Bank of Albania

FINANCIAL STABILITY REPORT

2019/HII

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INTRODUCTION

This is the twenty third issue of Bank of Albania's Financial Stability Report (hereinafter "the Report"), which is published half-yearly. The Financial Stability Statement, whose half-yearly release is a legal requirement, prefaces the Report. The purpose of this Report is to identify and assess risks to the financial system of the Republic of Albania and its infrastructure, and it assesses the ability of the financial system to absorb these risks. This Report provides to the public authorities the possibility to timely identify the relevant measures for corrections, as necessary.

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 2019 (hereinafter "the period"). Unless otherwise stated, the expectations for the economic and financial outlook extend through a period of up to 12 months.

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

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

The Financial Stability Report is compiled by the Financial Stability Department and is approved by the Supervisory Council of the Bank of Albania.

NOTES

As at end-December 2019, the classification of banks in the Albanian banking sector, is as follows:

I. By marginal contribution of each institution in the systemic risk in Albania[1], banks are grouped into: "Systemically important banks" (SIB) and "Other banks" (non-systemic).

II. Banks operating in Albania are divided into banks with foreign capital[2] and banks with Albanian capital, by capital origin:

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

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

III. Banks operating abroad:

The National Commercial Bank and Credins bank show an expansion of banking network abroad, with their subsidiaries in Kosovo[3].

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

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

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[1] *The individual marginal contribution is measured by "Financial Strengthening Index". For more information on this index and of the determination of SIB, please refer to the document: https://www.bankofalbania.org/Finanacial Stability/Macroprudential policy/ Macroprudential policy instruments/ Approved acts/*

[2] *A bank is classified with foreign capital, whenever the foreign capital amounts more than 50% of the bank's paid in capital.*

[3] *Credins Bank has been granted the approval by the relevant authorities to conduct banking activity in the Republic of Kosovo; the operational activity is expected to start soon.*

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

(3) The transformation of NCB's Kosovo branch into a subsidiary in 2018 represents a structural break in the reported series of data for the period, which has brought about an effect on the analysed indicators of the whole sector. In this Report, this effect for the main indicators of the banking sector activity is present only in the framework of the annual analysis of the banking sector's performance.

FINANCIAL STABILITY STATEMENT FOR 2019 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 promote awareness among financial institutions and the public at large of the situation in the Albanian financial system and potential risks to its stability, the Bank of Albania releases this periodic statement. This statement is an integral part of the Financial Stability Report for the same-stated period.
The Financial Stability Report and the Statement prefacing it assess the exposure of the banking sector to risks arising from its interaction with the external and internal economic environment, real economy agents, financial markets in Albania, as well as operational risks in the activity of the banking sector. Furthermore, these risks are assessed through the stress test and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

The Bank of Albania deems that in 2019 H2 (hereinafter 'the period'), banking sector showed positive developments in its activity, based on the indicators of financial performance and exposure to risks. Banking sector, driven by the improvement of intermediation, contributed in the economic growth of Albania. Capitalisation indicators and stress tests show the resilience of the banking sector's activity. This stability will be maintained, notwithstanding the serious and exceptional challenge countered by public health and the economic development due to the SARS-COV-2 outbreak. For this purpose and to broadly contribute in the safeguard of financial stability at home Bank of Albania, in close cooperation with banking industry and in full harmonisation with other public authorities, will use all the legal necessary instruments both proactively and in a transparent manner.

This Report, as a rule, analyses the developments in the financial system up to the end of 2019. Overall, these developments, prior to pandemic outbreak, confirmed:

- *A stable framework of the economic developments in Albania and abroad*. Economic growth during 2019, although affected by November 2019 earthquake, remained positive and is assessed as broad-based, hence providing further fall in unemployment rate and supporting overall positive developments in the balance of payments, driven by the good performance of tourism sector and the stability of remittances. The consolidation trend of fiscal policy was useful to ensure a necessary correction for withstanding the short-term effects of the earthquake. Globally, economic developments did not show notable changes from the previous period. They were determined by: the trade war amongst the largest economies; the regional conflicts; and the continuation of accommodative monetary policies given the contained inflationary pressures.

- *Smooth performance of financial markets in Albania.* During this period, these markets witnessed the increase of interest rates in the primary market of government debt securities, on both short and long - term issuances. Volume of transactions in the secondary market was down, and mainly concentrated in short-term issuances, by reflecting the investors' preference to hold debt securities to maturity. The volume of overnight and 7-day transactions fell in the interbank market, but the interest rates remained close to the Bank of Albania's policy rate. Lek exchange rate showed low fluctuations during the period. In the real estate market, the survey indicators showed an increase of prices, driven by the rise in both demand and supply. During the period, the operation of payment systems was optimal, with increases in both volume and number of processed payments.

- *More favourable financing conditions to households and enterprises.* Both households and enterprises increased their financing from banking sector during the period, but this growth was faster for enterprises. Deposits of both sectors at banks were risen. The expansion of households' deposits was around 6 times higher than enterprises. The growth of households' deposits, mainly in foreign currency, reflected also the fall in their holdings of securities. According to the regular surveys of the Bank of Albania, the share of households having a debt to repay is relatively low (24%), and the debt burden is estimated at affordable levels. For the next period, households appear more ready to increase the borrowing level. Also for enterprises, debt burden is estimated at appropriate levels given that the value of debt amounts to half the value of capital for 78% of enterprises, and almost 67% of them declare that the repayment of debt does not exceed 20% of the activity income. The debt burden is higher for small enterprises. Also, enterprises show a higher readiness to increase the borrowing level in the next period.

- *Good performance of the financial system.* During the period financial system activity expanded by around 2.6 percentage points, up to 107% of the Gross Domestic Product. The expansion of banking sector's activity, by around 4% during the period, provided the main contribution in this growth. Lending and placements provided positive contribution in this performance, mainly the activity of investments in securities. Credit grew during the period, and over 2019 it expanded by 4.8% driven by lending to enterprises, credit in Lek and long-term credit. Deposits grew 5.4% during the year driven by households' deposits, demand deposits and foreign currency denominated deposits.

Banking sector closed the year with a higher rate of profitability than in the previous year, with RoA and RoE standing at 1.4% and 13.5%, respectively. Financial result was notably affected by the expansion of profit from financial instruments, while net interest income, which dominates the banking activity income, fell by 4.8%. As a result, net interest margin dropped to 3.4% at the end of the period from 3.7% a year earlier. Although capital adequacy ratio fell by 0.2 percentage point during the period, its 18.3% level is assessed as rather good.

- *Controlled exposure of banking sector to risks.* During the period, credit portfolio quality continued to improve. As a result, non-performing loans ratio dropped to 8.4%, for the first time at a one-figure level during the last decade. Repayments, write offs and restructuring provided their contribution in the fall of nonperforming loans. The write-off of nonperforming loans have re-started after the regulatory amendments set forth by the Bank of Albania, to shorten to two years the classification time of the loan classified as "lost" beyond of which the bank should write-off the loan from the balance sheet. The improvement of credit quality is mainly noted in: credit portfolio to enterprises; credit in foreign currency; and credit with longer-term maturity. In their efforts to improve credit quality, banks proactively managed the situation created after the earthquake of November 2019, which was however a shock limited in time and damage. A rather more complex challenge is ahead and which relates to the effects resulting from the current situation of the health pandemic on the economic development of the country. Liquidity situation of the banking sector appears rather good, by showing few changes during 2019. Regarding market risks, banking sector is sensitive to exchange rate risk through the segment of unhedged loans in foreign currency. Exposure to interest rate risk remains present, but it is relatively limited.

Risks to banking activity reflect and are intertwined with developments of structural nature. Such one is the existence for a long period of the environment with low interest rates, which: maintains the pressure on the financial result of banks; urges the change of its financing structure towards shorter-term sources and the need for liquid assets; and maintains the potential for the increase of activity's stress in case of a strong and unexpected correction. The high use of foreign currency in the banking sector is accompanied with risks for the liquidity risk management in foreign currency.

Through the regulatory actions of microprudential nature and macroprudencial policy instruments, Bank of Albania has sought to address these risks. New regulatory acts which are being implemented, including: liquidity coverage ratio; de-euroisation package of measures; and the Regulation on the implementation of macroprudential capital buffers; aim at decreasing risks and heighten the banking sector resilience to them.

ASSESSMENT ON THE IMPACT OF PANDEMIC

The situation of financial system and financial stability, and its capacity to counter risks should be assessed based on a forward-looking position. In this process, it is needed an overall assessment on the effects that the current coronavirus pandemic might have on both the economy and financial system stability.

This pandemic and the measures undertaken by the Government to protect the life of citizens and to eliminate the coronavirus emergency in the short-term, are accompanied unavoidably with changes on the way we carry out our daily life. These changes also include economic activities where the impact, while temporary, will be considerable. In more concrete terms, both public and private enterprises (with the probable exception of those that provide basic life services), depending on their ability to adopt even partially, may face a disruption in the chain of trade relationships and will experience on average a considerable drop in the sale of goods and services. This will cause a decline of revenues and difficulty to pay the financial liabilities related to fixed and variable expenses. This situation will also affect the employees and the overall households' income, as the fall of the activity of enterprises may bring about a reduction of income or interruption of salary. In a chain reaction and for as much as it is not compensated by the savings of households and the state economic protective measures, it further may affect the weakening of their consumption and the difficulty to meet the financial obligations. The latter may include also the difficulty to repay loans taken at financial institutions, driving to a fall of credit quality in these institutions and a negative impact on their financial result. It is necessary, for as far as it is possible, that public authorities undertake rapid and important actions to interrupt the free occurrence of the above-stated scenarios and to support enterprises, households and the financial system in mitigating and countering the negative effects that accompany such scenarios.

This is also the position of international financial institutions and structures of European Union on the face of a situation which is assessed as an unprecedented one. The International Monetary Fund and the World Bank have made available financial funds and specific instruments to be used with the purpose of providing for rapid borrowing from countries with low and average income. The European Commission announced the special financial package amounting up to EUR 37 billion to counter the economic and financial effects that accompany the pandemic outbreak in a member country. The focus is on households and small and medium-sized enterprises, which may face urgent needs for liquidity. Recently, the European Commission declared that it will support the suspension of the Stability and Growth Pact obligations on fiscal responsibility, enabling member countries' governments to increase the necessary spending to counter the situation. In monetary sphere, the European Central Bank in the meeting of 12 March 2020, maintained the accommodative monetary conditions and increased at EUR 120 billion the size of the monthly package of liquidity injection through the purchasing of securities, aiming at also mitigating the fluctuations of interest rates. A few days later, a second package was approved amounting to EUR 750 billion. Previously, the central banks in USA and the United Kingdom had taken similar measures. These rapid actions, offered hope and helped in preventing and partially correcting the deep losses experienced by the most important financial markets. From the banking supervision view point in the European Union, the European Central Bank and the European Banking Authority have supported the need for flexibility in the regulatory treatment by the supervisory authorities, to enable banks to transform into a more effective transmission channel of liquidity in the economy during the current situation.

In Albania, public authorities have undertaken some measures which aim to mitigate the impact of pandemic on the economy, by expressing the need for a proportional and dynamic approach towards the developments of the situation and the uncertainties that surround it.

The initial financial package presented by the Government aims, in addition to strengthening the capacities of public health structures, to mitigating the financial consequences that this situation may bring about to the real agent of economy, hence to the economic growth of Albania. The package provides support to the population in need and ensures the basic income to employees of small enterprises and self-employed persons, in case their activity is interrupted due to the decisions taken by the Government. In parallel, the Government has offered state guarantees for the new borrowing of enterprises from banking sector in order to meet their short-term needs for liquidity. The latter provides the possibility to entrepreneurs to maintain the labour force in the short run but also to prepare in advance for an appropriate restart of the activity whenever that is possible given the situation. Further on, some "relaxations" in fulfilling the terms on tax reports are made public. Lastly, the announcement of the state of natural disaster situation by the Government turns the addressing of the pandemic situation into an absolute priority to the public structures; it accelerates the expansion, detailing and focus of supporting policies and provides the mechanisms that ensure a higher synergy between public and private entities, which is necessary to counter the situation.

The Bank of Albania has undertaken its actions regarding the institutional management, communication with the supervised entities, particularly banks, and in the framework of its legal policies.

As an institution, Bank of Albania has activated its emergency plan where in the centre are the health security of its staff and the continuation of critical functions of the central bank. For the first point, actions have been taken in compliance with the instructions given by the Institution of Public Health and the Government to limit the interaction with external persons; to prepare the framework for the identification and treatment of the potentially infected staff; to request the maximum implementation of the hygiene conditions; and to regularly disinfect the institution premises. In order to improve the conditions for physical distancing and reduce the infection possibility, a part of the staff is authorised to work from home. In parallel, it is ensured the continuation of the institution's critical functions, to fulfil the legal and contractual obligations. The open market operations of the central bank, transactions of cash supply to commercial banks, the well-functioning of payment systems and the relationships with contractors, have been at the centre of the attention.

Also, regarding the communication with banks, the initial focus was the same: activation of emergency plans with the purpose of ensuring the health protection of the staff and the continuation of the institution's critical functions. As the pandemic situation is unprecedented, the Bank of Albania shared with banks a Special Guideline regarding the actions of an organisation under such situation. In parallel, the communication with banks has continued to detail the organisation of their work and to agree the way of collaboration in order for Bank of Albania to provide supportive functions. So far, the volume of work is adapted to time limitations of activity and within these conditions, processes are carried out normally.

In the framework of its policies, the actions undertaken by the Bank of Albania may be divided into two groups: 1) in the monetary policy area; and 2) in the area of banking supervision and financial stability. The first group aim at supporting the liquidity situation of the financial system and the well-functioning of the money market. The Second group aim at, during this period of interruption of a considerable part of the economic activity in Albania, mitigating the impact of the situation on credit portfolio quality, releasing banks' resources from activities that may be postponed, and maintaining the good situation of liquidity and capitalisation of banks, in order that the basis for a recovery of the activity at the end of pandemic situation remains solid.

In the framework of monetary policy, the Supervisory Council in its meeting of 25 March 2020, decided to:

a) reduce the policy rate by 0.50 percentage point, to 0.5%; in this way banks may receive loans from the Bank of Albania at a lower cost and may reflect this lower cost in the liquidity they pass through into the economy. This is the lowest historical level of the policy rate of the monetary policy;
b) narrow the spread between the interest rates on overnight lending facility and overnight deposit facility, by reducing the interest rate for the overnight lending facility to 0.9%; once more, in this way banks that may need short-term liquidity, may meet such need by the special facility of the Bank of Albania.

Previously the Bank of Albania had decided to change the type of the daily auction of liquidity injection, to provide banks with unlimited liquidity at the policy rate.

In the framework of the actions regarding banking supervision and financial stability, Bank of Albania is focused on the need to help borrowers to temporary ease their liabilities to banks and other lending institutions, in case the borrower face difficulties in conducting the activity due to the measures undertaken to restrict the pandemic effect. For this purpose, the Governor of the Bank of Albania and the Prime Minister of the Republic of Albania issued a joint order requiring credit institutions to rapidly address the requests submitted by affected borrowers (enterprises and households) and postpone the repayments of their loans up to 31 May 2020. Following that, the Bank of Albania expects banks and other credit institutions to implement a proactive approach whereby, in consultation with borrowers, they engage in other known forms to reduce the probability of borrower's default, building on last years' experience. It is also necessary to assess and support the need of economic agents for new finance throughout and at the end of the pandemic situation.

In order to facilitate the activity of banks and other entities that are supervised, as they operate with a reduced number of staff, the Bank of Albania has temporary interrupted their on-site examination. Deadlines on consultations of various draft-regulations which relate to the activity of supervised entities have been postponed.

Although the pandemic will be temporary, it is unknown the time and pace that economy will exit its effects. For this reason, the Bank of Albania in consultation with commercial banks and other entities, will work to draft other regulatory actions which would be responsive to the developments. It should be highlighted that all the actions that are and will be taken, will be always oriented by the main objective: that of safeguarding the banking sector resilience. In this process, the capacities of the banking sector will be assessed on an on-going basis and for this purpose the stress test exercises will also be used.

For the end of 2019 and in relation to conventional risks, results of stress test exercises on the capitalisation and liquidity indicators show a rather good situation of these capacities. But the pandemic situation, due to the dynamic effects it is bringing to the economy of Albania, seems to represent a non-conventional risk. Facing this situation contains uncertainties which need to be captured appropriately by the current models that assess financial system and banking sector capacities. For these reasons, banks should:

- enhance the priority and frequency in realising these stress tests, by adapting the nature, the severity and the complexity of relevant scenarios;
- asses the adequacy of the capacities they have, to counter the eventual shocks arising from these scenarios, both in the short run and longer-term period;
- ensure a rapid and effective decision-making process, to strengthen these capacities. The focus should be on the undertaking of actions that not only maintain but also improve the situation of capital and liquidity buffers;
- strengthen the communication with the Bank of Albania to analyse the developments and financial results.

Although this Report analyses the developments until the end of 2019, it affirms that the pandemic found both financial system and banking sector at a good financial position. This financial position will enable banking sector to absorb the possible shocks arising from the effects that pandemic will have on the economy of Albania.

The Bank of Albania, in the framework of its role and policies, and in coordination with other public authorities, will undertake all the necessary actions in order that the banking system and financial markets operate in this period at most possible appropriate conditions and in a stable manner.

Hereinafter, you will find the detailed content of the Financial Stability Report for the second semester of 2019.

1. OVERVIEW OF THE MAIN RISKS TO FINANCIAL STABILITY

Macroeconomic and real indicators show a stable developments' framework, while banking activity appears more variable.

Overall, risks appear at contained levels.

1.1 FINANCIAL STABILITY MAP

As at end of 2019 H2, data in the Financial Stability Map show, overall, an unchanged level of risks in the overall macroeconomic environment and in real economy agents, and evidences various developments in risks related to banking sector activity. In more concrete terms:

A. Overall economic environment:

I. Risk from the "domestic economy" is rated as "average" and unchanged over a one-year period, mainly driven by the narrowing of output gap due to the decline in the size of the external debt stock to GDP and in the needs for external financing.

II. Risk from "external environment" remains at "average" rate, but downward during the year, mainly driven by the fall of oil prices in international markets. The economic performance of our trading partners and the fall in unemployment in countries with the highest share of remittances contributed at a lower degree in the mitigation of this risk.

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

I. Risk from "enterprises" is assessed as "average", maintaining the level of the previous year. Notwithstanding the improvement in the credit portfolio quality to enterprises and in the sub-indicator "financial position", private sector's expectations appear deteriorated regarding employment.

II. Risk from "households" is assessed as "average" and downward from the previous year. The rate of this category was affected by the upward pace of remittances, the improvement in credit portfolio quality to households and the developments in housing market.

III. Risk from "Government" continues to be assessed as "low" and unchanged over the last year. Nevertheless, the further expansion of deficit budget suggests for an increased attention on this sector.

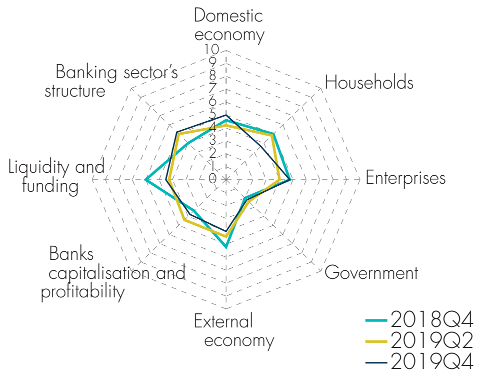
C. The banking sector activity at the end of the period:

I. Risk from "capitalisation and profitability" continues to be assessed as "average", albeit it showed an upward trend over the last year, mainly driven by the fall in the interest income of the banking activity

II. Risk from "funding and liquidity" fell from "moderate" in December 2018 to "average", reflecting a lower support on the external funding sources.

III. The risk associated with the "banking sector structure" is assessed as "average" but slightly upward from a year earlier, mainly as a result of the increase of concentration in the banking sector.

Chart 1 Financial Stability map



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

Source: Bank of Albania.

1.2 SYSTEMIC RISK[4]

1.2.1 INDICATORS RELATED TO THE MATERIALIZATION AND ACCUMULATION OF SYSTEMIC RISK

Exposure of banking system to systemic risk is assessed based on the indicators related to the materialisation and accumulation of systemic risk and of financial stress. Also, the perception of the banking industry regarding these risks[5] is included in this assessment.

Materialisation and accumulation of systemic risk and financial stress indices confirm that systemic risk levels remain contained.

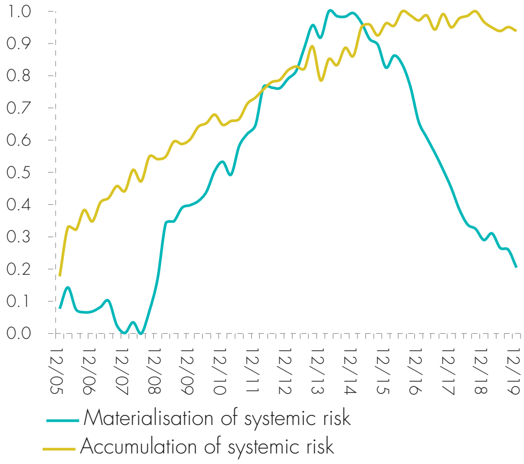
The materialisation and accumulation of systemic risk and financial stress indices reflect positive developments during the period. The improvement of credit quality, the fall of unemployment rate and the stability of foreign exchange rate contributed in the decline of risk materialisation. Also, financial stress index appears downward, by mainly reflecting the improvement from the expansion of deposits base.

