

(1) 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) sh.a., Veneto Bank (VB) sh.a., International Commercial Bank (ICB) sh.a., First Investment Bank, Albania (FIB) sh.a., Credit Bank of Albania (CBA) sh.a. They account for around 4.4% of the sector's total assets.

- Peer Group 2, each bank sharing 2-7% of total banking sector assets: Procredit Bank (PCB) sh.a., National Bank of Greece-Albania (NBG) sh.a., Société Générale Albania (SGA) sh.a., Alfa Bank – Albania (ABA) sh.a., Union Bank (UB) sh.a., Tirana Bank (TB) sh.a., American Bank of Investments (ABI) sh.a. They account for around 27.4% of the sector's total assets.

- Peer Group 3, each bank sharing over 7% of total banking assets: National Commercial Bank (NCB) sh.a., Raiffeisen Bank (RB) sh.a., Credins Bank (CB) sh.a., Intesa Sanpaolo Bank –Albania (ISBA) sh.a. They account for around 68.2% of the sector's total assets.

(2) By capital origin, the banks operating in Albania were divided as follows:

- Banks with foreign capital[1]: Raiffeisen Bank sh.a. (Austria); IntesaSanpaolo Bank - Albania sh.a., Veneto Bank sh.a[2]. (Italy); Alpha Bank Albania sh.a, Tirana Bank sh.a., National Bank of Greece Albania (NBG) sh.a[3]. (Greece); National Commercial Bank sh.a. (Turkey); Société Générale Albania sh.a. (France); ProCredit Bank sh.a. (Germany); First Investment Bank, Albania sh.a. (Bulgaria); International Commercial Bank sh.a. (Switzerland); United Bank of Albania sh.a. (Islamic Development Bank – Saudi Arabia); Credit Bank of Albania sh.a. (Kuwait).

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

2 *The Supervisory Council of the Bank of Albania, in its meeting of 6 September 2018, approved the merger by absorption between Intesa Sanpaolo Albania sh.a. and Veneto Banka sh.a.*

3 *The Supervisory Council of the Bank of Albania, in its meeting of 6 September 2018, approved the merger by absorption between the American Bank of Investments sh.a. and NBG Albania sh.a*

They account for around 80.8% of the sector's total assets.

- Banks with Albanian capital: Credins Bank sh.a., Union Bank sh.a., American Bank of Investments sh.a. They account for around 19.2% of the sector's total assets.

(3) Banks operating abroad:

Only the National Commercial Bank shows an expansion of banking network abroad, with its subsidiary in Kosovo[4].

Regarding the terms used in the Report, there should be taken into account that:

(1) The terms "loan" and "credit" are used interchangeably and have the same meaning in this Report; the same is valid for terms "enterprises" and "businesses";

(2) In this Report, outstanding credit refers to the balance of the account "relations with clients", as reported by banks in the balance sheets of the analysed reports. It includes outstanding credit granted by the banking sector to non-bank financial institutions, private and public, resident and non-resident ones. This outstanding is affected by the non-performing loans write off from the bank balance sheet in the reporting period. Hence, outstanding credit in this Report is a different concept from that of credit to the economy. The latter, in addition to the credit to banks, includes the credit granted to non-bank financial institutions. Also, the value of this credit includes only the resident private sector, and its value, is not affected by the written off loans from banks' balance sheets (these loans are already obtained by the economic entities and have affected in their economic value; their later write off does not affect this fact so far). The differentiation in this concepts on credit, should be considered even when it is interpreted the relevant analysis of credit indicators (growth rate, quality ratio, allocation by sector, by currency, etc.) in various reports of the Bank of Albania.

[4] *The change from "branch" to "subsidiary" has been finalized in March 2018. This change has not affected the analyzed indicators of this bank.*

FINANCIAL STABILITY STATEMENT FOR 2018 H1

Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18 December 2006 "On banks in the Republic of Albania", as amended, to inform the Assembly of the Republic of Albania and the Council of Ministers, and draw 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[5]. 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[6] 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

[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.

1. OVERVIEW OF MAIN RISKS OF FINANCIAL STABILITY

The Financial Stability Map shows the allocation of risk among factors that determine the stability of the financial system. These factors include the surrounding external and internal environment, the banking sector and the real economy agents: government, enterprises and households.

(1) As at the end of the first half of 2018, the map showes a slight increase of risks in the external economic environment, while the risks in the domestic economic environment related to banking activity and the agents of the real economy have moved toward opposite directions. In an analysis where developments are seen on a stand-alone basis, the value of indicators suggests that the risk for "households" and "domestic economy" declined, as part of the surrounding economic environment has been downward, due to positive developments in the performance of macroeconomic and financial indicators during the period. On the contrary, the indicators of banking activity related to the structure of banking sector and liquidity and financing, suggest a slight increase in the risk.

In more concrete terms,

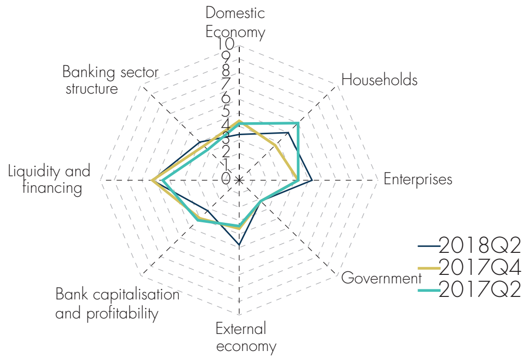
a. Overall economic environment

i. Risk from the "domestic economy" is rated as "low" and downward, following the narrowing of the output gap, and decline in the size of the external debt stock to GDP;

ii. Risk from the "external environment" is assessed again as "moderate", but slightly upward during the period, driven by the moderation of the economic growth rate in our trading partners, the rise of oil prices in international markets and the increase in the short-term interest rates in the money market[7], mainly as a result of the normalization of the Fed's monetary policy stance.

[7] *The indicator related to the short-terms of interest rates is calculated as a simple average of the three-month LIBOR and EURIBOR norms in the international markets, which approximate the costs by which our banks provide funds from foreign banks and holding banking groups. The growth of these rates means increased risk of financing in the foreign markets.*

Chart 1.1 Financial stability map



**Risk is rated: low for scores 0-3 on 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.
Source: Bank of Albania.

b. Real economy agents

i. Risk from "households" is assessed as "average" and downward, thanks to the improvement of the registered unemployment rate, the quality of the loan portfolio for households as well as remittances;

ii. Risk from "enterprises", is assessed as "average" and upward, in view of the deterioration in the performance of lending against its long-term trend for this category, the short-term expectations of enterprises; and the index of their financial situation;

iii. For the "government", the level of risk continues to be "low" and unchanged, affirming a fiscal stability for the period.

c. For the banking sector activity

i. Risk from "capitalisation and profitability", is assessed as "low" and downward during the period. On one hand, the improvement of the sector's capitalization and credit quality, and on the other hand, the slight increase in pre-tax income relative to sector's assets have contributed to the further reduction of risk from this category;

ii. Risk from "liquidity and financing" is assessed as "moderate" and trending slightly upward. This reflects the deepening of the banks' assets and liabilities mismatch up to three months[8], the further slowdown of households' deposits growth, as well as a slight increase in financing from non-residents. Notwithstanding the above stated, the liquidity indicator of the sector remains at adequate levels, supportive to the banking activity;

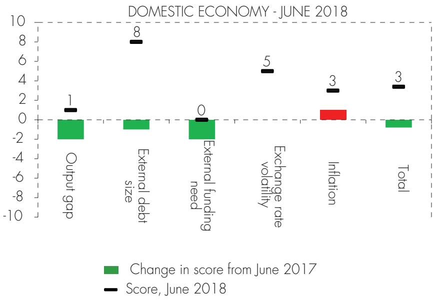
iii. Lastly, the level of risk associated with the "banking sector structure" is assessed as "low", but upward from a year earlier, as a result of a broader distribution of banks' capitalization compared to the average of sector, and the increase of lending concentration for the business sector.

Box 1.1 shows the Financial Stability Map components over 2018 H1, the score for each component and comparison with the scores in the previous year.

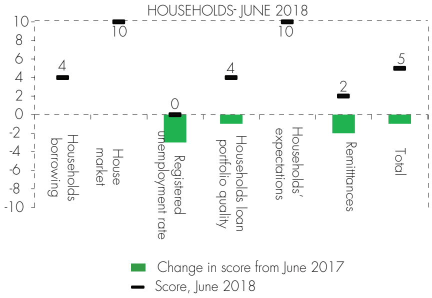
[8] *In this category, which is overall rated with low risk, the deepening of the gap is mainly a result of the change in the definition of the proper term, for the purpose of more detailed analyses by the supervisory authority.*

BOX 1.1 FINANCIAL STABILITY MAP

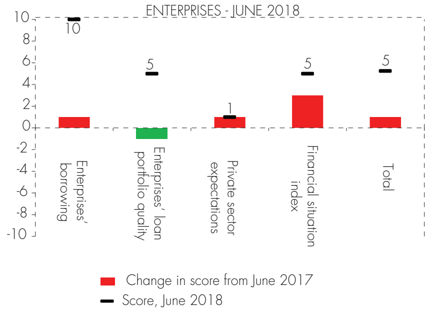
Rsik from "domestic economy is rated "low" and downward, due to the contractionof the output gap, the need for foreign funding and the slight decline of external debt size.



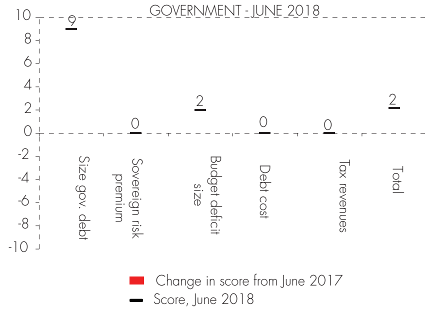
Risk from "households is rated "average and downward, due to the improvement of households' portfolio quality, the decrease of the unemployment rate and the increase of remittances.



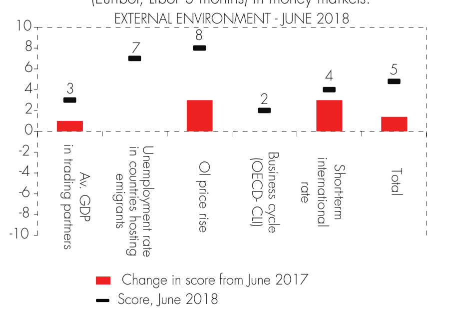
Risk from "enterprises" is rated "average" but upward, reflecting the developments in private sector borrowing, enterprises' expectations and the index of their financial situation.



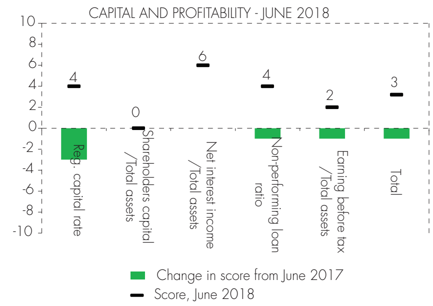
Risk from "government" is rated "low" and unchanged, registering the same assessment for all the indicators, compared with a year earlier.



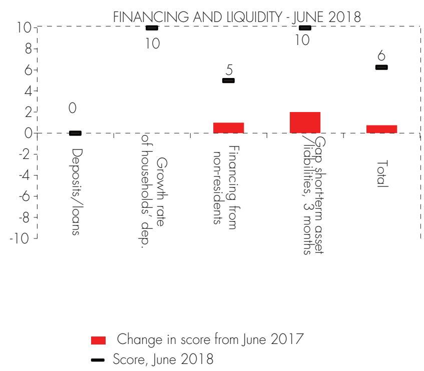
Risk from "external environment" is rated "average" and upward, affected by the slowdown of the economic growth of trading partners, the increase of oil prices in international markets and the increase of the average short-term interest rate (Euribor, Libor 3 months) in money markets.



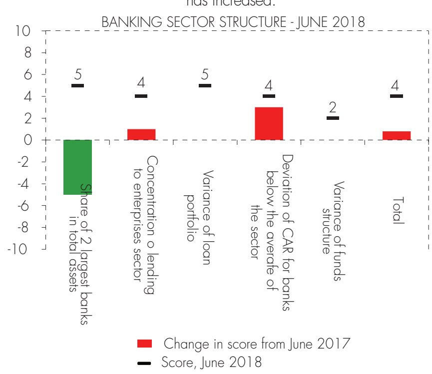
Risk fgrom "capital and profitability" is rated "low" and downward. the increase of banking sector's capitalisation, the improvement of loans' quality and the increase of earning before tax t total assets, have affected the mitigation of risk from this category.



Risk from "financing and liquidity" is rated "moderate" and upward, due to the deepening of the gap between short-term assets and and liabilities up to 3 months and the increase of financing from non-residents.



Risk from the "banking sector structure" remains low, but upward during the period, as the difference of lower values with the average value of capital adequacy rate has expanded, and the lending concentration to the enterprises sector has increased.



Source: Financial Stability Department, Bank o Albania.

1.1 SYSTEMIC RISK[9]

To assess the banking sector's exposure to systemic risk, the performance of indicators related to: a) the materialization and accumulation of the systemic risk; b) the stress level in the financial system; c) the perception of the banking industry regarding the exposure to systemic risks, is analysed.

The materialisation of the systemic risk assesses the actual level of the risk, whilst indices of the risk accumulation, financial stress, and the banking industry perception on it, focus mainly toward the future.

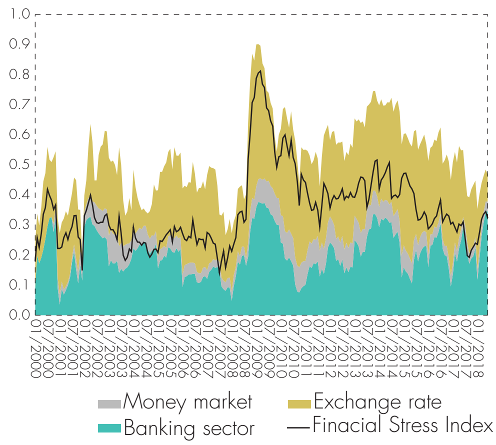
(2) Materialisation of systemic risk has been downward over the period. The improved credit quality to households, the decline in the unemployment rate in Albania, and the exchange rate performance have contributed to the performance of this index (see Chart 1.2.). Accumulation of systemic risk has been stable over the period, where the increased contribution of the index from household debt expansion and the increase in the value of loans which are vulnerable to interest rate fluctuations has been offset by the contribution to its decline from the fall in public debt and external debt segment.

(3) The financial stress index has increased, mainly due to the slowdown in the performance of banking sector indicators - deposits, loans and net interest margins – compared to their historical trend (Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk

Source: Bank of Albania.

Chart 1.3 Financial Stress Index



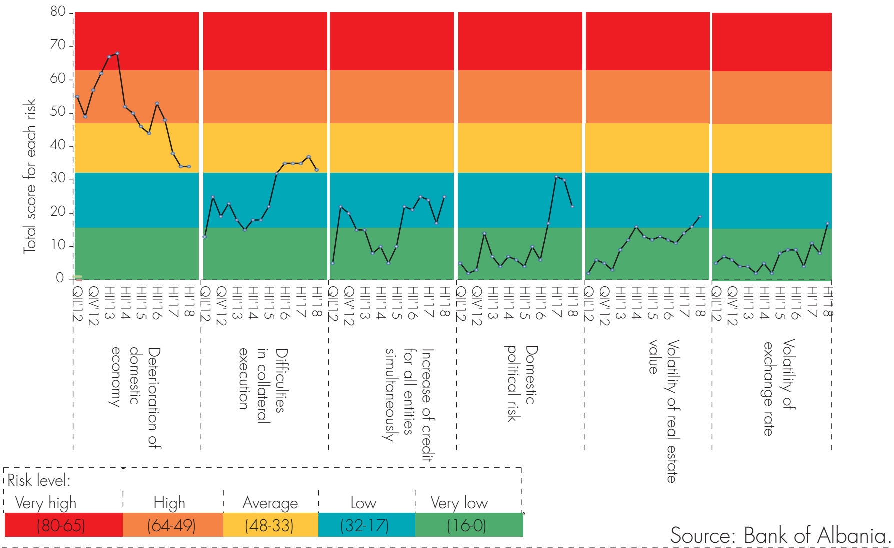
Source: Bank of Albania.

(4) The perception of the banking industry on systemic risks has not shown significant changes over the period. The risks of "economic

[9] *Systemic risk is defined as "the possibility for the materialization of shocks that impair the functioning of a financial system to the point where economic growth and welfare are affected materially".*

deterioration" and "collateral execution" remain at the "average" level of perception. The perceptions on the risks associated with "lending" and "volatility of the value of real estate" are at "low" but upward level. During the period, an increase in banks' perception of "exchange rate" risk has been noted, although it is not classified in the group of the five most important systemic risks in the country. The appreciation of the Albanian lek against the main currencies (especially the euro) over the period seems to have contributed to heightening the banks' attention to this phenomenon and its stability.

Chart 1.4 Banks' assessment of key systemic risks



Source: Bank of Albania.

2. INTERNATIONAL DEVELOPMENTS

(5) **During the period, global economic activity continued to expand, supported by generally favourable financing conditions, the continuation of accommodative policies in some of the advanced economies, and the growth of fiscal stimuli in the US.** Conditions in global financial markets remained broadly favourable over the period, despite signals for further monetary policy tightening by central banks of the largest economies. Global inflationary pressures were contained, but showed an upward trend from time to time, supported also by the recovery in oil prices. The latest data show a slowdown in the pace of growth and deepening of the economic performance divergence between advanced and emerging regions. This performance reflects the combined impact of rising oil prices, US interest rate increase, uncertainty surrounding global trade due to increased cases of the application of trade tariffs, and the continuation of geopolitical tensions in certain regions.

(6) **Most of the euro area member states recorded positive annual economic growth.** Economic activity is positively supported by increased consumption and investment, whereas trade activity provided a negative contribution. Labour market conditions continued to improve and the unemployment rate recorded the lowest value since December 2008. Inflationary pressures remained subdued, but they have shown signs of growth, mainly driven by the recovery of oil and raw material prices. In these circumstances, while the European Central Bank (ECB) continued to maintain an accommodative monetary policy stance, it has announced that it will reduce quantitative easing programs, thus signalling an adjustment of the accommodative monetary policy stance in the near future.

Table 2.1 Selected Macroeconomic Indicators for USA and euro area

	GDP change (annual %)			Annual inflation (annual %)		Unemployment (annual %)		Gross government debt (as a % of GDP)	
	2018 Q1	2018 Q2	2018p	March '18	June '18	March '18	June '18	2017 Q4	2018 Q1
U.S.	2.2	4.1	2.9	2.4	2.9	4.1	4.0	103.3	105.2
Euro area	2.5	2.1	2.2	1.3	2.0	8.5	8.3	86.7	86.8
- Germany	2.3	:	2.2	1.5	2.1	3.5	3.4	64.1	62.9
-France	2.2	:	1.8	1.7	2.3	9.2	9.2	96.8	97.7
- Italy	1.4	:	1.2	0.9	1.4	11.0	10.9	131.8	133.4
-Greece	2.3	:	:	0.2	1.0	20.1	20.2	178.6	180.4

Source: The European Central Bank, Eurostat, the International Monetary Fund (forecasts, July 2018), the Bureau of Economic Analysis (BEA). The US Bureau of Labour Statistics. ":"- no data available

(7) **Economic activity in the Western Balkans expanded, mainly driven by the increase of private investment and consumption.** At the regional level, the annual economic growth was 3.5% as at the end of 2018 Q1,

followed by the decrease in unemployment. The fiscal consolidation process has continued in all countries of this region, leading to a reduction in fiscal deficits and government debt. However, public debt levels are assessed as high, and remain a source of weakness in most of the countries in the region. Although inflation rates in these countries remain low, inflationary pressures have been rising, driven by the performance of oil and raw material prices. The central bank's monetary policies have remained on the easing side. Banks in the countries of the region continue to prefer lending to households over lending to enterprises. Bank lending capacity is also sustained by the further reduction of non-performing loans in most countries.

Table 2.2 Key macroeconomic and financial indicators for the Western Balkan countries.

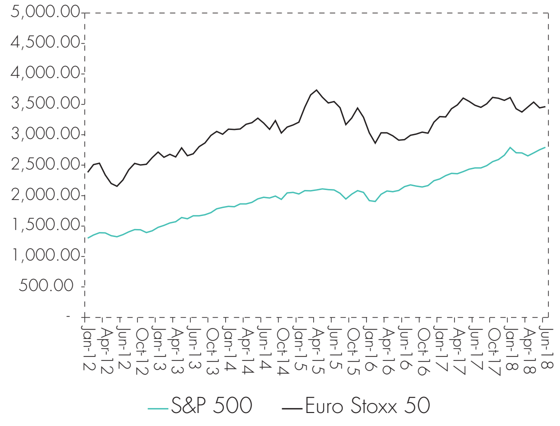
	GDP (real, annual %)			Unemployment (in %)		Sovereign debt (% of GDP)		Credit growth (annual %)		Non-performing loans ratio (in %)	
	2017 Q4	2018 Q1	2018p	2017 Q4	2018 Q1	2017 Q4	2018 Q1	2017 Q4	2018 Q1	2017 Q4	2018 Q1
B&H	0.5	2.0	:	:	:	35.5	35.8	6.7	6.7	10.1	9.7
Macedonia	1.2	0.1	3.1	21.9	21.6	38.7	39.7	5.4	6.2	6.3	5.1
Montenegro	3.9	4.5	3.0	17.4	16.5	60.4	59.0	11.8	9.9	7.3	7.3
Kosovo	3.2	3.5	:	30.6	26.5	16.6	:	11.1	11.0	3.1	:
Serbia	2.4	4.6	3.3	14.7	14.8	61.6	59.0	2.2	-1.2	9.9	9.2

Note: ":"-No data available
Source: European Commission, f- forecast July 2018

(8) In financial markets, developments have reflected a higher volatility owing to economic and political factors. In the EU, the costs of sovereign debt securities have had an upward trend, faster after the outcome of political elections in Italy. The same upward trend has also been observed in the US, where the increase of interest rates from the Federal Reserve and the possibility of overheating of the economy were the main determining factors. The key indexes of capital markets have been generally upward, as the better economic growth performance and fiscal incentives (in the US) are reflected in the financial situation of enterprises. On the other hand, capital inflows in emerging and developing economies have somewhat moderated, amid liquidity starting tightening in advanced economies and increasing trade tensions. The European banking sector[10] continues the consolidating process and cleaning of balance sheets from non-performing assets. In foreign exchange markets, the euro has generally been depreciated over the period against most of the currencies of advanced economies; yet, it has been more stable against the currencies in the main emerging and developing economies. In commodity markets, food prices have increased. Also, the oil price has increased by almost 16% (USD 80/barrel), mainly driven by supply-side factors.

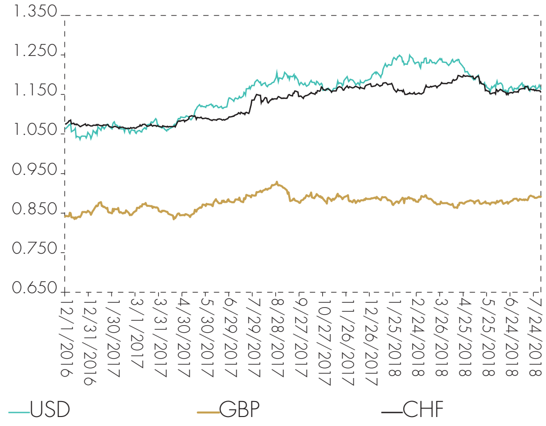
[10] *Similar to previous periods, foreign banking groups operating in our country represent stable levels of capitalization, although the financial result in some of them continues to be negative.*

Chart 2.1 Performance of key indexes in stock markets



Source: European Central Bank

Chart 2.2 Performance of euro exchange rate vs. other currencies



Source: European Central Bank.

