Bank of Albania

FINANCIAL STABILITY REPORT

2018 H2

Published by:
Bank of Albania, Sheshi "Skënderbej", Nr.1, Tirana, Albania
Tel.: + 355 4 2419301/2/3; + 355 4 2419401/2/3
Fax: + 355 4 2419408
E-mail: public@bankofalbania.org

www.bankofalbania.org

Printed in: 270 copies

C O N T E N T S

BOXES

TABLES

CHARTS

INTRODUCTION

This is the twenty-first 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 second half of 2018 (hereinafter "the period"). Unless otherwise stated, the expectations for the economic and financial outlook extend through a period of up to 12 months.

The financial system stability has been assessed based on the performance and risks arising from its interaction with the overall internal and external economic environment, as well as from its activity. In order to assess the risks arising from its interaction with the surrounding environment, this report analyses the latest highlights in international financial markets, and in advanced and regional economies. We have also assessed their impact on the financial system and the banking sector in Albania. Concerning the domestic indicators, this Report assesses the overall developments and expectations for economic growth, balance of trade, overall price level, exchange rate and fiscal indicators. Also, by analysing the performance of employment, income, and specific surveys, it evaluates enterprises and households' financial situation, and the impact on the solvency of the banking sector borrowers.

The Report presents briefly the results of the stress test, which assesses the banking sector's resilience against macroeconomic and financial shocks, expressed in terms of capital adequacy.

NOTES

As at end-December 2018, 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[1], each bank sharing 0-2% of total banking sector assets: United Bank of Albania, International Commercial Bank, First Investment Bank, Albania, Credit Bank of Albania (CBA). They account for around 3% of the sector's total assets.
- Peer Group 2[2], each bank sharing 2-7% of total banking sector assets: Procredit Bank, Société Générale Albania, Alfa Bank Albania, Union Bank, Tirana Bank, American Bank of Investments. They account for around 27% of the sector's total assets.
- Peer Group 3, each bank sharing over 7% of total banking assets: National Commercial Bank, Raiffeisen Bank, Credins Bank, Intesa Sanpaolo Bank Albania. 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[3]: Raiffeisen Bank (Austria); Intesa Sanpaolo Albania (Italy); Alpha Bank Albania, Tirana Bank sh.a. (Greqi[4]); National Commercial Bank (Turkey); Société Générale Albania (France)[5]; Procredit Bank (Germany); First Investment Bank Albania (Bulgaria); International Commercial Bank (Switzerland)[6]; United Bank of Albania (Saudi Arabia); and Credit Bank of Albania (Kuwait). These banks share around 78% in total assets of the banking sector.

---

[1] *Upon approval by the Bank of Albania, on 06.09.2018, the absorption of Banka Veneto by Intesa Sanpaolo Albania was finalised.*

[2] *Upon approval by the Bank of Albania, on 04.07.2018, the absorption of Banka NBG Albania by the American Bank of Investments was finalised.*

[3] *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.*

[4] *In February 2019, the Bank of Albania approved the change in ownership for Tirana Bank, which is accompanied by the change in the origin of the bank's capital from "Greece" to "Albania".*

[5] *In March 2019, the Bank of Albania approved the change in ownership for Société Générale Albania, which is accompanied by the change in the origin of the bank's capital from "France" to "Hungary".*

[6] *In March 2019, the Bank of Albania approved the change in ownership for the International Commercial Bank, which is accompanied by the change in the origin of the bank's capital from "Switzerland" to "Albania".*

- Banks with Albanian capital: Credins Bank, Union Bank and American Bank of Investments. These banks share around 22% 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 Kosovo[7].

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

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

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

[7] *The change from "branch" to "subsidiary" was finalized in March 2018. This change has not affected the analyzed indicators of this bank as at December 2018, taking into account that the Bank has reported consolidated statements*

FINANCIAL STABILITY STATEMENT FOR 2018 H2

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

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

The Bank of Albania assesses that in 2018 H2 (hereinafter, the "period"), the banking sector remained stable. Similar to previous periods, its activity was characterised by restrained risk exposures and good indicators of performance and financial resilience. As a result, banking sector's capability to withstand activity risks is assessed as robust. Economic developments and the performance of financial markets supported the overall activity of the financial system.

HIGHLIGHTS IN ECONOMIC AND FINANCIAL DEVELOPMENTS

The growth rate of global economic activity slowed down during the period, under the influence of trade tensions between advanced economies. As a result, financial conditions in these counties were somewhat tighter, in comparison with emerging economies, where financial conditions showed a greater variety. Global inflationary pressures remained subdued, reflecting the weaker economic expectations and the decrease in oil prices in international markets. Amid higher uncertainty surrounding economic growth, central banks in advanced economies lowered expectations for the monetary policy normalization. In the Balkans region, the slowdown of economic growth did not stop the overall improvement of employment indicators. Expectations for global economic developments reflect the increased uncertainty of the markets about the way economic and political constraints will be solved. Emerging economies may be more sensitive to the potential slowdown of economic growth.

In Albania, the annual economic growth rate was 4.5%[8] in 2018 Q3, driven by the sectors of production and services. Aggregate demand growth was sustained by the expansion of final consumption of the population and investments, particularly private investments. In annual terms, the deficit of the current account expanded in 2018 Q4, but it was fully covered by surpluses in the capital and financial accounts. Positive developments continued in the labour market, as confirmed by the reduction of the unemployment rate to 12.3%, at the end of the year. During the period, the Bank of Albania maintained its accommodative monetary policy and intervened in the foreign exchange market to curb the effect of the Albanian lek's appreciation in view of achieving its inflation target. The inflation rate was 1.8% at the end of the period, unchanged from the previous year. Fiscal policy maintained the consolidation trend.

FINANCIAL MARKETS AND PAYMENT SYSTEMS

The financial market activity developed normally during the period. In the market for government's debt securities the interest rates fell by almost 1 percentage point as the government's borrowing needs were regularly exceeded by the bidders' offer for securities purchase. The extension of the average maturity of the government debt continued during the period. In the interbank market, the average volume of transactions increased, while overnight interest rates remained close to the Bank of Albania's policy rate. In the foreign exchange market, the Albanian lek appreciated against the euro and the US dollar. The appreciation pace of the lek against the euro was significantly lower compared to 2018 H1. The indices that monitor the performance of the housing market in the country and in Tirana increased during the period. Developments in some determining factors point to growth of both demand and supply in this market. The operation of the payment systems was optimal during the period. Regarding payments instruments, electronic payments increased.

HOUSEHOLDS AND ENTERPRISES

During the period, households' creditor positions expanded, while enterprises' debtor positions narrowed. This performance was driven by the faster growth of deposits, mainly in foreign currency, for both households and enterprises. Households' preference for deposits was higher than for investments in government debt securities or participation in investment funds. The level and quality of loans to households improved during the period, mainly as a result of the performance of loans in lek. The NPL ratio for households fell to 6.4%.

[8] *This is the value published by the Institute of Statistics (INSTAT) as at the submission date of this report for review by the Supervisory Council of the Bank of Albania. Since then, INSTAT has revised the economic growth rate of 2018 Q3 to 4.66%, and has published the economic growth rate of 2018 Q4, equal to 3.1%. Our assessment is that these values do not cause significant change in this analysis.*

Survey results on the financial situation and borrowing of households show that their debt burdens remain overall at adequate levels. For almost ¾ of borrowing households, the value of debt servicing amounts up to 30% of the income level.

Loans to enterprises declined during the period, driven by loans in lek for resident enterprises. Loan quality improved considerably, over the period, also for enterprises. The NPL ratio stood at 14.3%. Survey results on the financial situation and borrowing of enterprises show that the debt burden of enterprises is assessed as affordable. For about 80% of the enterprises, the debt value is assessed at half the capital value. Most borrowing enterprises state that debt (loan) services amount to around 20% of the enterprise's income. According to survey results, the households and enterprises credit demand for the short-term future period is likely to remain moderate.

FINANCIAL SYSTEM ACTIVITY

The ratio of financial system assets to Gross Domestic Product (GDP) was 107.6%, almost unchanged from the previous six months, around 2.7 percentage points lower than at the end of 2017. The share of the banking sector assets was at about 96.8% of GDP. During the period, banking sector assets expanded by 1.9%, or ALL 27 billion, reaching ALL 1,453 billion. The increase in securities' investments was the main contributor to the change of the balance sheet. The appreciation of lek affected adversely the reporting of foreign currency values in the banking sector balance sheets, by about ALL 15 billion. The impact was concentrated in the last quarter of the year. The banking sector maintained high levels of net creditor position, in the relation with non-resident entities, with no significant changes during the period. In terms of financial soundness, the banking system was characterised by the increase of capitalisation levels, mainly driven by the fall in risk-weighted assets' value due to regulatory changes. Profitability is estimated at high levels, albeit lower than in 2017. Liquidity indicators are considered as satisfactory. The direct exposure of the banking sector to the non-banking sector is estimated as low, whereas the banking sector's performance remains a critical factor for the activity and stability of the non-banking sector.

BANKING SECTOR'S EXPOSURE TO ACTIVITY RISKS

The Bank of Albania assesses activity risks to the banking sector, as follows:

1. Non-performing loans (NPL) continue to decline at a good pace. During the period, the NPL declined by about 17%, to ALL 64 billion. As a result, the NPL ratio fell to 11.1%, nearly 2.2 percentage points lower than at the end of 2018 H1. By contribution, the decline in NPLs was

attributable to the repayments (for about ALL 17.6 billion), lost loans write-offs (about ALL 4.5 billion) and restructuring. Since the beginning of 2015, it is estimated that banks have written off nearly ALL 55.5 billion of lost loans from their balance sheets. The reduction of NPLs is accompanied by a faster decrease of provisioning, driving to the fall in their provisioning ratio by 0.8 percentage point, to 65.6%. Despite the decline in the provisioning ratio, coverage of net non-performing loans with capital improved. Collateralisation remains at high levels.

Despite the improvement, it is necessary for banks to maintain the downward trend of non-performing loans. This is especially important for those banks whose non-performing loans is above the average of the sector. The values of non-performing loans collection are at good levels, evidencing the banks' effort to collect them. The appreciation of the exchange rate the lower interest rate had an impact in the improvement of borrowers' solvency. Attention should be paid to the value of standard loans moving toward non-performing loan classes, because in the last two years these values were relatively stable. This highlights the need to maintain a prudent approach during the process of loans' underwriting and monitoring.

2. Liquidity risk in the banking activity remains low. The ratio of liquid assets, both in lek and in foreign currency, to short-term liabilities stand significantly above the minimum regulatory requirements. Deposits, accounting for almost 81% of liabilities, remain the main source of funding of the banking activity, by covering almost twice the volume of loans of the sector.

   In addition to the further decline of time deposits in the deposit structure of the banking sector, further growth of foreign currency deposits (although in terms of their share, there are no significant changes) was observed during the period, by both households and enterprises. This is a development that reflects a broad foreign currency presence in the economy, which is accompanied by challenges with regard to the effectiveness of economic and financial policies, as well as with certain risks to financial stability. Hence, in line with the Interinstitutional Memorandum for strengthening the use of national currency in the economy and the financial system, it is necessary for the respective authorities to take concrete steps toward the reduction of the use of foreign currencies by real economy agents. The Bank of Albania stands ready to provide all the necessary cooperation in this process.

3. The banking sector's exposure to market risks, albeit downward over the period, remains important. The exposures to both direct and indirect foreign exchange risk did not show considerable change over the period and over the past year. Loan portfolio in foreign currency unhedged against exchange rate risk stood at 24% of total outstanding credit, in

which enterprises continue to share around 2/3 of value. Regarding the impact of interest rate fluctuations, the banking sector remains exposed to them. The data show that the direct impact is moderate, given that the open balance sheet positions between interest-sensitive assets and liabilities, as a ratio to regulatory capital of the sector, is limited. Indirect impact from the interest rate risk remains important, because under the conditions when the credit portfolio is dominated by variable interest rates and when interest rates' spread is at historically low levels, the impact of a possible correction of interest rates on borrowers' solvency increases in the medium-term period.

4. As a result of a restructuring process, the share of domestic capital in banks operating in Albania has increased. This is a recent phenomenon present in other countries of the region as well. In parallel with the consolidation of the banking activity, based on the insofar experience, this development is expected to contribute to a more active role of the banking sector towards financial intermediation. At the same time, the Bank of Albania will maintain an appropriate supervisory approach to ensure that banking activity is carried out in accordance with the best standards on governance and risk management.

RISKS TO FINANCIAL STABILITY

To assess systemic risks, the performance of several indicators is analysed. Such indicators are related to the materialization and accumulation of systemic risk, the stress level in the financial system, and the perception of the banking industry regarding the exposure of its activity to systemic risk. Also, the financial stability map provides a consolidated approach for assessing risks to financial stability.

Overall, the financial stability map, the materialisation and accumulation of systemic risks indices and the financial stress index, show that risks to the financial stability are contained. Indicators related to developments in the real sector of the economy and the banking sector provided positive contribution, whereas risk indicators related to the external economic environment show a slight increase. Banks' responses in the relevant survey show that they did not have significant changes in the perception of systemic risks throughout the period, but within these risks the perception of banks for political risk increased. This response by banks was expected following the rising tensions in the political landscape in the country at the end of the period. It also evidences the importance of improving this climate to better support economic and financial developments, as well as restrain risks to the banking activity.

MACRO-PRUDENTIAL POLICY

During the period, work was carried out for finalising new indicators that signal developments in systemic risk, regarding its cyclical and structural elements. The list of indicators also includes those determining the financial cycle and systemically important banks, which will then serve to signal the possibility of implementing relevant macro-prudential instruments.

Furthermore, within the framework of measures undertaken to strengthen the use of lek in banking activity, which entered into full force during the period (July 2018), the Bank of Albania has identified and is monitoring several indicators to assess the effect of these measures and the need for reviewing/enriching them. Based on the performance of these indicators, during 2018 H2, it is noted that changes in most cases are minor, and in general, the indicators' values show significant deviation from the average values of the indicators for countries whose economy is similar to the Albanian one. Under these conditions, it is too soon to provide an assessment of the impact of these measures and the continuous monitoring of the relevant indicators is needed.

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. This time around, the stress-test exercise was carried out to also assess in greater detail the banking sector's liquidity situation.

At the end of the period, the banking sector's capital adequacy ratio was 18.2%, standing 1.2 percentage point higher than at the end of 2017 and notably higher than the 12% level of the minimum requirement. The fall in the value of risk-weighted assets dictated most of the improvement in the capital adequacy ratio. This fall arose from simultaneous factors related to changes in the regulatory framework. The financial result of the sector was at good levels. The profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.3% and 13% respectively, downward by 2.4 percentage points and 2.0 percentage points, respectively, than in the previous year. The net interest margin dropped at 3.75%, over the period, compared with 3.9% in the previous year, hence reflecting the impact of the presence of low interest rates for a prolonged period.

The adequacy of the above indicators was verified through stress tests, with scenarios that assumed adverse developments in macroeconomic and financial indicators for 2019-2020. Similar to before, extreme assumptions in the adverse scenario (with a low probability of occurrence) included the strong contraction of the economy and of credit, rapid growth of average interest rates and strong depreciation of the exchange rate.

Overall, the results of the stress tests show that in the scenario containing assumptions with a higher probability of occurrence, the banking sector remains well capitalized and shows good performance. In the more extreme scenarios, individual banks and the banking sector would need to increase capital.

With regard to the stress-test to assess the resilience of the banking sector and of individual banks against shocks to liquidity conditions, the stress-test conclusions indicate that the banking sector is resilient to these shocks. By currency, the resistance is better for the lek and the US dollar than for the euro. The strengthening of lek's resilience is related to the increase in the value of assets that can be liquidated when a need arises, while the weakening of euro's resilience reflects a decrease in the value of the ratio between inflows and outflows and a slight decrease in the volume of liquid assets available for liquidation in the case of a liquidity shock.

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 capacity to withstand various risks, in compliance with the supervisory and regulatory framework.

A more detailed analysis is presented in the financial stability report for the second half of 2018 that follows this statement.

1. OVERVIEW OF THE MAIN RISKS TO FINANCIAL STABILITY

1.1. FINANCIAL STABILITY MAP

(1) At the end of 2018, the Financial Stability Map[9] shows risks in the external economic environment increased slightly, whereas risks in the domestic environment related to banking activity and real sector developments decreased, compared to results as at the end of 2017. The value of indicators suggest that the risk related to developments in the "domestic economy", the "government" and "households" trended overall down, compared to the end of the previous year, whilst risk from "enterprises" trended upward. On the contrary, the indicators of banking activity related to "capitalization and profitability" and the "structure of the banking sector" did not show significant changes at the aggregate level of risk, whilst risk related to "liquidity and financing" was overall downward.

In more concrete terms, at the end of 2018, in:

a. Overall economic environment:

I. Aggregated risk from the "domestic economy" is rated as "moderate" and downward, compared to the previous year, mainly as a result of stable GDP growth, and decline in the size of the external debt stock.

II. Risk from the "external environment" continues to be classified as "moderate" but slightly upward compared to the end of 2017, driven by the slowdown of the economic growth rate in our trading partners. This slowdown may drive to a decline in the future demand for exports, while a potential increase in short-term interest rates in money markets may increase external financing costs.

b. Real economy agents:

I. Risk from "enterprises" is assessed as "moderate" and upward during the period, in view of the deterioration of short-term expectations by enterprises and of the index of their financial situation[10];

[9] 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. The closer to the "centre" of the map, the lower the risk.

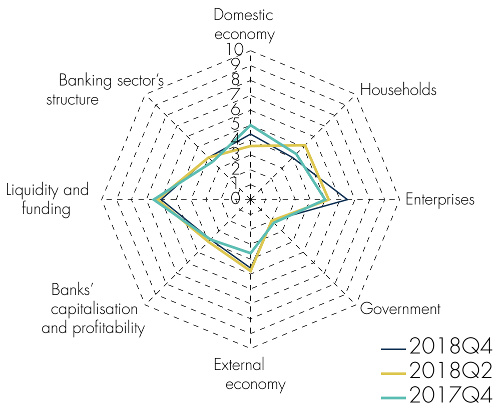
[10] The financial situation of enterprises is one of the sub-indices calculated by the Business Confidence Survey conducted by the Bank of Albania quarterly. In this methodology, this index substitutes the index of output volume, published by INSTAT.

II. Risk from "households" is assessed as "moderate" and remained almost unchanged during 2018.
III. Risk from the developments in the "government" sector, is assessed as "low" and slightly downward during the period, as a result of the decline in the size of government debt to GDP. The risk from other sub-indices in this category either remained unchanged or declined.

c. The banking sector activity:

I. Risk from "capitalisation and profitability", is assessed as "average" and remained unchanged compared with the end of the previous year. The increase of the sector's capitalization level and the improvement of credit quality, mitigated the risk from the decrease in the sector's revenues, keeping the aggregate risk level from this category unchanged.
II. Risk from "liquidity and financing" is assessed as "moderate" and trending slightly downward, compared to the previous year, reflecting the narrowing of the banks' assets and liabilities gap, of up to three months maturity, and a slight decrease in financing from non-residents.
III. Risk associated with the "banking sector structure" is assessed as "average" but trending slightly upward from a year earlier, as a result of the increase of concentration in bank credit to enterprises.

Chart 1 Financial Stability Map

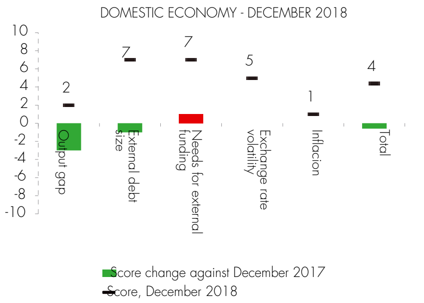


* Risk is assesses as: low for scores 0-3 in the map, average for scores 4-5, moderate for scores 6-8 and high for scores 9-10. The closer to the center, the lower the risk.
Source: Bank of Albania

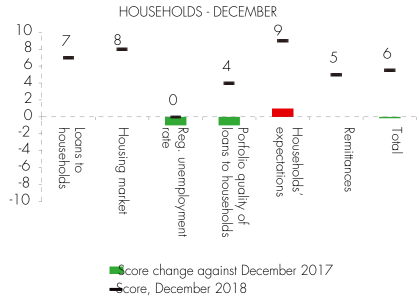
Box 1.1 shows the Financial Stability Map components over 2018 H2, the score for each risk level and comparison with the scores in the previous year.

BOX 1.1: FINANCIAL STABILITY MAP COMPONENTS

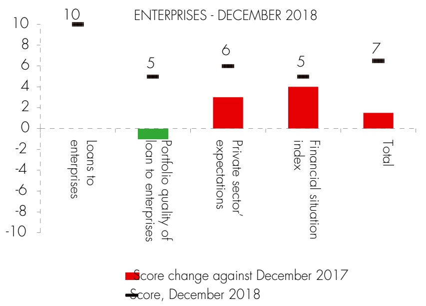
Risk from "domestic economy" is assessed as "average" but downward compared to the previous year, due to the constant growth of GDP against its long-term expectation, and decline of external debt size. On the other hand, increase of the need for external financing at the end of the year, contributed to the increased risk from this category.



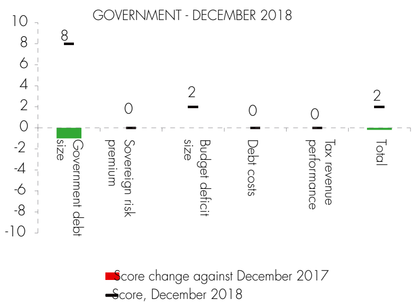
Risk related "households" is assessed as "moderate" with a slightly downward trend compared to the end of the previous year. The decrease of the registered unemployment rate and improvement of households' portfolio quality decreased the risk from this indicator, whilst the deterioration of their expectations contributed to risk increase.



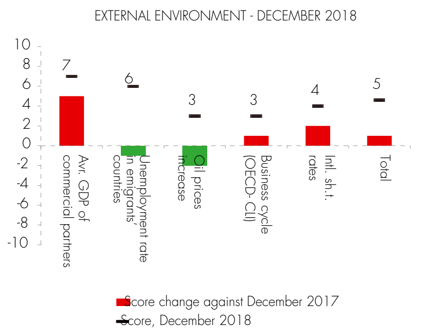
Risk from "enterprises" is assessed as "moderate" and upward during the period, reflecting the deteriorating of expectations and of financial situation in this sector (the financial situation index).



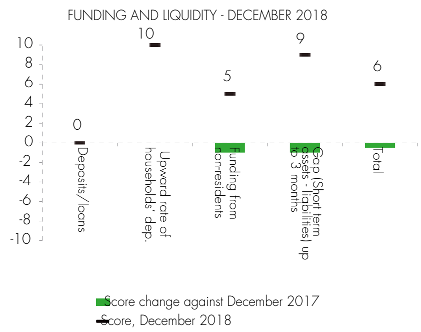
Risk from "government" is assessed as "low" and slightly down compared to the previous year, as a result of the decrease of the size of government debt vis-à-vis the GDP, whilst risk from other sub-indices of this category remained unchanged.



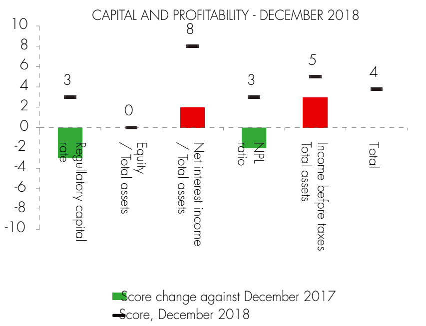
Risk from "external environment" is assessed as "average" and upward, driven by the slowdown of economic growth in our main trading partners (mainly Italy and Greece), increase of the average of short-term interest rates (Euribor, Libor 3 months) in money markets and signals for the decrease of the global business cycle according the CLI.*



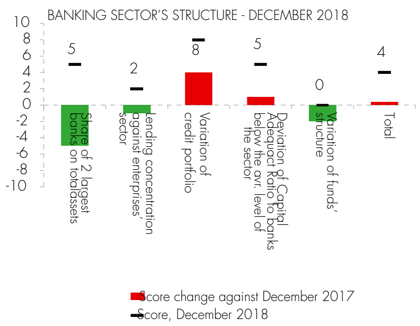
Risk from "financing and liquidity" resulted as "moderate" and downward, due to the narrowing of the short term assets and liabilities gap, up to three months, and the decrease of financing by non-residents.



Risk from "capitalisation and profitability" is assessed as "average" and unchanged during the period. Increase of capitalisation of the banking sector and improvement of the loan quality, led to risk decline in this category, whilst risk related to the sector revenues remained high and upward as a result of the continuous decline of revenues (albeit from high levels).



Risk from the "banking sector structure" remains "average" and slightly upward during the period, as a result of the growth of the deviation of CAR for banks to the average of the sector and the increase of lending concentration to the enterprises sector, measured by the variance of the business loan portfolio.



*The financial situation index (Composite Leading Indicator - CLI) is one of the main indicators 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.

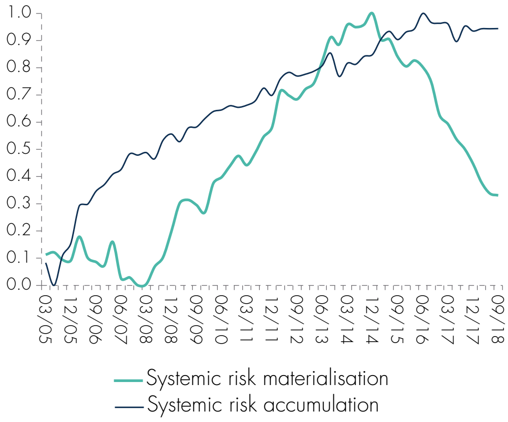
Source: Financial Stability Department, Bank of Albania

1.2. SYSTEMIC RISK[11]

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.

(2) **Materialisation of systemic risk was downward over the period, compared to the previous year, whilst the indices of risk accumulation decreased in annual terms.** The improved quality of credit to households, the decline in the unemployment rate at home, and the diminishing exchange rate volatility contributed to the performance of this index. Decrease of outstanding loans unhedged against the exchange rate and decrease of external and public debt contributed to the decrease of the systemic risk index.

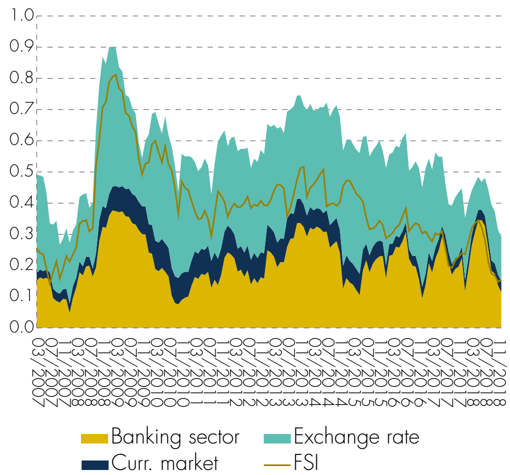
Chart 2 Indices of accumulation and materialisation of systemic risk



Source: Bank of Albania

(3) **The financial stress index resulted as downward,** mainly due to the improvement in the performance of certain banking sector indicators (such as deposits and net interest margins) compared to their historical trend, whilst the indicators of the money market and exchange rate did not cause significant changes in this index.

