Bank of Albania

FINANCIAL STABILITY REPORT

2019/HI

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INTRODUCTION

This is the twenty second 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 2019 (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 2019, the classification of banks in the Albanian banking sector, by size, origin of capital and geography of their activity, is as follows:

A) 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: As at June 2019, this group includes: United Bank of Albania, International Commercial Bank (ICB)[1], First Investment Bank, Albania (FIB) and Credit Bank of Albania (CBA)[2]. They account for around 3% of the sector's total assets.
- Peer Group 2, each bank sharing 2-7% of total banking sector assets: As at June 2019, this group includes: Procredit Bank (PCB), OTP Bank, Albania (OTP)[3], "Alpha Bank, Albania" (AB), Union Bank" (UB), Tirana Bank (TB), and "American Bank of Investments sh.a." (ABI). They account for around 27.5% of the sector's total assets.
- Peer Group 3, each bank sharing over 7% of total banking sector assets: National Commercial Bank (NCB), Raiffeisen Bank (RB), Credins Bank, (CB), and Intesa Sanpaolo Bank Albania (ISPB). They account for around 70% of the sector's total assets.

B) Banks operating in Albania are divided into the following groups by capital origin:

- Banks with foreign capital[4]: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank Albania (Italy); Alpha Bank Albania (Greece); National Commercial Bank (Turkey); OTP Bank, Albania (Hungary); Procredit Bank (Germany); First Investment Bank, Albania (Bulgaria); United Bank of Albania (Saudi Arabia); and Credit Bank of Albania (Kuwait). These banks share around 71% in total assets of the banking sector.

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1 *On 27.03.2019, the transfer of selling of 100% of shares from the partner of ICB Financial Group Holdings to Union Bank is registered in the NBC Register. On 03.07.2019, the Bank of Albania approved the finalisation of the absorption of International Commercial Bank by Union Bank.*

2 *On 05.06.2019, the Bank of Albania revoked the licence to Credit Bank of Albania.*

3 *On 13.3.2019, the Bank of Albania approved for owning 88.89% of the shares with voting rights of Bank Société Générale Albania by OTP Bank Nyrt.*

4 *By definition, a bank shall be considered to have foreign capital when foreign capital accounts for more than 50% of the bank's paid-in capital.*

- Banks with Albanian capital: Credins Bank, Union Bank, American Bank of Investments, Tirana Bank[5], International Commercial Bank. These banks share around 29% in total assets of the banking sector.

C) Banks operating abroad:

Only the National Commercial Bank shows an expansion of banking network abroad, with its subsidiary in Kosovo6.

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

(1) The terms "loan" and "credit" are used interchangeably in this Report; "enterprises" and "firms" are also used interchangeably.

(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 period under review. It includes outstanding credit granted by the banking sector to non-financial private and public, resident and non-resident entities. The outstanding credit is affected by the non-performing loans (NPL) write off from the banks' balance sheet in the period under review. Hence, outstanding credit that is analysed in the Financial Stability Report is a *different concept* from that of credit to the economy that is addressed in the monetary policy reports. The latter, in addition to credit by banks, includes the credit by non-bank financial institutions. Also, the value of this credit includes only credit to the resident private sector and its value is not affected by the NPL's writte off from banks' balance sheets, as these loans are already obtained by the economic entities and have affected their economic value; their later write off does not change this fact. The differentiation in these concepts on credit should be considered when interpreting the relevant analysis of credit indicators (growth rate, quality ratio, allocation by sector, by currency, etc.) in various reports of the Bank of Albania.

3) The transformation of NCB's Kosovo branch into a subsidiary represents a structural break in the reported series of data for the period, which has brought about an effect on the analysed indicators of the whole sector. In this Report, this effect for the main indicators of the banking sector activity is explained in more details and is qualified as "the structural break effect".

[5] *On 06.02.2019, the Bank of Albania approved the transactions for the transfer of the controlling shares' packet of "Tirana Bank" to an Albanian economic and financial group.*

[6] *After the transformation Kosovo "branch" into a "subsidiary", the reported data submitted by NCB included in this report for the end of the period, include only the activity performed by the bank that operates in Albania.*

FINANCIAL STABILITY STATEMENT FOR 2019 H1

Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18.12.2006 "On banks in the Republic of Albania", as amended, to inform the Assembly of the Republic of Albania and the Council of Ministers, and promote awareness among financial institutions and the public at large of the situation in the Albanian financial system and potential risks to its stability, the Bank of Albania releases this periodic statement. This statement is an integral part of the Financial Stability Report for the same-stated period.

The Financial Stability Report and the Statement prefacing it assess the exposure of the banking sector to risks arising from its interaction with the external and internal economic environment, real economy agents, financial markets in Albania, as well as operational risks in the activity of the banking sector. Furthermore, these risks are assessed through the stress test and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

The Bank of Albania deems that in 2019 H1 (hereinafter 'the period'), following significant structural changes, the banking sector continued to operate in a stable way.. Indicators of activity, exposure to risks and resilience remain at good levels. As a result, banking sector's ability to withstand risks is assessed as robust. Economic developments and the performance of financial markets supported the overall activity of the financial system.

HIGHLIGHTS IN THE SURROUNDING ECONOMIC AND FINANCIAL ENVIRONMENT

During the period, expansion in the global economic activity slowed down. Notwithstanding the positive performance in some advanced economies, the escalation of trade tensions between the US and China, prolonged uncertainties surrounding Brexit and economic slowdown in some emerging regions had a deceleration effect on global trade and economic growth. As a result of these developments, conditions in financial markets of advanced regions tightened in the last months and markets' volatility heightened. In emerging economies, financial conditions were tightened mainly in those countries with an uncertain political climate and weak macroeconomic structure. Global inflationary pressures remained contained, reflecting the slowdown in economic and trade activity as well as movements in oil prices. Against this backdrop, central banks of major economies have maintained the accommodative monetary policy stance. In Balkan countries, economic growth slowed down, inflationary pressures remained subdued, but improvements in the labour market continued. Overall, international financial institutions expect global economic activity to further weaken during this year and to stabilise in the next year.

In Albania, the economic growth rate dropped to 2.3% in the second quarter of the year. Aggregate demand was sustained by the expansion of final consumption of the population and private and public investments. In sectorial terms, trade provided the main positive contribution. Electrical energy production, dictated entirely by unfavourable weather conditions, had a negative impact on Albania's economic growth rate. In annual terms, the current account deficit expanded at the end of the second quarter, but it was fully covered by the surpluses in the capital and financial accounts. Positive developments in the labour market continued, as confirmed by the decline of the unemployment rate to 11.5%. In an environment with subdued inflationary pressures, during the period, the Bank of Albania maintained the accommodative monetary policy stance. The fiscal policy maintained the fiscal consolidation trend, but at a slower pace.

FINANCIAL MARKETS AND PAYMENT SYSTEMS

Activity in financial markets was conducted under normal conditions. In the primary market of government debt securities average yields decreased, although values increased slightly in the second part of the period. In the secondary market, the volume of trading increased bolstered by structural measures that guarantee the tradability of certain benchmark securities, with a long term to maturity. In the interbank market, transactions' maturity was up to one week, and rates hovered close to the policy rate of the Bank of Albania. In the foreign exchange market, the Albanian lek appreciated against the euro and the US dollar, but at a slower pace than in the previous year. Indices that monitor the developments of house prices nationwide and for Tirana rose for the period, but at a slower pace than in the previous year. Developments in certain determining factors point to growth of demand and supply in this market. During the period, the operation of payment systems was optimal, with increases in both volume and number of processed payments.

HOUSEHOLDS AND ENTERPRISES

For resident households and enterprises, credit and savings expanded during the period. Credit to resident entities expanded by 3.3% with over 60% of outstanding credit held by enterprises. Overdraft credit and credit for construction purposes contributed most to credit growth for this segment. For households, credit expanded 3% driven mostly by growth of credit in lek and credit for real estate. Interest rates on new loans granted during the period, both for enterprises and households, declined. At the same time, resident households expanded their investments in deposits, securities, and participation in investment funds. Credit quality improved for households and declined slightly for enterprises. Survey results on the financial and borrowing situation of households and enterprises show that their debt burden, overall, remains at appropriate levels. Among households, around 1/4 declare that they have a debt to repay and for 3/4 of them, the value of debt amounts up to 30% of their income level. Among enterprises, around 39% have a debt to repay and for almost 76% of borrowing enterprises the debt burden is assessed to amount to almost half the value of their capital. For most indebted enterprises, debt servicing accounts for around 20% of the enterprises activity income. According to respective survey results, households and enterprises' credit demand for the short-term future is expected to be moderate.

FINANCIAL SYSTEM ACTIVITY

Activity in the financial system continued amid a stable environment and key performance and resilience indicators remain at good levels. The share of assets of the financial system in the Gross Domestic Product fell by almost 2.1 percentage points. The fall came mainly from the decline in the reported value of banking sector assets, after the finalisation of the transformation of a bank branch abroad into a subsidiary. The reduction effect of this structural break in the data has been observed mainly in the foreign currency activities mostly with non-resident entities. Excluding this effect, banking sector assets would be 1.3% higher for the period. The appreciation of lek's exchange rate, which was stronger in the second half of the period, contributed negatively to the reported values in foreign currency of the banking sector's balance sheet; however, the impact was low. In terms of financial soundness, the banking sector was characterised by good levels of capitalisation and profitability. Liquidity indicators are assessed to be 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 a critical factor for the activity and stability of the non-banking financial sector.

BANKING SECTOR'S EXPOSURE TO ACTIVITY RISKS

The Bank of Albania assesses activity risks to the banking sector as contained.

Hence:

1. *Non-performing loans remained overall stable during the period, at ALL 63 billion.* The ratio of non-performing loans recorded 11.2%. From a year earlier, non-performing loans fell by 18%, whereas the ratio of non-performing loans stands around 2 percentage points lower. By size of contribution, the annual performance of non-performing loans was determined by repayments, write offs, and restructuring. During the period, it is estimated that banks have written off around ALL 2 billion of lost loans from their balance sheets; this value is smaller

compared to the amount of write offs in previous periods. The write offs, restructuring and repayment of loans have been accompanied by the change in the structure of non-performing loans. As a result, the share of lost loans has dropped to 45%. This change in structure has led to the statistical effect of reduction by almost 4.4 percentage points in the coverage ratio of non-performing loans with provisions, to 62%. Similarly, the coverage ratio of net non-performing loans with capital has also declined. On the other hand, the coverage of non-performing loans with collateral remains at high levels. Since the beginning of 2015, when banks began to write off loans classified as "lost" for more than three years, a total of ALL 57.4 billion have been written off as lost loans from banks' balance sheets. The amount of write-offs has dropped significantly over the last two years, reflecting the reduction of lost loans classified as such for a period longer than three years. The Bank of Albania deems that the write off process remains necessary to further reduce the non-performing loans ratio and to free resources that banks may better commit to lending. In this light, the Bank of Albania has adopted recently a regulatory change, according to which banks shall write off from their balance sheets lost loans classified as such for longer than two years. The change is expected to bolster the contribution of lost loans write offs to the reduction of non-performing loans. Overall, despite the welcome downtrend in non-performing loans, the Bank of Albania deems that banks should maintain their focus on this process.

2. *Liquidity risk in the banking activity remains low.* The ratios of liquid assets, both in lek and in foreign currency, to short-term liabilities stand significantly above the minimum regulatory requirement. Deposits remain the main source of funding the banking activity. They account for around 80% of liabilities and cover over twice as much the volume of loans. As a result of the considerable share of demand deposits and current accounts, maturity mismatches between short term liabilities and assets are in negative values. However, these mismatches are covered adequately by banks' liquid assets. The presence of high foreign currency levels in the activity of the banking sector, notwithstanding the relative reduction caused by the effect of the structural break, underscores the need for monitoring the performance of risk indicators and identifying other adjustment measures in response to developments. On the other hand, this high presence points to the wide use of foreign currency in the real sector of the economy, and reinforces the need for a concrete engagement of other public authorities for addressing this phenomenon.
3. *The banking sector's exposure to market risks, despite the decline observed over the period,* remains important. Exposures to direct and indirect risk from the exchange rate registered a relative decline, as the values of the open foreign currency position and unhedged loans against the exchange rate risk fell during the period. However, unhedged loans continue to account for around 24% of total outstanding credit, and enterprises hold around 2/3 of the value. Regarding the impact of interest rate fluctuations, the banking sector remains exposed to interest

rate fluctuations. Data show that the direct impact is moderate, given that the ratio of open balance sheet positions between rate-sensitive assets and liabilities, to the regulatory capital of the sector, is low. The indirect impact of interest rate risk remains significant. Given the historically low interest rate spreads and the fact that variable interest rate loans represent the majority of loans in the overall bank loans portfolio, a possible correction in the interest rate is expected to have a stronger impact on the borrowers' ability to pay, over the medium term. Based on the available information, the probability of this adjustment in the short-term period is assessed as low.

4. *The profitability of the financial system is conditioned by a low interest rate environment, for a prolonged period of time*; hence, it needs to be constantly monitored. Indicators of productivity in the banking activity are at good levels. At present, it is estimated that the return on equity for the banking sector is higher than the cost of equity. However, compared to the same period in the previous year, the net interest income has declined, reflecting the fall in income from interests in transactions with clients, and in net interest margins. From a longer-term perspective, the downtrend in net income from interests reflects in broader terms the impact from the presence of an internal and external environment with low interest rates for a prolonged period of time. As such, pressure on the financial result of the banking sector, as well as on the overall financial system will persist for as long as economic developments, inflationary pressures and interest rates, at home and abroad, remain close to current levels. Under this scenario, it is necessary for the banking sector to seek ways that keep activity costs in check and allow investments for expanding activities/ products with higher effectiveness and at risk levels that are identified properly and are assessed correctly. For as long as interest rates remain low, the sensitivity of financial institutions' balance sheet to fluctuations tends to rise. Among financial institutions, this effect varies according to certain elements including the profile of financial activity and composition and average term of the investment portfolio. Overall, it is important for the whole financial system, in particular in the case of the activity of collective investment companies, to monitor closely compliance with the regulatory requirements, in order to mitigate risks related to the volatility in the value and quality of these investments as a result of the potential interest rate fluctuations.

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 for the assessment of these risks.

Overall, the financial stability map, materialisation and accumulation of systemic risks and financial stress indices show that risks to the financial stability are contained. Indicators related to developments in the real sector of the economy have provided positive contribution to the mitigation of risks, whereas indicators related to the banking sector and the external economic environment show slight volatility in opposing directions. Banks' responses in the relevant survey show that their perception of political risk and its impact on overall economic developments has increased notably. This response of banks reflects the effect of the tense political climate during the period, and shows the need to lower such tensions.

MACRO-PRUDENTIAL POLICY

During the period, progress was made with regard to definition and operationalisation of macro-prudential policy instruments. Thus, following an extensive consultation process with the banking industry, on 5 June 2019, the Supervisory Council of the Bank of Albania adopted the Regulation No 41 "On macro-prudential capital buffers", which supports the use of conservative capital buffer, countercyclical capital buffer, capital buffer for systemically-important banks, and capital buffer for systemic risk as macro-prudential policy instruments. Implementation modalities for the countercyclical capital buffer and the capital buffer for systemically-important banks are set out in two specific methodologies attached to the Regulation. This Regulation allows for a period spanning over several years (until 1 January 2024), within which banks shall comply with (eventually) maximum levels of macro-prudential capital buffers and sets out, among others, stipulations related to instruments in which the capital buffer shall be implemented, frequency of assessments for determining them, reporting period by banks, and actions to be taken in the case of failure to comply with the level of the combined macro-prudential capital buffer.

In accordance with the authority stemming from this Regulation, the Governor of the Bank of Albania issued a decision on 28 June 2019 "On determining macro-prudential capital buffers" which specifies: a) level of countercyclical buffer for Albania, set at 0%; b) the list of systemically-important banks and respective capital buffers that they have to comply with for year 2020 (starting 29 March), at least 0.5%. These buffers are added to the conservative capital buffer which is set at 0.5% in the Regulation, for all banks, for the same-stated period. The decision of the Governor is based on conclusions deriving from the analysis of assessment indicators for systemic, cyclical and structural risks, conducted by the Bank of Albania in the last year. This Regulation is a response to the assessments in the Resolution of the Assembly of the Republic of Albania on the activity of the Bank of Albania in 2018 related to the implementation of the macro-prudential policy, and approximates in a comprehensive manner the respective stipulations in EU directives.

BANKING SECTOR'S ABILITY TO WITHSTAND RISKS

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

At the end of the period, the banking sector's capital adequacy ratio was 18.5%, down 0.2 percentage point from the end of 2018 and notably higher than the 12% minimum requirement. The performance of the capital adequacy ratio was dictated by the decline in the values of risk-weighted assets and of regulatory capital. The financial result of the sector was at good levels. Profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.5% and 14.3%, standing close to levels recorded in the previous year, and higher than at the end of 2018. During the period, net interest margin fell to 3.4% from 3.8% in the previous year, reflecting the decline in income from interests.

The adequacy of the above indicators was assessed through stress tests, with scenarios that assumed adverse developments in macroeconomic and financial indicators for 2019-2020. Similarly to before, extreme assumptions with a low probability of occurrence in an adverse scenario included a strong contraction of the economy, contraction of credit, rapid increase of average interest rates and strong depreciation of the exchange rate. Overall, test results show that the banking sector remains capitalized and shows good performance in scenarios assuming higher probability of occurrence. In the more 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 activity risks. As previously, banks should regularly analyse and test their ability to withstand various risks, in compliance with the supervisory and regulatory framework.

A more detailed analysis is presented in the ensuing Financial Stability Report for the first half of 2019.

1. OVERVIEW OF THE MAIN RISKS TO FINANCIAL STABILITY

1.1. FINANCIAL STABILITY MAP

(1) As at end of 2019 H1, data in the Financial Stability Map[7] show, overall, a contained performance of risks. Hence, risks related to both external and domestic economic environments were downward, while expectations on a slowdown of global economic growth were higher. The values of indicators related to developments in the banking sector and the activity of economic agents show more volatile risks arising from them.

In more concrete terms:

A. In the overall economic environment, at the end of period:

I. Risk from the "domestic economy" is rated as "low" and downward over a one-year period, mainly due to the decline in the size of the external debt stock to GDP, and the low and stable inflation.
II. Risk from "external environment" is slightly down remaining at "average" rate, mainly driven by the fall of oil prices in international markets. Nevertheless, during the period, our trading partners continued to record a slowdown of growth that may lead to an increase of risks related to the external demand for our exports.

B. Developments in the main real economy sectors show that:

I. Risk from "enterprises" continues to be assessed as "moderate", maintaining the level of the previous year. Notwithstanding the improvement in the credit portfolio to enterprises, the sub-indicator "financial position" of enterprises was downward.
II. Risk from "households" is assessed as "moderate", without crucial changes from the previous period, but upward from the previous year. The level of risk from this category was mainly driven by the developments in the sub-indicator related to "remittances", whose growth rate has been slowing down.
III. Risk from developments in the "government" sector continues to be assessed as "low" and almost unchanged during a one-year period.

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

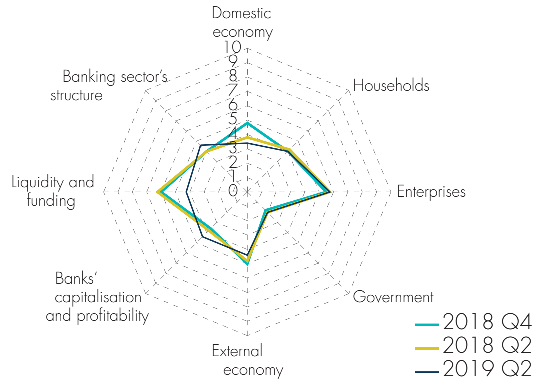
C. The banking sector activity shows that:

I. Risk from "capitalisation and profitability" continues to be assessed as "average". This risk showed a slight upward trend over a one-year period, mainly driven by the fall in the revenues of the banking activity.

II. Risk from "funding and liquidity" fell from "moderate" in 2018 to "average", reflecting the narrowing gap between banks' short term assets and liabilities (up to three months maturity) and the significant decrease in non-residents funding, due to the structural changes in the banking sector.

III. Also, the risk associated with the "banking sector structure" is assessed as "average" but upward from a year earlier, as a result of the structural changes in the banking sector in the previous year.

Chart 1 Financial Stability Map



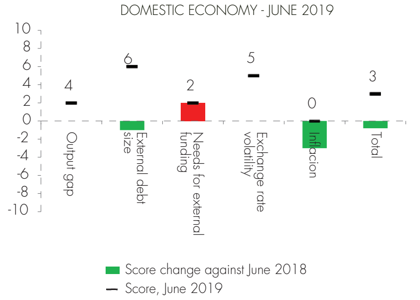
*Risk is assessed as: low for scores 0-3 in the map, average for scores 4-5, moderate for scores 6-8 and high for scores 9-10. The closer to the center, the lower the risk.

Source: Bank of Albania.

BOX 1.1 FINANCIAL STABILITY MAP COMPONENTS

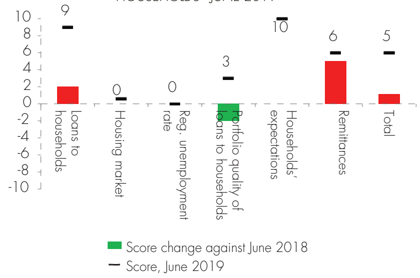
Risk from "domestic economy" is assessed as "low" and downward during the year, due to the positive economic growth, the fall in the external debt stock and the performance of inflation rate. The increase of the need for external financing contributed to the raised risk rate, while the risk from exchange rate fluctuations remained unchanged.

DOMESTIC ECONOMY - JUNE 2019



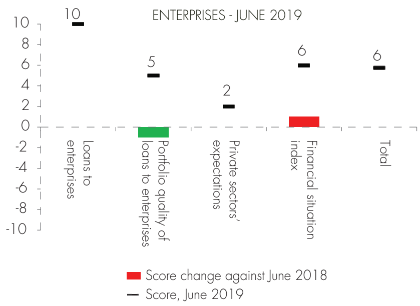
Risk from "households" is assessed as "moderate", but slightly up from end of 2018 and from the previous year. The improvement of households' portfolio quality drove to the fall of risk from this category, whilst it did not reduce the impact of a lower increasing pace of remittances and the still week ratio of borrowing ratio to GDP. The latter contributed to the finale rate for this category.

HOUSEHOLDS - JUNE 2019



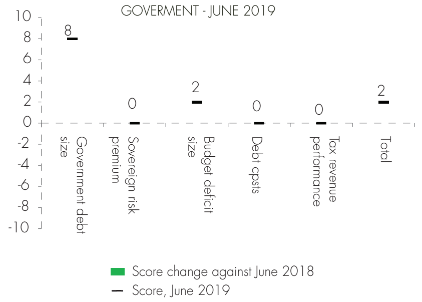
Risk from "enterprises" is rated as "moderate" without any change during the period and from a year earlier.

ENTERPRISES - JUNE 2019



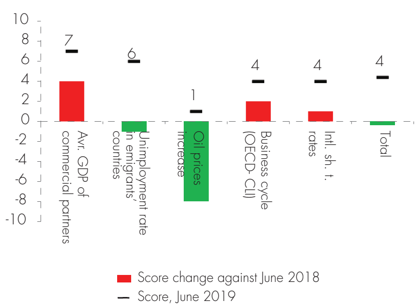
Risk from "government" is rated "low" and unchanged over one year period. Risk level related to the size of government debt remains high, albeit unchanged during the period.

GOVERMENT - JUNE 2019



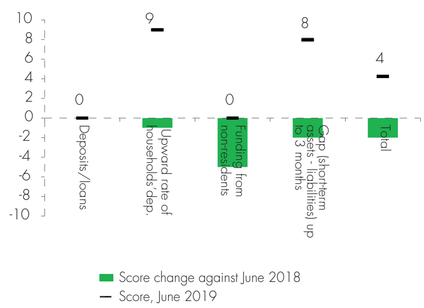
Risk from "external environment" is rated "average" and downward, affected by the performance of oil prices in international markets. Nevertheless, the slowdown of economic growth in trading partners and the turn of global business cycle are considered as increased risk factors.

EXTERNAL ENVIROMENT - JUNE 2019



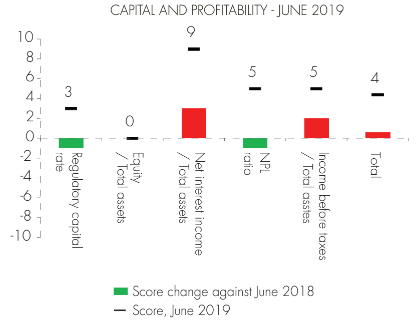
Risk from "financing and liquidity" resulted as "average" and considerably downward, due to the decrease of financing by non-residents and the narrowing of assets and liabilities gap, up to three months.

FINANCING AND LIQUIDITY- JUNE 2019



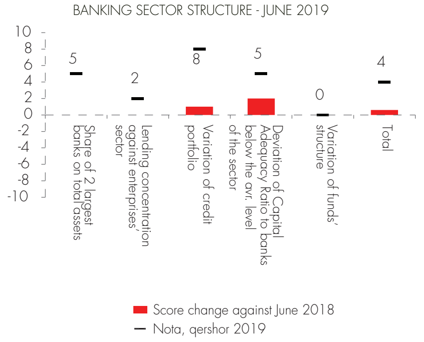
Risk from "capital and profitability" is rated again as "average", but trending upward. The increase of banking sector's capitalisation and improvement of loans' quality drove to risk decline from this category, whilst risk related to the sector revenues remains at considerable levels as a result of their fall at a higher pace than the fall of sector's assets.

CAPITAL AND PROFITABILITY - JUNE 2019



Risk from the "banking sector structure" remains "average", but upward during the period, mainly due to the increase of the deviation of CAR of some banks from the average CAR of the sector.

BANKING SECTOR STRUCTURE - JUNE 2019



*The financial situation index (Composinng Lending Indicator - CLI) is one of the main international indexes that signals the turning points in the business cycle or the fluctuations of the economic activity around its long-term potential level and it is evaluated by OECD.