3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

(9) The Albanian economy accelerated the annual growth rate to 4.45% at the end of the first quarter of the year[11]. Production and service sectors contributed to the economic growth, with the branches of quarrying industry, trade, transport and construction as the main contributors. Growth in aggregate demand was driven by the expansion of the final consumption of the population, primarily sustained by the increase in government consumption and the fixed capital formation. Meanwhile, the expansion of the current account deficit in the balance of payments, where the shrinking of the positive balance in trade of services coincided with the expansion of the deficit of goods trade[12], contributed to the opposite direction. The continuation of positive developments in the labour market was confirmed with the fall of the unemployment rate down to 12.4%[13], marking the lowest level during the last two decades. For the rest of the year, expectations on employment levels remain positive and above average values.

(10) The eased monetary conditions helped to the rise of inflation to 2.4% in June 2018, the highest rate of the last year. The rise in inflation over the period was favoured by the expansion of aggregate demand, following also the further lowering of the policy rate by the Bank of Albania at 1%. The appreciation of the lek exchange rate had a decelerating effect against the inflation performance. The Bank of Albania assesses that the continuation of economic growth and the favourable financing conditions are expected to establish adequate premises for the increase of inflation and its return to target in the medium term.

(11) Fiscal policy maintained the positive budget surplus, albeit at lower values. At the end of the period, the budget surplus was positive, about ALL 1.7 billion, almost ALL 1 billion lower compared to the previous year. This lower pace of fiscal consolidation is due to the higher annual growth of expenditures versus budget revenues[14]. During the period, the needs for debt servicing were met mainly in the domestic market. The fiscal consolidation process needs to continue in order to ensure the sustainability of economic growth in the long run. Adequate planning of the main budget items and the realization of capital expenditures remain important elements for fiscal policy effectiveness.

[11] *The real annual growth of economic activity in the country during 2017 Q1 and 2017 Q4 was respectively 3.92% and 3.63%.*

[12] *Data of the balance of payments for 2018 Q2, published on 10 September 2018, show a significant improvement in the current account balance (a decline of the deficit by about 33% in annual terms), suggesting a more positive contribution of external trade in the economic growth of the second quarter.*

[13] *The unemployment rate was 13.4% in 2017 Q4 and 13.9% in 2017 Q2.*

[14] *Revenues increased by 2.24% in annual terms, reaching ALL 217 billion, while total expenditures marked an annual growth of 2.74%, reaching ALL 215 billion.*

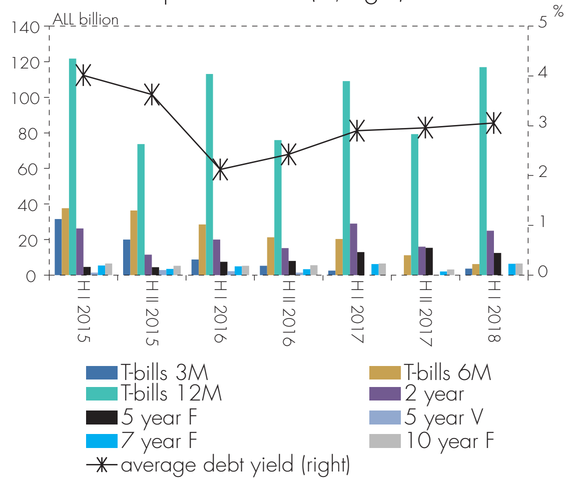
(12) At the end of the first quarter of the year[15], the overall balance of payments was positive. Current account deficit resulted 11% higher in annual terms, rising to EUR 165 million. The trade deficit in goods expanded to around EUR 615 million, despite the higher growth rate of exports versus imports. In the services account, the positive balance contracted during the period by nearly EUR 16 million, registering EUR 260 million. In the primary income account, the negative value of the balance expanded, while in the secondary income account inflows increased by 19% compared to the previous year. In this category, remittances account for around 73% of the total and are assessed to have provided foreign currency inflows at around EUR 147 million, almost 8% higher in annual terms. The flow of Albania financial liabilities to the world is assessed at EUR 299 million, recording 3% annual growth, compared to the previous year. Foreign direct investments (FDIs) amounted to EUR 284 million, or EUR 108 million higher than a year earlier. Energy and hydrocarbon sectors and financial intermediation continue to provide the main contribution to their growth.

[15] *Balance of payments data for 2018 Q2 were published on 10.09.2018, several days after this report was approved. Preliminary analysis of these data shows a significant improvement of the current account (decrease of the deficit by about 33% in annual terms), dictated by the improvement of the trade balance in goods, by the substantial expansion of the positive balance of the services account and by the expansion of the positive surplus of secondary income. Overall, the balance of payments was positive and resulted in the expansion of foreign exchange assets by EUR 85 million. These results suggest a positive contribution by the balance of payments in the economic growth of 2018 Q2, (still unpublished at the time this report was finished).*

4. MARKETS AND PAYMENT SYSTEMS

(13) **In the government debt securities market, the volume of issues increased, while the average interest rate did not show significant changes.** Domestic debt in lek issued during the first half year was around ALL 182 billion, or 43% higher compared with the debt issued in 2017 H2, and only 2% lower compared to 2017 H1. Compared to the previous six months, issues were 40% higher for T-bills (ALL 127 billion) and 50% higher for bonds (ALL 56 billion). At the end of the period, the weighted average interest rate was about 3.1%, slightly up towards the end of 2017 and being about 0.2 percentage point higher than the previous year. Treasury bills rates were upward during this six-month period, while bonds' rates dropped very slightly. The domestic debt structure remains dominated by treasury bills (70%).

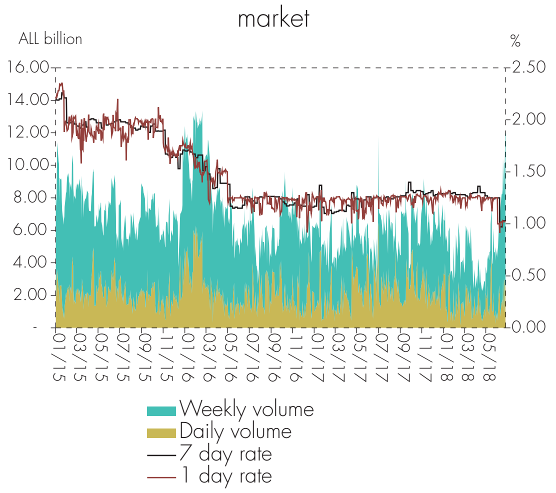
Chart 4.1 Composition of issued debt (ALL billion, left) and average interest rate performance (%, right).



Source: Bank of Albania.

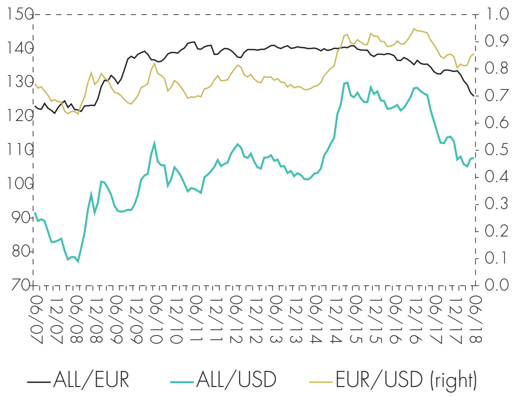
(14) **In the interbank market, banks have traded overall lower volumes at rates constantly below or close to the policy rate level, thus reflecting a stable liquidity situation.** Average interest rates for one and seven day interbank transactions remained almost unchanged at 1.25% and 1.28% respectively. In June, they declined, reflecting the Bank of Albania's key interest rate cut to 1%. The average 1-day borrowing volume dropped by 40% compared to the previous six months. The same performance was also observed in the average volume of 7-day transactions, which fell by 14% compared to the previous six months. The borrowing at 1-month maturity also registered a significant increase during this period (more than double), although this instrument is rarely used and at lower volumes compared with the shorter term borrowing instruments.

Chart 4.2 Interest rates in the international market



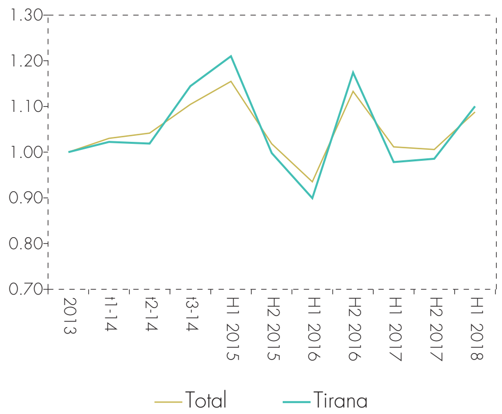
Source: Bank of Albania.

Chart 4.3 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

Chart 4.4 Fischer Index Performance - at national level, and for Tirana



Source: Bank of Albania.

(15) **In the foreign exchange market, the lek appreciated against the main currencies, particularly against the euro.** At the end of the period, lek was 5.5% stronger against the euro and 4.3% stronger against the US dollar, compared to the end of 2017. Lek's appreciation was stronger in the second part of the period, turning it into a factor that could hinder or postpone the achievement of the inflation target by the Bank of Albania. For this reason, the Bank of Albania took the decision to intervene in the market in order to mitigate this performance by removing from the market the currency surplus associated with one-time event factors.

(16) **In the real estate market, the main indicators appear upward.** As in any other market, the performance of this market is determined by demand and supply, with demand generally sustained by the level of income and financing conditions for purchase or development of real estate, whereas on the supply side, the number of properties for sale, both new (newly built) and existing ones was a determinant for the trading volumes and their prices.

(17) **Based on the available information, housing prices rose during the period.** Bank of Albania Survey results show that the Fischer house price index at country level, increased by 8.1% compared to the previous six months, and 8.8% compared with the base period (2013)[16]. The rise in the index from the previous six months is attributable to the respective sub-indices for Tirana and the coast, and reflects the respondents' positive expectations for the developments in this market.

When interpreting the index performance, we should consider the following factors and the possibility for their effect to extend beyond the period under review. Specifically:

a) From the demand point of view:

- the data from the banking sector on the period, show an almost unchanged level of outstanding loan for real estate purchase, followed by a slight decrease (0.5%) of the interest rates on this credit[17];
- the respondents report that about 75% of residential and commercial properties sold by them are purchased via a bank loan and this value

[16] The first year of the survey is taken as a base period.
[17] The average interest rate of real estate during 2008-2013 was 8.7%.

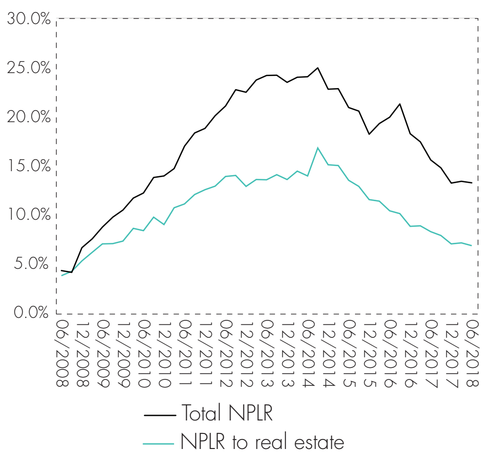
is similar to the one reported in the previous period;

- the relative cost of credit payment[18] for real estate purchase has declined, reflecting more eased financial conditions for the purchase of real estate from the borrower's aspect.
- based on the lending survey of the Bank of Albania for 2018 Q2, the households' demand for real estate loans increased, while the conditions for credit approval for this type of loan and this category of borrowers are reported to be more eased;
- survey respondents said that the average period needed to sell these properties at country level in the first six months of the year, was on average 10 months or 2.2 months shorter compared with the previous six months.

Chart 4.5 Real estate purchase loan and relative cost of loan payment

Source: Bank of Albania.

Chart 4.6 The ratio of non-performing loans to total loans and real estate loans



Source: Bank of Albania.

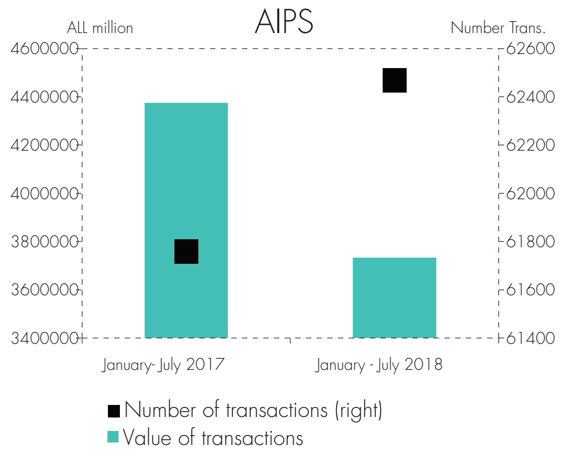
b) from the supply point of view:

- INSTAT data show a significant increase in the floor area index and number of construction permits for residential buildings;
- survey results show that sales volume increased only for the periphery of Tirana, and declined in other areas of Tirana, such as the coastal and other areas of the country;
- the outstanding loan portfolio for construction decreased by 5.2% at the end of 2017, and 3.2% compared to the previous year. Construction loans is accounted for 13.7% of outstanding loans to enterprises, remaining well below the level of around 20% recorded over the 2007-2011 period;
- the quality of real estate credit improved and the ratio of non-performing loans decreased to 6.8% from 7% in December 2017 and 8.3% in the previous year.

[18] *The relative cost of payment for real estate purchase is estimated as the difference between the real estate loan interest rate and the average rate of house price increase over the past four quarters. In case this difference increases, then the relative cost is estimated to increase and vice versa.*

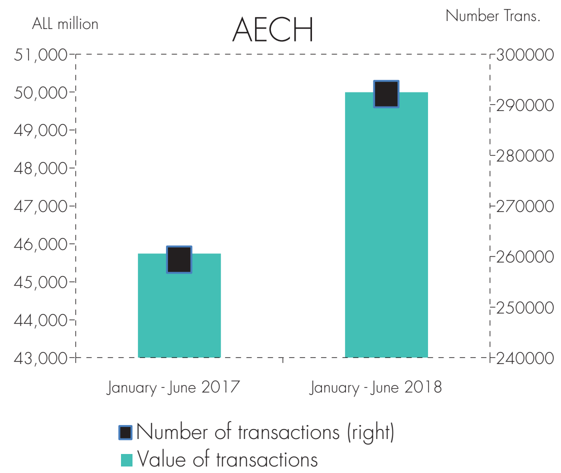
(18) Payment systems have handled a greater number of transactions compared to the previous year, but the volumes were volatile. In the large value payments system (AIPS), the number of transactions increased by 1.2%, while the value of the transactions went down by 14.7% compared to 2017 H1. In the small value payment system (AECH), the number of transactions increased by 12.6% and the value of transactions was about 9.3% higher compared to the respective indicators of 2017 H1.

Chart 4.7 Performance of AIPS (large value payments)



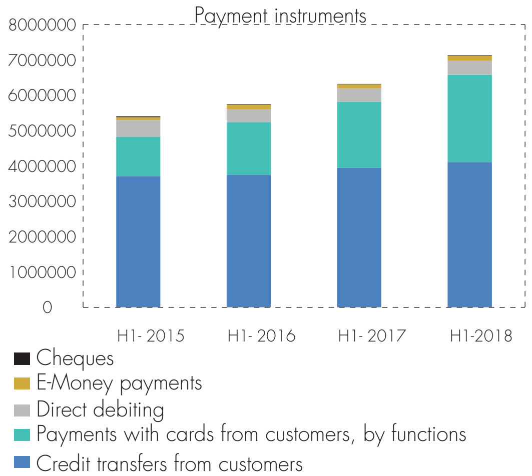
Source: Bank of Albania.

Chart 4.8 Performance of AECH (small value payments)



Source: Bank of Albania.

Chart 4.9 The performance of payment instruments in number, 2015-2018 H1



Source: Bank of Albania.

(19) By use of instruments, during the period, credit transfers continue to dominate in the payments instruments, but the share of this instrument has decreased. Within this category, the use of the instrument in the form of 'paper' decreased and transactions with non-paper instruments (e-banking and mobile platforms) recorded a double-digit increase (32% in number and 19% in value). During the period, payments by card have also recorded a faster growth.

5. FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

Chart 5.1 Financial position of households and businesses, ALL billion

Source: The Bank of Albania.

(20) During the period, the credit position of households and the debtor position of enterprises decreased. For households, the credit position decreased by 0.7% in the circumstances of faster credit growth (4.8%) than deposits (0.3%), due to domestic currency contribution. . For enterprises, the debtor position declined by 3.1%, this time because of the faster growth of deposits compared to the loans; all currencies provided positive contribution to this performance.

(21) During the period, the value of financial assets of resident households in the form of savings / investments in deposits, securities, or fund quotes marked a decline. The main contribution to this performance was from savings in the form of foreign currency deposits[19], deposits in lek and investments in investment funds. On the other hand, resident households expanded the portfolio of investments in long-term debt securities (bonds). In annual terms, household savings grew mainly in the form of foreign currency deposits and bond investments.

Table 5.1 Assets of resident households in the financial system

	2010		2013		December 2016		June 2017		December 2017		June 2018	
	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %
Deposits in ALL	357.6	49.8	449.5	43.7	454.3	40.3	465.1	42.1	467.2	41.0	456.7	41.1
Deposits in FX	304	42.3	418.4	40.7	476.4	42.3	432.8	39.2	469.5	41.2	447.1	40.3
T-Bills	56.7	7.9	70.6	6.7	65.2	5.8	67.3	6.1	63.6	5.6	65.1	5.9
Bonds	0.37	0.05	39.8	3.9	64.5	5.7	67.9	6.1	72.1	6.3	77.4	7.0
Investment funds*	-	-	50.3	4.9	65.4	5.8	70.8	6.4	65.1	5.7	62.5	5.6
Voluntary private pension funds*	0.12		0.43	0.04	1.2	0.1	1.3	0.1	1.6	0.1	1.8	0.2
Households portfolio*	718.8	100	1,029	100	1,127.00	100	1,105.20	100.00	1,139.10	100.00	1,110.60	100.00

Source: Bank of Albania and AFSA

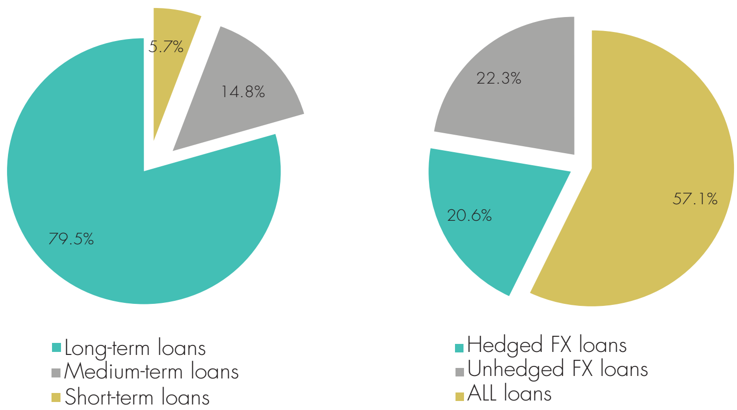
**: Data refer to the latest published period, March 2018.*

[19] The appreciation of Lek exchange rate against major currencies, which has decreased the reported value of this item also contributed to this performance.

5.1 LOANS TO HOUSEHOLDS AND CREDIT RISK

(22) During the period, loans to households increased by 2.4%[20]. By currency, the only positive contribution given to credit growth was by the domestic currency, thus increasing its share in the overall structure of credit. Regarding foreign currency loan, the share of the unhedged foreign currency loan to the total outstanding foreign currency loan to households was 51.9%, with little change over the period.

Chart 5.2 Loan structure for households by maturity term (left) and currency (right)



Source: Bank of Albania.

(23) The credit quality improvement for households slowed down during the period, but in annual terms the ratio of non-performing loans dropped by 2 percentage point at 7.5%[21]. This improvement has been more apparent for foreign currency loans, and for its unhedged part from the exchange rate risk, there are no significant changes. The ratio of foreign currency non-performing loans to households dropped to 8.9%, declining in annual terms by 2.2 pp. In lek, this ratio decreased by 0.5 pp to 6.5%. In the decline of non-performing loans to households, the contribution of loan repayment increased.

[20] *Only for resident household, credit grew by 1.8%. In annual terms, credit growth for households was 3.5%.*

[21] *The annual improvement in the report of non-performing loans to households has been stable since June 2015.*

BOX 4.1. SURVEY RESULTS OF THE FINANCIAL SITUATION AND BORROWING OF HOUSEHOLDS

The survey of the financial situation and borrowing of households is carried out every six months, on a randomly-selected sample of 1,209 households, of which 56% live in urban areas and 44% in rural areas.

During 2018 H1, the number of employed persons in the surveyed sample has decreased in annual terms, mainly due to the decline in employment in the public sector, while the number of those employed in the private sector and the self-employed have increased.

The overall level of income and expenditure of households has increased during the period, but expenditure growth has been more pronounced, resulting in a narrowing of the financial balance (income-expenses).

About 28% of households' state to have a loan to pay and this percentage remained the same as in the previous six months and a year earlier, but below the historical average.

The total reported loan surplus has increased compared to the previous survey, but it has declined compared to the previous year. Around 83% is provided by formal sources and 17% by informal sources. This structure has continued to shift in favour of formal borrowing compared to the previous period and the previous year.

Broken down by currency, 84% of the outstanding loan is denominated in lek and 16% in euro. By purpose of use, about 35% of the outstanding loans are reported for the purchase / renovation of a property, 41% for the start-up of a business and only 5% for consumption. During the period under review, the outstanding loan for the start-up of a business has increased, while for the other two items has decreased.

Borrowing households estimate a fall in the loan instalment over the referring period, reflecting the downward trend of the weighted interest rate on household loans.
About 60% of borrowing households state that their "repayment" capacity has not changed, while the rest declare deterioration compared to the previous six months and the previous year.

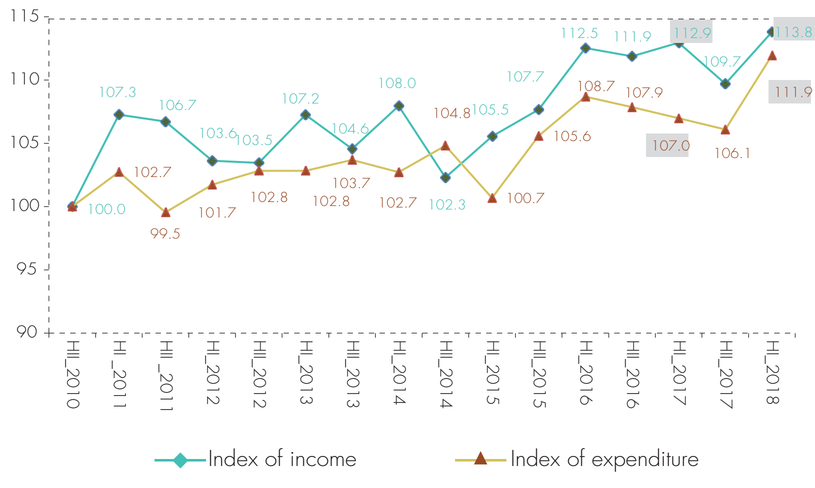
For 2018 H2, most borrowing households (about 74%) do not expect their repayment capacity to change, while the net balance of the rest of the respondents indicates a slight deterioration.