Chart 3 Financial Stress Index



Source: Bank of Albania

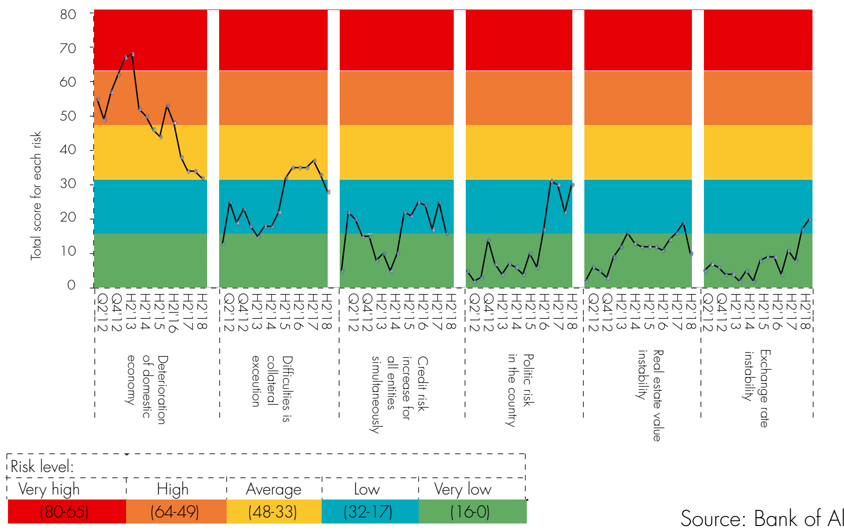
(4) **The perception of the banking industry on systemic risk was overall downward during the period;** the risk of the "deterioration of the domestic economy" remains the main systemic risk in the country, but the perception on its importance is assessed as "average" and downward. The steady growth of the country's economy over the recent years, has contributed to the reduction of the perception of the banking industry regarding this risk. The perception of risk associated with "collateral execution" was downward during the last two surveys. Although the process of collateral execution continues to be considered as difficult and costly for banks, the various legal, regulatory and administrative measures taken over the recent years within the framework of

[11] *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".*

the strategy for the treatment of non-performing loans may have contributed to facilitating this process.

(5) **During the period, banks' concern on "domestic political risk" and "exchange rate risk" has increased.** Political developments at the end of 2018, which led to a cabinet reshuffle, and pressures for the appreciation of the Albanian lek against the euro seem to have been reflected in heightened attention by banks to these risks, which they have identified as systemic risks.

Chart 4 Bank assessment of main systemic risks



Source: Bank of Albania

BOX 1.2: MACRO-PRUDENTIAL POLICY

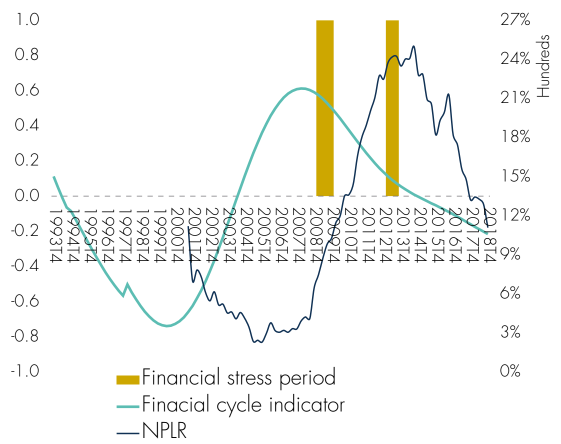
The macro-prudential policy focuses on the prevention of systemic risk and the strengthening of the financial system resilience against it. Systemic risk develops in two dimensions: cyclical and structural ones.

The cyclical dimension of the systemic risk is related to the tendency of financial institutions to increase their risk appetite in times of economic boom, and to show more reluctance in times of economic downturn. None of these behaviours are desirable; so, through its instruments, the macro-prudential policy aims to mitigate this pro-cyclical behaviour of the financial system. The Bank of Albania has worked to assess the procyclicality of the financial cycle with economic growth (GDP performance).

Thus, an index of the financial cycle was initially built, which, based on the relevant literature and the structure of the financial market in the country, correlates credit indicators with asset prices. The latter are considered as equally important variables of the financial cycle, though literature always considers them correlated with credit variables. More specifically, the financial cycle index for Albania includes:

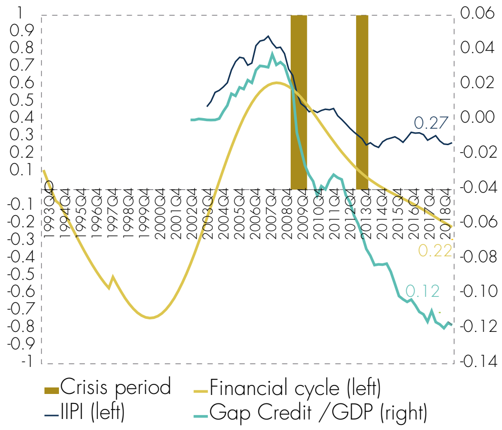
- *ratio of credit[12] to GDP, as an important variable of macro-prudential analysis;*
- *annual credit growth, as a variable that assesses the rate of credit expansion acceleration, adjusted for inflation.*
- *house price index, as a variable that captures price developments of non-financial assets, adjusted for inflation.*

Chart 5 Indicator performance of financial cycle (right) and NPLs (left)



Source: Bank of Albania

Chart 6 Performance of main financial indicators



Source: Bank of Albania

A rapidly developing financial cycle tends to improve financial indicators of financial institutions, and is accompanied by increased risk and, further on, its materialization. To estimate this link for Albania, the ratio of non-performing loans is considered as an indicator of the risk materialization. The chart clearly shows that the growth inthe financial cycle (index increase) during the period 2000-2007 was accompanied by a decrease in the ratio of non-performing loans, whereas its decline, in this case driven by the outbreak of the global financial crisis in 2008, was associated with the rise of non-performing loans in the period 2008-2013.

In order to better capture the financial cycle in view of the country's economic development stage, using another indicator, the Credit to GDP gap, is suggested.

This indicator, identifies the gap between the current value of "Credit/GDP" with its long-term trend. When this gap is significant, it is evaluated whether the credit growth/contraction is or is not excessive. In Albania, "credit to the economy" is taken as a credit indicator, which includes the loan to private non-financial resident entities by banks and non-bank financial institutions.

The "Credit to -GDP" gap is an important indicator for the macro-prudential policy. It serves as a primary indicator for implementing countercyclical capital buffers. The latter, trending upward for banks during the upturn of the cycle and permitted to decrease during its downturn, acts as a mechanism that lowers the procyclicality in banking activity, and mitigates major fluctuations in financial intermediation. The standards of the European Systemic Risk Board suggest that the above indicator should be supplemented/supported with other indicators that may signal unwanted developments more quickly. The Bank of Albania has defined and calculated these indicators for Albania. In addition to the Credit-to-GDP gap, the "Supplementary Early Warning Indicator" was used, which also includes some sub-indicators of credit intensity and non-financial asset prices.

From the performance of these indicators, it can be concluded that:

[12] *For credit, data relate to bank credit to the private non-financial sector;*

- *they capture adequately the current phase of the financial cycle, which is downward. However, the Credit - to-GDP gap and SEWIs indicators appear to suggest the downward trend stopped;*
- *in the context of the possible implementation of countercyclical capital buffers, the performance of the Credit-to-GDP gap (deeply in negative territory) does not suggest the need for implementing this instrument in the foreseeable future.*

In addition to the cyclical dimension, the Bank of Albania has also worked towards assessing the structural dimension of systemic risk. This dimension stems from the expansion of risk to parts of the financial system. It occurs when financial institutions are so large or are so interconnected that when they are affected by an unfavourable economic or financial development, local or cross-border, the consequences may jeopardise the stability of the entire financial system. In this regard, the focus of Bank of Albania's efforts was to review the methodology for determining systemically important banks, and to determine how the respective capital buffer could be applied for the systemic importance as an instrument of the macro-prudential policy.

Thus, in 2018, the scoring methodology for the assessment of systematic importance is reviewed, based on the methodological framework of the European Banking Authority and the Basel Committee on Banking Supervision; the minimum threshold for the designating of systemically important banks to reflect structural changes in the domestic banking sector is reviewed also, as well as the calculation of the requirement for capital buffer for each basket / interval of the systemic importance score is reviewed.

In order for the methodology to better reflect the features of the domestic banking sector and the relationships of this sector with other segments of the financial system, some of the categories of systemic importance scores, such as "size", "substitutability" and "complexity" have undergone changes of sub-indicators and relevant weights. Thus, "Substitutability" includes indicators related to the investment of banks in the stock exchange, assets under custody, and assets of investment and pension funds in which banks may be participating. The "Complexity" category includes the indicators of over-the-counter derivatives (OTCs) and illiquid investments. Despite the fact that the application of the revised methodology has not led to radical changes in the relevant scores and in the ranking of banks according to their importance, the Bank of Albania estimates that this methodology, which combines the best international practices with the experience and empirical results of the analysis of the Bank of Albania, represent an important instrument for assessing, monitoring and preventing structural risk increase in all its critical dimensions.

As part of the framework for macro-prudential capital buffers, the above-stated methodologies are published at Bank of Albania's website, for consultation by the banking industry and the public.

In the framework of implementing the macro-prudential policy in order to mitigate systemic risk in its structural dimension, the Bank of Albania has taken some measures to strengthen the use of lek in the banking activity. These measures entered into full force during the period (July 2018). In line with the commitments made in the respective inter-institutional memorandum, the Bank of Albania has identified some indicators to assess the impact of the measures and the need for their revision/enrichment. Based on the performance of these indicators during 2018 H2, it is noted that movements in most cases are insignificant, *and in general, the indicators' values remain largely deviant from the average values of the indicators for countries with similar economy to Albania. Against this backdrop, it is too soon to provide an assessment of the impact of these measures and a continued monitoring of the relevant indicators is needed.*

2. INTERNATIONAL ECONOMIC AND FINANCIAL DEVELOPMENTS

(6) **During the period, the expansion of the global economic activity moderated.** The maturity of the global economy cycle, the diminishing effects of supportive economic policies in advanced economies and the use of tariffs as instruments in trade disputes between the world's largest economies had a negative impact on the growth of trade and the global economy. The conditions in the financial markets of advanced regions tightened somehow over the last months, reflecting concerns over the escalation of trade tensions and expectations for a slowdown in economic growth. In financial markets of advanced regions, dynamics of developments have been diverse, while countries with weak macroeconomic structures and uncertain political climate have been characterized by a build-up of financial pressures. Global inflationary pressures remained subdued reflecting the fall in oil prices, but are expected to gradually rise as a result of spare capacities running up in the global economy. The global economy is expected to slow down even further in 2019 and stabilise thereafter, over the subsequent two years.

(7) **Most euro area member states recorded a positive annual economic growth, but the pace of growth slowed down during the last two quarters of 2018.** Economic activity is underpinned by the pickup in domestic demand, while trade activity contributed negatively. Labour market conditions continued to improve in most euro area countries and employment rose beyond pre-crisis level. As a result, the unemployment rate of this region fell to 7.9% at the end of 2018, the lowest since October 2008. Inflationary pressures subdued during the last months of the year, driven by the fall in oil and food prices. Under these circumstances, the European Central Bank (ECB) maintained the accommodative monetary policy stance, even though the quantitative easing program ended in December 2018.

(8) **In the European banking sector, lending continued to record positive and steady growth rates, albeit at moderate levels.** This performance was supported by still favourable financing conditions and increased demand for loans in all its categories. The overall fall in credit interest rates for all segments of customers and in most euro area countries reflects a more uniform transmission of ECB's accommodative monetary policy over the period.

(9) **Risks to economic outlook in euro area, overall, are assesses as moderated.** They are mainly related to the uncertainty of certain geopolitical developments, the risk of more trade barriers and higher volatility in financial markets. On the other hand, the still favourable financing conditions and the strengthening of domestic demand are expected to further support the

economic expansion of this region. The ECB has stated that its policies will remain accommodative and supportive of economic growth in the euro area.

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

	GDP change (annual %)				Annual inflation (annual %)		Unemployment (annual %)		Gross government debt (as a percentage of GDP)	
	Q3'18	Q4'18	2018p	2019p	Sep'18	Dec'18	Sep'18	Dec'18	Q2'18	Q3'18
U.S.	3.4	2.6	2.9	2.5	2.3	1.9	3.7	3.9	103.9	104.2
Euro area	1.6	1.1	1.6	1.7	2.1	1.6	8.0	7.9	86.3	86.1
Germany	1.2	0.6	1.3	1.6	2.2	1.7	3.3	3.3	61.5	61.0
France	1.3	0.9	1.5	1.6	2.5	1.9	9.1	9.1	99.1	99.5
Italy	0.6	0.0	0.6	0.9	1.5	1.2	10.4	10.3	133.1	133.0
Greece	2.1	1.6	:	:	1.1	0.6	18.6	:	177.4	182.2

Source: European Central Bank, Eurostat, p- forecasts (January 2019) of the IMF, BEA –Bureau of Economic Analysis). (U.S. Bureau of Labour Statistics). ": ": no available data.

(10) **In the Western Balkans region, economic activity continued to expand but growth dynamics differed among the countries.** In 2018 Q3, the region's economy grew by 3.7%, year-on-year, driven mainly by growth in investments and private consumption. Growth rates slowed down compared to the previous quarter (growth at 4.3%), mainly driven by the decline of economic growth in Serbia. Economic expansion continued to stimulate the creation of new jobs, which led to the decline of unemployment in all the countries of the region. Despite the positive performance, labour market conditions continue to remain challenging and unemployment rates remain at double-digit values. Due to the low production base and low competitiveness, high trade deficit remains a source of weakness for all countries in the region.

(11) **Over the period, inflationary pressures in the countries of the region were moderate and central banks maintained an accommodative monetary policy.** Credit to the economy continued to grow positively and to support economic growth, whilst faster growth of credit to households remains a common feature of the countries of the region. Non-performing loans continued to trend downward in all countries, driven by the improvement of the framework for their treatment and mandatory write offs. The decline in the stock and the ratio of non-performing loans had a positive effect on banks' lending capacity.

Table 2 Selected macroeconomic and financial indicators for Western Balkans

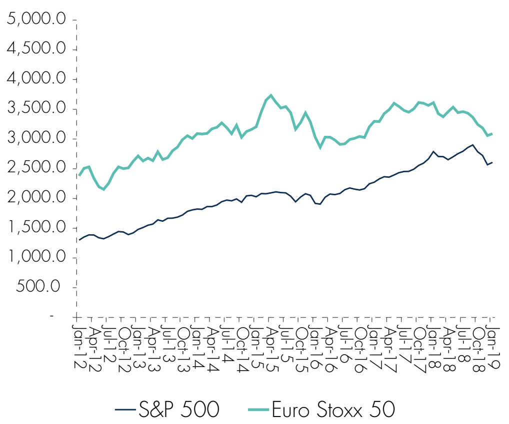
	GDP (real, % annual)			Unemployment (in %)		Sovereign debt (% of GDP)		Credit growth (% annual)		Non-performing loans ratio (in %)	
	Q2'18	Q3'18	2018p	Q2'18	Q3'18	Q2'18	Q3'18	Q2'18	Q3'18	Q2'18	Q3'18
B&H	3.6	3.0	:	:	35.0*	38.6	37.2	6.8	6.5	9.3	9.4
N.Macedonia	3.0	3.0	2.1	21.1	20.8	40.3	40.3	6.0	6.8	6.5	6.3
Montenegro	2.8	3.1	3.9	14.7	14.4	62.8	61.8	12.8	10.7	7.0	6.7
Kosovo	4.2	4.5	4.1	29.4	30.7	16.9	:	10.8	11.6	2.7	:
Serbia	4.9	3.8	4.4	11.9	11.3	59.7	:	0.3	6.0	7.8	6.4
Albania	4.2	4.7	4.1	12.4	12.2	72.5	72.6	-1.8	-1.6	13.3	12.9

Source: European Commission, 'p'-forecasts January 2019; ':' no available data.

(12) Financing conditions in global financial markets tightened and showed a higher volatility. This performance reflected the uncertainty regarding the development of the global economy and the prevalence of expectations for tightening of the Federal Reserves' monetary policy. As a result, the main indices of capital markets showed instability and their spreads widened. In emerging markets, the dynamics were more diverse and often linked to specific factors. Capital inflows in these countries were moderated or turned negative, due to tighter liquidity conditions in advanced economies and heightened trade tensions.

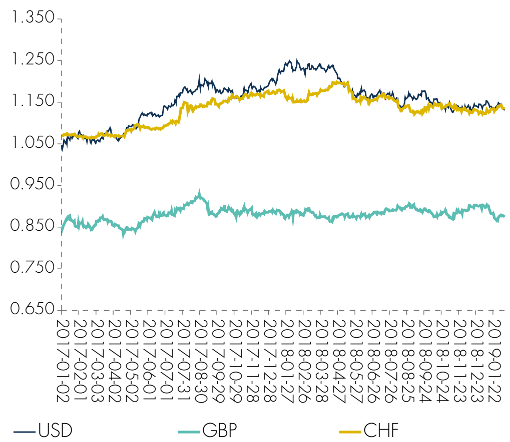
(13) Less optimistic expectations about the performance of the global economy, or economy of major regions, are reflected in the performance of other markets. Thus, in the foreign exchange markets, the euro followed a depreciation trend. Also, in commodity markets, metal prices and agricultural products fell over the period. The oil price was volatile during 2018 H2, but the downward trend strengthened in the last quarter of the year, standing at USD 55-60 per barrel.

Chart 7. Main indices in stock markets



Source: European Central Bank

Chart 8. Performance of euro exchange rate against other currencies



Source: European Central Bank

3. MACRO-ECONOMIC DEVELOPMENTS IN ALBANIA

(14) **At the end of 2018 Q3, the economy grew by 4.5%[13] in annual terms.** Production and service sectors were main contributors to economic growth, notably with the branches of: "Industry, energy and water", "trade, transport, accommodation and food services", and "construction". Aggregate demand grew supported by the expansion of the final consumption of the population and the fixed capital formation, as government consumption decreased during the period. The expansion of the current account deficit contributed to the decelerating trend, mainly due to the expansion of the negative balance in the primary income account. In the labour market, the unemployment rate continued the downward trend started in December 2015, marking 12.3% at the end of the year[14]. Expectations on employment remain largely positive, in the short-term.

(15) **Monetary policy maintained the accommodative stance during the period.** Although the results of economic analysis point to positive developments in economic activity, employment and confidence of economic agents, their values are yet to be reflected in inflation values,. Thus, in December 2018, annual inflation was 1.8%, unchanged from the previous year[15]. Inflation reflected the temporary supply-side shocks and the curbing effect of lek exchange rate appreciation. However, the Bank of Albania expects the effect of positive economic developments to extend in the following period, pushing inflation rates toward convergence with the target of 3% in the medium-term.

(16) **The fiscal policy has maintained the consolidation trend.** The budget deficit, in 2018, amounted to ALL 27 billion, about ALL 4 billion less than in the previous year. Increase in budget revenues by 4.4% against 3.1% in budget expenditures contributed to the annual narrowing of the budget deficit. The speed of budged deficit creation was faster in the last quarter of the year, thus highlighting the need to allocate expenditures, especially capital expenditures, in line with the objectives and consistently throughout the financial year.

(17) **At the end of 2018 Q4, the overall balance of payments resulted in expansion of foreign exchange assets to about EUR 274 million.** The current account deficit widened by 17% y-o-y, at EUR 364 million, due to the

13 This is the value published by INSTAT on the date of submission of this report for review by the Supervisory Council of the Bank of Albania. Since then, INSTAT has revised the economic growth rate for 2018 Q3 at 4.66%, and has also published economic growth rate for 2018 Q4, which is 3.1%. It is estimated that these values do not bring significant changes to the report's analysis.

14 Unemployment rate was 12.4% in 2018 Q2 and 12.2% in 2018 Q3.

15 In 2018 Q3 and 2017 Q4, inflation rates were respectively 2.2% and 1.8%.

deepening of the deficit in goods by 8% and the narrowing of the positive balance in the account of secondary income by around 6%. Regarding the latter, remittances were estimated at EUR 170 million, down by 2%. The positive balance of services account shrank slightly, by 1.3%, whilst the positive balance of primary income nearly doubled. The deficit of the capital account and the financial account, covered entirely the current account deficit. In the financial account, inflows (increase in financial liabilities with the world) in the financial account, grew by 29% and were EUR 541 million, almost equally divided between flows in the form of foreign direct investments and flows in the form of financial liabilities. During 2018, the current account deficit is estimated to have narrowed by 0.7% to EUR 860 million, while foreign direct investments grew by 14% or EUR 1,022 million.

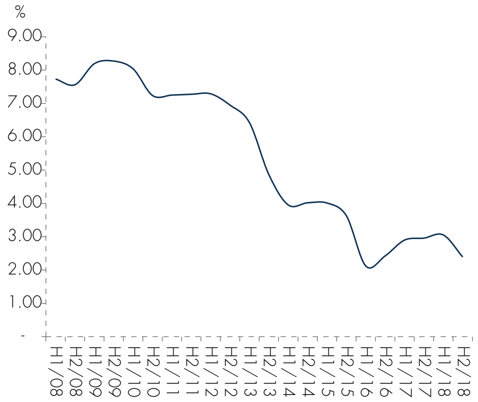
4. MARKETS AND PAYMENT SYSTEMS

4.1 MARKETS

SECURITIES MARKET

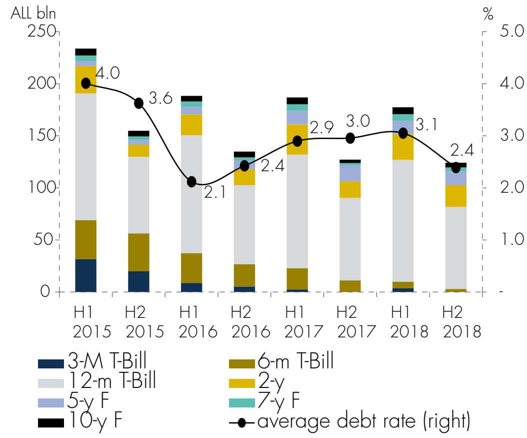
(18) **During the period, the average yields on government debt fell.** At the end of the year, this yield was about 2.4%, lower by almost 1 percentage point compared to the level of 2018 H1 and by about 0.6 percentage point compared to the level at the end of 2017. The structure of domestic debt in lek continues to be dominated by the short-term one (66%), although this share has been declining. Domestic debt in lek issued during the second half of the year was about ALL 124 billion, or 32% lower compared to the debt issued during the previous six months, and almost the same with the level of debt issued during 2017 H2.

Chart 9. Average yields on debt securities, in %



Source: Bank of Albania

Chart 10. Composition of debt issued during 2015- 2018 H2

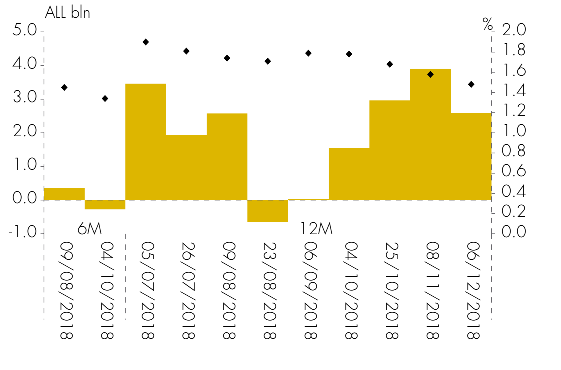


Source: Bank of Albania

(19) **For short-term debt securities, the average yield declined under the conditions of the decline in the volume of issuance.** During the period, the issuance of government debt securities in the form of Treasury bills amounted to about ALL 82 billion, about 36% and 10% less than the end of 2018 H1 and the end of the previous year. The bid for investment in treasury bills has almost always covered the government demand for borrowing in Treasury Bills. As a result, the average yield of treasury bills declined from the previous six months by 0.7 percentage point and by 0.6 percentage point from the end of 2017, standing at 1.7%. For T-Bills with 12-m maturity, which are highly preferred by

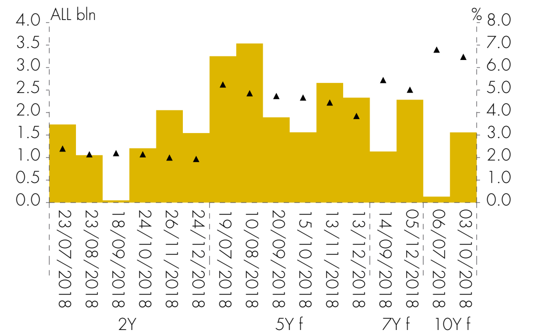
the investors, the yields declined during the period by around 0.4 percentage point, at 1.5% in the last issue of 2018.

Chart 11. Surplus on the amount announced for investment and treasury bills yields, for 2018 H1



Source: Bank of Albania

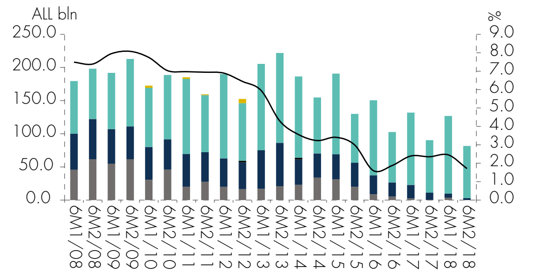
Chart 12. Surplus on the amount announced for investment and bonds yields, for 2018 H1



Source: Bank of Albania

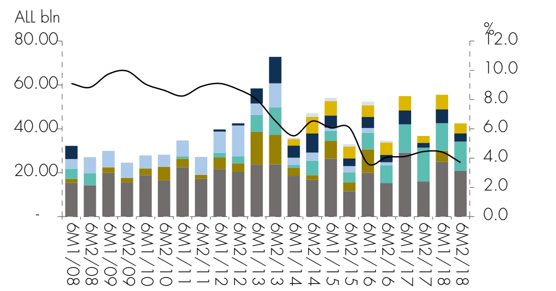
(20) **The average yield on long-term debt securities also declined, although their volume of issuance in annual terms was higher.** Issuance of debt securities in the form of bonds amounted to around ALL 43 billion, or 24% less than in the previous six months, but compared to the same period a year earlier, the volume of issuance was about 16% higher. Around 80% of the issued bonds is composed by 2 to 5-years maturity bonds, at fixed yield rate. In any case, the bid amount was higher than the borrowing demand by the government. As a result, the weighted average bond yield in lek for the second half of the year was 3.7%, almost 0.7 percentage point lower compared to the previous year.

Chart 13. Volume and weighted average yield on T-bills in the primary market



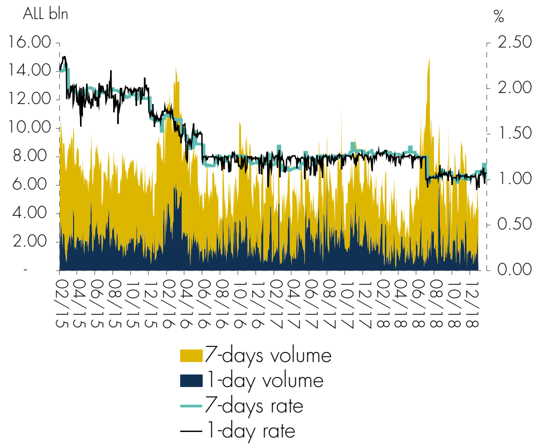
Source: Bank of Albania

Chart 14. Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania

Chart 15. Interest rates in interbank market

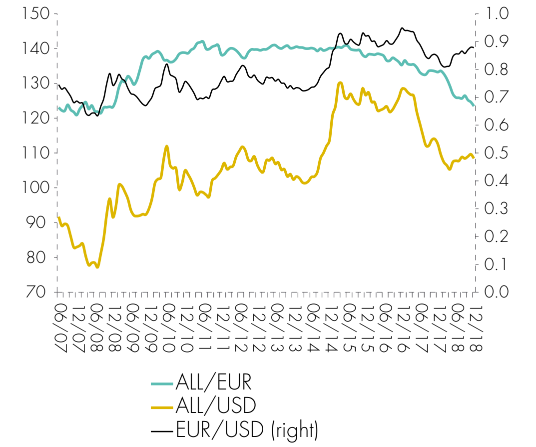


Source: Bank of Albania

INTERBANK MARKET

(21) **During the period, the average volume of transactions in the interbank market increased, while the average interest rates stood close to the Bank of Albania's policy rate.** Thus, the average 1-day borrowing volume increased by 13% compared to the previous six months, while the 7-days transactions volume increased by 62%. Average interest rates for 1-day and 7-days interbank transactions declined to 1.04% and 1.05%, respectively. The 1-month maturity borrowing also declined (by 86%), although this instrument is rarely used and used at lower volumes compared with the short-term borrowing instruments.