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

[5] *Banking sector perception related to main systemic risks in Albania is attained through and ad hoc survey.*

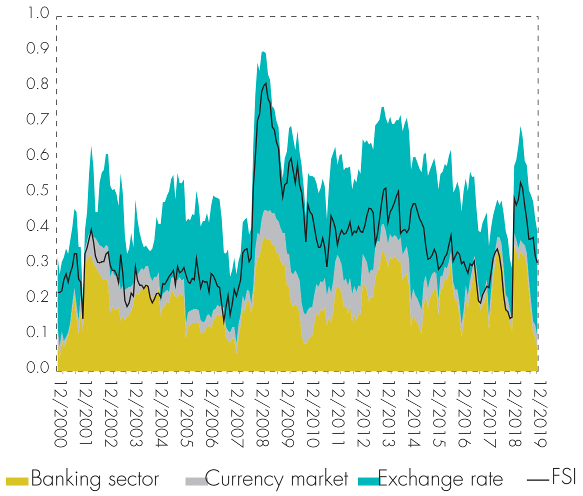
Systemic risk accumulation did not show strong movements during the year. Its increase is affected by the increase in the share of loans with variable interest rate, increase of house prices and the increase of loans to enterprises; while its fall is affected by the decrease in both public debt and external debt, in relative terms.

Chart 2 Accumulation and materialisation indices of systemic risk



Source: Bank of Albania.

Chart 3 Financial stress indices



Source: Bank of Albania.

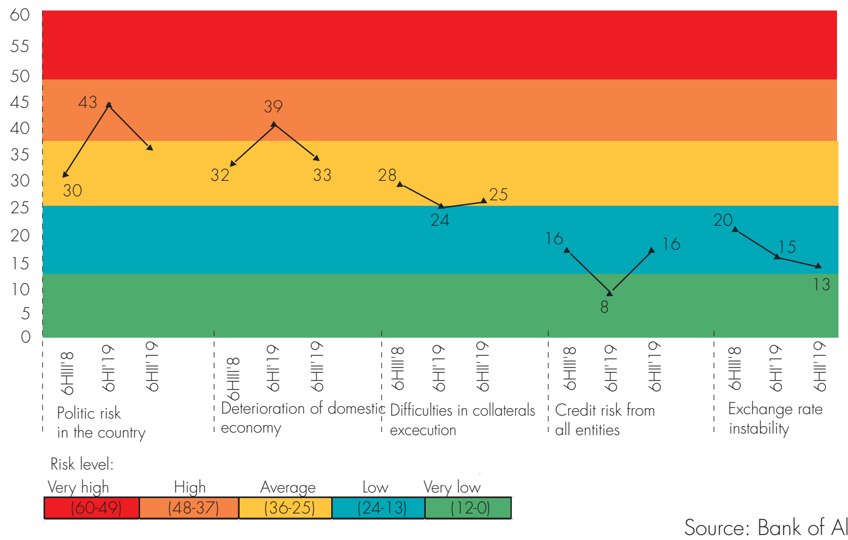
1.2.2 PERCEPTION OF BANKING SECTOR ON SYSTEMIC RISK

Although "domestic political risk" and "deterioration of domestic economy" remain the two most important systemic risks, the earthquake of November 2019 increased the uncertainty about the performance of a part of credit portfolio of banks.

Banking sector continues to identify "domestic political risk" and "the deterioration of domestic economy", as the two main systemic risks in the country. Nevertheless, the banks assessment on these risks has decreased from "high" in H1 2019 to "average" level in H2 2019.

On the other side, banks concern on "credit risk from all categories of clients" and on risk associated with the process of "execution of collaterals" has increased reflecting the overall uncertainty in the aftermath of the November 2019 earthquake, due to the major material and psychological damages caused.

Chart 4 Bank's assessment on the main systemic risks in Albania



Source: Bank of Albania.

2. MACROECONOMIC AND SECTORIAL DEVELOPMENTS

The fragile recovery of global economic activity is expected to be restrained by the escalation of the trade tensions and the impact of coronavirus pandemic "SARS-COV-2". The latter has caused already the disruption of production chain, globally, and it is assessed to affect the global economy, through the fall in consumption, investments, trade and tourism.

2.1 INTERNATIONAL ECONOMIC AND FINANCIAL DEVELOPMENTS

Global economic activity expanded at a slower pace during the period[6]. The reduced trade tensions between US and China, after reaching a prior deal, the continuation of accommodative monetary and fiscal policies in advanced economies and in a part of emerging economies, as well as diminished fears of a hard Brexit process, affected the stabilisation of the economic and trade activity. The overall developments in financial markets were positive and stable, benefiting from the supportive financial conditions. As a result equity market advanced, financial flows to emerging market economies strengthened and debt interest rates were downward. Global inflationary pressures increased somewhat during the end of the year, driven mostly by oil and food prices. Nevertheless, short-term inflationary pressures remain contained both in developing and advanced countries, reflecting the moderate economic growth rates.

International financial institutions[7] such as IMF, expect a modest pickup of global economic activity in the next two years[8]. The favourable conditions in financial markets and the continuation of accommodative policies in advanced countries and in a part of developing countries are expected to remain supporting factors of growth. On the other hand, the escalation of geopolitical tensions and migratory movements among countries, the re-emergence of concerns on trade policies, and recently coronavirus SARS-COV- 2 pandemic, are considered as the main risks to global economic outlook.

Developments in both foreign exchange market and commodities market reflected the global economic and political developments and the relevant expectations. In the foreign exchange markets, euro appreciated against the major currencies such as US dollar and the Swiss franc, but it depreciated against the British pound amid news of an increased likelihood of a smooth Brexit. In oil markets, after a downward period until October 2019, prices showed an upward trend, standing at around 70 USD per barrel at the beginning of January 2020. This performance was affected by the geopolitical

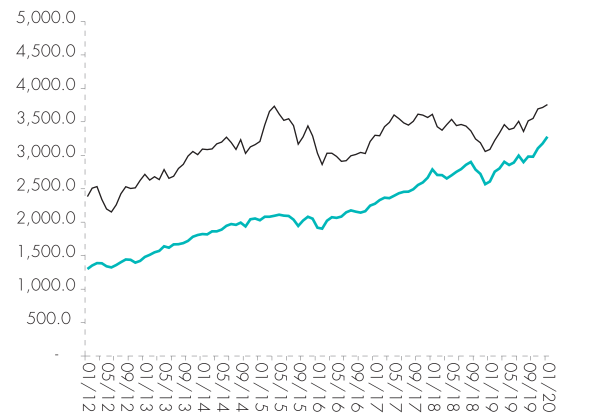
6 *Escalation of geopolitical and trade tensions, and the domestic economic and social problems in some developing countries, restricted its expansion.*

7 *These expectations do not include the latest reactions related to coronavirus pandemic (SARS-COV-2). According to these reactions, the negative impact of pandemic on global economy, and particularly on the most-affected countries, will be considerable, although temporal.*

8 *IMF forecasts global economy will grow by 3.3% during 2020, and by 3.4% during 2021. (World Economic Outlook, January 2020).*

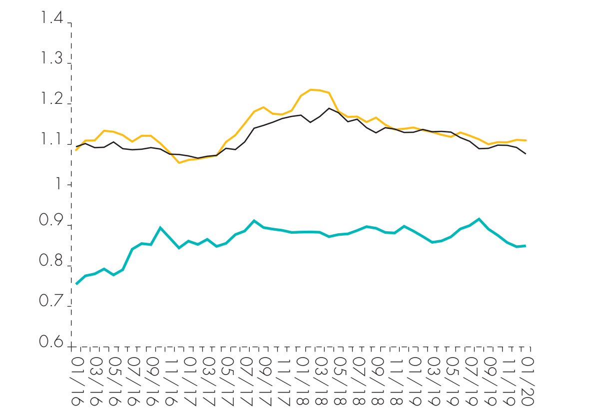
tensions in Middle East and the temporary mitigation of trade dispute between the US and China.

Chart 5 Main indices in shares market



Source: European Central Bank.

Chart 6 Euro exchange rates against other currencies



Source: European Central Bank.

Economy in Euro area continued to grow during the period, albeit at a moderate pace in 2019 Q4. Economic activity was mainly underpinned by domestic demand and the increase of investments, while net exports provided a negative contribution in reflecting the weakness of global trade activity and the fall in the external demand. In labour market, conditions continued to improve. At regional level, unemployment, fell to 7.4% in December 2019, the lowest recorded level in the last decade. Inflationary pressures remain contained, although they showed a slight increasing trend at the end of the year, mainly affected by the performance of oil prices. Against this backdrop, the European Central Bank (ECB) affirms its commitment to maintain the accommodative monetary stance, to support the regional economic growth and convergence of inflation close to 2%.

Euro area economic activity is expected to expand at a slow pace. The heightened external demand, the favourable financial conditions in international markets and the continuation of accommodative monetary and fiscal policies are expected to positively support the economic expansion of this region. Uncertainties related to the solution of trade disputes among larger economies, rising vulnerabilities in emerging markets, unexpected geopolitical tensions, and recently Coronavirus SARS-Cov-2 pandemic, are risk factors to economic outlook in the euro area.

In the European banking sector, lending to private sector continued to recover at a steady rate. In annual terms, lending to enterprises moderated at the end of the year, while lending to households continued to gradually consolidate, supported by the favourable financing conditions and the positive developments in the real estate market.

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

	GDP change (annual %)				Inflation annual (%)		Unemployment (annual %)		Government debt (% of GDP)	
	2019 Q3	2019 Q4	2019f	2020f	June 2019	Dec. 2019	June 2019	Dec.2019	2019 Q2	2019 Q3
U. S.	2.1	2.3	2.3	2.0	1.6	2.3	3.7	3.3	103.2	105.4
Euro area	1.2	0.9	1.2	1.3	1.3	1.3	7.5	7.4	86.4	86.1
Germany	0.6	0.5	0.5	1.1	1.5	1.5	3.1	3.2	61.1	61.2
France	1.4	0.8	1.3	1.3	1.4	1.6	8.5	8.4	99.6	100.5
Italy	0.5	0.0	0.2	0.5	0.8	0.5	9.8	9.8	138.0	137.3
Greece	2.3	:	:	:	0.2	1.1	17.1	:	179.6	178.2

Source: European Central Bank, Eurostat, International Monetary Fund (f- IMF estimates, January 2020),
BEA –Bureau of Economic Analysis). (U.S. Bureau of Labour Statistics). " : "- ": no available data.

Economic activity in the Western Balkans continued to recover. In 2019 Q3, annual real GDP growth averaged, 4.1% for the region, up from 2.9% in the previous quarter, mainly driven by the domestic demand and a rebound in investments in some of the countries. Economic expansion has led to the further improvement in the labour market conditions. Unemployment rate was down in most of the Western Balkan countries, although remaining considerably higher than in Western European countries. The strengthening of the domestic demand drove to an improvement of tax income, while public debt to GDP ratio decreased in some regional countries. Trade deficit also narrowed in most of the countries, but external imbalances still remain a key economic challenge to the region. Given the low inflationary pressures, the central banks monetary policy remained accommodative and in some cases there have been further cut in key policy rate[9].

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

	GDP (real, annual %)			Unemployment (in %)		Credit growth (annual %)		NPLs ratio (in %)	
	2019 Q2	2019 Q3	2020f	2019 Q2	2019 Q3	2019 Q3	2019 Q4*	2019 Q3	2019 Q4*
B&H	2.6	2.6	:	:	:	5.2	6.4	7.7	:
North Macedonia	3.4	3.6	3.2	17.5	17.1	6.3	6.4	4.8	:
Montenegro	3.2	4.7	3.0	14.7	15.6	1.6	3.5	4.7	4.6
Kosovo	4.1	4.4	:	25.3	24.5	10.4	10.2	2.1	2.0
Serbia	2.9	4.8	3.8	10.3	9.5	4.9	4.8	4.7	4.6
Albaniaa	2.5	3.8	3.7	12.0	11.8	3.0	4.8	10.6	8.4
Turkey	-1.6	0.9	3.1	13.2	14.2	-1.6	10.4	5.0	5.2

Source: European Commission, respective central banks.
f- Forecast for January, 2020; ':' no available information; "": data refer to November 2019 "a": data refer to 2019 Q4.*

Bank credit growth accelerated in 2019 Q4 compared to the previous quarter. In some countries, such as Albania and Serbia, lending growth to enterprises exceeded that to households. Non-performing loans ratio continued to trend downward, leading to further improvement of banks' balance sheet and expanding their lending capacity.

[9] *National Bank of Serbia and National Bank of the Republic of North Macedonia.*

2.2 MACROECONOMIC ENVIRONMENT IN ALBANIA

The interaction between monetary and fiscal stimulus with the positive performance of domestic financial environment, established the premises for a simulating macroeconomic and financial environment in Albania.

Gross Domestic Product registered a negative annual growth of 0.15% in 2019 Q4[10]. Nevertheless, prior estimations of INSTAT show an annual growth close to 2.2%. Overall, economic activity, during the period, was underpinned by the expansion of consumption and exports, while private investments were downward. Analysis by sectors of economy evidences that the positive and the increasing contribution of branches of "industry", "trade and transport" and "real estate", did not succeed to offset the negative contribution of the activity of "construction", "art, entertainment and leisure" and "agriculture". The narrowing of current account deficit in the balance of payments determined the positive contribution of the external sector of economy. In labour market, positive developments are confirmed by the fall of the unemployment rate at the lowest historical level of 11.2%[11]. Nevertheless, the expected developments in the short run about the employment in the main sectors of economy are on the downside, where the situation after the earthquake of November 2019 appears to have affected the overall perception of the agents. The ample financing of re-construction programme appeared to considerably improve this perception. But the coronavirus pandemic outbreak in Albania, depending on the diffusion intensity, the undertaken measures and its prolongation, is rather likely to provide a negative impact on the economy of Albania and on the labour market.

The narrowing of current deficit during the last quarter was mainly driven by the expansion of the surplus in services account and in secondary income.

The monetary policy maintained the accommodative stance, given the low level of inflation, which stood at 1.1% in December 2019[12]. Till the end of the year, the estimation was that the monetary conditions were adequate to sustain a stable economic growth and for the convergence of inflation to target in the medium term. But the impact of pandemic on economy drove to additional actions for a further easing of the monetary conditions. These actions guided by the objectives of the Bank of Albania, help to address the acute difficulties of the economic agents to deal with the economic challenges that they may face in the longer-term period.

As at end 2019, the budget deficit amounted to ALL 31.5 billion[13], with an annual growth of ALL 5.3 billion. During the year, budget revenues increased by 2.3%, but at a lower level than budget expenditures up by 3.3%. Budget deficit was entirely financed by internal funds. In relative terms, budget deficit accounts for around 2% of GDP, somewhat higher than in the previous year. The increase of budget deficit reflects the need for higher public expenditures to rapidly counter the damages caused by the earthquake of November 2019. During this year, fiscal policy challenges appear higher, given the need to financially face the acute challenges to maintain public health due to the

10 *Annual real growth of economic activity in Albania during 2019 Q3 was 4.2%, from 3.05% in the previous year (2018 Q4).*

11 *Unemployment rate was 12.3% in 2018 Q4 and 11.5% in 2019 Q2.*

12 *Average inflation in 2019 Q4 was 1.3%, from 1.4% in 2019 Q2 and 1.8% in the previous year (2018 Q4).*

13 *In the previous year (December 2018) budget deficit amounted at around ALL 26.2 billion.*

pandemic situation and to support a rather rapid recovery of economy at the end of the pandemic.

The overall balance of payments resulted with a narrowing of foreign exchange assets by about EUR 73 million[14]. Current account deficit narrowed by around 7%, in annual terms, at EUR 346 million. This development reflects the considerable expansion of surplus in services account and in the secondary income, notwithstanding the deepening of trade deficit in goods[15]. Remittances amounted around EUR 182 million, comparable to the previous period, but considerably upward from the previous year, around 8%. In relative terms, it is estimated that current account deficit accounts for around 8% of GDP, with an annual upward trend[16]. In the financial account, inflows amounted around EUR 77 million, driven by the upward trend of inflows in the form of direct investments[17]. In capital account, net positive flows were EUR 26 million, or down by 37% in annual terms. Foreign reserve assets cover 6.5 months of average imports in goods and services.

2.3 DEVELOPMENTS IN SPECIFIC SECTORS OF ECONOMY

2.3.1 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES[18]

The expansion of financial position by sector is attributable to the growth of deposits in foreign currency to households and of credit in lek to enterprises.

During the period, households expanded their creditor position, while enterprises expanded their debtor position.

In more concrete terms, both households and enterprises recorded a simultaneous growth of deposits base and outstanding loans, with a contribution from all currencies. For households, banks report an expansion of deposits (mainly in foreign currency) and credit stock, by around ALL 38.2 billion and ALL 7.0 billion, respectively. For enterprises, the growth by around ALL 9.7 billion of loans (mainly in ALL) was accompanied with an ALL 6.9 billion growth of deposits.
As a result, at the end of 2019, creditor position of households was up at around ALL 807 billion, and debtor position of enterprises expanded by around ALL 162 billion.

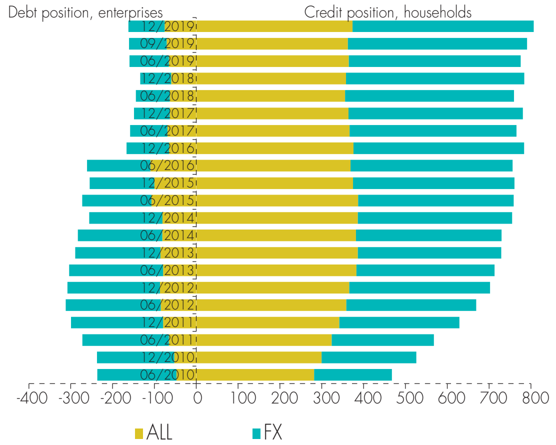
14 *Developments as per 2019 Q4 period.*
15 *Trade deficit in goods deepened by around 1.4% in annual terms following the fall in expenditures for imports by around 1.3% (mainly for fuels and the group " plastic and their items") and the fall in income from exports by around 10% (mainly in basic metals).*
16 *Current account deficit accounted for around 7% of GDP in 2018 Q4.*
17 *Foreign Direct Investments flows in the form of capital expansion are estimated at EUR 288 million, mainly concentrated in the sectors of energetic, fuels and financial intermediation".*
18 *The analysis refers to the main developments in the financial position of households and enterprises. For more information about banking sector developments see the respective chapter.*

2.3.2 HOUSEHOLDS

Albanian households' savings remain essentially oriented towards investments in the banking sector and less towards other investment forms provided by the alternative markets.

Resident households increased their savings, during the period, by around ALL 33 billion. Deposits growth provided the main contribution in this regard, despite the narrowing of investments in Government short-term securities of, and in investments funds of. In annual terms, households' savings oriented mainly towards investment in deposits in all currencies, as well.

Chart 7 Financial sectorial position (in ALL billion)



Source: Bank of Albania.

Table 3 Resident households' assets in the financial system

	2016, December		2017, June		2017, December		2018, June		2018, December		2019, June		2019, December	
	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %
ALL deposits	454.3	40.3	465.1	42.1	467.2	41.0	456.7	41.1	462.8	41.2	475.4	41.6	490.8	41.7
FX deposits	476.4	42.3	432.8	39.2	469.5	41.2	447.1	40.3	464.6	41.3	469.6	41.1	492.4	41.9
T-bills	65.2	5.8	67.3	6.1	63.6	5.6	65.1	5.9	59.4	5.3	56.8	5.0	52.7	4.5
Bonds	64.5	5.7	67.9	6.1	72.1	6.3	77.4	7.0	77.1	6.9	77.6	6.8	78.4	6.7
Investment funds	65.4	5.8	70.8	6.4	65.1	5.7	62.5	5.6	58.5	5.2	61.4	5.4	59.5	5.1
Supplem. private pension funds	1.2	0.1	1.3	0.1	1.6	0.1	1.8	0.2	2.2	0.2	2.3	0.2	2.6	0.2
Households' portfolio	1,127.00	100	1,105.20	100	1,139.10	100	1,110.60	100	1,124.60	100	1,143.10	100	1,176.44	100

Source: Bank of Albania, AFSA.
Note: Values market with "" belong to 2019 Q3 according to the last reports.*

*BOX 1 SURVEY RESULTS ON HOUSEHOLDS' FINANCIAL AND BORROWING SITUATION**

This survey refers to the developments in 2019 H2 and expectations for 2020 H1. Around 89% of the selected sample of households participated in the survey. Around 53% of them live in urban areas and 47% in rural areas. The Institute of Statistics is engaged in the selection of the sample, the on-site administration of the survey and its quality control.

The total number of employed individuals in the surveyed sample decreased compared to the previous six months and to the previous year. In both periods this decrease was driven by the decline in all three categories of employment (public sector, private sector and self-employed).

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

Around 24% of interviewed households state that they have at least one debt to repay, obtained through various sources. This share remained unchanged from 2019 H1 and slightly downward (by 1.8 percentage points) compared with the previous year, remaining below the historical average. The income index for the borrowers increased during the period, while the living expenses index registered a decline, resulting in an improvement of their financial balance (income - expenses).

The total outstanding debt reported increased in semi-annual and annual terms. Around 73% of the outstanding debt was obtained by formal sources (68% by banks and 5% by non-bank financial institutions) and around 27% by informal sources ("natural persons", "unpaid goods", etc.). This distribution shifted by 3 percentage points in favour of formal borrowing in both semi-annual and annual terms. By currency, 71% of outstanding debt was reported in ALL, whereas 14% in foreign currency (mainly in euro).

Regarding the debt purpose around 36% of the total outstanding debt amount was used to purchase/renovate a property, 36% to start/develop a business and only 7% for consumption. The share of the outstanding debt for purchasing/renovating a property has increased in semi-annual and annual terms, while the share of debt for starting/developing a business has increased in semi-annual terms but decreased in annual terms.

Most of the borrowing households reported that their monthly debt repayment has not changed during the half-year under review. Around 68% of borrowing households declared that their solvency has not changed, while the rest declared an improvement compared to both 2019 H1 and 2018 H2. For 2020 H1, most of households (around 75%) do not expect their solvency to change, while the net balance of the rest of responses shows weaker expectations.