The possibility to borrow during 2018 H2 is estimated to be almost the same as in the previous six months, but declining compared to the previous year, which indicates a moderate demand of households for loans.

(24) The household debt burden remains at relatively adequate levels. Based on the above survey for the period, around 28% of Albanian households have at least one debt to pay. This value has been the same as in the previous two periods, and is only 1 percentage point below the historical average (since 2010). By their level of income, a higher concentration can

be found in the households with higher income. The performance of income and expenditure for borrowing households shows that both their income and expenditures indexes have increased, but in the last period expenditures have increased somewhat faster.

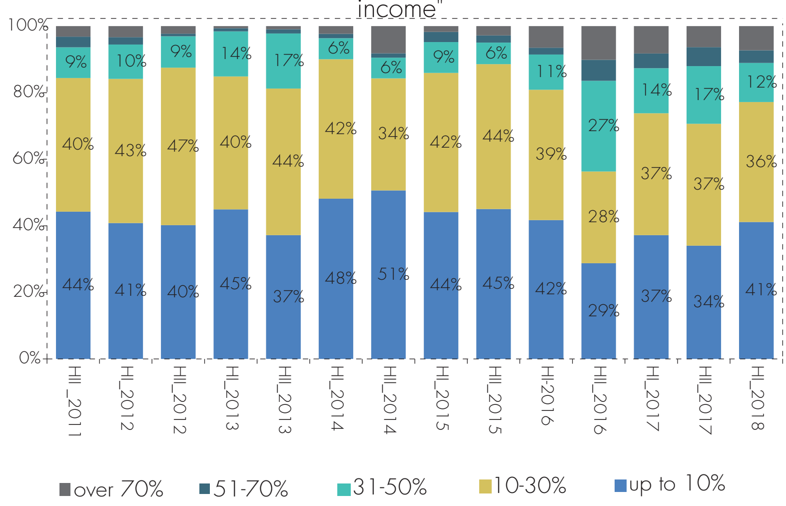
Chart 5.3 Index of income and expenditure for borrowing households



Source: Bank of Albania.

(25) During the period, borrowing has shifted in favour of the lower ratios of "loan instalments / monthly household income". The ratio of repayment to total income results "up to 10%" for 41% of borrowing households, "10-30%" for 36% of households and "over 30% of income" for 29% of households (down by 7 percentage points compared to 2017 H2). Compared with the previous survey, there is a shift of this distribution in favour of lower ratios of "loan instalments / monthly income".

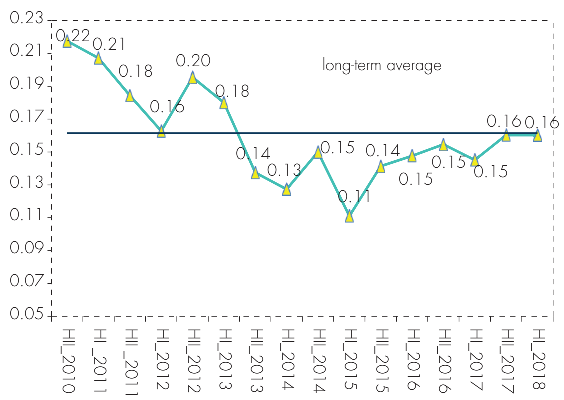
Chart 5.4 Borrowing according to the "Loan instalment / Total monthly income"



Source: The Bank of Albania.

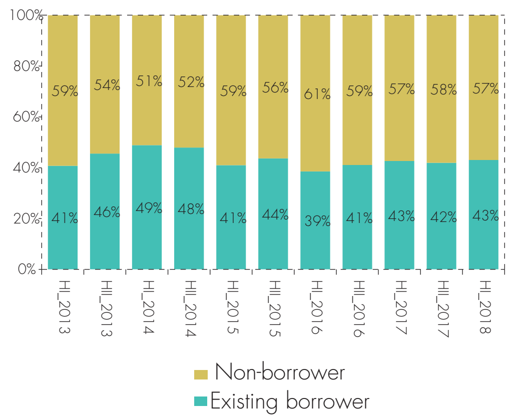
(26) Although households' debt burden remains adequate, their credit demand is moderate. According to the survey, around 62% of the respondent's state that they "do not expect to take a new loan in the next six months", and this has remained the same as in the previous six months. The index for the possibility of a new loan[22] was 0.16, almost the same with the long-term average, remaining unchanged compared from the previous six months but lower than in the previous year.

Chart 5.5 Index of taking/retaking a loan



Source: Bank of Albania.

Chart 5.6 Household which plan to ask for a new loan in the next six months



Source: Bank of Albania.

Analysing only the group of households planning to borrow a new loan, shows that about 57% of them are "new borrowers", that is they have no unpaid loan at the time of the interview, and 43% are existing borrowers already. Compared to the last six months, there was a fall by 1 percentage point in the share of "new borrowers" compared to the existing ones.

5.2 LOANS TO ENTERPRISES AND CREDIT RISK

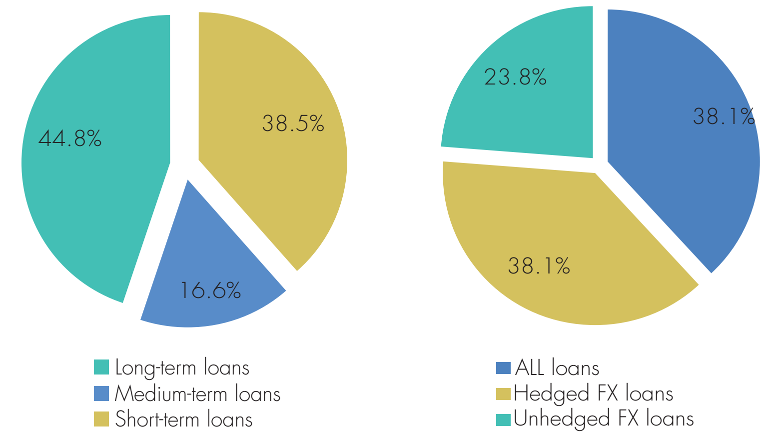
(27) During the period, loans to enterprises shrank mainly driven by the foreign loans and resident businesses. By currencies, the share of foreign credit declined to 61.9%, while the share of the loan unhedged from adverse exchange rate fluctuations (to total loans to enterprises) also declined to 23.8%.[23]. In the structure of loans to enterprises, by maturity, there have

[22] *The index is calculated as the weighted average of the % of responses for each alternative with the respective coefficients. For the determination of coefficients, the interval 0-1 is divided into 4 sub-intervals equal to 0.33. The criteria for each alternative are: 0 ('not likely'), 0.33 ('somewhat likely '), 0.66 (' very likely ') and 1 ('definitely'). The index gets a value from 0 to 1, the closer the 0, the smaller the possibility of borrowing, the closer to 1, the higher the possibility to get a new loan in the next six months.*

[23] *In June and December 2017 it was respectively 26.4% and 24.7% of total business loans.*

been no significant changes. For resident enterprises[24], the outstanding loans narrowed during the period by ALL 8.5 billion (or 2.6%), to ALL 321 billion. By currency, the main contributor to the narrowing of outstanding loans for resident businesses during the period was the credit contraction in euro by about ALL 8.3 billion (or 4.7%).

Chart 5.7 Loan structure for businesses by maturity term (left) and currency (right)



Source: Bank of Albania.

(28) In the stock of loans to enterprises, concentration on small and medium-sized enterprises has increased over a one-year period. Credit share for these businesses increased, respectively 21.8% and 23.2% of total loans to businesses, while the share of credit to larger enterprises decreased to 55%[25]. During the period, small and medium-sized enterprises continued to increase their share of short-term loans, while the larger enterprises were oriented towards long-term loans. By currency, it is noticed that small and medium-sized enterprises have reduced the share of borrowing in the domestic currency in favour of the foreign currency; while the larger enterprises has expanded borrowing in lek.

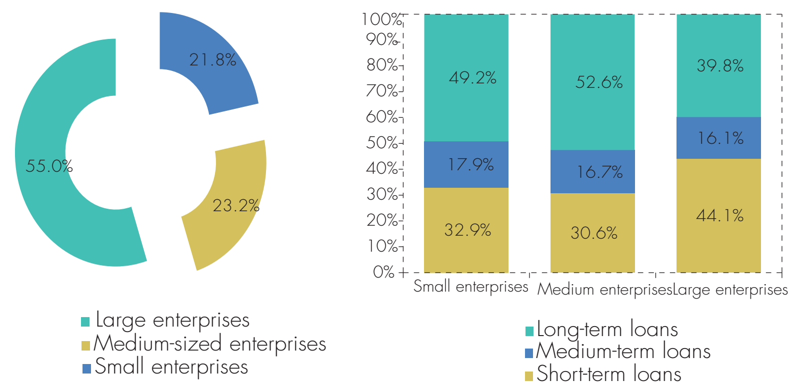
(29) The portfolio quality for loans to enterprises has remained largely changed over the period, while in annual terms it has improved in all its components. As at June 2018, for enterprises, the non-performing loans ratio (NPLR) was 17.1%, from 19.5% a year earlier[26].

[24] *It accounts for about 63% of loans to resident entities.*

[25] *These values were respectively: 55.5% (B .Large); 22.8% (B .Medium) and 21.7% (B. small) in December 2017; while in June 2017 they were respectively: 56.9%; 22.5%; and 20.7%.*

[26] *By contrast, there is a slight deterioration of this indicator compared with December 2017, with a value of 16.9%*

Chart 5.8 Enterprises' loan structure by size



Source: Bank of Albania.

BOX 4.2. SURVEY RESULTS ON THE FINANCIAL SITUATION AND BORROWING OF ENTERPRISES

Survey of financial situation and borrowing of enterprises has been carried out for eight years now, with a six-month frequency. Starting from 2016 H1, this survey was launched with a sample of about 1200 enterprises of all sizes located across the country and carry out their activity in the main sectors of the economy. In 2018 H1, the sample of enterprises was reviewed to ensure the preservation of its characteristics, in addition to the level and quality of responses but without changing the total number of enterprises.

During the first half of the year, enterprises report that the issues related to access to finance and financing costs have marked a slight increase in the assessment for all sizes of enterprises.

Competition and finding a market are considered as the main challenges for enterprises activity, while the issues related to access to finance and financing costs increased slightly.

Sales continue to trend upward during 2018 H1 for large enterprises but downward for small and medium-sized enterprises. In line with sales performance, large enterprises have assessed as upward the positive financial result during the period. The positive performance of the sales level and the financial result was also reflected in the expansion of the activity of these enterprises, where both small and medium-sized enterprises have stated an increase in their investments. Expectations for enterprises of all sizes are positive regarding to sales, financial performance and expansion of the activity, continuing to deliver optimistic signals for their performance in the short and medium term.

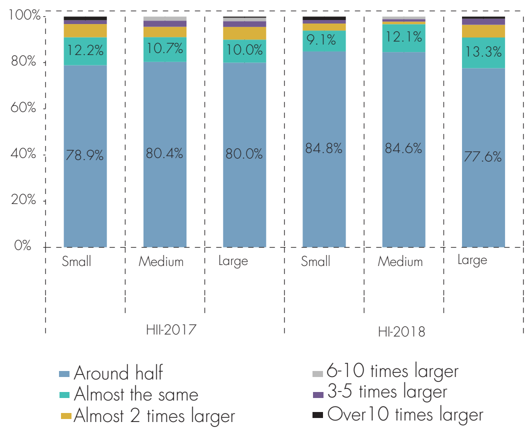
Over the period, more than half of the total enterprises that have responded have financed their activity through sales. The borrowing as a separate or combined source was used by 21.1% of large enterprises, 20.5% of medium-sized enterprises and 11.1% of small enterprises. About 42.5% of the total *enterprises (473 enterprises in total) state they have a loan to pay. This share has remained largely unchanged compared to the survey results for 2017 H2 for small and medium-sized enterprises; meanwhile, there has been a slight decline for large enterprises. About 88.2% of the total borrowing enterprises claim to have asked banks to lend them a loan. This share reaches 90.5% for the total of formal sources (banks and non-bank financial institutions).*

About 74.2% of small enterprises, 77.2% medium-sized and 79.5% of the large enterprises consider their borrowing level to be adequate for financing the activity. Compared to 2017 H2, this share is lower for all sizes of enterprises.

Borrowing is carried out only in domestic currency for 44.4% of the total of small borrowing enterprises, 51.2% of medium-sized enterprises and 40.3% of large enterprises. Borrowing in the European currency has a greater share for large enterprises, precisely for 44.9% of them, outperforming domestic currency. This borrowing accounts for 41.3% for small enterprises, while for medium-sized enterprises it accounts for 36%. Borrowing in US dollar has a small share that does not exceed 7.9% of the total (small enterprises). New borrowing during the six-month period is declared by 7.6% of small enterprises, 8.7% of medium-sized enterprises and 11.2% of large enterprises.

The borrowing process is estimated between "normal" and "difficult" by the banks, while the importance of the relationship with banks is rated between "important" and "necessary" level for all three sized enterprises.

Chart 5.9 Distribution of enterprises and loan / capital ratio



Source: Bank of Albania.

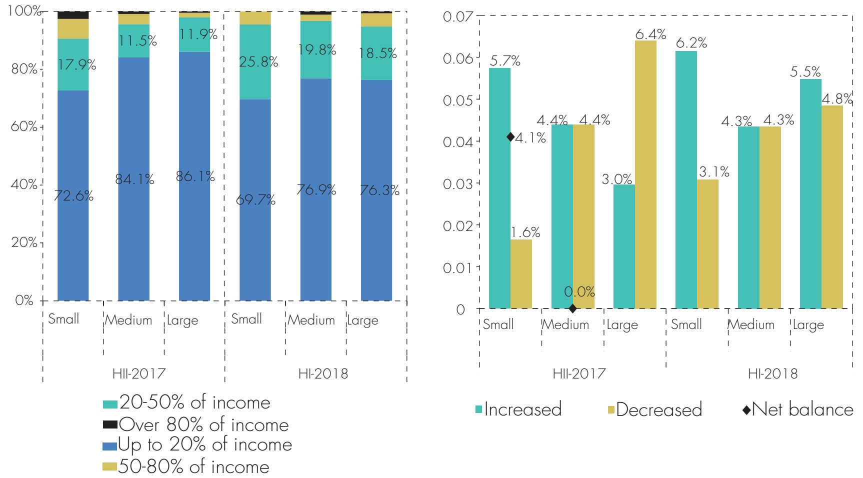
(30) Enterprises debt burden shows no significant changes over the period, and is estimated at affordable levels. More concretely, according to the above survey, about 42.5% of surveyed enterprises state they have a loan to pay. This value is almost the same as the one in the previous period. The share of borrowing enterprises is higher in the trade sector (57.8%) and construction (48.5%). The total value of the loan results roughly half of the enterprise's capital value for 80% of borrowing enterprises. Size shows that the debt burden is higher for large enterprises, where about 22.4% of them state that the value of the loan is equal to or greater than the capital value. Analysing the results of the responses by sectors, it turns out that the industry sector has the highest share of enterprises that have a loan burden larger than the enterprise's capital value.

Table 5.2 Share of enterpriseswith higher loan value than equity: by sectors

	Industry	Services	Construction	Trade
2016 H1	18%	11%	13%	20%
2016 H2	11%	7%	8%	9%
2017 H1	7.9%	15.7%	5.8%	13.3%
2017 H2	10.2%	11.9%	7.3%	8.3%
2018 H1	10.3%	6.3%	4.3%	6.7%

(31) Most of the borrowing enterprises (75.3%) state that the loan payment amounts goes up to 20% of the enterprise's revenue and this share has decreased compared to the previous six months. The burden of loan payments seem to be heavier for small enterprises, where the number of enterprises which report that this payment exceeds 20% of revenues, accounts for about 30.3% of the total of the group[27]. For medium-sized enterprises this share is 23.1%, while for the large ones 23.7%.

Chart 5.10 Distribution of Enterprises and Payment report (left) and Relevant Changes (right)

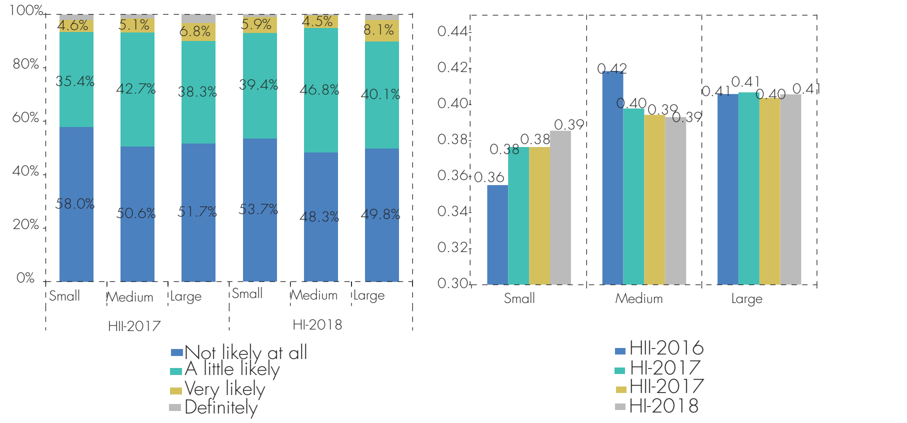


Source: Bank of Albania.

(32) The enterprises credit demand remains moderated. According to the survey, more than half of the total enterprises (50.3%) stated that there is no chance of borrowing a new loan in the next six months. This share resulted in decline for all three groups of enterprises. Meanwhile, for all sizes the share of enterprises that state that there are few chances to obtain a loan in the following period has increased.

27 Calculated as the sum of the responses' weight: "20-50% of income", "50-80% of income" and "over 80% of income".

Chart 5.11 Loan planning and the relevant index*



*The index is calculated by weighting the weights of enterprise responses to the total of responses by a coefficient which increases with the increase of borrowing potential. The coefficient for "not likely at all" is 0.25, for "a little likely" it is 0.5, for" very likely "it is 0.75 and for" definitely "is 1.

Source: The Bank of Albania.

(33) **Loan borrow planning index** for the next six months has marked the lowest value by 0.39 (small enterprises) and the higher 0.41 (large enterprises), showing somewhat bigger chances of borrowing during 2018 H2 for these enterprises.

6. FINANCIAL SYSTEM STRUCTURE

(34) Financial system structure shows a decrease in the share of total assets to Gross Domestic Product (GDP). This performance was driven by the decrease in the share of banking sector's total assets. Meanwhile, non-banking sector activity, in terms of GDP, remained stable.

*Table 6.1 Share of segments of the financial system to GDP over the years**

Licencing and supervising authority	Financial system	2011	2012	2013	2014	2015	2016	2017	6ml-2018
Bank of Albania	Banking Sector	88.1	92.1	94.8	97.6	97.3	100.5	99.4	97.1
	Non-bank institutions	2.7	2.7	2.7	3.0	2.9	3.0	3.2	3.2
	SLAs and their Unions	0.8	0.8	0.7	0.8	0.8	0.6	0.6	0.6
Albanian Financial Supervision Authority	Insurance companies	1.5	1.6	1.7	1.9	2.1	2.1	2.1	2.1
	Pension funds	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
	Investment funds		1.2	3.9	4.8	5.0	4.7	5.0	4.7
Financial intermediation		93.1	98.6	103.8	108.2	108.0	111.0	110.5	107.8

Source: Bank of Albania.

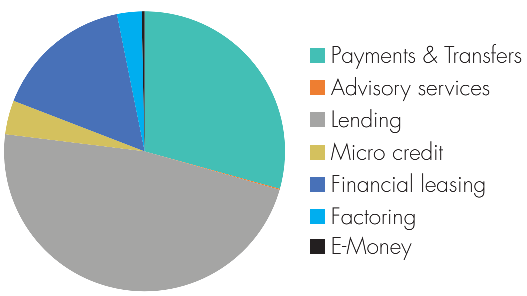
**: The GDP value is supported by the statistics published by INSTAT. For the period, this value corresponds to 2018 Q1, the latest value published up to the approval of this Report.*

6.1 NON-BANK FINANCIAL SECTOR

6.1.1 INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA

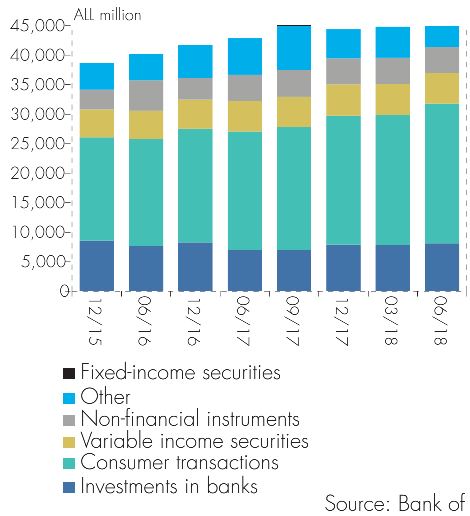
(35) During the period, non-bank financial institutions (NBFIs) expanded their activity and their financial indicators showed good performance. As at end of June 2018, 30 NBFIs were operating, mainly engaged in microcredit, lending, leasing, factoring and e-money, etc. Lending NBFIs had the main share, followed by those that provide payment and transf er services. NBFIs'

Chart 6.1 Structure of NBFIs by type of activity



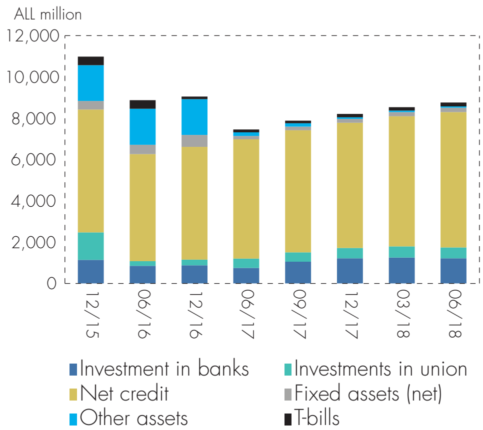
Source: Bank of Albania.

Chart 6.2 Structure of the assets of NBFIs



Source: Bank of Albania.

Chart 6.3 Structure of savings and loan associations, ALL million



Source: Bank of Albania.

assets registered ALL 47 billion, up in both half-yearly and annual terms by 5.8% and 9.8%, respectively. The NBFIs' financial result was positive at ALL 1.2 billion, and upward from a year earlier (ALL 0.7 billion); capitalisation of the activity was adequate.

(36) **Savings and loan associations performed positively and expanded their activity, both in annual and half-yearly terms.** The growth of investments in the banking sector, in the form of current accounts, deposits and net credit, determined the behaviour of savings and loan association for the period. The financial result of SLAs was positive, but lower than in the previous year, at ALL 44 million. Net loans to members and investments in banks represent the main items in NBFIs assets. As at June 2018, thirteen active savings and loan associations operated in the market.

6.1.2 INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY

(37) **The activity of insurance companies increased.** As at end-2018 H1, there were 11 licensed insurance companies carrying out life and non-life insurance activity and one re-insurance company. The assets of these institutions recorded 4.1% annual growth, at ALL 30.5 billion. Investments in banks have the main share in the balance sheet of insurance companies, around 30% for the period. Gross written premiums[28], with the main contribution from non-life premiums (92%), which represent the main source of funding for the insurance companies activity, expanded by 3.9% in annual terms.