Chart 16. Exchange rate in the domestic foreign exchange market



Source: Bank of Albania

FOREIGN EXCHANGE MARKET

(22) **During the period, the appreciation of lek against the euro continued at a slower pace.** This performance reflected Bank of Albania's temporary interventions in the foreign exchange market.[16] At the end of the year, one euro was traded for around 123.4 lek, from around 125.9 lek and 133 lek, at the end of June 2018 and end of 2017, respectively. Against the US dollar, the Albanian lek depreciated reflecting developments in the euro/US dollar international foreign exchange markets. Over the period, in average terms, the lek appreciated by 3.3% against the euro and depreciated by 1.4% against the US dollar. Compared with the previous year, the lek appreciated by 6% against the euro and by 4% against the US dollar.

4.2 REAL ESTATE MARKET

(23) **In the real estate market, the main indicators suggest a positive situation.** Compared to the previous period and the long-term trend in this market, the volume of sales and prices increased. Agents' expectations for the short and long-term future continue to be optimistic, albeit at lower levels compared to the two previous periods. Also, the performance of construction permits, which can be considered as a lead indicator of developments in the real estate market, was positive, given that the number of permits during the second half of the year increased significantly compared to the previous periods.

[16] *In the meeting of 6 June, the Supervisory Council approved the use of interventions in the domestic foreign exchange market and an instrument of the monetary policy.*

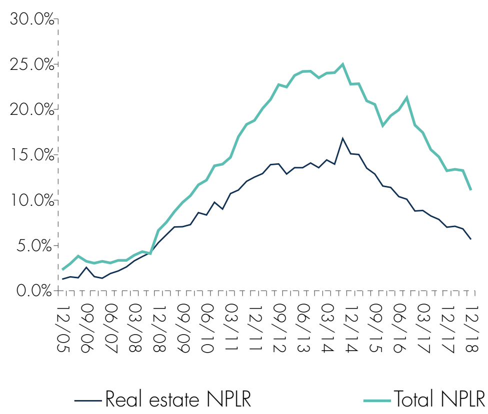
(24) **House prices, calculated according to the Fischer House Price Index, were up by 5% compared to the previous six months and by 15.2% compared with the base period (2013).** The index is built on the basis of data reported by construction companies and agents operating in the real estate market. The Fischer House Price Index for Tirana, which include the centre, suburbs and extra urban areas, increased by 3.8% compared to the previous period and 14.2% compared to the base period.

(25) **The agents' assessment on the overall situation in the real estate market was generally neutral[17],** but the balance of responses, starting from 2017 H2 improved notably compared to the long-term average of this indicator. Also, the net balance on the expected performance of prices was positive, but somewhat lower compared to the previous two periods.

Chart 17. Fischer Index - National level, and Tirana

Source: Bank of Albania

Chart 18. Credit quality for real estate purchase



Source: Bank of Albania

(26) **Direct and indirect activity indicators in the real estate market suggest that supply and demand were generally up during the period.** In the real estate market, demand generally reflects the demographic developments, revenues and financing conditions for purchase or development of real estate, whilst supply is related to the number of construction permits and the number of properties (new and existing) that are offered for sale in any given period. When interpreting the performance of the index, the factors listed below and the possibility that their effect may extend beyond the period under review, should be considered.

17 *This means that the number of respondents who answered "the situation has deteriorated compared to the previous period" is almost the same as the number of respondents who answered "the situation was better".*

a) **From the perspective of demand:**

- data from the banking sector on the period show the level of outstanding loans for real estate purchase decreased during the six months, but the level is higher compared to the previous year;
- interest rates for real estate loans increased slightly during the second half of the year;
- respondents reported that around 54% of residential and commercial properties sold by them are purchased with a bank loan;
- based on the lending survey of the Bank of Albania for 2018 Q4, households' demand for real estate loans increased, while the conditions for approval for this type of loan and this category of borrowers are continued to ease;
- respondents said that the average period needed to sell these properties at country level in the second half of the year, was on average 10.9 months, or around 1 month longer compared with the previous six months; for Tirana and Other Areas, the sales time increased by 1-2 months while for the Coastal Area the selling time reduced by 2.5 months.

b) **From the perspective of supply:**

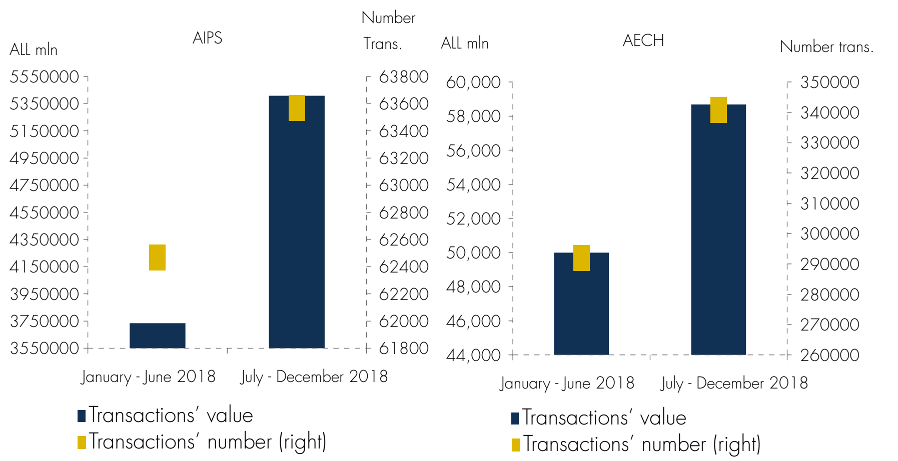
- similar to 2018 H1, INSTAT data show a significant increase in the floor area index and number of construction permits for residential buildings;
- survey results show that sales volume increased only for the suburb of Tirana and declined in other areas, such as the Coastal Area and Other Areas;
- outstanding loan portfolio for construction increased by 8.7% compared with the end of the first half of the year, and by 3.1% compared with the end of the previous year. Loans for construction account for 15% of outstanding loans to enterprises, and this share has increased but remains below the 20% recorded during the 2007-2011 period;
- quality of real estate loans improved and the non-performing loans ratio was down to 5.7% from 6.8% in June 2018, and 7% a year earlier.

4.3 PAYMENT SYSTEMS

(27) **During the period, the core infrastructure for the clearing and settlement of payments in the domestic currency continued to operate effectively and securely, thus supporting the financial stability and the implementation of monetary policy.** In terms of processing activity, in AIPS, 63,569 payments accounting for ALL 5,408 billion were settled/processed during the period. The number and value of transactions increased by 1.8% and 45%, respectively, compared to the first half of the year. In parallel, in the small-value payment

system - AECH, during the period 340.849 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 around 17%).

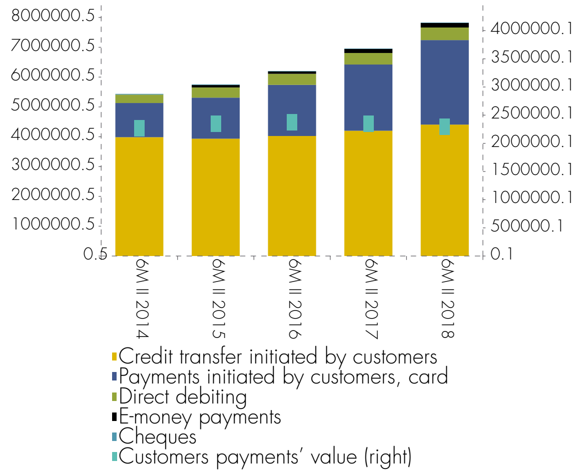
Chart 19. Performance of AIPS (left) and AECH (right)



Source: Bank of Albania

(28) **Regarding payments, the use of electronic payments continues to increase.** Credit transfers continue to dominate the payment instruments, but the share of this instrument decreased reflecting the fall in the volume of instruments in paper form. On the other hand, the non-paper credit transfers (e-banking, mobile banking) increased, also payments by card increased in terms of both volume and value.

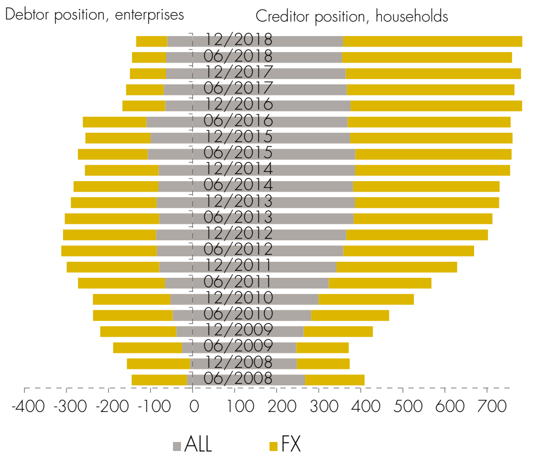
Chart 20. Payment instruments in volume and value



Source: Bank of Albania

5. FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

Chart 21. Financial positions of households and enterprises, in ALL billion



Source: Bank of Albania

(29) During the period, households' creditor position expanded, whereas enterprises' debtor position[18] narrowed. Regarding the household sector, the growth of deposits by 3% was faster than the credit growth by 1.8% and the main contribution to deposit growth was given by the foreign currency.[19] As a result of this performance, the sector's credit position expanded by 3.2%. For the enterprises sector, deposits grew by 4.7% while credit shrank by 0.8%.[20] The contribution of foreign currency was significant as well. As a result, the enterprises' debtor position narrowed by 7.1%.

(30) According to the latest data of 2018, the savings of resident households increased by 1.2% or by ALL 13 billion over the period, but remain All 16 billion lower compared to the end of 2017. Deposits in lek and foreign currency account for over 80% of households' total savings, while investments in bonds, treasury bills and in investment funds account for 6.9%, 5.3% and 5.1% respectively, of total financial assets of households. During the period, households increased their investments in deposits (mainly in the form of foreign currency deposits), while investment in treasury bills and investments funds fell slightly in nominal terms (by 8% and 10%, respectively) and in share against the investment structure.

Table 3 Households' assets in the financial system, ALL billion

	2016, Dec.		2017, Jun.		2017, Dec.		2018, Jun.		2018, Dec.	
	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	456.7	41.1	462.8	41.2
FX deposits	476.4	42.3	432.8	39.2	469.5	41.2	447.1	40.3	464.6	41.4
T-Bills	65.2	5.8	67.3	6.1	63.6	5.6	65.1	5.9	59.4	5.3
Bonds	64.5	5.7	67.9	6.1	72.1	6.3	77.4	7	77.1	6.9
Investmets funds	65.4	5.8	70.8	6.4	65.1	5.7	62.5	5.6	57.3	5.1
Supplem. private pension funds	1.2	0.1	1.3	0.1	1.6	0.1	1.8	0.2	2.1	0.2
Households' portfolio	1,127.00	100	1,105.20	100	1,139.10	100	1,110.60	100	1,123.30	100

Source: Bank of Albania, Albanian Financial Supervisory Authority.

[18] This analysis is based only on data on deposits and loans to businesses and households in the banking sector.

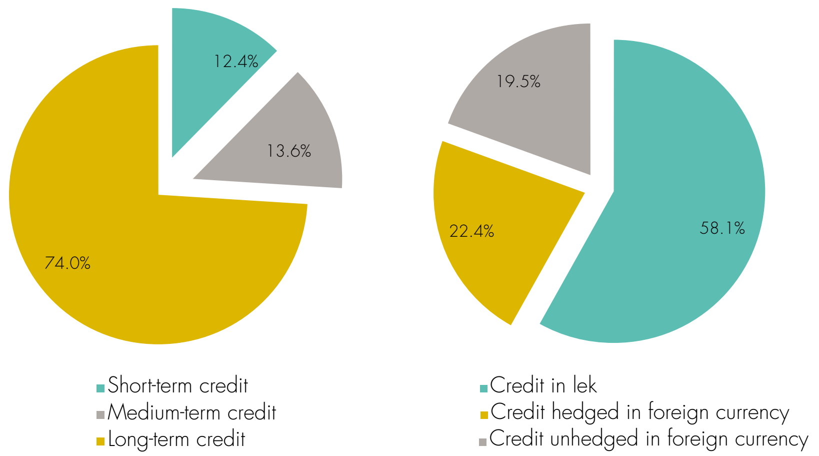
[19] Also, annual developments are in the same direction, but this time due to faster credit growth by 3.9% against deposits growth by 1.0%. Domestic currency gave the main contribution to credit growth.

[20] Even in this case, annual developments remained in the same direction, where deposits growth by 5.4%, was accompanied by the decrease of credit by about 2.0%

5.1. LENDING TO HOUSEHOLDS[21] AND CREDIT RISK

(31) **Credit to households grew by 1.8% during the period.**[22] The growth was due to growth of lek loans to households, which also led to an increase in the share of credit in lek in the overall credit structure.[23] Within credit in foreign currency, the share of unhedged foreign currency credit to total outstanding credit in foreign currency to households fell to 46.5%, from about 52% in the first half of the previous year.

Chart 22. Structure of credit to households by maturity (left) and currency (right)



Source: Bank of Albania

(32) **The portfolio quality of loans to households improved throughout 2018, mainly owing to the credit in lek.** During the period, the ratio of non-performing loans fell by 1.2 percentage points to 6.4%.[24] For portfolio in lek, the ratio of non-performing loans fell by 1 percentage point to 5.5%, whilst the ratio of non-performing loans in foreign currency was 8.8%, with no significant changes during the year. In the foreign currency portfolio, the quality of the unhedged loan portfolio against exchange rate risk improved considerably.[25] The increase in loan collection continues to give the main contribution to the decline of non-performing loans to households.

[21] *The analysis of the structure of credit by term and currency refers only to resident households.*
[22] *Only for resident households, the increase was 1.7%. In annual terms, credit growth for households was about 3.8% and for resident households was 3.5%.*
[23] *The share of credit in lek reached 65.5%, 1.2 and 6.2 percentage points higher than in June 2018 and December 2017, respectively.*
[24] *Improvement in the ratio of non-performing loans to households continues since June 2015.*
[25] *The ratio of non-performing loans to unhedged foreign currency loans decreased to 8.7%, from 10.7% in June 2018 and 9.8% in December 2017.*

BOX 5.1: SURVEY RESULTS ON HOUSEHOLDS' FINANCIAL AND BORROWING SITUATION

The survey of households' financial and borrowing situation is conducted half-yearly. It is based on a randomly selected sample of 1210 households, of which 54% live in urban areas and 46% in rural areas.

During the period, the total number of those employed, among the surveyed sample, increased compared with the previous six months and the previous year. *In annual terms, this increase was due to the increase of the number of those employed in the private sector and the increase in the number of self-employed, while the number of those employed in the public sector decreased during the year.*

The overall level of income and expenditure of households has increased*. Revenue growth was somewhat higher compared to spending, improving slightly the financial balance (income-expense) of households.*

About 26% of households' state they have a loan to pay. *This percentage is 2 percentage points lower than in the previous six months and a year earlier, remaining below the historical average. In these households, income and expenditure decreased during the period.*

Total reported outstanding credit was down compared to both the previous survey, and the previous year. *Around 70% is provided by formal sources and 30% by informal sources. This structure reflects the significant decrease of "formal loans", compared with both a half-year and a year earlier. The change may be mainly statistical, emphasised by the revision of the sample of interviewed households.* [26]

By currency, around 86% of loans is denominated in lek and 14% in euro. *By purpose of use, around 27% of outstanding credit is reported for the purchase / renovation of a property, 44% for a business development and only 9% for consumption. During the surveyed period, the share of loans for the purchase/ renovation of a property decreased, while the share for 'business development' and 'consumption' it increased.*

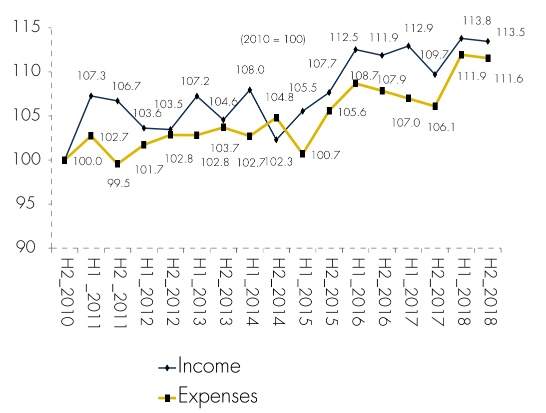
Borrowing households report that the loan instalment over the referring period, fell, reflecting the downward trend of the weighted interest rate on household loans. *Around 59% of borrowing households state that their "repayment" capacity has not changed, while the rest declare improvement compared to the previous six months and the previous year. For 2019 H1, most borrowing households (around 80%) do not expect their repayment capacity to change, while the net balance of the rest of the respondents indicates a slight deterioration.*

The possibility to borrow during 2019 H1 ***is estimated as downward compared with the previous six months and the previous year****, which testifies for a still-unsustainable demand from households for borrowing.*

[26] *As part of the regular revision of the interviewed sample, about 20% of sample households were changed by INSTAT for this survey.*

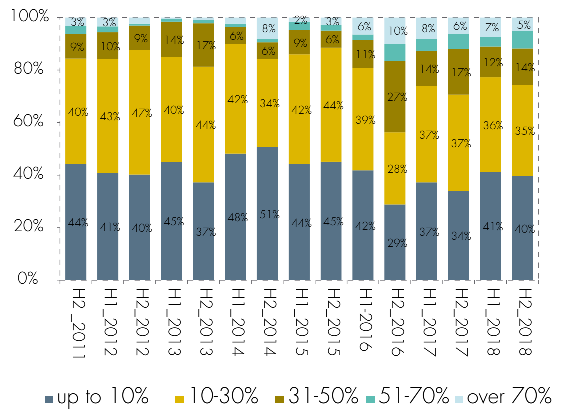
(33) **The households' debt burden remains at relatively adequate levels, and has trended downward.** Based on the survey of the households' financial and borrowing situation for the period, around 26% of Albanian households have at least one debt to pay, as at the end of 2018 H2. This value has decreased compared with the previous two periods, and is 3 percentage points below the historical average (since 2010). The analysis of the households' level of income and expenditures reveals that income and expenditures decreased during the period, almost at the same level.

Chart 23. Income and expenses of borrowing households



Source: Bank of Albania

Chart 24. Borrowing according to the "Loan instalment / Total monthly income" ratio



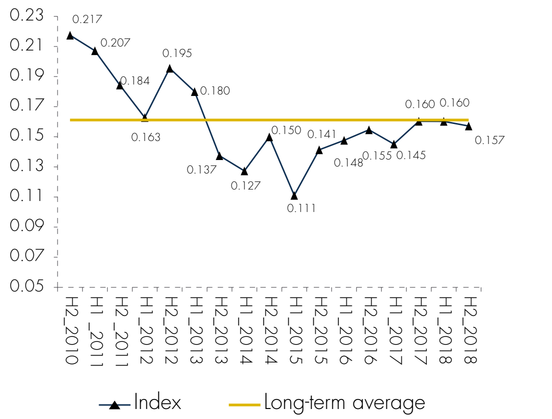
Source: Bank of Albania

(34) **During the period, borrowing shifted in favour of the higher ratios of "loan instalments / monthly household income".** The ratio of repayment to total income results "up to 10%" for 40% of borrowing households, "10-30%" for 35% of households and "over 30%" of income for 26% of households (down by 6 percentage points compared to the first half of the year).

(35) **Households' credit demand remains moderate.** According to the survey, around 63% of the respondents state that they "do not expect to take a new loan in the next six months", and this has increased compared with the previous six months. The index for the possibility of a new loan was 0.157[27], slightly down compared to the value in the previous survey and the previous year, remaining below the historical average. Among households planning to take a new loan, the share of new borrowers (with no debt burden) increased slightly, to 59%.

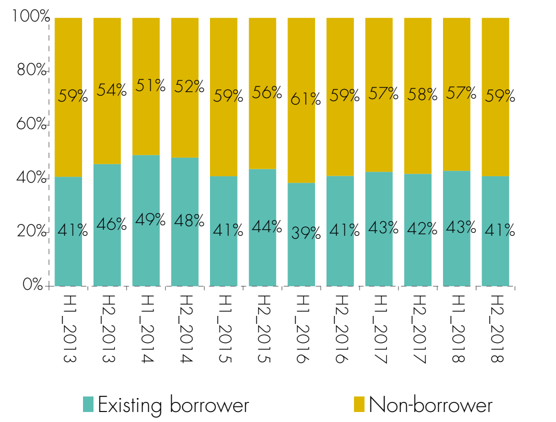
[27] *The index is calculated as weighted average of % of responses for each alternative with relevant coefficient. On the definition of the coefficients, the interval 0-1 is separated in sub-intervals with equal length of 0.33. The criteria for each alternative are: 0 ('not likely'), 0.33 ('somewhat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

Chart 25. Index of taking/retaking a loan in the next six months (Sample total)



Source: Bank of Albania

Chart 26. Households that plan to take a loan in the next six months

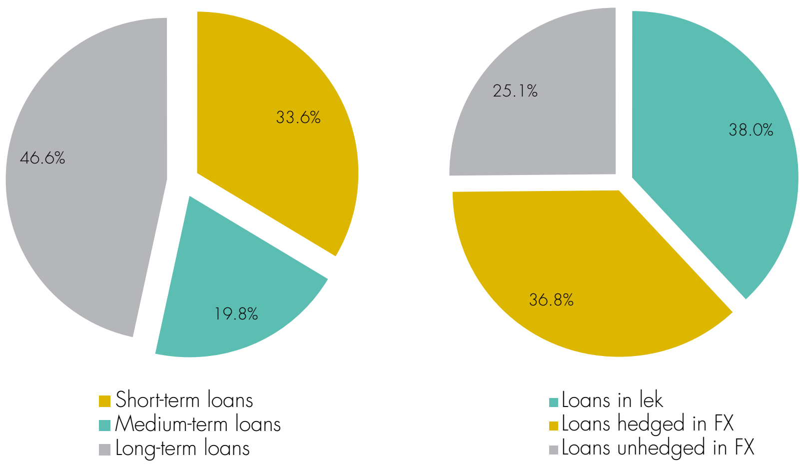


Source: Bank of Albania

5.2. LOANS TO ENTERPRISES[28] AND CREDIT RISK

(36) **During the second half of the year, outstanding loans to enterprises narrowed, mostly driven by credit to resident enterprises.** The share of foreign currency loans continues to fluctuate around 62%, unchanged during the period, whilst the share of unhedged credit from unfavourable exchange rate fluctuations to total loans to enterprises increased to 25%.[29] In the structure of loans to enterprises according to the maturity term, short and medium-term loans increased slightly,

Chart 27. Structure of loans to enterprises by maturity (left) and currency (right)



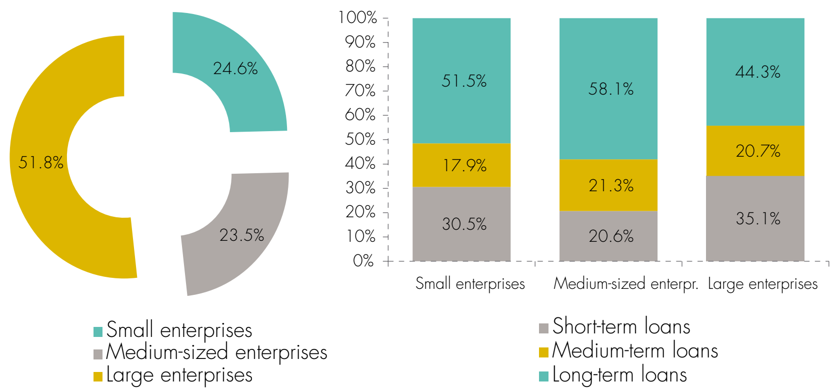
Source: Bank of Albania

28 Analysis of the structure of credit by term and currency, refers only to resident enterprises.
29 Its share in June 2018 and December 2017, accounted for 23.8% and 24.7% of total credit to enterprises, respectively.

but long-term loans decreased.[30] The outstanding loan to resident enterprises[31] during the period shrank by ALL 3.1 billion (or by 1%), down to ALL 318 billion. The contraction of outstanding loans for "real estate" and "working capital" was the main contributor to this performance. By currency, the main contributor to the narrowing of outstanding loans for resident enterprises during the period was the credit contraction in lek by about ALL 1.8 billion (or 1.4%), followed by credit in US dollars, contracted by ALL 1.3 billion (or 6%).

(37) During 2018, the share of credit to small and medium-sized enterprises increased. Share of credit for these two categories were up by 24.6% and 23.5% of total loans to enterprises, while the share of credit to large enterprises fell to 51.8%[32]. During the period, the share of medium-term loans increased for all enterprises, and this phenomenon was more pronounced for medium-sized enterprises.[33] The credit in lek increased for the medium-sized and large enterprises, whilst the share of credit in foreign currency increased for the small enterprises.[34]

Chart 28. Structure of loans to enterprises by size and term



Source: Bank of Albania

(38) The portfolio quality for loans to enterprises improved in all its components, over the period and in annual terms. As at December 2018, the non-performing loans ratio (NPLR) fell to 14.3% from 17.1% and 16.9%, in June 2018 and December 2017, respectively.

30 *Short-term and medium-term loans grew to 31.6% and 19.8% during the period, respectively 2.2 pp and 1.2 p.p higher than the previous six months; while long-term loans fell by 3.4 pp, down to 46.6%.*

31 *It accounts for about 62% of the loan to resident entities.*

32 *These values were respectively: 55.5% (large enterprises); 22.8% (medium-sized enterprises) and 21.7% (small enterprises) in December 2017, while in June 2018 they were: 52.7%, 22.9% and 24.4% respectively.*

33 *In annual terms, for all three categories of enterprises the long-term loans increased and the short-term loans decreased.*

34 *In annual terms, for all three categories of enterprises, the share of foreign currency loans increased, against domestic currency loans, notably for large enterprises.*

BOX 5.2: 4.1 SURVEY RESULTS ON THE FINANCIAL AND BORROWING SITUATION OF ENTERPRISES

The half-yearly survey of financial and borrowing situation of enterprises has been carried out since 2010. Starting from 2016 H1, this survey was launched with a sample of about 1200 enterprises of all sizes across the country, operating in the main sectors of the economy.