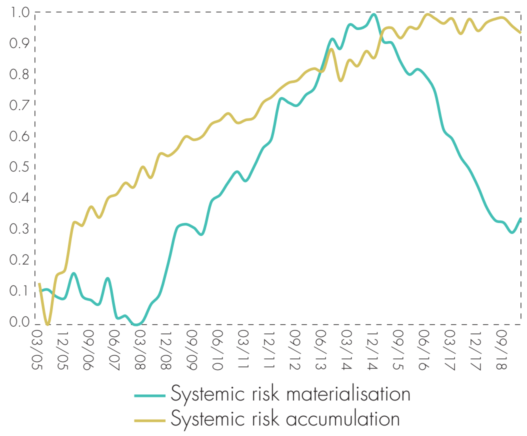
Source: ?? Bank of Albania.

1.2. SYSTEMIC RISK[8]

(1) The level of banking sector exposure toward systemic risk is estimated on the basis of the developments of certain indicators measuring risk accumulation and materialisation, as well as the results of the survey on banking sector perceptions on such risk. The overall developments in the accumulation and materialisation indices show no significant changes in the risk level, while the banks' perception on risks from political tensions and their impact on economic performance has increased.

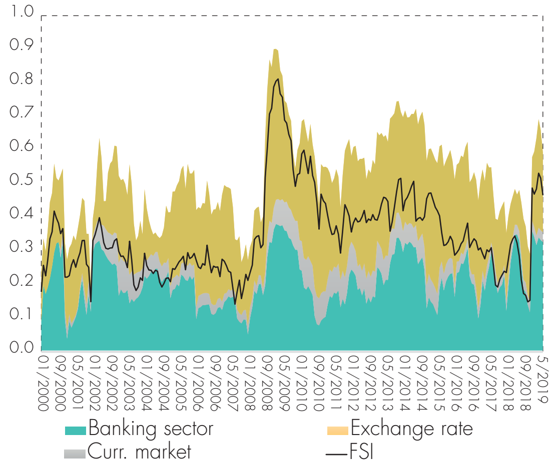
(2) The slight fall in credit quality to enterprises and volatilities of the exchange rate provided a higher contribution to the performance of systemic risk materialisation and financial stress indices. The performance of loans unhedged against exchange rate volatility, the increase in the share of loans with variable interest rate and the relative increase of public debt affected the accumulation index of system risk. Meanwhile, the decrease of current deficit and the contraction of outstanding credit contributed to the fall of this index.

Chart 2 Indices of accumulation and materialisation of systemic risk



Source: Bank of Albania

Chart 3 Financial Stress Index



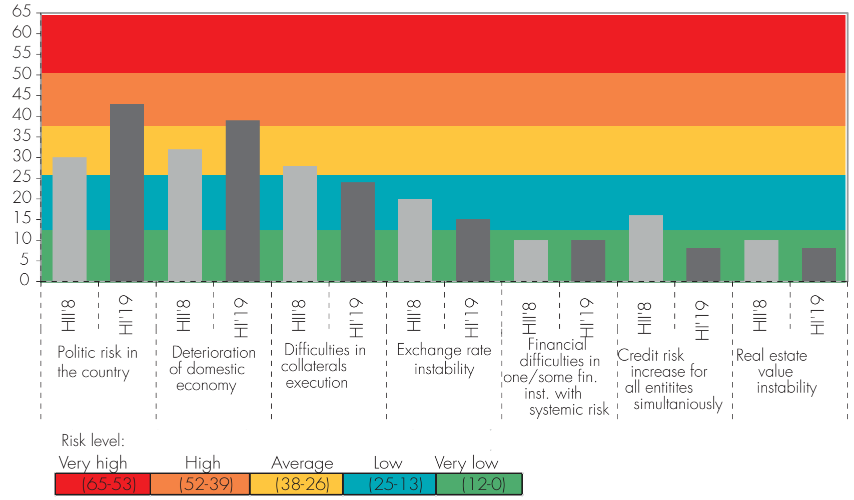
Source: Bank of Albania.

(3) The perception of the banking industry on the main systemic risks in Albania over 2019 H1, remains focused on political risk and economic development-related risk. The escalating domestic political tensions during the referring period increased the banking industry's concern about their effects on the business climate, investments and the country's outlook. This was reflected

[8] *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 suffer materially". To assess the banking sector's exposure to systemic risk, we analyse the performance of indicators related to: a) the materialization and accumulation of systemic risk; b) the stress level in the financial system; and c) the perception of the banking industry regarding the exposure to systemic risk. The materialisation of the systemic risk assesses the actual level of the risk, whilst indices of risk accumulation, financial stress, and banking industry perception on it are mainly forward looking.*

on an overall increase of the political risk assessment, and on the increased risk of the deterioration of the domestic economy, from "average" (in 2018 H2) to "high". The general perception regarding the developments in the rest of the risk factors shows an overall fall of risks.

Chart 4 Banks' assessment of main systemic risks



Source: Bank of Albania.

BOX 1.2 MACRO-PRUDENTIAL POLICY

On 05.06.2019 the Supervisory Council of the Bank of Albania approved by Decision No. 41, the Regulation "On macro-prudential capital buffers". This Regulation, in accordance with the respective European directives, lays down the framework for the implementation of macro-prudential capital buffers, as instruments aiming at preventing or mitigating systemic risks. These capital buffers shall be established and comprised of Common Equity Tier 1 (CET1), representing the most qualitative part of the bank's capital. In concrete terms, starting from March 2020, the Regulations stipulates the use of:

- *A capital conservation buffer - to be accumulated by 0.5% each year up to the maximum level of 2.5%, from 1 January 2024. This buffer shall be implemented at the same value for all banks;*
- *The countercyclical buffer - to be oriented upon some core indicators, most importantly the credit growth pace as a ratio to the Gross Domestic Product, compared to its historical values. The size of required capital for each bank will depend on the composition of certain credit exposures that the bank has, including their expansion by jurisdiction, and the countercyclical capital buffer determined by the responsible authority of that jurisdiction. For Albania, this authority is the Bank of Albania.*
- *The capital buffer for systemically important banks. Upon the definition of systemically important banks, based on an approved method and on the respective rate of systemic importance, banks are listed in baskets of systemic importance. Each basket is assigned a certain capital buffer, and each systemically- important bank is subject to the requirement on capital buffer aligned with the respective basket. Capital buffer for systemic importance*

aims at strengthening the systemically-important bank's resilience to possible shocks, thus safeguarding the entire financial sector; and

- *The capital buffer for systemic risk - which may be used more broadly, depending on the performance of risks, in the whole structure of the banking activity; or for particular banks;*

Based on the requirements laid down in the Regulation, the Governor of the Bank of Albania issued the Decision No. 3368, dated 28.06.2019, which stipulates:

- *The countercyclical capital buffer rate for Albania, at 0%; because the value of selected indicators and the expert's opinion suggest that risks related to the faster increase of lending, currently are not important;*
- *the systemically important banks and the respective capital buffer, as a minimum value that they they should comply with in 2020;*
- *The first date of reporting the combined macro-prudential buffer by banks, including the value of the conservative capital buffer value, will be 29 March 2020.*

Bank of Albania assesses that current good levels of capital adequacy for our banks, the gradual accumulation of capital buffers over a several-year period (till 1 January 2024), and the connection of countercyclical capital buffer with the cycle phase of banking sector activity enable compliance with these buffers by the banking sector with no considerable cost. In accordance with the Regulation, failure to comply with the combined macro-prudential capital buffer does not constitute an event that drives to the suspension of the bank activity, but will be accompanied by some supervisory measures, which aim at fulfilling the required levels of capital within the shortest time period possible. The above Regulation, the accompanying methodologies and the Decision of the Governor are published at the website of the Bank of Albania under Financial Stability/Macro-prudential policies.*

In the framework of macro-prudential policy implementation, to diminish the systemic risk in its structural dimension, the Bank of Albania has taken some measures to promote the use of lek in the banking activity. These measures entered into full force in July 2018. In compliance with the commitments taken in the respective inter-institutional Memorandum, the Bank of Albania has identified some indicators used to assess the effect of measures and the need to review/enhance them. Based on the performance of these indicators, during the period, the special report published at the beginning of August 2019, notes, among others, that the indicators have shifted slightly towards values that show lower risk levels. The completion of the transformation of a subsidiary into a branch of a bank abroad has contributed to this performance. This structural break in the data series drove to the fall of values of some indicators of the activity in foreign currency of some banks, during 2019 H1. This effect is expected to be partly cancelled out till the end of 2019. Notwithstanding this performance, the Bank of Albania upholds that the complete effect of the undertaken measures needs more time.

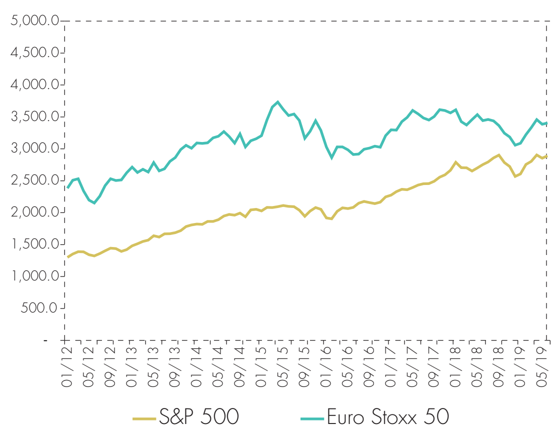
** The space avaible they have above the required minimum level.*

2. INTERNATIONAL ECONOMIC AND FINANCIAL DEVELOPMENTS

(4) During the period, the expansion of the global economic activity slowed down. Irrespective of the positive performance in some of the advanced economies, escalation of trade tensions between the US and China, prolonged uncertainties surrounding Brexit and economic slowdown in some emerging regions, had a deceleration effect on global trade and economic growth. Based on these developments, the financial conditions in advanced regions tightened over the last months, being reflected in higher debt securities spreads and increasing volatility in stock markets. Among the emerging economies, the tightening of financial conditions was mainly present in countries with an uncertain political climate and weak macroeconomic structure, where the volatility of capital flows and, in turn, of exchange rates increased. Global inflationary pressures remained subdued, reflecting the slowdown in economic activity and trade as well as oil prices performance. International financial institutions, overall, expect global economic activity to continue to weaken during this year and to stabilise in the next year.

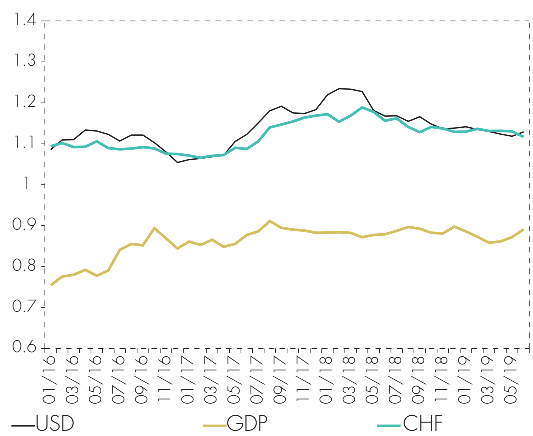
(5) Economic and political developments, and the relevant expectations, are reflected in both the foreign exchange and commodities markets. Hence, euro showed a depreciating trend against the US dollar and the Japanese yen, but it appreciated against the British pound and the Chinese renminbi. Oil markets were characterised by high price volatility during the period. Meanwhile, geopolitical tensions in main oil producing countries drove to the rise of oil prices in the first months of the year. The re-emergence of concerns on trade barriers and their effect on the global economy drove to a new fall of prices after April.

Chart 5 Main indices in stock markets



Source: European Central Bank.

Chart 6 Euro exchange rate against major currencies



Source: European Central Bank.

(6) During the period, most euro area economies recorded a slowdown of growth. Economic activity was mainly underpinned by domestic demand, and less by international trade. The unemployment rate fell to 7.5% in June 2019, at the lowest level since July 2018. Inflationary pressures weakened, attributable to oil prices, services sector's prices and seasonal factors. In these circumstances, the European Central Bank (ECB) affirmed its commitment to maintain the accommodative monetary stance till the middle of 2020, to support the regional economic growth and the convergence of inflation close to 2%.

(7) In the European banking sector, lending continued to grow at positive and steady rates. Credit growth was supported by the favourable financing conditions, which reflected the ECB's accommodative monetary policy stance, and the consolidation of banks' balance sheets. On the other hand, notable differences across member states characterised the credit dynamics, while banks profitability remains, overall, low in most banks of the region.

(8) Under the effect of external factors, risks to economic outlook of euro area are more notable. Uncertainties mainly relate to risks of strengthened trade protectionism across large economies, economic weakening of emerging regions and the unexpected geopolitical tensions. On the other hand, the still favourable financing conditions, the robust domestic demand and the support with fiscal policies in some member states are expected to further boost economic expansion of this region.

Table 1 Selected macroeconomic indicators for the U.S. and euro area

	GDP change (annual %)				Annual inflation (annual %)		Unemployment (annual %)		Gross government debt (% of GDP)	
	2019 Q1	2019 Q2	2019f.	2020f.	March'19	June '19	March'19	June '19	2018 Q4	2019 Q1
U.S.	3.1	2.0	2.6	1.9	1.9	1.6	3.8	3.7	105.2	104.4
Euro area	1.3	1.2	1.3	1.6	1.4	1.3	7.7	7.5	85.1	85.9
Germany	0.9	0.4	0.7	1.7	1.4	1.5	3.2	3.1	60.9	61.0
France	1.3	1.4	1.3	1.4	1.3	1.4	8.7	8.7	98.4	99.7
Italy	-0.1	-0.1	0.1	0.8	1.1	0.8	10.1	9.7	132.2	134.0
Greece	1.1	1.9	:	:	1.0	0.2	18.2	:	181.1	181.9

Source: European Central Bank, Eurostat, International Monetary Fund (f- IMF estimates, July 2019), BEA –Bureau of Economic Analysis). (U.S. Bureau of Labour Statistics). " : "- ": no available data.

(9) In the Western Balkans region, economic activity also slowed down. In 2019 Q1, the regional economy grew by 2.7% at annual level, driven mainly by growth in domestic demand. Growth slowed down from the 3.7% recorded at the end of 2018. Labour market conditions continued to improve and the unemployment rate fell across all regional countries. High trade deficit (from 14% in Serbia, to higher than 44% of GDP in Kosovo and Montenegro), due to the low production base and low competitiveness, remains a source of weakness for all Western Balkan countries. Over the period, inflationary pressures remain moderate, notwithstanding the strengthening of the domestic demand and the increase of food prices. Central banks maintain an accommodative monetary policy stance.

Table 2 Key macroeconomic and financial indicators for the Western Balkan countries

	GDP (real, annual %)			Unemployment (in %)		Credit growth		Non-performing loans ratio (in %)	
	2018 Q4	2019 Q1	2019f.	2018 Q4	2019 Q1	2018 Q4	2019 Q1	2018 Q4	2019 Q1
B&H	3.2	2.3	:	18.4	:	6.4	5.5	8.8	8.5
North Macedonia	3.7	4.1	3.0	19.4	17.8	7.8	8.2	5.2	5.1
Montenegro	4.8	3.0	2.9	16.4	15.2	8.5	12.0	6.9	5.9
Kosovo	3.8	4.1	:	31.4	26.9	11.2	11.4	2.8	2.6
Serbia	3.4	2.5	3.1	12.9	12.1	7.7	6.9	5.7	5.5

Source: European Commission, respective central banks
f- forecast April 2019; ":"-No available data.

(10) Over the period, bank credit continued to grow positively, recording faster rates in Kosovo and Montenegro. The propensity to lend to households is a common characteristic of regional countries. Non-performing loans ratio continued to trend downward, driving to the improvement of banks' balance sheet and a positive effect on their lending capacity.

3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

(11) The annual economic growth rate[9] was 2.3% at the end of 2019 Q2, from 3.3% at the end of 2018. Aggregate demand grew, sustained primarily by the expansion of the final consumption of the population and the fixed capital formation. Services sector was the main contributor to economic growth, notably its branch of "trade, transport, accommodation and food services". In the construction sector, the fall in investment flows in some strategic energy projects, which are in their final stage, offset the more positive developments in the real estate market during the period. The expansion of the current deficit determined the negative contribution of the external sector. In the labour market, positive developments were confirmed in the further drop of the unemployment rate at 11.5%,[10] the lowest value recorded since 2015. Expectations on labour market in the short term remain mainly positive, albeit the more contained optimism in the main sectors of economy.

(12) Monetary policy, kept the policy rate unchanged and maintained the accommodative stance during the period. The performance of inflation reflected mainly the effect of the exchange rate, notwithstanding the positive economic activity and labour market developments. Hence, in June 2019, inflation dropped at 1.3%, from 1.8% at the end of 2018, and 2.4% a year earlier. These developments also reflected supply-side shocks on agricultural prices. Although the deterioration of external environment postponed the projections for the return of inflation to target, the expectations of the Bank of Albania remain positive regarding both the economic development at home and the strengthening of domestic inflationary pressures.

(13) Fiscal consolidation continued over the period, albeit at a slower pace. Fiscal policy remained tightening, against the negative value of budget balance recorded in the last month of the period. In June 2019, budget balance was ALL -3.27 billion, and it is financed by internal funds. In the previous year, the budget balance was positive, ALL 1.94 billion. In relative terms, budget deficit accounts for around 0.2% of GDP, trending downward during the period and a year earlier. The increase of budget revenues 3.8% against the 6.2% increase of budget expenditures deepened the budget deficit. Nevertheless, the realisation of capital expenditures according to the planning experiences difficulties. Realisation of capital expenditures and their most effective allocation throughout the financial period remains crucial not only to support economic

[9] The real annual growth of economic activity in Albania during 2019 Q1 was 2.43%, from 4.26% a year earlier (2018 Q2).

[10] Unemployment rate was 12.4% in 2018 Q2 and 12.3% in 2018 Q4.

growth and the performance of macroeconomic indicators, but also to manage the needs for liquidity in interbank market.

(14) At the end of 2019 Q2, the overall balance of payments resulted in a fall of foreign exchange assets by around EUR 44 million. The current account deficit expanded by 62% in annual terms, at EUR 273 million, due to the deepening of trade deficit in goods[11] and in primary income account[12]. Remittances were EUR 186 million, up by around 2% annually. The surplus of both capital and financial accounts covered entirely the current account deficit. In the financial account, inflows (increase in financial liabilities with the world) grew by 8%, amounting to EUR 307 million. In capital account, net positive flows were EUR 12 million, down by 42% in annual terms. Foreign reserve assets cover 6.6 months of average imports in goods and services.

[11] *Trade deficit in goods expanded by around 14% in annual terms, due to the increase of imports by 6% and fall of exports by around 13%.*

[12] *Primary income account, from work and capital, closed at a net negative flow of EUR 3 million, with the entirely contribution from the annual expansion of the negative balance of income from investments by around 30%.*

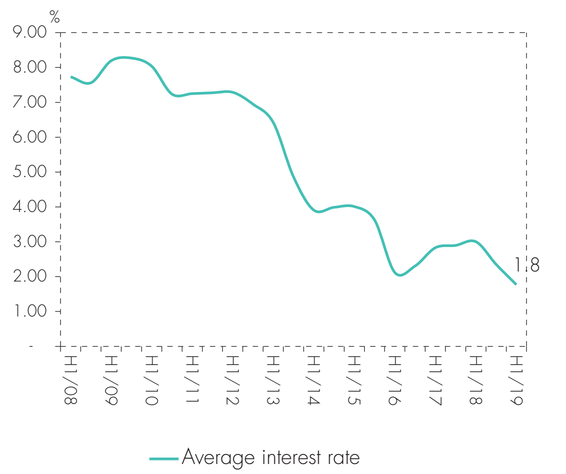
4. MARKETS AND PAYMENT SYSTEMS

4.1 MARKETS

Primary market of securities

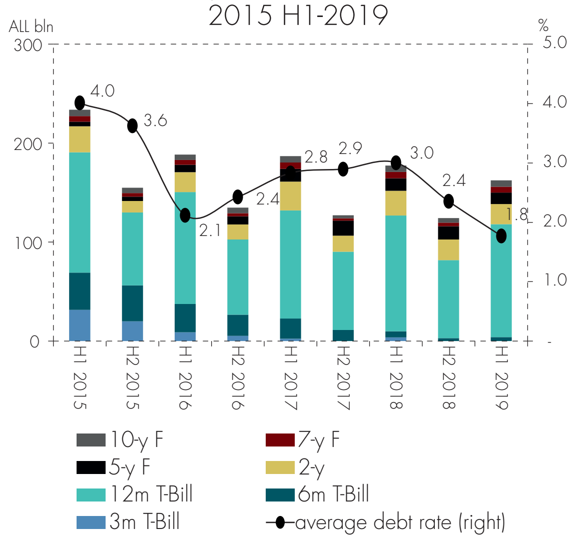
(15) **During the period, the average yield on government debt securities continued to fall.** During the period, the yield dropped to a historical minimum of 1.8%, from 2.4% and 3.0% in 2018 H1 and 2018 H2, respectively. Domestic debt in lek issued during the first half of the year was around ALL 170 billion, almost equal to the values of debt issued in 2018 H1. The structure of domestic debt in lek continues to be dominated by the short-term one (around 66%).

Chart 7 Average yield on debt securities, in %



Source: Bank of Albania.

Chart 8 Composition of issued debt during 2015 H1-2019

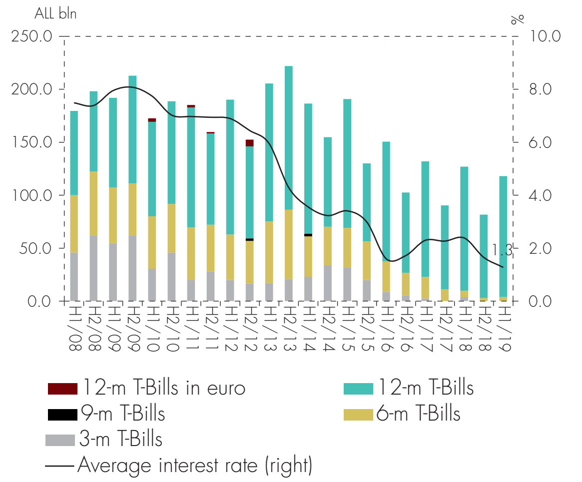


Source: Bank of Albania.

(16) **The average yield on short-term debt securities, over the period, fell at 1.3%[13], but the yield has been increasing during the second quarter.** The fall by around 0.4 percentage points of weighted average yield on 12-month T-bills, which constitute around 97% of short-term debt, affected the fall of the average yield. In the first quarter, the bid for investment in treasury bills was continuously higher than government's demand for borrowing and the yield decreased. The failure to meet the government's demand in two auctions at the beginning of the second quarter pushed the yield on T-bills to 1.7% at the end of the period.

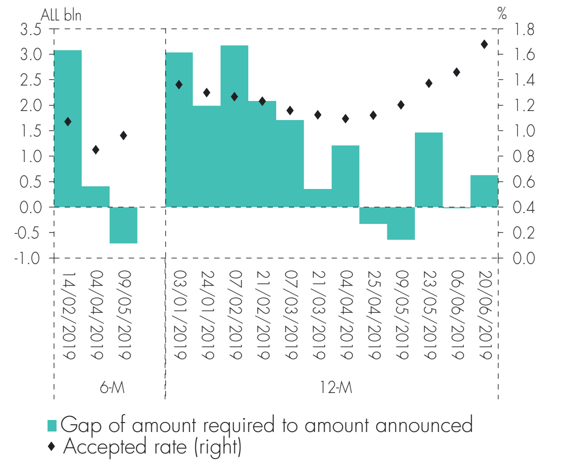
[13] It was 1.8% and 2.4%, in 2018 H2 and 2018 H1, respectively.

Chart 9 Volume and weighted average yield on T-bills in the primary market



Source: Bank of Albania.

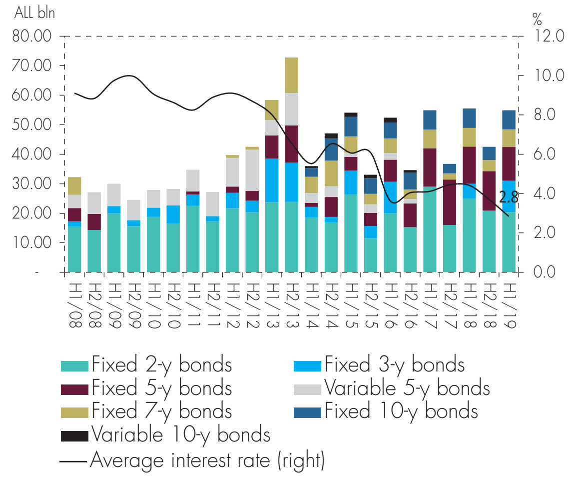
Chart 10 Surplus on the amount announced for investment and treasury bills yields, for 2019 H1



Source: Bank of Albania.

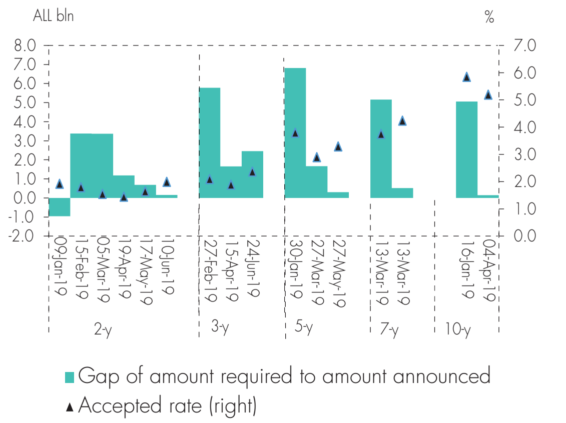
(17) The average yield on long-term debt securities of the government also declined, at 2.8%[14]. Despite the fall in the yield, the long-term debt issued during the period amounted to ALL 55 billion, up 30% from the previous period, affected also by the new issue of 3-year bonds. Around 60% of the amount of issued bonds consist of 2 to 5-year maturity bonds, at a fixed yield rate. Overall, public's bid for investment in long-term securities has exceeded government's demand for borrowing. For some securities, yields trended slightly upward in 2019 Q2.

Chart 11 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

Chart 12 Investment announced amount surplus and bonds interest rates, for 2019 H1



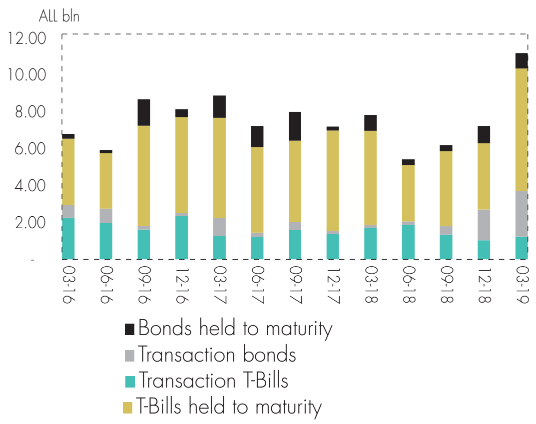
Source: Bank of Albania.