(38) **The activity of investment funds[29] shrunk compared with the end of 2017, as a result of the decrease of investments in government securities.** The value of net assets fell to ALL 66.5 billion, from ALL 72 billion. Four active investment funds operate in the Albanian financial system. Funds' assets are mainly invested in T-bills and bonds issued by the Government of the Republic of Albania in lek and euro.

(39) **Supplementary Private Pension Funds[30] expanded their activity during the period.** In Albania, 3 supplementary private pension funds operate in the financial market. The assets of these funds registered ALL 2 billion or 16% higher than the end of 2017. The activity of pension funds is dominated by investments in government debt securities.

[28] *AFSA, "Insurance Market Statistical Report: January-June 2018", published on 25 July 2018.*
[29] *AFSA, "Tregu i sipërmarrjeve të investimeve kolektive", 30 Qershor 2018, publikuar 27 gusht 2018 (in Albanian only).*
[30] *AFSA, Statistical Report "Developments in the private supplementary pensions", 30 June 2018, published on 16 August 2018.*

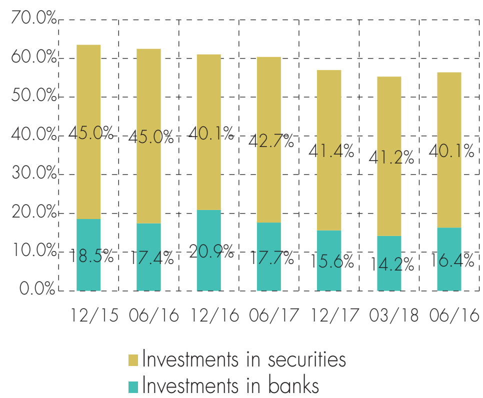
(40) Albanian Securities Exchange (ALSE) licensed by the Albanian Financial Supervision Authority (AFSA) in July 2017, started its activity on 22 February 2018. In accordance with the limited license for the first year, the activity of ALSE during the period consisted in transactions with government debt securities. At the end of the period, ALSE had four members, all of which are banks. The transactions conducted in ALSE are transactions on behalf of ALSE members' portfolio (interbank transactions) and transactions on behalf of customers (individuals and legal persons). As at end- June 2018, the volume of trading in ALSE was ALL 1,263 million. The statistical data reported in AFSA shows that interbank transactions share around 81.5% of the trading volume; the rest belongs to transactions with clients. Depending on AFSA's decision, ALSE projects to list and accept other securities for trading in the future.

6.1.3 RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANK SECTORS

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

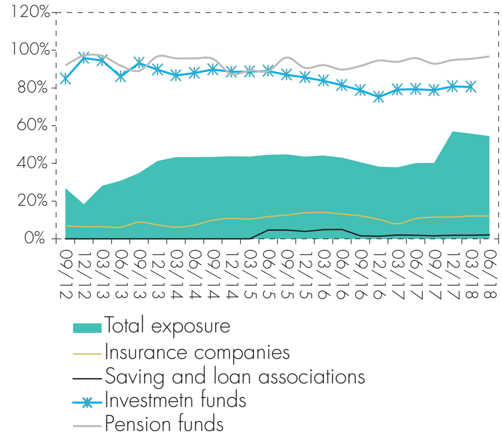
(42) The vulnerability of non-banks to the activity of the banking sector is high and upward during the period. In total, this exposure accounts for 16.4% of the assets of non-banks compared with 16% at the end of 2017. Insurance companies and non-bank financial institutions (NBFIs) have the highest share of exposure to the banking sector, with their placements in banks in the form of deposits and equity instruments accounting for 31.2% and 17.2%, of respective assets. Pension funds and NBFIs record decreasing exposure.

Chart 6.4 Investments of non-bank sector in banks and government securities to the total assets of the non-bank sector (share, in %)



Source: Bank of Albania.

Chart 6.5 Investments of non-bank sector financial institutions in government securities, to their total assets (in %)



Source: Bank of Albania.

6.2 BANKING SECTOR

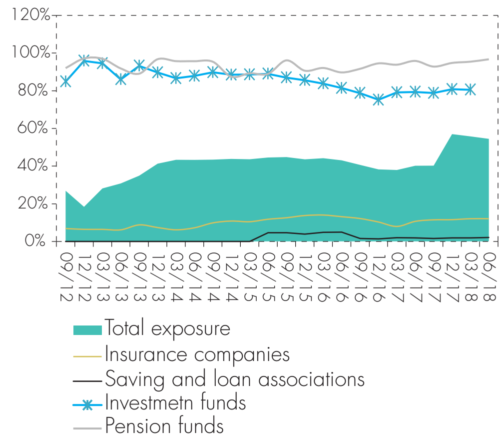
(43) During the period, banking sector's assets shrunk by 1.3%; meanwhile changes in the balance-sheet structure were insignificant. The reported value of total assets dropped by ALL 20 billion, affected by two items: "treasury and interbank transactions" and "customer transactions" (credit). Banking sector's assets expanded by 2.3% compared with a year earlier.

Table 6.2 Structure of banks' balance sheet, June 2018

Asset	% of assets	Annual change,%	Liability	% of liabilities	Annual change,%
I. Treasury and interbank transactions	33	3.2	I. Treasury and interbank transactions	5	13.2
II. Customer transactions (credit)	41	-2.4	II. Customer transactions (deposits)	80	0.7
Loans to enterprises	26	-5.1	Of which: public sector	12	0.2
Loans to households	13	4.6	Of which: private sector	68	2.0
III. Securities transactions	26	3.2	III. Securities transactions	1	65.9
IV. Created Reserve funds	-4	-23.1	IV. Other liabilities	1	12.4
V. Other assets	5	9.3	V. Permanent sources	13	6.0
			of which: Subordinated debt	1	-8.9
			of which: Shareholders' equity	11	8.7
Total assets	100	2.3	Total liabilities	100	2.3

Source: Bank of Albania.

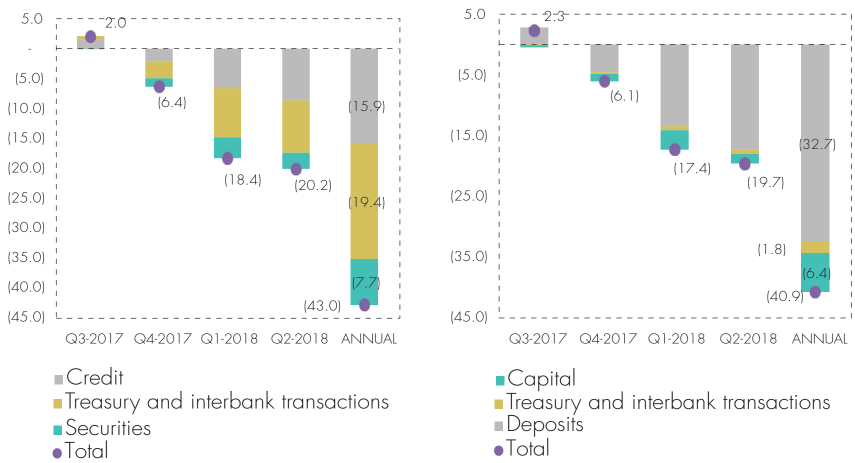
Chart 6.5 Investments of non-bank sector financial institutions in government securities, to their total assets (in %)



Source: Bank of Albania.

(44) The appreciation of lek exchange rate against the main foreign currencies provided an important diminishing contribution to the performance of the reported value of banking sector's assets. At the end of the period, banking sector's assets in foreign currency account for around 55% of total assets; liabilities in foreign currency account for 53% of total assets. These shares slightly change from the previous periods. Based on the values of these shares by period, Chart 6.6 shows the impact of lek's exchange rate appreciation, during the last year for the main items in the banking sector's balance sheet. This impact of the exchange rate should be taken into account when analysing the banking sector indicators in the future.

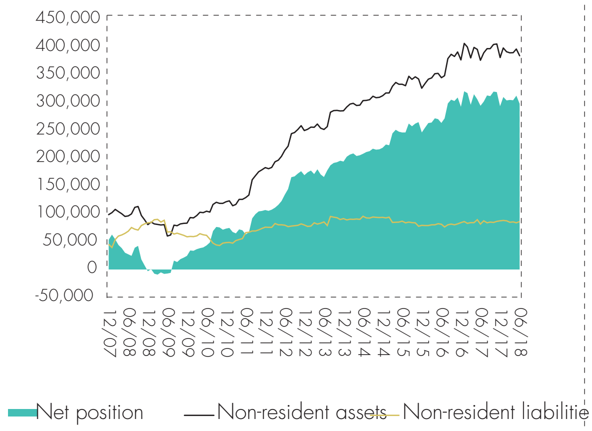
Chart 6.6 The exchage rate impact on key items of assets (left) and liabilities (right), in ALL billion



Source: Bank of Albania.

(45) **Banking sector exposure position to non-residents remains creditor and expanded somewhat during the period.** In terms of share, assets to non-residents accounted for 27% of total assets, while liabilities accounted for 6% of total assets, at the end of the period. Since 2016, these shares have fluctuated at approximate values.

Chart 6.7 Assets and liabilities to non-residents



Source: Bank of Albania.

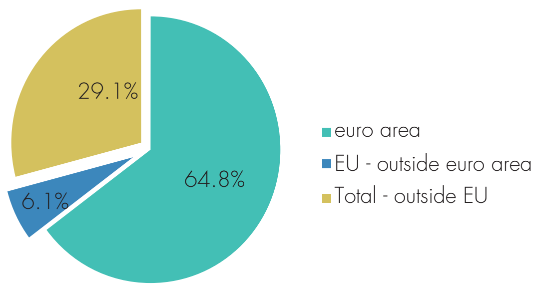
BOX 6.1. NON-RESIDENTS' EXPOSURES COMPOSITION

Focusing on the asset side of the banking sector's balance sheet, the exposure to non-residents is in the form of placements with non-resident financial institutions, investments in debt and capital instruments , and credit to non-resident financial entities.

By currency, on the asset side, placements with non-residents are denominated primarily in euro (74.2%), followed by those in USD (17.6%) and in GBP (7.2%), with euro being the main currency for placements with parent banking groups (69%).

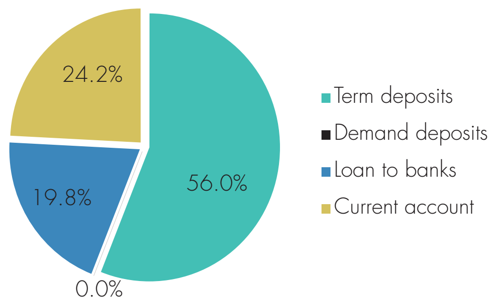
By type, the bulk of the placements with non-residents is in the form of time deposits, followed by current accounts and loans granted to banks.

Chart 6.8 Geographical distribution of placements, on asset side



Source: Bank of Albania.

Chart: 6.9 Geographical distribution by product, on asset side



Source: Bank of Albania.

By geographical distribution, placements with non-residents continues to concentrate in the euro area, within which, Germany, Austria and Italy have the highest share. Placements within the European Union (EU), but outside the euro area, have a low share (6.1%). Meanwhile, placements outside the EU share less than 1/3 of total of placements with non-residents.

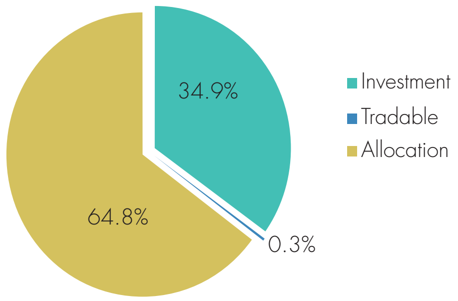
- Investments in securities of non-residents accounted for 6.3% of total assets of the banking sector. This investment increased in 2018 Q2, by around 15.6%. The composition of these investments is as follows:

By currency, securities purchased by the banking sector are denominated in euro (59.7%), followed by US dollar (31.5%). The Turkish lira and the British pound have a lower share.

By type, banks continue to hold mainly available for sale (AFS) securities, with a nominal value of ALL 58.2 billion, or 64.8% of the value of non-resident securities portfolio. The rest are mainly in the form of held to maturity (HTM) securities (34.9%) with an absolute value of ALL 31.4 billion.

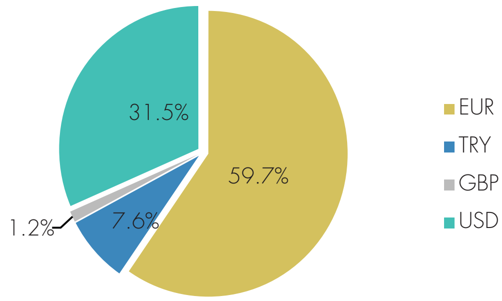
By geographical distribution, securities purchased in euro area institutions amount to 28.4% of the total, while those outside the euro area, but within the EU, amount to 20.6%. The rest is invested outside EU (51%).

Chart 6.10 Composition of investments in securities by type of instrument



Source: Bank of Albania.

Chart 6.11 Composition of investments in securities by currency



Source: Bank of Albania.

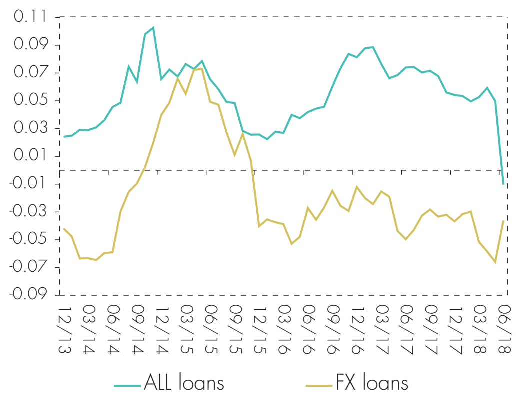
6.2.1 LOANS

(46) The reported outstanding loans fell by almost 3.1% in 2018 H1. Loans by: maturity, sector (credit to enterprises and to public sector), and currency, recorded lower values compared to the end of the previous year, while loans to households expanded by 1.9%. The decline was also observed in the annual change of the outstanding loans, which fell 2.5%. Loans to enterprises, loans in foreign currency and short and long-term loans recorded the highest fall in annual terms. ALL 7.6 billion loans have been written off the balance sheet of the banking sector over the last twelve months, ending in June 2018. If written off loans were included, then the annual contraction of loans would be 1.2%. Excluding the exchange rate effect, during the period, the growth of outstanding loans would be about 0.5% in annual terms.

Table 6.3 Loans by currency, entity and term

	Indicator and unit	Value (in ALL bln)	Share to total credit (%)			Change (%)	
	Period	06/2018	06/2017	12/2017	06/2018	Annual	Six monthly
By currency	Loans in Lek	254	43	44	44	-1.0	-3.1
	Foreign currency loans	329	57	56	56	-3.6	-3.1
By institution	Public sector	28	5	6	5	-9.4	-27.1
	Enterprises	373	66	64	64	-5.1	-3.0
	Households	181	29	30	31	4.6	1.9
By maturity	Short-term	171	31	31	29	-7.5	-8.1
	Medium-term	107	20	18	18	-10.1	-2.6
	Long-term	304	49	51	52	3.7	-0.2
	Outstanding loans	582	100	100	100	-2.5	-3.1

Chart 6.12 Performance of loans by currency (annual growth)

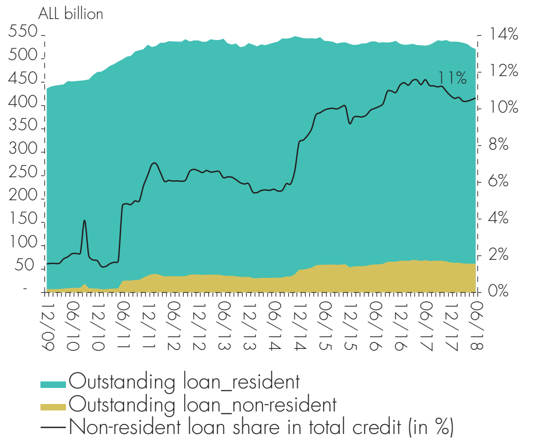


Source: Bank of Albania.

(47) The fall in loans to enterprises and the increase in loans to households, during the period, has changed the structure of loans by sectors. Currently, loans to enterprises account for 64% of outstanding loans, from 66% in the previous year (and 70% in 2014). The contraction in the loans to enterprises reflects the weak credit demand from enterprises, which is reflected in the reduction of new loans to this sector, tightening of lending standards from banks for certain categories of clients and loans, as well as the measures taken by banks to reduce the non-performing loans stock, where loans to enterprises are dominant. By residency, loans to resident and non-resident enterprises fell by 2.6% and 6.3%, respectively. During July 2017 - June 2018, banks have written off from their balance sheet in total ALL 6.4 billion loans to enterprises classified as "lost". The increase in both loans to resident households (accounting for 95% of loans to households) and to non-resident households by 1.8% and 5.6%, respectively, positively affected the growth of loans to households. Consumer loans recorded the highest growth (by 5%) in the credit to resident households. Real estate loans (accounting for 63% of credit to households) remained unchanged during the period, and amounted to ALL 108 billion. Banks reported that households credit demand remains strong; meanwhile, lending standards to households were somewhat eased during 2018 Q2.

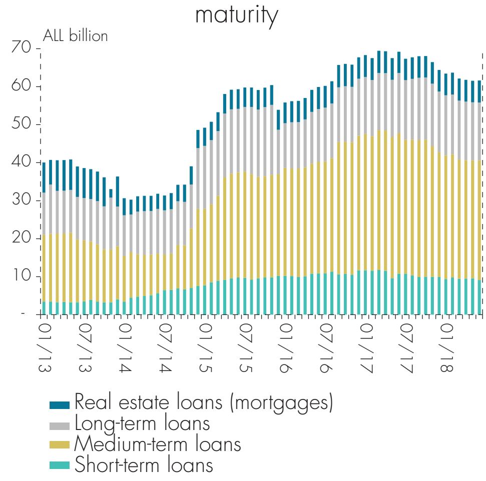
(48) During the period, loans to non-resident entities and their share to total loans trended downward. At the end of 2018 H1, loans to non-residents were around ALL 62 billion, accounting for 10.6% of outstanding loans of the banking sector, from 11.6% a year earlier. During 2018 H1, loans to non-residents fell by 4.3%, but compared with the previous year, the stock shrunk considerably by 11%, mainly driven by the fall in loans to non-resident enterprises by 6% in semi-annual terms, and 15% in annual terms. Loans in euro dominate the segment of loans to non-residents. Overall, loans to non-residents have long-term maturities, (over 12 months), with the medium-term loans having the main share in these loans.

Chart 6.13 Performance of loans to non-residents and residents



Source: Bank of Albania.

Chart 6.14 Structure of loans to non-residents by maturity



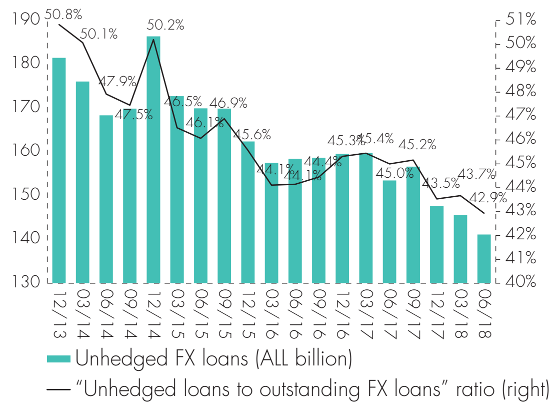
Source: Bank of Albania.

BOX 6.2 BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

Banking sector's exposure to indirect credit risk remains high, although, in recent years, the share of loans unhedged against the exchange rate to outstanding loans in foreign currency has declined. In June 2018, foreign currency loans unhedged against exchange rate fluctuations accounted for 43% of total foreign currency loans (around 2.1 p.p. less than in the previous year) and 24% of total outstanding loans (1.5 p.p. less than a year earlier). During 2018 H1, unhedged foreign currency loans decreased by 4.4%, to ALL 140 billion, mainly due to the contraction of unhedged loans in euro. Loans to enterprises have the main share (67%) in outstanding foreign currency loans unhedged against the exchange rate risk. The decline in these loans by 10% had the main contribution on the contraction of outstanding unhedged loans. Unhedged loans to households shrunk by 2%. In annual terms, unhedged foreign currency loans shrunk by 8% and mainly reflect the decrease of unhedged outstanding euro loans to enterprises.*

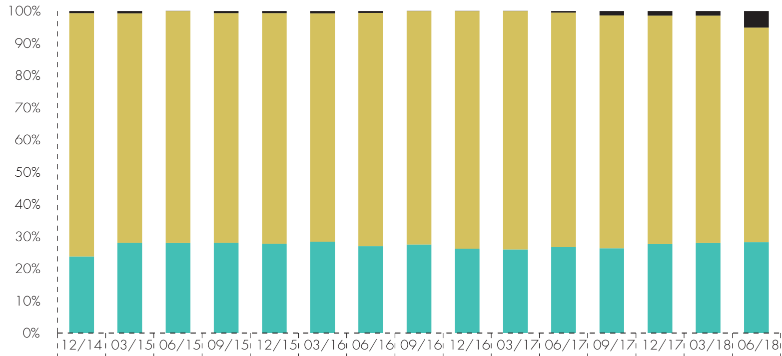
Unhedged loans for investments in real estate have the main share (around 48%) in the total stock of unhedged foreign currency loans, followed by loans granted for trade purposes (30%). The rest of the unhedged foreign currency loans were granted mainly for business development, consumption and other purposes. Unhedged loans to the trade sector, down by 15% during the period, provided the main contribution to the performance of outstanding loans unhedged against the exchange rate risk.

Chart 6.15 Performance of unhedged foreign currency loans



Source: Bank of Albania.

Chart 6.16 Unhedged foreign currency loans, by subject, %

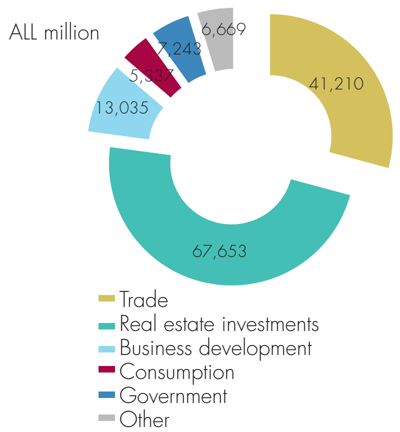


	12/14	03/15	06/15	09/15	12/15	03/16	06/16	09/16	12/16	03/17	06/17	09/17	12/17	03/18	06/18
Government	1%	1%	0%	1%	1%	1%	1%	1%	0%	0%	1%	2%	2%	2%	5%
Enterprises	75%	71%	72%	71%	71%	71%	72%	72%	74%	74%	73%	72%	71%	70%	67%
Households	24%	28%	28%	28%	28%	28%	27%	27%	26%	26%	26%	26%	27%	28%	28%

Source: Bank of Albania.

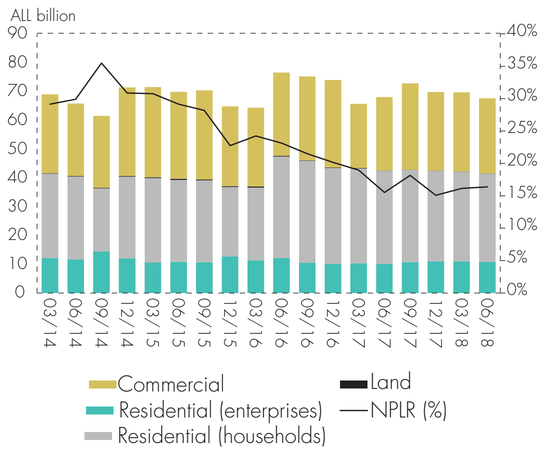
The exchange rate movements have affected the lek-denominated value of unhedged foreign exchange loans. The strengthening of lek's exchange rate against main foreign currencies (mainly euro) affected the narrowing of the reported value of unhedged foreign currency loans.