*During the first half of the year, enterprises report that issues related to **access to finance** and **financing costs** are assessed upward for medium-sized enterprises, but reduced for small and large enterprises.*

***Competition** and **finding a market** continue to be considered as the main challenges for enterprises activity. During the period, the importance of competition is assessed somewhat upward for medium-sized enterprises, but downward for small and large enterprises, while issues related to finding a market are assessed as reduced.*

***Performance of sales** is assessed upward during 2018 H2, for medium-sized and large enterprises, and downward for small enterprises, but it has improved compared to the previous period. In line with the sales performance, small enterprises continue to assess the **financial result** as downward, while medium-sized and large enterprises assessed it as increased during the period. The positive performance of the sales level and the financial result was also reflected in the **expansion of the activity** of both medium-sized and large enterprises, while small-enterprises did not report expansion of their activity during the period. Expectations for enterprises of all sizes are positive regarding sales, financial result and expansion of the activity, but they appear less optimistic compared to 2018 H1, in particular small enterprises.*

*Over the period, **more than half of total respondent enterprises have financed their activity through sales.** Borrowing as a separate or combined source was used by 19.4% of large enterprises, 17.8% of medium-sized enterprises and 14% of small enterprises. About 42.2% of the total enterprises (464 enterprises in total) state they have a **loan to repay**. This share has been slightly downward compared to 2018 H1 for large and medium-sized enterprises, and upward by 2.8 percentage points for small enterprises. About 85.4% of the total borrowing enterprises claim to have applied to banks for loans. This share fell by 3 p.p. in half-yearly terms and by 6 p.p. in annual terms. In the total of formal sources, the share of borrowing enterprises reaches at 90.5% (banks and non-bank financial institutions), unchanged from the previous period.*

*About 75% of small, 78.9% of medium-sized and 79.7% of the large enterprises consider their **borrowing level to be adequate** for financing the activity. Compared to 2018 H1, this share is higher for all sizes of enterprises.*

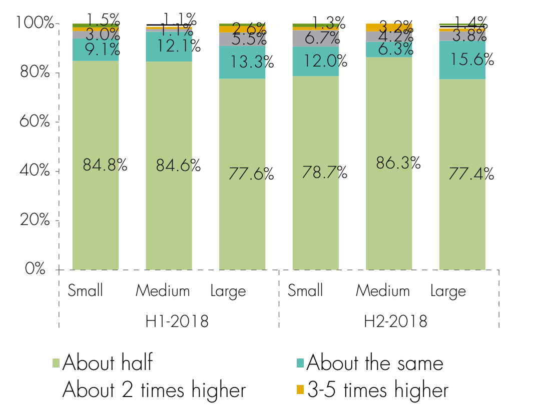
*By currency, over the period, 46% of small enterprises, 49.3% of medium-sized enterprises and 35.7% of large enterprises declare that their borrowing is **only in domestic currency**, while the rest in foreign currency (euro and/or US dollar). Borrowing in the **European currency** has a greater share for large enterprises (53% of them), outperforming domestic currency, and less for medium-sized enterprises (41.3%). The shares of enterprises borrowing in both lek and euro, for small enterprises, resulted almost equal.*

***New borrowing** during the period is declared by 10.7% of small enterprises, 6.5% of medium-sized enterprises and 8.9% of large enterprises. The share of new borrower increased for small enterprises, both in half-yearly and annual terms. Meanwhile, the share was downward for medium-sized and large enterprises.*

***The bank borrowing process** is rated between "normal" and "difficult" by the banks, while the **importance of the relationship with bank**s is rated between "important" and "necessary", and upward during the period, for all groups of enterprises (small, medium-sized and large enterprises).*

(39) **Enterprises debt burden was slightly down over the period, and is estimated as affordable by enterprises.** According to the survey on the financial and borrowing situation of enterprises, around 42.2% of surveyed enterprises state they have a loan to repay. This ratio is slightly down by 1.3 percentage points compared to the previous period. The share of borrowing enterprises is higher in the trade sector (56.1%) and construction (45.3%), but these shares have declined compared to the previous period. The total value of the loan results roughly half of the enterprise's capital value for 79.5% of borrowing enterprises. The debt burden is higher for large enterprises. Around 22.6% of them state that the value of the loan is equal to or greater than the capital value. The analysis of the responses, by sector, shows that the trade sector has the highest share of enterprises that have a loan burden larger than their capital value, followed by the industry sector.

Chart 29 Distribution of enterprises and loan /capital ratio



Source: Bank of Albania

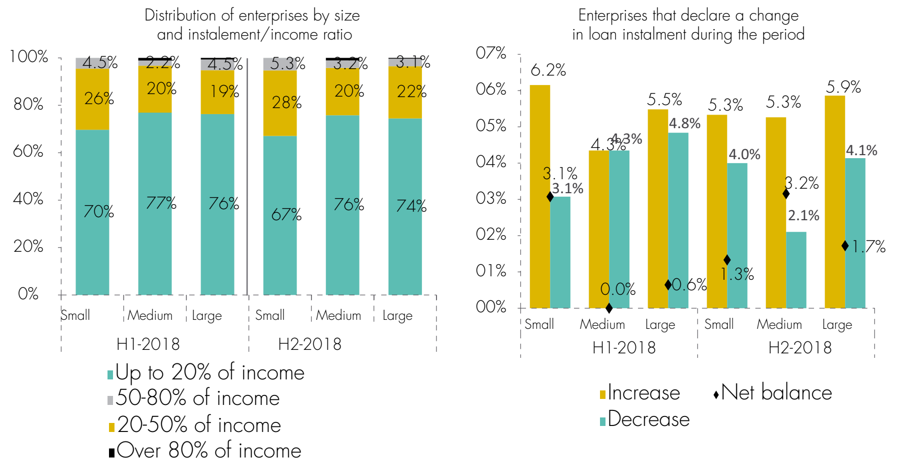
Table 4 Share of enterprises with higher loan value than equity: by sectors

	Industry	Services	Construction	Trade
H2 2016	11.0%	7.0%	8.0%	9.0%
H1 2017	7.9%	15.7%	5.8%	13.1%
H2 2017	10.2%	11.9%	7.3%	8.3%
H1 2018	10.3%	6.3%	4.3%	6.7%
H2 2018	7.7%	5.0%	6.3%	10.2%

(40) **Most of the borrowing enterprises (73.5%) state that the loan payment amounts goes up to 20% of the enterprise's revenue and this share has decreased by 1.8 percentage points compared to 2018 H1**. The burden of loan payments is heavier for small enterprises. Among them, the number of enterprises reporting that this payment exceeds 20% of revenues accounts for

about 33% of the total of the group[35]. For medium-sized enterprises, this share is 24%, while for the large ones 25.5%.

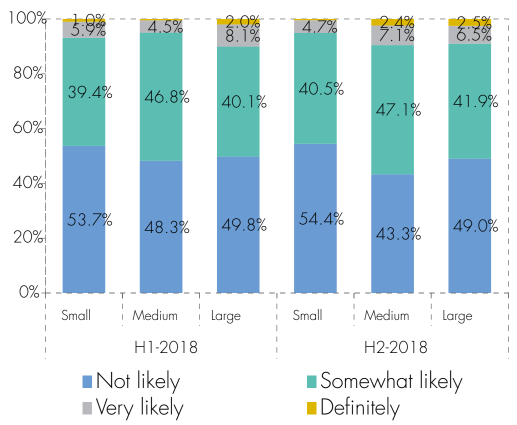
Chart 30 Distribution of Enterprises and Payment report (left) and Relevant Changes (right)



Source: Bank of Albania

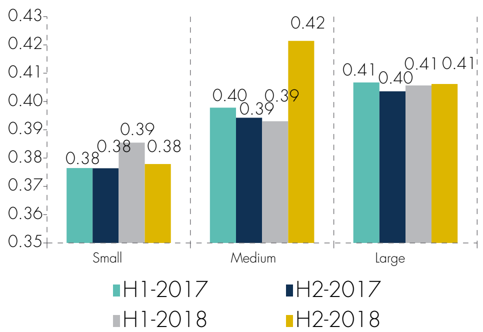
(41) The enterprises credit demand remains moderated. Around 49% of enterprises stated that there is no chance of borrowing a new loan in the next six months. This share resulted in decline for medium-sized and large enterprises, and slightly up for small enterprises.

Chart 31 Distribution of Enterprises by loan planning



Source: Bank of Albania

Chart 32 Loan planning and the relevant index



Note: The index is calculated by weighting the share of enterprises' responses against total responses according to a coefficent, which increases with the likelyhood of borrowing. Coefficent for the alternative "not likely" =0.25, "somewhat likely" = 0.5, "very likely" = 0.75, "definitely" = 1.
Source: Bank of Albania

(42) The index of planning to borrow in the next six months, compared to the previous period has fallen for small enterprises; and has remained unchanged for large enterprises. On the other hand, this index increased notably for medium-sized enterprises, by showing that, compared to small and large enterprises, medium-sized enterprises are more inclined to borrow during 2019 H1.

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

6. FINANCIAL SYSTEM

(43) **Banks continue to dominate the structure of the financial system[36]. The share of total assets of the financial system in Gross Domestic Product (GDP) fell at 107.6% at the end of 2018 Q3, from 110.3% at the end of 2017.** The fall was driven by the higher growth of GDP compared to the growth of the financial system's assets. The share of banking sector fell at 96.8%, from 99.4% at the end of 2017; the share of non-bank financial institutions increased slightly at 3.3%, from 3.1%; while the activity of investment funds contracted and their share fell at 4.5%, from 5%.

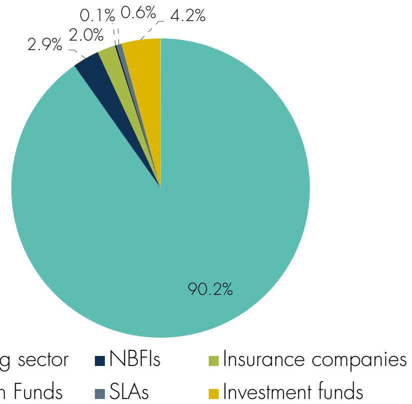
Table 5 Share of segments of the financial system to GDP over the years

Liccencing 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 Supervision Authority.

(44) **The activity of the banking and non-banking sector in terms of the financial system performance appears stable.** All segments of the system recorded a growth of the activity, except investment funds. The performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels.

Chart 33 Share of financial system segments/total assets of the financial system, December 2018



Source: Bank of Albania, Albanian Financial Supervision Authority

[36] *Balance sheets of the banking sector, investment funds and savings and loan associations, as at end 2018. For the other segments of the financial system, (non-banks, insurance companies and pension funds), the balance sheets belong to 2018 Q3, according to the reporting to the Bank of Albania and to the Albanian Financial Supervision Authority. The GDP value corresponds to September 2018, the latest value published by INSTAT, as at the time of the preparation of this Report.*

Table 6 Main indicators of the banking system's financial soundness

In per cent	2010	2011	2012	2013	2014	2015	2016	2017	2018
Capital-based indicators									
Regulatory capital to risk-weighted assets	15.40	15.56	16.17	17.96	16.84	15.72	16.01	17.03	18.24
Tier 1 capital to risk-weighted assets	14.52	14.30	14.57	14.88	13.79	13.45	14.10	15.53	16.99
Shareholders equity to total assets	9.40	8.69	8.57	8.37	8.58	9.53	9.73	10.17	10.15
Asset quality									
Net NPLs to regulatory capital	35.95	52.01	55.62	40.22	38.25	24.28	23.08	15.72	15.51
NPLs (gross) to total loans	13.96	18.77	22.49	23.49	22.80	18.22	18.27	13.23	11.08
Profitability									
ROE (annual basis)	7.58	0.76	3.78	6.43	10.53	13.16	7.15	15.71	12.96
ROA (annual basis)	0.72	0.07	0.33	0.54	0.89	1.20	0.69	1.54	1.32
FX net open position to captial									
FX net open position to regulatory capital	5.03	3.94	3.98	4.08	8.49	7.66	7.03	6.68	7.78
FX net open position to Tier 1 capital	5.33	4.29	4.41	4.92	10.37	8.95	8.00	7.34	8.35
Asset-based indicators									
Liquid assets to total assets	25.95	26.53	29.37	27.64	31.94	32.26	31.29	30.22	34.23
Liquid assets to sh.t. liabilities (up to 1 year)	30.62	33.15	36.71	34.71	40.36	41.43	40.57	40.79	46.21
Client deposits to total loans	166.39	163.20	171.62	180.83	180.16	187.78	192.84	194.00	203.25

Source: Bank of Albania.

6.1. BANKING SECTOR

(45) **During the period, banking sector's assets expanded by 1.9%; meanwhile changes in the balance-sheet structure were insignificant.** The reported value of total assets increased by ALL 27 billion during the period, reaching at ALL 1,453 billion, mainly driven by the expansion by about ALL 17 billion in the item of investment in securities and the fall by around ALL 9 billion in the credit risk provision fund. The slowdown in credit growth is reflected in a low and negative contribution of "customer transactions" in the half-yearly and annual change of the total assets of the sector. The annual growth pace of assets slowed down at 0.6%, from 2.7% a year earlier.

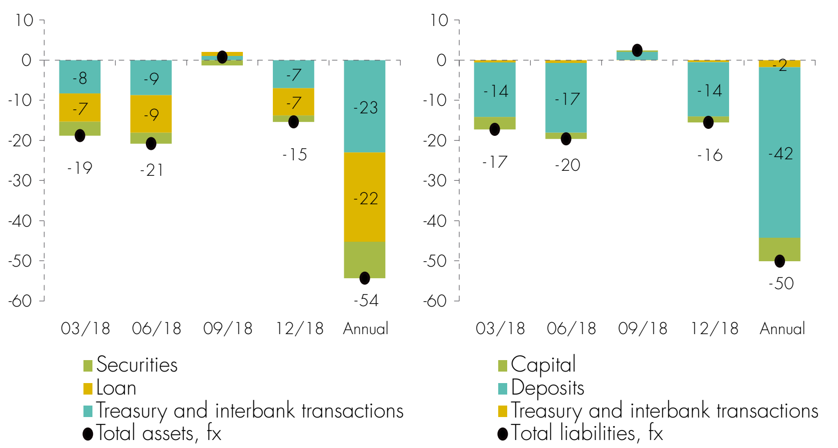
Table 7 Structure of banks' balance sheet and annual change, December 2018

Asset	% of assets	Annual change, %	Liability	% of liability	Annual change, %
I. Treasury and interbank transactions	32.6	-1.8	I. Treasury and interbank transactions	5.5	3.8
II. Customer transactions (credit)	39.8	-3.3	II. Customer transactions (deposits)	81.0	1.2
Of which: public sector	1.9	-26.1	Of which: public sector	1.9	-0.7
Of which: private sector	38	-1.8	Of which: private sector	79.4	1.3
III. Securities transactions	26.5	7.8	III. Securities transactions	0.5	-10.1
IV. Created Reserve funds	-3.0	-25.3	IV. Other liabilities	1.3	-3.4
V. Other*	4.1	-9.3	V. Permanent sources	11.8	-4.3
			of which: Subordinated debt	1.0	-36.9
			of which: Shareholders' equity	10.1	0.6
Total assets	100	0.6	Total liabilities	100	0.6

** "Other" in the balance sheet refers to "Other assets", "Fixed assets" and "Accrued interests"*
Source: Bank of Albania.

(46) **The appreciation of lek exchange rate against the main foreign currencies provided an important diminishing contribution to the performance of the reported value of banking sector's assets.** At the end of the period, banking sector's assets in foreign currency account for around 55% of total assets; liabilities in foreign currency account for 53% of total assets. These shares show slight changes from the previous periods. Based on the values of these shares by periods, the impact of lek's exchange rate appreciation, during 2018, has been calculated for the main items in the banking sector's balance sheet. On the asset side, the most important impact is recorded for: Treasury and interbank transactions (ALL -23 billion) and Customer transactions (credit) (ALL -22 billion); on the liability side, almost the entire diminishing impact from the exchange rate is reflected in the performance of deposits denominated in foreign currency (ALL-42 billion); while the impact on the capital in foreign currency of the banking sector was lower (ALL-6 billion). This impact of the exchange rate should be taken into account when analysing the banking sector indicators in the future.

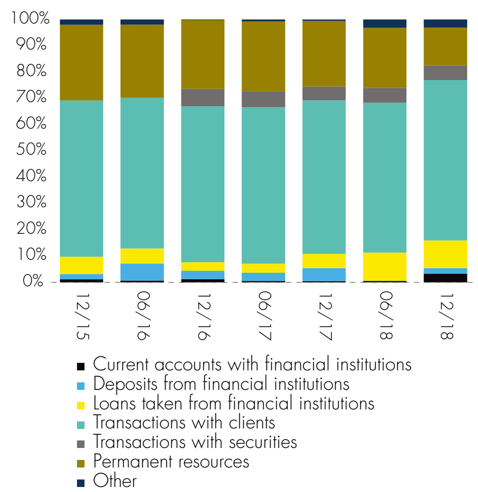
Chart 34 Exchange rate effect in lek equivalent on key items of assets (left) and liabilities (right)



Source: Bank of Albania

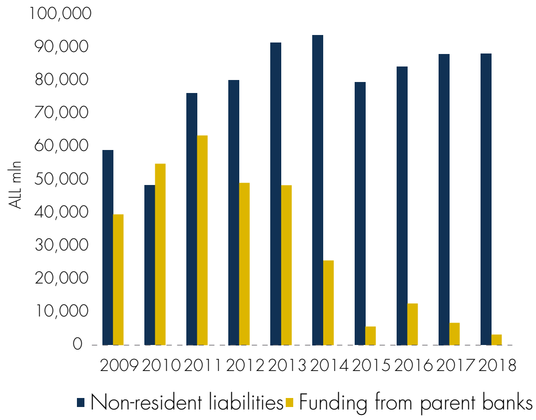
(47) **Deposits and own funds are the main financing sources of the activity of the banking sector; meanwhile, reliance on external financing sources remains limited.** Nevertheless, liabilities to non-residents, in the form of current accounts of non-resident financial institutions and deposits placed by non-residents at domestic banks, expanded. These developments have narrowed the net credit positions of the banking sector.

Chart 35 Structure of non-resident liabilities



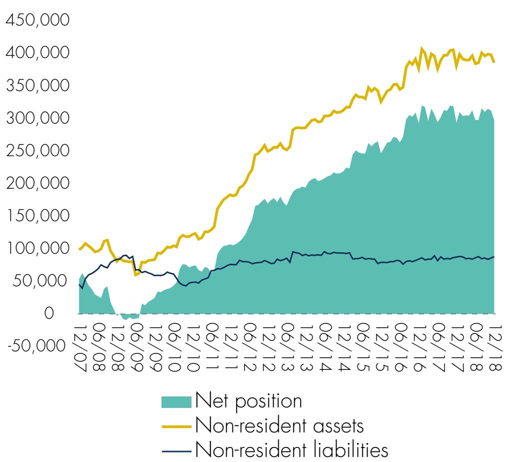
Source: Bank of Albania

Chart 36 Foreign financing



Source: Bank of Albania

Chart 37 Assets and liabilities to non-residents



Source: Bank of Albania

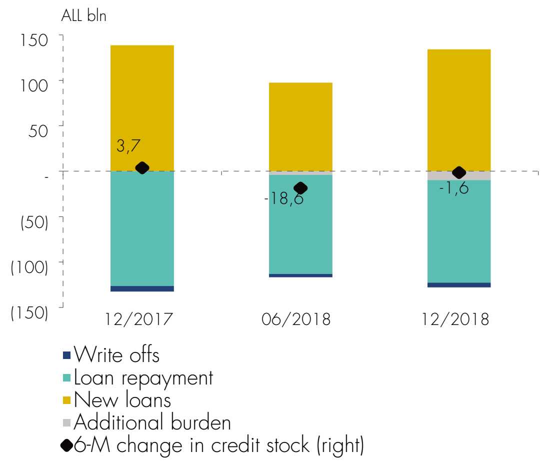
(48) **Claims to non-residents accounted for 27% of total assets, while liabilities to non-residents accounted for 6% of balance sheet total.** In the last two years, the share of claims and liabilities to non-residents has maintained relatively stable levels and the net credit position of the banking sector has remained unchanged, around ALL 300 billion. Interbank transactions and Securities transactions issued by non-resident entities dominate the claims to non-residents; meanwhile, liabilities to non-residents are mainly in the form of customer transactions (deposits) and permanent sources (capital).

6.1.1 LOANS

(49) **At the end of 2018, the outstanding loans were ALL 581 billion, standing ALL 1.6 billion or 0.3% lower than at the end of 2018 H1, and around ALL 20 billion or 3.4% lower than in 2017 H2.** Albeit new loans were higher than in 2018 H1, the performance of outstanding loans reflected the high level of loan repayments, which, during the period, reached at around ALL 120 billion. During the period, banks have written off

from their balance sheet in total around ALL 5 billion loans classified as "lost". If written off loans were included in the portfolio of banking loans, then the outstanding loans would have increased by 0.5% during the period.

Chart 38 Change in outstanding loans by element (new loans, loan repayments written off loans)



Source: Bank of Albania

(50) Loans to enterprises declined by 1.4%, or around ALL 5 billion, and provided the main contribution to the decline of loans, during the period. The fall in outstanding loans to enterprises is registered in loans both in foreign currency and in lek. Loans to households grew by 1.8%. This performance changed the loans' structure by sector, in favour of loans to households. At the end of the period, loans to enterprises were around ALL 370 billion, accounting for 63% of outstanding loans of the banking sector, from 64% a year earlier, and 70% at the end of 2014[37]. In annual terms, the reported value of loans shrank by 3.4%. In addition to the negative contribution by loans to enterprises, outstanding loans were also affected negatively by the performance of loans to the public sector, which, at the end of year, were 26% lower compared to the previous year[38].

Table 8 Data on main categories of loans

	Indicator and unit	Value (ALL billion)	Share in total loans (%)			Change (%)	
	Period	12/2018	12/2017	06/2018	12/2018	Annual	6-M
By currency	Lek loans	255	44	44	44	-2,5	0,6
	Foreign currency loans	326	56	56	56	-4	-1
By institution	Public sector	28	6	5	5	-26	1,3
	Enterprises	368	64	64	63	-4,4	-1,4
	Individuals	185	30	31	32	3,8	1,8
By maturity	Short-term	166	31	29	29	-11	-3,1
	Medium-term	111	18	18	19	1	3,6
	Long-term	304	51	52	52	-0,3	0
	Outstanding loans	581	100	100	100	-3,4	-0,3

Source: Bank of Albania.

(51) The structure of loans to enterprises has changed over the last two years. Hence, loans for working capital contracted, both in lek and in foreign currency. As a result, the share of loans for working capital in outstanding loans to enterprises fell at 14%, from 18% at the end of 2016. Loans for equipment purchase sharing around 1/3 of loans to enterprises grew for the domestic currency, but fell sharply for the foreign currency-denominated portfolio.

[37] *Outstanding loans to enterprises, at the end of 2018, were around 13% lower than the highest value registered during the last 5 years; while loans to households were 23% higher than the one registered 5 years ago.*

[38] *The repayment of a bank loan by the Albanian Electro Energy Corporation, after its financing by a loan granted from the European Bank of Reconstruction and Development, provided an important impact on the fall of outstanding loans to public sector and on the overall annual performance of banking loans.*

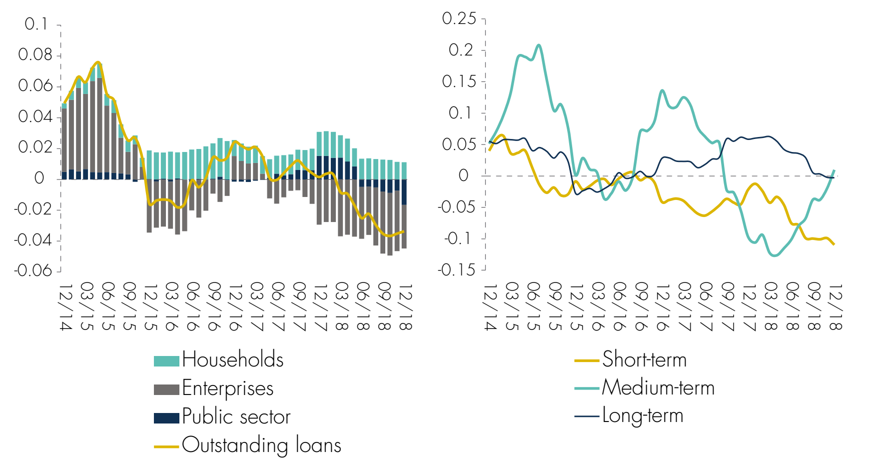
The share of loans for real estate purchase in the outstanding loans to enterprises has remained unchanged (around 25%) in the last two years; meanwhile, the share in lek of this portfolio has dropped by around 15%, and the share in foreign currency has remained almost unchanged throughout this period.

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

Source: Bank of Albania

(52) Loans to resident households (sharing 93% of loans to households) grew 1.7%, providing thus the main contribution to the performance of loans to households. Both loans for real estate, sharing around 65% of outstanding loans to resident households, and consumer loans, sharing 13% of loans to households, recorded faster growth. Outstanding loans for real estate grew by around 2% and reached ALL 110 billion. By currency, growth is affected by the contribution of loans in lek. Foreign currency loans to households were 6% lower compared to 2017 H2, and 2% lower compared to 2018 H1. The loans portfolio expanded (by around 4%) also for non-resident households.

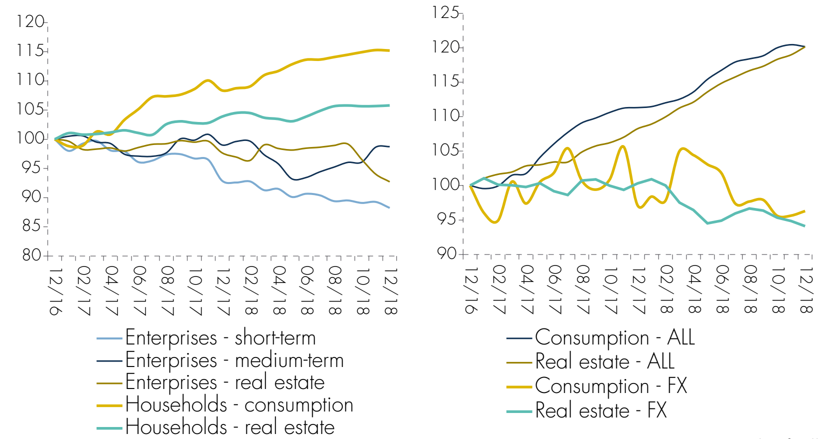
Chart 40 Loans by sector, contribution in percentage points (left) and loans by maturity, annual changes (right)



Source: Bank of Albania

(53) **By maturity, medium-term loans grew, short-term loans fell, while long-term loans did not change, during the period.** The contraction in short-term loans was conditioned by the fall in loans for working capital and overdrafts to enterprises, which share around 30% of the overall outstanding loans to the private sector[39]. Medium-term loans to enterprises, sharing around 20% of outstanding loans increased during the period, approaching the level of the previous year. Loans to enterprises for real estate fell by around 6% during the period.

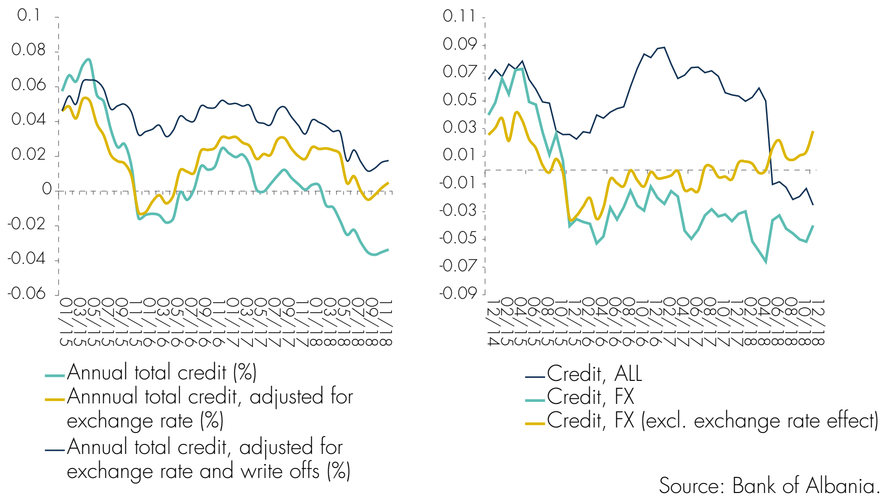
Chart 41 Loans by sector and purpose of use (left), and of loans to households by purpose of use and currency (right) (index, December 2016 = 100)



Source: Bank of Albania.