[14] *It was 3.8% in 2018 H2.*

SECONDARY MARKET OF SECURITIES[15]

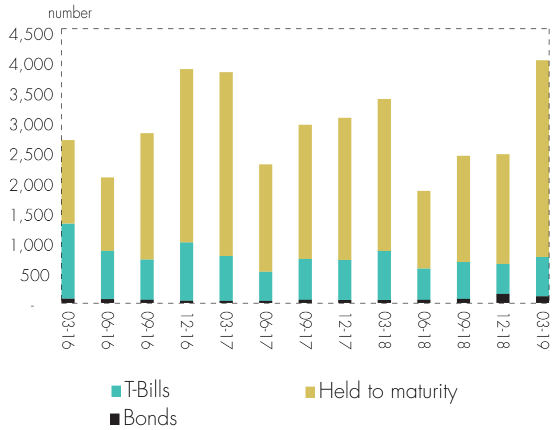
(18) **In 2019 Q1, the secondary market of government debt securities increased considerably both in value and number of transactions.** The volume of both long and short-term securities transactions carried out in the secondary market, in 2019 Q1, was around ALL 4 billion, or 40% higher from 2018 Q4. The number of transactions was 770 or 18% higher compared with 2018 Q4. These transactions account for 20% of the total number of securities in the market, as investors prefer to hold securities until the payment of nominal value at maturity. The measures undertaken to develop the secondary market (see Box 4.1) are showing their first results manifested in the increase of the trade volume of debt securities in the secondary market. T-bills transactions have dominated the transactions in the secondary market, although in the last two quarters the volume of bonds traded in this market increased. This volume increased from 60% in 2018 Q4 to 67% in 2019 Q1, due to the introduction into the market of the latest issuance of Albania's benchmark bond.

Chart 13 Volume of securities transactions in secondary market, in ALL billion



Source: Financial Supervision Authority.

Chart 14 Volume of securities transactions in secondary market



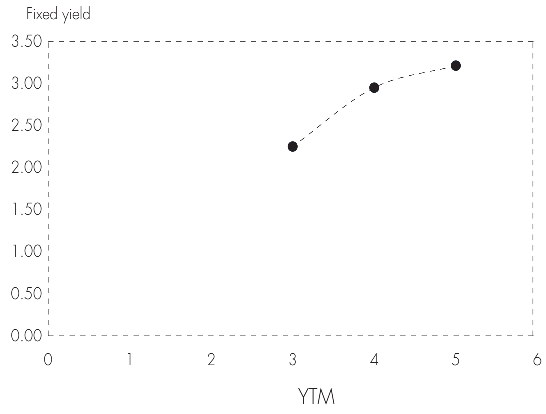
Source: Financial Supervision Authority.

[15] *Secondary market or retail market of securities is the secondary market organised in the physical or virtual windows of the entities being licensed to conduct transactions for these instruments with investors.*

BOX 4.1 BENCHMARK BONDS AND DEVELOPMENT OF SECONDARY MARKET

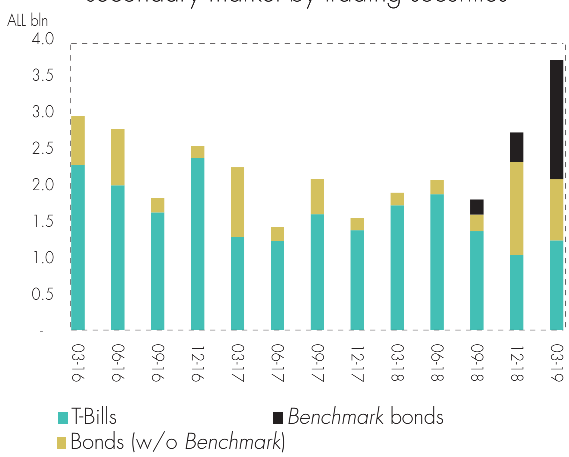
In June 2018, in the context of a pilot project, for the first time, benchmark bonds of 5-year maturity, were issued in the market. The objective of this initiative undertaken by the Ministry of Finance and Economy in collaboration with the Bank of Albania is to develop the securities in secondary market in order to increase the liquidity of over 2-year securities. Since the beginning of 2019, in addition to benchmark bonds of 5-year maturity, 3-year bonds were issued. Auctions for benchmarks are exclusively for market makers, who may make bids for their account or on behalf of their clients. Market makers are financial institutions selected based on the criteria set forth by the Ministry of Finance and Economy. Currently, there are five banks that may make competitive and non-competitive bids. Benchmarks are quoted on a daily basis, thus providing for the calculation of the yield curve** for government bonds, which serve as a benchmark for other debt securities in the market and increases transparency by providing real time information on the price of government's long-term securities. In 2019 Q1, the 3 and 5-year benchmark securities accounted for around 44% of the volume traded in the secondary market of securities. 65% of the total volume of securities traded in the secondary market are 5-year securities.*

Chart 15 Yield curve on 28.06.2019



Source: Bank of Albania.

Chart 16 Volume of transactions in the secondary market by trading securities



Source: Financial Supervision Authority.

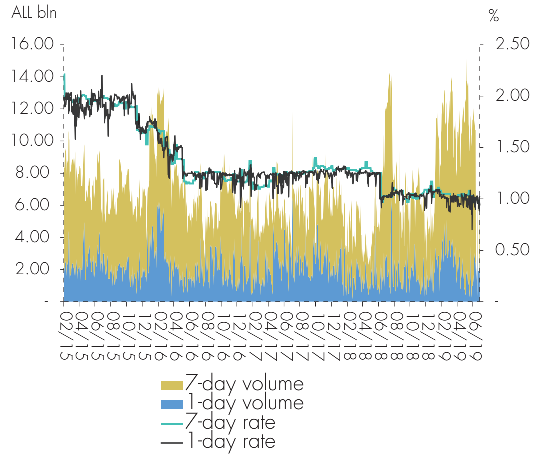
** ABI, CB, ISPB, NCB, FIB.*

*** Yield curve shows debt securities with the same quality, in case of government bonds "no risk", but at different maturity dates and shows the relation between the yield and the time to maturity.*

INTERBANK MARKET

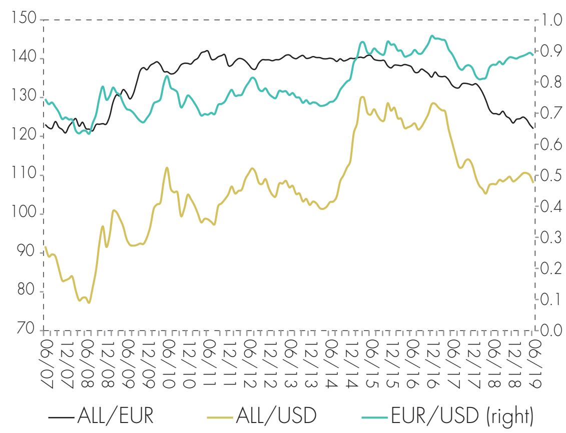
(19) During the period, the average volume of transactions in the interbank market shrunk, while the average interest rates remained close to the Bank of Albania's policy rate. The overnight and 7-day interbank transactions continued to dominate the interbank market. Their volume increased[16] by 40% and 45%, respectively, compared with 2018 H2. At the end of period, the interest rate on overnight and 7-day interbank transactions were 1.02% and 0.94%, respectively. No 1-month transactions took place during the period.

Chart 17 Interest rates in interbank market



Source: Bank of Albania.

Chart 18 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

Foreign Exchange Market

(20) At the end of the period, lek appreciated slightly against both the euro and the US dollar. The appreciation of lek was more pronounced during the second part of the period. In June, the average lek/euro exchange rate was 122.0 lek, from 123.45 lek in December 2018. In the same period, the average lek/ US dollar exchange rate was 108.2 lek from 108.43 lek in December 2018. Compared with same period in the previous year, lek appreciated by 3.1% against the euro and depreciated by 0.2% against the US dollar.

4.2 REAL ESTATE MARKET

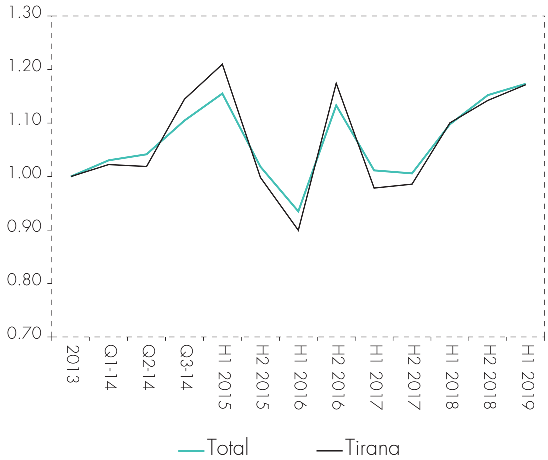
(21) In the real estate market both the demand and supply expanded, but the increase in demand was slightly stronger. Overall, the demand was supported by the increase in credit to households for real estate purchase, favoured by low interest rates and the easing of banks' lending conditions

[16] *This performance reflected also the intervention of the Bank of Albania in money market, during the first quarter of year, through one-week repo to inject liquidity in the system.*

applied on this type of loans. The reports by real estate agents point to an: increase in demand; decrease in the number of unsold properties; increase in the number of sold properties; and a shortening in the time needed to sell the properties. Supply in the real estate market continues to be supported by the strong performance in the credit for the construction sector. Credit for construction continued to expand albeit at a slower pace compared with the previous period. Data on the number of construction permits show that interest for new constructions continues to be strong, but the total number of new permits was lower in 2019 Q1, compared with 2018 Q3 and Q4.

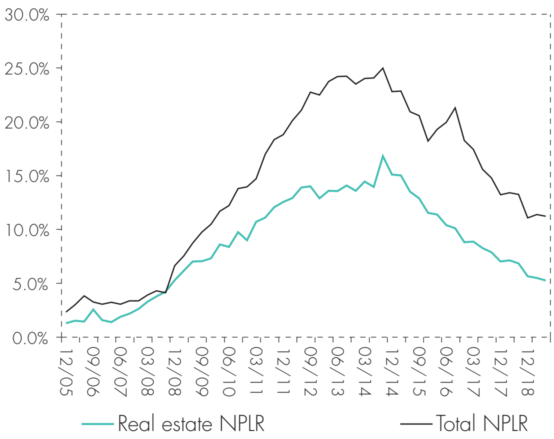
(22) For the period, real estate agents reported higher prices from the previous period, but the price increase was lower than the increase observed throughout 2018. House prices, calculated according to the Fischer House Price Index[17] for successful sales during the period, were up by 1.8% compared to the previous period, and by 17.3% compared with the base period (2013). The Fischer House Price Index for Tirana, which includes the centre, suburbs and extra urban areas, increased by 2.6% compared to the previous period and by 17.2% compared to the base period.

Chart 19 Fischer Index - National level, and Tirana



Source: Bank of Albania.

Chart 20 Credit quality for real estate purchase



Source: Bank of Albania.

(23) Agents remain relatively optimistic for developments in the real estate market, and the situation in this market is assessed, overall, as stable. Agents expect a fall in the number of new properties to be listed for sale and increase of the prices of real estates, in the next period.

(24) Data of the banking sector show increase of outstanding credit for real estate and slight improvement of its quality, compared to 2018 H2 and to 2018 H1. The non-performing loans ratio for this type of credit dropped at 5.3%, from 5.6% at the end of 2018, and 6.8% a year earlier. Outstanding credit for construction maintained the level recorded at end of 2018, but it

[17] *The index is built on the basis of data reported by construction companies and agents operating in the real estate market.*

was around 5% higher compared with the previous year. The share of credit for construction in the total credit portfolio, during the last two years, has remained almost unchanged, at 14%. Survey data show that around 46% of sold properties from responding entities are financed with bank credits. This ratio has declined over the last two years. The fall by around 4% in outstanding credit collateralised with real estate reflects a reduction of almost the same size the total outstanding credit due to the structural changes in the banking sector. The quality of credit collateralised with real estate continues to be good and notably better compared with the quality of non-collateralised credit and with the quality of credit guaranteed with collateral other than real estate. The ratio of credit collateralised with real estate for both households and enterprises (62% and 38%) to total credit held by the respective sector has not changed notably during the period.

BOX 4.2 SUMMARY OF RESULTS FROM THE REAL ESTATE MARKET SURVEY AND HOUSE PRICE INDEX FOR 2019 H1

The situation in the real estate market is assessed through the field survey of a sample of 230 real estate agents, whose main business is the trading of real estate. The selected entities are real estate agents and construction companies whose sales represent around 75-80% of the turnover of the entire population. The Bank of Albania is in charge of the questionnaire design, data entry, data processing and analysis, while the Institute of Statistics performs the field interviews, the main processes of sampling and the physical check of the completed questionnaires. The survey results for the period are as follows:

General assessment: The assessment of agents for the overall situation of the market was somewhat more pessimistic compared with the previous period. The net balance of responses [-7.3]% for the question "How do you assess the market situation compared with the previous period" shows a slightly higher number of agents providing negative response (worse) than the positive response (better). Meanwhile, more than 60% of responses are reported as neutral. This balance value, albeit negative during the last years, has decreased considerably compared with the long-term average of around [-22]%. The same indicator assessed only for the entities reporting sales during the period was [-5.3]%, while in the previous periods, this balance recorded continuously positive values.

Performance of prices and sales: At the end of period, Fischer House Price Index, on a national level, was up by 17.3 % compared with the base period (year 2013), and by 1.8% from the previous period. The sales volume increased in central and suburb areas of Tirana and in Other Areas of the country, but it fell slightly in the coastal areas. The Price Index for Tirana increased by 17.2% from the base period, and 2.6% from the previous period. The average prices increased in the centre of the capital (+3.2% from the previous period and 14.7% from the base period), while they were relatively stable in its other areas. At national level, prices in Other Areas fell by 2.3% from the previous period, but they remain increased by 20.6% compared to the base period. Prices in the Coastal Area do not show notable changes for the period, and are around 9% higher compared with the base period.*

Number of listed properties: Agents report a lower number of properties listed in their books; the net balance of those reporting increase in the number of *registered houses and those reporting decline in their number was around [-12.5]%, almost unchanged from the previous period. The number of unsold properties, both for residential and commercial buildings, continued to be down for several six-month periods, consecutively.*

Average sale period: The average time of sale for property, at the national level, is 9.9 months or more than one month shorter compared to the previous period. In Tirana, the respondents reported the average sales time was 11.1 months, or 1.2 months longer compared with the previous period. For the coastal area, the average sales time increased, from 7.4 months to around 8.3 months; while in other areas the sales times is considerably shortened, from 13.2 months to 9.2 months.

Financing through bank credit: According to agents, around 46% of properties for both residential and commercial buildings sold by them are purchased with a loan. This figure is down compared with 54% in the previous period. Around 65% of these properties are purchased with a bank loan that accounts for up to 80% of the value.

Expectations for the future: Agents have positive expectations about the market performance in the territory they operate in the short-term future and are optimistic for a longer-term period (up to two years). The expected new listings for sale during the forthcoming period are assessed as downward (net balance stood at [-7.5]%). Agents expect increase of real estate prices. The net balance was positive for both residential buildings (9.3%) and commercial buildings (5.1%), reflecting the agents are optimistic. This balance has recorded positive values at similar levels with current values for several six-month periods, consecutively.

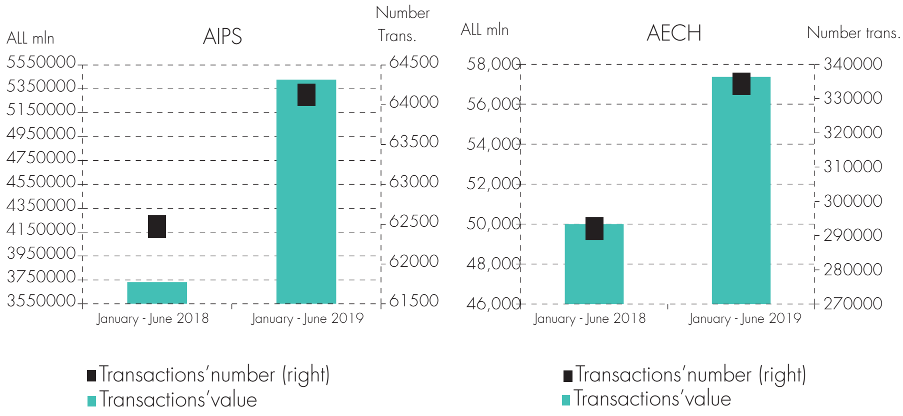
Rent demand and price: Most responses from agents show constant demand for renting during the period, for both residential and commercial buildings. In the same line, rental prices are reported as unchanged. It should be emphasised that these responses are concentrated in Tirana.

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

4.3 PAYMENT SYSTEMS

(25) **During the period, payment systems have successfully supported a higher number and value of the settled payments.** Thus, in the large value payments system (AIPS), around 64,000 payments accounting for ALL 5.4 billion were settled during the period. The number and value of transactions rose by 2.7% and 45%, respectively, compared with 2018 H1. At the same time, in the small value payment system (AECH), around 330,000 payments were cleared, with an average value per transaction of around ALL 172,000. Compared with 2018 H1, the activity of AECH increased, both in number and value, by 14% and 15%, respectively.

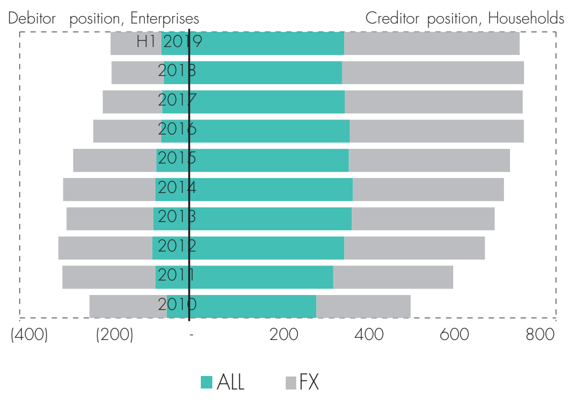
Chart 21 Performance of AIPS (left) and AECH (right) in 2018 H1 and 2019 H1.



Source: Bank of Albania.

5. FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

Chart 22 Net position (deposits and loans) for households and enterprises



Source: Bank of Albania..

(26) The impact of structural break[18] is reflected in a deepening of the debtor position of enterprises and contraction of the creditor position of households. Both sectors registered a decline of deposits and loans compared with the end of 2018, with foreign currency contributing most to this performance. Regarding households, banks report a contraction of deposits by around ALL 14 billion and of outstanding loans by around ALL 3 billion. Regarding enterprises, deposits declined by ALL 20 billion, and the loans stock by around ALL 15 billion. At the end of June, the creditor position of households was around ALL 780 billion and the debtor position of enterprises was around ALL 200 billion.

HOUSEHOLDS

(27) Compared with the end of 2018 and the previous year, households' savings in the form of deposits, securities and participation in funds increased by around ALL 19 billion, reaching ALL 1,143 billion[19] at the end of June. During the last 12 months, the volume and share of investments in government T-Bills has been declining. The expansion of savings reflects mainly the increase in deposits from resident households in both lek and foreign currency. The increase in foreign currency deposits was stronger during 2018 H2 and slowed down somewhat during 2019 H1, whereas the increase of deposits in lek during the period maintained high paces.

Table 3 Resident households' assets in the financial system

	2016, Dec.		2017, June		2017, Dec.		2018, June		2018, Dec.		2019, June	
	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %
ALL deposits	454.3	40.3	465.1	42.1	467.2	41.0	456.7	41.1	462.8	41.2	475.4	41.6
FX deposits	476.4	42.3	432.8	39.2	469.5	41.2	447.1	40.3	464.6	41.3	469.6	41.1
T-Bills	65.2	5.8	67.3	6.1	63.6	5.6	65.1	5.9	59.4	5.3	56.8	5.0
Bonds	64.5	5.7	67.9	6.1	72.1	6.3	77.4	7.0	77.1	6.9	77.6	6.8
Investment funds	65.4	5.8	70.8	6.4	65.1	5.7	62.5	5.6	58.5	5.2	61.4	5.4
Supplem. private pension funds	1.2	0.1	1.3	0.1	1.6	0.1	1.8	0.2	2.2	0.2	2.3	0.2
Households' portfolio	1,127.00	100	1,105.20	100	1,139.10	100	1,110.60	100	1,124.60	100	1,143.10	100

Source: Bank of Albania, Albanian Financial Supervisory Authority.
**Note: The values are for 2019 Q1 according to the latest reports.*

[18] *See "Notes", at the beginning of the Report.*
[19] *These data include only information on resident entities.*

BOX 5.1 SURVEY RESULTS ON HOUSEHOLDS' FINANCIAL AND BORROWING SITUATION

The survey of households' financial and borrowing situation is conducted half-yearly. The survey is based on a randomly selected sample of 2010 households, across Albania. This survey refers to developments in 2019 H1 and expectations for 2019 H2. Around 90% of the selected sample of households took part in the survey. Around 56% of them live in urban areas and 44% in rural areas. The Institute of Statistics is engaged in the selection of the sample, the on-site administration of the survey and its quality control.

During the period, the total number of employed persons among the sample decreased from the previous period and the previous year. In annual terms, the decrease was driven by the decline of the number of self-employed, whereas employment in other sectors increased.

The overall level of households' income and expenses resulted in decline over the period. However, the decline of expenses has been somewhat sharper than that of income, which brought a slight improvement of households' financial balance (income-expenses).

Around 24% of respondent households declare that they have at least one loan to repay, obtained through various sources. This share decreased by 2 percentage points compared with the previous period and 4 percentage points compared with the previous year, remaining below the historic average. For these households, the index of income and expenses registered a decline during the period.

Total reported outstanding loans registered a decline compared to the previous survey and the previous year. Around 67% of outstanding loans are obtained by banks and this share increased by 1.2 percentage points compared with the previous period. Overall, around 70% of the loan value is obtained by formal sources (banks and non-bank financial institutions). The structure of loan value by currency remained unchanged from the previous period; around 86% of loans were in lek, whereas 14% in euro.

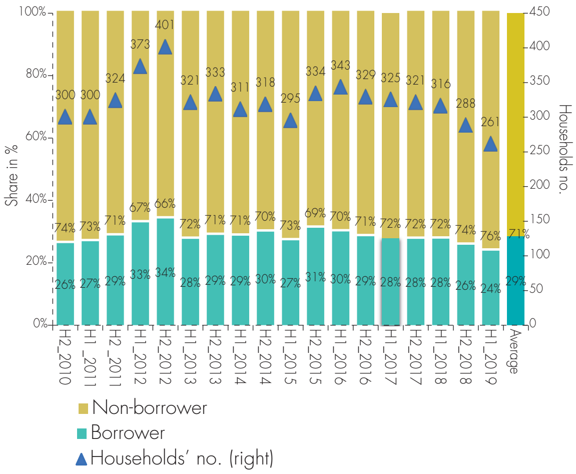
The share of loans for purchase/renovation of real estate and consumption increased during the period. Around 37% of declared outstanding loans are used for purchase/renovation of real estate, around 33% for business development and 13% for consumption. While the share of loans for purchase/renovation of real estate and that for consumption increased compared with the previous period and the previous year, the share of loans for business development declined.

Borrowing households report a decline of loan instalment during the period and improvement of their solvency. Around 61% of borrowing households declared that their solvency has not changed, while the rest declared an improvement compared with the previous period and the previous year. For 2019 H2, most of households (around 78%) do not expect a change in their solvency, while the net balance of the rest of responses shows weaker expectations.

The possibility to borrow during 2019 H2 is estimated as downwards compared with the previous period and with the previous year, confirming a still unstable demand by households for loans.

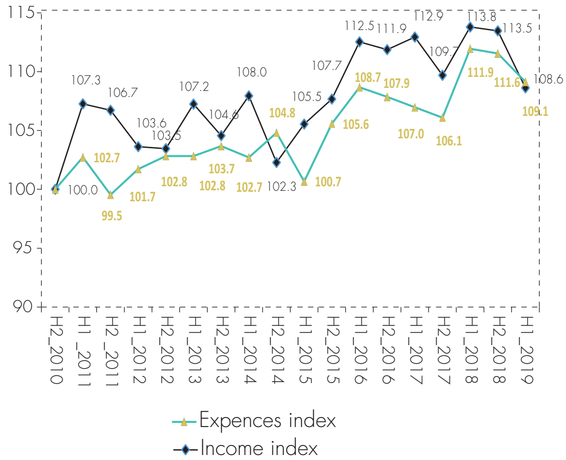
(28) Households' debt burden remains at relatively adequate levels and shows a downward trend. The survey of households' financial and borrowing situation shows that, at the end of 2019 H1, around 24% of surveyed Albanian households have at least one debt to repay. This share has resulted in decline in the last three periods and is 5 percentage points below the historic average (since 2010). The analysis of income and expenses of borrowing households reveals that they were downward during the period, but the decline of income was somewhat more pronounced.

Chart 23 Borrowing of households (% of total responding households)



Source: Bank of Albania.

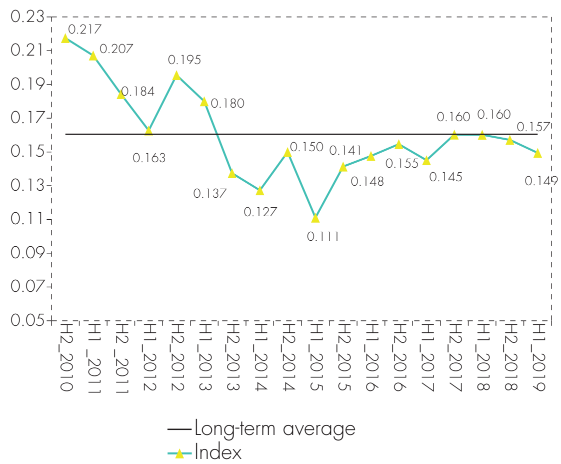
Chart 24 Income and expenses of borrowing households



Source: Bank of Albania.