Chart 6.17 Unhedged foreign currency loans (composition)



Source: Bank of Albania.

Chart 6.18 Unhedged foreign currency loans for real estate and its quality (right)

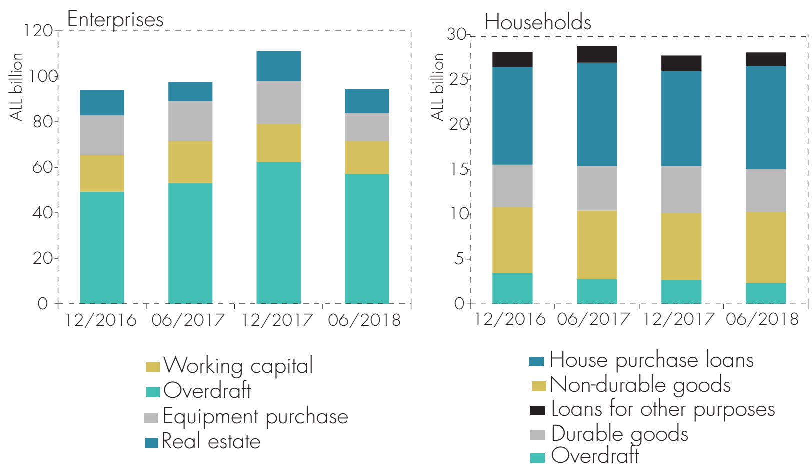


Source: Bank of Albania.

* *Outstanding euro loans, when the borrower's income is in Albanian lek, accounts for 88% of the outstanding unhedged foreign currency loans*

(49) New loans granted by the banking sector during the period were 12% lower compared with 2017 H2, and amounted to ALL 124 billion. The fall in new loans was conditioned by the contraction of new loans to enterprises (by 16%, at ALL 95 billion); meanwhile the new loans to households were somewhat higher from the previous period. By currency and maturity, new euro loans and new long-term loans had the main contribution to the reduction of new loans during the period. The share of the new loans in lek was 55% of the overall flow of new loans and their amount was similar to those of 2017 H1 and 2017 H2.

Chart 6.19 New loans to enterprises and households by purpose of use



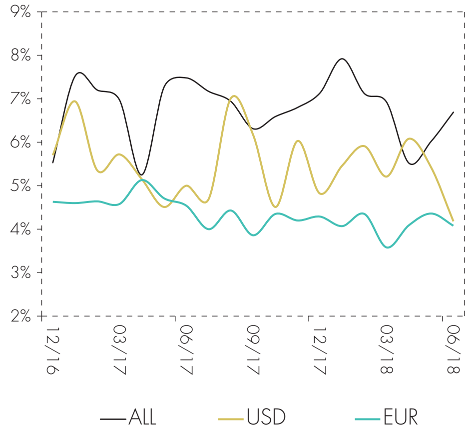
Source: Bank of Albania.

(50) Interest rates on new loans increased in 2018 Q2, but remain below the level of the previous period. In June 2018, the weighted average interest rate on new loans was 5.6%, around 0.1 percentage point lower than the rate on new loans granted in December 2017. The aggregate interest rate on new loans was primarily influenced by the interest rates on loans in lek to enterprises. In 2018 Q2, interest rates on both loans in lek and loans to enterprises increased. The increase in interest rates and the tightening of lending standards on specific borrower categories may have dampened the credit demand by enterprises. The weighted interest rate on new loans in lek was around 7%, while the interest rate on loans in euro and US dollar was around 4%. The interest rate on new loans to households continues to be higher compared with the interest rate on loans to enterprises, but the fluctuations around the average were insignificant and the rate was stabilised around the value 6%.

Chart 6.20 Weighted interest rates on new loans

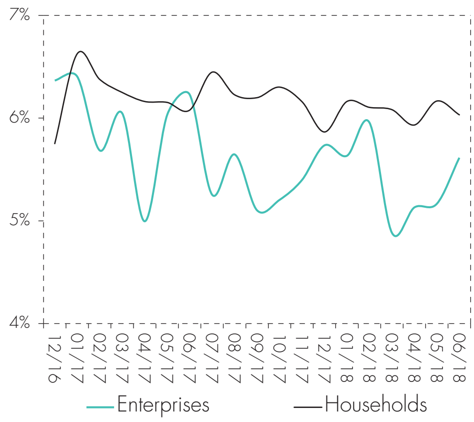
Source: Bank of Albania.

Chart 6.21 Interest rates on new loans, by currency



Source: Bank of Albania.

Chart 6.22 Interest rates on new loans, by entity



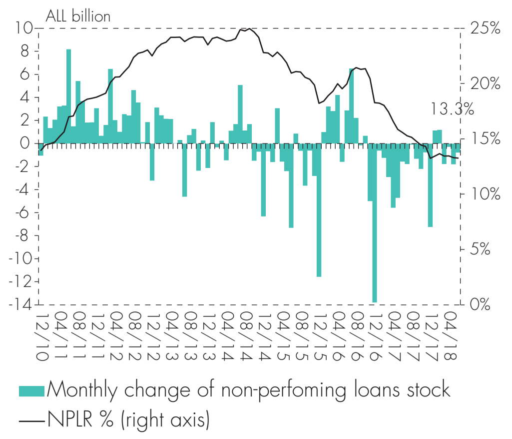
Source: Bank of Albania.

6.2.2 CREDIT RISK AND MITIGATING FACTORS

(51) During the period, the stock of non-performing loans decreased by 3%, at ALL 77 billion. The decrease, by order of size of contribution, was influenced by: loan repayments; the write off of lost loans, and the reclassification of some non-performing loans to the performing classes of loans. Since December 2017, around ALL 9.5 billion have been paid, and around ALL 3.1 billion loss loans are written off[31], mainly represented by loans to enterprises in lek. However, the amount of new non-performing loans during the period was higher compared to the previous period. The outstanding NPLs shrank by around ALL 16 billion, or 17%, compared with the previous year.

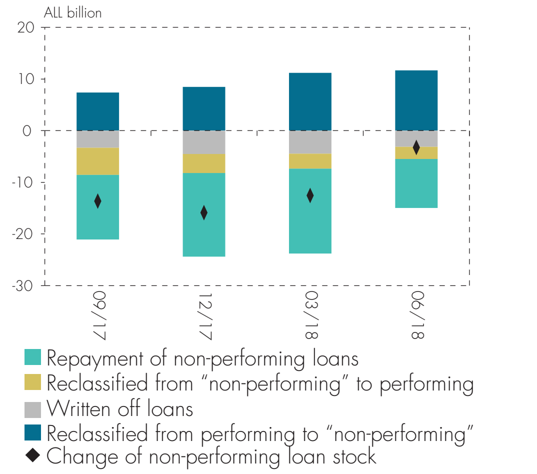
[31] *Starting from January 2015, banks are obliged under the regulatory requirements to undertake the process of balance sheets cleaning - the write off of loans falling under the "lost" category for more than three years. Overall, since the start of the process ALL 51 billion of lost loans have been written off.*

Chart 6.23 NPL ratio and monthly change in the NPL stock



Source: Bank of Albania.

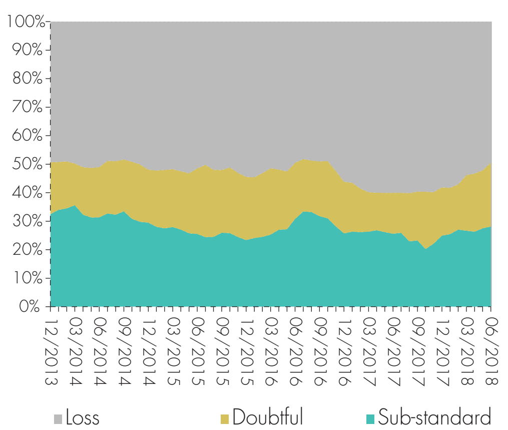
Chart 6.24 Contribution to the change of the non-performing loans stock



Source: Bank of Albania.

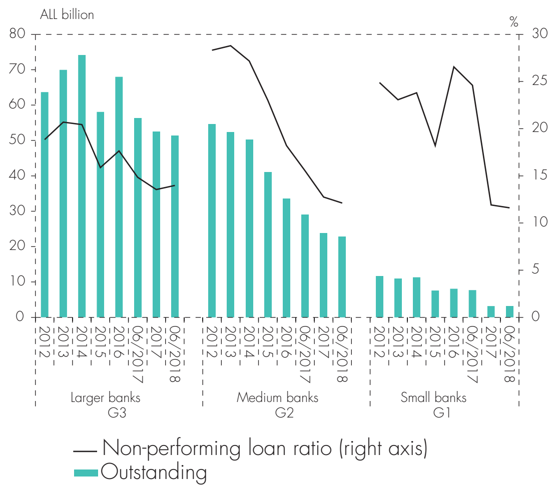
(52) The non-performing loans ratio stood at 13.3%, at the end of the period, and was equal to the end of 2017, but down by 2.2 percentage points from the previous year. "Lost" loans continue to account for the majority of non-performing loans (50%), but this share has fallen by 9 percentage points since December 2017.

Chart 6.25 Non-performing loans structure



Source: Bank of Albania.

Chart 6.26 NPL portfolio by bank groups



Source: Bank of Albania.

(53) Medium-sized and larger banks provided the main contribution to the improvement of credit quality. In absolute value, non-performing loans for this groups contracted by ALL 1.1 and 1 billion, whereas their NPL ratio was 12.1% and 14%, from 15.5% and 13.7% at the end of 2017. Larger banks continue to have the highest non-performing loans ratio.

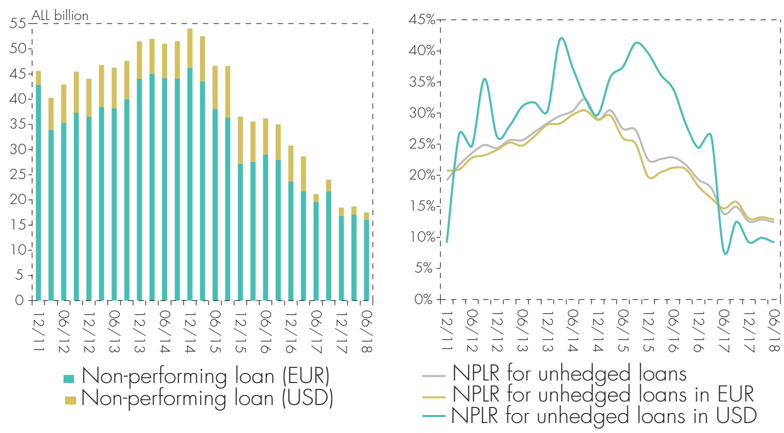
(54) The quality is lower for loans in foreign currency, loans to enterprises, and long-term loans. In June 2018, the NPL ratio for each of these loan segments stood at 14.1% (foreign currency), 17.1% (enterprises) and 15.1% (long-term), respectively. All these indicators have slightly declined during the period.

Chart 6.27 Non-performing loans in the Albanian banking sector, by sector, currency and term

Source: Bank of Albania.

(55) The quality of unhedged foreign currency loans has slightly improved during the period, and this trend has been observed since 2015. The ratio of non-performing loans for this category fell to 12.4% from 12.6% at the end of the 2017. Loans in euro provided the main contribution to the improvement of the quality of unhedged loans. The NPL ratio for unhedged euro loans fell from 13% to 12.9%, whereas the ratio for unhedged US dollar loans, maintained the same level as in December 2017 (9.2%).

Chart 6.28 Quality of the unhedged loans portfolio against the exchange rate risk



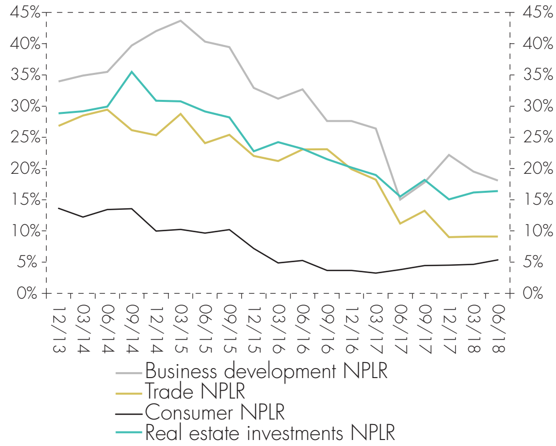
Source: Bank of Albania.

(56) Within the portfolio of foreign currency loans unhedged against the exchange rate risk, the quality of loans for business development improved considerably as the NPL ratio for this portfolio dropped by 4 percentage points during 2018 H1. Unhedged loans granted for purposes other than business development did not register notable changes in the non-performing loans ratio.

(57) The quality of loans to non-resident entities declined during the period. Outstanding loans to non-residents fell by around 4.3%, meanwhile non-performing loans to these entities increased by 38%, reaching ALL 3.5 billion. As result of these developments, the NPL ratio for loans to non-residents increased to 5.6%, at the end of the period, from 3.9% at the end of 2017. In the forthcoming period, the performance of this portfolio, the forms and jurisdictions where this portfolio is present, will continue to be monitored with the aim to manage potential risks.

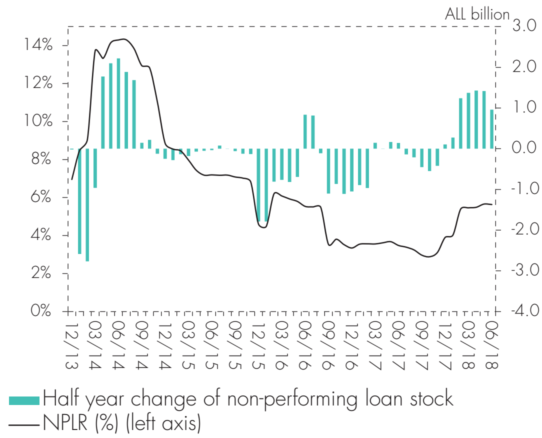
(58) The provisioning ratio for the non-performing loans fell by 5 percentage points, at 66.4%. The provisions for credit risk fell faster compared with the contraction in the stock of non-performing loans. In June 2017, this ratio was 72.5%.

Chart 6.29 Quality performance for the unhedged loan portfolio against the exchange rate risk, by purpose of use



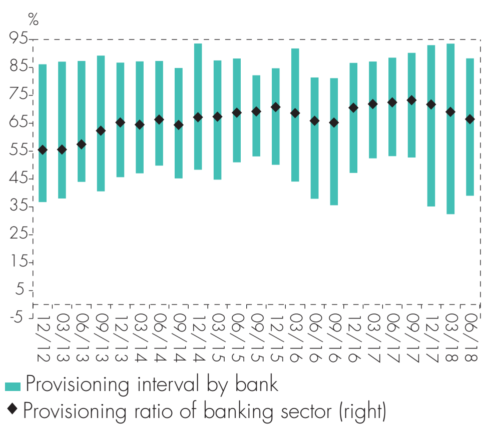
Source: Bank of Albania.

Chart 6.30 Non-performing loans for non-resident entities



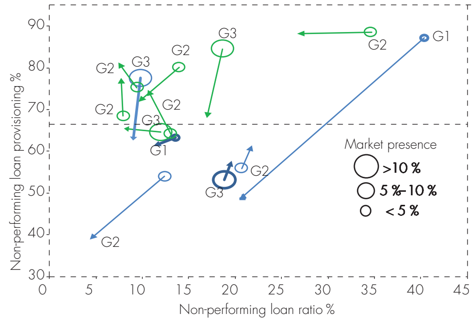
Source: Bank of Albania.

Chart 6.31 Provisioning ratio over time



Source: Bank of Albania.

Chart 6.32* Annual change in provisioning ratios - arrows show change from June 2017 to June 2018



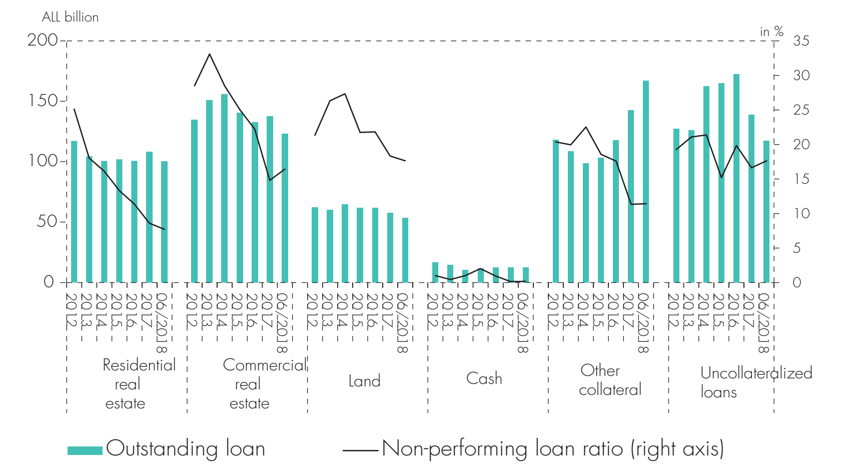
Note: This includes banks sharing more than 1% in total assets. Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows the average ratio of non-performing loan provisioning at sector level, 66.4% at the end of June 2018.

Source: Bank of Albania.

(59) During the period, capital coverage of net non-performing loans also decreased[32]. As a result of the expansion in outstanding net non-performing loans by 15%, the "net non-performing loans/regulatory capital" ratio increased to 17.2%, from 15.3% in December 2017. In the previous year, this ratio stood at 18.6%. Also, net performing loans ratio to outstanding loans expanded by 0.7 percentage point, standing at 4.5%, due to the expansion in net non-performing loans stock. In the previous year, this ratio was 4.3%.

(60) Loan collateralisation increased and is at a high level. Amongst the different types of collateral used to guarantee the loan, collateral in the form of real estate continues to have the main share. At the end of the period, collateralisation[33] stood at 80% from 77% at the end of 2017, and 72% a year earlier. Loans covered with collateral in the form of real estate account for around 61% of collateralized loans, and 48% of outstanding loans. Loans collateralised with "other" types of collateral account for about 30% of the portfolio and went up by 17%. The increase in this portfolio had a significant impact on the increase of the overall stock of collateralised loans. The quality of collateralized loans has not changed compared with the end of 2017, but it has improved considerably compared with the previous year. The NPLR for collateralised loans stood at 12.4%. The quality of non-collateralized loans, which account for 20% of overall outstanding loans has deteriorated over the period and compared with a year earlier. This performance was reflected in the increase of NPLR at 17.6%, from 16.6% in December 2017, and 15.5% in June 2017.

Chart 6.33 Outstanding loans and non-performing loans ratio by collateral



Source: Bank of Albania.

32 *Non-performing loans after the deduction of provisions.*
33 *Collateral in the form of real estate (residential, commercial or land), cash etc.*

6.3 DEPOSITS

(61) During the period, deposits fell by 1.7% or about ALL 20 billion, at ALL 1,146 billion. The fall was observed in all types of deposits by currency, sector and product. Demand deposits grew by around 3%. Time deposits, households' deposits and foreign currency deposits shrunk considerably by ALL 15, 19, and 15 billion, respectively. The stock of deposits at the end of H1 2018 was about 1% higher compared with the previous year. Enterprises' deposits, current accounts and demand deposits recorded significant annual growth by 4.7%, 2.7% and 16%, respectively. Households' deposits remained almost unchanged.

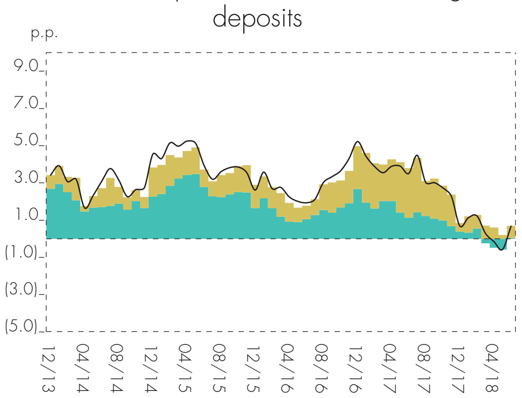
Table 6.4 Value, share and changes in main items of deposits

	Indicator and Unit	Value (ALL bln)	Share in total deposits (%)			Change (%)	
	Period	06/2018	06/2017	12/2017	06/2018	Annual	6-m
By currency	Deposits - lek	544	47	47	47	0.8	-0.8
	Deposits - fx	602	53	53	53	0.6	-2.4
By entity	Public sector	27	2	2	2	-0.8	0.0
	Enterprises	168	14	14	15	4.7	-0.2
	Households	951	84	83	83	0.0	-2.0
By product	Current account	378	32	33	33	2.7	-1.4
	Demand deposits	110	8	9	10	16.0	3.1
	Time deposits	640	58	56	56	-2.2	-2.2
	Stock of deposits	1,146	100	100	100	0.7	-1.7

Source: Bank of Albania.

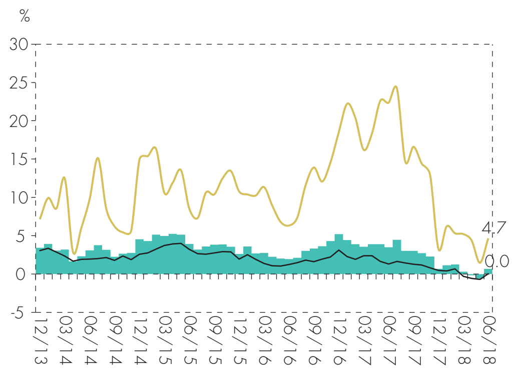
(62) Although households' deposits continue to dominate the deposit structure of the banking sector (by 83%), the main contribution to the growth in the stock of deposits over the last two years has come from the growth in the deposits of enterprises.

Chart 6.34 Contribution of enterprises and households' deposits in the annual change of deposits



Source: Bank of Albania.

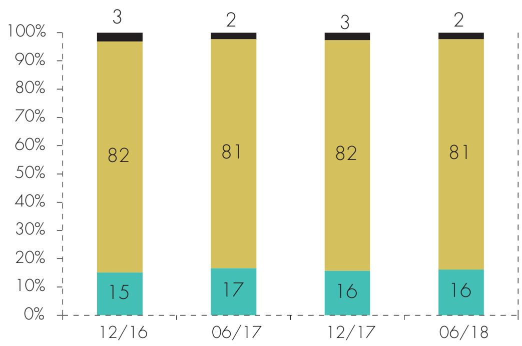
Chart 6.35 Annual change in enterprises' deposits, households' deposits and total deposits



Source: Bank of Albania.

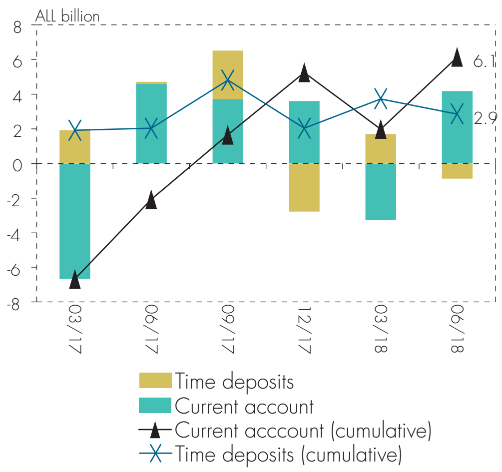
(63) **This performance is closely related to the structure of deposits by maturity.** The decrease of time deposits, which are preferred by households, given the lower interest rates, was accompanied by an increase in demand deposits and current accounts, which are preferred by enterprises.