(54) **Excluding the exchange rate appreciation and the written off loans during the year, the total outstanding loans would have grown by 1.8% in annual terms, against the reported contraction by 3.4%.** Over the last 12 months, ALL 7.6 billion loans have been written off from the banking sector's balance sheet (of which, ALL 6.4 billion represented lost loans to enterprises).

Chart 42 Total loans excluding the effect of the exchange rate and write offs (left), Loans in FX excluding the exchange rate effect (right) (annual changes, in %)



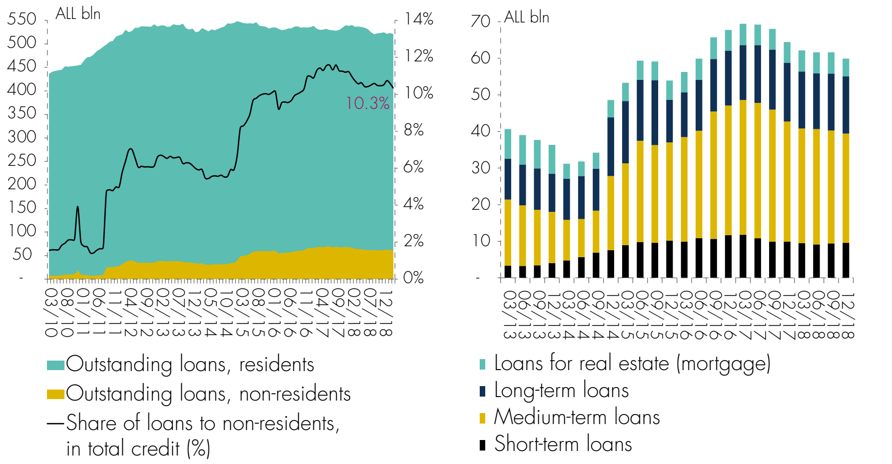
Source: Bank of Albania.

[39] *Enterprises and households.*

If written off loans were included in total loans, then the annual contraction of loans would be 2.1% (from 3.4%). Due to the share of foreign currency loans in total loans, exchange rate volatility[40] affects the outstanding loans value. As a result, movements in the exchange rate are assessed to have provided a negative effect on the reported value of foreign currency loans, by around ALL 23 billion, in annual terms (EUR: - ALL 22 billion and USD: - ALL 1 billion). Excluding this effect, foreign currency loans would have expanded by 2.8% compared to a year earlier, against the reported contraction of around 4%.

(55) **During the period, loans to non-resident entities and their share in total loans were downward.** At the end of 2018, loans to non-residents were around ALL 60 billion, accounting for 10% of outstanding loans of the banking sector, from 11% a year earlier. During the period, loans to non-residents fell by 2.8%, providing the main contribution to the performance of outstanding loans. Loans to non-residents fell by 7%, compared with the previous year, mainly driven by the fall in loans to non-resident enterprises by 11%. Loans in euro dominate the loans to non-residents. Overall, loans to non-residents have long-term maturities, (over 12 months), with the medium-term loans having the main share in outstanding loans to non-residents.

Chart 43 Loans to residents and non-residents (left); loans to non-residents by maturity (right)



Source: Bank of Albania.

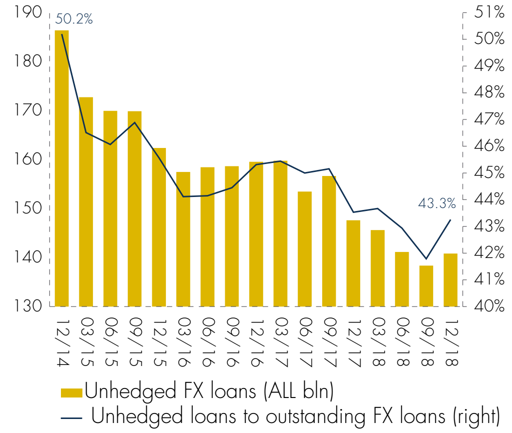
(56) **Unhedged foreign currency loans fell slightly during the period, and 4.6% in annual terms.** The decline of these loans in annual terms reflects the fall of unhedged loans to enterprises and the fall of unhedged loans in euro. In 2018 H2, unhedged loans to households fell by 11%; meanwhile, unhedged loans to enterprises grew by around 4%. The share of unhedged loans in foreign currency, against both loans in foreign currency and total loans, remained almost unchanged compared to the previous year (at 43.3% and 24.3%, respectively), and the indirect exchange rate risk against lending activity remains high.

[40] *The currency in which loans are reported.*

BOX 6.1: BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

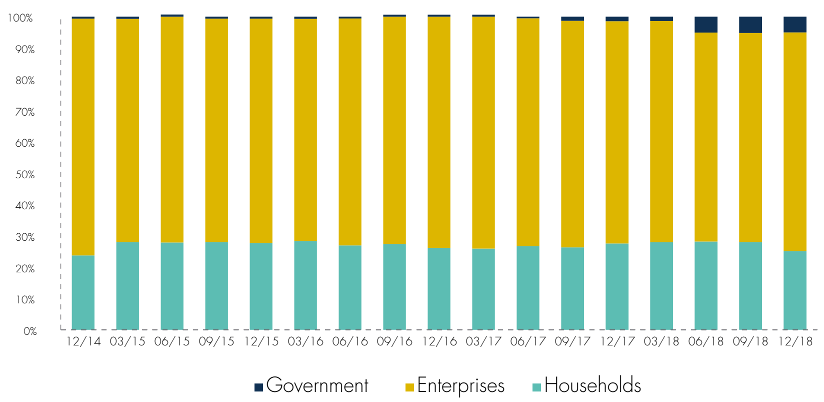
Banking sector's exposure to indirect exchange rate risk remains high, although, in recent years, the share of loans unhedged against the exchange rate to outstanding loans in foreign currency has trended downward. In December 2018, foreign currency loans unhedged against exchange rate fluctuations accounted for 43% of total foreign currency loans and 24% of total outstanding loans, maintaining the respective shares of the previous year. During 2018 H2, unhedged foreign currency loans slightly decreased by 0.2%, to ALL 141 billion, mainly due to the contraction of unhedged loans in euro[41]. Meanwhile, unhedged loans in US dollar (accounting for 13% of unhedged loans) expanded by 14% during the period. Loans to enterprises have the main share (70%) in outstanding foreign currency loans unhedged against the exchange rate risk, while loans to households and to government share 25% and 5%, respectively. The decline in unhedged loans to households by 11% provided the main contribution to the contraction of outstanding unhedged loans. Unhedged loans to enterprises expanded by 4.4% over the period. In annual terms, unhedged foreign currency loans shrank by 4.6% and reflect mainly the decrease of unhedged outstanding loans to enterprises and in euro.

Chart 44 Unhedged foreign currency loans



Source: Bank of Albania.

Chart 45 Unhedged foreign currency loans, by subject, %



Source: Bank of Albania.

By purpose of use, unhedged loans for investments in real estate have the main share (around 48%) in the total stock of unhedged foreign currency loans, followed by loans for trade purposes (30%). The rest of the unhedged foreign currency loans were granted for business development, consumption, to the government and other purposes. Unhedged loans for "investments in real estate" and for "consumption", down by 0.7% and 4.4%, respectively, during the period, provided the main contribution to the performance of outstanding loans unhedged

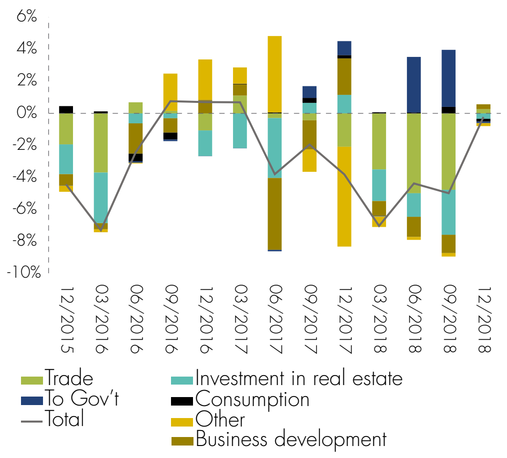
[41] *Outstanding euro loans, when the borrower's income is in Albanian lek, accounts for 86% of the outstanding unhedged foreign currency loans.*

against the exchange rate risk. Meanwhile, unhedged foreign currency loans for "trade" and "business development" were upward during the period.

Chart 46 Unhedged foreign currency loans (composition)

Source: Bank of Albania.

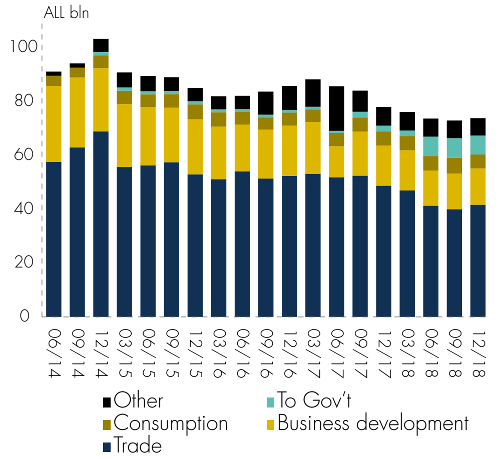
Chart 47 Unhedged foreign currency loans, 6-M performance (contribution by sector)



Source: Bank of Albania.

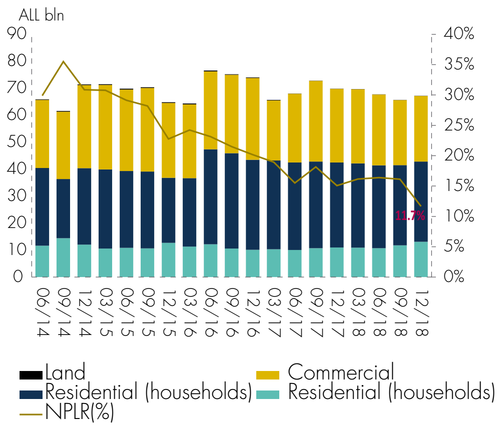
Unhedged loans for real estate are granted for real estate for: residential, commercial and land purposes. Unhedged loans to households for residential real estate have the main share (44%), down by 3% during the period.

Chart 48 Unhedged foreign currency loans (excl. real estate)



Source: Bank of Albania.

Chart 49 Unhedged foreign currency loans for real estate and its quality (right)

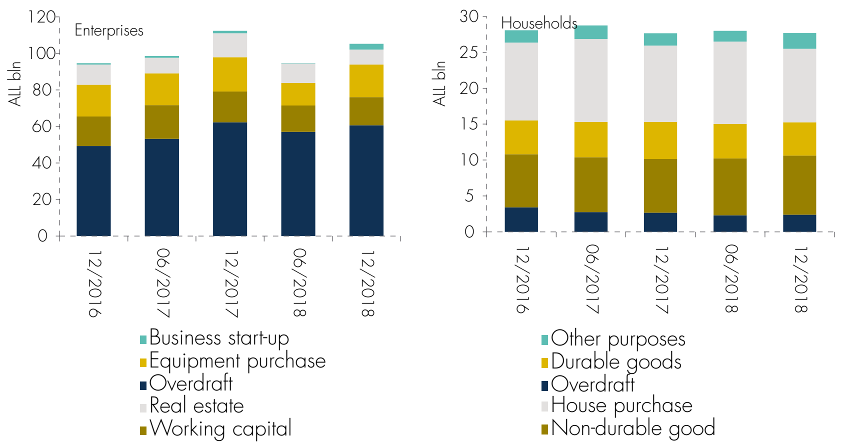


Source: Bank of Albania.

The appreciation of lek's exchange rate has affected negatively the reported value of unhedged foreign currency loans. Excluding the appreciation of the exchange rate, the unhedged foreign currency loans would have expanded approximately 1.6%, against the 0.2% contraction.

(57) New loans granted by the banking sector, during the period, amounted to ALL 136 billion, 9.5% higher compared with 2018 H1. The performance of loans to enterprises, which was ALL 11 billion higher during the period, determined the performance of new loans. The growth in new loans to enterprises is mainly observed in loans for equipment purchasing, business start-up loans and overdraft loans. The latter has the main share in new loans to them (58%). New loans to households fell by 1.1% during the period, driven by the fall in new loans for house purchase. By currency and maturity, euro loans and medium-term loans had the main contribution to the expansion of new loans during the period. New loans in US dollar, accounting for 7% of the overall new loans during the period reduced by 22% .

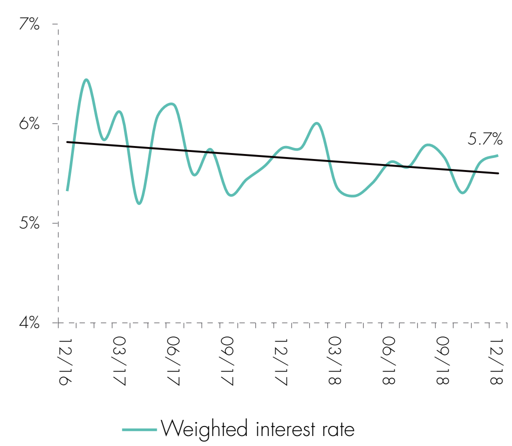
Chart 50 New loans to enterprises (left) and households (right) by purpose of use



Source: Bank of Albania.

(58) The weighted interest rate on new loans during the period[42] was slightly up. In December 2018, the weighted average interest rate on new loans was 5.7%, around 0.1 percentage point higher than the rate on new loans granted in June 2018. The increase in the average interest rate was mainly reflected on loans in foreign currency (euro and usd) and on loans to households. By currency, the weighted average interest rate on new lek loans stood at 6.8%, in December 2018, higher compared with the interest rates on loans in euro and US dollar, which were 4.4% and 5.5%, respectively at the end of year.

Chart 51 Weighted interest rates on new loans

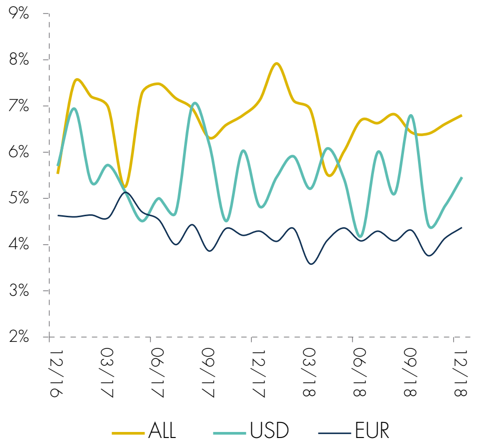


Source: Bank of Albania.

(59) The interest rate on new loans to households continues to be higher than interest rate on loans to enterprises. In December 2018, the weighted

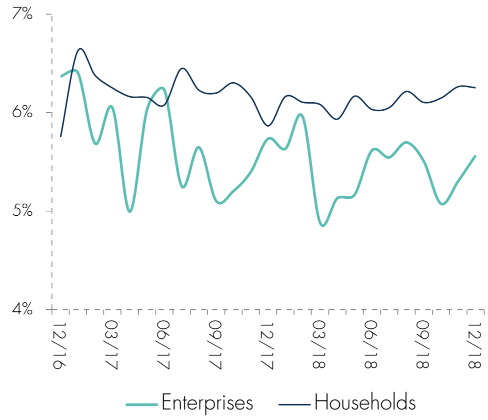
[42] *Calculated as six-month average.*

Chart 52 Interest rates on new loans, by currency



Source: Bank of Albania.

Chart 53 Interest rates on new loans, by entity



Source: Bank of Albania.

interest rate on loans to households was 6.3%, from 6% in June 2018. At the same time, the average interest rate on new loans to enterprises was around 5.6%, unchanged from the average rate at the end of 2018 H1.

BOX 6.2: REJECTION RATE OF LOAN APPLICATIONS BY BANKS IN ALBANIA

General provisions

To complete the analyses framework related with the performance and tendency of bank lending to the private sector in Albania, the Financial Stability Department at the Bank of Albania has collected, over recent years, data on the number of loan applications evaluated by banks, classified by the loan application's status (approved, rejected and in process) and by type of client (small and medium-sized enterprises, other enterprises[43] and households). These data have been collected half-yearly, starting from 1 December 2016 and include a total of six half-year periods: 1 December to 31 May; and 1 June to 30 November of each year. The last period is from 1 June 2018 to 30 November 2018 and is included as an analysis of 2018 H2. For the period 2016 H1 - 2018 H1, the analysis includes data reported by 16 banks of the system, while for the last period (2018 H2) the analysis includes 14 remaining banks after the merger by absorption of Veneto Bank by Intesa SanPaolo Bank Albania and the National Bank of Greece by American Bank of Investments.

Based on the data submitted by banks on the number of loan applications, the number of applications by both enterprises and households considered by banks during the relevant periods is analysed, as a proxy for market demand for bank loans, and the rejection rate of loans, ("rejection rate") is constructed and analysed for each period, as an indicator of banking sector disposition to respond to this demand. This rate is calculated as a ratio of the number of rejected applications by the bank, against the total number of evaluated applications,

[43] "Other enterprises" mainly includes large enterprises and all types of enterprises, which are not included in the group "small and medium-sized enterprises".

during the relevant period. The increase of the rejection rate may signal a fall of loan supply and a tightening of credit standards by banks.

Number of evaluated applications and rejection rate analysis

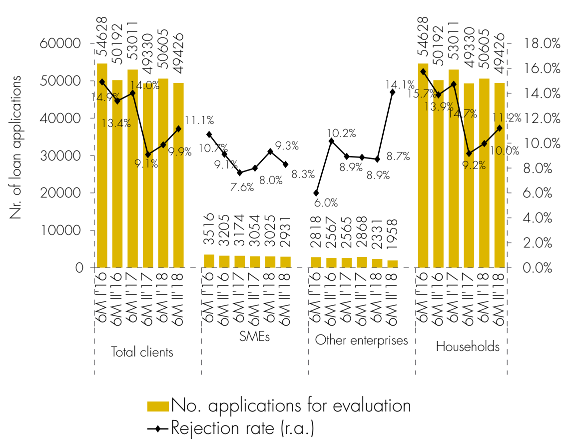
During 2018 H2 (1 June - 30 November 2018), banks evaluated a total of 49,426 loan applications, of which around 10% from "enterprises" (2,931 applications from "small and medium-size enterprises" and 1,958 applications from "other enterprises") and 90% from "households" (44,537 applications). The total number of evaluated applications was downward (by 3.7%), compared to the previous period (1 December 2017 - 31 May 2018), driven by the segment of "enterprises" (half-yearly fall by 8.7%) and the segment of "households" (half-yearly fall by 1.6%). In annual terms, compared with the period 1 June - 30 November 2017, the total number of evaluated applications remained almost unchanged (increased only 0.2%). By category, applications from households increased by 2.6% and application from enterprises fell by 17.4%[44].

In the total evaluated applications during the period, banks rejected around 11%, approved 87 % and 2% are under evaluation. The rejection rate (11%) increased compared to the previous six-month period and the previous year, diverging from the downward trend of the period 2016-2017. The increase in the rejection rate during the period is more notable for the categories of "households" and "other enterprises"; meanwhile, the rejection rate for "small and medium-size enterprises" trended downward.

The analysis of the rejection rate by size of banks (peer groups G1, G2, G3) and by category of clients shows that the small and medium-sized banks have the highest rejection rate for all three categories of clients. Nevertheless, the rejection rate of medium-sized banks (G2) showed a downward trend, ranging 12 -13% for all categories of clients. On the other hand, the rejection rate for larger banks (G3) fluctuated at 4 -9% for loans to all three categories of clients, showing a slight falling trend for loans to both groups of enterprises and an upward trend for loans to "households".

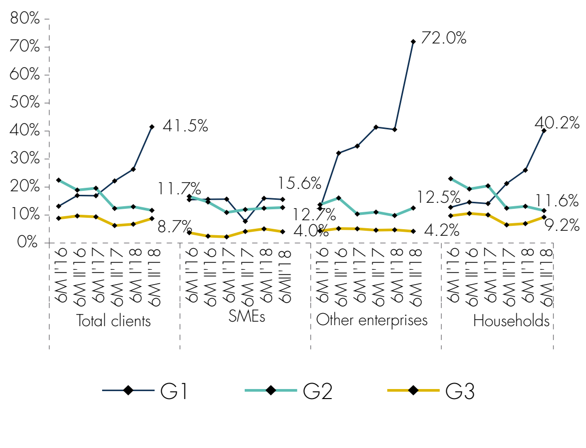
The analysis of the rejection rate of banks, divided into domestic banks and foreign-owned banks, shows that, in recent years, the rate for domestic banks has been continuously lower compared with foreign-owned banks, across all categories of clients. For 2018 H2, the total rejection rate of applications for loans by foreign-owned banks (against the total applications) remained unchanged at 14%, compared with 2018 H1, and somewhat upward compared with 2017 H2. By segments of clients, these banks mostly rejected the applications for loans to "households" and "other

Chart 54 Number of evaluated applications and rejection rate analysis



Source: Bank of Albania.

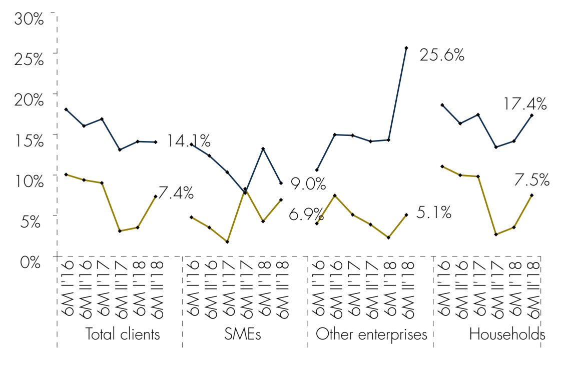
Chart 55 Rejection rate for loans, by bank peer group and category of clients



Source: Bank of Albania.

44 Annual fall from "small and medium-sized enterprises" by 4% and from "other enterprises" by 31.7%, respectively.

Chart 56 Rejection rate of loans, for domestic and foreign-owned banks



Source: Bank of Albania.

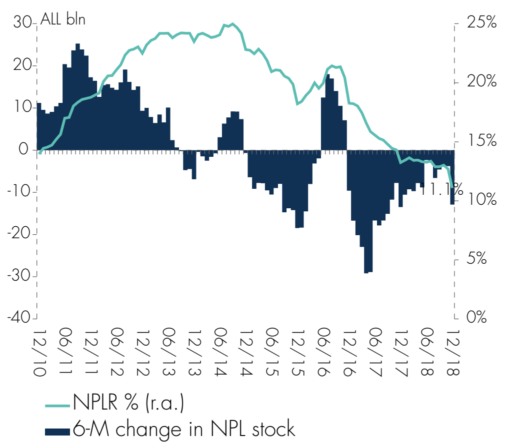
enterprises"; meanwhile, they were more accepting to "small and medium-sized enterprises". On the other hand, the rejection rate by domestic banks increased during the period for all segments of clients, but more pronounced for the segment of "households".

Overall, the analysis concludes that the performance of the evaluated applications by banks, during 2018, is somewhat lower (2.2%) than in the previous year. The preference of banks to lend has resulted, overall, downward for "households" and "large enterprises", and upward for "other enterprises", mainly driven by the group of larger banks (G3) and the group of of smaller banks (G1).

6.1.2 CREDIT RISK

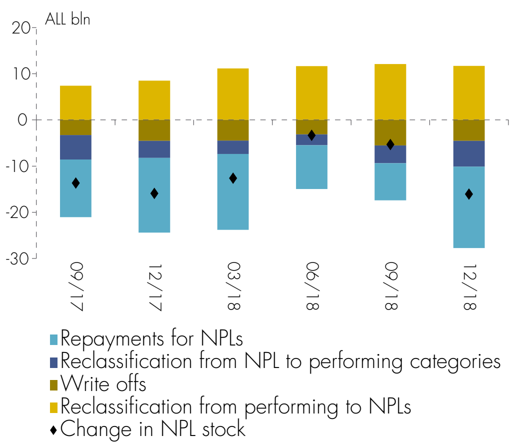
(60) **The credit quality improved considerably, during the period, due to the decrease of non-performing loans stock by 17%, at ALL 64 billion.** This is the lowest rate of outstanding non-performing loans recorded since 2010. Meanwhile, compared to the end of 2014, when non-performing loans peaked, the stock has halved. The decrease in outstanding non-performing loans by size of contribution was driven by: loan repayments; write off of lost loans, and reclassification of some non-performing loans to performing classes of loans (mainly due to restructuring). Since June 2018, around ALL 17.6 billion non-performing loans have been repaid, and around ALL 4.5 billion lost loans

Chart 57 Non-performing loans ratio and outstanding NPLs



Source: Bank of Albania.

Chart 58 Contribution to the change of the non-performing loans stock

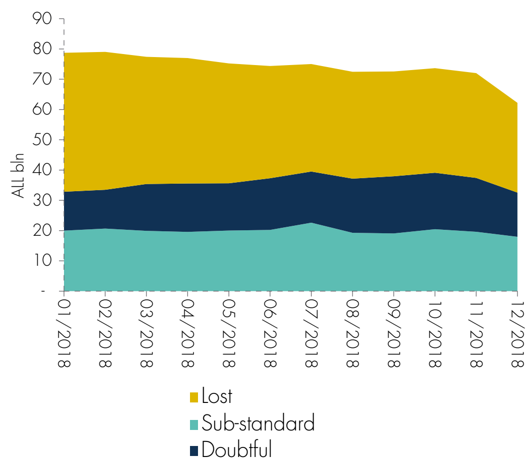


Source: Bank of Albania.

have been written off[45], mainly represented by loans to enterprises in lek. The stock of non-performing loans contracted by ALL 15 billion or 19%, compared with the end of 2017, mainly driven by loan repayments and the lost loans write off.

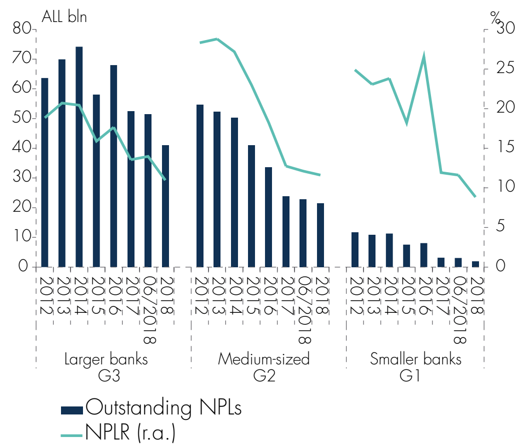
(61) **In December 2018, the non-performing loans ratio stood at 11.1%, down by 2.2 percentage points durin the period from the previous year.** The fall in outstanding lost loans by around 19%, provided the main contribution to the improvement of credit quality during the period. "Lost" loans continue to account for a large share of non-performing loans (48%), but this share has fallen considerably from 58% in the previous year. The non-performing loans classified in two other classes: "sub-standard loans" and "special-mention loans" also were down, due to the repayment of a part of past due loans and the reclassification of some non-performing loans performing classes.

Chart 59 Non-performing loans structure



Source: Bank of Albania.