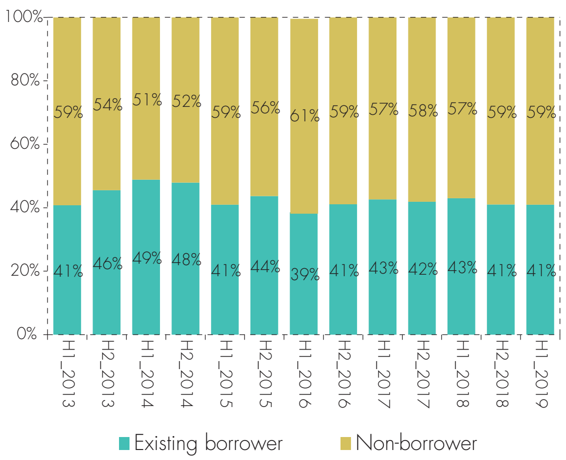
(29) Households' credit demand remains moderated. Based on the survey, around 67% of respondents declared that they "do not expect to take a new loan in the next six months". The index for the possibility of a new loan was 0.149 and has decreased compared with the previous survey and the previous year, remaining below its long-term average. Among households planning to

Chart 25 Planning to take a new loan in the next six months (total sample)



Source: Bank of Albania.

Chart 26 Households planning to take a loan in the next six months



Source: Bank of Albania.

take a new loan, more than half of them (59%) are "new borrowers", so they do not have unpaid loans at the moment of interview and 41% are "existing borrowers". These shares are largely unchanged from the previous period.

ENTERPRISES

(30) During the period, enterprises' debt burden remained unchanged and is estimated at affordable levels. Survey data show that the total value of loans resulted approximately at half of the enterprise's equity, for 76% of borrowing enterprises, and equal to or higher than the value of equity, for 24% of them. The debt/equity ratio resulted higher and upward for medium-sized enterprises, with around 27% of them declaring that this ratio is equal or exceeds the value of equity, implying a higher debt burden. By sector, debt burden is more pronounced in enterprises operating in trade and in industry.

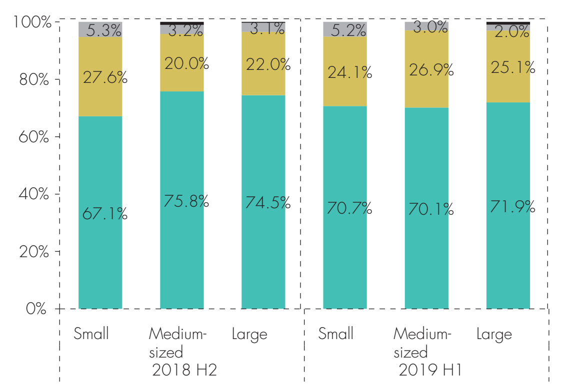
Table 4 Share of enterprises whose debt value is equal or higher than equity, by sector

	Industry	Services	Construction	Trade
2018 H1	22.4%	19.8%	15.2%	20.2%
2018 H2	20.7%	14.9%	15.0%	29.6%
2019 H1	26.8%	18.5%	18.3%	28.8%

Source: Bank of Albania.

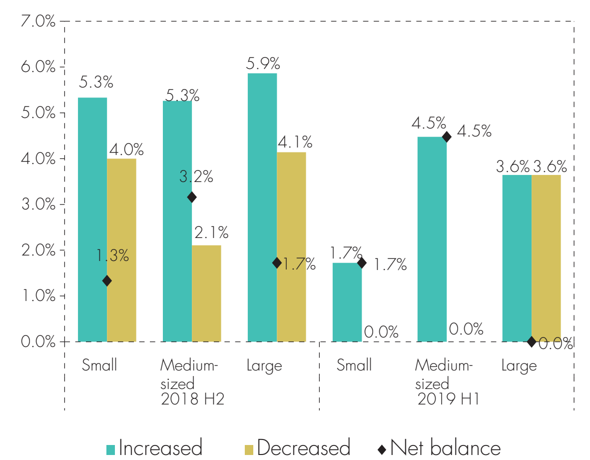
(31) Most of borrowing enterprises (72%) declare that the loan repayment amounts to 20% of the enterprise's revenue and this share has decreased by 2 percentage points compared to the previous period. Debt payment seems to be more burdensome on small and medium-sized enterprises, with enterprises that report that it exceeds 20% of revenues accounting for 29% and 30% of the total of the group, respectively[20], while for large enterprises

Chart 27 Enterprises by size and loan instalment/income ratio



Source: Bank of Albania.

Chart 28 Enterprises that declare a change in the loan instalment during the period



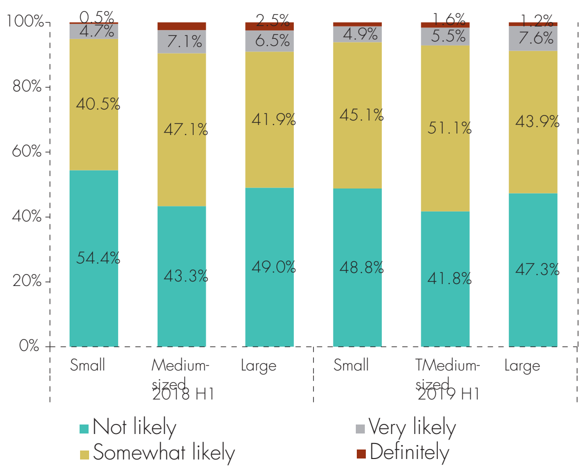
Source: Bank of Albania.

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

this share accounts for 28%. Asked if the loan repayment has changed during the period, most enterprises (98% of small enterprises, 96% of medium-sized enterprises and 93% of large ones) state that this repayment has not changed, while the rest resulted in net positive balances for small and medium-sized enterprises, showing an increase of this expenditure during the period, and remained unchanged for large enterprises.

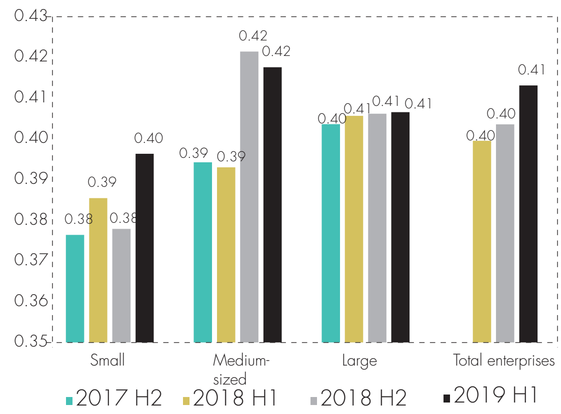
(32) Enterprises' credit demand in the next six months, judging by their responses related to bank borrowing planning, has given upward signals. Around 54% of total responding enterprises declare with various degree of confidence that they plan to take a new loan in 2019 H2 and this share has increased compared with the previous period for all three groups of enterprises. The borrowing plan index[21] for the next six months resulted in an increase for total enterprises, signalling the possibility of a recovery in their credit demand, but this trend is more marked among small enterprises.

Chart 29 Enterprises planning to borrow in the next six months



Source: Bank of Albania.

Chart 30 Bank borrowing planning index in the next six months



Source: Bank of Albania.

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[21] *This index aggregates the responses of enterprises on borrowing planning and is calculated weighting the share of enterprises' responses to total responses by a coefficient, which increases with the increase of borrowing possibility. The coefficients for each alternative are respectively: "no possibility" = 0.25; "little possibility" = 0.5; "probable" = 0.75; "certain" = 1.*

BOX 5.2 SURVEY RESULTS ON THE FINANCIAL AND BORROWING SITUATION OF ENTERPRISES

The survey of the financial and borrowing situation of enterprises has been carried out since 2010, half yearly. Initially, this survey was conducted on a sample of 700 large enterprises operating in Albania, but starting from 2016 H1 the sample was expanded to 1200 enterprises of all sizes, operating in the main sectors of the economy and geographically located in various regions of the country. This survey refers to developments in 2019 H1 and expectations for 2019 H2. The Institute of Statistics is engaged in the selection of the sample, the on-site implementation of the survey and its quality assurance.

During the period, surveyed enterprises report that competition and finding a market remain the main challenges of their activity. The significance of this factor is assessed as somewhat upward by small enterprises, but diminishing by medium-sized and large enterprises. Issues related to access to funding are assessed as increased by small and large enterprises and reducing by medium-sized ones.

Sales and financial result during the period are assessed as downwards for small enterprises and upwards for medium-sized and large enterprises. Compared with the previous period, these items had a downward trend across all three enterprises' groups.

All three enterprises' groups seem to have increased the efforts for expanding their activities. Increased expenses for business expansion may have contributed to the decline of the financial result during the period, but may bring an improvement in the future, which is also supported by expectations of all three enterprises' groups regarding sales, financial result and investments performance in 2019 H2.

Over the period, more than half of total responding enterprises declare that they have financed their activity through sales. Reliance on this source alone has fallen for all three groups of enterprises, while the propensity to combine several sources of funding continues to increase. Borrowing as a separate or combined source was used by 19% of total large enterprises, 16% medium-sized enterprises, and 8% small enterprises.

Around 38.6% of total surveyed enterprises (overall 436 enterprises) declare that they currently have loans to repay, taken from different sources. This share declined by 3.5 percentage points in half-yearly terms and by 3.8 percentage points in annual terms, deriving from small and medium-sized enterprises.

Around 88% of borrowing enterprises declare that they have turned only to the banking sector to borrow, while 6% of them have combined this source with others. The share of enterprises that have borrowed from banks increased by 4 percentage points compared with 2018 H2 and by 1 percentage point compared with the previous year. For the total of formal sources (banks and non-bank financial institutions), the share of borrowing enterprises reached 95% of total surveyed enterprises, increasing from the previous period and the previous year.

During the period, borrowing in foreign currency (mainly in euro) was used more by large enterprises (51%) and less by small enterprises (44%). Compared with the previous six months, the share of enterprises that have loans in foreign *currency registered a decline in the group of small enterprises (by around 3 percentage points) and large ones (by around 3 percentage points) and a slight increase (by 1 percentage point) in the case of medium-sized enterprises.*

Most enterprises consider the current level of borrowing to fund the activity as adequate. On the other hand, credit demand during the period - as net balance of enterprises' responses that would want to obtain more or less loans - resulted higher for large enterprises and lower for medium-sized ones. Compared with the two previous periods, credit demand from small enterprises showed an upward trend, and appears to be weaker from medium-sized and large enterprises.

Bank borrowing continues to be assessed between "normal" and "difficult". Compared with 2018 H2, the level of borrowing difficulty is assessed as mitigated for medium-sized enterprises and increasing for small and large ones. The importance of relationships with banks is assessed between "important" and "necessary". During the period, this assessment registered a decline for all three enterprises' groups, but the decline is more marked in the case of small enterprises.

6. FINANCIAL SYSTEM

(33) The share of total financial system assets in Gross Domestic Product (GDP) dropped to 104.8%[22], from 106.9% at end-2018. The decline of the share of the financial system reflects the contraction of banking sector assets due to the structural break of data[23]. At the end of the period the share of the banking sector declined at 93.6% from 96% at end-2018; the share of the non-bank sector increased to 11.2% from 10.7% due to the expansion of the activity of non-bank financial institutions and investment funds. Performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels.

Table 5 Share of segments of the financial system in GDP over the years

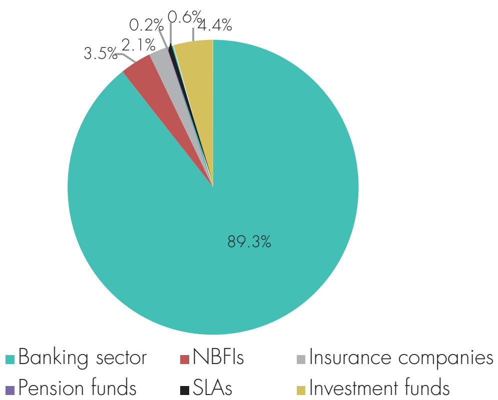
Licencing and Supervising Authority	Financial system	2011	2012	2013	2014	2015	2016	2017	2018
Bank of Albania	Banking sector	88.1	92.1	94.8	97.6	97.3	100.5	99.4	96.8
	NBFIs	2.7	2.7	2.7	3.0	2.9	3.0	3.1	3.3
	SLAs and their Unions	0.8	0.8	0.7	0.8	0.8	0.6	0.6	0.6
Financial Supervisory Authority	Insurance companies	1.5	1.6	1.7	1.9	2.1	2.1	2.1	2.2
	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	4.5
Financial intermediation		93.1	98.6	103.8	108.2	108.0	111.0	110.3	107.6

Source: Bank of Albania, Albanian Financial Supervisory Authority.

6.1 BANKING SECTOR

(34) The structural break effect contributed to the decline of banking sector's assets during the period. As a result, the reported value of assets decreased by around ALL 30 billion during the period, reaching around ALL 1,420 billion. The decline came mainly from the contraction of investment in securities and the reduction of the portfolio of foreign currency loans to non-residents by ALL 19 billion in each category. Of all the items in banking sector assets, loans to non-residents were most affected by the structural break. The expansion of interbank investments in the form of

Chart 31 Share of financial system segments to total assets of the financial system, June 2019



Source: Bank of Albania, Albanian Financial Supervisory Authority.

[22] *The banking sector balance sheet analysis refers to 2019 H1, whereas for other segments of the financial system (NFBIs, SLAs, pension funds and investment funds), balance sheets belong to 2019 Q1, according to the latest reports to the Bank of Albania and the Albanian Financial Supervision Authority. The latest available GDP data are as at 2019 Q1, according to the most recent publications from the Institute of Statistics.*

[23] *See "Notes", at the beginning of the Report.*

current accounts in financial institutions reduced the negative contribution of treasury and interbank transactions. The decrease of provisions had a positive impact of around ALL 4 billion on the performance of assets. When adjusted for the impact of the structural break, banking sector's assets increased by 1.3% during the period and by 2% in annual terms.

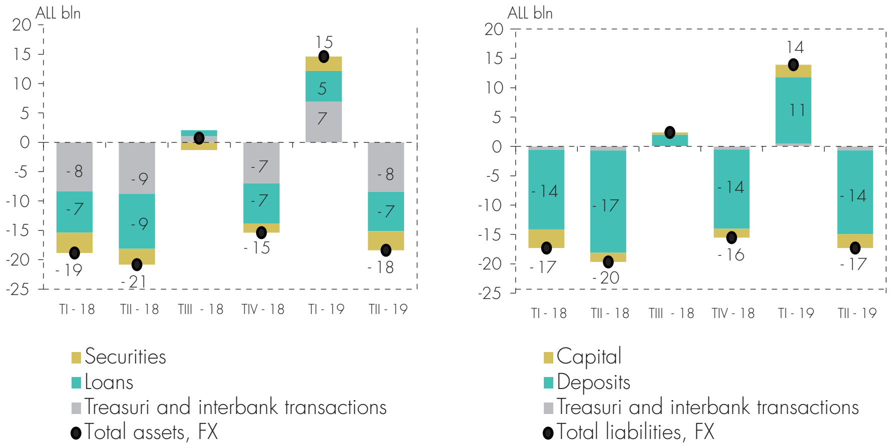
Table 6 Structure of banks' balance sheet and annual change, June 2019

Asset	% of assets	Annual change, %	Liability	% of liability	Annual change, %
I. Treasury and interbank transactions	32.9	0.2	I. Treasury and interbank transactions	5.8	13.9
II. Customer transactions (credit)	39.3	-3.4	II. Customer transactions (deposits)	80.2	-0.04
Of which: public sector	2.0	1.0	Of which: public sector	1.9	-3.3
Of which: private sector	37.5	-3.7	Of which: private sector	78.6	0.05
III. Securities transactions	25.7	-0.5	III. Securities transactions	0.6	-29.3
IV. Created Reserve funds	-2.8	-24.4	IV. Other liabilities	1.0	-8.0
V. Other	4.9	7.7	V. Permanent sources	12.1	-4.4
			of which: Subordinated debt	1.0	-30.4
			of which: Shareholders' equity	10.4	-0.7
Total assets	100	-0.2	Total liabilities	100	-0.2

Source: Bank of Albania.

(35) The appreciation of lek against main foreign currencies had a net negative impact on the foreign currency balance sheet of the banking sector, but this impact showed opposite trends in the first two quarters of the year. Hence, as a result of the depreciation of lek in 2019 Q1 and its appreciation in 2019 Q2, the statistical effect of the exchange rate on the reported value of foreign currency balance of the banking sector in each quarter was positive (+ ALL 15 billion) and negative (- ALL 18 billion), respectively. At the end of the period, foreign currency assets and liabilities of the banking sector accounted for 52.4% and 51% of the total balance, respectively, and registered a slight decrease from previous periods. On the assets side, the impact of the exchange rate has been stronger on treasury, interbank and customer (credit) transactions, whereas on the liabilities side, almost the entire statistical effect of the exchange rate is reflected on the equivalent value in lek of foreign currency deposits.

Chart 32 The exchange rate effect on the lek equivalent amounts of main items in assets (left) and liabilities (right)

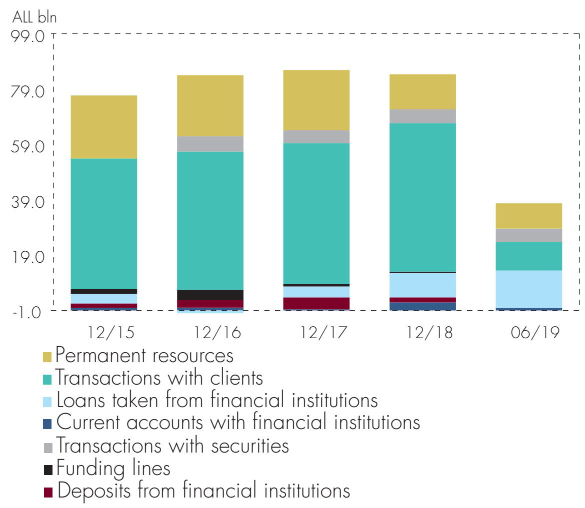


Source: Bank of Albania.

Compared with 2018 H1, the effect of the exchange rate was significantly smaller due to the change in the trend of the euro-lek exchange rate during the period January - March 2019. The following analysis should be interpreted by also taking into account the statistical effect of the exchange rate on the equivalent value in lek of banks' foreign currency balance.

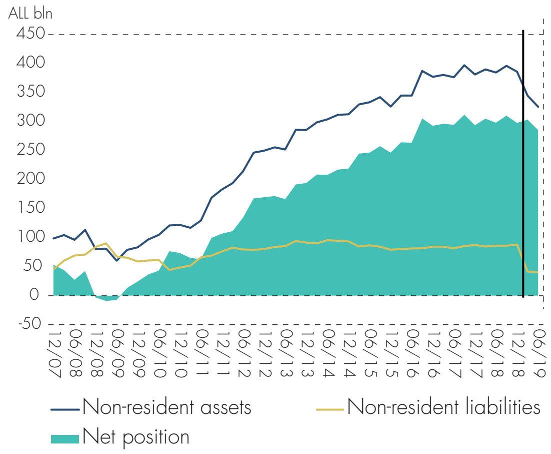
(36) Deposits and own funds continue to be the main funding source of the banking sector's activity, accounting for over 90% of total liabilities and this structure did not register significant changes during the period. Reliance on external funding sources remained limited and declined further during the period. Due to the structural break, liabilities to non-residents in the form of deposits decreased significantly. At the same time the non-resident loan portfolio decreased as well, contributing to the decline of the net creditor position of the banking sector.

Chart 33 Structure of non-resident liabilities



Source: Bank of Albania.

Chart 34 Net position with non-residents



Source: Bank of Albania.

**The vertical black line (right) reflects the period of transformation of the NCB branch in subsidiary*

(37) The effect of the structural break on assets and liabilities with non-residents was of a similar size and the net position to non-residents has remained unchanged at 20% of total balance sheet size of the banking sector. At the end of the period, claims to non-residents accounted for 23% of total assets while liabilities to non-residents were as high as 3% of total balance. From mid-2016 to beginning 2019, the share of claims and liabilities to non-residents has maintained relatively stable at levels (27% and 6%, respectively), and the net creditor position of the banking sector has remained unchanged, at ALL 300 billion. Structural changes were reflected in the decline of the absolute value and the relative share of liabilities and claims to non-residents, as well as in the size of the net creditor position; the latter, however, has maintained a similar relative share to the total balance of the banking sector, at around 20%.

6.1.1 LOANS

(38) At the end of the period, the amount of outstanding loans of the banking sector was around ALL 562 billion. Due to the structural break, outstanding loans were 3.3% and 3.5% lower compared with the previous period and year. During the period, monthly changes indicate that loans to households, loans in lek and long-term loans had a particularly good performance, whereas foreign currency and medium and short-term loans continued to contract. The strongest decline has been observed in the category of performing loans ("standard" and "special-mention" loans).

Table 7 Data on main categories of loans

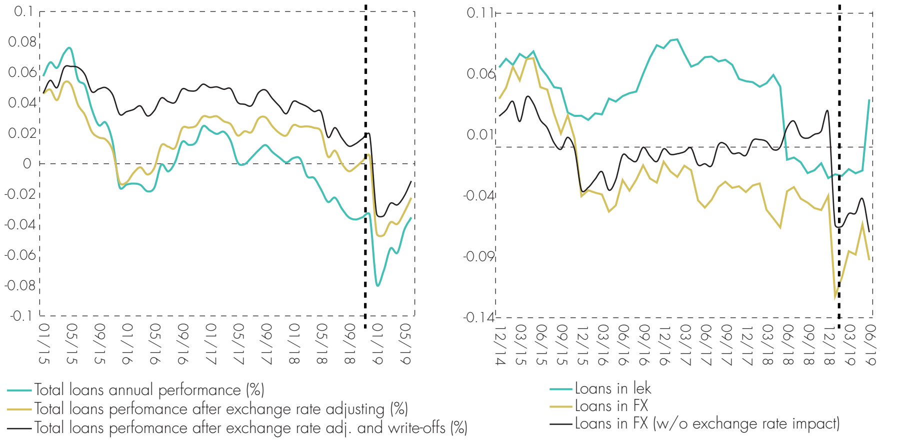
		ALL billion		% to total		Change (%)		
	Period	06/2019	06/2018	06/2019	6-M	Annual	6-M*	Annual*
By maturity	Short-term	159,880	29	28	(3.6)	(6.6)	(2.4)	(5.5)
	Medium-term	94,883	18	17	(14.4)	(11.3)	7.5	11.4
	Long-term	306,951	52	55	1.0	0.9	5.0	4.9
By institution	Public sector	27,829	5	5	(0.4)	1.0	(0.4)	1.0
	Enterprises	352,635	64	63	(4.2)	(5.6)	2.8	1.3
	Households	181,305	31	32	(1.8)	(0.0)	4.9	6.9
By currency	Lek loans	263,507	44	47	3.3	3.9	3.6	4.2
	Foreign currency loans	298,262	56	53	(8.4)	(9.3)	3.1	2.1
	Outstanding loans	561,769	100	100	(3.3)	(3.5)	3.3	3.1

** - excluding the structural break effect.*
Source: Bank of Albania.

(39) The diminishing effect of the slight appreciation of lek against euro and US dollar on the lek equivalent of foreign currency loans over the period has been more subdued. During the last 12 months, the euro/lek exchange rate contributed to this diminishing effect. Overall, in annual terms, the diminishing effect of the appreciation of lek on the growth rate of foreign currency loans and total loans is estimated at respectively 2 and 1.3 percentage points, respectively.

(40) During the period, the banks have continued to write off lost loans from their balance sheets, albeit at a slower pace. The value of written-off loans during the last 12 months, as at June 2019, was ALL 6.4 billion, but the majority of write-offs were realized in 2018 H2. The stock of written-off loans is around 10% of overall outstanding of non-performing loans, as at the end of June 2019, and the impact on the annual rate of change is estimated to be around -1.1 percentage points.

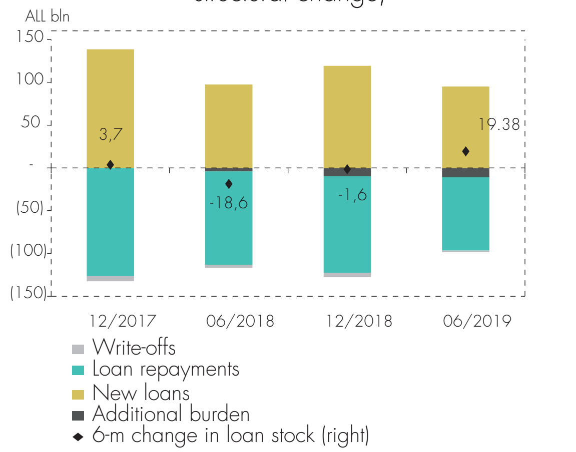
Chart 35 Performance of total loans excluding the effect of the exchange rate and write-offs (left) and of loans in foreign currency excluding the exchange rate effect (right), annual changes, in %



Source: Bank of Albania.

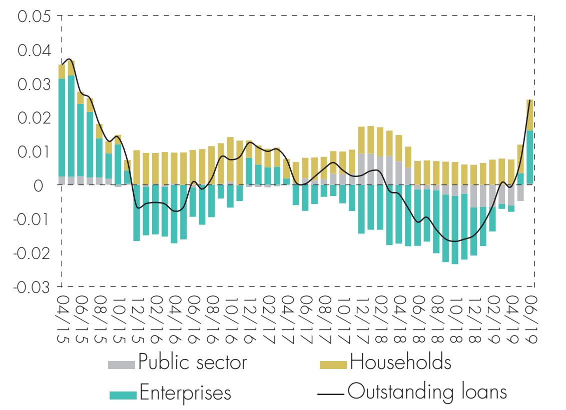
(41) **If the effect of the structural change is not taken into account, the change in the outstanding loans portfolio during the period would be around ALL +19 billion or +3.3%, and the annual change in the loan portfolio would be +3.1%.** With the exception of short-term and public sector loans, all the other aggregates registered positive growth values, compared with both 2018 H2 and 2018 H1.

Chart 36 Six-month change in outstanding loans by composing elements (excluding the effect of structural change)



Source: Bank of Albania.

Chart 37 Credit performance by sectors - Contribution in percentage points, 6-month changes (excluding the effect of structural change)



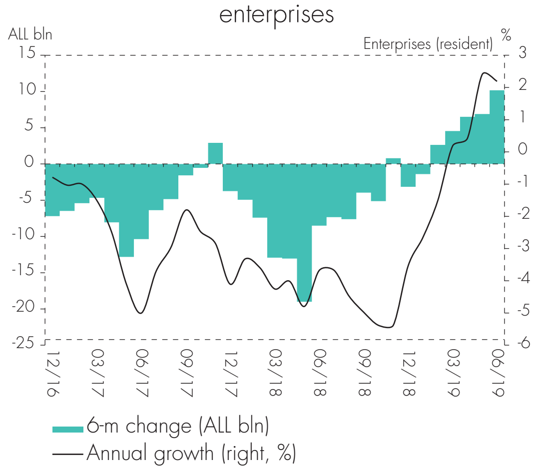
Source: Bank of Albania.