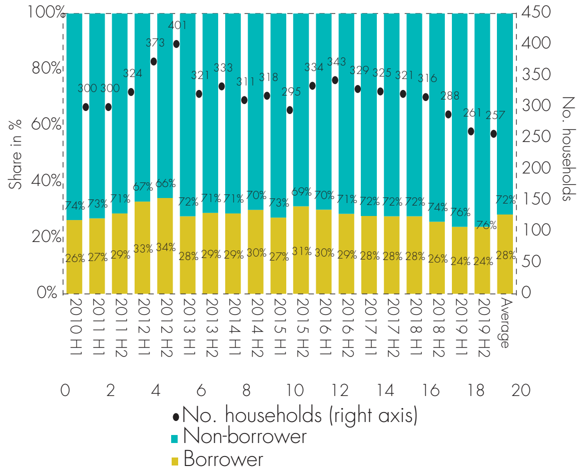
The probability to borrow during 2020 H1 is estimated as upwards compared with the previous period and the previous year, signalling a recovery of the demand for loans by households.

* For more information about this survey see: https://www.bankofalbania.org/Financial Stability/Analysis and studies/Surveys/Survey on the financial situation and borrowing of households in Albaniai.html

Households' debt burden remains at relatively adequate levels and shows a downward trend. The survey of households' financial and borrowing situation shows that around 24% of surveyed Albanian households have at least one debt to repay. This share has remained unchanged compared with the previous survey and has resulted in a slight decline compared with the previous year, but it remains 4 percentage points below the historical average (since 2010).

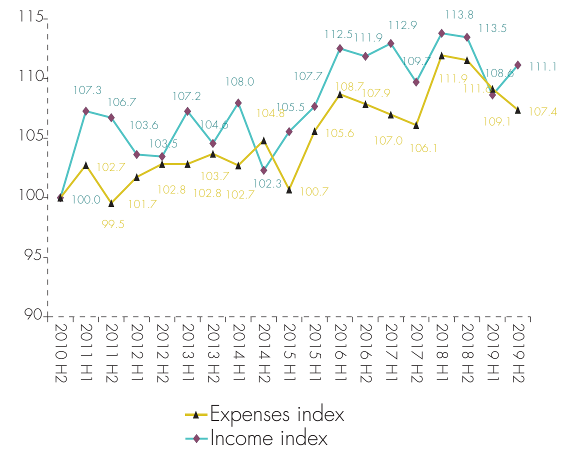
Households' debt burden remains at contained levels and the recovery of the demand for loans is a positive development.

Chart 8 Borrowing households
(in % to total responding households)



Source: Bank of Albania.

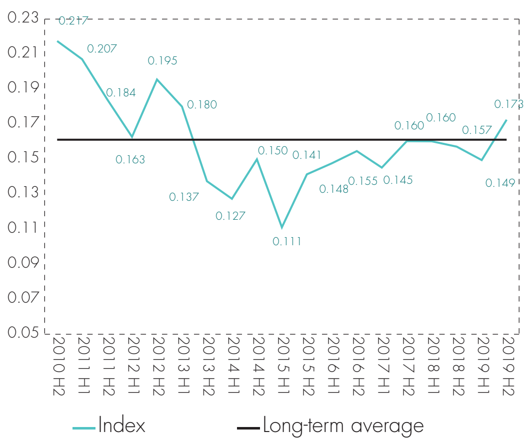
Chart 9 Borrowing households income and living expenses indices (2010=100)



Source: Bank of Albania.

Households' credit demand has shown recovery signals. Around 40% of responded households declared that they plan to borrow in the next six months. This share has increased compared to the results in the last two surveys. As a result, "the new borrowing planning/rollover index" has increased standing above its long-term average. In the group of households planning to take a new loan, around 63% of them are "new borrowers", meaning they do not have any debt to repay at the moment of interview.

Chart 10 New borrowing planning/rollover index



Source: Bank of Albania.

Chart 11 Households planning to borrow in the next six months

Source: Bank of Albania.

This share has increased in semi-annual and annual terms (by 4 percentage points respectively), supporting the positive expectations on new borrowing.

2.3.3 ENTERPRISES

Debt of enterprises is estimated at affordable levels, in terms of equity and income.
The more optimistic expectations for new borrowing in the short run represent a positive development.

The enterprises' debt burden is estimated at affordable levels and downward throughout the year, more pronounced for small and medium-sized enterprises. The total value of debt resulted approximately at half of the enterprise's equity, for 78% of borrowing enterprises, and equal to or higher than the value of equity for 22% of them. The debt/equity ratio resulted higher for large enterprises, with 23% of them declaring that this ratio is equal or exceeds the value of equity, implying a higher debt burden. By sector, debt burden is more pronounced in enterprises operating in services and in trade sectors.

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

	Industry	Services	Construction	Trade
2018 H1	22.4%	19.8%	15.2%	20.2%
2018 H2	20.7%	14.9%	15.0%	29.6%
2019 H1	26.8%	18.5%	18.3%	28.8%
2019 H2	20.4%	28.0%	13.4%	26.5%

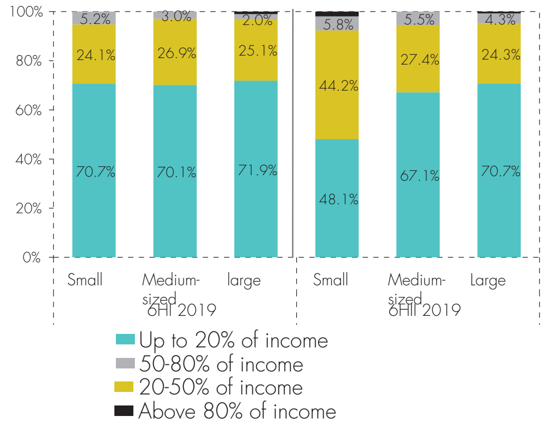
Source: Bank of Albania.

Most of borrowing enterprises (67%) declare that the loan repayment amounts to 20% of the enterprise's revenue and this share has decreased by 4.2 percentage points compared to the previous period. Debt payment seems to be more burdensome on small enterprises, with enterprises that report that it exceeds 20% of revenues accounting for 52% of the total of the group[19]; while for medium-sized and large enterprises, this share accounts for 33% and 29%, respectively. Asked if the debt repayment has changed during the period, most enterprises (94% of small enterprises, 92% of medium-sized enterprises and 93% of large ones) state that this repayment has not changed, while the rest resulted in net positive balances for small and large enterprises, showing an increase of this expenditure during the period, while it appears negative for medium-sized enterprises.

Enterprises' credit demand in the next six months, judging by their responses related to bank borrowing planning, has given upward signals. Around 48%

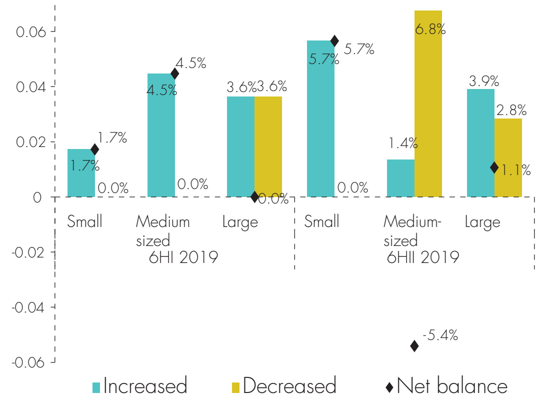
[19] *Calculated as the sum of weight for responses: "20-50% of total income","50-80% of total income" and "higher than 80% of total income".*

Chart 12 Enterprises by size and debt instalment/income ratio



Source: Bank of Albania.

Chart 13 Enterprises that declare a change in the debt instalment during the period

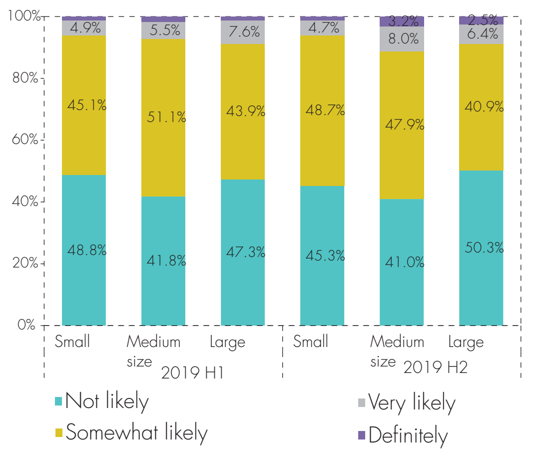


Source: Bank of Albania.

of responding enterprises declare that there is no possibility to demand a loan during the next period. Compared with the previous survey, this share has declined for small and medium-sized enterprises, but it increased for large enterprises. On the other hand, the share of small enterprises that affirm there is some possibility to take a loan in 2020 H1 has been increased, while the share of medium sized enterprises that declare there is a lot of possibility that such a thing happens is upwards. Also, all groups of enterprises, particularly medium-sized and large enterprises have recorded an increase in the alternative "it is certain", by appearing more optimistic in planning to borrow. This performance may signal an increase of credit demand in the short run.

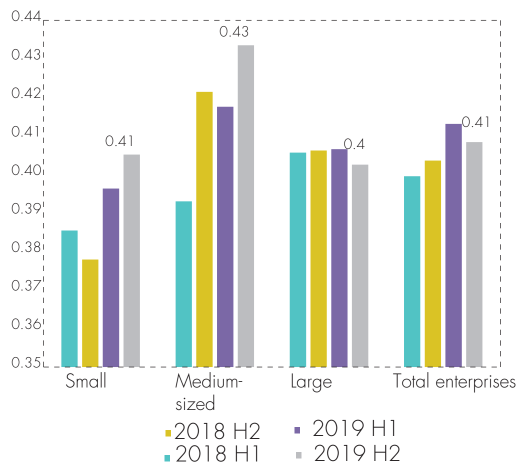
*BOX 2 SURVEY RESULTS ON THE FINANCIAL AND BORROWING SITUATION OF ENTERPRISES**

Chart 14 Enterprises planning to borrow in the next six months



Source: Bank of albania.

Chart 15 Bank borrowing planning index in the next six months



Source: Bank of albania.

This survey refers to developments in 2019 H2 and expectations for 2020 H1. This survey was conducted on a sample of around 1360 enterprises of various sizes, geographically located in various regions of the country and operating in the main sectors of the economy. 1111 enterprises or 82% of total enterprises participated in the survey by fully or partially responding to the questions of the survey.

During the period, surveyed enterprises report that competition and finding a market remain the main challenges of their activity. The significance of these factors is assessed as somewhat downward by small and medium-sized enterprises. Financing costs and availability of qualified staff have increased across all three groups of enterprises.

Sales and financial result during the period are assessed as upwards for medium-sized and large enterprises, and downwards for small enterprises, but improving compared with both previous surveys. All three enterprises' groups seem to have increased the efforts for expanding their activities, more pronounced for medium-sized and large enterprises. Expectations across all groups of enterprises remain positive related to the sales, financial result and the expansion of the activity, but they appear less optimistic compared with the previous period.

Over the period, more than half of total responding enterprises declare that they have financed their activity through sales. Reliance on this source alone has fallen for all three groups of enterprises, while the propensity to combine several sources of funding continues to have a considerable and expanded share during the period for all the three groups of enterprises.

Around 37% of total surveyed enterprises (overall 410 enterprises) declare that they are currently indebted. This share declined by 1.6 percentage points compared with 2019 H1 and by 5.2 percentage points compared with the previous year.

91% of borrowing enterprises responded that they used formal sources of borrowing (from banks and non-bank financial institutions), downwards by 4 percentage points compared with 2019 H1. Among them, around 86% of borrowing enterprises declare that they have turned only to the banking sector to borrow. Around 4% of enterprises affirm borrowing from only informal sources. 5% of enterprises have used a combination of both formal and informal sources.

Borrowing by enterprises is mainly used to conduct long-term investments (around 45% of total responding enterprises) and to face current expenses (30% of responding enterprises). During the period, borrowing in lek by 57% of small enterprises, 56% of medium-sized enterprises and 36% of large enterprises, while the rest is in foreign currency and/or in combined currency. Borrowing in foreign currency (mainly in euro) was used more by large enterprises (54%, exceeding the domestic currency, and less by small and medium-sized enterprises (35% and 38%, respectively).

Most enterprises consider the current level of borrowing to fund the activity as adequate. This share is lower for small enterprises and slightly lower for large enterprises, while it is upward for medium-sized enterprises.

Bank borrowing continues to be assessed between "normal" and "difficult". Compared with 2019 H1, the level of borrowing difficulty is assessed as *mitigated for large enterprises and increasing for small enterprises. The importance of relationships with banks is assessed between "important" and "necessary", but somewhat downwards across all groups of enterprises, more pronounced for small enterprises.*

* *For more information for this survey see: https://www.bankofalbania.org/Financial stability/Analyses and studies/Surveys/Survey on Enterprises' Financial situation and borrowing in Albania.html*

The results of the analysis on the number of applications for loan and the rejection rate on them from the banking sector support the positive expectations on the new borrowing. Against a high demand, mainly from "households", banking sector's supply appears less supporting towards them. This is reflected on the high number of rejections, compared with the number of rejections to "small and medium-sized enterprises" and to "other enterprises". Nevertheless, the analysis by structure identifies a different approach of domestic banks from foreign banks. More detailed information on the applications for loans and the respective rejections is presented following.

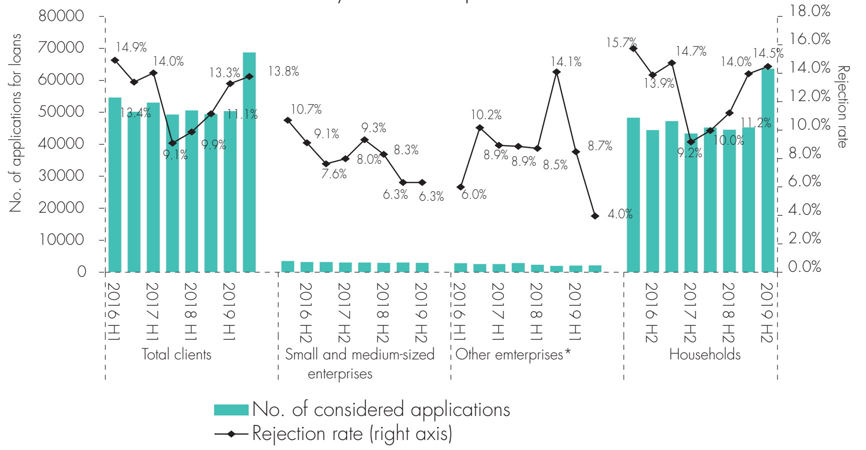
BOX 3 NUMBER OF LOAN APPLICATIONS AND ANALYSIS OF THE REJECTION RATE, 2019 H2

During the period, banks report that they screened overall 68,751 loan applications, with around 7% from "enterprises" (2,959 applications from "small and medium-size enterprises (SMEs)" and 2,149 applications from "other enterprises"), and 93% from "households" (63,643 applications). This structure has been shifted in favour of "households" compared with the two previous periods.*

*Total number of applications resulted around 36% higher compared to the previous period, driven completely by the segment of "households" (half-yearly increase by 41%), while the segment of "enterprises" in total has not changed (the share of "SMEs" fell by around 3%, while "other enterprises" increased by 4%). In annual terms, total number of screened applications increased by 39%, mainly driven from the segment of "households" (up 43%, and less from the segment of "enterprises" (total increase around 5%**.*

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

Chart 16 Performance of the considered applications' number and the analysis of the rejection rate

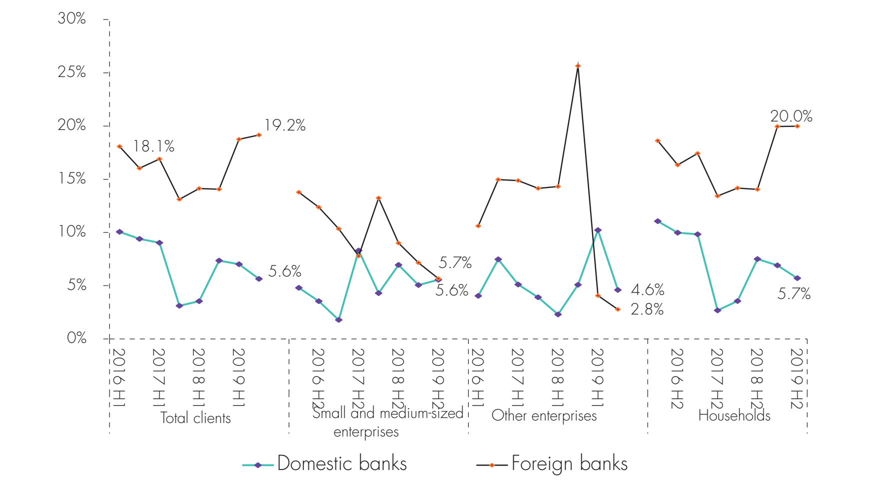


Source: Bank of Albania.

The analysis of the rejection rate by capital origin shows that, during the last years, this rate has been continuously lower for domestic banks compared with foreign banks. For the period under review, it appears that lending trend of both domestic and foreign banks continued to perform on different directions. Thus, the total number of rejected applications for loans by foreign-owned banks continued to increase at 19.2% (from 18.7% registered in the previous period), whereas for domestic banks the rate declined at 5.6% (from 7% registered in the previous period).

By customer segment, foreign-owned banks remained more rejecting to applications for loans to "households", and more accepting to applications from "SMEs" and "other enterprises". On the other hand, the rejection rate of domestic banks declined for "households" segment and "other enterprises", and increased somewhat for small and medium-sized enterprises.

Chart 17 The rejection rate for loans



Source: Bank of Albania.

Overall, the above analysis reveals that the number of applications screened by banks during 2019 H2 points to an upward credit demand from the segment of "households" while their preference to credit "large enterprises" continued to increase.

* *This group mainly consists in large enterprises and any type of other enterprises that is not classified as "small and medium-sized enterprises".*

** *Annual growth by 1% from "small and medium-sized enterprises" and annual growth by around 10% from "other enterprises, respectively.*

3. MARKETS AND PAYMENT SYSTEMS

Although investors' bid overall has been higher than the demand of Government for borrowing, the average yield on domestic debt increased during the period. The average yield on debt does not show significant changes from the same period of the previous year Short-term debt securities continue to account for the main share of debt, but their share has trended downwards.

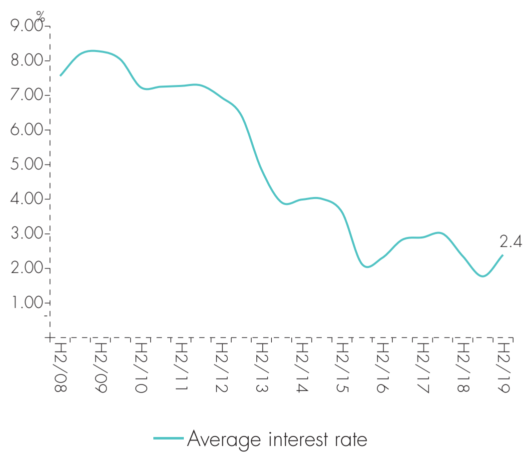
3.1 MARKETS

PRIMARY MARKET OF SECURITIES

In 2019 H2, the average yield on government debt securities increased. At the end of the year, this yield increased at 2.4%, around 0.6 percentage point higher from the historical minimum of 1.8% in 2019 H1, but comparable with the average yield in the same period of the previous year. Domestic debt in lek issued during the second half of year was around ALL 130 billion, or 25% lower compared with 2019 H1, but close to the value in the previous year. The concentration of issues during the first half of year has been a characteristic of the last years.

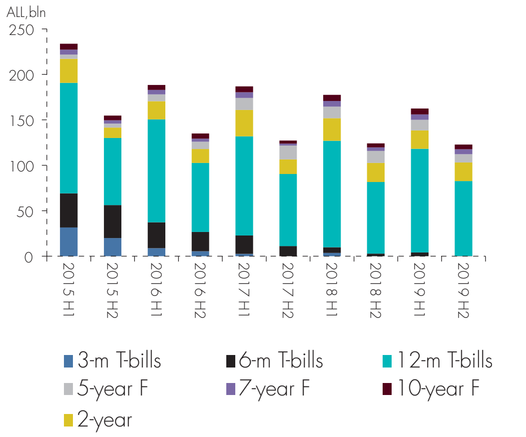
The structure of domestic debt in lek continues to be dominated by the short-term one, 63% of total. Nevertheless this share has been gradually downward.

Chart 18 Average yield on debt securities, in %



Source: Bank of Albania.

Chart 19 Composition of issued debt during 2015-2019



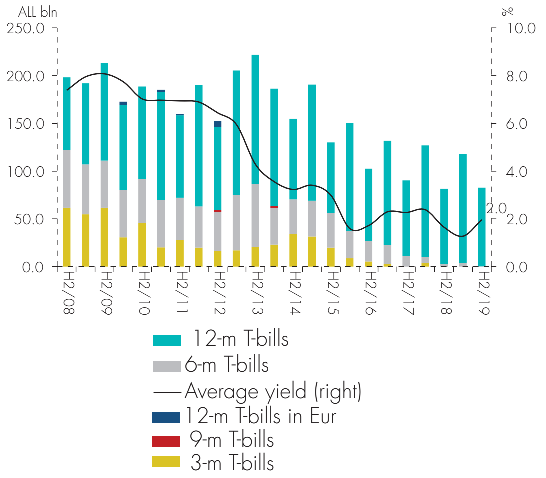
Source: Bank of Albania.