Chart 60 NPL portfolio by bank groups



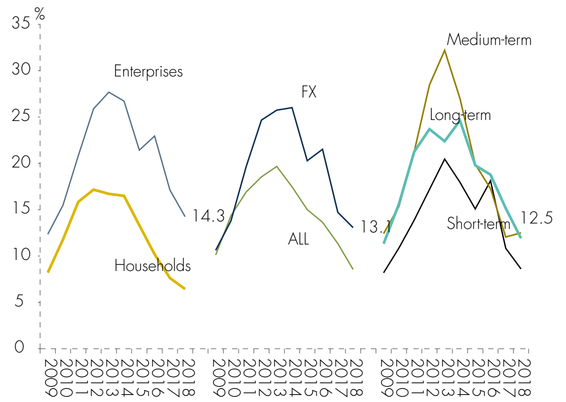
Source: Bank of Albania.

(62) **Larger banks provided the main contribution to the improvement of credit quality.** The outstanding non-performing loans of larger banks decreased, during the period, by ALL 10.4 billion (or by 20%); meanwhile, the non-performing loans ratio for larger banks fell at 11% from 14%. Also, medium-sized and smaller banks reported a contraction in the stock of non-performing loans. Medium-sized banks have the highest non-performing loans ratio (11.6%); while smaller banks have the lowest non-performing loans ratio (8.8%). The structural changes in the group of smaller banks also affected the improvement of credit quality for these banks.

---

[45] *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 55.5 billion of lost loans have been written off.*

Chart 61 NPLs ratio by sector, currency and term

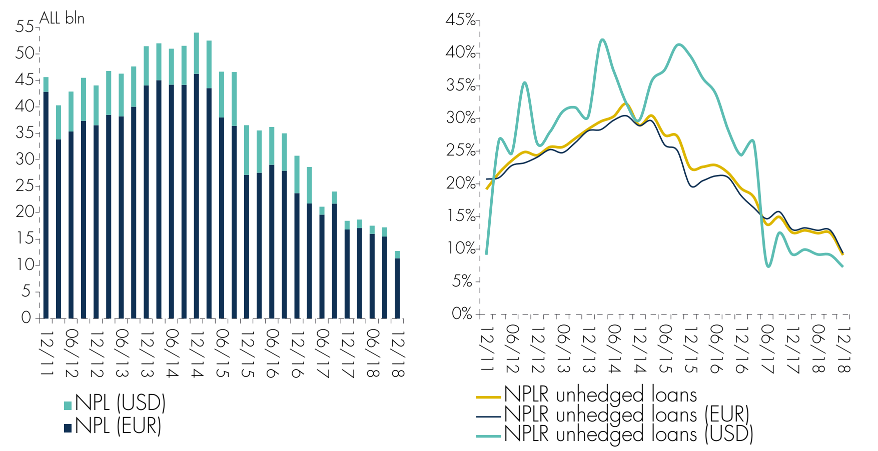


Source: Bank of Albania.

(63) The credit quality is lower for loans to enterprises, loans in foreign currency, and medium-term loans. In December 2018, the NPL ratio for each of these loan segments stood at 14.3%, 13.1%, and 12.5%, respectively. All types of loans, by entity, currency and maturity recorded a fall in their NPLs ratio, compared with the end of 2018 H1, and 2017 H2, except of the medium-term loans, whose quality reduced during 2018.

(64) The quality of unhedged foreign currency loans has slightly improved during the period, and this trend has been observed since 2015. In December 2018, non-performing loans for unhedged foreign currency loans recorded the lowest level, since 2009, around ALL 13 billion. The ratio of non-performing loans for this category fell to 9.1% from 12.4% at the end of June 2018. Loans in euro provided the main contribution to the improvement of the quality of unhedged loans. The NPL ratio for unhedged euro loans fell from 12.9% to 9.4%, whereas the ratio for unhedged US dollar loans fell to 7.3% from 9.2 %.

Chart 62 Quality of unhedged loans against the exchange rate risk in ALL billion (left); and as a ratio to total unhedged loans by currency (right)

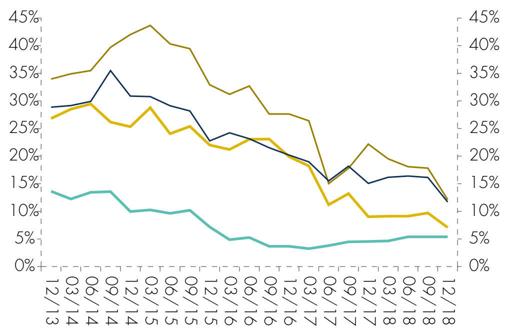


Source: Bank of Albania.

(65) In loans unhedged against the exchange rate risk, the quality of loans for business development, loans for real estate and loans to trade improved. Loans for business development improved considerably, whose non-performing loans ratio dropped by 6 percentage points during the period, at 12.1%. Loans for investment in real estate have the main share (around 61%) in unhedged non-performing loans from the exchange rate. The NPLs ratio for this category fell by 4.7 percentage points, during the period, at 11.7%. The NPLs ratio for unhedged consumer loans is low, and it did not change during the period, standing at 5.4%.

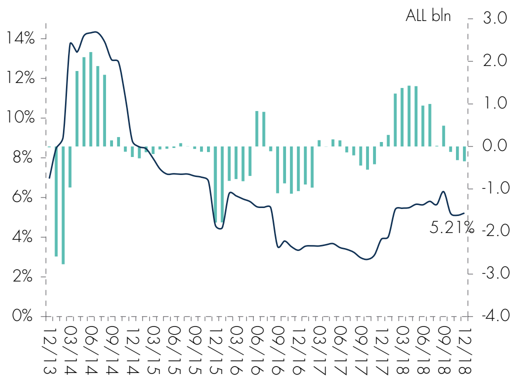
(66) The quality of loans to non-resident entities continues to be good and improved during the period. Meanwhile, loans to non-residents accounts for around 10% of total loans. The non-performing loans for this category of borrowers accounts for only 5% of total non-performing loans. During the period, the NPLs stock in this category narrowed 10%, by mainly reflecting the reduction in "sub-standard" loans. As result of these developments, the NPLR for loans to non-residents fell at 5.2%, at the end of December 2018, from 5.6% at the end of 2018 H1. The loans classified as lost have the highest share (47%) within the structure of non-performing loans.

Chart 63 Quality for unhedged loans against exchange rate risk, by purpose of use



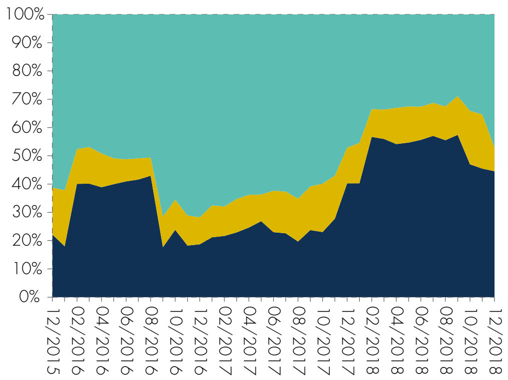
Source: Bank of Albania.

Chart 64 Half-yearly change in NPLs stock and NPLR for loans to non-residents



Source: Bank of Albania.

Chart 65 Structure of Non-performing loans for non-residents



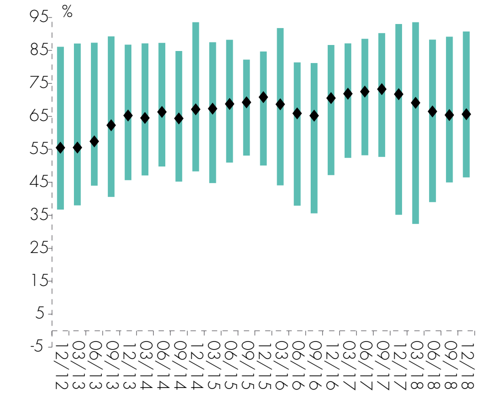
Source: Bank of Albania.

(67) The provisioning ratio for the non-performing loans fell by 0.8 percentage point, during the period, at 65.6%. The provisions for credit risk fell faster than the contraction in the stock of non-performing loans. This performance reflects the write off of non-performing loans (lost); a process that has a relatively higher impact on the reduction of outstanding provisions, compared with the reduction of outstanding non-performing loans. In the previous year, this ratio stood at 71.7%.

(68) During the period, capital coverage of net non-performing loans[46] increased. As a result of the narrowing in outstanding net non-performing loans by almost 15%, the "net non-performing loans/regulatory capital" fell to 15.5%, from 18% in June 2018. In the previous year, this ratio stood at 15.4%.

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

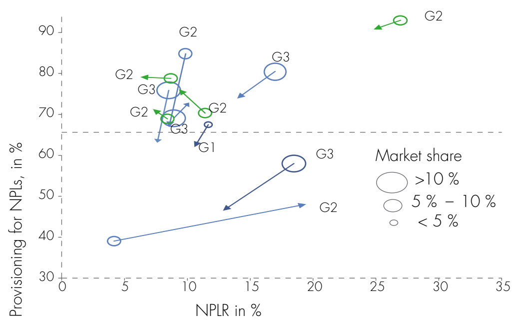
Chart 66 Provisioning ratio over years



■ Interval of provisioning coverage at bank level
♦ Ratio of provisioning coverage for the banking sector (right)

Source: Bank of Albania.

Chart 67 Annual change in provisioning ratios - arrows show change (Dec 2017 - Dec 2018)*



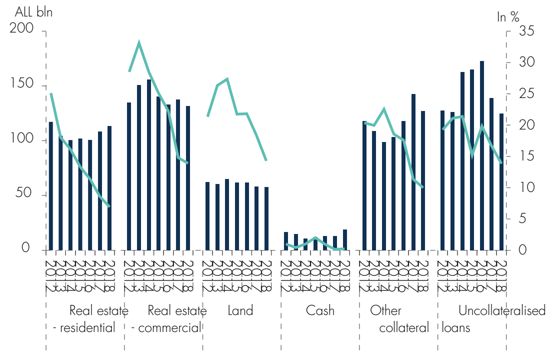
* This includes banks sharing more than 1% in total assets. G2 are medium-sized banks (with 2-7% of banking sector's assets) and G3 are larger banks (over 7% of total assets). Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows average ratio of NPL provisioning at sector level, 65.6% at end Dec. 2018.

Source: Bank of Albania.

Also, net non-performing loans ratio to outstanding loans narrowed by 0.6 percentage point, standing at 3.8%, due to the faster fall in net outstanding non-performing loans compared with the fall in outstanding loans. In the previous year, this ratio stood at the same level (3.8%).

(69) **Loan collateralisation remains at high levels and has been increasing since the beginning of 2017.** Maintaining high levels of loan collateralisation contributes to the mitigation of credit risk. At the end of the period, loan collateralisation[47] stood at 78.2%, around 1.3 percentage lower than at the end of the previous period, and 1.5 percentage points higher than a year earlier. Loans collateralised in the form of real estate account for around 68% of collateralized loans, and 53% of outstanding loans. Loans collateralised in the form of real estate and those collateralised with cash increased during the period. Loans collateralised with "other" types of collateral, accounting for about 28% of the overall loans, fell by around 15% during the period.

Chart 68 Outstanding loans and non-performing loans ratio by collateral



■ Outstanding loans
— NPLR (r.a.)

Source: Bank of Albania.

(70) **Quality of collaterised loans continued to improve during the period, and the NPLs ratio for this type of loans fell at 10.5% in December 2018.** This ratio fell by around 2 percentage points from the end of 2018 H1 and the end of 2017. The fall in non-performing loans stock for this category has started since 2016. During the period, the fall is noted in all types of loans, by form of collateral, and mainly for loans collateralised with "other" types of collateral and for loans collateralised in the form

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

of commercial real estate. Also, the quality of un-collateralised loans improved compared with the end of the previous period and with a year earlier. The NPLR for un-collateralised loans fell at 13.8%, from 17.6% in June 2018 and 16.6% in December 2017.

6.1.3 DEPOSITS

(71) The deposit base held in the banking sector reached ALL 1,180 billion at the end of the year, up by 3% during the period and 1.2% during the year. The main contribution during the period came from deposits in foreign currency, demand deposits, current accounts and household deposits, which increased by 4%, 13%, 5% and 3%, respectively. Time deposits continued to register a decrease in annual term, but remained largely unchanged during the period. In 2018 H2, the shares of time deposits and household deposits in total deposits continued to decline. At the same time, due to the acceleration of the increase of foreign currency deposits, their share in the general deposit stock increased to 53% against the 52% average registered in 2018 H1.

Table 9 Data on the performance of deposits by maturity, sector and currency

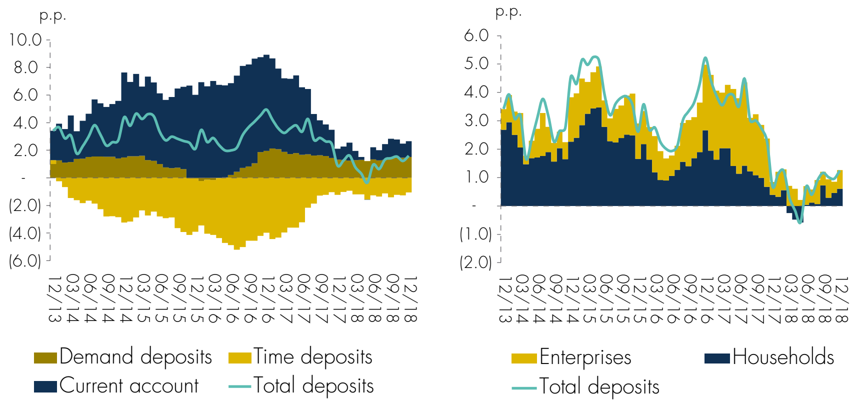
	Indicator and unit	Value (ALL bln)	Structure (% to total)	Contribution to growth rate (p.p.)		Change (%)	
	Period	12/2018	12/2018	Annual	6-months	Annual	6-months
By currency	Lek deposits	553	47	0.4	0.8	0.8	1.7
	FX deposits	627	53	0.9	2.2	1.7	4.2
By institution	Public sector	27	2	0.0	0.0	-0.7	-0.7
	Enterprises	176	15	0.7	0.7	4.6	4.8
	Households	977	83	0.6	2.3	0.7	2.8
By product	Current account	397	34	1.2	1.6	3.5	5.0
	Demand deposits	124	11	1.5	1.2	16.5	12.9
	Time deposits	643	54	-1.1	0.2	-1.9	0.4
	Deposits, Stock	1,180	100	1.2	3.0	1.2	3.0

Source: Bank of Albania

(72) Households' deposits continue to account for over 80% of the total stock of deposits; but, over the last two years, their growth has been slower compared with the growth of enterprises' deposits. The slow growth and, in some periods, the contraction of households deposits, when time deposits shared around 65% of the total, has reflected an environment with low interest rates.

(73) The deposits of enterprises has given the main contribution to the increase of the deposit base in the last two years and continued to register a high growth pace during the period. This performance is reflected in the structure of deposits maturity. The fall of time deposits, which are preferred by households, is followed by the increase of demand deposits and current accounts, which are preferred by enterprises.

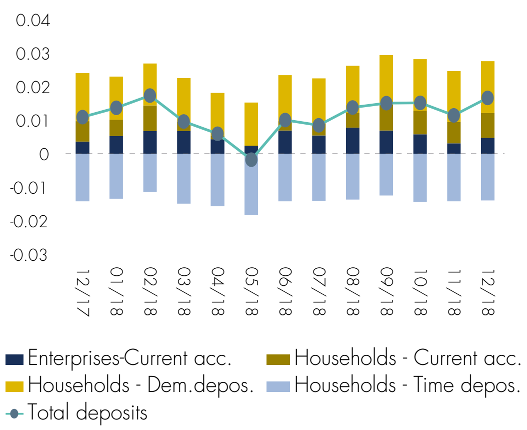
Chart 69 Annual growth of deposits: contribution of deposits by maturity (left) and by sector (right)



Source: Bank of Albania.

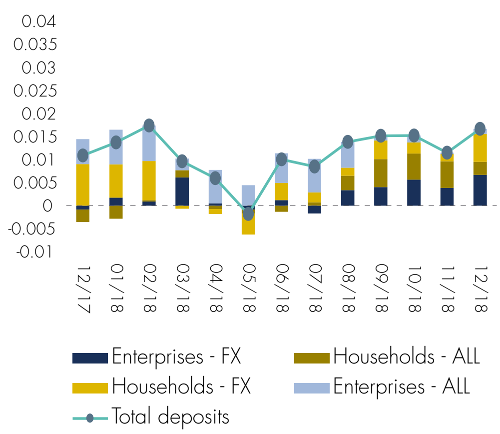
(74) **Households' demand deposits continued to grow rapidly during the period and annually and gave the main contribution to the growth of total deposits.** The annual average growth of demand deposits was around 16% in both half years of 2018, but this pace has somewhat slowed down compared with the performance registered in the previous 2-3 years. The households registered a notable tendency to expand current accounts and demand deposits and contract time deposit. Meanwhile, enterprises continued to expand current accounts, which are mainly used for operational purposes. Due to the negative contribution of time deposits to total deposits and the positive contribution of demand deposits and current accounts, during the last two years, in the structure of deposits by maturity, the share of time deposits fell by 5 percentage points, at 54%, the share of demand deposits increased by 3 percentage points, at 11%, while the share of current accounts remained unchanged at 33%.

Chart 70 Contribution to deposit increase by sector and maturity (p.p.)



Source: Bank of Albania.

Chart 71 Contribution to deposit increase by sector and currency (p.p.)

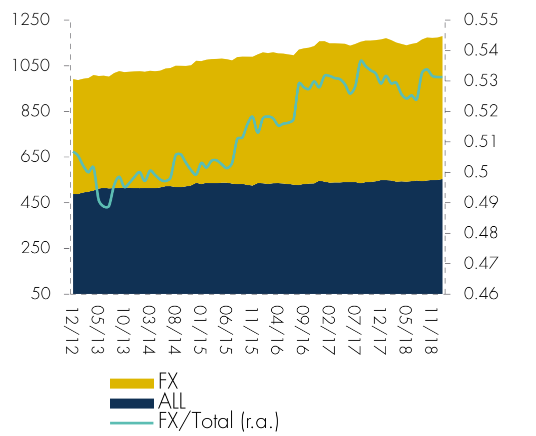


Source: Bank of Albania.

(75) **Foreign currency deposits showed strong signs of recovery during the period, reflecting mainly the increase of enterprises' current accounts denominated in foreign currency.** Foreign currency deposits increased by ALL 25 billion during the period, and by almost ALL 10 billion during the year. The share of foreign currency deposits in total deposits registered 53% at the end of the period. Euro deposits, which account for over 85% of foreign currency deposits, increased by 8% over the period and by 11% over the year, by EUR 330 million and EUR 440 million, respectively.

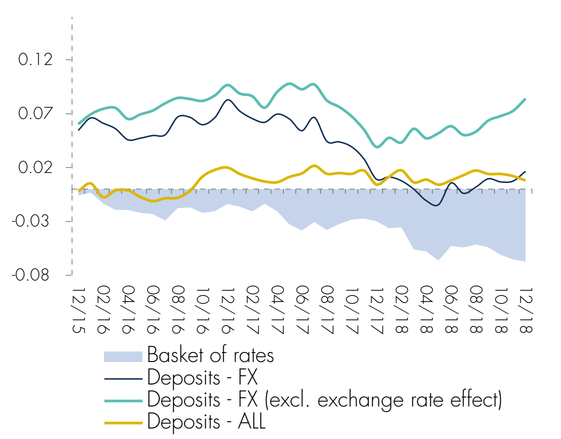
(76) **The appreciation of lek against the main foreign currencies had a significant contracting impact on the performance of deposits over the year and the period.** Excluding the impact of the exchange rate, the half-year and annual growth of total deposits would be 4% and 4.9%, from 3% and 1.3%, which is the change reported in the banking sector balance sheet. This impact is channelled through the effect on foreign currency deposits, for which the appreciation of lek is assessed to have had a downward effect of ALL 42 billion, over the year. Only for the period, this effect is assessed at ALL 12 billion. Excluding the statistical effect of the exchange rate, the growth of foreign currency deposits would be ALL 53 billion over the year, and ALL 36 billion over the period.

Chart 72 Performance of deposits by currency (ALL bln) and share of foreign currency deposits



Source: Bank of Albania.

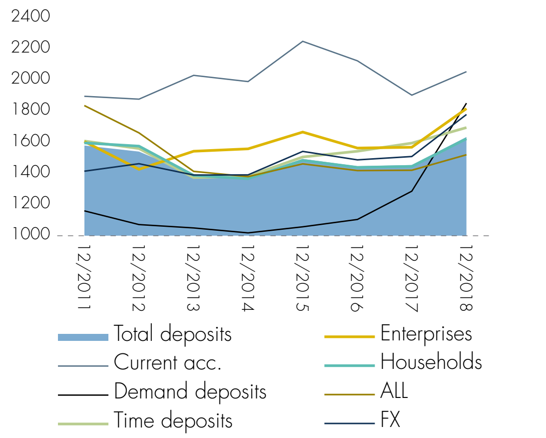
Chart 73 Annual growth of lek and FX deposits, and FX deposits excluding the exchange rate effect



Source: Bank of Albania.

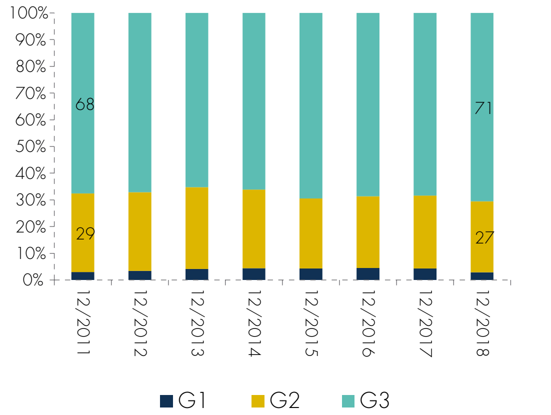
(77) **The concentration of deposits in the banking sector remains low, although trending upward during the period.** This has reflected mainly the increase of the share in some categories of some larger banks. The higher increase of concentration was observed in demand deposits, but the overall coefficient of concentration for the category of deposits remains low. Current accounts have the highest concentration, while deposits in lek and demand deposits have the lowest concentration. Structure of deposits by the size of banks - G1, G2, and G3 - has remained almost unchanged since the end of 2011. Around 70% of deposits is held by G3 banks and 27% by G2 banks.

Chart 74 Herfindahl Index for deposits by maturity, sector and currency



Source: Bank of Albania.

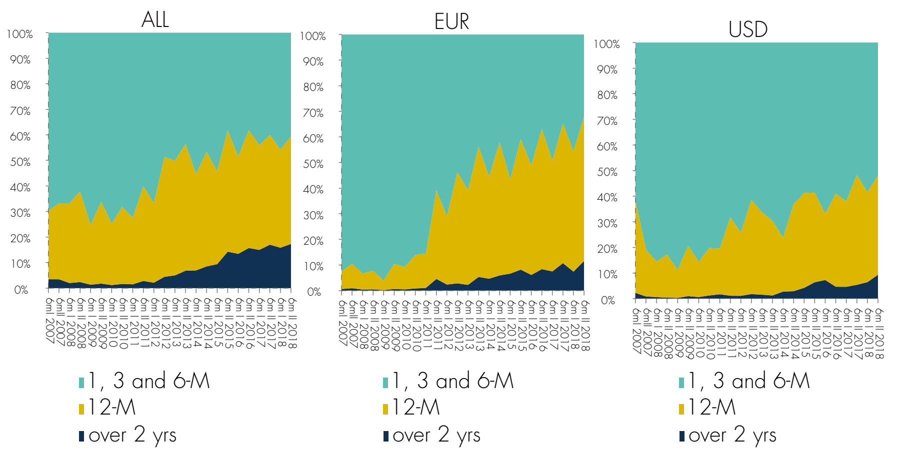
Chart 75 Share in total deposits by banking groups, G1, G2, G3



Source: Bank of Albania.

(78) **Over the period the flow of new time deposits in the banking sector was ALL 277 billion or around 21% higher than 2018 H1.** The share of new time deposits in total new deposits increased by around 14.5%, from 13% in 2018 H1, but it was lower than 16% in the previous year. There was a significant shift to longer-term maturities within the structure of new time deposits, for the three currencies. An increase of new deposits was registered for lek, euro and US dollar. New deposits in lek expanded by around 17%, in euro by 35% and in US dollar by around 8%.

Chart 76 New time deposits by currency and maturity, 6-month flows



Source: Bank of Albania.

(79) **The average interest rates on new time deposits showed negligible volatility during the period.** The average rate on new time deposits in lek was around 1%, and in US dollar and euro were 0.5% and 0.16%, respectively.

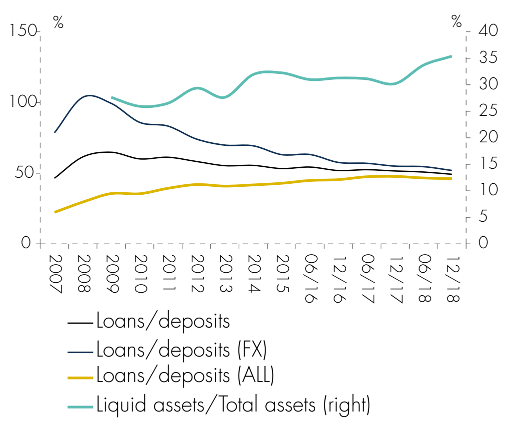
6.1.4 LIQUIDITY RISK

(80) **The banking sector's liquidity position is assessed as satisfactory and improved during the period.** The liquidity indicators, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source of funding bank lending, covering almost twice the volume of bank loans. At the end 2018, the loans/deposits ratio registered 49.2%, from 50.8% and 51.6%, in the previous period and in the previous year, respectively. The loans/deposits ratio for foreign currency and domestic currency was 51.9% and 46.1%, respectively, declining for both lek and foreign currency, compared with the previous year and the previous period. Overall, the decline of this ratio compared with the levels at the end of 2018 H1 was caused by the weaker performance of lending against deposits, both in total and by currency.

(81) **Liquid assets in banks' balance sheets remain high, reflecting a slow performance of lending.** At the end of December 2018, the ratio of liquid assets to total assets of the banking sector was 35.4% or around 3.2 percentage points higher than in the previous period. The other liquidity indicator - "liquid assets to total short-term liabilities" - also increased by 4.5 percentage points, to 47.7%.

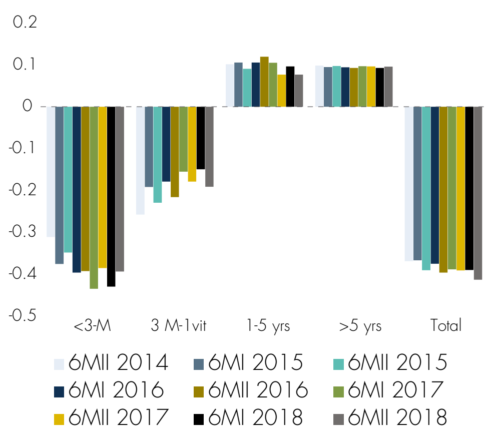
(82) **Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities by residual contractual maturity segments[48] is relatively high and has been deepening.** At the end of 2018, this indicator registered 42%, or 3 p.p. higher than the end of the previous period and a year earlier. During 2018 H2, the ratio deteriorated due to the deepening of the negative gap for the 3 m - 1 year maturity and the narrowing of the positive gap for the 1 - 5 years maturity. The the gap structure by maturity baskets has changed from period to period, during 2015-2018. However, a deepening of the very short-term maturity gap (up to 3 months) - which has also

Chart 77 Liquidity indicators*



*Off-balance sheet assets and liabilities are also included.
Source: Bank of Albania.