LOANS TO RESIDENT ENTITIES - ENTERPRISES

(42) **Loans to resident entities[24] increased by 3.1% over the period.** This credit accounts for around 96% of total loans. Over 60% of loans to resident

[24] *These loans are not affected by the structural breakdown.*

Chart 38 Performance of loans to resident enterprises



Source: Bank of Albania.

entities are held by the enterprises sector. Loans to this sector expanded by around ALL 10 billion amounting to around ALL 330 billion at the end of the period. The expansion in this category was driven by the increase in loans for working capital and real estate loans. The latter continued to account for around 27% of outstanding loans to enterprises.

(43) The structure of loans to enterprises has changed over the last years. The share of "Overdraft" loans has declined, due to the decline in the stock of foreign currency overdrafts. Loans "for equipment purchase" registered a similar performance as well. The share of loans for "real estate purchase" in outstanding loans to enterprises has increased slightly during the last two years, supported by a nearly 7% increase of the portfolio in foreign currency.

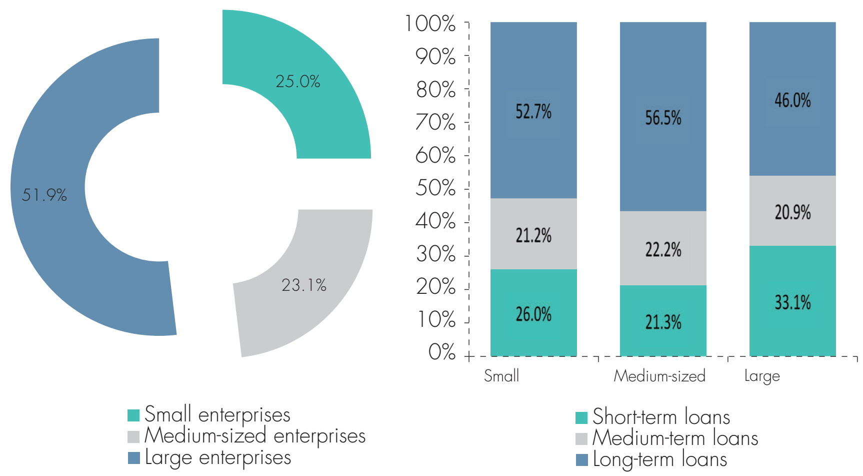
Chart 39 Loans to enterprises by purpose of use and currency, index, December 2016 = 100

Source: Bank of Albania.

(44) Over the period, the shares of loans to large and medium-sized enterprises to total loans held by resident enterprises increased, whereas the share of loans to small enterprises[25] decreased. Small and large enterprises have expanded their long-term loan portfolio and contracted the short-term loan portfolio. Medium-sized enterprises registered an expansion of their short-term loan portfolio and a contraction of their long-term loan portfolio.

[25] *These values marked respectively: 50.8% (large enterprises); 23.0% (medium-sized enterprises) and 26.2% (small enterprises) in December 2018; whereas in June 2018 they were respectively: 52.7%; 22.9%; and 24.4%.*

Chart 40 Structure of loans to enterprises by size and maturity

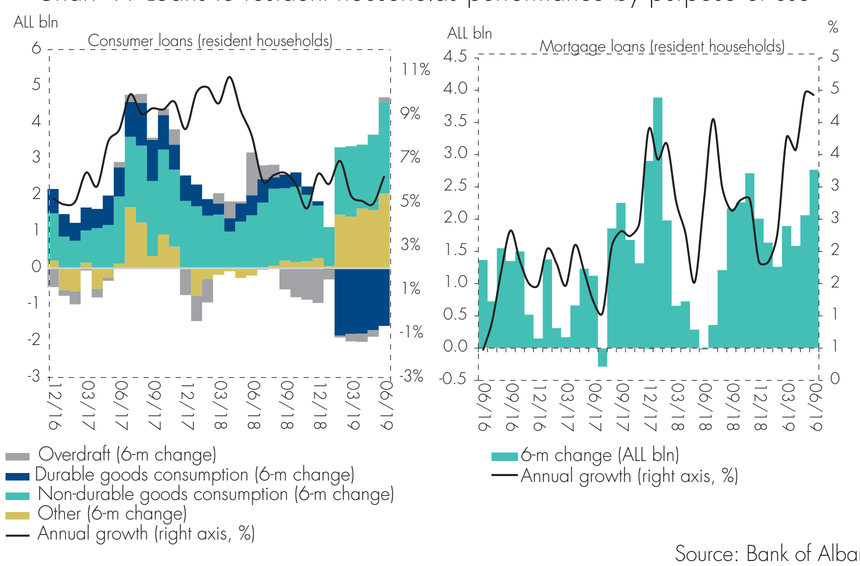


Source: Bank of Albania.

LOANS TO RESIDENT ENTITIES - HOUSEHOLDS

(45) Loans to resident households expanded by 3% over the period, mainly owing to the increase of loans in lek. Real estate and consumer loans for non-durables which account for 62% and 17% of loans to households, respectively have registered the fastest growth. Outstanding loans for real estate increased by around 3% and reached ALL 113 billion. Compared with the previous year, loans to households expanded by 5%. During 2015-2018, loans to households have increased steadily, whereas loans to enterprises have decreased. This performance has brought about changes in the structure of loans by sector, as the weight of loans to households has gone up. Loans to enterprises accounted for 32% of outstanding loans in June 2019, from 31% in the previous year and 25% at the beginning of 2015.

Chart 41 Loans to resident households performance by purpose of use

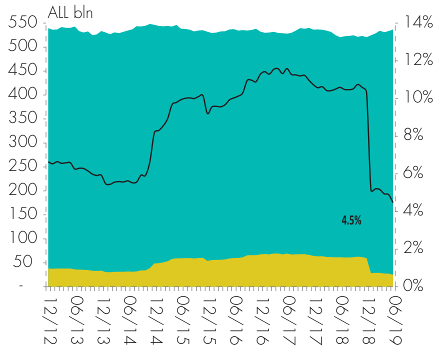


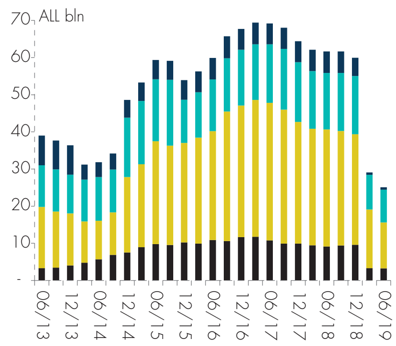
Source: Bank of Albania.

LOANS TO NON-RESIDENTS

(46) Over the period, due to the impact of the structural break, loans to non-resident entities declined sharply. As at June 2019, loans to non-residents were around ALL 25 billion and accounted for 4.5% of outstanding loans of the banking sector, from ALL 60 billion and 10% at the end of the previous period. By sector, currency and maturity, the highest decrease was registered in loans to enterprises, in euro and medium-term loans, which have the highest share in the stock of loans to non-resident entities.

Chart 42 Loans to residents and non-residents (left) and loans to non-residents by maturity (right)





Source: Bank of Albania.

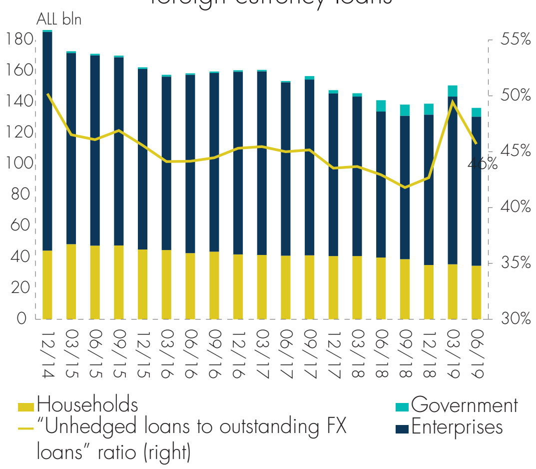
UNHEDGED FOREIGN CURRENCY LOANS

(47) The exposure of the banking sector to indirect exchange rate risk, as measured by the share of unhedged foreign currency loans, remains high. Unhedged foreign currency loans had a performance similar to the overall loan portfolio, and decreased by 2% and 3.5% compared with the previous six months and a year earlier. The impact of the exchange rate on the rate of change of the unhedged loan portfolio for the period was around -0.4 percentage points. The decline was observed in all types of unhedged loans by sector but the government sector made the main contribution. The share of unhedged loans to overall outstanding loans remained unchanged at 24%, but their share to the foreign currency loan portfolio during 2019 H1 increased at 46% from 43%.

BOX 6.1 BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

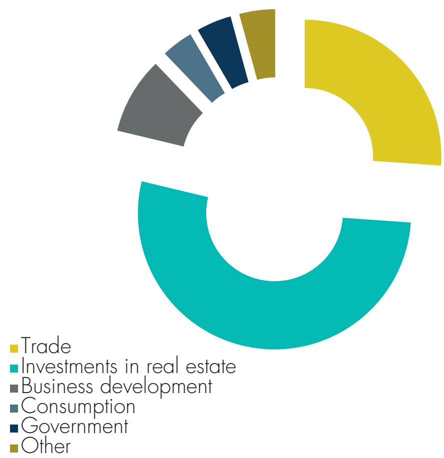
During 2019 H1, unhedged foreign currency loans decreased by 2%, at ALL 136 billion, mainly due to the contraction of unhedged loans in US dollar (by 18%) whereas unhedged loans in euro registered a slight increase. Loans to enterprises account for 70% of outstanding foreign currency loans unhedged against the exchange rate risk, while loans to households and to government account for 25% and 4%, respectively. The decline in unhedged loans to government by 20% gave the main contribution to the contraction of outstanding unhedged loans. Unhedged loans to households and to enterprises also registered a decline over the period by 1.2% and 1%, respectively. In annual terms, unhedged foreign currency loans contracted by 3.5%, due to the decrease of loans to households and loans in euro.*

Chart 43 Performance of unhedged foreign currency loans



Source: Bank of Albania.

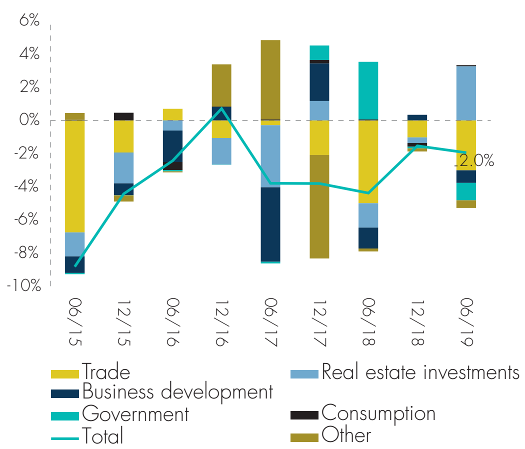
Chart 44 Unhedged foreign currency loans, by purpose of use, in %



Source: Bank of Albania.

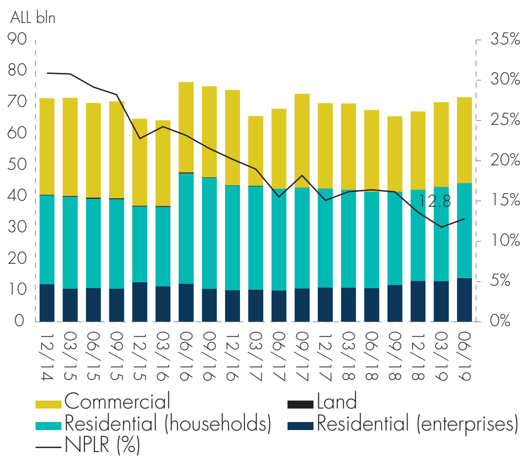
Unhedged loans granted for investments in real estate continue to account for the main share (around 53%) of total unhedged foreign currency loans, followed by loans for trade (26%). The rest of the unhedged foreign currency

Chart 45 Six-month performance of unhedged foreign currency loans (contribution by sectors)



Source: Bank of Albania.

Chart 46 Unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania.

loans were granted for business development, consumption, to the government and other purposes.

The main contribution to the performance of outstanding unhedged loans against the exchange rate risk over the period came from the decline of unhedged loans for "trade" and to the "government", which decreased by 10% and 20%, respectively. Unhedged foreign currency loans for "investment in real estate" were the only category of unhedged loans that registered an increase over the period (+7%).

Unhedged loans for real estate are granted for the purchase of residential and commercial real estate and land. Unhedged loans for residential real estate granted to households have the main share (42%), expanding 4% during the period. The main contribution to the expansion of unhedged loans for real estate over the period came from the increase by 10% of unhedged loans for commercial purposes. Banks report an expansion of the stock for all the categories of loans for real estate unhedged against the exchange rate. The appreciation of lek exchange rate made negative contribution to the reported value of unhedged foreign currency loans (by ALL 0.6 billion). Excluding the appreciation of lek exchange rate, unhedged foreign currency loans would have contracted by 1.6% from 2% over the period.

* *Outstanding loans in US dollar, when the borrower's income is in Albanian lek, account for 11.3% of the outstanding unhedged foreign currency loans.*

(48) **The amount of new loans granted during the period was smaller compared with the previous two periods, and the decline reflects the structural break effect.** The contraction was more pronounced in the new short-term foreign currency loans to enterprises, which declined by nearly 20%. For the households sector, in which the impact of the structural break was negligible, the amount of new loans was somewhat higher compared with the previous period and compared with the average of each period in the last two

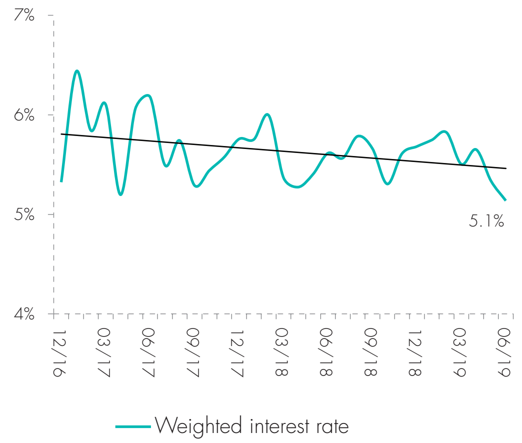
Chart 47 New loans to enterprises (left) and households (right) by purpose of use

Source: Bank of Albania.

years. These loans went mainly for house purchases. Over the period, new loans granted amounted to ALL 117 billion, or nearly 13% lower compared with the previous period, and below the average of each period of the last two years. By currency, new loans in euro, accounting for 39% of the overall new loans flow, contracted over the period by 13%.

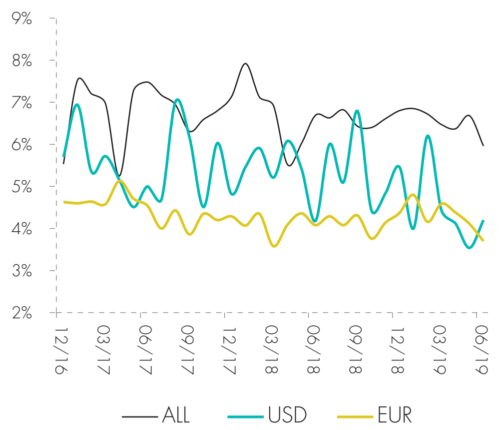
(49) The weighted interest rates on new loans granted over the period[26] registered a decline for all types of loans. In June 2019, the weighted average interest rate on new loans was 5.1%, around 0.5 percentage points lower than the average rate on new loans granted in 2018. The strongest decline was registered in the interest rates on new loans in US dollar and new loans to enterprises. At the end of the period, the weighted interest rate on new loans in lek stood at 5.7%, whereas the rates on loans in euro and US dollar were equal to 3.6% and 4.2%, respectively. The interest rates on new loans to households remain higher compared to those on loans to enterprises, whereas for both these categories banks have reported a decline of the weighted interest rate over the last two years. In June 2019, the weighted rate on loans to households registered 5.9%, from 6.2% in December 2018, while for enterprises it was around 5% from 5.6% in December 2018. New loans to enterprises exhibit an upward trend in the interest rates on short-term loans and a decrease in interest rates on long-term loans and those for real estate purchase.

Chart 48 Weighted interest rates on new loans



Source: Bank of Albania.

Chart 49 Interest rates on new loans, by currency



Source: Bank of Albania.

Chart 50 Interest rates on new loans, by entity

Source: Bank of Albania.

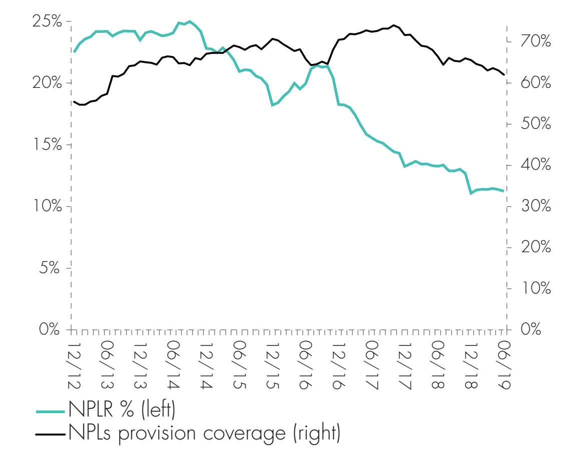
[26] *Calculated as six-month average.*

6.1.2 CREDIT RISK

(50) Over the period, the loan portfolio quality remained unchanged, whereas the coverage ratio of non-performing loans with provisions, capital and collateral decreased. At the end of June, the non-performing loan ratio, the provisioning ratio and the collateral coverage ratio registered 11.2%, 62% and 77.4%, from respectively 13.2%, 66.4% and 79.6% the previous year. Credit quality improved mainly for the portfolio of loans to households, foreign currency loans and long-term loans. The main contribution to the decline of non-performing loan stock came from repayments, restructuring and the write-off of some of the lost loans from banks' balance sheets.

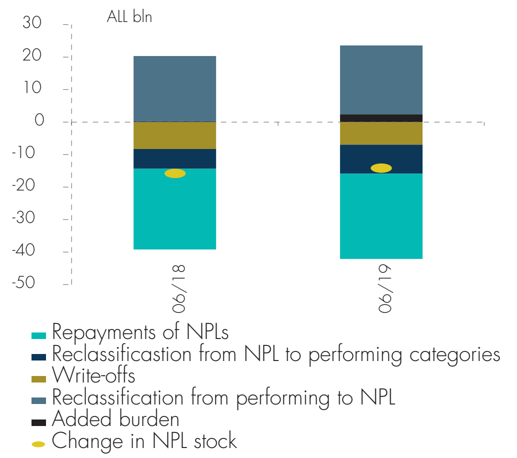
(51) At the end of the period, the stock of non-performing loans was ALL 63 billion or 18% lower compared with the previous year. The reduction in the stock of non-performing loans was the result of repayments, the reclassification of non-performing loans in performing classes ("standard" and "special-mention") and the write-off of part of lost loans. The process of writing off lost loans[27] from banks' balance sheets continued over 2019 H1 as well, but the pace of write-offs slowed down significantly compared to 2015-2017[28].

Chart 51 Non-performing loan ratio and provision hedging of NPLs



Source: Bank of Albania.

Chart 52 Contribution to the annual change of the non-performing loans stock



Source: Bank of Albania.

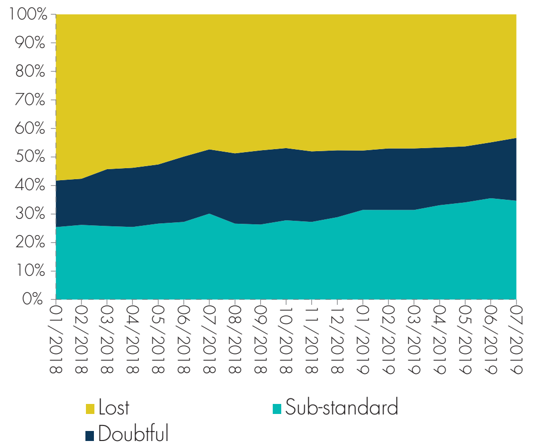
(52) At the end of the period the ratio of non-performing loans to outstanding loans registered 11.2%, unchanged from end-2018 H2, but was 2 percentage points lower than 2018 H1. The share of lost loans in the

27 *Since June 2018, around ALL 6.4 billion of lost loans were written off, mainly represented by loans to enterprises in lek. The pace of lost loans write-offs from banks' balance sheets declined during the last year. In the same period the previous year, were written off around ALL 8 billion of lost loans.*

28 *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 57.4 billion of lost loans have been written off.*

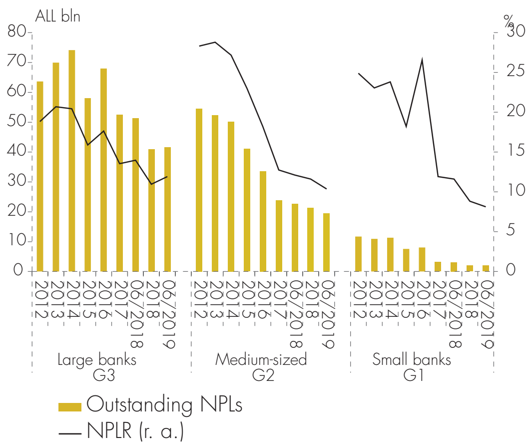
non-performing loan stock declined at 45% from 50% in the previous year and from 60% in 2017 H1. Over the last 12 months, , the share of "sub-standard" loans in the stock of non-performing loans increased significantly whereas the share of the other two categories decreased. This performance reflects the result of repayments, restructuring of non-performing loans and their reclassification to a higher quality class, as well as the lost loans write-off. By group, large banks have the highest non-performing loans ratio (12%), while small banks have the lowest non-performing loan ratio (8.1%). Over the period, the non-performing loans ratio fell in the small and medium-sized bank group, and increased slightly in the group of large banks.

Chart 53 Non-performing loans structure



Source: Bank of Albania.

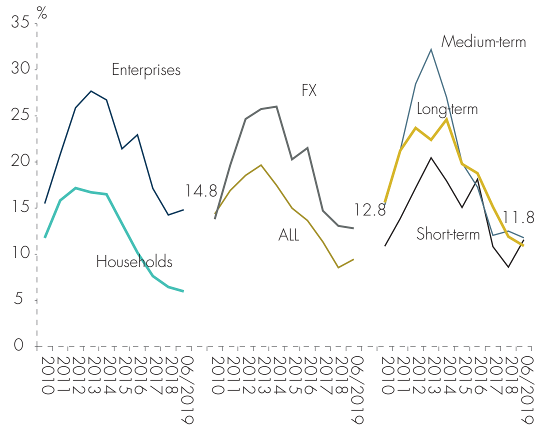
Chart 54 NPL portfolio by bank groups



Source: Bank of Albania.

(53) **The credit quality is lower for loans to enterprises, loans in foreign currency, and medium-term loans**. Over the period, the non-performing loans ratio increased for loans to enterprises, loans in lek and medium-term loans and decreased for the other types of loans.

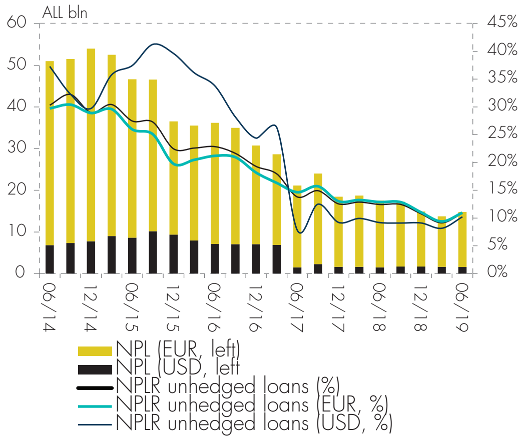
Chart 55 NPLs ratio by sector,, currency and term



Source: Bank of Albania.

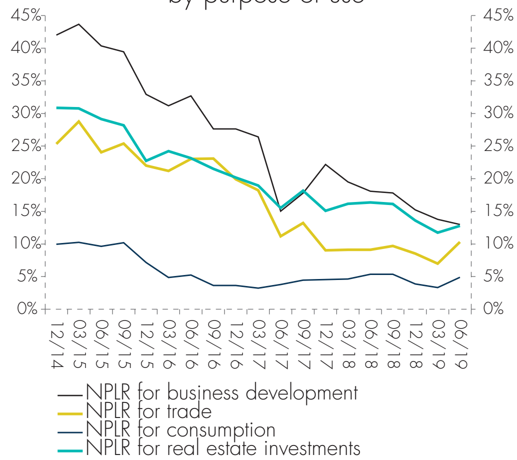
(54) **For foreign currency loans unhedged against exchange rate fluctuations, the quality improved compared with the previous year, but has somewhat deteriorated during 2019 Q2.** The non-performing loans ratio for this type of loans was 10.9% at the end of the period, and its trend is determined by the performance of unhedged loans in euro. By purpose of use, over the period, the non-performing loans ratio for unhedged loans for real estate purchase decreased at 12.8% (from 13.6%); the ratio for loans for business development (which continues to have the highest non-performing loans ratio within this category) decreased at 13% (from 15.2%), and the ratio for consumer loans registered the lowest value, at 4.9%.

Chart 56 Non-performing loan performance for loans unhedged against exchange rate fluctuation, by currency



Source: Bank of Albania.

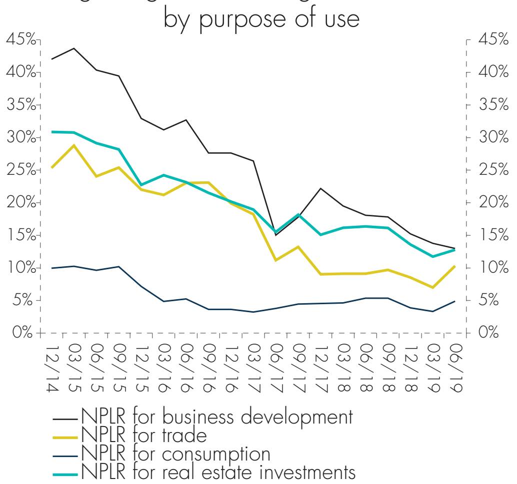
Chart 57 Quality performance for loans unhedged against exchange rate fluctuations, by purpose of use



Source: Bank of Albania.

(55) **The credit quality of the loan portfolio held by non-residents, which was more than halved due to the impact of the structural break, thas improved during the period.** The non-performing loans ratio for non-residents was equal to 2.6% and decreased significantly from 5.2% in the previous period. Non-performing loans stock for this category is split almost equally between lost and doubtful loans.