Chart 6.36 Structure of enterprises' deposits by maturity



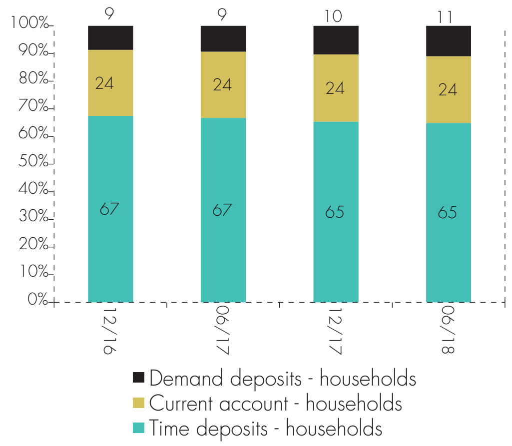
Source: Bank of Albania.

Chart 6.37 Nominal and cumulative change in enterprises ' deposits by maturity



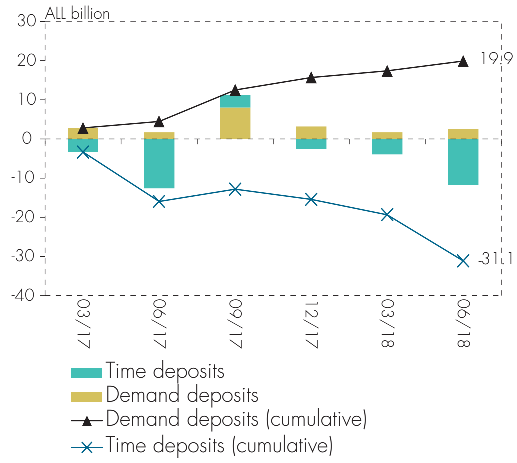
Source: Bank of Albania.

Chart 6.38 Structure of households' deposits by maturity



Source: Bank of Albania.

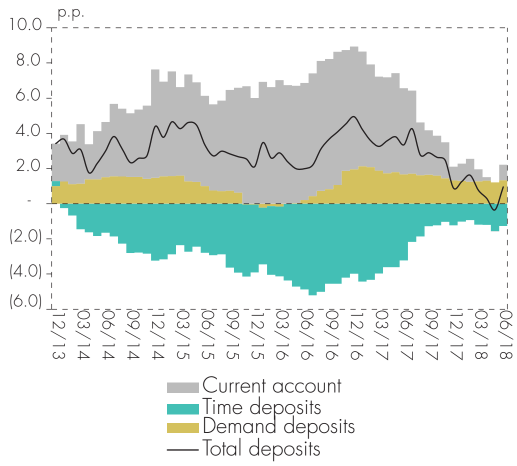
Chart 6.39 Nominal and cumulative change in households' time and demand deposits



Source: Bank of Albania.

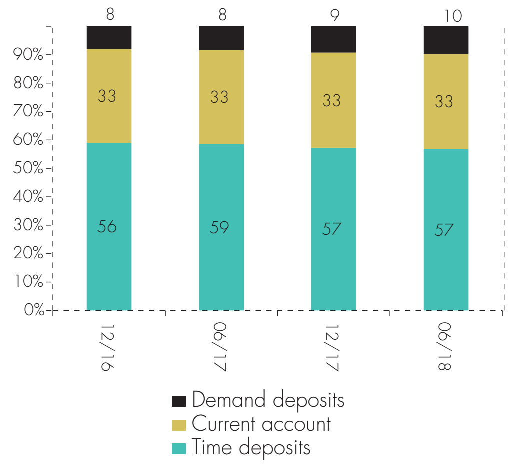
(64) **The annual growth of current accounts, demand deposits and total deposits continues to remain positive, but the growth rate has been downward in the last two years.** Due to the negative contribution of time deposits to total deposits and the positive contribution of demand deposits and current accounts, during the last two years, to the structure of deposits by maturity, the share of time deposits fell by 2 percentage points, at 57%; the share of demand deposits increased by 2 percentage points, at 10%; while the share of current accounts remained unchanged at 33%.

Chart 6.40 Contribution of deposits by maturity in the annual growth of deposits



Source: Bank of Albania.

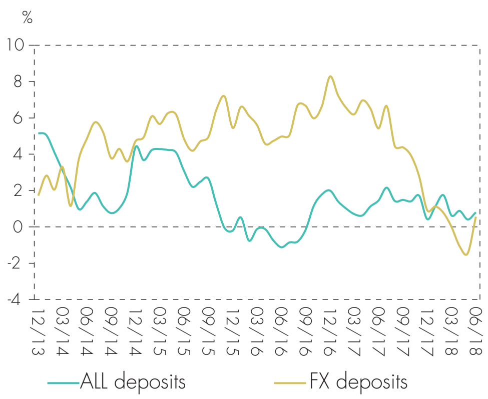
Chart 6.41 Structure of deposits by maturity



Source: Bank of Albania.

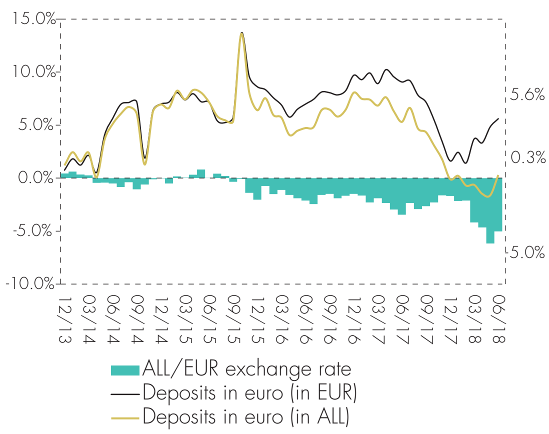
(65) The share of foreign currency deposits in total deposits remained unchanged during the period, and was 52.9% at the end of June. The share of foreign currency deposits to total deposits has remained unchanged, despite the negative impact of the lek/euro exchange rate appreciation, because foreign exchange deposits in their original currencies have increased. The appreciation of the lek against the two main foreign currencies has lowered the lek-value of foreign currency deposits by ALL 31 billion during 2018 H1 and by ALL 33 billion in annual terms. Excluding lek's appreciation, deposits in foreign currency would have increased by ALL 16 billion during the period and by ALL 36 billion from a year earlier. Meanwhile, in the original currency, deposits in euro, accounting for about 85% of deposits in foreign currency, grew by EUR 110 million during the period, and by EUR 210 million from a year earlier, or by 2.9% and 5.6%, respectively.

Chart 6.42 Annual growth of deposits by foreign currency



Source: Bank of Albania.

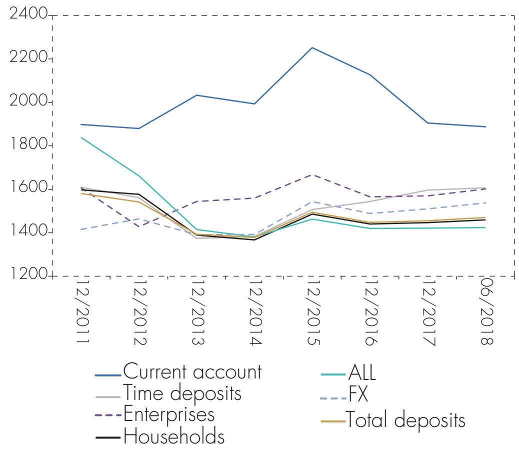
Chart 6.43 Annual growth of deposits in euro, in the original currency and in lek, and annual change in ALL/EUR exchange rate



Source: Bank of Albania.

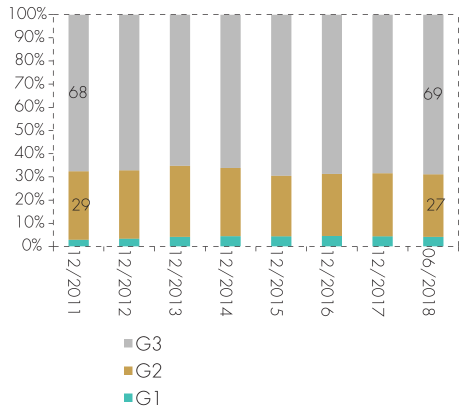
(66) The concentration of deposits in the banking sector remains low and has not changed considerably during the period. Current accounts have the highest concentration ratio, while deposits in lek and demand deposits have the lowest concentration. Structure of deposits by the size of banks, peer groups G1, G2, and G3 has remained almost unchanged since the end of 2011. Around 70% of deposits are held by the banks of G3 and 27% by banks of G2.

Chart 6.44 Herfindahl Index for deposits by maturity, sector and foreign currency



Source: Bank of Albania.

Chart 6.45 Share in total deposits by banking peer groups, G1, G2, G3

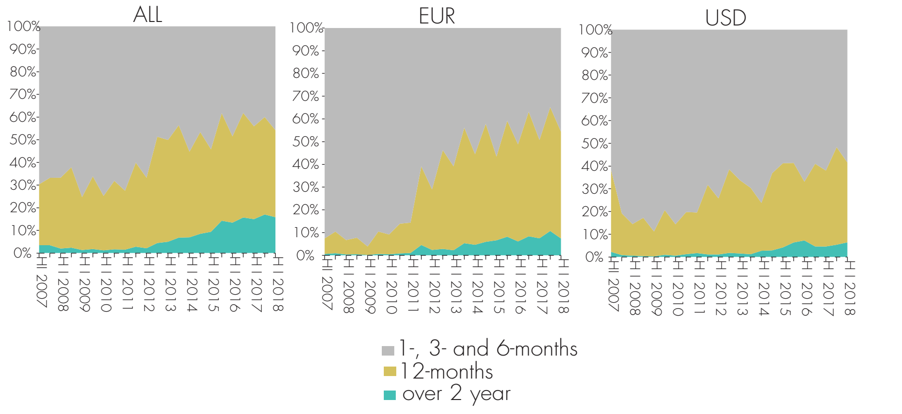


Source: Bank of Albania.

(67) During the period, the flow of new time deposits in the banking sector was ALL 228 billion or around 23% lower than in 2017 H2. The share of new time deposits in total new deposits fell by around 13%, from 16% in 2017 H2 and in the previous year. Within the category of new time deposits, there was a slight shift towards shorter-term maturities for the three main currencies. The fall in deposits was observed in the new deposits denominated in lek, euro and US dollar. New deposits in lek decreased by around 17%, in euro by 30% and in US dollar by around 11%.

(68) The average interest rates on new time deposits showed low volatility during the period. The average rate on new time deposits in lek was around 1%, while those for deposits in US dollar and euro were 0.46% and 0.14%, respectively. The share of deposits up to 12 months, in the total flow of new time deposits, increased during the period.

Chart 6.46 New time deposits by currency and maturity, 6-month flows

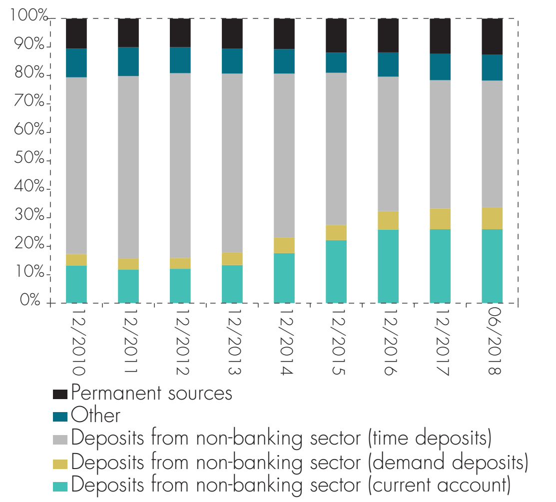


Source: Bank of Albania.

6.4 LIQUIDITY RISK

(69) Liquidity position of the banking sector remains at good levels. The deposits of the private sector and of households, accounting for around 80% of the overall value of the sector's liabilities, continue to represent the main financing source of the activity of the banking sector. The funding from deposits and interbank loans and from securities does not exceed 5% of overall liabilities. The share of deposits to liabilities of the banking sector has maintained this level for a long period, but in the last 4-5 years, the structure of deposits has changed in favour of current accounts.

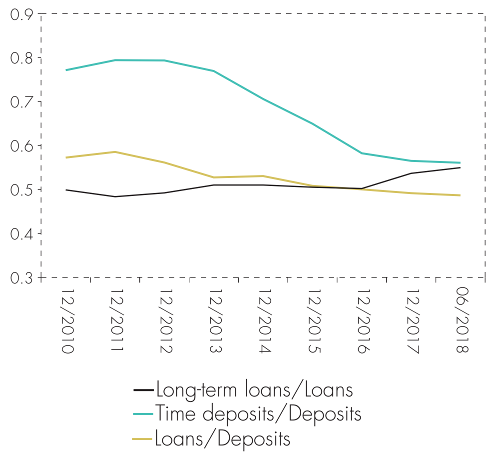
Chart 6.47 Structure of banking sector funding



Source: Bank of Albania.

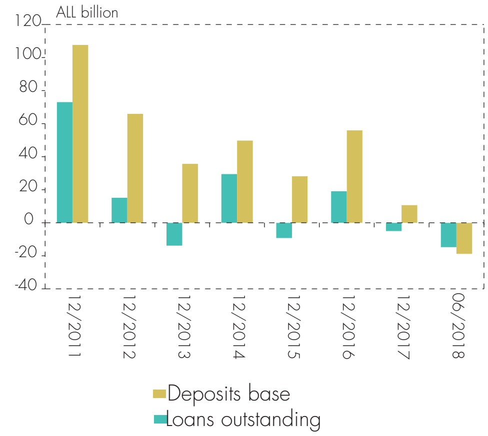
(70) Outstanding loans account for 50% of total deposits; this ratio trended down during the period. By currency, this ratio stands at 46.6% for lek and 54.6% for foreign currency. Over the last decade, this ratio has dropped by around 10 percentage points, due to the faster growth in the base of deposits compared with loans. In the period 2011 - 2017, private sectors and households' deposits expanded on average by ALL 50 billion per year; meanwhile, outstanding loans, including the years with negative changes (2013, 2015, and 2017) expanded on average by ALL 16 billion per year. The banking sector has a sufficient inflow from deposits, to finance and expand both its overall activity and lending. Nevertheless, the change in the funding structure towards short-term sources and the increase in the share of long-term loans are likely to put pressure on the stability of the liquidity of the banking sector.

Chart 6.48 Ratio of: loan-to-deposit; time deposits-to-total deposits; and long-term loan-to-total loans



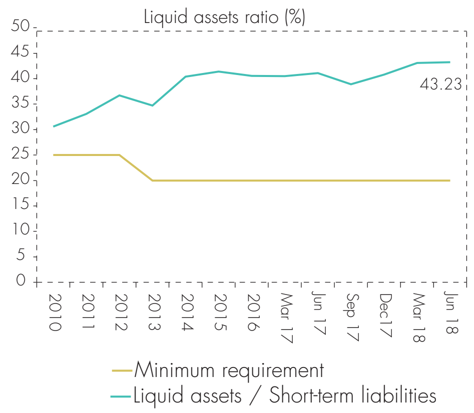
Source: Bank of Albania.

Chart 6.49 Change in outstanding loans and deposits in years



Source: Bank of Albania.

Chart 6.50 Liquidity indicators



Source: Bank of Albania.

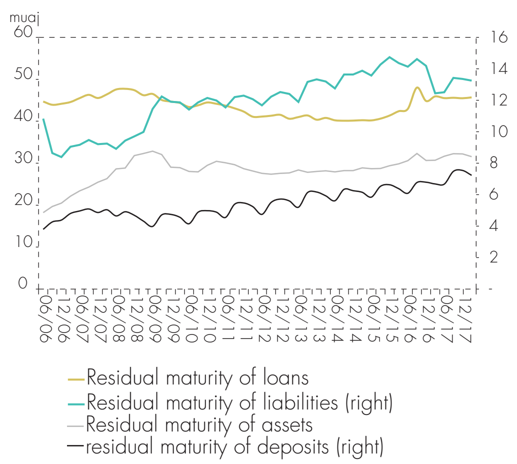
(71) The share of liquid assets in the banks' balance sheets remain high, reflecting the slowdown in lending. At the end of June 2018, the ratio of liquid assets to total assets of the banking sector was 32.2% or around 2 percentage points higher than in 2017 H2. The other liquidity indicator - "liquid assets to total short-term liabilities" - also increased by 2.4 percentage points, to 43.2%. Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities, by residual maturity segment, against total assets in the short-term, needs to be carefully and regularly monitored.

(72) The mismatch between medium-term assets and liabilities decreased over the period. At the end of June 2018, this mismatch was around 18.3 months, from 18.9 months at the end of 2017. The remaining maturity of deposits, as the most representative category of liabilities, dropped to 7.2 months (from 7.5 months), during the period, as a result of the decline in the stock of time deposits. The residual maturity for loans, increased very slightly at 45.5 months, reflecting the banks propensity to grant loans for longer-term periods.

6.5 FINANCIAL RESULT

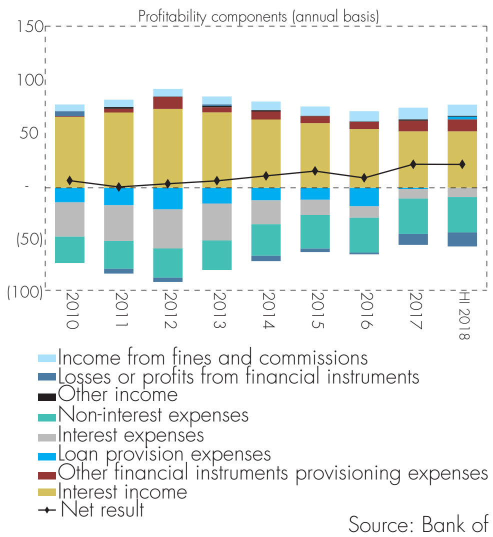
(73) The net financial result of the banking sector at the end of H1 2018 was positive and comparable in size to the result recorded over the first half of the previous year. Net interest income was also comparable with that registered in 2017 H1, since both interest income and interest expenses did not change significantly. At the end of 2018 H1, the banking sector registered a positive financial result of ALL 11 billion. This amount was ALL 1 billion lower than in 2017 H1. The decline in the net financial result was affected by higher losses from financial instruments. The net interest income rose slightly. The average profitability indicators RoA and RoE were 1.54%; and 15%, from 1.64% and 16.7%, respectively, a year earlier.

Chart 6.51 Average residual maturity



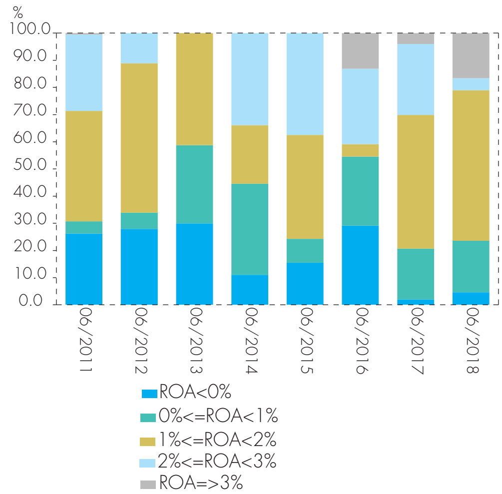
Source: Bank of Albania.

Chart 6.52 Financial result components



Source: Bank of Albania.

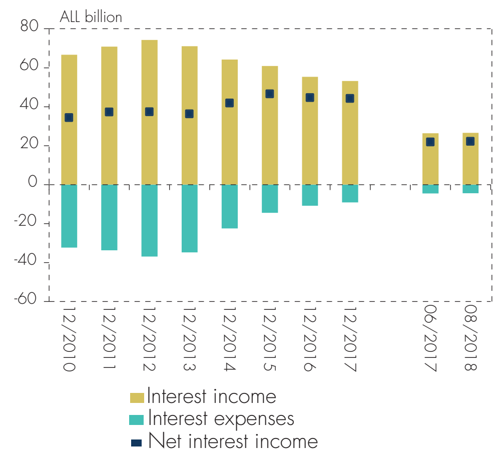
Chart 6.53 ROA by banks' share in the assets of the sector



Source: Bank of Albania.

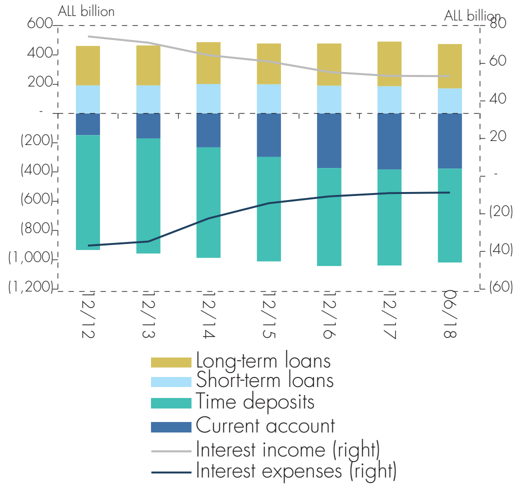
(74) Interest income grew slightly due to the gradual increase of interest rates on loans to enterprises, which account for 64% of total lending since December 2017. Another factor that may have affected the stability of interest income is the growth of long-term outstanding loans with higher interest rates, while the stock of medium and short-term loans has been declining.

Chart 6.54 Interest income and cost and net interest result



Source: Bank of Albania.

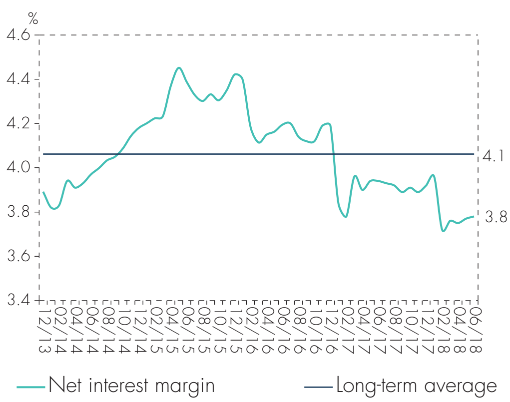
Chart 6.55 Deposits and loans by term and interest income and expenseses



Source: Bank of Albania.

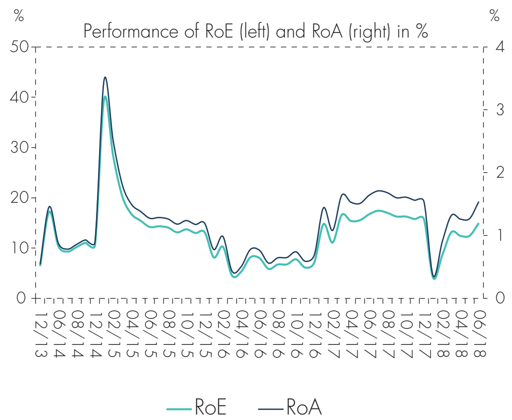
(75) **The slight growth of net interest income was not sufficient to increase the net interest margin indicator, since average income-generating assets grew faster.** Net interest margin fell at 3.8% from 3.9% in the previous year. Net interest income registered around ALL 22.2 billion, being 1.5% higher than the net interest income recorded in the previous year. The marginal growth in the net interest income was due to the increase in interest income and the decrease in interest expenses. After a 4-year period of continuous decrease, interest income and interest expenses stabilized in 2017. During 2017, the decrease on both sides was very low compared with the previous year. Interest expenses continued to decline over the period as a result of the fall in interest rates on deposits as well as the decline in the stock of time deposits in favour of current accounts and demand deposits.