Chart 78 Assets and liability maturity gap*



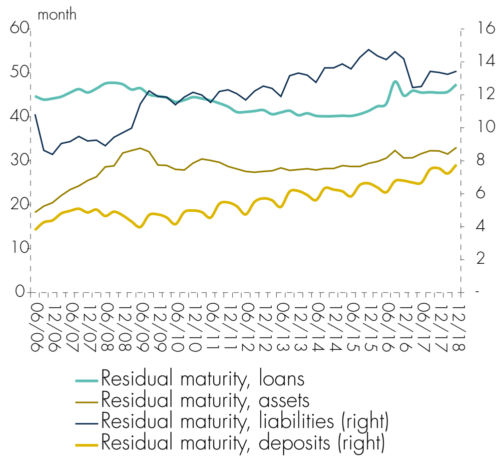
*Off-balance sheet assets and liabilities are also included.
Source: Bank of Albania.

48 *By residual maturity baskets, it is the difference between assets and liabilities in relation with total assets and expressed in %.*

the largest share in overall gap - and a narrowing in the short-term gap (3-M to 1year) has been observed. Meanwhile, the gap for the other two maturities has remained largely unchanged.

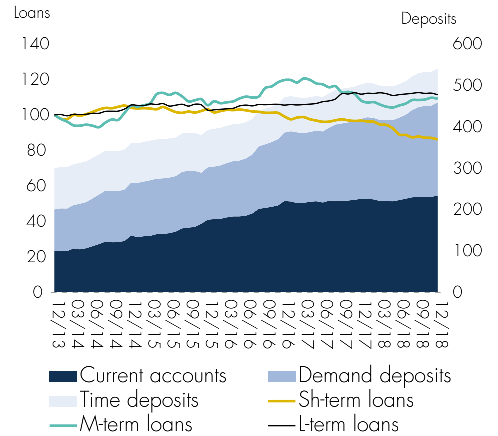
(83) **During the period, an increase in the mismatch of average maturity of assets and liabilities was observed.** At the end of December 2018, this mismatch was around 19.6 months, from 18.3 months at the end of 2018 H1. Deposits' residual maturity, which represent the most significant category of liabilities, increased to 7.8 (against 7.2) months over the period. The performance of this indicator was affected by the increase of the average maturity of time deposits, despite the decline of their share in total deposits. The residual credit maturity also increased to 47.4 months (from 45.7), reflecting the banks propensity to grant credit for longer maturities. During 2018 H2, the decline of short-term credit outstanding strengthened and the increase in medium-term credit granted by the banking sector portfolio accelerated.

Chart 79 Average residual maturity



Source: Bank of Albania.

Chart 80 Performance of loans and deposits by maturity (index, December 2013 = 100)



Source: Bank of Albania.

(84) **The value of credit lines from parent banking groups accounts for a very low share in the banking sector's funding sources.** Over the period, the total value of these lines was ALL 3.2 billion, from ALL 4.8 billion at the end of the previous period. For banks that have credit lines with parent banking groups as at the end of the period, their utilization rate was 16%, from 13.7% in June 2018.

6.1.5 MARKET RISKS

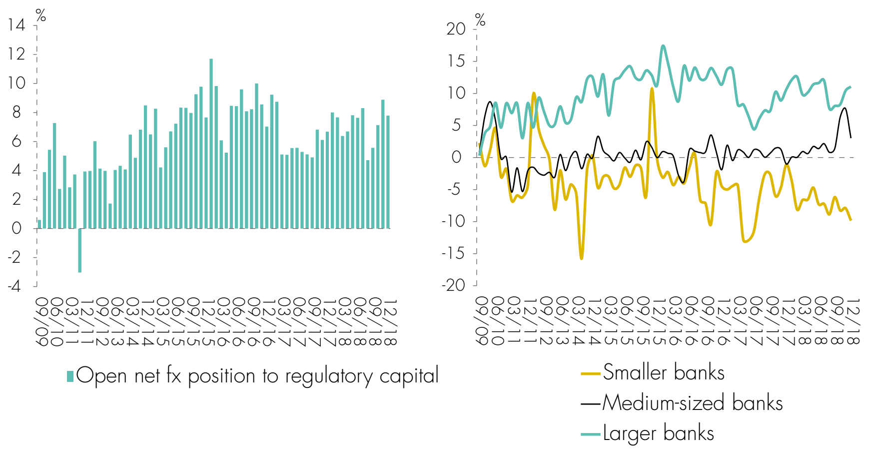
EXCHANGE RATE RISK

(85) **Net open foreign currency position levels indicate a limited exposure towards direct impacts on the balance sheet from exchange rate fluctuations, despite the slight increase registered during 2018 H2.** The aggregate indicator

for all banks, as well as the indicator for group of banks by size recorded much lower values compared with the 30% cap of regulatory capital established in the respective regulation.

(86) The net open foreign currency position of the banking sector in relation to regulatory capital has slightly increased compared to the previous periods. At the end of 2018, the net open foreign currency position of the banking sector was long and at 7.8% of regulatory capital, almost the same as that registered in 2018 H1 and 1.1 percentage points higher than the open position at the end of 2017. The performance of this indicator for the banking sector is driven mostly by the larger banks group, who continue to maintain a long open position. This position was at 11.1% of regulatory capital, significantly higher compared with the previous two periods and affected by the increase of the long position in euro. The medium banks' group also kept a long net position, but with a lower value against regulatory capital, around 3%. On the other hand, the small banks' group deepened its short foreign currency position compared with the previous period, registering 9.8% of regulatory capital, at the end of the period.

Chart 81 Open foreign currency position to regulatory capital for the sector and by size



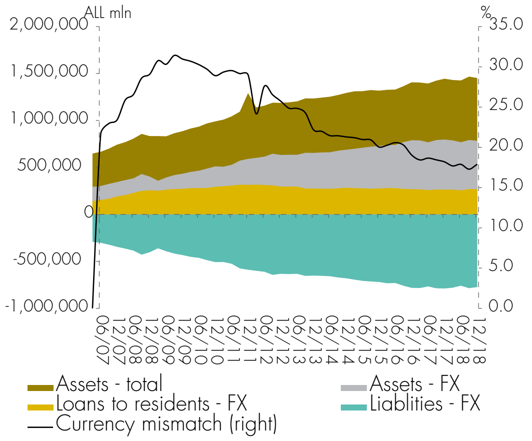
Source: Bank of Albania.

(87) During the period, the exposure of the banking sector to the exchange rate indirect risk did not have significant fluctuations. At the end of December 2018, the foreign currency mismatch[49] for all currencies resulted at 17.8% of total assets from 17.3% and 17.7% in the previous period and in the previous year, respectively. The increase of the value of the index reflects the somewhat faster increase of liabilities in foreign currency (2%) compared with the increase

[49] *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 movements in the exchange rate. for the calculation of the exchange rate indicator, refer to the Financial Stability Report 2016 H1.*

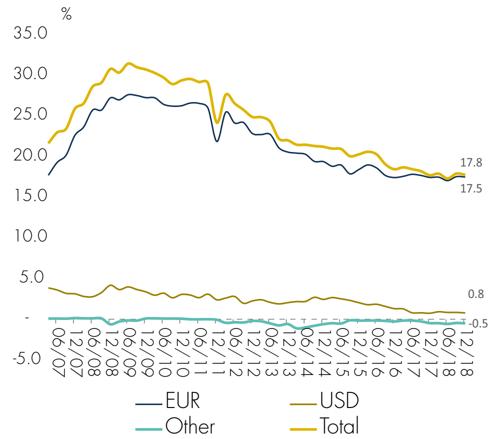
of assets in foreign currency (1.9%). The increase of the value of the index for the banking sector overall is due to the increase of the index for the euro by 0.4 percentage point in 17.5% of total assets.

Chart 82 Indices components for the banking sector



Source: Bank of Albania.

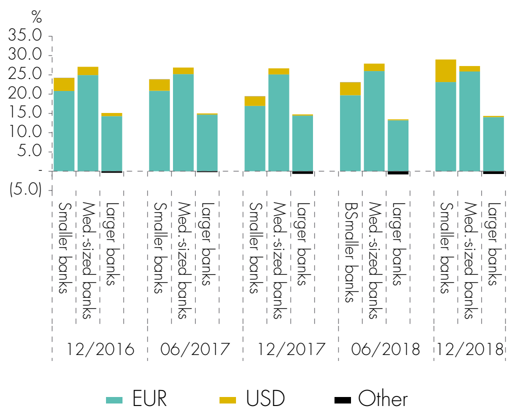
Chart 83 Currency mismatch, by currency



Source: Bank of Albania.

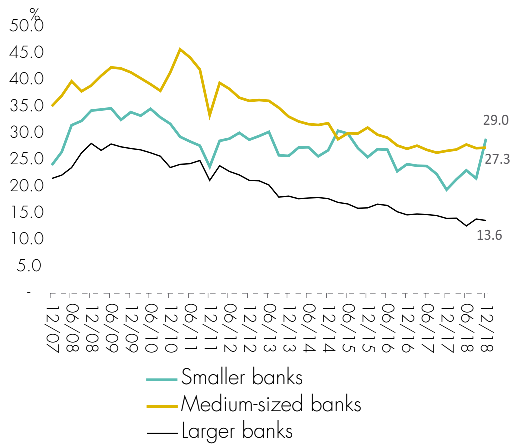
(88) The performance of the foreign currency mismatch index during the period was affected by the increase of the values of the index for medium and small banks. At the end of 2018, these indices registered 27.3% and 29%, respectively. The larger banks group continues to register the lowest values of the foreign currency mismatch. The index calculated for these banks declined by 0.4 percentage point during the period and registered 13.6%, at the end of the year. Since the size of the index is in inverse proportionality with the degree of hedging foreign currency liabilities with foreign currency assets, larger banks have lower exposure, while smaller banks have higher exposure

Chart 84 Mismatch by currency



Source: Bank of Albania.

Chart 85 Currency mismatch for groups, by size



Source: Bank of Albania.

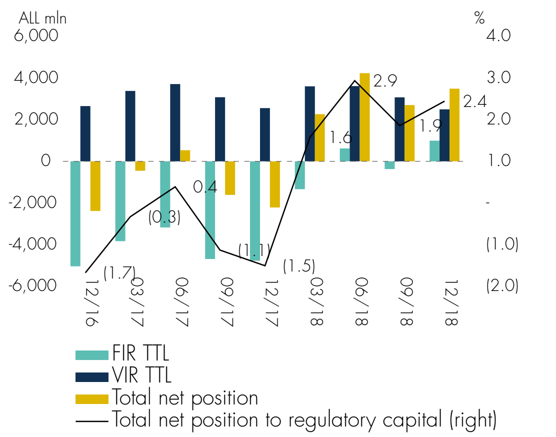
to the exchange rate indirect risk. For small banks, the main impact on the increase of the overall index for the group came from the change of the value of the index for the US dollar; meanwhile, the index for euro also increased.

INTEREST RATE RISK

(89) **The banking sector's exposure to the interest rate risk has been limited.** The weighted total net position in banks' balance sheet against regulatory capital remains low. This position was at 2.4% of regulatory capital[50] at the end of 2018, decreased in half-year terms and increased from the end of 2017. The performance of the indicator is conditioned by the performance of the net position with fixed interest rates (FIR)[51], which at the beginning of 2018 shifted to the positive side. Compared with 2017, during 2018, an expansion of the positive position for lek and US dollar, and a contraction of the negative position for euro were observed. The net position for instruments with variable interest rates (VIR), while downward during the period, maintained positive values and similar levels with the previous year. Although the total net position is positive - as the regulatory capital hedging of these positions remains high and the space for further decrease of the interest rates is objectively limited - the cost that may arise for the banking sector due to further interest rate decrease can be easily absorbed.

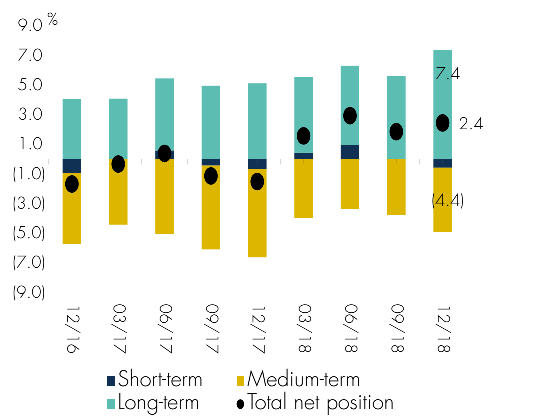
(90) **The shift of the overall position of the banking sector from low negative values during 2017 to low positive values during 2018 was due to the expansion of the positive position in lek and the contraction of the negative position in euro.** The weighted net position in euro for all three bank groups by size has low negative values and, during 2018, contracted significantly

Chart 86 Weighted aggregate net position in bank's balance sheets against regulatory capital, in %



Source: Bank of Albania.

Chart 87 Weighted net position by currencies against regulatory capital, in %



Source: Bank of Albania.

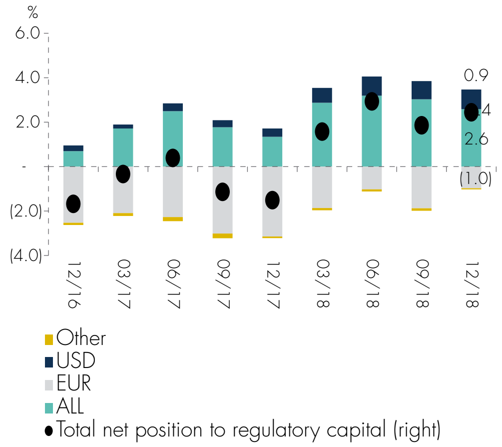
50 *In accordance with the relevant regulation, the absolute value of this indicator (assets sensitive to interest rate minus sensitive liabilities to interest rate) should not exceed 20% of regulatory capital.*

51 *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.*

compared with the previous year. The position in US dollar is positive, has very low values and is held by larger banks.

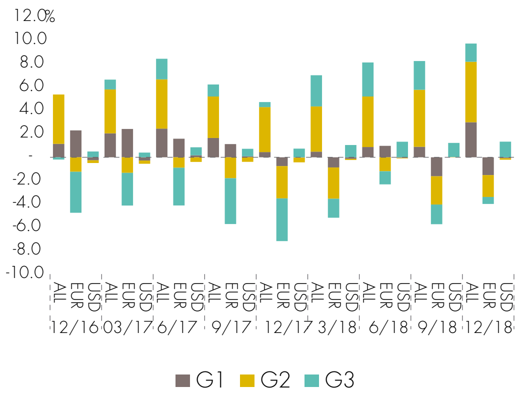
(91) **During 2018, the positive position for long-term maturity expanded and the negative position for medium-term maturity contracted.** At the end of 2018, the weighted net position for long-term maturity registered its highest level against regulatory capital at 7.4%. The main contribution to this development came from the increase by ALL 2.7 billion of the net position with fixed interest rate in euro. The short-term gap held the lowest level of exposure (-0.6%) and did not register significant changes in the last two years. For medium-term maturity, the negative position between assets and liabilities was 4.4% of regulatory capital at the end of 2018, standing higher than in 2018 H1, but around 2 percentage points lower than in the previous year.

Chart 88 Gap by maturity against regulatory capital, in %



Source: Bank of Albania.

Chart 89 Weighted net position by currencies and groups against regulatory capital, in %



Source: Bank of Albania.

(92) **Compared with larger and small banks, medium-sized banks have the highest exposure in the domestic currency.** For these banks, the weighted net position in lek was 5.2% at the end of the year, notably higher compared with the position of the other two groups. This position expanded throughout 2018. Larger banks have a lower net position in lek, at around 2%. This position reduced, compared with the average level registered during the previous two years.

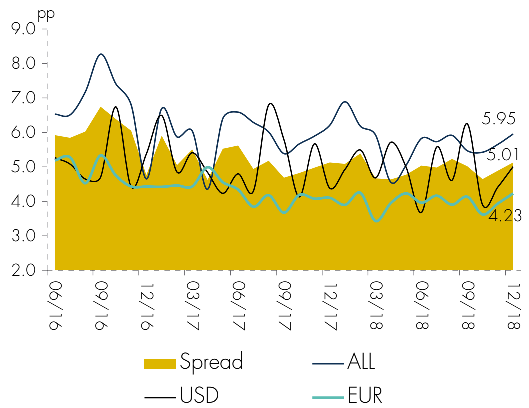
(93) **Indirect risk to interest rate change[52] registered a slight increase during the period.** The weighted credit interest rate increased, while that of deposits did not register changes. As a result, the spread of interest rates expanded,

[52] *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).*

with the main contribution coming from the domestic currency. At the end of 2018, the spread between new credit and new deposits interest rates in the banking sector registered 4.23 percentage points for the euro, 5 percentage points for the US dollar and 5.95 percentage points for the lek.

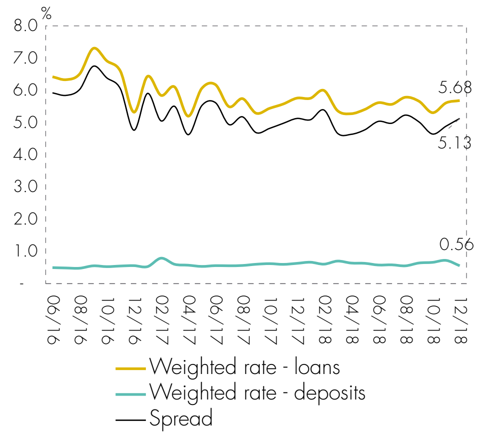
(94) **Compared with the previous year, the spread for all currency has not changed.** By currency, this indicator registered a slight expansion for the euro, a stronger increase (0.6 percentage point) for the US dollar and a decrease by 0.3 percentage point for the lek. At the end of the year, the weighted interest rate for new loans was lower than in the previous year, while the weighted interest rate for new deposits decreased at 0.56% in December 2018, after a several months period of slight but steady increase.

Chart 90 Loans and time deposits weighted interest rates and interest rates spread, in %



Source: Bank of Albania.

Chart 91 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 of five indicators, which represent five dimensions of the banking sector: capital, asset 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 results as improving from the previous year. Its value decreased at 0.43 from 0.46 registered at the end of December 2017.[53]

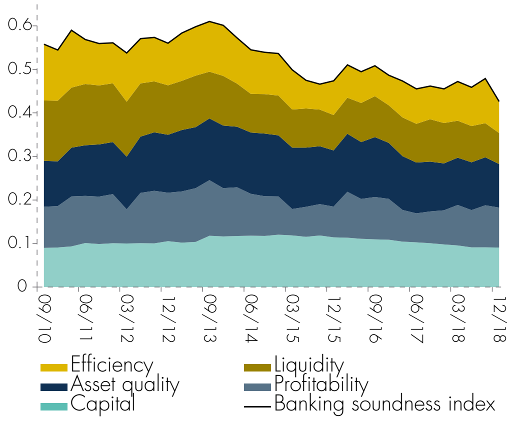
The components of the index, which registered a better performance in the last year, are: capitalization, asset quality, liquidity and efficiency. Meanwhile, the

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

decrease of "profitability" against the previous year contributed to the decline of the Banking Soundness Index, which registered 0.46 from 0.39 at the end of December 2017. Compared with a year earlier, banks' income declined, affected mainly by the decrease of net income from interest. Overall, the main contribution to the risk continues to come from asset quality. However, the considerable decrease of the non-performing loans stock, and as a consequence of the non-performing loans ratio, decreased the contribution of this indicator to risk. Meanwhile, "liquidity" registered the most significant improvement during the year, driven by the considerable expansion of its main indicator "liquid assets to total assets".

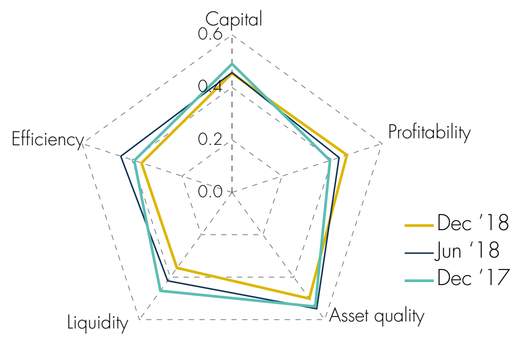
During the last five years (2013-2018), the aggregate banking soundness index has registered a downward trend, which means better soundness and higher stability for banks.

Chart 92 Banking Soundness Index*



*Higher index value shows lower soundness. The breadth of each dimension means its contribution to risk.
Source: Bank of Albania.

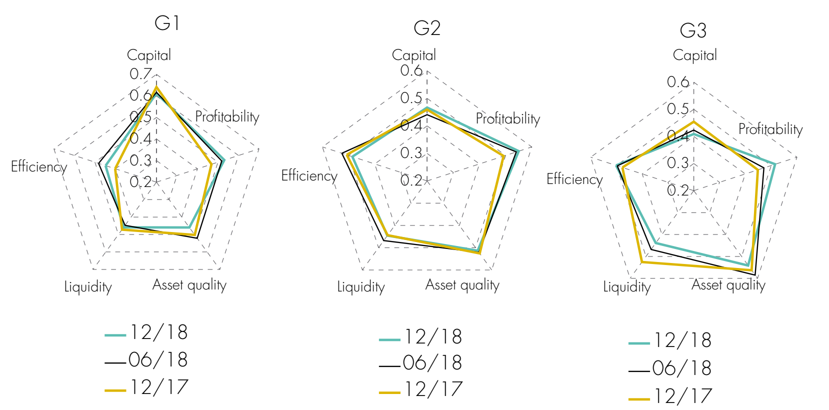
Chart 93 Banking Soundness Map*



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

The overall performance of banks, by size, is presented below. Medium-sized (G2) and small (G1) banks registered the same level of the index (compared with

Chart 94 Banking soundness map in groups by size*



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

the previous year), reflecting the same level of soundness. For these two bank groups, a decline was observed in the indicator of profitability, while "assets quality" improved, decreasing the contribution of this indicator to risk. Profitability declined due to the decrease of the net profit value, which also reflected a deterioration of RoA. The improvement of asset quality is attributable mainly to the continuous decrease of the non-performing loans stock. Larger banks (G3) report an improvement of the index, in the last year. The aggregate soundness index for this banking group decreased slightly, driven by the improvement of liquidity, asset quality and the expansion of capitalization, reflecting the increase of the Capital Adequacy Ratio. Larger banks have the lowest level of the Index.

6.2 BANKING SECTOR RESILIENCE

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

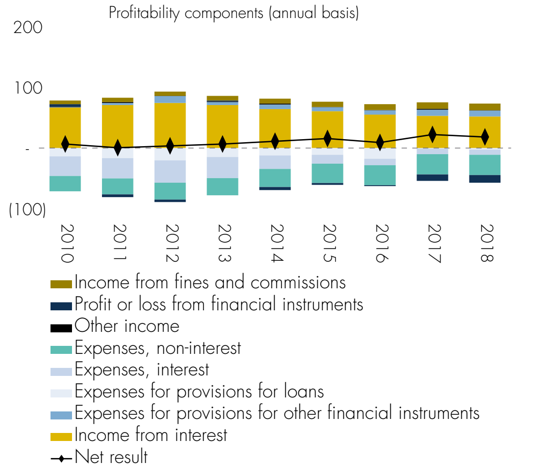
6.2.1 FINANCIAL RESULT

(95) The banking sector closed 2018 with a positive financial result of around ALL 18.4 billion. This result was ALL 3.7 billion lower than in the previous year, but higher than the financial result registered during the other years of the last decade. Compared with 2017, the financial result contracted mainly due to the higher losses from financial instruments and the increase of provisions. Net result from interests registered a slight decrease and had a small negative impact on the net result change. The decline of the financial result is reflected in a slight decrease of the average indicators of profitability of the banking sector, with the return on assets (RoA) and return on equity (RoE) declining at 1.3% and 13%, respectively, from 1.5% and 15.7% in the previous year.

(96) The financial result was adequately distributed by banks and their size. More concretely, all three banking groups by size reported positive values of the profitability indicators, although only larger banks registered increase, compared with the previous year. The banks that registered a financial loss share around 3% of the banking sector's total assets.

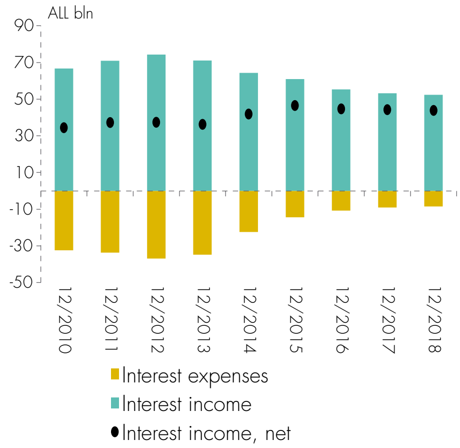
(97) The net result from interests registered ALL 40.3 billion, or ALL 0.4 billion lower than in the previous year. During 2018, banks collected around ALL 52 billion from interests and spent around ALL 9 billion to pay interest. Compared with 2017, interests' income and expenditure were ALL 1 billion and ALL 0.5 billion less, respectively. It must be noted that the decrease of interests' income is the result of the decrease of interests' income from transactions with clients (loans), whereas income from securities, the treasury and interbank transactions increased. On the side of expenditures for interests, the decline affected deposit, securities and treasury transactions. Net margin from interests declined at 3.75% from 3.9% in the previous year, reflecting not only the decline of the net result from interests, but also the increase of the level of average income earning assets.

Chart 95 Financial result components



Source: Bank of Albania.

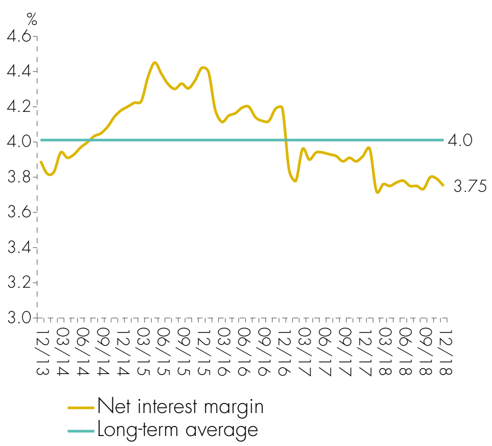
Chart 96 Interest income and expenses, and net interest result



Source: Bank of Albania.

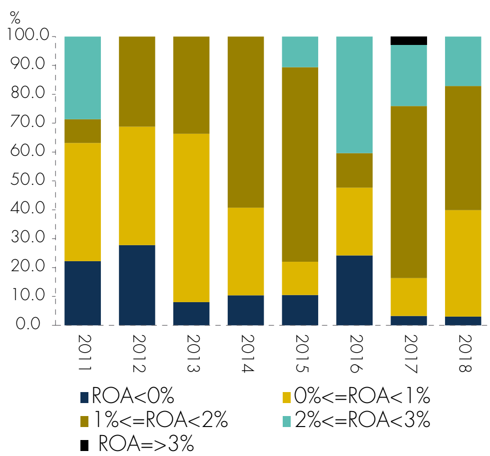
(98) **Income from other activities (not related with interest) declined by around ALL 2.4 billion in annual terms shifting into negative value (ALL -0.4 billion).** This shift was due to higher losses from financial instruments, which expanded by ALL 2 billion compared with the previous year. Overall activity expenditures increased by ALL 0.5 billion. On the other hand, extraordinary income made a positive contribution to the net result, registering ALL 4 billion, or ALL 2 billion more that the value reported in 2017. The latter were affected by the repayments of non-performing loans.

Chart 97 Net interest margin



Source: Bank of Albania.