Chart 57 Quality performance for loans unhedged against exchange rate fluctuations, by purpose of use



Source: Bank of Albania.

(56) **Over the period, the coverage ratio of non-performing loans with provisions declined by 5 percentage points, at 62%, reflecting the higher decline of provisions compared with the decline in the stock of non-performing loan.** Due to the high weighting coefficient, a certain decrease in the lost loan stock within the non-performing loans portfolio is reflected in a higher decrease of the provisions stock for the loans.

(57) **Capital coverage of net non-performing loans[29] declined at 5.9 times from 6.6 times, during the period.** This decline reflected the increase of net non-performing loans and the slight decrease in the value of the regulatory capital of the banking sector[30]. In June 2019, the net non-performing loan ratio against outstanding loans registered 4.3% thus being 0.5 percentage points higher than December 2018.

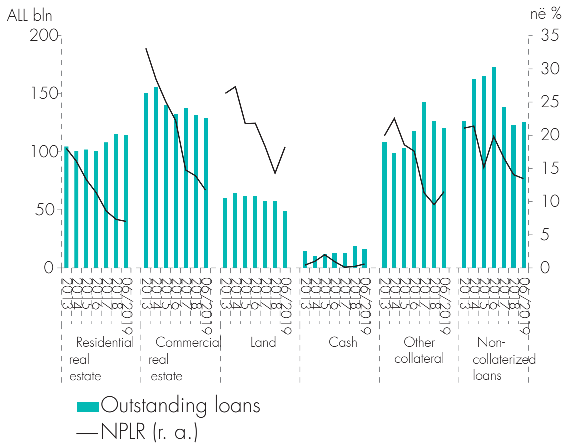
[29] *Non-performing loans after the deduction of provisions.*

[30] *As a result of the expansion in outstanding net non-performing loans by nearly 8% and the decline of regulatory capital by around 3%, in December 2018 the "net non-performing loans/regulatory capital" ratio increased to 16.9%, from 15.2%.*

(58) Despite a slight decline, collateralization of loans remains at high levels. At the end of the period, collateralization[31] stood at 77.4%, around 1.2 percentage points lower than at the end of the previous year, and 2.2 percentage points lower than in the same period in the previous year. Loans collateralized with collateral in the form of real estate accounted for around 68% of collateralized loans, and 53% of outstanding loans. Outstanding uncollateralized loans expanded by 2% during the period.

(59) The quality of collateralized loans, determined by the performance of loans collateralized with real estate, improved during the period. The non-performing loans ratio for this type of loans was 8.3% at the end of 2019 H1, from around 12.7% in the previous year. The decline in the stock of non-performing collateralized loans has started since 2016. Compared to the end of 2018, the non-performing loan ratio for loans collateralized with commercial real estate dropped by 2.1 percentage points, at 11.7%. This is the lowest level recorded since 2010. Loans collateralized with cash continue to exhibit the lowest level in non-performing loans ratio. The quality of non-collateralized loans also improved compared with the end of the previous period and with the previous year. The non-performing loans ratio for non-collateralized loans decreased at 13.5% from 14% in December 2018 and 18% in June 2018.

Chart 59 Outstanding loans and non-performing loans ratio by collateral



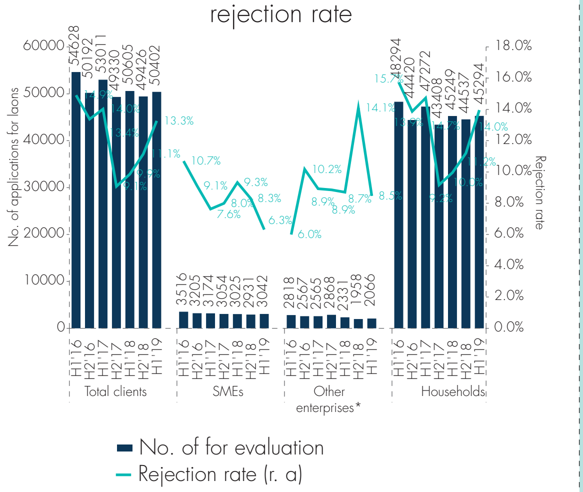
Source: Bank of Albania.

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

BOX 6.2 NUMBER OF LOAN APPLICATIONS AND ANALYSIS OF THE REJECTION RATE, 2019 H1

During 2019 H1 (1 December 2018 - 31 May 2019), banks report that they screened overall 50402 loan applications, with around 10% from "enterprises" (3042 applications from "small and medium-size enterprises" and 2066 applications from "other enterprises"), and 90% from "households" (45294 applications). This structure remained almost unchanged compared with the previous period (1 June, 2018 - 30 November, 2018). Total number of applications resulted 2% higher compared to the previous period, driven by both the segment of "enterprises" (half-yearly increase by 4.5%), and the segment of "households" (half-yearly increase by 1.7%). In annual terms (compared with the period 1 December 2017 - 31 May 2018), total number of screened applications fell slightly by 0.4% driven by the decline of total number of applications from enterprises by 4.6%, whereas the number of applications from households increased 0.1%, annually.*

Chart 60 Performance of the considered applications' number and the analysis of the rejection rate

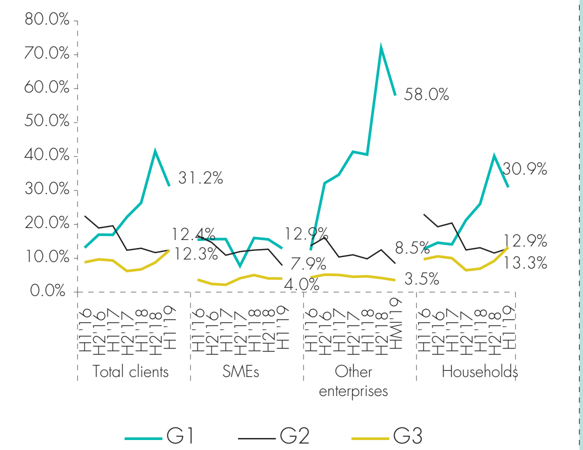


Source: Bank of Albania.

From the total applications screened during the period, around 14% of them were rejected by banks and this rate has continued the upward trend observed since 2017 H2. The increase of the rejection rate during the period seems to remain oriented towards the "households" segment, whereas for "small and medium-sized enterprises" and "other enterprises", this rate has dropped significantly.

The analysis of the rejection rate by banks' size (bank groups G1, G2, G3) and customer category shows that small banks (G1) continue to have the highest rejection rates for all three categories of customers, but downward compared with the previous period. The rejection rates in medium-sized banks (G2) and large ones (G3) trended downwards for enterprises and upwards for households.

Chart 61 The rejection rate for loans, by group of banks and by category of customers



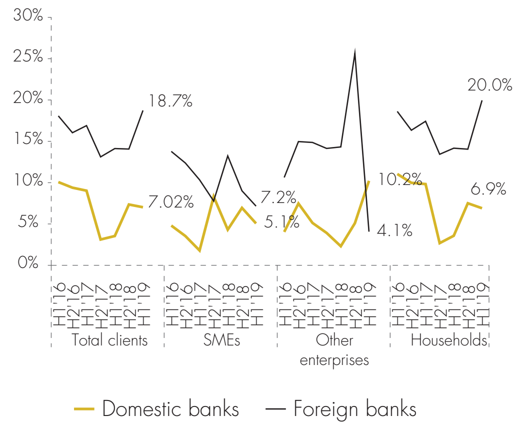
Source: Bank of Albania.

The analysis of the rejection rate by capital ownership shows that, during the last years, this rate has been continuously lower for domestic banks compared with foreign banks. For 2019 H1, total number of rejected applications for loans by foreign-owned banks (against total number of clients) increased at 18.7% (from 14.1% registered in the previous period), whereas for domestic banks the rate declined at 7% (from 7.4% registered in the previous period). By customer, foreign-owned banks were more rejecting to applications for loans to "households", and more accepting to applications from "small and medium-sized enterprises" and "other enterprises". On the other hand, the rejection rate of domestic banks declined for small enterprises, large enterprises and households segments, and increased for other types of enterprises.

*It should be taken into account that the fluctuation of the rejection rate of domestic and foreign-owned banks from the insofar trends may derive from the reclassification of groups due to the change of ownership of two banks from foreign-owned to domestic ownership**.*

Overall, the above analysis reveals that the number of applications screened by banks during 2019 H1 points to a credit demand that is still moderated but trending upwards for all customer segments. Banks remain generally reluctant against the households' segment, whereas their preference to credit "small and medium-sized enterprises" and "large enterprises" increased during the period.

Chart 62 Rejection rates of loans, by domestic and foreign banks



Source: Bank of Albania .

* Annual increase from "small and medium size enterprises" by 0.6% and annual decrease from "other enterprises" by 11.4%, respectively.

** In 2019 Q1, due to the change of controlling shareholders, the Commercial International Bank and Tirana Bank switched from foreign-owned banks to Albanian-owned banks.

6.1.3 DEPOSITS

(60) The deposits held by the public in the banking sector reached ALL 1.146 billion at the end of the period. Primarily as a result of the structural break, the stock of deposits contracted by circa 2.9% (ALL 34 billion) compared to the end of the previous year, and remained almost unchanged compared to the stock recorded at end of June 2018. During the period, only deposits in lek increased, while other categories of deposits were down.

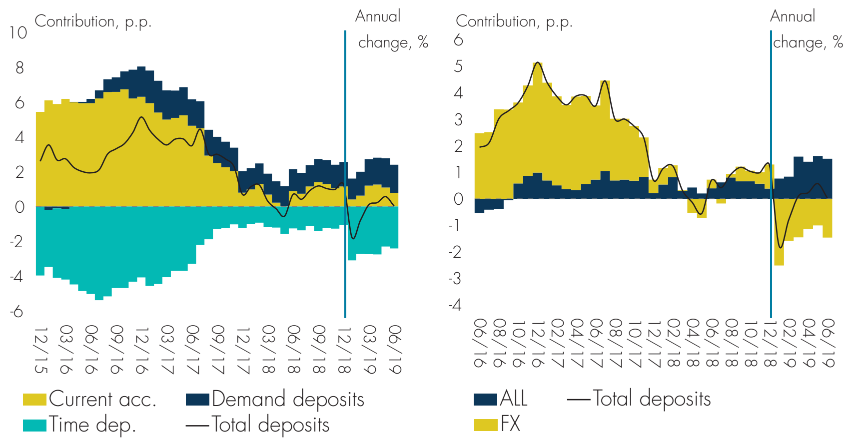
Table 8 Data on the performance of deposits by maturity, sector and currency

	Indicator and unit	ALL bln	Structure (% to total)		Change (%)			
	Period	06/2019	06/2018	06/2019	6-months	Annual	6-months	Annual
By maturity	Current account	387	34	34	(2.5)	2.4	1.5	6.7
	Demand deposits	130	11	11	4.6	18.1	9.4	24.3
	Time deposits	613	54	54	(4.6)	(4.3)	(0.5)	(0.1)
By institution	Public sector	26	2	2	(2.5)	(3.3)	9.5	8.6
	Enterprises	155	15	14	(11.5)	(7.3)	(0.6)	4.8
	Households	964	83	84	(1.4)	1.3	1.3	4.1
By currency	Lek deposits	562	47	49	1.5	3.2	2.0	3.7
	FX deposits	584	53	51	(6.8)	(3.0)	0.4	4.9
	Deposits, Stock	1,146	100	100	(2.9)	(0.0)	1.2	4.3

'* - excluding the effect of Structural break
Source: Bank of Albania

(61) **Without taking into account the effect of the structural break, the change in the stock of deposits from six months earlier would be 1% (ALL 13 billion).** The effect of the structural break was more pronounced in the reported values of time deposits, households' deposits, and foreign currency deposits, for which the adjusted annual growth rates would be 0%, +4% and+5%, from respectively -4%, +1% and -3%.

Chart 63 Distribution deposits growth by term (left) and currency (right)



Source: Bank of Albania.

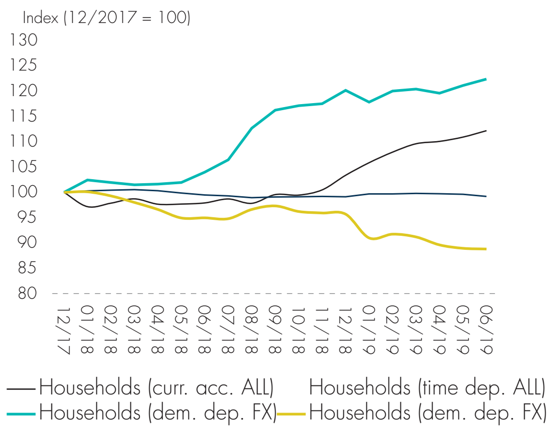
(62) **In the overall performance of deposits, current accounts and demand deposits continued to provide a positive contribution, while time deposits maintained the negative contribution.** Since mid-2016, households' demand deposits provided a steady and almost constant contribution (about 2 percentage points) to overall deposit growth, while the contribution of current accounts was higher, but more volatile. The share of time deposits in total stock of deposits has dropped to 54% from 75% five years earlier.

(63) **A low interest rate environment has continued to favour customers' preference for demand deposits and current accounts over time deposits.** This preference is more pronounced for foreign currency savings. Time deposits, held mainly by the households, have the major share in deposits in lek (around 60%), but account for less than 50% of the total deposits in foreign currency.

(64) **Compared to the previous year, the structure of deposits by currency has changed in favour of the domestic currency due to the strong increase of deposits in lek and the contraction of deposits in foreign currency.** The annual growth by 3% of deposits in lek was entirely led by the increase in current accounts of households, which continued to expand at a rapid pace (over 10% per year), while time deposits in lek remained almost unchanged. The performance of deposits in foreign currency, which currently account for 51% of the stock deposit surplus, is determined by the increase in demand deposits and the decline in households' time deposits. Excluding the structural change, the average annual change over the period for demand deposits and

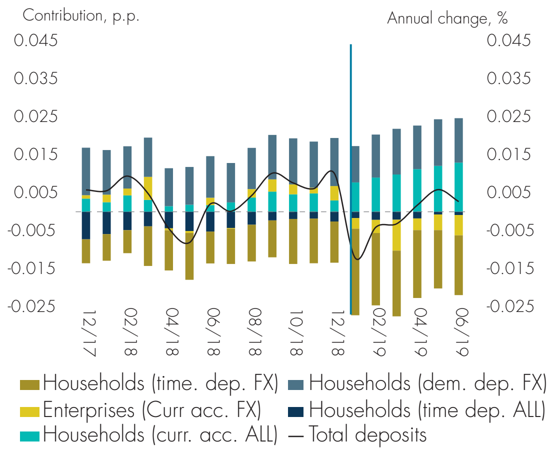
time deposits in foreign currency of households was + 20% and + 1% from + 18% and -7%, respectively.

Chart 64 The performance of household deposits by term and currency



Source: Bank of Albania.

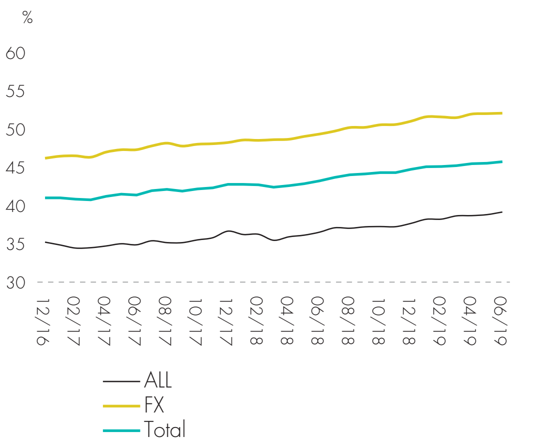
Chart 65 Composition of deposit growth by term, sectors and currency



Source: Bank of Albania.

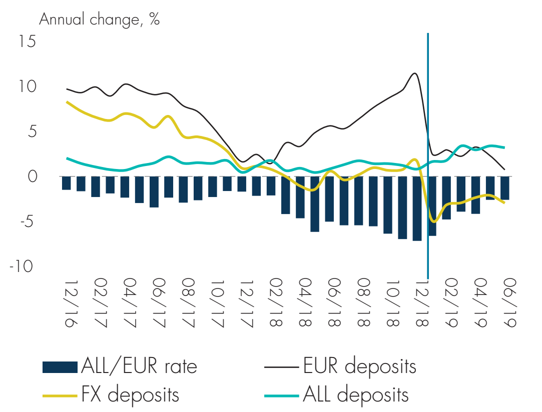
(65) The appreciation of lek against euro and US dollar had a diminishing impact on the reported value of deposits[32], but this effect was smallr compared to the previous periods. This contracting effect is estimated at about ALL 3 billion, and it has further deepened the negative impact of the structural break on the performance of foreign currency deposits.

Chart 66 Ratio of current accounts and demand deposits to the total



Source: Bank of Albania.

Chart 67 Performance of deposits in foreign currency and the exchange rate effect



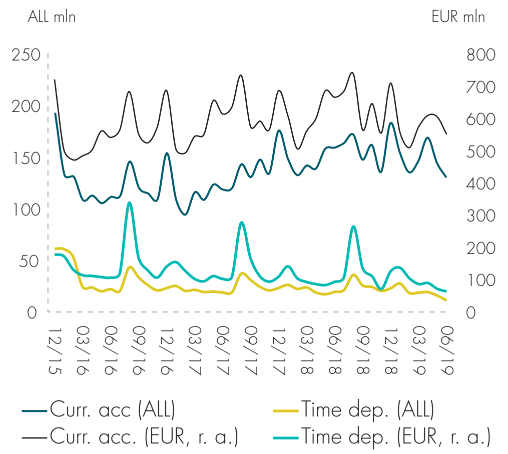
Source: Bank of Albania.

(66) The average interest rates on new deposits fell for deposits in lek and recorded minor changes for deposits in foreign currencies. The decrease by 0.3 percentage point to 0.7% of the average interest rate of time deposits, led

32 *Through the fall of the equivalent value in Albanian lek of foreign currency deposits.*

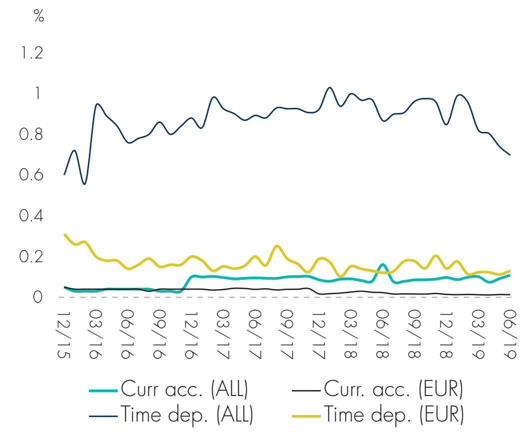
to a fall in the average interest rate for deposits in lek. This decline, narrowed the interest rates spread of demand deposits and current accounts, which was up to 0.9 percentage point in 2018. For deposits in euro, interest rates on current accounts and time deposits continue to remain at very low levels and the spread between them is about 0.1 percentage points.

Chart 68 New flows of current accounts and time deposits in Lek and Euro



Source: Bank of Albania.

Chart 69 Interest rates on new deposits in lek and euro



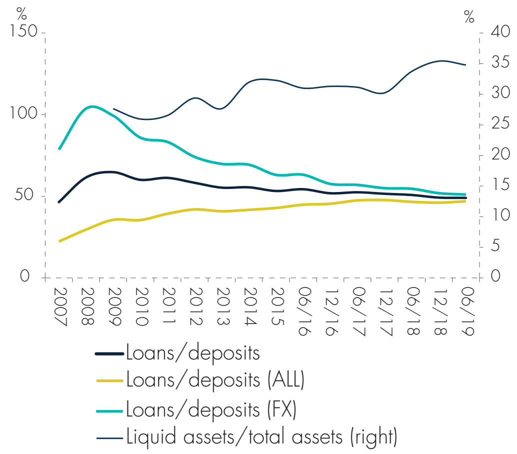
Source: Bank of Albania.

6.1.4 LIQUIDITY RISK

(67) The banking sector continued to operate under abundant and stable liquidity conditions. The liquidity indicators, both in lek and foreign currency, stand notably above the minimum regulatory ratios. Deposits remain the main source for funding bank credit, and are sufficient to cover almost twice the volume of bank loans. At the end 2019 H1, the loans/deposits ratio registered 49%, down by 2 percentage points compared to the previous year, yet with no notable difference to the end 2018. The structural break effect resulted in a slight decrease of the ratio to 48% in January, since the relative effect of structural change was more significant on the credit stock than in the deposit stock.

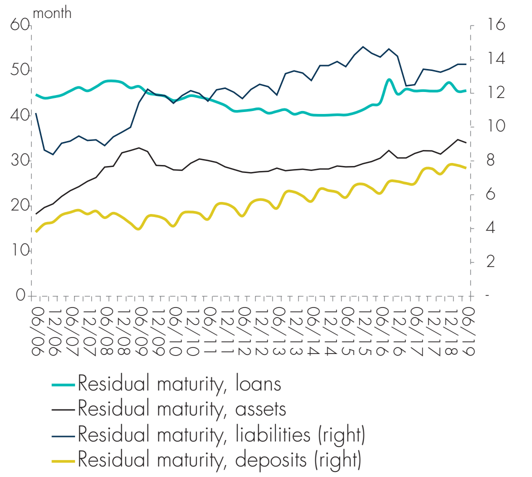
(68) The level of liquid assets in banks' balance sheets remains high, owing to the slow performance of lending. At the end of June 2019, the ratio of liquid to total assets of the banking sector was 34.8% or around 0.5 percentage points higher than in the previous six months. This performance reflects the greater contraction of total assets compared to the reduction of liquid assets in banks' balance sheets. The ratio of liquid assets to total short-term liabilities also increased by 1.2 percentage points, up to 47.4%.

Chart 70 Liquidity indicators



Source: Bank of Albania.

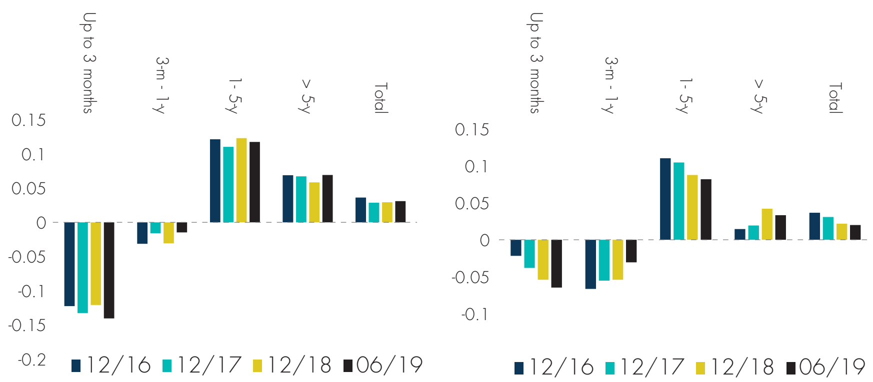
Chart 71 Average residual maturity



Source: Bank of Albania.

(69) The negative gap between short-term assets and liabilities by residual contractual maturity segments[33] for the period up to 3 months, expanded over the period. The overall gap continues to be positive and remained almost unchanged from the end of last year, and amounts to about 6% of banking sector's assets. For lek and euro, the currencies with the highest share in the banking sector's assets and liabilities, the negative gap for the "1-day to 3 months" basket was -14% and -6% of assets, respectively, and has been deepening over the past two years. During this period, there was an improvement of the negative position and a deterioration of the positive position for the euro for the "3 months - 1 year" and "1-5 years" baskets. Negative values generally

Chart 72 Maturity mismatch between assets and liabilities in Lek (left) and Euro (right), in% to total assets.



Source: Bank of Albania.

[33] *Calculated as the ratio of 'difference between assets and liabilities' to 'total assets' for each basket of residual maturity. Off-balance sheet items are included in the value of assets and liabilities.*

indicate an accepted characteristic of banking activity, where the average term of investments (securities, deposits, loans) is longer than the average term of liabilities that fund these investments (deposits from the public). In Albania, the presence of liquid assets in high values serves to mitigate the signals transmitted by the mismatch in the balance sheet by maturity terms.

(70) The average maturity mismatch between assets and liabilities has increased during the period. At the end of June 2019, this mismatch was around 20.3 months, from 19.6 months at the end of 2018. Focusing on loans and deposits, the residual maturity of loans, despite the considerable shortening to 45.6 months, from 47.4 months, remains close to the average value of the last three years, reflecting the banks' tendency to grant loans for longer maturities. The residual maturity of deposits, which represent the majority of liabilities, remained almost unchanged and was 7.6 months at the end of the period.

(71) The value of credit lines from parent banking groups accounts for a very low share in the banking sector's funding sources. According to the latest reporting of the period, the total value of these lines was almost negligible, from about ALL 3 billion at the end of the previous period. The utilization rate of these lines was 16% during the last six months and 13.7%, a year earlier.

6.1.5 MARKET RISKS

EXCHANGE RATE RISK

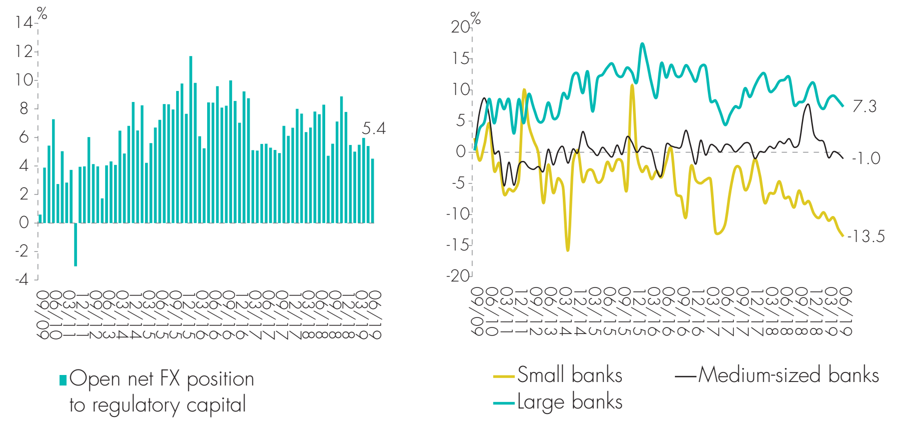
(72) Net open foreign currency position levels point to a limited and declining exposure to the direct impact of exchange rate fluctuations on banks' balance sheets. The aggregate indicator for all banks, as well as the indicator for the group of banks by size, showed very low values compared with the 30% upper limit of regulatory capital defined by the respective regulation.