The average yield on short-term debt securities stood at 2.0%, upwards in semi-annual and annual terms[20]. The increase by around 0.7 percentage point of average yield on 12-month T-bills, which currently represent the entire short-term debt, affected the performance of the average yield. The issuance of Treasury-bills amounted to ALL 82 billion, or 30% lower than in 2019 H1, but at the same level with the previous year. During the period, the bid for investment in treasury bills was equal or higher than government's demand for borrowing. The yield

[20] *1.3% and 1.7, respectively.*

on T-bills with 12-m maturity increased from 1.7% up to 2.3% during the third quarter, but the continuing increase of the bid for investments affected the gradual decline of yield during the last quarter of year, and its return to 1.7%.

Chart 20 Volume and weighted average yield on T-bills in the primary market



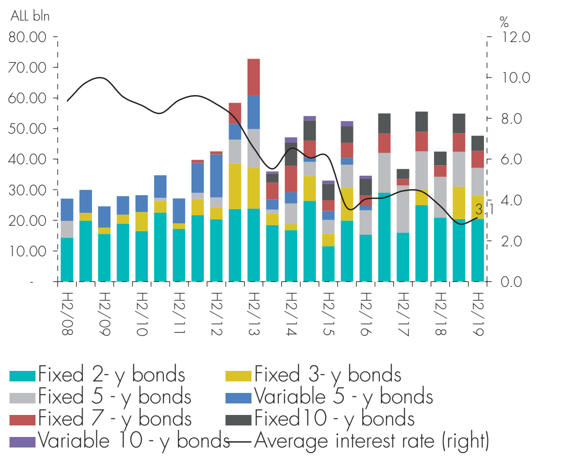
Source: Bank of Albania.

Chart 21 Surplus on the amount announced for investment and treasury bills yields, for 2019 H2

Source: Bank of Albania.

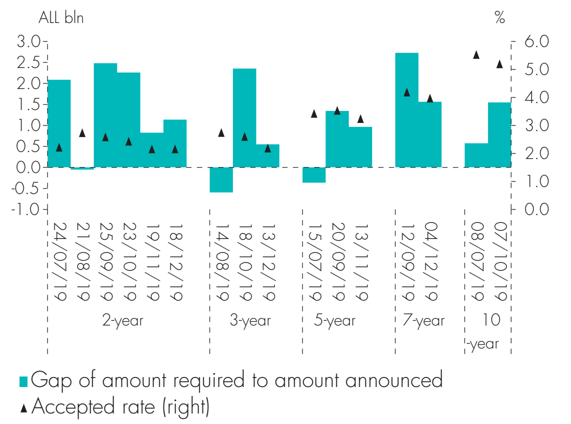
The average yield on long-term debt securities of the government increased standing at 3.1%, from 2.8% during 2019 H1. All long-term securities, except of 10-year maturity[21], recorded an increase of the average yields, from 0.04 up to 0.7 percentage point. The issued volume amounted to around ALL 48 billion, or 13% lower than in 2019 H1, but a comparable level with the previous year. Around 60% of the amount of issued bonds consists of 2 to 5-year maturity bonds, at a fixed yield rate. Overall, public's bid for investment in long-term securities has exceeded government's demand for borrowing, driving to a declining trend of yields during the last quarter of year.

Chart 22 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

Chart 23 Investment announced amount surplus and bonds interest rates, for 2019 H2



Source: Bank of Albania.

21 *Average yield was down by 0.2 percentage point.*

Activity the secondary market of government debt securities registered a decline in value and number of transactions.

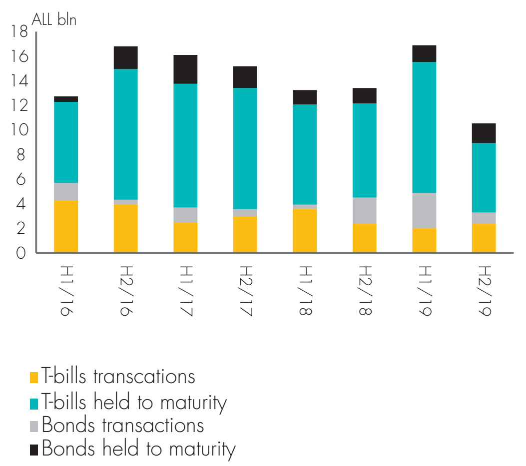
Investors in the retail secondary market continue to show a preference to keep securities up to maturity.

SECONDARY MARKET OF SECURITIES

During the period, the secondary market of government debt securities registered a decline in value and number of transactions. The volume of both long and short-term securities retail transactions carried out in the secondary market was around ALL 3 billion, and 33% lower compared with 2019 H1 and 27% lower compared with the previous year. The number of transactions was 1,120, or 11% lower compared with 2019 H1. The main impact in this trend came from the decline in volume and number of long-term securities by 70% and 40%, respectively, compared with the values of 2019 H1.

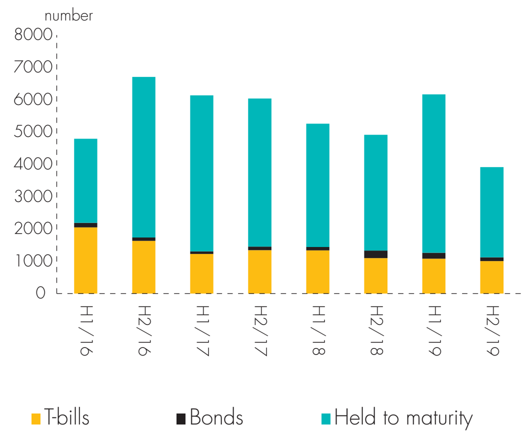
T-Bill transactions dominate securities transactions in the retail market, accounting for around 70% of the traded volume. Although the number of transactions has trended downwards compared with previous half-year and year[22], the traded volume increased slightly compared with 2019 H1, but remained at similar levels to those of 2018 H2. Investors in the retail secondary market continue to show a preference to keep securities until maturity (only around 30% of them are traded).

Chart 24 Volume of securities transactions in secondary market



Source: Financial Supervision Authority.

Chart 25 Number of securities transactions in secondary market



Source: Financial Supervision Authority.

Market makers have continued the daily quotations of benchmark securities (reference bonds with 3 and 5-year maturity), but the volume and number of transactions register lower values compared with the previous six-months and year. The daily quotation of benchmark securities allows the calculation of the yield curve, which serves as reference for other debt securities in the market and increases transparency by providing real-time information on long-term securities prices. The arched and rising yield curve signals a normal economic situation in which longer-term bonds have a higher yield than shorter-term bonds.

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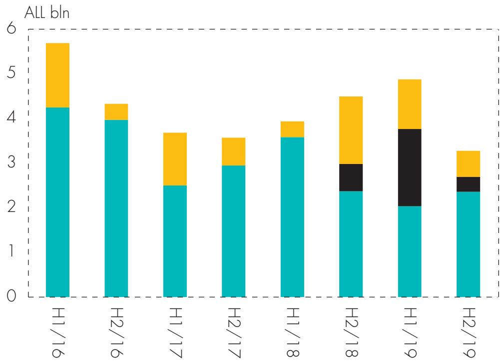
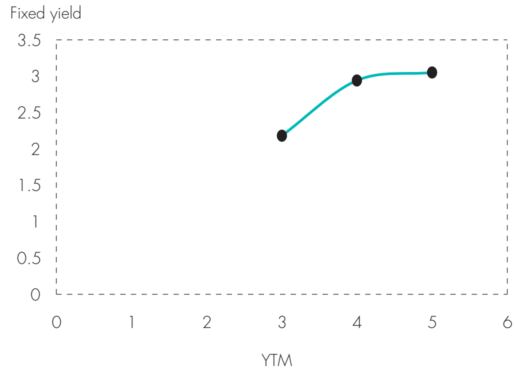
22 *Lower by 7% and 8%, respectively.*

Chart 26 Volume of securities transactions in secondary market



Source: Albanian Financial Supervisory Authority.

Chart 27 Yield curve (YTM) on 31.12.2019



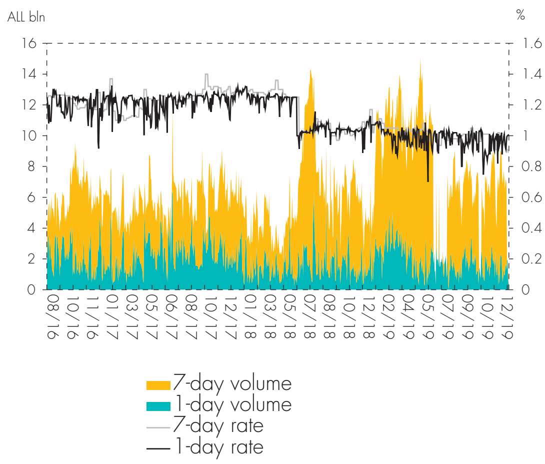
Source: Bank of Albania.

INTERBANK MARKET

Activity in the interbank market has contracted, while interest rates have fluctuated near the policy interest rate.

During 2019 H2 the number of transactions in the interbank market has contracted, while interest rates have fluctuated near the policy interest rate decided by the Bank of Albania. The interbank market continues to be dominated by one-week transactions (64% of the volume of interbank borrowing) followed by overnight transactions (22%). Compared with 2019 H1, the volume of transactions registered a decline due to the contraction of the volume of overnight and one-week transactions. Meanwhile, after a long period of absence, one-month transactions have reappeared in the market. The volume of these transactions accounted for 10% of the overall volume. Banks have also carried out 2-day and 3-day transactions, but at lower volumes, compared with other types. Interest rates remained near the policy interest rate of 1%.

Chart 28 Interest rates in the interbank market



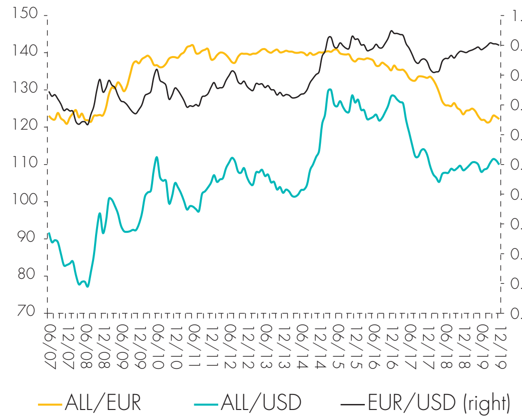
Source: Bank of Albania.

FOREIGN EXCHANGE MARKET

In the foreign Exchange market, the exchange rate overall has fluctuated at a low rate. It mainly has reflected the developments in international markets.

During 2019 H2, ALL/EUR and ALL/USD exchange rates maintained the trends registered in 2019 H1, while also following the trend of EUR/USD exchange rate in international markets. During 2019, the domestic market registered a slight appreciation of lek against euro (by 1%) and its depreciation against US dollar (by 1.4%). In December 2019, the average values of the exchange of euro and US dollar were ALL 122.2/unit and ALL 109.9/unit, respectively. Compared with June 2019, these values registered a slight depreciation of lek.

Chart 29 Exchange rate in the foreign exchange rate market



Source: Bank of Albania.

REAL ESTATE MARKET

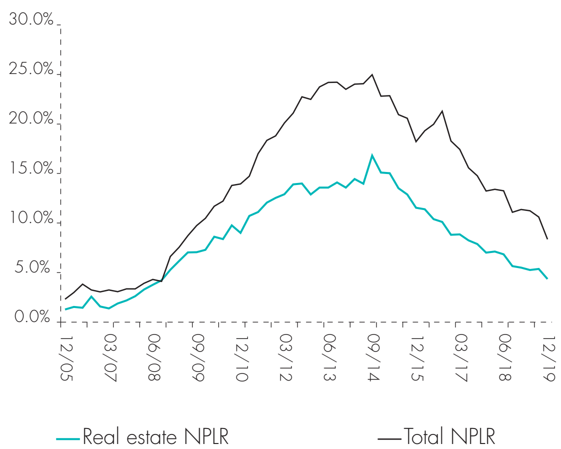
Indicators in the real estate market indicate an increase of demand and supply in 2019 H2. Overall, demand is supported by the increase of households' loans for real estate purchase, favoured by low interest rates and the easing of terms and conditions by banks for this type of lending. The reporting from real estate trading agents also indicate an increase of demand in 2019 H2, which show e decline of the number of real estate unsold and an increase of real estate sold. Supply in real estate market continues to be supported by lending for construction, which has maintained the level of the two previous periods. Data on the number of construction permits and surface size indicate that the interest for new constructions continues to be high. In 2019 H2, real estate trading agents have reported higher selling prices compared with the previous half-year. House prices, calculated based on the Fischer Index[23] for sales carried out during the period have increased by 13.8% compared with the previous half-year and by 33.5% compared with the base period (2013). For sales realized in the Tirana area, which includes down town, suburbs and the areas outside the city, the Index registered an increase of 14.9% compared with the previous period and 34.7% compared with the base period.

In real estate market, data from the survey and indicators of bank credit to construction and real estate show a good performance of the activity and support the increase of house price index. The agents remain relatively optimist on the developments of the real estate market.

Chart 30 Fischer Index of House Prices – National level and Tirana

Source: Bank of Albania.

Chart 31 Credit quality for real estate purchase



Source: Bank of Albania.

The agents remain relatively optimist on the developments of the real estate market, and overall the situation in this market is assessed as sustainable. Regarding the successive period, the agents expect the same number of real estate to register for sale and an increase of their prices.

[23] *The Index is calculated on the basis of data reported by construction companies and agents that operate in the real estate market.*

Banking sector data show an increasing level of lending surplus for real estate and an improvement of its quality for the period against the previous year. Lending stock for real estate purchase for households registered around ALL 120 billion at the end of 2019 and was around 6% higher compared with the end of 2018. The performance of this credit is also favoured by somewhat lower interest rates for this category of lending. Non-performing loans ratio for this type of lending decreased at 4.4%, from around 5.5% in the previous year. Outstanding loans for construction maintained similar levels with those at the end of 2019 H1 and the end of the previous year. The share of loans for construction accounts for 14% of outstanding loans to enterprises, maintaining levels almost unchanged over the last two years.

At the end of the period, the stock of loans collateralized with real estate increased, mainly based on the performance of collateralized loans in the domestic currency. Within this subdivision, 62% of the stock is held by the households sector and the rest by the enterprises sector.

BOX 4 SUMMARY OF RESULTS FROM THE "REAL ESTATE MARKET" SURVEY AND THE PERFORMANCE OF HOUSE PRICES INDEX FOR 2019 H2

The data on the performance of prices and the assessment of the situation by real estate market agents is collected through the field survey of a sample composed by 230 subjects whose main activity is trading real estate. The selected subjects are real estate agents and construction companies whose sales represent 75%-80% of the turnover of the entire population. The Bank of Albania conducts the drafting of the questionnaire as well as the submission and processing of the results, while the Institute of Statistics conducts the interviewing on-site, the main sampling and the physical control of the completed questionnaires.

General assessment: The assessment of the agents on the overall situation of the market does not show relevant changes compared with the previous period. Responding to the question "How do you assess the market situation compare with the previous period (six-months)?", the net balance of responses resulted [-2.2]% and shows that the number of agents that gave positive responses (better) has been almost the same with the number of those that have responded "worse", meanwhile around 60% of responses were neutral - "no change". This balance, although with a slight negative value, during the last years has narrowed significantly compared with the long-term average of around [20.7]%. The same indicator assessed only for subjects that have reported sales during the period resulted, as expected, with a positive value of 13.4%, in line with the long-term trend.

Performance of prices and sales: At the end of the period, Fischer House Prices Index, on a national level, registered an increase by 33.5% compared with the base period (2013) and an increase by 13.8% compared with the previous six-months. Sales volumes have declined slightly only in the central areas of Tirana, and have increased in all other areas of the capital and on a national level. The Price Index for Tirana increased by 34.7% compared with the base period and by 14.9% compared with the previous period. Average prices are reported to have significantly increased in all the country, but they have been relatively stable in coastal cities. In Tirana, they increased by 15.3% in the* *centre, around 25% in the areas outside the city and very slightly in the suburbs. In other areas**, prices also increased by 15.4% compared with the previous period. This performance may reflect the impact created by the earthquake of November 2019 where the demand for low-rise houses, mainly outside Tirana, is reported as upwards.*

Number of listed proprieties: Agents report a lower number of new proprieties listed in their books; the net balance of those reporting an increase of the number of listed proprieties and those that report a decrease was around [-11.5]%, showing slight changes from the previous period. The number of unsold proprieties, both for residential and commercial buildings, continues to be down for several consecutive six-months.

Average sale period: The average sale period of proprieties, at the national level, is reported to be 10.3 months, and registered a slight increase compared with the previous six-month. For Tirana, interviewed subjects reported an average sale period of 9.2 months or two months shorter than that reported for the previous six-months. For the coastal area, the sale period has increased from 8.3 months to around 10.3 months and for other areas the sale period increased from 9.2 months to 11.3 months.
Financing through bank credit: According to agents, around 65% of both residential and commercial proprieties sold by them were purchased with a bank loan. This figure registers an increase compared with the value of 46% reported in the previous period.

Expectations for the future: Agents have positive expectations about market performance in the territory in which they operate for the short-term future and are optimistic for a longer-term future (up to two years). The new listing for sale in the forthcoming period are expected to not have significant changes (net balance resulted [-2.3]%). Agents expect an increase of real estate prices. Net balance was positive for residential (16%) and commercial (15.8%) buildings, reflecting that the agents are optimistic. This balance has registered positive values at similar levels to the current value for several consecutive six-months.

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

* *The increase of the Price Index for Tirana and for the entire territory changes from the increase of average prices because Price Index also takes into account the "sales volume during base period/sales volume during reference period" ratio. The base period (2013) is characterized by high volumes and low prices of sales compared with the current period. For this reason, the increase in Price Index is lower compared with the increase of just average prices, which does not take into account sales volume.*

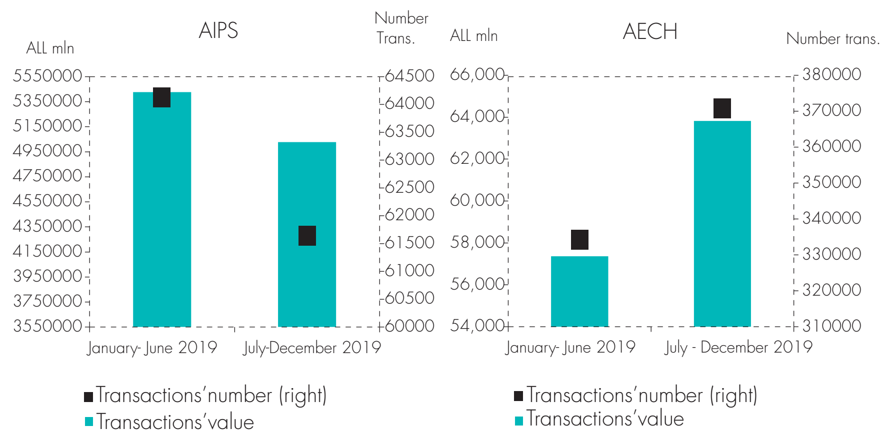
* *"Other areas" include all areas except for Tirana and the coastal area.*

3.2 PAYMENT SYSTEMS

The core infrastructure for clearing and payment settlements in the domestic currency has continued to function reliably and efficiently.

The core infrastructure for clearing and payment settlements in the domestic currency has continued to function reliably and efficiently, supporting financial stability and the implementation of monetary policy. In terms of processing activity, in the AIPS system were cleared 61,643 payments during the period with a value of ALL 5,026 billion. The number and value of transactions registered a decline of 4% and 7%, respectively, compared with 2019 H1. In parallel, in the small payments system, AECH, during the period were cleared 370,856 payments, with an average value for transactions of around ALL 172,000. Compared with 2019 H1, the activity of the AECH system registered an increase in both number and value of almost 11%, respectively.

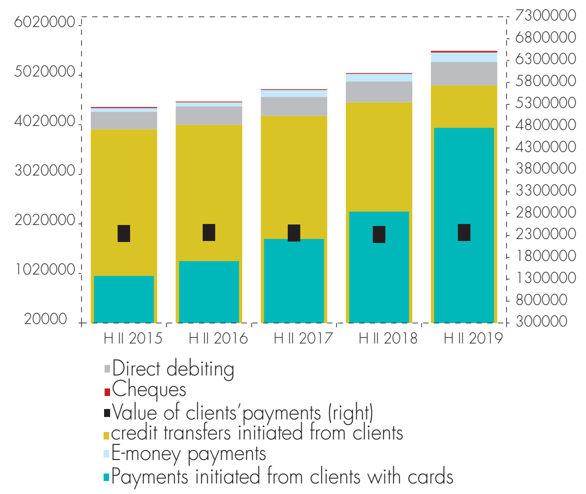
Chart 32 Performance of AIPS and AECH during 2019



Source: Bank of Albania.

Use of payment instruments registered a significant increase during 2019 H2. In this period were carried out around 10.3 million payments with a total value of ALL 2,374 billion. Compared with 2019 H1, the number of transactions increased by 23% while the value increased by 11%. Credit transfers continue to dominate in payment instruments, but the share of this instrument has declined, driven by the decrease in number and value of credit transfers in non-paper form (internet banking, mobile banking) as well as an increase of transactions carried out by card.

Chart 33 Performance of payment instruments in number and value (2014 H2-2019)



Source: Bank of Albania.

4. FINANCIAL SYSTEM

The share of total financial system assets to Gross Domestic Product (GDP) increased. Banking sector provided the main contribution in this regard.

Financial system performance indicators, in terms of capitalization, profitability, liquidity and asset quality, remain at good levels.

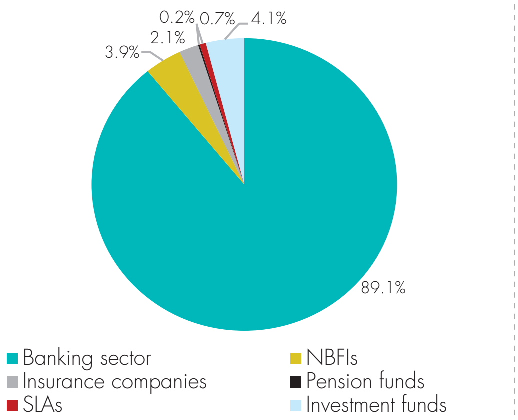
The share of total financial system[24] assets to Gross Domestic Product (GDP) increased to 107% from 104.4% at the end of 2019 H1, but did not change compared with the level of the previous year. The activity of the banking sector and non-bank financial institutions supported the increase of financial system assets, while investment funds assets registered a contraction.