Chart 6.56 Net interest margin



Source: Bank of Albania.

Chart 6.57 Profitability indicators



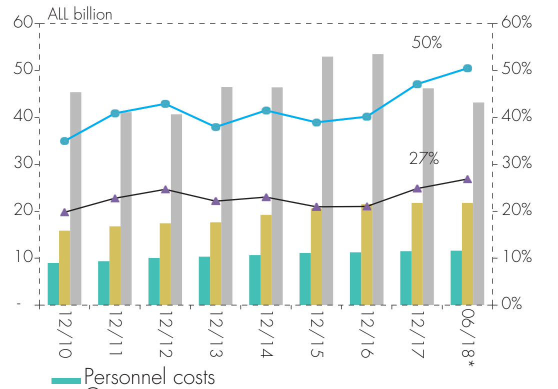
Source: Bank of Albania.

(76) Non-interest income during the period, was negative (ALL 0.6 billion) and lower than the previous year (ALL 1.3 billion). This item recorded the most significant change in the sector's financial result and represents the main factor behind the banking sector's decline in profits. Within the non-interest income category, the strongest negative contribution came from losses from financial instruments. These losses were ALL 1.8 billion higher than in the previous year. Non-interest expenses also increased, by ALL 1 billion, putting additional downward pressure on the net result.

(77) Expenses associated with credit risk provisions declined considerably by around ALL 3.7 billion as a result of reversal of credit losses. The value of provisions' reversals was around ALL 0.6 billion higher compared with the end of the previous year, providing a positive impact on the net financial result of the banking sector. The share of banks' assets that registered financial losses against the banking sector's assets was around 4.5%; during the period, only three small banks reported low financial losses.

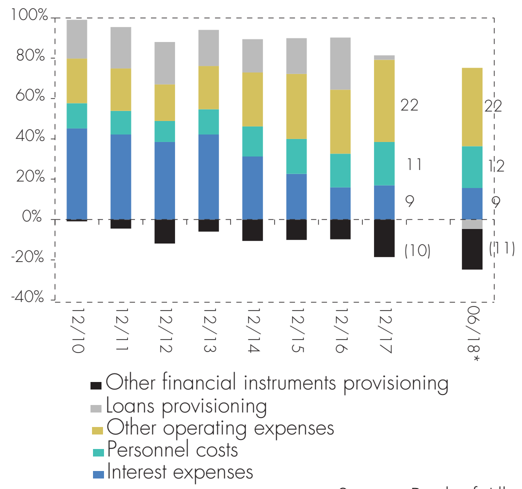
(78) The operating costs of the banking activity were covered by non-interest expenses. Overall, personnel costs and other operating expenses have been stable. Interest costs also remain low and stable, due to the low level of the interest rates. In the last period, the banking sector has reported loan provision expenses, while provision reversal for other financial assets continued. As a ratio against total income, personnel costs and other operating expenses registered an increase during the last two years, mainly due to the downward trend of income. Personnel costs and other operating expenses had the most significant share in total expenses.

Chart 6.58 Personnel costs and other operating expenses to gross income (2018 H1, annualized)



Source: Bank of Albania.

Chart 6.59 Main against total expenses



Source: Bank of Albania.

(79) Historically, the financial result of the banking sector has recorded positive values with the performance of loan loss provision expenses providing the main contribution to this outcome. The fall in interest rates is reflected in a significant decline in interest income and expenses in 2013-2017. Net interest result remained positive and has trended upwards during most of the period, since the decline in expenses has been higher than the interest income. During 2018 H1 income contracted by around 6% while expenses by 24% compared to the previous year. The income/expenses ratio increased from 2 times in 2011 to around 6 times in 2017. Personnel costs and other operating expenses, overall, have been stable, with a very gradual increase. Provision expenses have been considerable during 2012-2016, but they decreased significantly in 2017, reflecting the improvement of the quality of the banking sector's credit portfolio.

Table 6.5 Statement of income and expenses of the banking sector (ALL billion)

	12/12	12/13	12/14	12/15	12/16	12/17	06/17	06/18
Interest income	74	71	64	61	55	53	26	27
Interest expenses	(37)	(35)	(22)	(14)	(11)	(9)	(4)	(4)
Net interest income	*37*	*36*	*42*	*46*	*45*	*44*	*22*	*22*
Income from fines and commissions	7	8	8	9	10	11	5	5
Losses or earnings from financial instruments	(4)	2	(5)	(3)	(2)	(10)	(5)	(7)
Other income	0	1	2	1	1	1	0	1
Personnel costs	(10)	(10)	(11)	(11)	(11)	(11)	(6)	(6)
Other operating expenses	(17)	(18)	(19)	(21)	(21)	(22)	(10)	(11)
Provision expenses	(20)	(15)	(12)	(11)	(17)	(1)	(2)	1
Other financial instruments provision expenses	11	5	8	6	7	10	6	6
Extra-ordinary items	1	(1)	2	2	2	2	1	0
Income tax	(1)	(1)	(3)	(2)	(2)	(2)	(1)	(1)
Net result	*4*	*7*	*11*	*16*	*9*	*22*	*12*	*11*

Source: Bank of Albania.

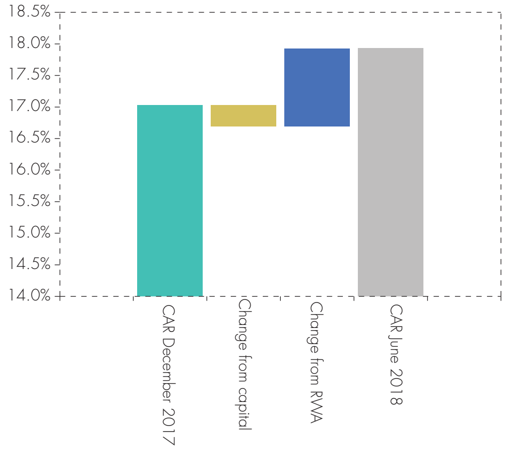
6.6 ACTIVITY CAPITALISATION AND SOLVENCY RISK

(80) The capitalisation of the banking sector in June 2018 was adequate, and its performance was almost entirely affected by the decline of the value of risk-weighted assets. The abrogation of the countercyclical measure on additional capital requirements for investment by non-residents in foreign currency[34] and the reduction in the capital requirement for credit risk led to the decline of risk-weighted assets in 2018 H1. During the period, the value of regulatory capital registered a slight decline.

(81) At end-2018 H1, the Capital Adequacy Ratio stood at 17.9%, from 16.6% as at end-2017 and 16.3% a year earlier. Risk-weighted assets were around 6.8% lower compared with December 2017 and registered ALL 800 billion, contributing to the increase of the Capital Adequacy Ratio by 1.2 percentage points. On the other hand, the regulatory capital contracted by 1.8% at ALL 144 billion, affecting the decrease of the Capital Adequacy Ratio by 0.3 percentage point.

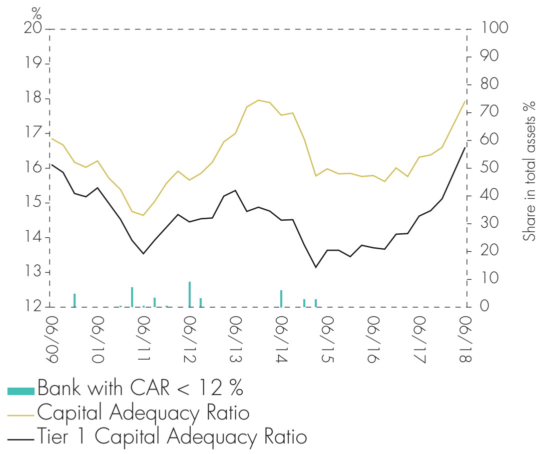
[34] *Decision "Some amendments in the Regulation "On Capital Adequacy", dated 02.05.2018 on the abrogation of countercyclical measures.*

Chart 6.60 Capital adequacy items, percentage points



Source: Bank of Albania.

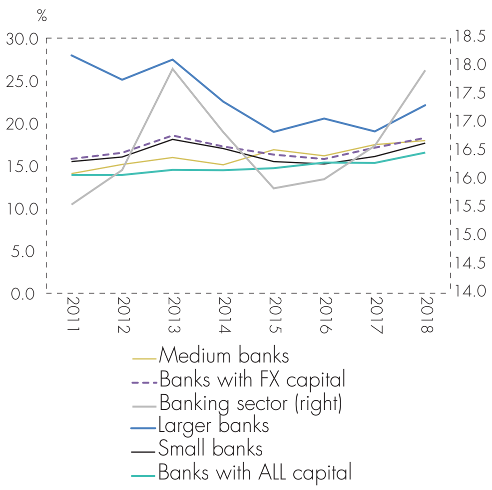
Chart 6.61 Capital Adequacy Ratio in %, and share of banks with CAR < 12% (right axis)



Source: Bank of Albania.

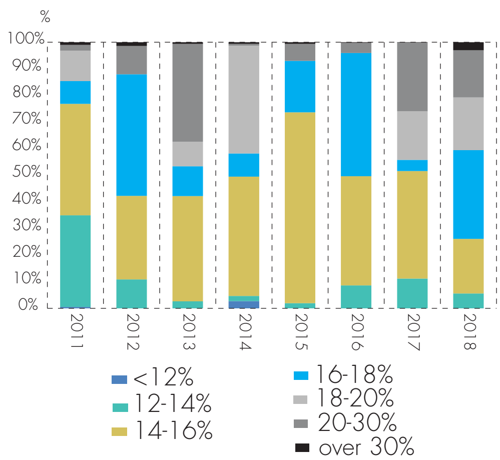
(82) At peer group level, larger banks with foreign capital have the highest level of Capital Adequacy Ratio. Individual banks maintain Capital Adequacy Ratios in the 16%-18% range and shifted from the14%-16% range observed in the previous period.

Chart 6.62 The Capital Adequacy Ratio of groups by size and by origin of capital



Source: Bank of Albania.

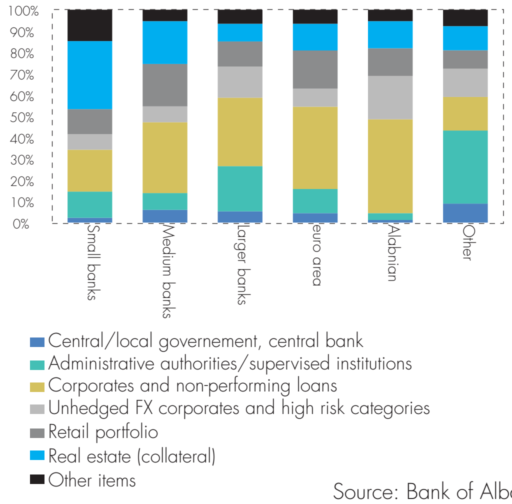
Chart 6.63 Asset allocation of banking sector by Capital Adequacy Ratio



Source: Bank of Albania.

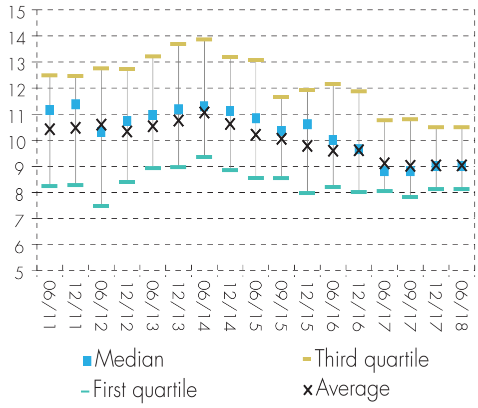
(83) Risk-weighted assets linked to credit risk represent the majority of risky assets of the banking sector. At the end of the period small banks had a high exposure to loans hedged with collateral in the form of real estate; medium-sized banks had a higher exposure to loans to corporations and non-performing loans, while larger banks, in addition to the exposures listed for medium-sized banks, remain exposed to lending to managing bodies and supervised institutions. By origin of capital, banks with Albanian capital have a higher exposure to the class "Credit to corporations and non-performing loans".

Chart 6.64 Credit classes' exposure of banks by size of activity and origin of capital, June 2018



Source: Bank of Albania.

Chart 6.65 Financial leverage ratio



Source: Bank of Albania.

(84) Risk-weighted assets linked to market risks registered a slight increase in 2018 H1, while those linked to operational risk remained unchanged. Risk-weighted assets related to market risks were ALL 14.8 billion or 4% higher compared with end-2017 H2, accounting for 1.8% of risk-weighted assets. Risk-weighted assets for operational risk maintained the level of ALL 86 billion, accounting for around 10.7% of total risk-weighted assets.

(85) The Albanian banking sector is characterized by an adequate financial leverage ratio, which confirms a satisfactory level of capitalisation. The financial leverage ratio[35], as of end of June 2018, was 9.5 times, from 10.1 a year earlier. The financial leverage at individual banks level has not shown any significant changes.

6.7 MARKET RISKS

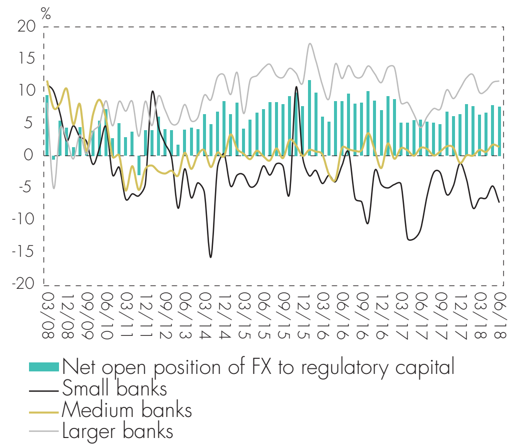
6.7.1 EXCHANGE RATE RISK

(86) The ratio of the net open foreign currency position of the banking sector to regulatory capital has slightly increased compared with the two previous periods. At 2018 H1, the net open long position of the banking sector was 7.6% of the regulatory capital, or 1.2 percentage points higher than in 2017 H2, and 2.1 percentage points higher than in 2017 H1. The performance of this indicator for the banking sector is driven mainly by larger banks that continue to maintain a long open position. The regulatory limit of the net open foreign currency position to regulatory capital is 30%, so the current levels of the net open position of the banking sector indicate a limited direct exposure in the balance sheets to the exchange rate fluctuations, despite a slight increase registered in 2018 H1.

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

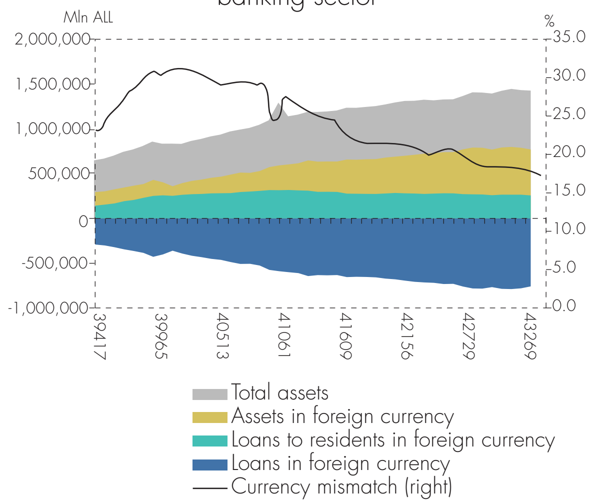
(87) In 2018 H1, the banking sector's exposure to indirect exchange rate risk was lower than in 2017 H2 and in the previous year. At the end of June, the exchange rate mismatch indicator[36] for all currencies amounted to 17.3% of total assets, from 17.7% and 18.4%, respectively in 2017 H2 and 2017 H1. The main cause of the decline in the value of the index was the faster decline of liabilities in foreign currency (3.8%) compared with the decline of assets in foreign currency (3.6%). At the same time, the value of the index was also affected by the performance of total assets of the banking sector, which decreased at a slower pace at around 1.3% compared to the end of 2017. By currency, the decrease of the index for the position in euro by 0.4 percentage points at 17% of total assets determined the overall performance of the indicator for the banking sector.

Chart 6.66 Open position to regulatory for the sector and groups by size



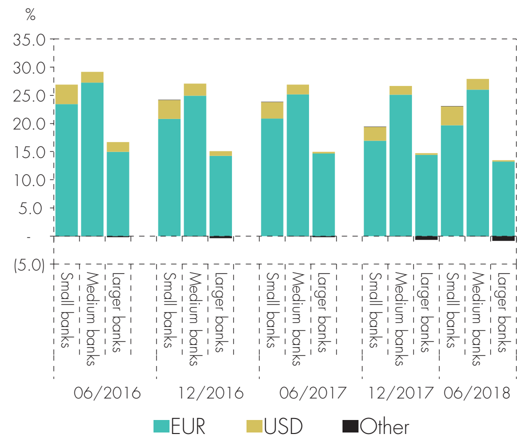
Source: Bank of Albania.

Chart 6.67 Indexes components performance for the banking sector



Source: Bank of Albania.

Chart 6.68 Foreign currency mismatch by currency



Source: Bank of Albania.

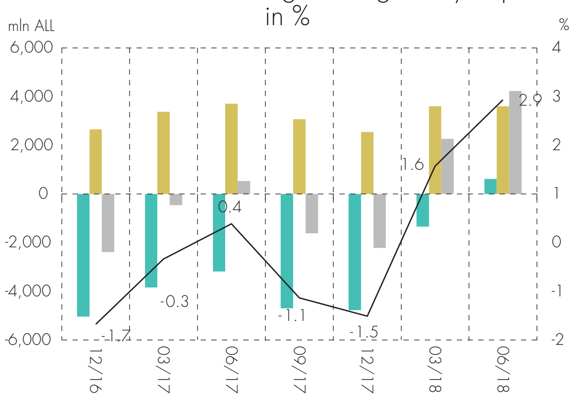
(88) Exposure to indirect exchange rate risk has decreased, mainly for the larger banks. Larger banks also have the lowest level of the indicator, which accounts for about 12.4% of their total assets, while medium-sized banks have the highest exposure or the lowest coverage of foreign currency liabilities with foreign currency assets, at 28 % of total assets.

[36] *The foreign currency mismatch indicator measures the hedging rate of the banking sector's liabilities in foreign currency with assets in foreign currency set off with resident credit in foreign currency. A low value of this indicator's ratio to assets shows a low exposure to movements in the exchange rate. For the calculation of the exchange rate indicator, refer to the Financial Stability Report 2016 H1.*

6.7.2 INTEREST RATE RISK

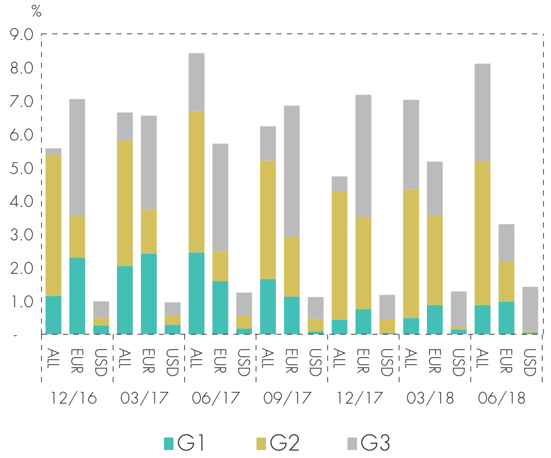
(89) At end of 2018 H1, the total net weighted position in bank books was 2.9% of the regulatory capital[37], and registered an increase in both semi and annual terms. The performance of the indicator is determined primarily by the performance of instruments with fixed interest rates, which during the period shifted from a negative to a positive position. At the same time, the positive position of instruments with variable interest rates increased due to the increase of the weighted position in euro. Since the banking sector has more assets than liabilities that are sensitive to exchange rate changes, it would be exposed to the interest rate risk in the case of an interest rate decline. However, the extent of the exposure remains low since both the interest rates and the net position are currently low. Larger and medium-sized banks have the highest, and growing, exposure to the domestic currency, while small banks are exposed to the euro. The weighted net position by currencies shows that the weighted position in the domestic currency at 3.2% has determined the overall indicator for the banking sector.

Chart 6.69 Weighted aggregate net position in bank's balance sheets against regulatory capital, in %



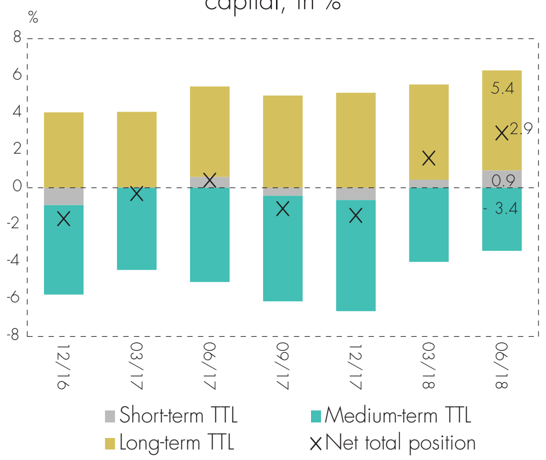
Source: Bank of Albania.

Chart 6.70 Weighted net position by currencies and groups against the regulatory capital, in %



Source: Bank of Albania.

Chart 6.71 Gap by maturity against regulatory capital, in %



Source: Bank of Albania.

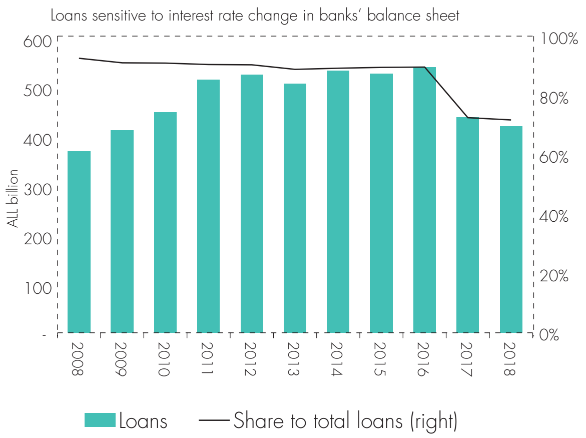
Weighted net position against regulatory capital, during the period, was driven by the performance of the short-term position.

(90) The exposure of the banking sector to indirect interest rate risk is significant. Variable interest rates loans dominate the total stock of loans of the banking sector, although they have decreased somewhat during 2018 H1.

[37] *According to the relevant regulation, this indicator, taken in absolute value, should not exceed the 20% limit of the regulatory capital.*

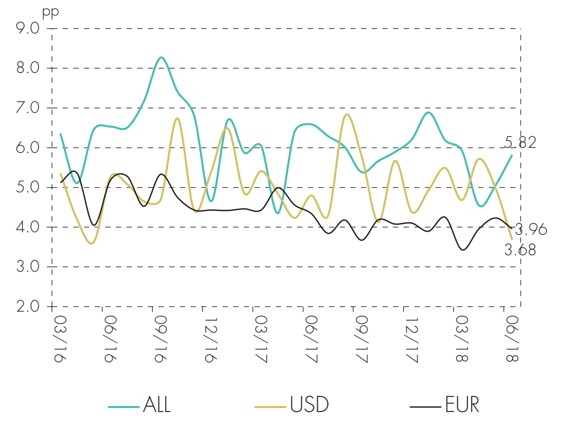
(91) On the other hand, the spread between the interest rates of loans and deposits narrowed during 2018 H1. The narrowing of the spread was driven mainly by the decline in the interest rate of loans for the three currencies, whereas the average deposit rates did not show significant changes compared with same period a year earlier. A further narrowing of the spread at low levels would exert pressure on the solvency of borrowers, in case of a quick reversal.

Chart 6.72 Loans and interest rates



Source: Bank of Albania.