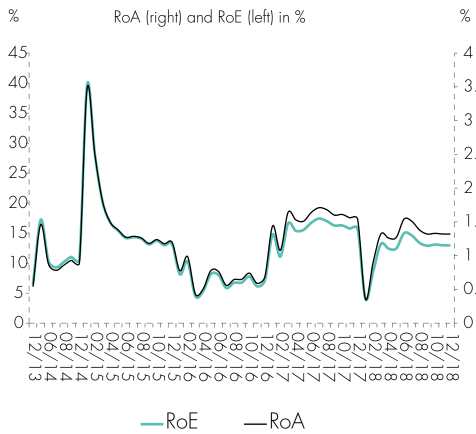
Chart 98 ROA by banks' share in the assets of the sector



Source: Bank of Albania.

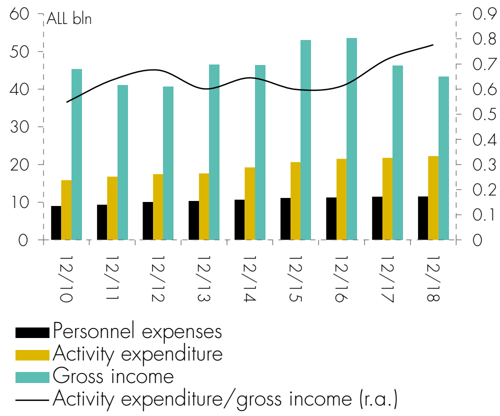
(99) Banks' expenditures in the form of provisions for credit risk during 2018 were ALL 2.3 billion, remaining significantly below the average level of ALL 15 billion of the period 2012-2016. However, compared with 2017, these expenditures increased by ALL 1.1 billion and affected negatively the financial result of the banking sector. Expenditures for other financial assets were negative (reversal of provisions). The value of reversal of provisions for these assets was around ALL 9 billion and decreased slightly compared with the previous year. Due to the increase of loans provisioning and the decrease by around ALL 0.7 billion in the value of reversal of provisions for other financial assets, the profit of the banking sector contracted by around ALL 1.8 billion.

Chart 99 Profitability indicators



Source: Bank of Albania.

Chart 100 Activity expenditure and net income



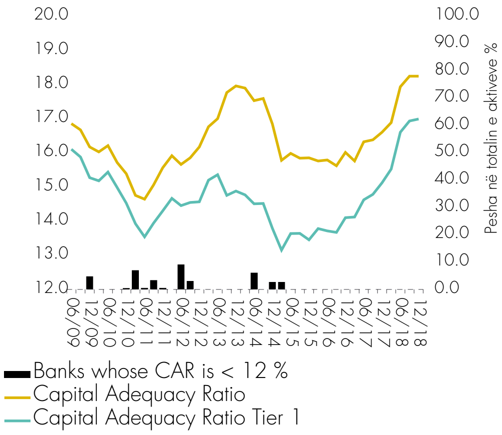
Source: Bank of Albania.

(100) Activity costs were well covered by activity income. Overall, personnel costs and other operating expenses maintained stable levels and currently share around 80% of gross income from the banking sector's activity. Interest expenditures also remain low and stable, due to the low level of the interest rates. As a ratio against total income, personnel costs and other operating expenses have increased, in the last two years, mainly owing to the downward trend of gross income. Operating expenses are around twice higher than personnel costs and have registered a faster increase than personnel costs during the last 10 years.

6.2.2 CAPITALISATION OF ACTIVITY

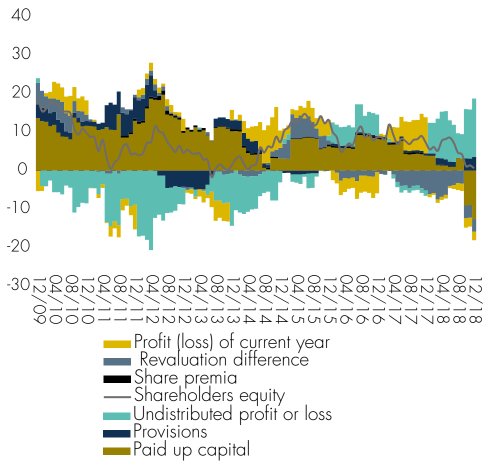
(101) The capitalisation of the banking sector during the period registered a growth. At the end of 2018, the Capital Adequacy Ratio stood at 18.2%, from 17.9% at the end of 2018 H1 and 17.0% at the end of 2017. Small banks and those with foreign capital have the highest level of Capital Adequacy Ratio. Since mid-2015, 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 10 banks of the system. Compared with the previous period, a higher number of banks have Capital Adequacy Ratios on the 16%-18% and 20%-30% ranges, while during 2018 H1 most banks fell in the 14%-16% range.

Chart 101 Capital Adequacy Ratio



Source: Bank of Albania.

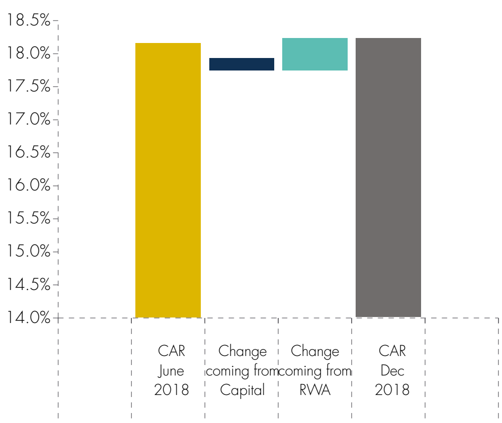
Chart 102 Annual contribution in capital increase by component instruments, in p.p.



Source: Bank of Albania.

(102) The Capital Adequacy Ratio increased driven by the decline of risk-weighted assets, whereas the regulatory capital decreased slightly. The decrease of risk-weighted assets is mainly the result of the abrogation of the countercyclical measure in the form of requirement for capital buffers for investments in non-resident financial institutions in foreign currency[54]; capital requirement for credit risk also registered a decrease. At the end of 2018, total risk-weighted assets in the banking sector were around ALL 780 billion. This level was around 2.6% lower than in the end of 2018 H1 and the decrease of risk-weighted assets improved (increased) the Capital Adequacy Ratio by around 0.5 percentage point. The regulatory capital of the banking sector decreased by 1% at ALL 143 billion, as a result of the contraction of paid up capital, which is the main element of the shareholders' equity. The merger by absorption of two banks during 2018 as well the capitalisation of losses determined the behaviour of banking sector's paid-up capital and regulatory capital overall. The decline of regulatory capital provided a negative effect of 0.2 percentage point to the Capital Adequacy Ratio.

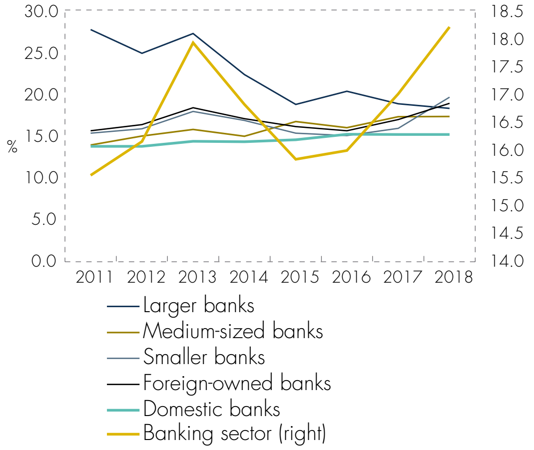
Chart 103 Capital adequacy items, in p.p.



Source: Bank of Albania.

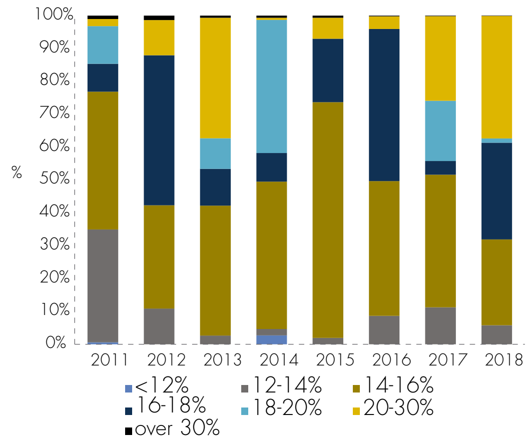
[54] *Decision dated 02.05.2018 "On some changes in the Regulation on capital adequacy".*

Chart 104 Capital Adequacy Ratio of groups by size and by capital



Source: Bank of Albania.

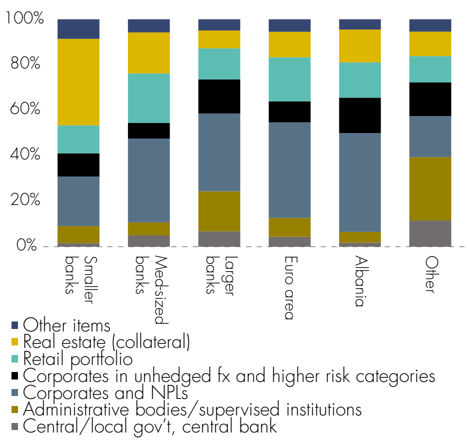
Chart 105 Asset allocation of banking sector by Capital Adequacy Ratio



Source: Bank of Albania.

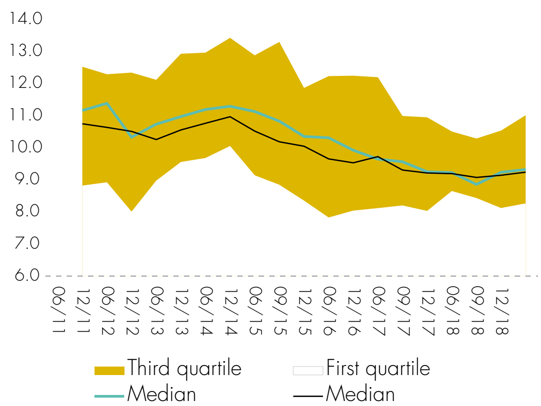
(103) **Assets related with credit risk continue to dominate the banking sector's total riskier assets, accounting for around 90% of them.** At the end of the period, small banks registered a high exposure in loans collateralised with real estate, while medium-sized and larger banks registered a high exposure in loans for corporations and non-performing loans. By capital origin, banks with domestic capital as well as those with European capital have high exposure in "loans to corporations and non-performing loans", whereas banks with domestic capital have a higher exposure in "unhedged loans to corporations in foreign currency and high risk categories" and "loans collateralized with real estate".

Chart 106 Credit classes' exposure of banks by size of activity and origin of capital, December 2018



Source: Bank of Albania.

Chart 107 Financial leverage ratio



Source: Bank of Albania.

(104) **Assets related with market risk increased by almost 15.9% during the period, reaching ALL 17 billion, or 2.2% of risk-weighted assets.** Assets related with operational risk decreased, but maintained the 10% share in total risk-weighted assets.

(105) **The Albanian banking sector is characterized by an adequate financial leverage ratio, thus confirming the good level of capitalisation.** The financial leverage ratio[55], as at December 2018, was 9.8 times, unchanged from the previous year. At bank level, the ratio appears also as stable and without significant shifts.

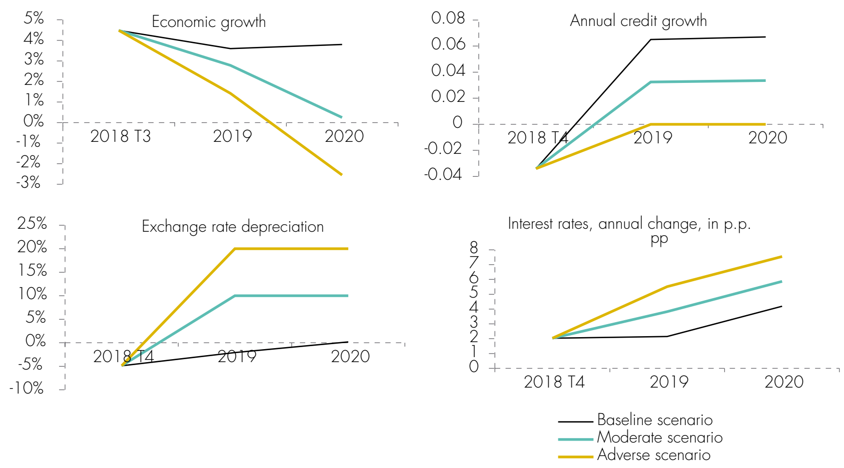
6.2.3 ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING

(106) **The stress test exercise assesses the banking sector's resilience in the face of hypothetical economic and financial developments, for the period 2019-2020.** The results show that the banking sector remains resilient. The impact of these assumptions in terms of capital adequacy evidences the need for additional capital in some banks, particularly in the case of the adverse scenario, where the assumptions are also more extreme. Liquidity stress test supports the assessment of a satisfactory liquidity situation of the banking sector, although in the two year horizon, inflows show a higher increase than outflows compared with the results of the previous year.

6.2.3.1 Assessing resilience to macroeconomic shocks

(107) **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. The last two scenarios have a lower probability of occurrence and more extreme assumptions.

Chart 108 Assumptions for stress-testing



Source: Bank of Albania.

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

(108) **The baseline scenario assumes a positive but downward economic growth throughout the timeframe of the exercise.** In this scenario, 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 value of the non-performing loans portfolio, mainly according to factual collections and expectable write-offs from balance sheets (although the latter with a downward contribute until the end of 2020), is expected to further improve until the end of the exercise.

(109) **The moderate scenario assumes again a positive economic growth for the two years of the exercise, but lower compared with the baseline scenario;** meanwhile, the adverse scenario assumes again a lower economic growth on 2019 and its contraction in 2020. To the assumptions on the economic performance in the moderate and 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 until it stops. These developments resulted in the decrease of the credit portfolio quality, which by the end of 2020 deteriorates up to 8.4 percentage points (moderate scenario) and 15.5 percentage points (adverse scenario) compared with the factual values of December 2018. Overall, these assumptions contribute to downward values of the capitalisation indicators of the banking sector.

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

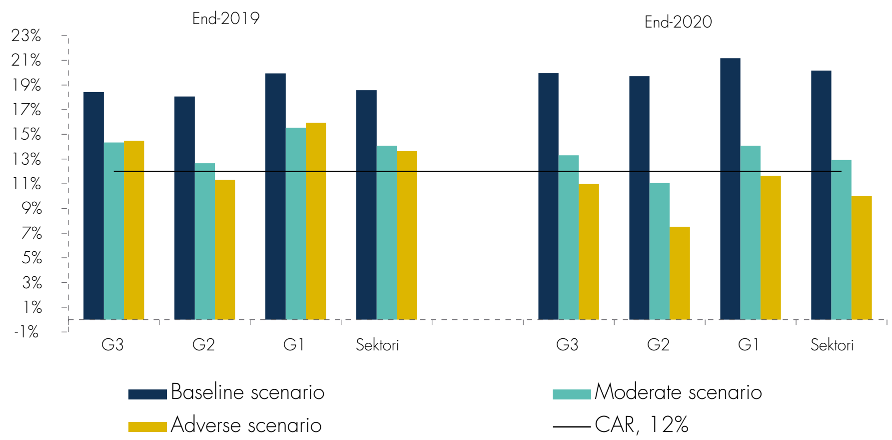
a. **In the baseline scenario, the Capital Adequacy Ratio (CAR) of the banking sector appears stable and upward against factual values of December 2018**. This rate is assessed to reach around 20.1% at the end of 2020, based on the assumptions of this scenario. This development reflects the assumption 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. The assumed performance of interest rates also gave positive contribution, based on the structure of "assets and liabilities sensitive to the up-to-12 months interest rate" of the banking sector. Developments by banking groups register good levels of capital, significantly above the minimum requirement by the regulatory framework.

b. **In the moderate scenario, the banking sector's CAR registers 14.1% at end-2019 and 12.9% at end-2020.** This rate is affected by the assumptions on the slowdown of economic growth, the halving of the growth of credit to the economy, the depreciation of the domestic currency and the increase of the non-performing loans ratio. Based on the above assumptions and the results obtained, developments in particular banks evidence the need for capital injection during the second year of the exercise. Specifically, seven banks appear under-capitalised by the end of 2020, accounting for around 22% of the sector's assets. In this case, the need for additional capital amounts up to ALL 3.7 billion.

c. **In the adverse scenario, the banking sector's CAR declines at around 13.0% at end-2019 and at 10.0% at end-2020 driven by the significantly more adverse assumptions included in this scenario.** The number of banks that fall into under-capitalisation rises to eleven and account for 88% of the sector's assets. The extreme macroeconomic developments included in the scenario, besides the negative trend of lending to the economy, affects the significant deterioration of credit quality. Also, this scenario assumes losses in the securities portfolio and higher exposure towards market and operational risks. In this case, the needs for additional capital are almost six-fold.

To express the required values for additional capital from the point of view of current banking sector developments, we note that the average value of annual growth of banking sector's paid up capital during the 2008-2018 period was around ALL 6.3 billion.

Chart 109 Capital Adequacy Ratio, by stress-test scenarios



Source: Bank of Albania.

6.2.3.2 *Liquidity stress test*

(111) **The purpose of the liquidity stress test is to assess the capability of individual banks and of the banking sector overall to withstand extreme but possible shocks in financing their activity.** These tests aim to evidence weaknesses or deficiencies of the sector and particular banks in certain currencies, instruments or time horizons; assess banks' readiness to cope with extreme liquidity shortfall scenarios; and, assist the supervision authority to undertake specific policies that address liquidity management, including measures aimed at reducing exposures or creating specific buffers.

(112) The liquidity stress test is implemented according to the "top-down" approach, with data reported by banks, once per year at the end of the year. The exercise uses data on forecasts for money inflows and outflows according to the main instruments and for a time period constituted by 8 maturity baskets that cover a period from "up to 1 day" to "over 1 and up to 2 years". The test is implemented for the lek, the euro and the US dollar and is based on the condition that the liquidity excess in a currency may not be used to cover the liquidity shortfall in other currencies, due to the probability of the fast depreciation of the exchange rate in times of liquidity crises.

(113) To calculate the liquidity gap, specific coefficients are applied for the withdrawal of funding sources (of deposits) and for the reinvestment of assets (loans) by all the maturity baskets. For financing sources, the coefficient shows only that part of the liabilities amount that matures in the relevant basket, which will be withdrawn to be reinvested by the client. For money inflows, the reinvestment coefficient means that part of the amount rights that matures in the relevant basket, which will be converted in money inflow and will not be reinvested by the bank.

(114) A bank is considered as failing the stress test only if expanded liquid assets, which are sold with haircuts defined by the exercise shrink to the level when additional liquidity by the Bank of Albania is needed, in the form of "loan for liquidity support".

(115) The results of the exercise indicate that the banking sector generally successfully passes the liquidity stress test, but the resilience of the banking sector to liquidity shocks is different depending on the currency. The ability of the banking sector to withstand liquidity shocks is assessed as "very good" for the lek and the US dollar and "good" for the euro. The gap between expected inflows and outflows at the end of the two-year horizon has deepened compared with the previous year, due to the liquidity situation in euro. Expected inflows in euro are significantly lower than in the previous year, while outflows are expected to grow slightly.

(116) The number of banks that continue to register a negative liquidity gap has risen particularly for euro, but the share of liquidity gap against the assets of the banking sector in each currency in significantly low and does not exceed 2.5% of assets in each respective currency. The scenario that assumes the use of expanded liquid assets to close the liquidity gap shows that: for the lek, the number of banks that fail to close the gap ranges one to two; for the euro, three banks continue to have a negative gap for all baskets, while the maximum number of banks with negative gap (6 banks) is registered in the 6-12 months maturity; for the US dollar, the maximum number of banks that fail in the test, assessed for the 3-12 months maturity, is three.

(117) The banking sector is assessed to have strengthened its resilience to liquidity shocks in lek compared with the previous year, but appears weaker

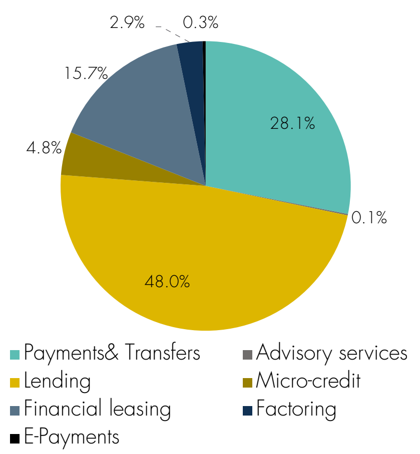
against potential shocks in euro. The strengthening of the resilience in lek is related to the increase of the volume of counterweighting capacities, while the weakening of the resilience in euro reflects the deterioration of the ratio between inflows and outflows as well as a slight decrease of liquid assets available for liquidation in the event of a liquidity shock.

6.3 MAIN DEVELOPMENTS IN THE NON-BANKING SECTOR

INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA.

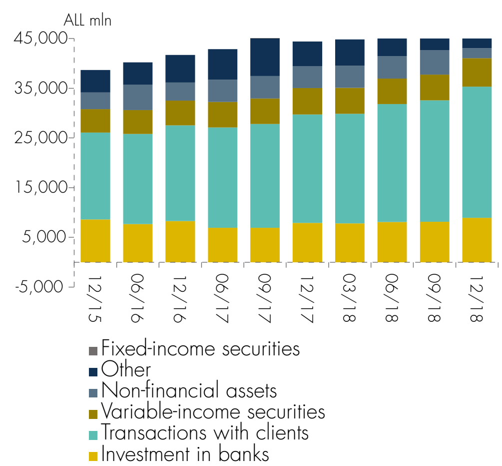
(118) During the period, non-bank financial institutions (NBFIs) expanded their total assets and registered good indicators of financial performance. As at the end of 2018 Q3, 30 NBFIs operated in the financial system, mainly engaged in microcredit, lending, leasing, factoring, e-money, etc. Lending NBFIs had the main share followed by those that provide payment and transfer services. NBFIs' assets reached around ALL 50 billion, or around 4% more than the total assets reported at 2018 H1 and around 10% more compared with 2017 H2. NBFIs reported a positive financial result (around ALL 1 billion) somewhat higher than the previous year. The capitalisation of the activity of NBFIs remained at satisfactory levels.

Chart 110 Structure of NBFIs by type of activity



Source: Bank of Albania.

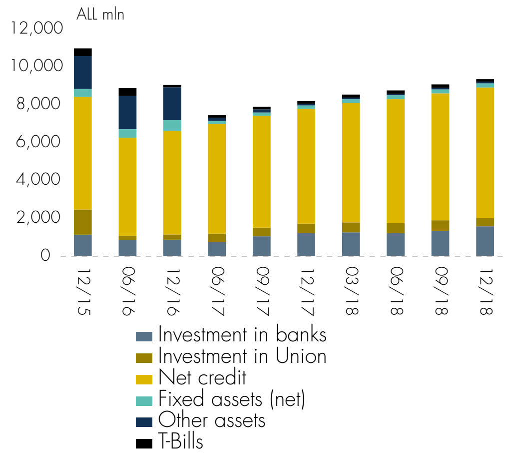
Chart 111 Structure of NBFIs assets



Source: Bank of Albania.

(119) The activity of Savings and Loan Associations (SLAs) registered an expansion in half-year and annual terms supported by the positive performance of the activity of the members (net loans) and the growth of investments in the banking sector in the form of current accounts. SLAs financial result was positive[56] and higher than in the previous year. Net loans to members and investments in banks represent the main items of NBFIs' assets. At the end of 2018, there were 13 licensed Savings and Loan Associations operating in the market.

Chart 112 Structure of savings and loan associations



Source: Bank of Albania.

INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY

(120) The activity of insurance companies increased during 2018 H2. As at end- 2018, there were 11 licensed companies providing life and non-live insurance and one company providing reinsurance services. The assets of these institutions recorded 9% annual growth and reached ALL 33 billion. Investments in banks held the main share (around 32%) in insurance companies' balance sheets. Gross written premiums[57], with the main contribution from non-life premiums (92%), which represent the main funding source for the insurance companies activity, expanded by 5.5% in annual terms.

(121) The activity of investment funds[58] contracted from the end of 2017, as a result of the decrease of investments in government securities. The value of net assets declined at ALL 66 billion, from ALL 73 billion in the previous year. 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.

(122) Supplementary Private Pension Funds[59] 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 2.2 billion or 26% higher than the end of 2017. The activity of pension funds is dominated by investments in government debt securities.

(123) The Albanian Securities Exchange (ALSE) licensed by the Albanian Financial Supervision Authority in July 2017, started its activity on 22 February 2018. In accordance with the limited license for the first year, the activity of the ALSE during the period consisted in transactions with government debt securities. The ALSE counts 4 members, which are banks and one brokerage company. The transactions conducted in ALSE are transactions for the account

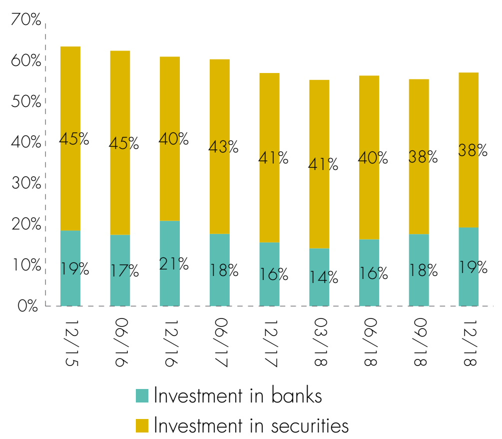
56 *Around ALL 110 million.*
57 *AFSA, "Insurance Market Statistical Report: Year 2018", published on 25 January 2019.*
58 *AFSA, "Collective investment undertakings market", 31 December 2018, published on 14 February 2019.*
59 *AFSA, Statistical Report "Developments in the private supplementary pensions", 30 September 2018, published on 16 November 2018.*

of ALSE members' portfolio (interbank transactions) and transactions for the account of customers (natural and legal persons). During the first year of its activity in February-December 2018, the volume of trade at the stock exchange was ALL 2.6 billion. The reported statistical data to the AFSA shows that interbank transactions share around 63% of the trade volume; the rest belongs to transactions with clients. Depending on AFSA's decision, the ALSE expects to list and accept for trading other securities in the future.

RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANK SECTORS

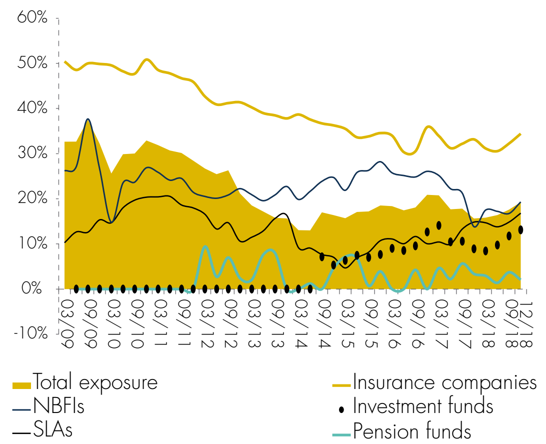
(124) **The banking sector's exposure to the non-banking sector in Albania remained low.** This exposure on the side of banks' assets is represented by loans and participation in the capital of non-bank financial institutions; meanwhile, on the side of liabilities it is in the form of funds collected by them (various accounts). In total, this exposure accounts for only 2% of the value of assets of the banking sector.

Chart 113 Investments of non-banks in banks and gov't securities, to total assets of non-banks (in %)



Source: Bank of Albania, AFSA.

Chart 114 Investments of NBFIs in banks, to their total assets



Source: Bank of Albania, AFSA.

(125) **The sensitivity of the non-banking sector to the activity of the banking sector remained high and upward during the period.** In total, this exposure accounts for 18% of the assets of the non-bank sector compared with 16% at the end of 2017. 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 32% and 17%, respectively, of relevant assets. The exposure of pension funds and investment funds to the banking sector has been increasing as well.