During the period, the share of the banking sector in GDP increased by 2.5 p.p., at 95.5%, whereas the share of the non-bank sector increased by 0.3, at 11.7%. Financial system performance indicators, including capitalization, profitability, liquidity and asset quality, remain at good levels.

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

Licensing and Supervising Authority	Financial system	2011	2012	2013	2014	2015	2016	2017	2018	2019
Bank of Albania	Banking sector	88.1	92.1	94.8	97.6	97.3	100.5	99.4	96.0	95.5
	NBFIs	2.7	2.7	2.7	3.0	2.9	3.0	3.1	3.5	4.2
	SLAs and Union	0.8	0.8	0.7	0.8	0.8	0.6	0.6	0.6	0.7
Albanian Financial Supervisory Authority	Insurance compnaies	1.5	1.6	1.7	1.9	2.1	2.1	2.1	2.1	2.2
	Pension funds	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2
	Investment funds		1.2	3.9	4.8	5.0	4.7	5.0	4.5	4.3
Financial intermediation		93.1	98.6	103.8	108.2	108.0	111.0	110.3	106.9	107.2

Chart 34 Share of financial system segments to total assets of the financial system, December 2019



Source: Bank of Albania and Albanian Financial Supervisory Authority.

[24] *Financial system is composed of banking sector and non-banking sector (non-bank financial institutions, savings and loan associations, insurance companies, pension funds and investments funds). The database for insurance companies is for the period 2019 Q3, while for the other segments of the end of year 2019.*

4.1 BANKING SECTOR

4.1.1 MAIN DEVELOPMENTS IN THE BANKING SECTOR

Deposits and own funds remain the main funding sources of the banking sector's activity. The dependence on foreign funding sources remains limited, and records a further fall. The lowering impact of the exchange rate appreciation decreased considerably.

During the period, banking sector assets expanded by around 4%, while compared with the previous year assets' increase is around 1.5%. The reported value of assets increased by ALL 52 billion during the period, reaching around ALL 1,476 billion. The main contribution in assets' increase came from the expansion of securities investments by ALL 38 billion and the reduction of reserve funds by around ALL 10 billion. Lending and interbank activity affected positively assets performance due to the expansion of long-term loans and deposits in banks, credit institutions and other financial institutions.

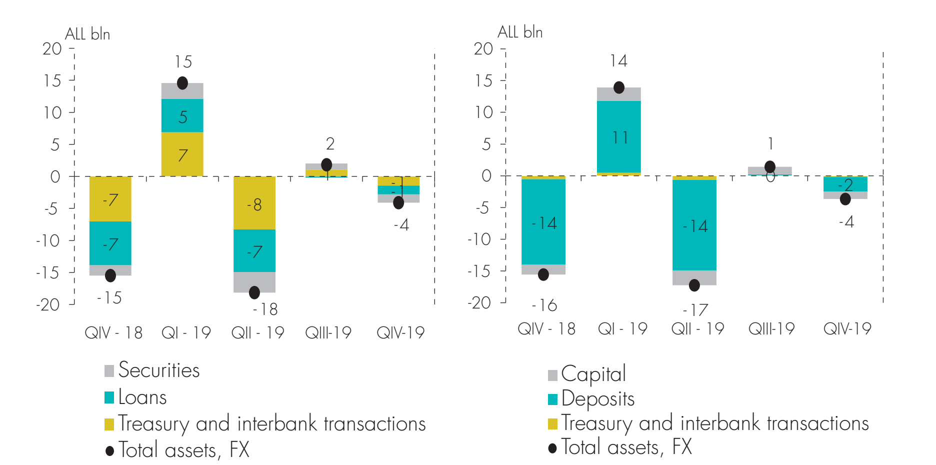
Table 6 Structure of banks' balance sheets and annual change, December 2019.

Asset	% of assets	Annual change,%	Liability	% of liabilities	Annual change,%
I Treasury and interbank transactions	31.9	-0.9	I. Treasury and interbank transactions	6.0	9.7
II Customer transactions (credit)	38.9	-0.8	II Customer transactions (deposits)	80.6	1.1
Of which: public sector	2.1	8.2	Of which: public sector	1.9	1.3
Of which: public sector	36.8	-1.3	Of which: public sector	78.8	1.1
III Securities transactions	27.4	5.1	III. Securities transactions	0.2	-63.6
IV Created Reserve funds	-1.9	-33.9	IV Other liabilities	0.9	-7.5
V. Other*	3.8	-5.6	V. Permanent sources	12.1	4.0
			Of which: Subordinated debt	1.0	3.5
			Of which: Shareholders' equity	10.5	4.2
Total assets	100	1.5	Total liabilities	100	1.5

Source: Bank of Albania.
** The item "Others" in the balance sheet refers to "Other assets", "Sustainable assets" and "Calculated interest".*

During the period, the statistical impact of the exchange rate on the value of foreign currency balance in banks decreased significantly compared with the previous two six-months, but has continued to affect the decline of reported values

Chart 35 The exchange rate effect on the lek equivalent amounts of main items in assets (left) and liabilities (right)

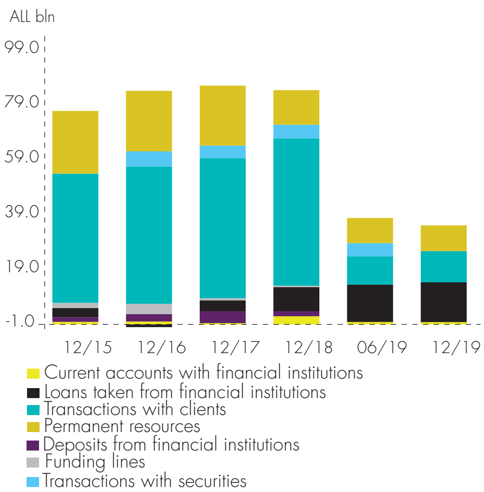


Source: Bank of Albania.

for foreign currency transactions. Foreign currency assets and liabilities in the banking sector constituted 53% and 51%, respectively of total balance, with a slight increase compared with 2019 H1. Regarding assets, the exchange rate has affected the main activities of banks in the same measure, while regarding liabilities, almost the entire statistical impact of the exchange rate (of ALL -2 billion) is reflected in the equivalent value in lek of foreign currency deposits.

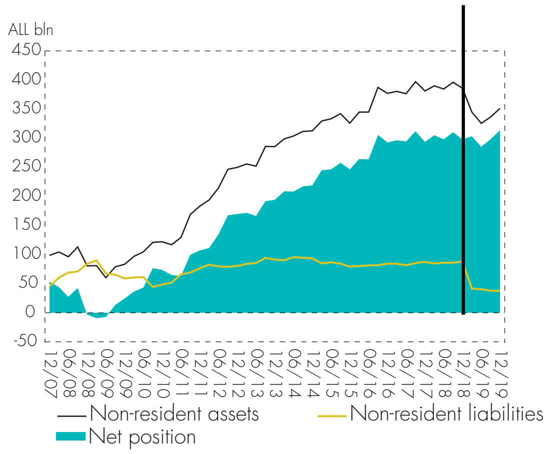
Deposits and own funds continued to be the main funding sources of banking sector's activity, accounting for over 90% of total liabilities and this structure did not register significant changes during the period. Reliance on external funding sources remained limited and declined further during the period. Liabilities to non-residents in the form of deposits and REPO purchased/sold securities continued to decrease. At the same time there has been an increase of deposits in the form of interbank deposits in non-residential entities and securities investments, which has affected the expansion of net credit position of the banking system. At the end of the period, claims against non-residents were 24% of total assets while liabilities were lower than 3% of total balance sheet. Net credit position expanded in both absolute and relative terms, reaching around 21.3% of total balance from 20% in the previous period.

Chart 36 Structure of non-resident liabilities



Source: Bank of Albania.

Chart 37 Net position with non-residents



*The vertical black line (right) reflects the period of transformation of the NCB branch in subsidiary.
Source: Bank of Albania.

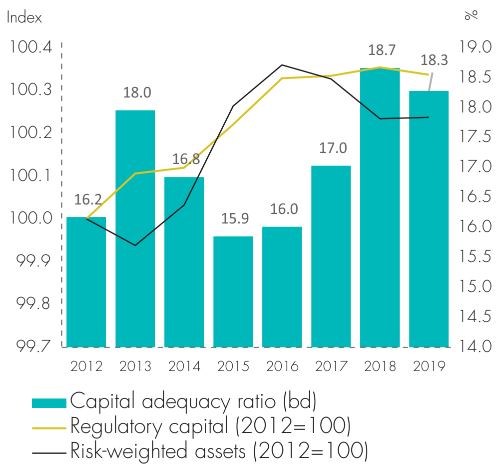
The faster growth of risk-weighted assets compared with the growth of regulatory capital, affected the slight fall pf capital adequacy ratio. Systemically-important banks, as a group, show high indicators of activity capitalisation. The performance of financial leverage indicator affirms that the sector's capitalisation shows at pleasant levels.

4.1.1.1 Capitalisation of activity

The banking sector continues to be characterized by high level of capitalisation indicators and at the level of individual banks no bank of the sector result with an adequacy ratio below the regulatory minimum of 12%. At end-2019, the Capital Adequacy Ratio registered 18.3% from 18.5% in July 2019 and 18.7% in the previous year.

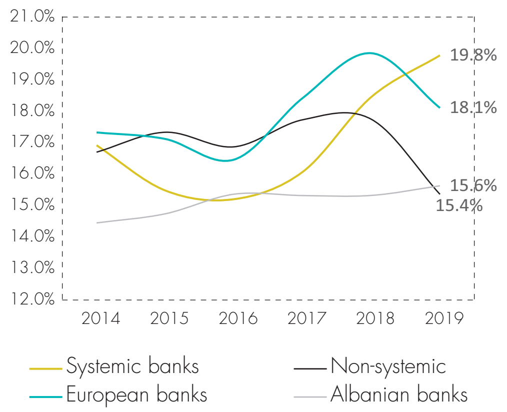
Banks classified as with systemic importance and banks with European capital have the highest level of Capital Adequacy Ratio. The decline of the number of banks from 14 in 2019 H1 to 12 at the end of the year was reflected in the changes in the distribution of Capital Adequacy Ratios according to certain ranges. Currently, 9 out 12 banks have a Capital Adequacy Ratio over 15% and there also an increase of the share of banks with Capital Adequacy Ratio in the ranges 18%-20% and over 20%.

Chart 38 Capital Adequacy Ratio



Source: Bank of Albania.

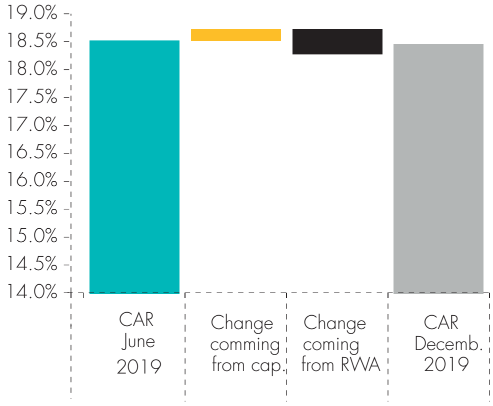
Chart 39 Capital Adequacy Ratio for groups by size and by origin of capital



Source: Bank of Albania.

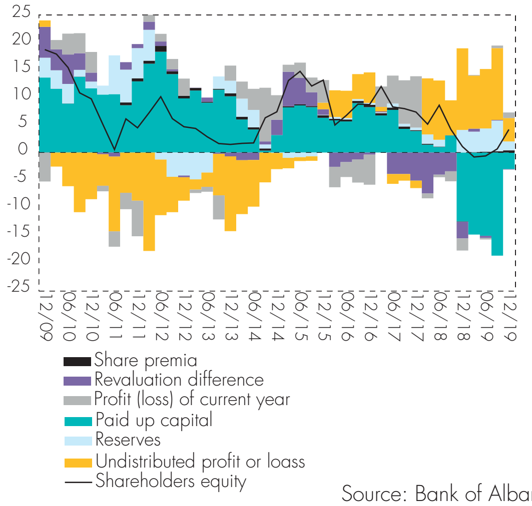
In the performance of the Capital Adequacy Ratio, the negative impact of the increase of risk-weighted assets was higher compared with the positive impact of the increase of regulatory capital. During the period, regulatory capital increased slightly at ALL 143 billion, giving an upwards impact of 0.2 p.p. to Capital Adequacy Ratio. Its performance was supported by the increase of reserves and retained profits and by the positive performance of financial result. These factors together mitigated the impact of the structural changes in banks' ownership, which resulted in a slight decline of paid capital. On the other hand risk-weighted assets reached around ALL 790 billion or ALL 20 billion more than in July 2019, as result of increased exposure to trade companies (corporations). The increase of this factor gave a declining contribution of 0.5 p.p. to Capital Adequacy Ratio.

Chart 40 Contribution of capital adequacy items (in p.p.).



Source: Bank of Albania.

Chart 41 Annual contribution in capital increase by component instruments (in p.p.)

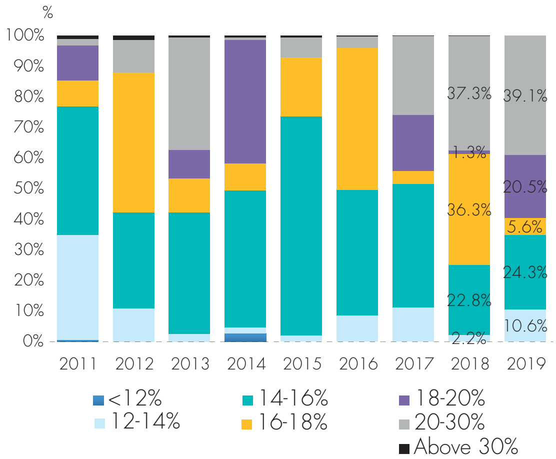


Source: Bank of Albania.

The structure of risk-weighted assets by risk has not changed and continues to be dominated by risk-weighted assets for credit risk (88%). Risk-weighted assets for market and operational risks expanded by ALL 5 billion and ALL 2 Billion, respectively, compared with the previous six-month, but maintained their shares in total risk-weighted assets of 2% and 10%, respectively.

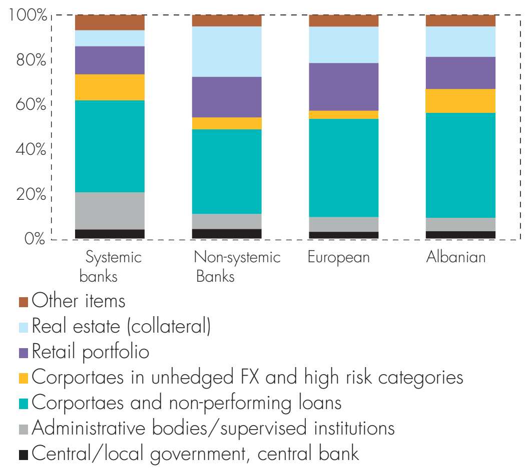
Compared with the previous two six-months, no significant changes have been reported in the distribution of weighted assets for credit risk, both for the sector as a whole and for banks grouped by systemic importance and origin of capital. Banks classified as with systemic importance register high exposure for credit to trade companies (corporations), non-performing loans, and loans to other institutions supervised by the bank of Albania and the Albanian Financial Supervisory Authority.

Chart 42 Banking sector asset distribution by Capital Adequacy Ratio



Source: Bank of Albania.

Chart 43 Credit classes' exposure of banks by systemic importance and origin of capital for December 2019

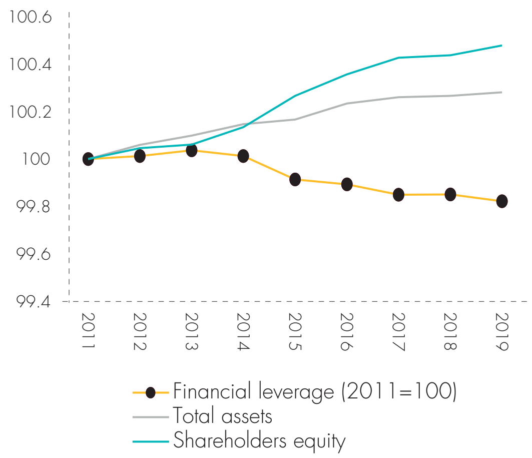


Source: Bank of Albania.

Other banks (non-systemic) register exposure towards real estate (collateral) as well, in addition to the exposure to corporation loans. By origin of capital, banks with European capital have a higher exposure towards the classes "corporation loans and non-performing loans" and "retail portfolio", while banks with domestic capital in addition to the above-mention exposures register also exposures towards portfolios classified with higher risk and uncovered from exchange rate fluctuations.

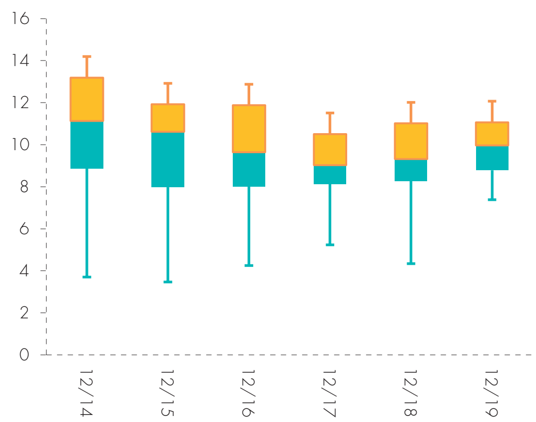
The Albanian banking sector is characterized by an adequate financial leverage ratio, thus confirming the good level of capitalisation. The financial leverage ratio[25] in December 2019 was 9.6 times, marking a decline compared with the end of 2918 and unchanged compared with 2019 H1. The declining trend in annual terms reflects the faster increase of equity compared with asset performance. At bank level, the values of the indicator have trended towards the average value, constituting a positive development for the funding structure of the banking sector.

Chart 44 Financial leverage performance by components



Source: Bank of Albania.

Chart 45 Distribution of financial leverage at bank level



Source: Bank of Albania.

4.1.1.2 Financial result

The banking sector closed 2019 with a positive financial result of around ALL 20 billion. This result was around ALL 1.5 billion higher than the previous year. The factor that mainly affected the increase of financial result was profit from financial instruments. Net income from costumer interest – the main source of banking sector's income – continued to decline, while general expenses for provisions increased. The increase of the profit of the sector was also reflected in growth of the profitability indicators of the banking sector, where Return on Assets (RoA) increased at 1.4% from 1.3%, while Return on Equity (RoE) reached 13.5% from 13% in the previous year.

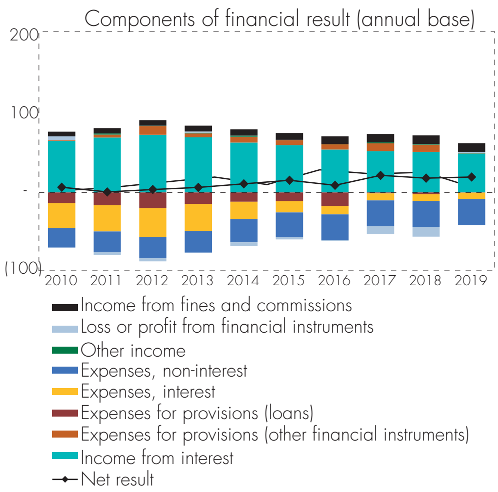
The banking sector expanded the positive financial result during 2019, being reflected in the upward values of profitability indicators. Profit from financial instruments provided the main contribution in this regard.

The continuous contraction of net interest result provided the main contribution in the further narrowing of net interest margin.

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

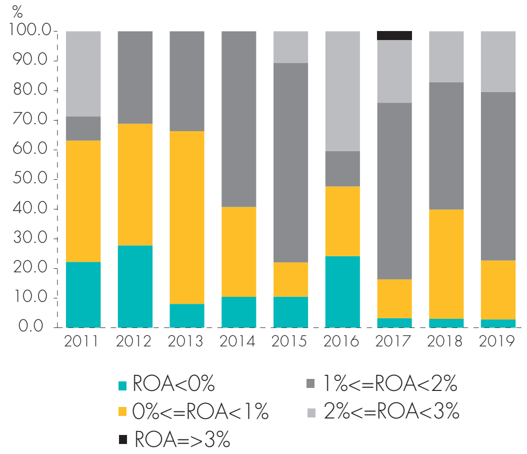
Net result from interests declined by 4.8%, at ALL 41.7 billion, with a joint contribution from the decrease of interest expenditure and the income from them. Income from interest declined at a level significantly higher (around ALL 3 billion) than expenses for interests. Despite the fact that income from interests have decreased for all items, the declined focused on interests from customers, while on the expenditure side, the decline has been registered in both interests on deposits and paid interests on securities.

Chart 46 Financial result components



Source: Bank of Albania.

Chart 47 RoA by banks' share in sector assets

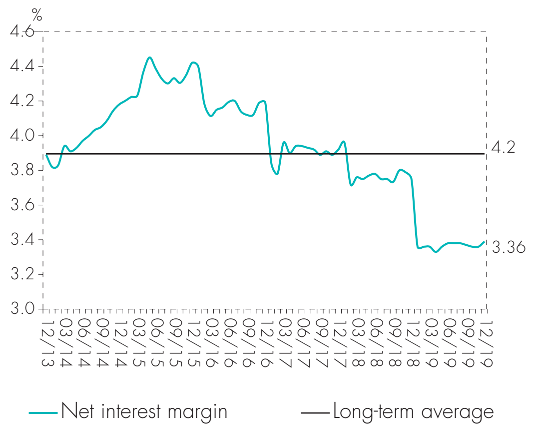


Source: Bank of Albania.