(73) The ratio of the net open foreign currency position of the banking sector to regulatory capital decreased during the period. At the end of the period, the net open foreign currency position of the banking sector was long and accounted for 4.5% of the regulatory capital, being 3.3 percentage points below the level registered at the end of 2018, and 3.1 percentage points lower compared to the level registered a year earlier. The performance of this indicator for the banking sector is determined by the group of large banks, which continues to maintain a long open position, at 7.3% of the regulatory capital. This value is significantly lower compared with the previous two periods[34]. This performance for the large banks group was affected by the decrease in the open long position in euro. The small banks group deepened its net open short position to 13.5% of the regulatory capital. The medium-sized banks group

[34] *The large banks' open position was 3.8 percentage points and 4.3 percentage points lower, compared to December and June 2018, respectively.*

exhibits the lowest exposure to exchange rate fluctuations by holding a long net open position in foreign currency rather low level (1% of regulatory capital).

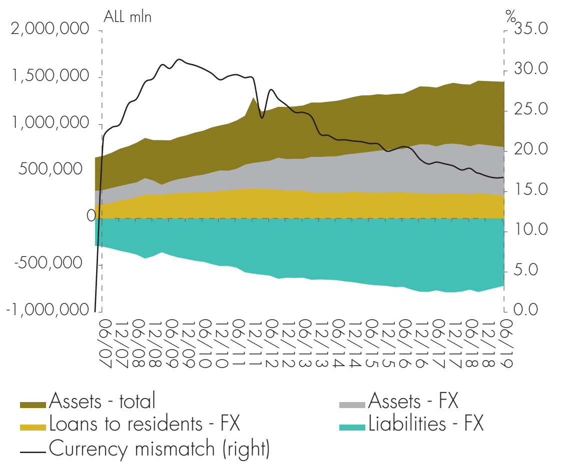
Chart 73 Open foreign currency position to regulatory capital for the sector (left) and groups by size (right)



Source: Bank of Albania.

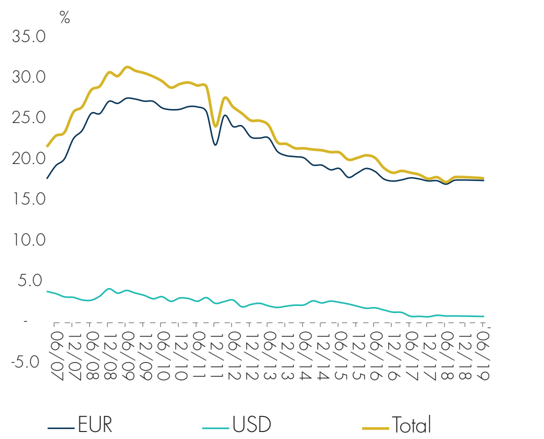
(74) During the period, the exposure of the banking sector to indirect exchange rate risk has decreased. At the end of the period, the foreign currency mismatch[35] for all currencies was equal to 16.8% of total assets from 17.8% and 17.3% at the end of 2018 and the previous year. The decrease was dictated by the higher fall in foreign currency assets (-7.1%) compared to that in foreign currency liabilities (-6.5%). This performance is also affected by the structural break . The performance of the index is determined by the decline of the value of the euro index to 16.5% of total assets, from 17.5% at the end of 2018 and 17.0% a year earlier.

Chart 74 Performance of Indexes components for the banking sector



Source: Bank of Albania.

Chart 75 Performance of foreign currency mismatch indicator by currencies

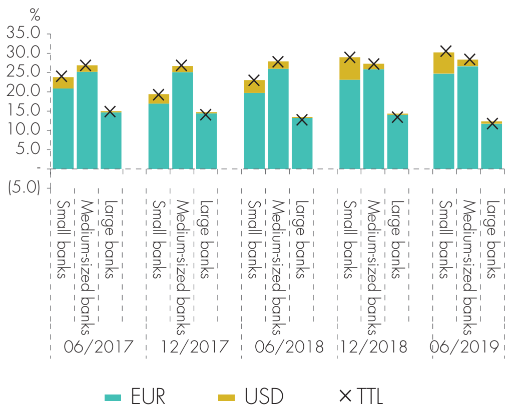


Source: Bank of Albania.

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

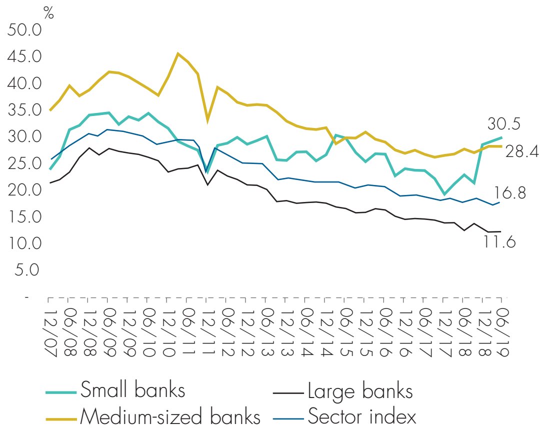
(75) **The performance of the foreign currency mismatch index, during the period, has been affected by the decrease of the values of the index for the large banks.** The large banks group continues to report the lowest values of the foreign currency mismatch index. At the end of the period, the total index for larger banks stood at 11.6%, from 13.6% in the previous six months and 12.6% in the previous year. The main contribution comes from the drop in the European currency index to 11.9%. For the group of small and medium-sized banks, the indices increased by 1 to 1.5 percentage points, at 30.5% and 28.4%, respectively. Index values by groups36 indicate that larger banks have lower exposure, while small banks have higher exposure to indirect exchange rate risk. Regarding the group of small and medium-sized banks, the main impact on the growth of the overall index of the group was given by the change in the value of the index for the euro currency.

Chart 76 Foreign currency mismatch by currency



Source: Bank of Albania.

Chart 77 Currency mismatch for groups by size



Source: Bank of Albania.

INTEREST RATE RISK

(76) **The bank's exposure to the interest rate risk has been limited and the indicator used for measuring the exposure slightly decreased over the period.** The weighted total net position in banks' balance sheet against regulatory capital of the banking sector remains low. This position was at 1.9% of regulatory capital[37] at the end of the period and registered a decline in semi-annual and annual terms. The decline of the indicator is conditioned by the performance of the net position with fixed interest rates (FIR)[38], which at the end of the period shifted to the negative side. During the period, an expansion

[36] *The size of the index is in inverse proportionality with the degree of hedging foreign currency liabilities with foreign currency assets.*

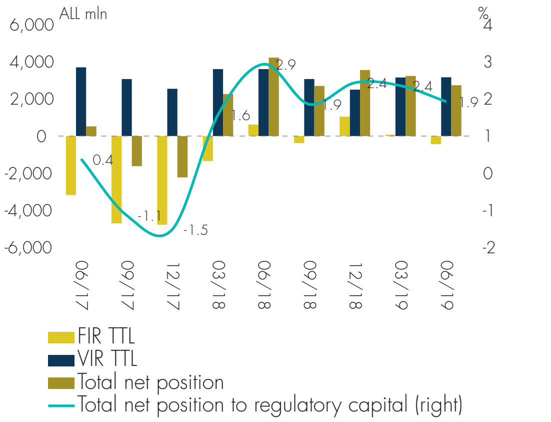
[37] *In accordance with the relevant regulation, the absolute value of this indicator (assets sensitive to interest rate minus liabilities sensitive to interest rate) should not exceed 20% of regulatory capital.*

[38] *Positions sensitive to interest rate are classified in positions with fixed interest rate (FIR) and positions with variable interest rate (VIR), by maturity and currency.*

of the positive position for lek and a deepening of the negative position for the euro currency was observed, compared with the end of 2018. Net position on variable interest rate (VIR) activities increased during the period, but remains at lower levels compared to the previous year. Despite the fact that the total net position is positive, under conditions where the regulatory capital hedging of these positions remains high and having limited room for further decrease of the interest rates, the cost that may come to the banking sector due to further decrease of interest rates can be easily absorbed.

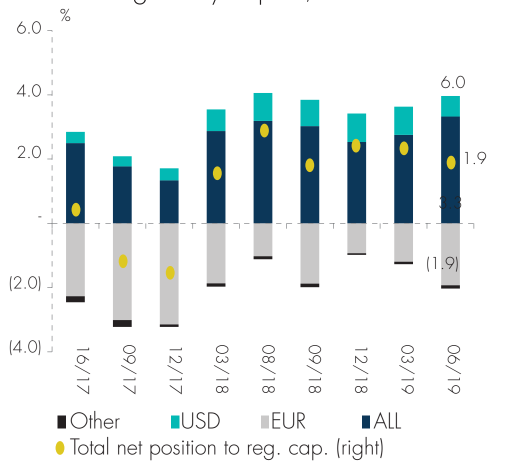
(77) By currency, the value of total net position to regulatory capital was affected by the expansion of the positive position in the national currency and the deepening of the negative position in euro. The net position in euro for all three groups of banks shows low negative values and has slightly expanded over the previous period. The position in US dollar is positive, has very low values and is held by large banks.

Chart 78 Weighted aggregate net position in bank's balance sheets as a share of regulatory capital, in %



Source: Bank of Albania.

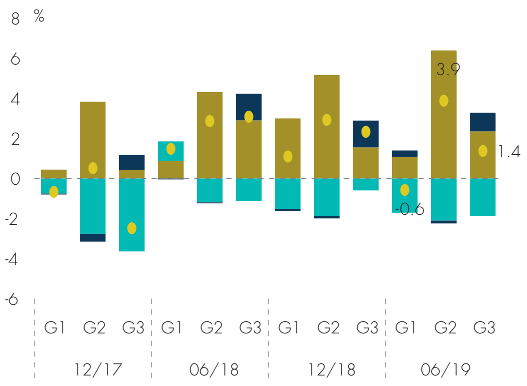
Chart 79 Gap by currency as a share of regulatory capital, in %



Source: Bank of Albania.

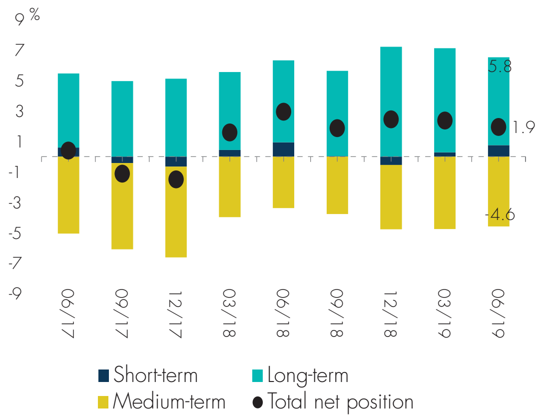
(78) By maturity, the value of the total net position against regulatory capital was affected by the decline of the positive position for long-term maturity and the expansion of the negative position for medium-term maturity. At the end of the period, the weighted net position for long-term maturity fell by 1.4 percentage points to 5.8% of regulatory capital from the end of 2018. The main contribution in this development came from the decrease by ALL 1.4 billion of the long-term net position with fixed interest rate in euro. For medium-term maturity the negative position between assets and liabilities was 4.6% of regulatory capital at the end of the period, increased by 0.4 percentage point compared to the end of the previous six-months and by 1.2 percentage points compared to the previous year. Changes in short-term maturity were not significant.

Chart 80 Weighted net position by currencies and groups as a share of regulatory capital, in %.



Source: Bank of Albania.

Chart 81 Weighted net position by maturity as a share of regulatory capital, in %



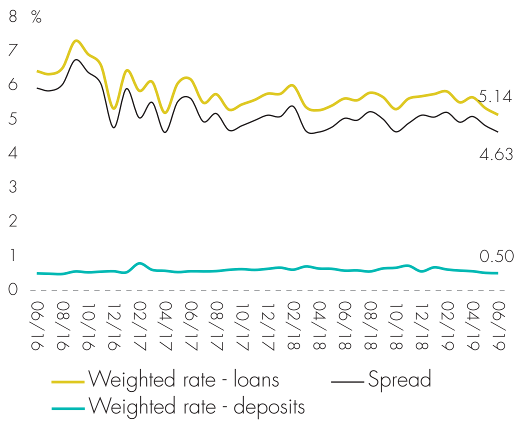
Source: Bank of Albania.

(79) Medium-sized banks have the highest exposure to interest rate risk. The value of total net position to regulatory capital for this group of banks is 3.9%, mainly affected by the activity conducted in lek for which the indicator accounts for 6.4% of regulatory capital. This position has been expanding during 2019 H1. The total exposure of large banks accounts for 1.4% of the regulatory capital, and the exposure in lek has the major share (2.4%). The group of small banks has the lowest exposure to interest rate risk (-0.6% of regulatory capital) and its main exposure is in euro (-1.7%).

(80) Indirect risk to interest rate change[39] decreased during the period. The weighted interest rate on loans decreased by 0.5 percentage point compared to the end of 2018, while the weighted deposits rate decreased by 0.1 percentage point. Compared to a year earlier, the spread declined for all three currencies, and this performance led to a fall in overall spread by 0.4 percentage point. This performance was driven mainly by the interest rates in the local currency. At the end of the period, the spread between new credit and new deposits interest rates in the banking sector was 3.6 percentage points for the euro, 3.3 percentage points for the US dollar and 5.26 percentage points for the Albanian lek.

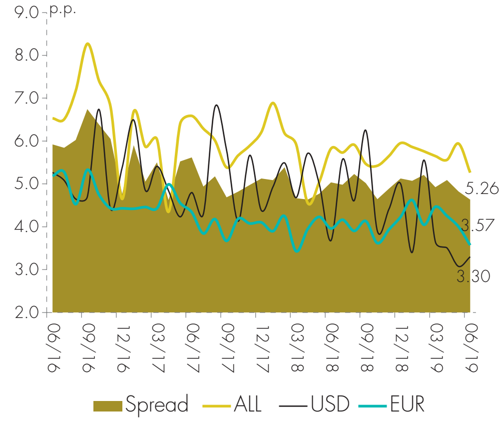
[39] *This risk refers to the impact that the change in the interest rate has on banks' clients. For example, despite the fact that the increase of the interest rate may have a positive impact on bank's balance sheet (due to positive value of the net position between assets and liabilities sensitive to the interest rate), this increase will have a negative impact on the solvency of bank's borrowers when the loans is granted with variable interest rates (indirect risk).*

Chart 82 Loans and time deposits weighted interest rates and interest rates spread, in %



Source: Bank of Albania.

Chart 83 Spread of weighted interest rates of loans and term deposits by currency, in p.p.



Source: Bank of Albania.

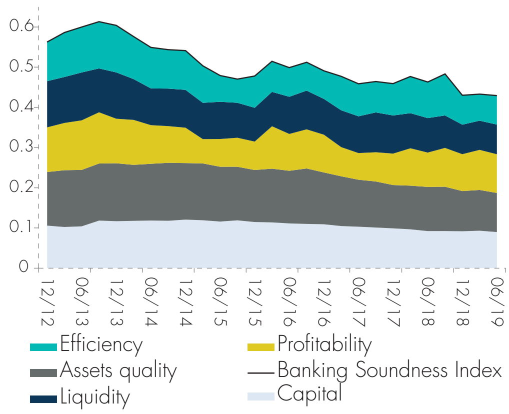
BOX 6.3 BANKING SOUNDNESS INDEX

The banking soundness index represents an overall assessment of the core conditions and significant factors of risk that affect the stability of the banking sector and of individual banks. The index is composed by five indicators, which represent five dimensions of the banking sector: 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 has improved compared to the previous year. Its value decreased at 0.43 from 0.46 that was at the end of June 2018. The components of the index, which have performed better in the last year are: capitalization, asset quality, liquidity and efficiency. Meanwhile, the "profitability" has contributed to the increase of risk, and at the same time, to the decline of banks' soundness index, reaching at 0.48 from 0.43 at the end of June 2018. Compared with the previous year, banks' profit declined, affected mainly by the decrease of net income from interest.*

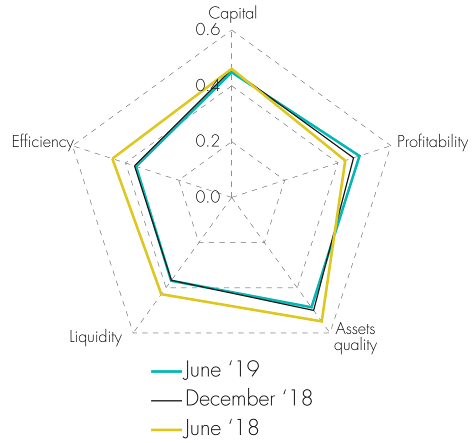
The quality of assets continues to provide the main contribution to this risk, but the improvement of loan quality has contributed to the fall of this contribution. Since the beginning of 2015, the contribution of this indicator to risk has dropped significantly and steadily, from 0.71 in March 2015 to 0.49 in June 2019. The most notable improvement, over the one-year period, was recorded in "efficiency", which reflects a more efficient management of expenditures expressed in decreased costs on the activity and on staff. "Capital" and "liquidity" indicators have also been positive, contributing to the improvement of banks' soundness. The liquidity indicator was affected by the significant increase of the liquid assets ratio to total assets. The improvement in the capital ratio reflects the increase of the banking sector's capital adequacy ratio compared to the previous year. During the last six years (2013-2019) the aggregate banking soundness index showed a downward trend, which means better soundness and higher stability for banks.

Chart 84 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.

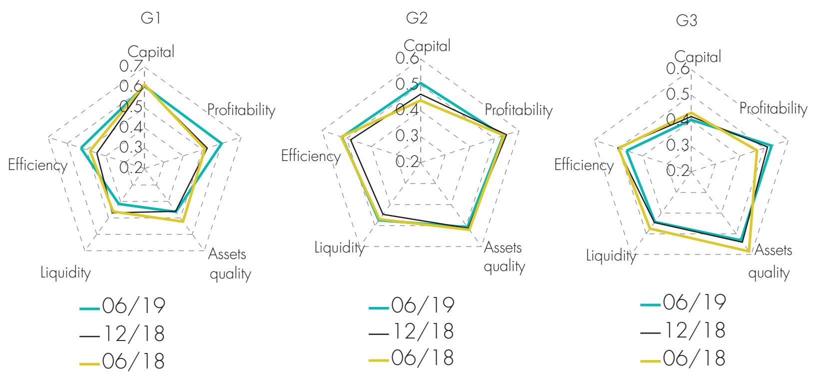
Chart 85 Banking Soundness map*



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

The soundness index for medium-sized banks (G2) and small banks (G1) did not change compared to the previous year. Small banks' group registered deterioration in the indicator of "profitability", while "asset quality" and "liquidity" improved. Meanwhile, for the group of medium-sized banks there has been a deterioration in the capital indicator, while other indicators have remained at almost the same levels. The deterioration of the capital ratio, coupled with the decline in the capital adequacy ratio for medium-sized banks, is related mainly to the recent structural changes in the banking system. Larger banks (G3) report an improvement in the index over the course of a year that reflects the improvement of liquidity, asset quality, efficiency and capitalization. Larger banks have the lowest index value, which indicates better soundness and stability compared to the other two groups.

Chart 86 Banking soundness map in groups by size



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

* *The decrease of the value of the index implies the improvement of banking soundness and vice versa.*

6.2 BANKING SECTOR RESILIENCE

To assess the banking sector resilience, financial performance and activity capitalisation are analysed. Also, stress test exercises are carried out to assess the response of banking sector's capitalisation and liquidity indicators to the proposed scenarios.

6.2.1 FINANCIAL RESULT

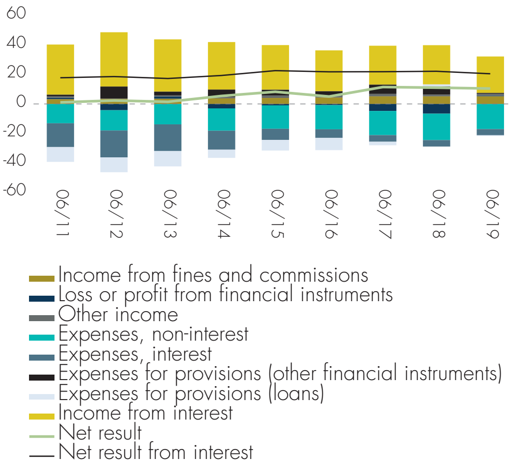
(81) At the end of the period, the banking sector reported a positive financial result of around ALL 10.5 billion. This result was ALL 0.5 billion and ALL 1 billion lower than in 2018 H1 and 2017 H1, respectively. A negative impact on banks' profitability has been attributed to the decrease in net interest income and the significant decrease in the reversal of provisions for other financial assets, while the return from loss to profit from financial instruments has significantly improved the financial result of the banking sector. The decline in the financial result is reflected in a slight fall in the sector's average profitability indicators. Return on Assets (RoA) and Return on Equity (RoE) decreased to 1.5% and 14.3%, from 1.52% and 14.8%, respectively, a year earlier.

(82) The financial result was proportionately distributed among banks by their size. Some banks that have about 50% of the sector's assets report a return on assets between 2-3% and a return on equity between 17% and 20%. Meanwhile, only four banks, which together account for less than 4% of assets of the sector, reported a negative financial result for the first half of the year.

(83) Net result from interests fell by 8% (or ALL 2 billion) to ALL 20.5 billion as a result of the decline of a similar size in interest revenues. During 2019 H1, banks collected around ALL 25 billion from interests and spent around ALL 4 billion to pay interests. In comparison to the same period of the previous year, revenues were about 7% or ALL 2 billion less, while expenditures remained almost unchanged. The decrease in the interest revenues reflects the decrease in interest income from transactions with customers (loan), while regarding expenditures, banks reported a slight decrease in interest paid for securities. Net margin from interests declined at 3.4% from 3.8% in the previous year, reflecting not only the decline of the net result from interests (numerator), but also the increase of average income earning assets (denominator).

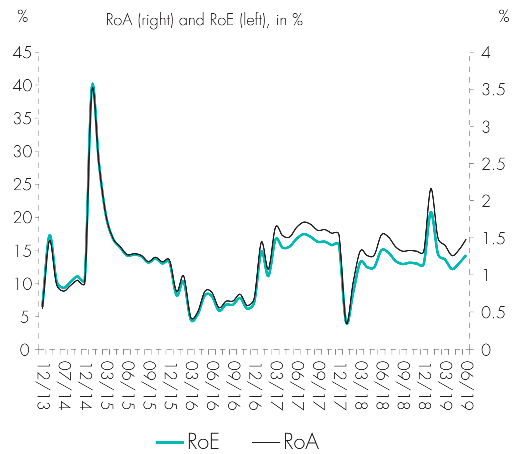
(84) Income from other activities (not-interest related) was about ALL 6 billion, and had a significant positive impact on the financial result of the banking sector. The banking sectors' income from fines and commissions represents the largest share of non-interest income and has remained unchanged from the last year at about ALL 5 billion, but unlike the previous year, banks recorded a positive result in the profit/loss account of financial instruments. The overall operating expenses were about ALL 16 billion and declined slightly due to the decrease in the item "other expenses'' and the slight contraction in "personnel costs".

Chart 87 Financial result components



Source: Bank of Albania.

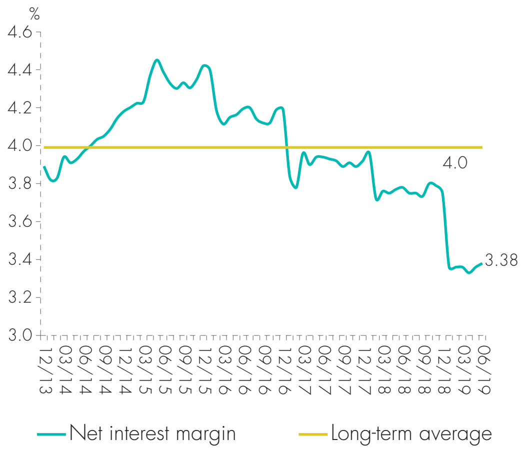
Chart 88 Profitability indicators



Source: Bank of Albania.

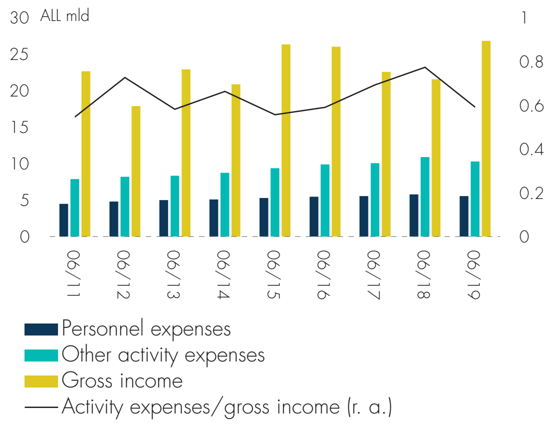
(85) During the period, banks did not record any reversal of provisions for loans and other financial assets. During the period January-June 2018, the amounts of reversal of provisions for loan loss and financial assets were ALL 1.3 billion and ALL 5.6 billion, respectively. In 2019 H1, banks reversed less than ALL 1 billion from the provisions for financial assets and spent about ALL 0.5 billion on loan loss.

Chart 89 Net interest margin



Source: Bank of Albania.

Chart 90 Activity expenditures and net income



Source: Bank of Albania.

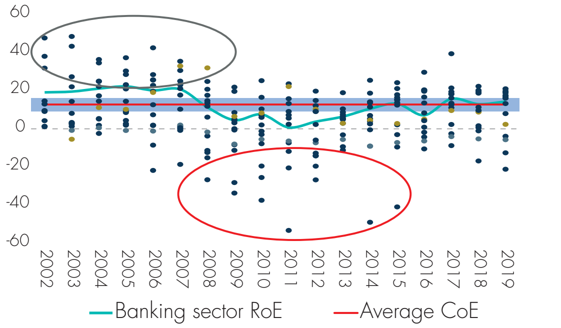
(84) Activity costs were sufficiently covered by activity income. The ratio of operating expenses to income was 59% and has fallen sharply from 80% a year earlier, but is comparable to the average cost to income ratio for the first half of 2011 - 2017. During this period, there was a faster increase in other operating expenses compared to personnel costs. During 2019 H1, these two categories of expenditures recorded ALL 10 billion and ALL 6 billion, respectively.