Chart 6.73 Spread of weighted interest rates of loans and term deposits, in p.p.



Source: Bank of Albania.

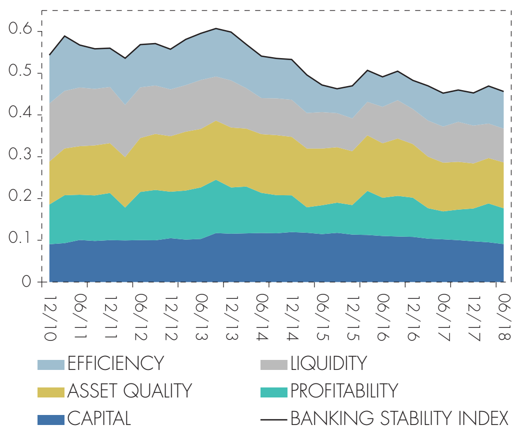
BOX 6.3 BANKING SOUNDNESS INDEX

The banking soundness index represents an overall assessment of the core conditions and substantial factors of risk that affect the stability of banking sector and of individual banks. The index consists of five indicators, which represent five characteristics of the banking sector activity: Capital; Assets quality; Profitability; Liquidity and Efficiency. (MISHRA et.al (RBI); 2013):

The aggregate index of key indicators used to track the performance and the banking stability situation remained unchanged from the previous year, at 0.46. The index components that show an improvement over last year are: Capitalization, Asset quality and Liquidity. The main contribution to the risk continues to come from asset quality. However, the significant fall in the stock of non-performing loans, and as a consequence also of non-performing loans to total loans ratio, affected the decrease of the contribution of this indicator to risk. In addition to asset quality, a positive contribution to the Banking Soundness Index came from the satisfactory level of Liquidity (mainly due to the expansion of the "liquid assets/total assets" ratio) and the significant expansion of capital adequacy. The two other indicators, Profitability and Efficiency contributed to the increase of risk, expanding at 0.43 and 0.44, respectively, from 0.33 and 0.40 a year earlier. The decline of banks' profit has provided the main impact on increasing the risk deriving from the "Profitability" indicator, while the increase in the "operating expenses to income" ratio contributed to the increased risk deriving from the "Efficiency" indicator.

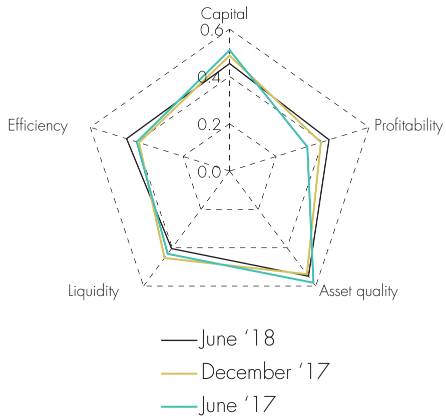
During the last five years (2013-2018) the aggregate banking soundness index registered a downward trend, which means better soundness and higher stability for banks.

Chart 6.74 Banking Soundness Index*



*The increase of the indicator value shows a lower stability. The breadth of each dimension means its contribution to risk.
Source: Bank of Albania.

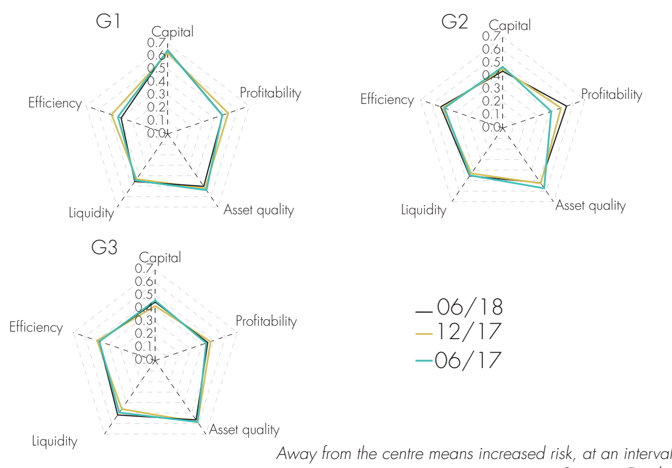
Chart 6.75 Banking Soundness map*



*Away from the centre means increased risk, at an interval from 0 to 1.
Source: Bank of Albania.

The overall performance of banks, by size, is presented below. Medium-sized (G2) and small banks (G1) registered a deterioration of the Index in June 2018 (compared with the previous year), reflecting an increase of risk. The decline in the overall index for these two groups came from the decline of Profitability and Efficiency.. The decline of these banks' profitability is affected mainly by the decrease of net profit, which is also reflected in the deterioration of RoA. Meanwhile, larger banks (G3) report an improvement of the Index in the last year. The aggregate soundness index for this banking group decreased slightly, affected by the improvement of liquidity and the expansion of capitalization, through the increase of the Capital Adequacy Ratio. Larger banks have the lower level of the Index.

Chart 6.76 Banking soundness map divided in groups by size



Away from the centre means increased risk, at an interval from 0 to 1.
Source: Bank of Albania.

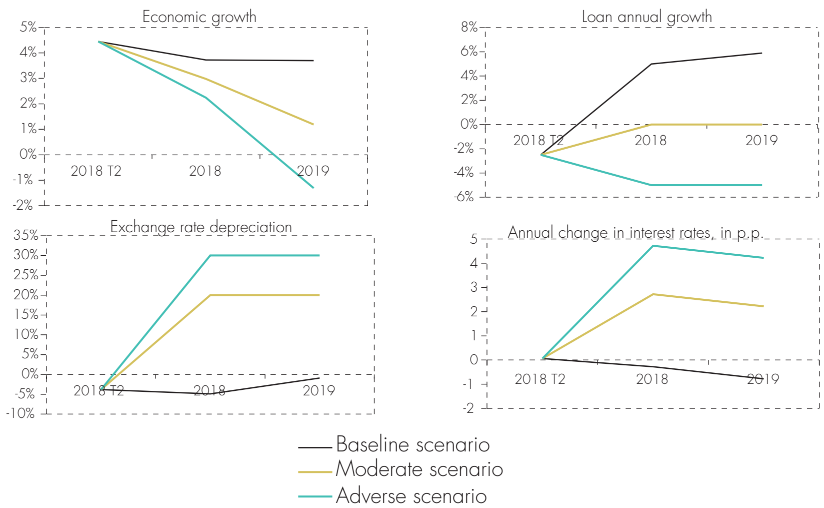
7. ASSESSMENT OF THE BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING

(92) The stress test exercise is used to assess the banking sector resilience in different scenarios of economic and financial developments for the period 2018-2019. The results show that the banking sector remains resilient. In terms of capital adequacy, the impact of these assumptions indicates the need for additional capital in some individual banks, particularly in the case of the adverse scenario, in which the assumptions are also more extreme.

7.1 ASSESSING THE RESILIENCE TO MACROECONOMIC SHOCKS

(93) The stress test exercise assesses the banking sector's resilience in terms of capital adequacy for the period 2018-2019. The assessment of the impact from macroeconomic situations on the financial situation of the banking sector excludes the possibility of the increase in paid-in capital during the period. The exercise includes three scenarios: the baseline scenario, the moderate scenario and the adverse one. The last two scenarios have a lower probability of occurrence and are based on more extreme assumptions.

Chart 7.1 Assumptions for stress-testing



Source: Bank of Albania.

(94) The baseline scenario assumes a positive economic growth throughout the time horizon of the exercise. In this scenario, the economic growth is accompanied with positive growth rates of lending, supported also by a significant improvement of the credit portfolio quality until the end of 2019.

The improvement in the non-performing loans portfolio, based on the actual loan recoveries and write offs, is expected to continue in the short run. The moderate scenario is is based on the assumption that economic growth will remain positive over the 2-year horizon of the exercise, but the growth rate is lower than the growth rate assumed in the baseline scenario; the adverse scenario is based on the assumption that economic growth will be positive in 2018 but negative in 2019.

(95) The assumptions on the economic performance in the moderate and adverse scenario are supplemented with assumptions on: a depreciation of the exchange rate of the domestic currency, an increase of the interest rate and a deceleration of the lending growth rate or contraction of the credit stock. The outcome of the exercise indicates a deterioration in the credit portfolio quality, with the NPL ratio increasing by 3.7 percentage points by the end of 2019 (moderate scenario) and 4.4 percentage points (adverse scenario) compared with the values of the baseline scenario. Overall, the materialization of these assumptions would have a negative impact on the capitalisation level of the banking sector.

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

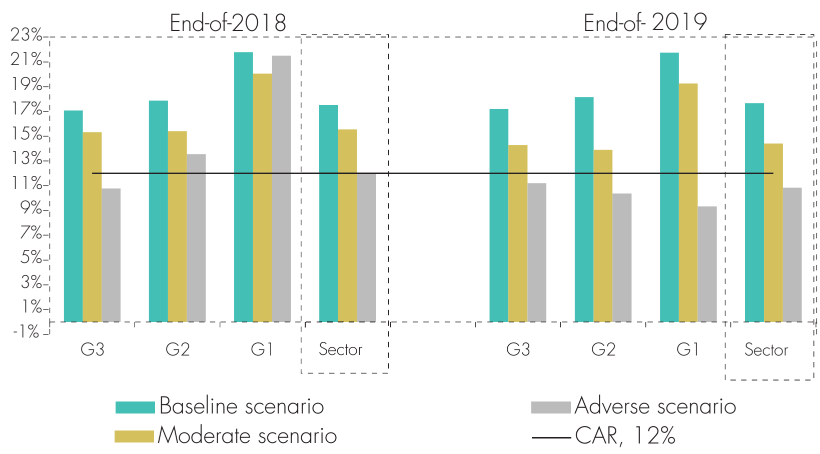
a. **In the baseline scenario,** the Capital Adequacy Ratio (CAR) of the banking sector is stable, standing at 17.7% at the end of 2019 against 17.9% that was recorded at the end of June 2018. This outcome is contingent upon the assumption of faster economic growth, an improvement in the growth of lending, a significant improvement in the stock of non-performing loans and favourable developments in the exchange rate. The exercise results by banking groups also indicate levels of capital that are well above the minimum level required by the regulatory framework.

a. **In the moderate scenario,** the banking sector's CAR is equal to 15.6% at end of 2018 and 14.4% at end-2019. This outcome derives from an assumptions of a lower growth rate of the economic activity; contraction in the credit stock; increase in interest rates; and, depreciation of the domestic currency. In this scenario, the drop in the CAR level points to a need for capital injection by individual banks. The number of banks that are under-capitalised by the end of 2019 is 4 and they account for around 20% of the banking sector's assets. In this case, the need for additional capital until the end of 2019 equals around ALL 0.9 billion.

b. **In the adverse scenario**, the banking sector’s CAR drops near 12% by end-2018 and to 10.8% by end-2019 as a result of the significantly harsher assumptions included in this scenario. The number of under-capitalized banks increases to ten and these banks account for 50% of the sector’s assets. The significant deterioration in the quality of credit results from the strongly adverse assumptions on macroeconomic trends as well as the contraction in the lending activity. The adverse scenario assumes losses in the securities portfolio and increased banks' exposure to market and operational risks. In this case, the need for additional capital amount up to ALL 16.5 billion.

To assess the size of additional paid-in capital injection required under each of the stress scenarios, vis-a-vis historical growth in the paid-in capital of the banking sector, the average annual growth in the paid-in capital of the banking sector during 2008-2016 was about ALL 9 billion.

Chart 7.2 Capital Adequacy Ratio, by stress test scenarios



Source: Bank of Albania.

8. MACRO-PRUDENTIAL POLICY

(97) In the Macro-prudential Policy Strategy[38], approved by the Supervisory Council of the Bank of Albania with the Decision No 38, dated 02.08.2017, as final objective is defined the prevention of systemic risks and the strengthening of the resilience of the financial system, in order to safeguard financial stability. The achievement of the final objective is carried out through the definition and realisation of several intermediate objectives, their relevant indicators and the instruments necessary to be operationalized to address specific risks. The entire process follows a well-defined cycle that includes the identification and assessment of the risk, selection and calibration of the instrument, the implementation of the policy and its communication, and the assessment of its impact. Having as primary role the implementation of the macro-prudential policy, the Bank of Albania has also defined in the document its structures that are directly engaged in the fulfilment of the macro-prudential policy cycle.

(98) Two important elements in the implementation of the macro-prudential policy are the:

a) definition and monitoring of the indicators that are needed to signal and activate macro-prudential instruments;
b) identification, calibration and operationalization of the most adequate macro-prudential instruments to address the systemic risk identified.

(99) With regard to these, the Bank of Albania, with the support and expertise of the International Monetary Fund, has worked towards the preparation of the relevant methodologies and the creation and structuring of the necessary database. Currently, the focus is on the creation of a set of indicators that signal systemic risk developments and the preparation of the necessary methodological and regulatory basis for the implementation of macro-prudential capital increase, in line with the Basel Committee recommendations, the requirements of the relevant European Directives, The European Systemic Risk Board, the technical standards issued by the European Banking Authority and the features of our financial system.

[38] *https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Macro-prudential_strategy/ /*

8.1 MACROPRUDENTIAL CAPITAL BUFFERS AND THEIR IMPLEMENTATION IN ALBANIA

(100) The global financial crisis of 2008 showed that its roots could also be found, among other things, in these developments:

a. the fast growth of lending by banks and other similar institutions;
b. the funding of this expansion through unstable financial sources and the inadequacy of capital levels and quality;
c. the presence of incentives to increase banks' size, increase their impact of systemic risk and the creation of institutions "too-big-to-fail".

(101) Immediately after the outbreak of the crisis, international financial institutions began to work on improving the regulatory supervision framework in order to prevent similar crises in the future and to best cope with them. Specifically, the Basel Committee on Banking Supervision published in 2010, what is now known as the Basel III standard. Among other things, this standard suggests the implementation of several capital buffers, which aim to:

a. improve the quality and quantity of capital, since these capital buffers are placed above the minimum capital under Pillar I and are composed by equity Tier 1 instruments;.
b. mitigate the volatility of the financial cycle and ensure a better stability, in the conditions where capital buffers will increase throughout the expansion of the financial cycle, and will decrease in case of need to absorb losses during the downturn phase of the financial cycle;
c. reflect the contribution to the systemic risk of the financial institutions with international and national systemic importance.

(102) The main objective remains the prevention of systemic risks and strengthening the resilience of financial sector against them. For this reason, these capital add-ons are considered as key instruments of macro-prudential policy, in fulfilment of its objective. Hence, the Bank of Albania, in the framework of its primary role for the implementation the macro-prudential policy, aims to apply these instruments to the Albanian banking sector, which consists in:

a. Capital Conservation Buffer (CCB), which is applied to all banks of a jurisdiction, and is 2.5% of risk-weighted exposures;
b. CounterCyclical Capital Buffer (CCyB), which varies from 0 to 2.5% of risk-weighted exposures, and is applied to all banks according to the composition of their exposures;
c. Systemic Risk Buffer (SRB), which is applied in the conditions of the presence of structural systemic risks, non-cyclical, and which varies from 1 to 3% of risk-weighted exposures;
d. Capital buffer from financial institutions with system importance (DSIB), which is applied towards banks with systemic importance, and is suggested to be 0-2% of risk-weighted exposures.

(103) The Bank of Albania aims to implement these instruments in the Albanian banking sector. For this purpose it has prepared the relevant methodologies and a special regulatory project, which currently are in consultation phase with the banking industry and other interested parties[39]. Similarly to the Directive 2013/36/EU and the relevant regulations of the European Union, the draft-regulation provides that macro-prudential capital add-ons in Albania are to be implemented in "phases", throughout 2020-2023.

(104) In the draft are defined the levels of the capital conservation buffer that banks have to meet in the targeted time period. These values are fixed, since the level of this macro-prudential add-on is also fixed (2.5%). Our preliminary analysis shows that, overall, banks will not have problems to meet this requirement, according to the levels predicted throughout the 4-year period.

(105) Countercyclical capital buffer is a new instrument in the implementation framework of the macro-prudential policy, whose value may change during the financial cycle. The countercyclical capital buffer has values from 0% to 2.5% of total exposures, but might be even higher in the cases where risks that are associated with excessive credit growth or other systemic risks are assessed as very high. During the accumulation period of systemic risk the Bank of Albania may apply the countercyclical capital buffer that may be used during the downturn phase of the financial cycle. Thus, during the rapid growth phase, banks need to create sufficient capital reserves that can be used during the downturn cycle to absorb possible losses on the balance sheet so that the credit supply in the economy is not reduced or discontinued.

(106) For this macro-prudential capital buffer, the project provides how the Bank of Albania will select the benchmarks, evaluate them and announce its rate for Albania, or accept/announce it for the foreign jurisdictions where the bank has credit exposures to the private sector. The project also envisages the development of a methodology by the Bank of Albania to detail the process, and the way the benchmarking analysis is linked to the add-on levels. Under the current conditions of the financial cycle, the benchmarks analysed by the Bank of Albania show the high likelihood that the level of this add-on will be zero or minimal over the medium-term. On the other hand, if there are unexpected developments suggesting acceleration of lending, the Bank of Albania may change the terms and the limits of the values of this macro-prudential add-on.

(107) Also, the Bank of Albania identifies "systemically important banks" and has some higher supervisory requirements towards them, mainly in the content of recovery plans. The draft-regulation presents for the first time the requirements for the corresponding capital increase for banks of systemic importance and it is proposed that this ranges from 0.5% to 2.5% throughout the target period. The identification of banks of systemic importance and the manner of determining the respective macro-prudential capital add-on are supported

[39] *https://www.bankofalbania.org/Stabiliteti_Financiar/Politika_makroprudenciale/Strategjia_makroprudenciale/Akte_ne_proces_konsultimi/*

by a revised methodology, with the latest technical standard of the European Banking Authority.

(108) The last of the macro-prudential capital add-ons, which is defined in the project, is that of **systemic risk buffer**. This is about structural, long-term and non-cyclical risks. The minimum and maximum levels of this macro-prudential capital add-on are the same as those contained in European directives (1%-3%) and its implementation will take place upon Bank of Albania's announcement. For this add-on, the project does not contain any implementation calendars. The definition of the values of the add-on will require a specific analysis which will be assessed below.

(109) The draft provides for the bank to have up to 12 months in case of an increase of their capital, while in case of its decrease, the implementation may be immediate if it was not defined otherwise. All macro-prudential capital add-ons must be fulfilled with equity Tier 1 instruments.

(110) The project envisages the possibility of non-compliance of macro-prudential capital add-ons, and in accordance with the Basel III standard, but also with the European legislation, the project stipulates that non-compliance is accompanied by restrictions on some payments that decrease the level of equity Tier 1 (the rates of these limits are set) and the bank may be required to present a plan of measures to strengthen the capital position in this case.

(111) The adoption of this regulatory project for the implementation of macro-prudential capital add-ons is appropriate when:

- the quantity and quality of banks' capital, as well as the timely implementation of requirements, are adequate to enable them to be satisfied by banks without significant cost;
- it represents an important step towards:
  - implementing a macro-prudential policy;
  - complying with the European legal/regulatory framework in the financial field; and,
  - maintaining positive assessments for the competitiveness and stability of the banking sector in the country, compared to that of our region and beyond.

9.2 BENCHMARK PACKAGE

(112) The Macro-prudential Policy Strategy Document contains the intermediate objectives of this policy which are to: i) mitigate and prevent excessive credit growth and leverage; ii) mitigate and prevent excessive maturity mismatch and market illiquidity; iii) limit direct and indirect exposure concentration; iv) limit excessive risk-taking by systemically important financial institutions . The first two objectives address cyclical risks, while the others two structural risks.

(113) The nature of systemic risks is dynamic and needs a broad monitoring of the system to prevent potential risks, despite the fact that, in a particular period they may not be significant. Due to the difficulty of identifying the main risks in a timely manner, a broad selection of indicators organized according to the macro-prudential intermediate objectives has been established to identify imbalances or accumulation of risks at the right time. Although part of the indicators may not be at a critical level, they will be monitored continuously for any changes they may have in the future. Each indicator is assessed based on thresholds, which will also serve to indicate the risk level. The results will be presented for a point in time, as well as quarterly time series over the past years, thus facilitating the monitoring and the decision-making process for macro-prudential policies.

(114) Currently, this package contains several indicators, not all with the same importance, grouped according to the four macro-prudential intermediate objectives. The indicators of each intermediate objective are grouped under sub-categories to facilitate their monitoring and analysis. More specifically, some of the indicators that will be monitored and analysed as part of the Package, are the following:

Objective 1: Mitigate and prevent excessive credit growth and leverage.

- Credit to GDP gap and leverage indicators - monitor the size of the credit portfolio compared with the GDP, the growth pace and the funding sources of capital or liabilities.
- According to industry and currency - identifies rapid growth in a particular industry or currency;
- Indices - are used to assess the supply and demand for lending according to households and enterprises, the performance of house prices, rent and the relative cost of housing.

Objective 2: Mitigate and prevent excessive maturity mismatch and market illiquidity.

- Liquidity indicators - include the key indicators for measuring the overall liquidity level of the financial system.
- Maturity gap indicators - addresses the gap between assets and liabilities by maturity as well as the imbalances on banks' balance sheets.
- Foreign exchange market indicators - are very important for monitoring the volume and prices to identify risk accumulations in the system.
- Money market and secondary market – provides important information on the performance and the liquidity cost in the interbank and money markets.

Objective 3: Limit direct and indirect exposure concentrations.

- Large exposures, exposures to the real economy and to parent bank - these indicators measure the concentration of the exposure to large borrowers, the share of credit to GDP and the exposure of the banking system to the owning groups.
- Concentration by industry and geography - helps to identify the exposure of the banking system to a certain country or economic sector.
- Financial system interconnectedness - measures the exposure of the financial system among the stakeholders of the banking and non-banking systems.
- Foreign currency concentration - the exchange rate risk is one of the most significant risks due to the level of use in the economic activity and the financial system.

Objective 4: Limit excessive risk-taking by systemically important financial institutions.

- Sizes - defines the extent of the banking activity against GDP, the share of banks with systemic importance against GDP.
- Interconnectedness - measures the exposure of banks against the interbank and sovereign markets.
- Substitutability - monitors the share of systemically important banks as a share of the total banking system to indicate the level of concentration.
- Complexity - is assessed through non-resident assets and liabilities, non-interest income and marketable portfolio as a percentage of total assets.

(115) The potential risks to be monitored every quarter will be assessed based on the objectives and the indicators' sub-groups. Although the intermediate objectives are unchangeable, the indicators themselves are dynamic and will be reviewed/enriched periodically. Also, the thresholds for each indicator will be reassessed at least once a year, considering the regulatory framework, the historical performance, foreign expertise, as well as the level of the indicators in countries with an economy and financial system similar to Albania.

ANNEX I

Table 1 Financial soundness indicators

In per cent	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	6M/2018
Capital-based ratios												
Regulatory capital to risk-weighted assets	17.08	17.23	16.17	15.40	15.56	16.17	17.96	16.84	15.72	16.01	16.60	17.93
Core capital to risk-weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79	13.45	14.10	15.12	16.60
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	10.17	10.50
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	15.72	17.98
Gross non-performing loans to total loans	3.36	6.64	10.48	13.96	18.77	22.49	23.49	22.80	18.22	18.27	13.23	13.27
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	15.71	14.98
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	1.54	1.54
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	6.68	7.63
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	7.34	8.25
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	30.22	32.20
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	40.79	43.23
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	194.00	196.84