The decline in net interest result is reflected in the decrease of net margin from interests at 3.4%, from 3.7% in the previous year. The decline came not only as a result of the contraction of interest income, but also due to the increase of the denominator: the average assets that bring in income. Income from other activities registered a high increase of around ALL 14 billion, registering a positive value due to the return to a profit around ALL 2 billion of the losses of the previous year. General activity expenditure did not register changes.

Expenses in the form of provisions were ALL 7 billion higher than the previous year, affecting the contraction of the financial result. The item "Provision for other financial assets", unlike the previous year when it improved the sector's profit with a return value of ALL 9 billion, during 2019 played a negligible role. On the other hand, expenses for potential credit losses declined significantly at ALL 0.2 billion from ALL 2.3 billion registered during 2018, bringing a positive impact in the net result of the banking sector. The banks' asset share that registered financial losses against banking sector assets was around 4%.

Chart 48 Net interest margin



Source: Bank of Albania.

Chart 49 Profitability indicators

Source: Bank of Albania.

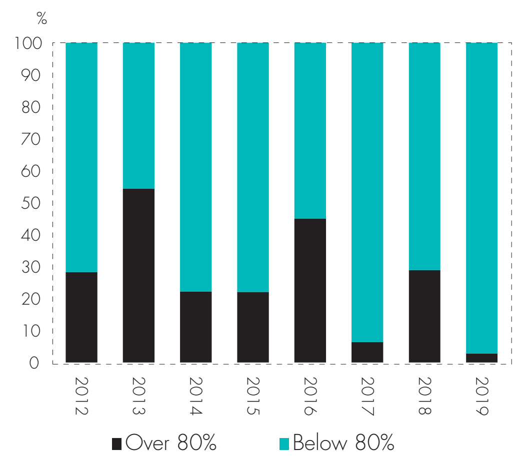
Activity costs were covered at good levels by activity income. The ratio of activity expenditure to income at the end of the year was around 60% and registered a significant decline compared with the previous year, where this ratio approached 80%. The strong increase of gross income contributed to the decline of this indicator, reflecting the increase of income from other activities. Activity expenditure, within which personnel and operational expenses carry the main share, maintained similar levels to 2018. An improvement in the distribution of banks by this indicator was observed during the last years. In the period 2012-2015 the average share of banks' activity with this indicator above 80% was around 30%, while in the period 2016-2019 this value has

The efficiency of sources was improved mainly driven by the result of the increased gross income and the controlled activity expenses.

Chart 50 Expenditure to activity income

Source: Bank of Albania.

Chart 51 Banks' distribution by expenditure/income ratio (% of total assets)



Source: Bank of Albania.

declined to 20%.

BOX 5 BANKS' ACTIVITY IN DOMESTIC AND FOREIGN CURRENCY

In the balance sheet of the banking sector, assets and liabilities in foreign currency account for around 50% of overall values, income and expenditure statements indicate that the banking sector during the previous two years has generated a significantly higher profit from foreign currency activity compared with domestic currency activity. Thus, in 2018, from the profit of ALL 18 billion, around ALL 11billion resulted from foreign currency activity. In 2019 domestic currency activity generated a profit of ALL 5 billion while that in foreign currency a profit of around ALL 15 billion. A more detailed analysis of income and expenditure indicates that, despite the fact that domestic currency activity generates around 1.5 to 2 times more income than foreign currency activity, the latter ensures to the banking sector a higher profit due to the significantly lower value of operational and personnel expenditures compared with domestic currency activity.

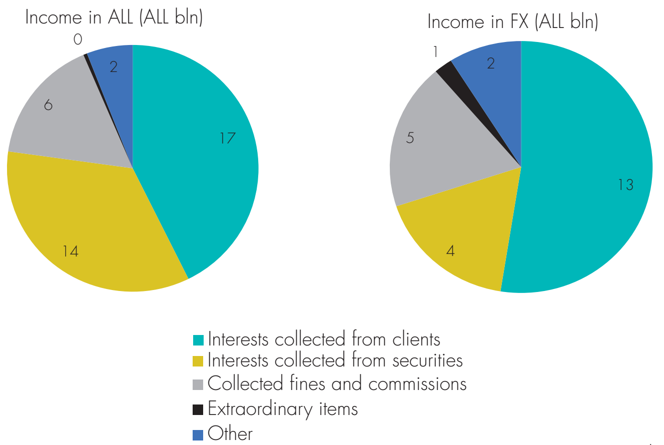
Table 7 Main income and expenditure of the banking sector for 2018-2019 currencies.

ALL bln	2018		2019	
	ALL	FX	ALL	FX
Interest from customers	16	15	17	13
Interest from securities	14	4	14	4
Fines and commissions	6	5	6	5
Other	4	-9	3	3
Income	40	16	40	24
Interest disbursed to customers	5	1	5	1
Personnel expenditure	10	1	11	1
Operational expenditure	15	7	15	7
Other expenditure	3	-6	4	1
Expenditure	33	4	35	9
Financial result	7	11	5	15

Source: Bank of Albania.

On the income side, interests collected from customers represent the main source of income for both domestic and foreign currency activities, but income from interests in the domestic currency are somewhat higher than those from

Chart 52 Structure of income in domestic and foreign currencies by main items (2019)

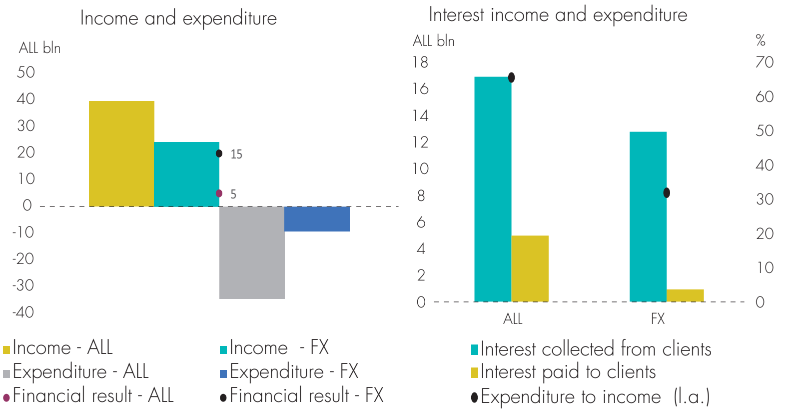


Source: Bank of Albania.

foreign currency due to the positive difference of interest rates in domestic and foreign currency. Incomes from fines and commissions for domestic and foreign currencies have comparable values and have registered no changes during 2018-2019. Albanian Government's securities investments represent a continuous and significant source of profit for the banking sector and income from this investments in domestic currency are significantly higher that income from securities interest issued by resident and non-resident entities in foreign currency.

The difference between the expenditure for interest disbursed to customers in domestic and foreign currency is comparable with the respective difference of income collected from customers (around ALL billion), but while for domestic currency activity the disbursed/collected interest ratio is around 30%, for the foreign currency activity this ratio is lower than 10%. This trend indicates that the financial intermediation efficiency of the banking sector in foreign currency is higher compared with the financial intermediation in domestic currency. At the same time personnel and operational expenditures against total income are assessed at around 30% for foreign currency activity and at over 65% for domestic currency activity. This difference is explained with the fact that salaries and other operational expenditures of banks in domestic currency are significantly higher than those carried out in foreign currency. On the other hand foreign currency activity is characterized by a higher degree of unpredictability related with the impact of the foreign exchange rate on financial instruments and the performance of provisions for investments in financial instruments and lending, particularly in conditions when lending unhedged for exchange rate risk continues to have an important place in outstanding loans in foreign currency and overall lending granted by the banking sector.

Chart 53 Income and expenditure for the total and for interests by currency (2019)



Source: Bank of Albania.

4.1.1.3 Loans

The expansion of outstanding loans was mainly affected by the increase of new loans. In annual terms, the increase of loans would have been higher if excluding the effect of the exchange rate and the written off loans from banks' balance sheets.

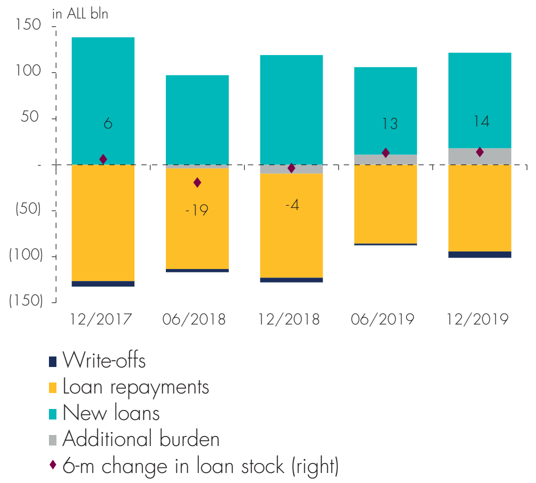
At the end of the period, the amount of outstanding loans of the banking system expanded in six-month and annual terms by 2.5% and 4.8%, respectively, reaching the level of around ALL 574 billion[26]. The performance of lending was mainly affected by the increase of new loans flow. Positive improvements were also registered in the quality of the portfolio, where the non-performing loans stock in banks' balance sheets decreased significantly over the period.[27] The best performance was registered for loans with long-term maturity; loans in domestic currency and for enterprises, while in foreign currency have continued to decrease. In annual development of lending as well, the main impact on its growth came from the expansion in the performing classes of loans to enterprises and those with long-term maturity.

Table 8 Loans performance by maturity, sector and currency

		Value (ALL bln)	Share to total loans (%)		Change (%)	
	Period	12/2019	12/2018	12/2019	6-M	Annual
By currency	Lek loans	281	46	49	6.5	10.0
	Foreign currency loans	295	54	51	-1.1	0.3
By entity	Public sector	30	5	5	9.1	8.7
	Enterprises	359	63	62	1.7	3.7
	Households	187	32	32	3.0	6.5
By maturity	Short-term	163	29	28	2.0	2.2
	Medium-term	95	17	17	0.4	-0.9
	Long-term	317	53	55	3.4	8.1
	Loans stock	576	100	100	2.5	4.8

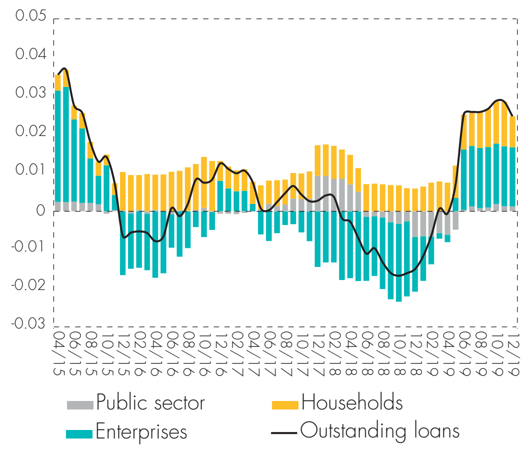
Source: Bank of Albania

Chart 54 Six-months change in outstanding loans by component elements



Source: Bank of Albania.

Chart 55 Loans performance, by sector, contribution in p.p., six-months change



Source: Bank of Albania.

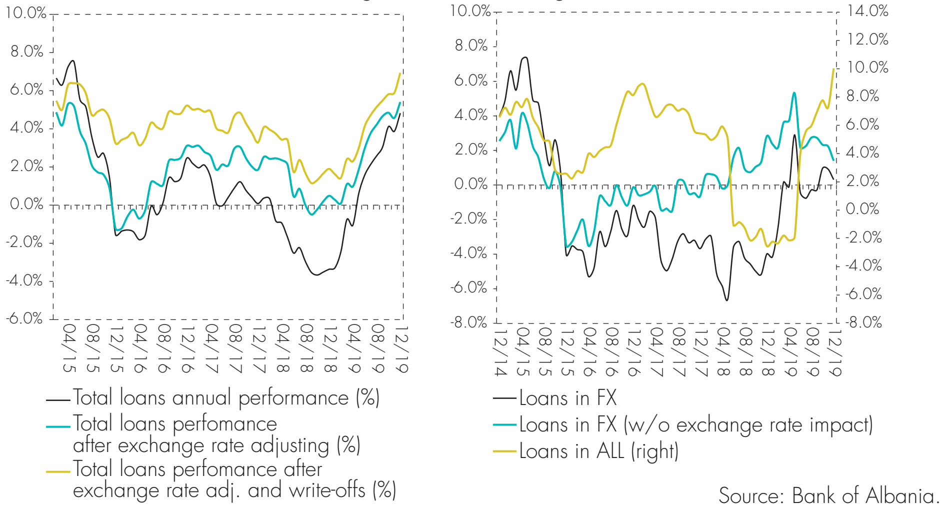
The slight appreciation of lek has given a downward impact of around ALL 3.4 billion in the equivalent value in lek of loans in foreign currency during the year.

[26] *The positive rates of the increase of outstanding loans are calculated excluding the statistical impact of the structural breakdown in the banking sector.*

[27] *For more detailed information, see the analysis on credit risk in the relevant session.*

The main contribution to this downward impact came from the appreciation of against euro. Overall, in annual terms[28], it is assessed that the downward impact of the appreciation of lek to loans and foreign currency and total loans has been 1.1 p.p. and 0.5 p.p., respectively.

Chart 56 Performance of total loans excluding the impact of the exchange rate and write-offs (left) and loans in foreign currency excluding the exchange rate (right), annual changes, in %



Source: Bank of Albania.

During the period, the banks continued the process of removing lost loans from balance sheets. The regulatory approved during 2019 affected the increase of write-offs flow, particularly in 2019 H2. The value of written-off loans during the last 12 months was ALL 8.4 billion, where ALL 7.4 billion were realised in 2019 H2. Written-off loans stock during 2019 accounted for around 17% of total outstanding non-performing loans reported by banks at the end of December 2019. If these loans had not been written-off over the year, the annual growth of loans stock would be 6.4% (from 4.8%). Excluding the impact of the exchange rate and that of write-offs at the same time, credit annual growth would register 6.9%.

LOANS TO RESIDENT ENTITIES - ENTERPRISES

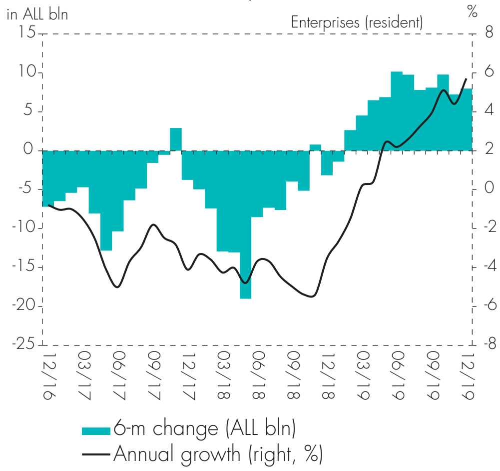
Loans to resident entities increased by 3% over the period. This credit accounts for around 96% of total loans. Over 60% of loans to resident entities are held by the enterprises sector. Loans to this sector expanded by around ALL 8 billion and at the end of the period accounted for around ALL 336 billion. The increase in this category was due to the increase of mortgages and loans for short-term purposes (such as loans for circulatory capital and overdraft). Loans for investments in real estate have the main share (around 27% of outstanding loans to enterprises, and during the period expanded by 5%.

The expansion of loans to residents was driven by the common contribution from loans to households and enterprises, mainly in the national currency. Resident enterprises, with the main share in credit portfolio, report an expansion of loans for the first time since 2014. Loans were mainly provided to sectors with the better performance.

Over the year, loans to resident enterprises expanded by 5.7%. This is the first year since 2014 during which enterprises report an annual growth of credit

[28] *Excluding the statistical impact of the structural changes in the banking sector.*

Chart 57 Performance of loans to resident enterprises



Source: Bank of Albania.

stock. The contribution in this positive performance came from the rapid expansion of loans for investments in real estate (+14%) and those for circulatory capital (+37%). During 2019, the banking sector granted around 50% more new loans for investments in real estate compared with the previous year, and this growth provided the main impact on the annual change of credit stock for this category.

The structure of loans to enterprises has changed over the last years. For "overdraft" loans and "equipment purchase", a shift of loans from foreign currency to the domestic currency was observed[29] At the same time, the share of "overdraft" and "equipment purchase" loans in total loans to enterprises has declined. These loans accounted for 25% and 26%, respectively, of loans to enterprises, from 28% and 30% registered two years ago. Meanwhile, the share of loans for "circulatory capital" and "real estate" has increased over the previous two years, affected by the increase of around 10% and 6% of foreign currency portfolios.

Chart 58 Annual performance of loans to enterprises by purpose of use and currency (in %)

Source: Bank of Albania.

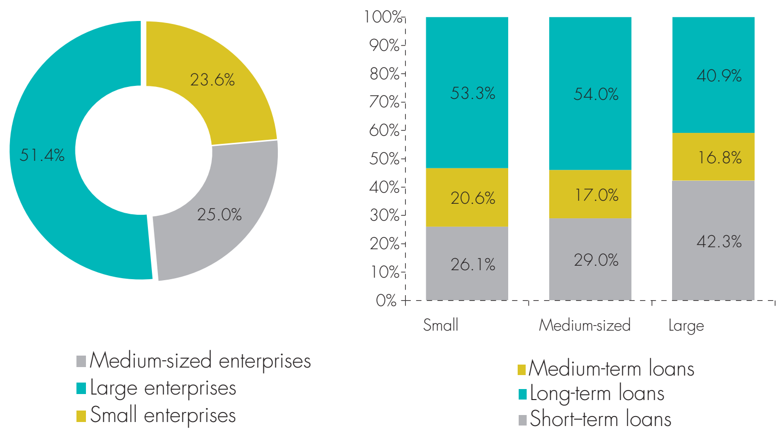
By size, the structure of loans shows an increase of the share of medium-sized enterprises against the decline of small enterprises. Large enterprises did not register significant changes[30]. Meanwhile, the analysis by maturity indicates that medium-sized and large enterprises have increased the share pf short-term loans, whereas small enterprises have slightly increased long-term loans[31].

[29] *Affected by the rapid contraction of foreign currency loans.*

[30] *These values marked, respectively: 50.8% (large enterprises); 23.0% (medium-sized enterprises) and 26.2% (small enterprises) in December 2018; whereas in June 2019 they were respectively: 51.9%; 23.1%; and 25.0%.*

[31] *In annual terms, small enterprises have increased the share of medium-term and long-term loans, while medium-sized and large enterprises have increased the share of short-term loans.*

Chart 59 Structure of loans to enterprises by size and maturity



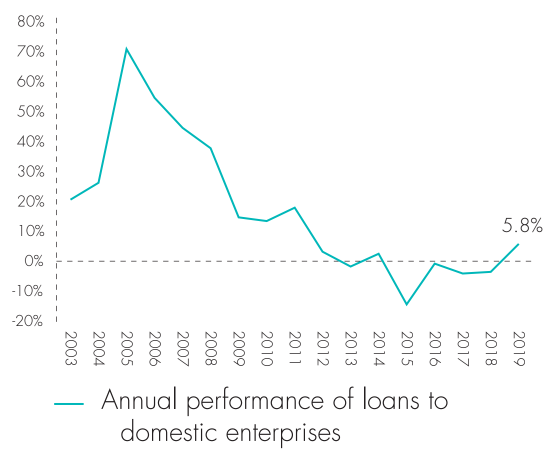
Source: Bank of Albania.

BOX 6 STRUCTURE AND EFFICIENCY OF LOANS TO ENTERPRISES BY SECTORS OF THE ECONOMY

Loans granted by banks to domestic enterprises represent a significant share of total loan portfolio, albeit its share has decline from over 80% in 2002 to around 60% at the end of 2019. The period 2003-2006 was characterised by a very rapid increase in the in the portfolio of loans to domestic enterprises. The positive performance, albeit at a slower pace, continued until the end of 2013. Later, the performance of loans to enterprises registered negative values (with contraction) for six years consecutively. Meanwhile, in the last year, we observe a recovery in these loans, where annual growth registered 5.8% in December 2019.

Currently, loans to domestic enterprises account for e relatively low share of Gross Domestic Product (around 20%), compared with EU countries. Almost half of enterprises' debt is in the form of loans from the banking sector. The rest is funded through enterprises' securities and loans from other sources. The accommodative policies undertaken by central banks, which have affect the decline of loan interest rates in the last years, seem to have affected enterprises borrowing as well in the previous two years. The share of loans taken by banks in total enterprises debt has increased at 48% in December 2019 (from 45% in 2017). The rapid decline of the ratio loans/investments to enterprises since 2010 reflect a relatively faster increase of investments compared with credit growth. During this period enterprises have significantly expanded their investments, affecting positively the economic growth of Albania. During 2019, the loans/investments ratio has increased due to the annual growth of loans to domestic enterprises. Loans to domestic enterprises are 1/5 of banking sector's total assets. Despite the

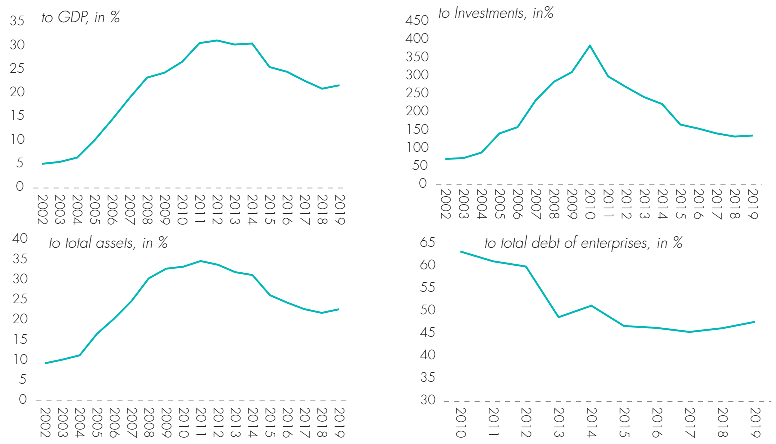
Chart 60 Annual performance of loans to domestic enterprises



Source: Bank of Albania.

increase registered during 2019, the share of loans to enterprises against total assets remains far from the peak of 35% registered in 2010.