BOX 6.4 THE COST OF EQUITY (COE) IN THE ALBANIAN BANKING SECTOR

Cost of Equity (CoE) refers to a shareholder's required rate of return on an equity investment. The difference between this indicator and the actual Return on Equity (RoE) is a measurement of a bank's profit adequacy from its shareholders' point of view. The estimation of the cost of equity in the banking sector is based on the risk premium estimated for the country where the bank operates in** and the bank's risk premium***. Based on these indicators, the cost of equity for banks in Albania according to the latest data for 2019 H1, is estimated between 9.25% and 16.25% with an average value of 12.75%****. For several banks of the sector, whose assets account for about 23% of the sector's assets, current rates of return on equity are lower than the estimated cost of equity. At the sector level, the return on equity at 14.3% is higher than the average cost of equity at 12.75%. This means the banking sector, in average terms, is able to cover the cost of equity through the income it generates from its activity.*

The global financial crisis of 2008 was also reflected in our country's financial soundness indicators, mainly over the period 2008-2012. During this period, a significant number of banks have recorded significantly lower return on equity values compared to the estimated minimum cost of equity of 9.25%. Even the return on equity indicator for the entire domestic banking sector dropped from about 22% in the pre-crisis period to less than 1% in 2011. From 2017 onwards, the return on equity of the banking sector has fluctuated near the average estimated cost of equity of 12.75%.

Chart 91 The performance of return on equity (RoE) at bank level against cost of capital (CoE) before and after the financial crisis of 2008



* Each blue circle represents the rate of return of a bank's equity in that period. The grey circle represents the years before the crisis and the red circle represents the years after the financial crisis. The part coloured in light blue represents the range of minimum (9.25%) and maximum (16.25%) value of the estimated capital cost.
Source: Bank of Albania.

Can banks operate steadily at lower rates of return on equity than its cost? This is entirely possible, when the equity represents a long-term commitment from the shareholders, and when banks operate with positive performance margins on their balance sheets. As a matter of fact, according to the European Central Bank, the average cost of banks' equity in the euro area stands between 8% and 10%, while the return on equity rate is currently 6% on average. However, the failure to cover the cost of capital with what the bank gains from its investments, indicates its limited ability to expand its domestic resources, and may be associated with increased risk in conditions where banks may aim to increase the return on equity.

* The methodology for measuring the capital cost is presented in the Financial Stability Report for 2017 H2.

** According to the latest estimates (January 2019), Albania's risk rating stands at 6.25%. This assessment is based on Aswath Damodaran's study "Country Risk: Determinants, Measurements and Implications"- Stern School of Business, 2016, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html.

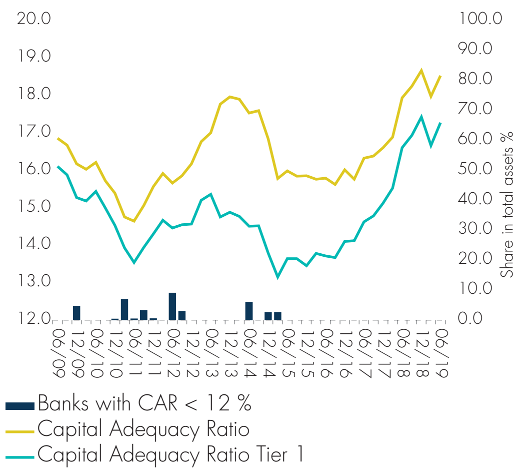
*** In the absence of these assessments in Albania, early studies for developed countries suggest that the specific premium risk for banks is in the range of 3 to 10% based on King, M.R., "Capital Costs for Global Banking: A perspective by CAPM from 1990 to 2009, "BIS Quarterly Report, September 2009, http://www.bis.org/publ/qtrpdf/r_qt0909g.pdf .

**** The average assessment of the equity cost is calculated by the formula: 6.25% + 0.5*(10+3) % =12.75%.

6.2.2 CAPITALISATION OF ACTIVITY

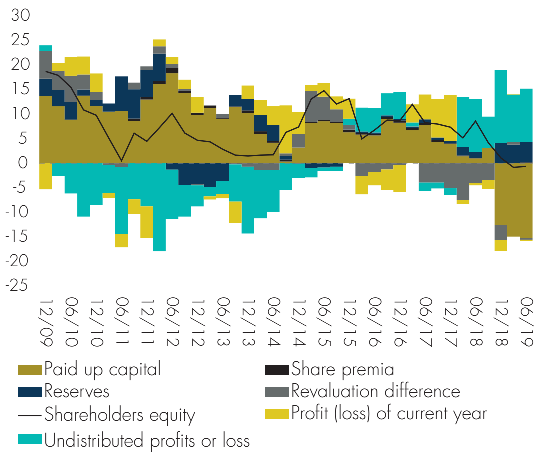
(87) Capitalisation of the banking sector activity remained at good levels during the period. At the end of the period, the Capital Adequacy Ratio stood at 18.5%, from 18.7% as at end- 2018 and 17.9% a year earlier. Larger banks and those with foreign capital have the highest level of Capital Adequacy Ratio. Since 2015 Q1, in the domestic banking sector there has been no case of the Capital Adequacy Ratio falling below the 12% regulatory minimum, while currently the Capital Adequacy Ratio is above 15% for 12 banks. Compared to the previous six months, the number of banks that have Capital Adequacy Ratios on the 20% -30% range increased.

Chart 92 Capital Adequacy Ratio



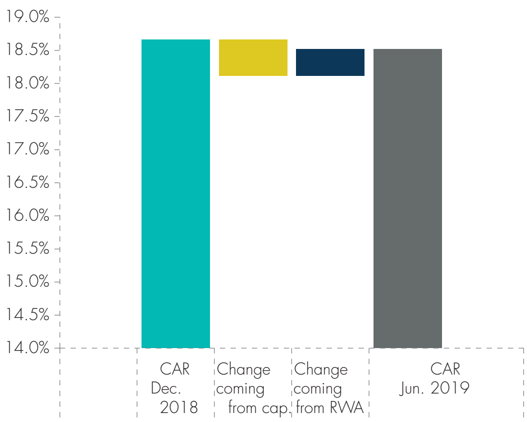
Source: Bank of Albania.

Chart 93 Annual contribution in capital increase by component instruments, percentage points



Source: Bank of Albania.

Chart 94 Contribution of capital adequacy items, percentage points



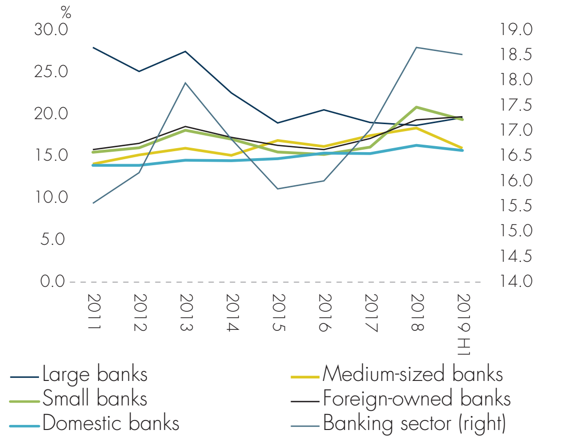
Source: Bank of Albania.

(88) In the performance of the capital adequacy ratio, the negative effect of the decline in the regulatory capital was greater than the positive effect of the decline in the risk weighted assets. During the period, following the structural changes associated with the consolidation and change of shareholders of some banks, the regulatory capital of the banking sector fell by around 3% to ALL 142 billion. The decline of regulatory capital had a negative impact of 0.6 percentage points on the Capital Adequacy Ratio. On the other hand, at the end of the period, risk-weighted assets were about ALL 770 billion or ALL 17 billion less than the end of the previous period, as a result of the decrease of the exposures to high-risk categories[40]. The decline in this

[40] *These exposures include the value of the loan granted outside the territory where the bank operates through its subsidiaries, branches or agencies. This performance represents mainly the effect of structural breakdown.*

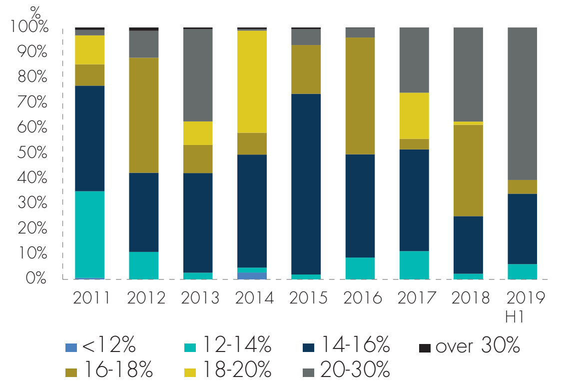
indicator contributed positively by 0.4 percentage points to the change in the capital adequacy ratio.

Chart 95 The Capital Adequacy Ratio of groups by size and by origin of capital



Source: Bank of Albania.

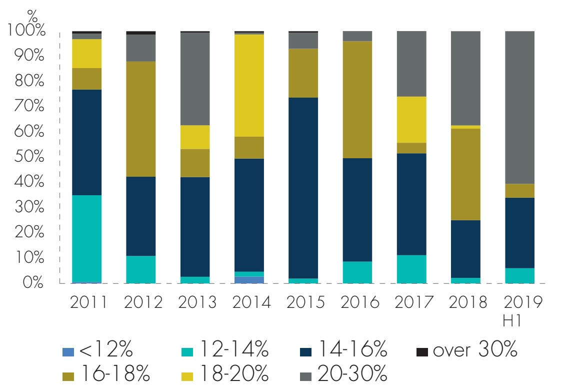
Chart 96 Asset allocation of banking sector by Capital Adequacy Ratio



Source: Bank of Albania.

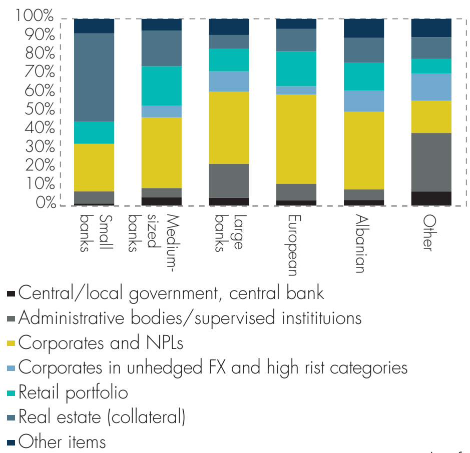
(89) The structure of risk weighted assets by risk category has not changed and is still dominated by risk weighted assets for credit risk (88%). Risk-weighted assets for market risk decreased by ALL 4 billion, while those for operational risk remained unchanged compared to the previous year. The respective weights of these two categories of risk weighted assets to total risk weighted assets maintained their levels of 2% and 10%, respectively.

Chart 96 Asset allocation of banking sector by Capital Adequacy Ratio



Source: Bank of Albania.

Chart 97 Credit classes' exposure of banks by size of activity and origin of capital, June 2019



Source: Bank of Albania.

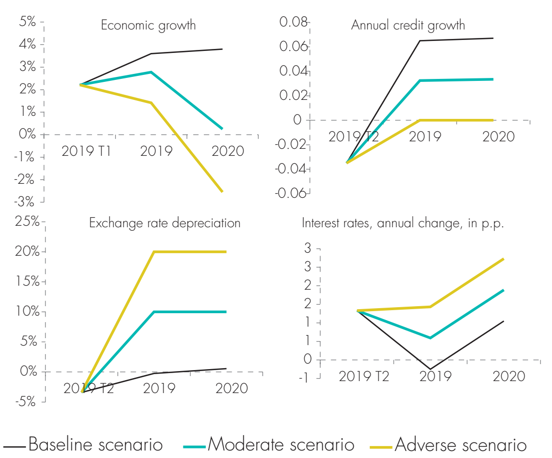
(90) Compared to the previous period and the previous year, no significant changes were reported in the allocation of risk weighted assets for credit risk, for the sector in general and for banks grouped by size and country of origin of capital. Small banks have a high exposure in loans guaranteed with collateral in the form of real estate, while medium and larger banks have a higher exposure in loans for corporations and non-performing loans. By capital origin, both domestic and European-based banks have the highest exposure in "loans to corporations and non-performing loans", whereas banks with capital originating from other regions have a higher exposure in "potential exposures to supervised institutions".

(91) The Albanian banking sector is characterized by an adequate financial leverage ratio, thus confirming the good level of capitalisation. The financial leverage ratio[41], in June 2019, 9.6 times, marking a smaller value compared to the end of 2018, and showing no change compared to the previous year. At the bank level, the ratio represents a shift (increase) due to capital contraction.

6.2.3 ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING

(90) The stress test exercise assesses the banking sector's resilience in the face of hypothetical economic and financial developments for the remaining part of 2019 and for 2020. The results show that the sector remains resilient, despite developments in the adverse scenarios. Although these developments are extreme and of low probability of occurrence, their impact in terms of capital adequacy points to the need for additional capital in some of the individual banks of the sector.

Chart 99 Assumptions for stress-testing



Source: Bank of Albania.

(93) The stress test exercise assesses the banking sector's resilience in terms of capital adequacy for the period 2019-2020. 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 is conducted by applying three scenarios: the baseline scenario, the moderate scenario and the adverse scenario. Their results are shown in the following chart.

(94) The baseline scenario assumes a positive economic growth trending upward throughout the time frame 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 quality of the credit portfolio by the end of 2020. The moderate scenario assumes again a positive economic growth for the two years of the exercise, but notably lower compared with the baseline scenario; while the adverse scenario assumes again an economic growth during the remaining months of 2019 and its significant contraction in 2020.

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

(95) **To the assumptions on the economic performance in both adverse scenarios are also attached the respective assumptions for a depreciation of the exchange rate of the domestic currency, an increase of the interest rate and a decrease of the lending pace up to its stoppage.** These developments, in addition to the downward values in the volume of written-off loans, are reflected in a deterioration in the quality of the loan portfolio. The ratio of non-performing loans by the end of 2020 deteriorates up to 6.3 percentage points (moderate scenario) and 14.8 percentage points (adverse scenario), compared with the June 2019 real data. These assumptions lead to a decline in the indicators' value of the banking sector capitalisation, more sensitive to particular groups of banks and mainly during the second year of exercise.

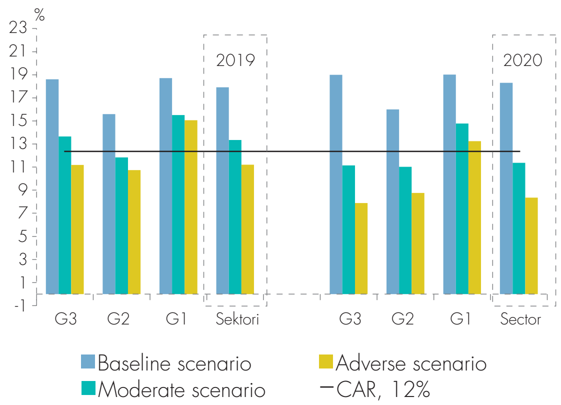
(96) **Stress test results in terms of capital adequacy show that:**

a. In the baseline scenario, the Capital Adequacy Ratio (CAR) of the banking sector appears stable and at comparable levels with the actual values as of June 2019. In concrete terms, this ratio reaches around 18.0% at the end of 2019 and increased to 18.3% at the end of 2020. This development reflects the assumption on the economic growth pace, the positive growth of lending to the economy, the further improvement of the non-performing loan portfolio and the favourable performance of the exchange rate. On the other hand, the assumed performance of interest rates (see chart above), given the structure of "the assets and liabilities sensitive to the up-to-12 months interest rate" of the banking sector, has provided an effect on opposite directions. Specifically, it affected the decline of sectors' CAR during the first year of the exercise and its growth during the second year. Developments by banking groups register high levels of capital, significantly above the minimum level required by the regulatory framework.

b. In the moderate scenario, the banking sector's CAR decreases at 13.3% at the end-2019 and 11.4% as at end-2020. This rate is influenced by assumptions for a low growth rate of economic activity, halving of the credit growth rate, depreciation of the domestic currency, growth of the non-performing loans- following a lower level of lost loan write-offs from the bank balance sheets - and portfolio losses on securities. Based on the above assumptions and the results obtained, developments in particular banks evidence the need for capital injection during the two years-time period. The number of banks that are under-capitalised by the end of the period is 6, accounting for around 70% of the banking sector's assets. In this case, the need for additional capital amounts up to around ALL 10.6 billion.

c. In the adverse scenario, the banking sector's CAR declines at 11.2% at end-2019, and at 8.4% at end-2020, driven by the significantly more adverse assumptions included in this scenario. The number of banks that fall into under-capitalisation increases to eight and account for around 2/3 of the sector's assets. The extreme macroeconomic developments included in the scenario, in addition to stopping the lending to the economy, lead to the significant deterioration of the credit quality. Also, this scenario assumes losses in the securities portfolio and increase of the exposure towards operational risk. In this case, the needs for additional capital are about twice as high.

Chart 100 Capital adequacy ratio, by stress test scenarios



Source: Bank of Albania.

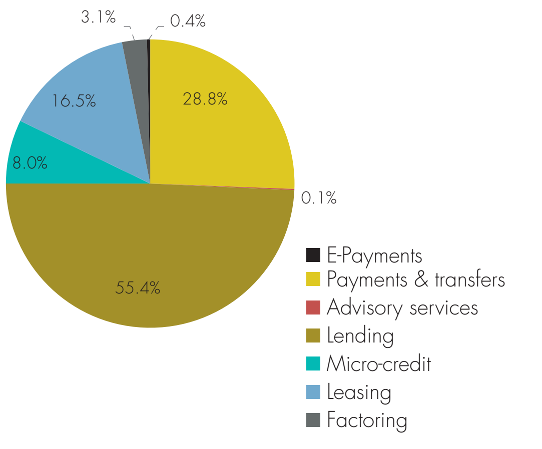
(97) **Based on the above, but also from a comparative perspective with the previous period, the current results indicate a higher sensitivity of the banking sector to the assumed economic and financial developments, reflecting lower levels of the CAR at sector level.** In this respect, even the supposed needs for additional capital appear higher. However, these needs are estimated as manageable by the banking sector, when the average growth of paid-in capital during 2018 Q4 - 2019 Q2 is about ALL 5.6 billion.

7. MAIN DEVELOPMENTS IN THE NON-BANKING SECTOR

INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA

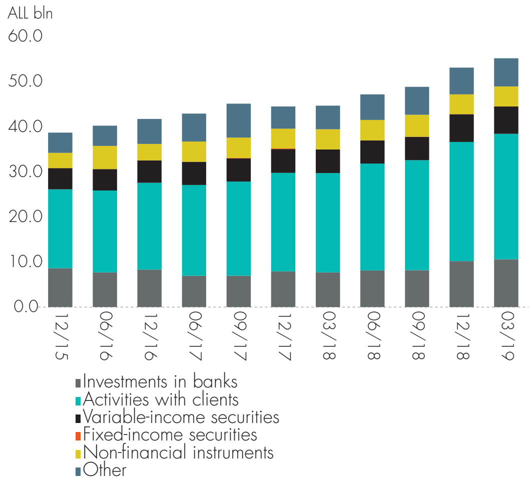
(98) **During the period, non-bank financial institutions (NBFIs) have expanded their activity, and this performance was due to the expansion in their lending activity.** As at the end of 2019 Q1, 30 NBFIs operated in the financial system. These entities are, mainly engaged in microcredit, lending, leasing, factoring and electronic money and their total assets amount to ALL 55 billion. Compared to the end of 2018 and the previous year, NBFIs' assets were 4% and 23% higher, respectively. Lending NBFIs have the main share, followed by those that provide payment and transfer services. NBFIs reported a positive financial result (around ALL 0.6 billion) somewhat higher than the previous year. The level of capitalisation of the activity of NFBIs continued to remain at satisfactory levels. Credit portfolio quality improved, as the ratio of non-performing loans, at the end of the first quarter, fell to 9%, from 13% at the end of 2018.

Chart 101 Structure of NBFIs by type of activity



Source: Bank of Albania.

Chart 102 Structure of the assets of NBFIs

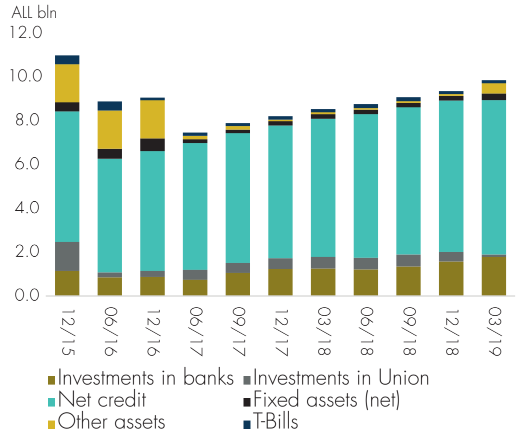


Source: Bank of Albania.

(99) **The activity of savings and loan associations (SLAs) expanded in quarterly and annual terms, supported by the growth of net credit (transactions with members) and the growth of investments in the form of time deposits at the banking sector.** SLAs financial result was positive[42], but lower compared with the previous year. Net loans to members and investments in banks represent the main items of SLAs' assets. At the end of 2019 Q1 there were 13 licensed Savings and Loan Associations in the market.

[42] *Around ALL 5 million.*

Chart 103 The structure of Savings and Loan Associations



Source: Bank of Albania.

INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY

(100) **The activity of insurance companies increased during 2019 H1.** There are 11 licensed insurance companies providing life and non-life insurance and one company providing reinsurance services. The assets of these institutions recorded 8% annual growth and reached ALL 33 billion. Investments in banks held the main share (around 32%) in insurance companies' balance sheets. Gross written premiums[43], with the main contribution from non-life premiums (92%), which represent the main funding source for the insurance companies activity, expanded by 8% in annual terms.

(101) **The activity of investment funds[44] expanded compared with the end of 2018, as a result of the increase of investments in government securities in the form of bonds.** The value of net assets increased to ALL 69 billion from ALL 66 billion at the end of 2018. Currently, five investment funds operate in the Albanian financial system. Investment funds' assets are mainly invested in T-bills and bonds issued by the Government of the Republic of Albania in lek, and others in euro.

(102) **Supplementary Private Pension Funds[45] expanded their activity during the period.** In Albania, three supplementary private pension funds operate in the financial market. The assets of these funds registered ALL 2.4 billion or 6% higher than the end of 2018. The activity of pension funds is dominated by investments in government debt securities.

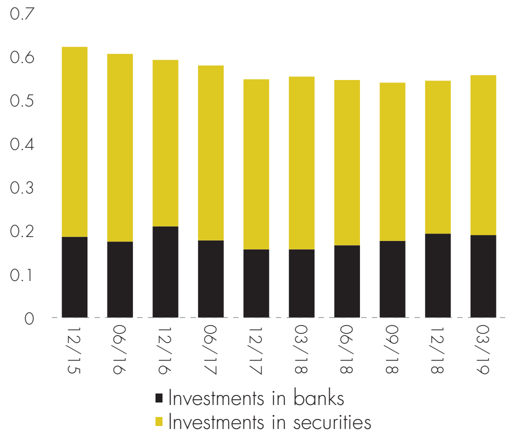
(103) **The Albanian Securities Exchange (ALSE) licensed by the Albanian Financial Supervision Authority in July 2017, started its activity on 22 February 2018.** The activity of ALSE, during the period, consisted in transactions with government debt securities. The ALSE counts 4 members, which are banks and one brokerage company. According to the statistics of the ALSE Stock Exchange, during June 2019,[46] the value of bonds traded was around ALL 220 million. Regarding the instruments traded in the stock exchange market, transactions executed for the account of customers in terms of number, volume and value are dominant, while transactions executed for the account of ALSE members have a very small share of the overall volume of trade.

[43] *AFSA, Monthly Periodicals No.125, June 2019.*
[44] *AFSA, "The Market for Collective Investment Ventures", 31 March 2019, published on 15 May 2019.*
[45] *AFSA, Statistical Report "The market of private supplementary pensions", 31 March 2017, published on 11 May 2017.*
[46] *AFSA, Monthly Periodicals No.125, June 2019.*

RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANKING SECTORS

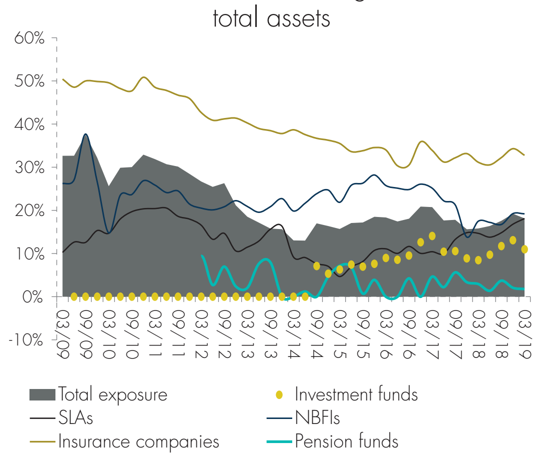
(104) The banking sector's exposure to the non-banking sector in Albania remained low and stable. This exposure on the side of banks' assets is represented by loans and participation in the capital of non-bank financial institutions; meanwhile, on the side of liabilities it is represented in the form of funds collected by banks (various accounts). In total, this exposure accounts for around 2% of the value of the banking sector's assets, and has not recorded a significant fluctuation in recent years.

Chart 104. Investments of non-bank sector in banks and government securities, to total assets of the non-bank sector (share, in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 105 Investments of non-bank sector financial institutions the banking sector to their total assets



Source: Bank of Albania, Albanian Financial Supervisory Authority.

(105) The sensitivity of the non-bank sector to the activity of the banking sector remained high, but the exposure has been declining during the period. In total, this exposure accounted for 18% of the non-banking sector's assets, as at end 2019 Q1, compared with 19% at the end of 2018. Insurance companies and non-bank financial institutions (NBFIs) show the highest exposure to the banking sector, since their placements in banks in the form of deposits and capital instruments, account for 33% and 19%, respectively, of relevant assets. The savings and loans associations increased the exposure, and at the same time the sensitivity to developments in the banking sector, as these entities have increased their demand deposits in the banking sector.

ANNEX 1 MAIN INDICATORS OF FINANCIAL SOUNDNESS

In %	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	6M-2019
Capital-based indicators													
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	17.03	18.66	18.52
Tier 1 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	15.53	17.42	17.27
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	10.15	10.45
Asset quality													
Net NPLs 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	15.51	16.91
NPLs (gross) 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	11.08	11.23
Profitability													
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	12.96	14.26
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	1.32	1.48
FX net open position to captial													
FX net open 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	7.78	4.52
FX net open position to Tier 1 capital	1.80	4.54	4.12	5.33	4.29	4.41	4.92	10.37	8.95	8.00	7.34	8.35	4.84
Asset-based indicators													
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	34.23	34.77
Liquid assets to sh.t. liabilities (up to 1 year)	73.96	64.86	32.58	30.62	33.15	36.71	34.71	40.36	41.43	40.57	40.79	46.21	47.44
Client 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	203.25	203.96

Source: Bank of Albania.