Chart 61 Loans to domestic enterprises 2002-2019



Source: Bank of Albania and INSTAT.

The following analysis addresses the performance of manufacturing sectors by several macroeconomic indicators for the period 2018-2019 and the performance and quality of banking loans, focusing on the relation between sectoral productivity and credit efficiency. The analysis also addresses the borrowing sectors' risk characteristics and impact of borrowers with high risk potential in the overall performance of lending.

What can be observed is the dominance of the energy sector in the annual expansion of loans to enterprises during 2019. While this sector is responsible for around 40% of the expansion of ALL 18 billion in loans to enterprises during the year, its contribution to economic growth was negative. Although it seems that credit growth is not accompanied by production increase in this sector, it is relevant to highlight that considerable share of new loans to the sector over the year was granted for investment purposes and the impact of loans for investments in economic growth materialise after a longer period of time compared with loans for circulatory capital and equipment purchase. Overall, the energy sector has a low level of credit risk, a low intensity of loans and a level of profitability significantly higher than the average of the other sectors. The non-performing loan ratio for this sector is around 6%, being around 1/2 of the NPLR for enterprises (11.3%). On the other hand, only 36% of investments in the sector are funded through banking lending.*

The sectors that contributed to the annual growth of lending, and at the same time, gave a positive contribution to economic growth over 2019 are: services, trade, transport, accommodation and food services.

Trade has the main share in total loans to enterprises and its contribution to the annual credit growth is moderate (around 7%). This sector at the same time gave the main contribution to GDP annual growth (around 30%), and is characterised by a high intensity of lending, high productivity, lower profitability than the average of the other sectors, moderate risk and continuous decline in the loan portfolio.

Around 60% of the annual increase of loans to enterprises is related with the sectors of the economy, for which productivity ("net sales to number of employees" ratio) is higher compared with the other sectors. Profitability, which has a positive correlation with the ability of a company to settle liabilities, is a significant indicator. Enterprises' profitability indicators are the share of profit in the annual turnover of the company, and the share of profit in debt. Over 90% of the annual growth of lending is the share of those sectors which report the highest levels of profitability. Overall, loans to sectors with high profitability support both economic growth and financial stability, due to the support of economic agents with good solvency.

In conclusion, we analyse the main indicator directly related with credit risk. Credit quality has improved for eight of the ten sectors of the economy and the overall non-performing loan ratio declined at 11.3% from 15.7% in the previous year. Sectors with NPLR higher than average gave a small contribution to annual credit growth, during 2019. The processing industry is the sector with the highest level of non-performing loan ratio. However, credit quality for this sector has improved continuously over the last years. At the same time, this sector is characterised by a high level of profitability.

Table 9 Performance of loans to enterprises and economic indicators by manufacturing sectors

	Loans to enterprises			Added value		Intensity of loan[1]	Profitability[1]		Productivity	Credit risk indicator		
	annual growth 2018-2019 (in %)	contribution in annual growth of loans to enterprises (2019)	share to total loans to enterprises, in % (2019)	real annual growth, in % (09/2018-09/2019)	contribution in annual growthre	loans to investments (in %)	profit to net sales (in %)	profit to debt (in %)	net sales to employees' number	share of loan loss to total NPLs	annual change of NPLs(%)	NPLR % (2019)
Agriculture, forest and fishing	(10.2)	(0.2)	1.5	1.2	0.3	n/a	n/a	n/a	n/a	45.8	(29.4)	5.3
Quarrying industry	18.9	0.5	3.0	(0.3)	(0.0)	46	14	123	6.7	3.6	(13.6)	2.3
Manifacturing industry	(5.3)	(0.8)	14.4	5.0	0.4	152	9	44	2.4	19.5	(7.8)	21.3
Electricity, natural gas, steam, and water supply, waste management and remediation activities	38.4	2.4	8.3	(1.9)	(0.1)	36	13	100	7.0	42.3	(33.5)	5.8
Construction	(0.8)	(0.1)	13.5	1.4	0.2	117	11	60	5.7	24.4	(45.8)	9.5
Retail and whole trade; vehicle reparing	1.0	0.4	35.6	5.2	0.6	268	6	46	7.9	44.6	(23.5)	12.5
Transport and storing	63.5	1.2	2.8	5.2	0.2	38	10	267	4.1	19.0	31.6	6.4
Accomodation and food service	17.8	0.8	4.8	5.2	0.1	178	7	31	1.1	30.9	10.5	17.0
Other (services)	10.9	1.7	16.0	3.5	1.3	199	12	59	2.1	30.1	(43.6)	5.4
All industries	5.8	5.8	100.0	3.1	3.1	133	8	58	4.2	32.7	(23.9)	11.3

Source: Bank of Albania and INSTAT.
**Calculation are done with the latest data of 2018.*

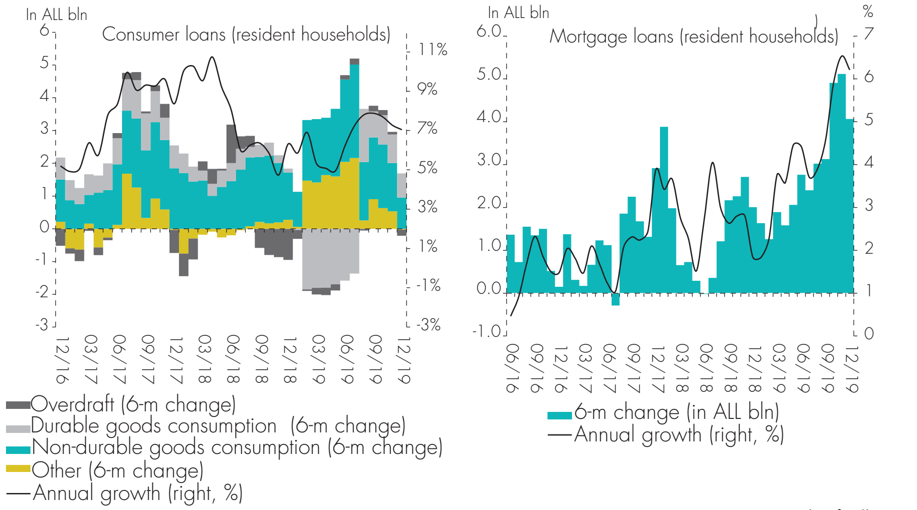
In conclusion, during 2019, banks granted loans mostly to sectors of the economy with higher profitability, high productivity and low non-performing loan ratio. At the same time, the sectors of the economy which were credit the most such as: energy, extractive industry and transportation, report higher levels of investments in relation to the value of lending. This is tightly related with an upward efficiency of economy's funding from the banking sector in the last year.

** The data refer to the annual growth until 2019 Q3.*

LOANS TO RESIDENT ENTITIES - HOUSEHOLDS AND PUBLIC SECTOR

Loans to resident households expanded by 3% during the period and by 6.5% compared with the previous year, where the main contribution to this growth came from the increase of loans in lek, mortgages and consumer loans for non-durables. The last two account for 63% and 17%, respectively, of loans to households. Outstanding loans for real estate grew by around 3.6% and reached ALL 117 billion. During 2015-2018, there has been a steady increase of loans to households on one hand, and a decrease of loans to enterprises on the other. This performance drove to changes in loans structure by sectors, in favour of loans to households. Loans to households in December 2019 accounted for 34% of outstanding loans, from 27% in 2015.

Chart 62 Loans to resident households performance by purpose of use



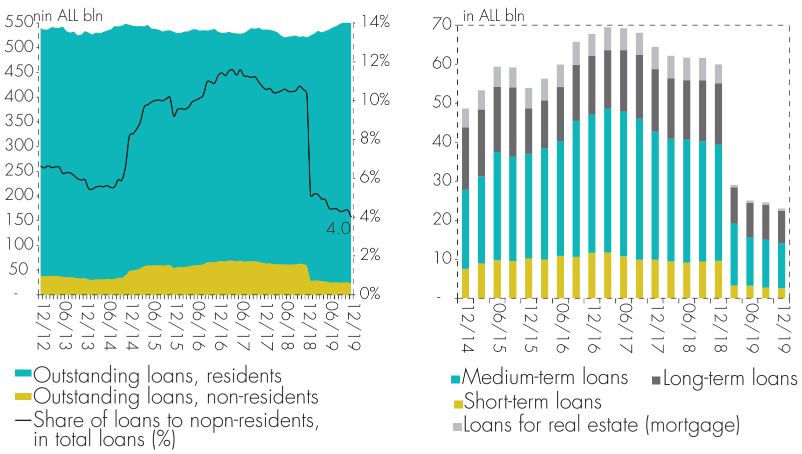
Source: Bank of Albania.

Loans to public sector account for a very small share of loans (5%), against the high share of loans to private sector (enterprises and households). However, in the last year it was observed an expansion of around 9% in the stock of loans to this sector.

LOANS TO NON-RESIDENT ENTITIES

During the period, loans to non-resident entities registered a decline. In December 2019, loans to non-residents were around ALL 23 billion and accounted for 4% of outstanding loans of the banking sector, from 4.5% at the end of the previous six-month. By sector, currency and maturity, the highest decrease was registered in loans to enterprises, in foreign currency and medium-term, which were the categories with the highest share in the stock of loans to non-resident entities.

Chart 63 Loans to residents and non-residents (left) and loans to non-residents by maturity (right)



Source: Bank of Albania.

UNHEDGED FOREIGN CURRENCY LOANS

The exposure of the banking sector to the indirect exchange rate risk, reflected in the share of loans in foreign currency unhedged against unfavourable changes of the exchange rate (unhedged foreign currency loans), continues to remain at relatively high levels, and requires constant monitoring. Unhedged foreign currency loans declined by 3% over the period, and continued to contract for the third six-month consecutively. The annual decline was 5% and the contraction is registered in unhedged loans to enterprises and the government sector. Meanwhile, households report a slight expansion in stock of unhedged foreign currency loans during the year. The share of unhedged loans to total outstanding loans has contracted slightly over the period, by 1.4 p.p., at 23%, while its share to foreign currency loan portfolio decreased by 1p.p., at 45%.

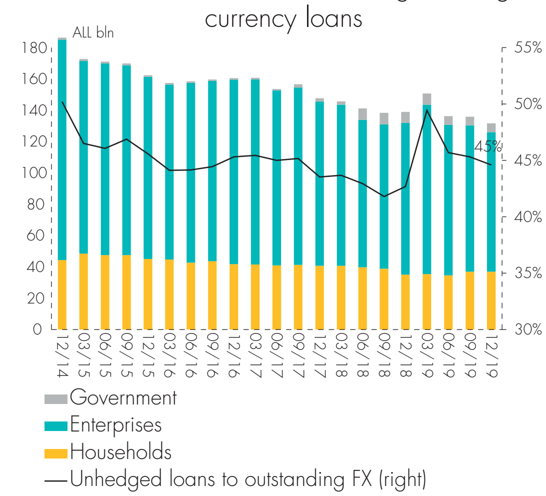
Notwithstanding the contraction in the values of values of unhedged foreign currency loans for the third successive semester, the exposure of the banking sector to the indirect exchange rate risk requires constant monitoring.

BOX 7 BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

During 2019 H2, unhedged foreign currency loans decreased by ALL 5 billion, at ALL 132 billion, mainly due to the contraction of unhedged loans in euro (by 4.6%, whereas unhedged loans in US dollar registered a slight increase.*

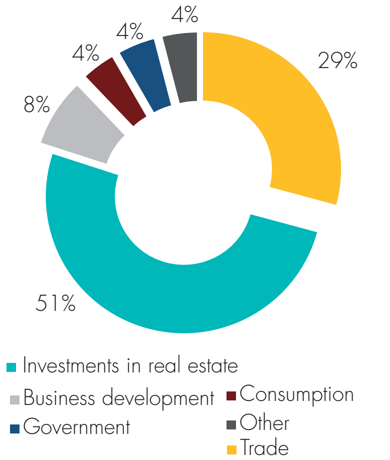
Loans to enterprises constitute 68% of outstanding foreign currency loans unhedged from the exchange rate risk, while loans to households and to government account for 28% and 4%, respectively. The contraction of outstanding unhedged loans is related with the decline by 7% of unhedged loans to enterprises. Unhedged loans to households during the period registered an increase by around 7%, while those to government did not change. In annual terms, unhedged foreign currency loans contracted by 5.3%, due to the decline of loans to enterprises and loans in euro.

Chart 64 Performance of unhedged foreign currency loans



Source: Bank of Albania.

Chart 65 Unhedged foreign currency loans, by purpose of use, %

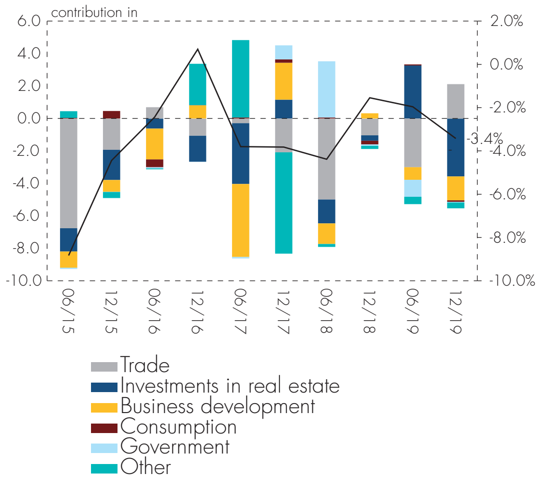


Source: Bank of Albania.

By purpose of use, unhedged loans granted for investments in real estate continue to account for the main share (around 51%) of total unhedged foreign currency loans, followed by loans for trade (29%). The rest of the unhedged foreign currency loans were granted mainly for trading and business development purposes. The main contribution to the performance of outstanding unhedged loans against the exchange rate risk over the period came from the decline of unhedged loans for "investments in real estate" and business development", which decreased by 7% and 16%, respectively. Unhedged foreign currency loans for "trade" were the only category of unhedged loans that registered an increase over the period, by 8%.

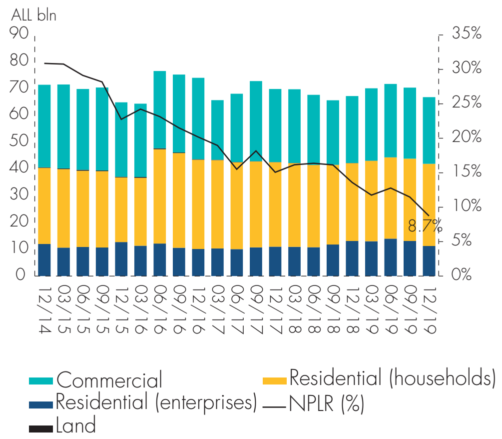
Unhedged loans for real estate are granted in the purchase of residential, commercial real estate and land. Unhedged loans for residential real estate granted to households have the main share (46%), which expanded slightly during the period.

Chart 66 Six-month performance of unhedged foreign currency loans (contribution by sectors)



Source: Bank of Albania.

Chart 67 Unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania.

Loans for residential real estate to enterprises and those for commercial real estate registered a decline 2019 H2, affecting almost at the same level the decline of outstanding unhedged loans for the period. The appreciation of lek's exchange rate has affected negatively, but not significantly, the reported value of unhedged foreign currency loans. Excluding the appreciation of lek's exchange rate, unhedged foreign currency loans would have contracted by 2.9% from 3.4% over the period.

* *Outstanding euro loans, when the borrower's income is in Albanian lek, account for 87% of the outstanding unhedged foreign currency loans.*

NEW LOANS

The increase in new loans was mainly driven by loans to enterprises, within which the main impact came from the increase of long-term. New loans expanded-in all three main currencies, but the preference for loans to households was in lek.

New loans granted over the period registered around ALL 130 billion, increasing by almost 12% compared with the previous six-month but being around 3% lower than the same period in the previous year. The expansion of the flow of new loans during the period was due mainly to the increase of loans to enterprises (around 14%), within which the main impact came from the increase of long-term loans. For the households sector, new loans expanded by 7% compared with the previous six-months. The lower growth rate compared with loans to enterprises and the lower share to total lending also made it that its contribution to the performance of new loans was lower. New loans to households went mainly for housing purchases. By currency, new loans registered an expansion in all three main currencies. Around 60% of the value of new loans was in lek.

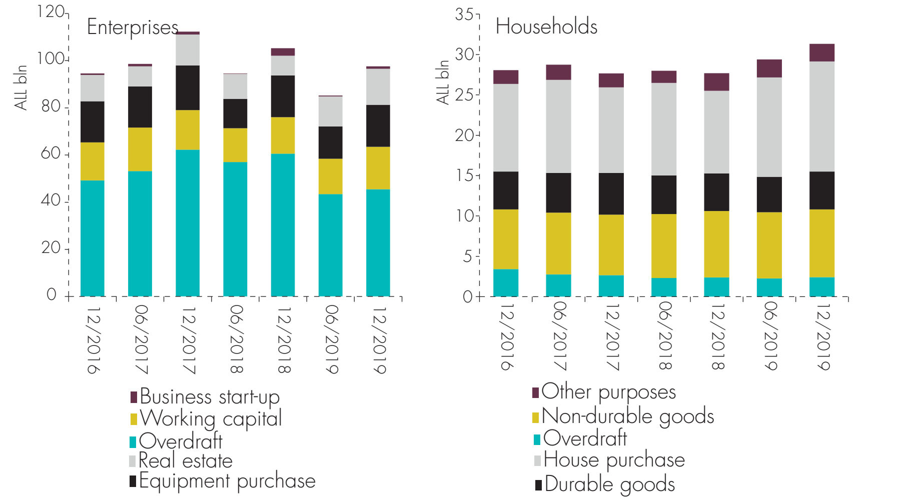
The weighted interest rates on new loans recorded a downward trend during the year.

By group of loans, the interest rate on new loans in lek and the new loans to households show higher levels.

The weighted interest rates on new loans granted over the period[32] registered a decline at 5.5% and the decline was for all types of loans. The average weighted rate of new loans during 2019 H2 was around 0.2 p.p. lower than that registered in 2019 H1. The stronger decline in the average interest rates was registered in rates on new loans in US dollar and on new loans to enterprises.

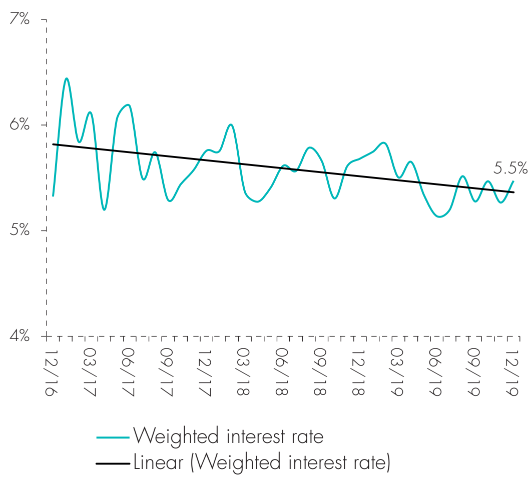
[32] *Calculated as six-month average.*

Chart 68 New loans to enterprises (left) and households (right) by purpose of use



Source: Bank of Albania.

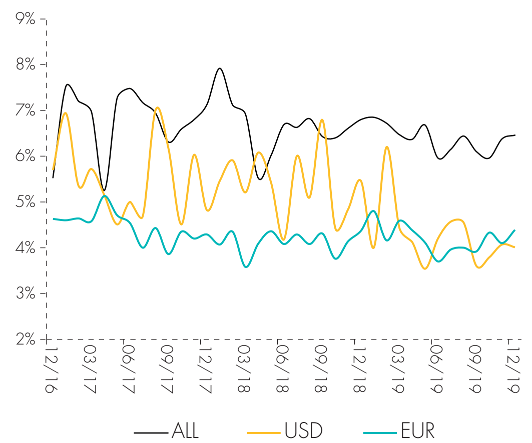
Chart 69 Weighted interest rates on new loans



Source: Bank of Albania.

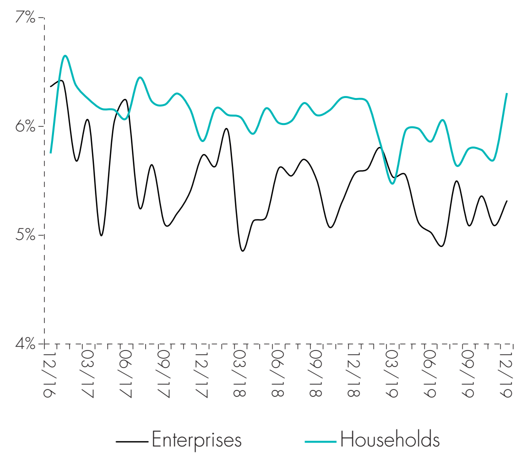
By currency, the interest rate of new loans in lek continued to register higher levels than the other two currencies (euro and US dollar), but this interest rate has shown a significant downward trend throughout the year. In December 2019, the interest rate of new loans in lek registered 6.4% from 6.9% at the beginning of the year. The interest rate on new loans to households continues to be higher compared with the interest rate on loans to enterprises. In December 2019, this rate registered the highest level of the year with around 6.3%, affected by the performance of the interest rate on consumer loans.

Chart 70 Interest rates on new loans, by currency



Source: Bank of Albania.

Chart 71 Interest rates on new loans, by entity



Source: Bank of Albania.

The average interest rate on new loans to enterprises continued to fluctuate around an average value of 5% throughout the year.

4.1.1.4 Deposits

At the end of 2019, the level of deposits in the banking system registered ALL 1,193 billion, with an increase of ALL 50 billion (or 4.1%) during the period and ALL 60 billion (or 5.4%) compared with the previous year[33]. The stronger increase of deposits during the period, but also throughout the year, is supported by the increase of demand deposits and current accounts, the increase of households' deposits and the increase of foreign currency deposits. The increase of lek deposits has continued, but their growth rate was lower compared with foreign currency deposits. The statistical impact of the exchange rate during 2019 H2 has been negative but at very low levels.

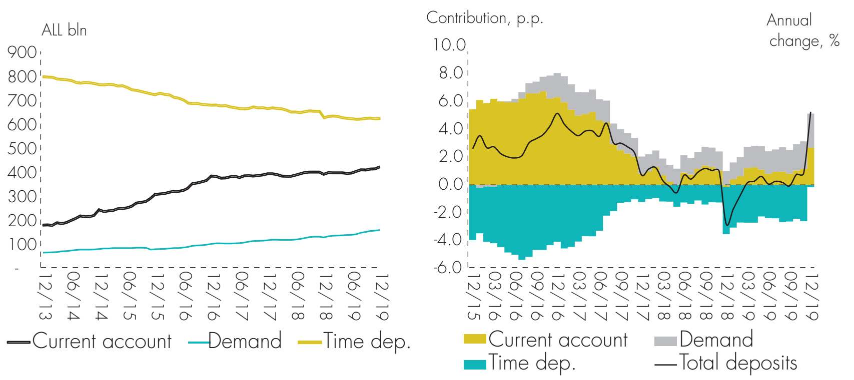
Deposits grew strongly during the period, mainly supported by demand deposits, households' deposits and foreign currency denominated deposits.

Table 10 Data on the performance of deposits by maturity, sector and currency

		ALL mln	% to total	Change in %		Contribution in growth rate (p.p.)	
		12/19	12/19	6-M	Annual	6-M	Annual
By maturity	Current account	412	35	6.6	8.2	2.2	2.8
	Demand deposits	149	13	15.1	25.9	1.7	2.7
	Time deposits	614	51	0.2	(0.3)	0.1	(0.2)
By entity	Public sector	27	2	3.9	13.8	0.1	0.3
	Enterprises	163	14	4.6	4.0	0.6	0.5
	Households	1,003	84	4.1	5.4	3.4	4.5
By currency	Lek deposits	579	49	3.1	5.1	1.5	2.5
	FX deposit	614	51	5.2	5.6	2.6	2.9
	Deposits, stock	1,193	100	4.1	5.4	4.1	5.4

Source: Bank of Albania.

Chart 72 Deposits performance by maturity (in ALL bln, left) and contribution to annual change (in p.p., right)

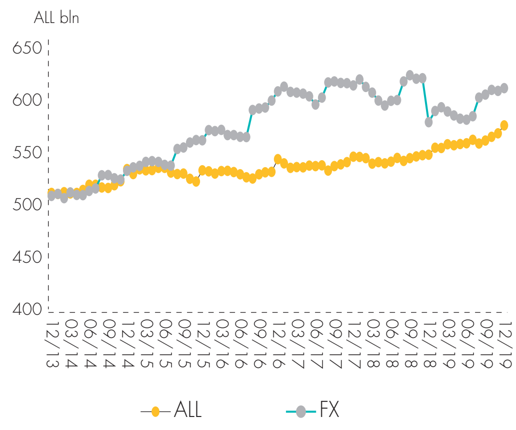


Source: Bank of Albania.

33 *The value of deposits excludes the impact of structural breakdown.*

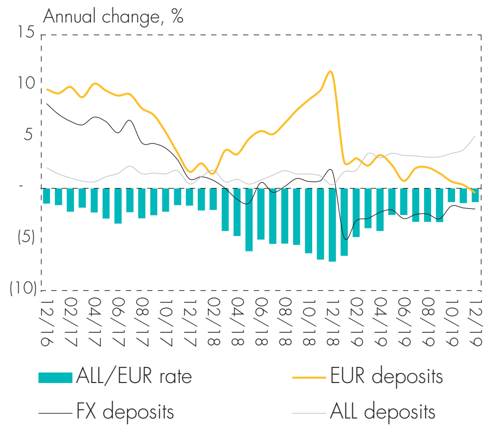
During 2019 H2 as well, demand deposits and current accounts gave a positive contribution deposit performance, while time deposits continued to register negative rates of annual changes. Demand deposits and current accounts expanded by 26% and 8%, respectively, in annual terms, while the decline of time deposits has shown sign of slowdown.

Chart 73 Deposits in lek and foreign currency



Source: Bank of Albania.

Chart 74. Annual changes of exchange rate and deposits in lek, foreign currency and euro



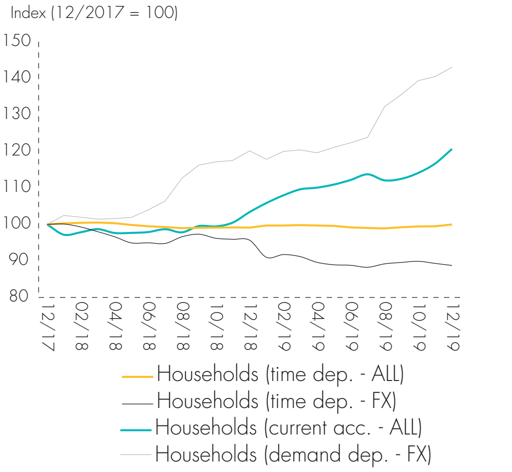
Source: Bank of Albania.

Since middle 2016, households' demand deposits have given a stable and almost constant contribution (of 2 p.p.) to the overall growth of deposits, while the contribution of current accounts has been higher but less stable. In comparison with five years before, the share of time deposits to total deposit stock has declined at around 50% from around 70%, while current accounts have increased their share from 20% to around 35%.

The environment with low interest rates continues to support the preference of consumers for demand deposits and current accounts against time deposits, and this preference is more pronounced for savings in foreign currency. Time deposit held mainly by the households sector have the main share in lek deposits (around 60%), but they account for less than 45% of total foreign currency deposits. Current accounts and demand deposits taken together account for around 40% of lek deposits, 54% of foreign currency deposits and 47% of total deposits. Current accounts and demand deposits in foreign currency, held mainly in euro, reached up to 28% of total deposits.

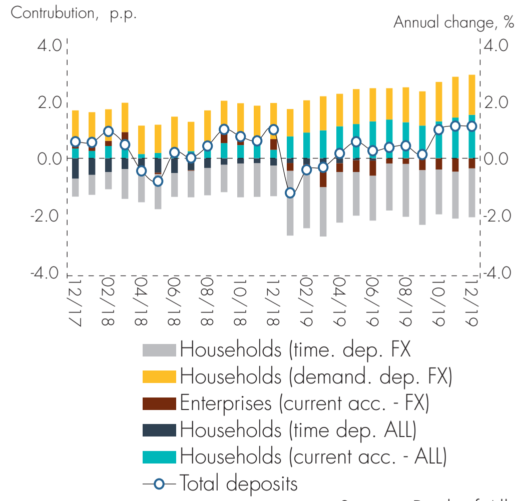
The households sector holds over 80% of total deposits and has continued to expand its deposits in the banking sector. The increase of households' deposits is supported by the expansion of demand deposits in foreign currency and current accounts in lek. At the same time, households time deposits in foreign currency account for around 23% of total deposit and have continued to contract in annual terms, but have maintained almost an unchanged level over 2019 H2.

Chart 75 Performance of households deposits by maturity and currency



Source: Bank of Albania.

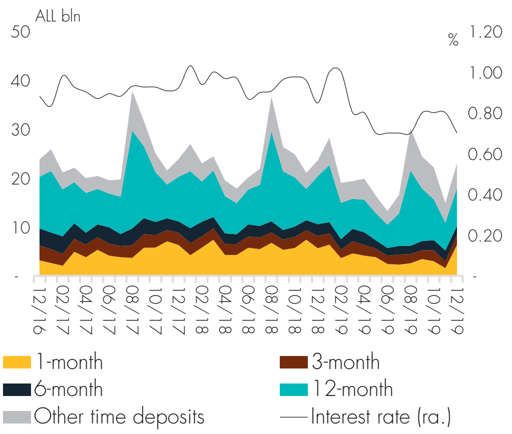
Chart 76 Composition of deposit growth by maturity, sector and currency



Source: Bank of Albania.

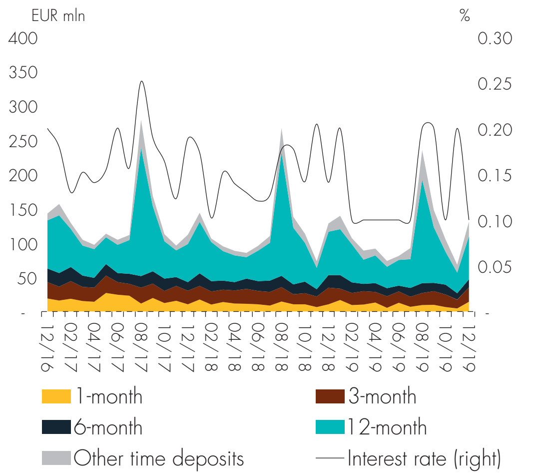
Interest rate for time deposit in lek and euro registered 0.7% and 0.1%, respectively, at the end of the year and returned to the levels of the beginning of the period, after a slight increase during 2019 H2. New deposits have maintained their seasonal behaviour registering higher values during August, but for both this currencies it is observed a downward trend compared with the performance reported during 2016-2018. The quantity of new time deposits reported during 2019 was around 8% smaller compared with new deposits in 2018 and the strongest decline (around 13%) was registered in new time deposits in lek, whereas time deposits in euro were also around 6% lower compared with the flow of 2018.

Chart 77 Flows and average interest rate for new time deposits in lek



Source: Bank of Albania.

Chart 78 Flows and average interest rate for new time deposits in euro



Source: Bank of Albania.

4.1.2 RISKS TO THE ACTIVITY OF THE BANKING SECTOR

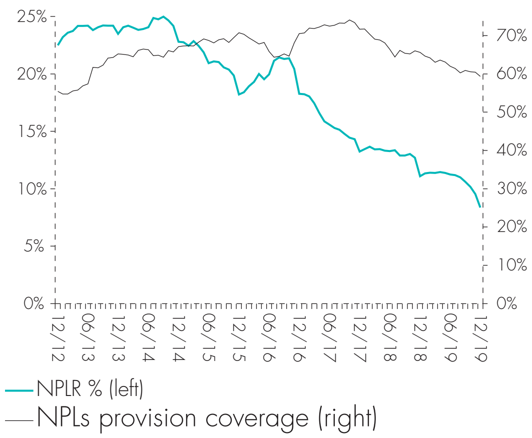
4.1.2.1 CREDIT RISK

The considerable improvement of credit portfolio quality was a joint contribution of the non-performing loans written off, payment and restructuring. The improvement of credit quality was more notable in loans to enterprises, loans in foreign currency and long-term loans.

Non-performing loans ratio (NPLR) fell in one-figure level for the first time in a decade, staying at 8.4% in December 2019, from 11.2% in June 2019. NPLs stock fell at ALL 48 billion[34], around 24% lower in semi-annual and annual terms, with a contribution from written off loans and their restructuring. The written off of loss loans from banks' balance sheets was intensified in 2019 H2[35], mainly affected by the regulatory amendments undertaken by the Supervisory Council of the Bank of Albania. The improvement in loans quality is mainly noted in credit portfolio to enterprises, loans in foreign currency and in loans with longer maturity terms. The Bank of Albania will continuously monitor the performance of credit portfolio, particularly under the circumstances of a possible impact from the consequences of earthquake in November 2019 and further from the coronavirus pandemic.

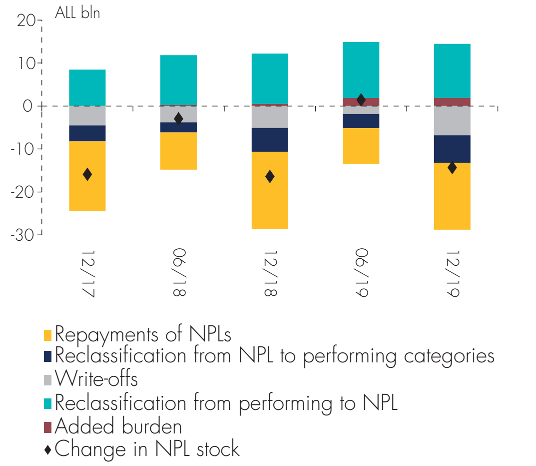
During the period, the improvement of credit portfolio quality was accompanied by the improvement of non-performing loans structure, together being reflected in their lower provisioning. At the end of year, provisioning ratio fell at 59.4%, from 62% respectively in June 2019.

Chart 79 Non-performing loans ratio and provisioning



Source: Bank of Albania.

Chart 80 Contribution in the annual change of non-performing loans stock



Source: Bank of Albania.

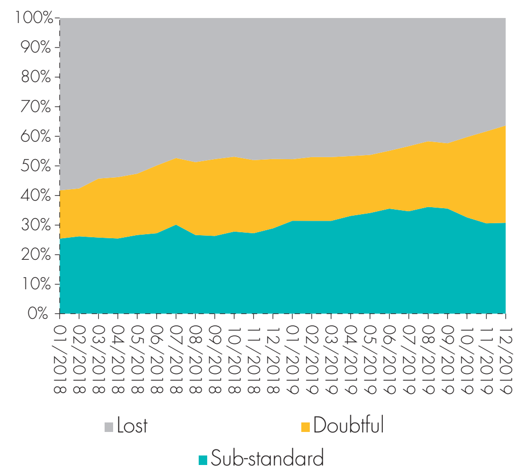
Compared to the previous year, the ratio of non-performing loans fell by 3 percentage points and the decline mainly reflects the contraction in the stock

[34] The stock of non-performing loans which are paid during 2019 H2 doubled, compared with 2019 H1, being the main source of the fall of non-performing loans stock.

[35] During 2019, around ALL 8.4billion loss loans are written off, mainly represented by loans tin foreign currency to enterprises. The flow of written off loons from banks' balance sheets during 2019, is equal with the flow which are reported during the two previous years. In total, since the beginning of the written off process (January 2015), ALL 65 billion loss loans are written off.

of non-performing loans. In recent years, there has been share shift between non-performing loans classes, from the "lost loans" to those with lower risk. The share of lost loans in the non-performing loan stock declined at 36% from 48% in the previous year and from 60% in middle of 2017. This performance mainly reflects the write-off of lost loans, the payment of arrears and the restructuring of some of them. Over the last 12 months, the non-performing loan stock has seen a significant increase of the share of "doubtful" loans by 10 pp, at 33%.

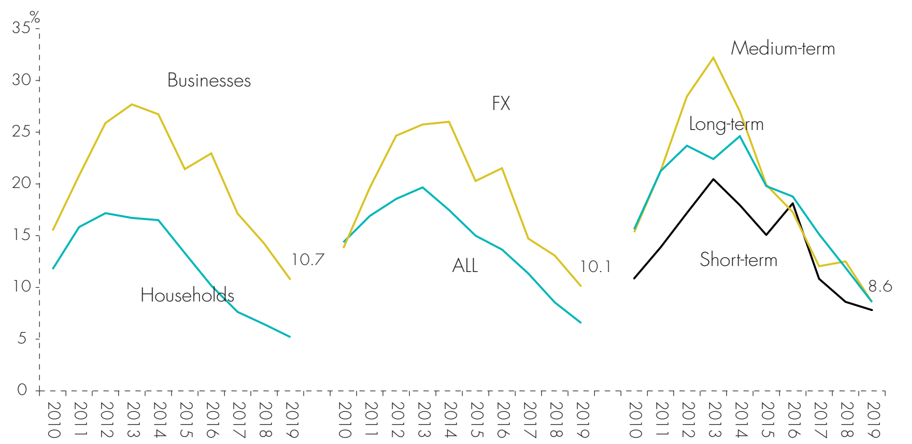
Chart 81 Non-performing loans structure



Source: Bank of Albania.

For all categories by term, entity and currency, a significant improvement in the quality of assets during 2019 was observed. The quality of loans is weaker for loans to enterprises, foreign currency loans and medium-terms loans; however these are also the divisions with the strongest decline in the stock of non-performing loans.

Chart 82 NPLs ratio by sector, currency and term



Source: Bank of Albania.

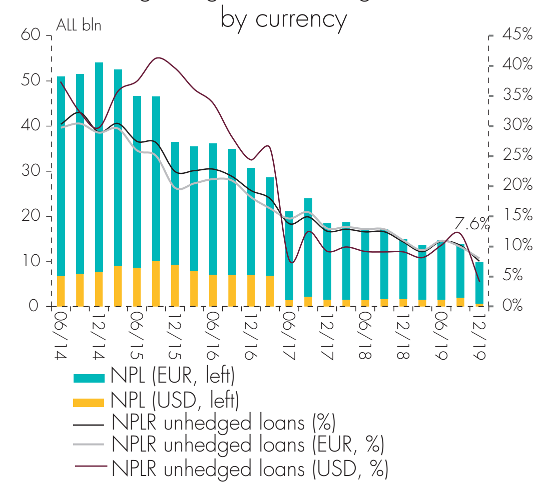
For foreign currency loans unhedged from exchange rate fluctuations, the quality improved significantly compared to a year ago and during the period, with the main contribution from the reduction of the stock of non-performing loans. The non-performing loan ratio for this type of loans marked 7.6% at the end of the period, driven by the performance of unhedged loans in euro, for real estate purchase.

By purpose of use, during the period, NPLs decreased:

- for unhedged loans granted for the purchase of real estate at 8.7%, from 12.8%;
- for loans for business development at 8.7%, from 13%;
- for trade at 7.2%, from 10.3%; and

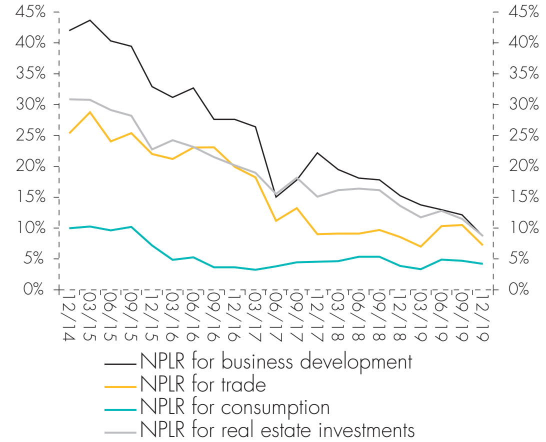
- for consumption - which also has the lowest ratio of non-performing loans - to 4.2%, from 4.9%.

Chart 83 Non-performing loan performance for loans unhedged against exchange rate fluctuation, by currency



Source: Bank of Albania.

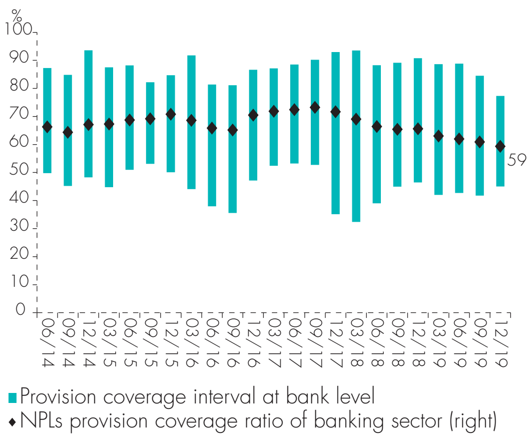
Chart 84 Non-performing loans for unhedged loans against exchange rate fluctuations, by purpose of use



Source: Bank of Albania.

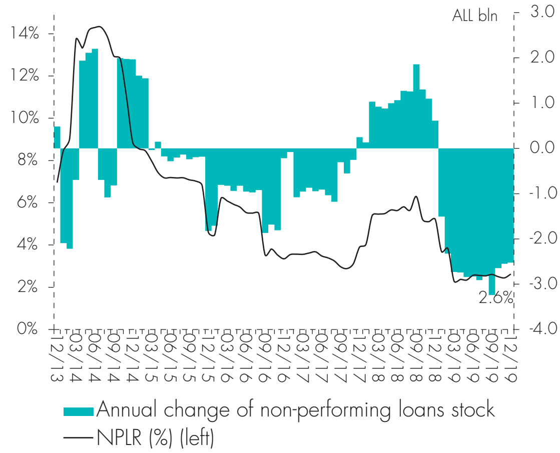
For the non-resident loan portfolio, which has been halved due to structural break, the quality of the loan remained unchanged during the period and the non-performing loan ratio reached 2.6%. Non-performing loan stock for this category is split almost equally between lost and doubtful loans. Almost the entire stock of non-performing loans for non-resident entities is held by businesses and these loans have been disbursed in Euro.

Chart 85 Provisioning ratio over time



Source: Bank of Albania.

Chart 86 Annual change of the non-performing loans stock and NPLs for non-resident entities



Source: Bank of Albania.

Over the period, the level of hedging of non-performing loans with reserve funds declined by 2.6 percentage points, at 59%, reflecting the higher decline of reserve funds compared with the decline of non-performing loan stock. Due to the high weighting coefficient, a certain decrease in the lost loan stock within the non-performing loan portfolio is reflected in a higher decrease of the reserve fund stock for the loans.

During the period, the main contribution to the significant decline in the stock of reserve funds was given by the significant contraction in the surplus of lost loans.

Capital coverage of net non-performing loans[36] expanded to 7.3 times from 5.9 times at the end of the first half of the year. This expansion reflected the rapid decline in the net non-performing loans[37]. In December 2019, the net non-performing loan ratio against outstanding loans registered 3.4% or 0.9 percentage point lower than June 2019.

One of the most positive developments of the period was the further increase of the collateral coverage ratio of loans. At end-December 2019, this indicator marked the highest level of the last seven years (about 80%). Compared to the previous period, the collateral coverage ratio of loans[38] expanded by about 2.7 pp. Loans with collateral in the form of real estate account the main share by around 66% of collateralized loans, and 53% of outstanding loans. Outstanding uncollaterized loans contracted by 10% during the period.

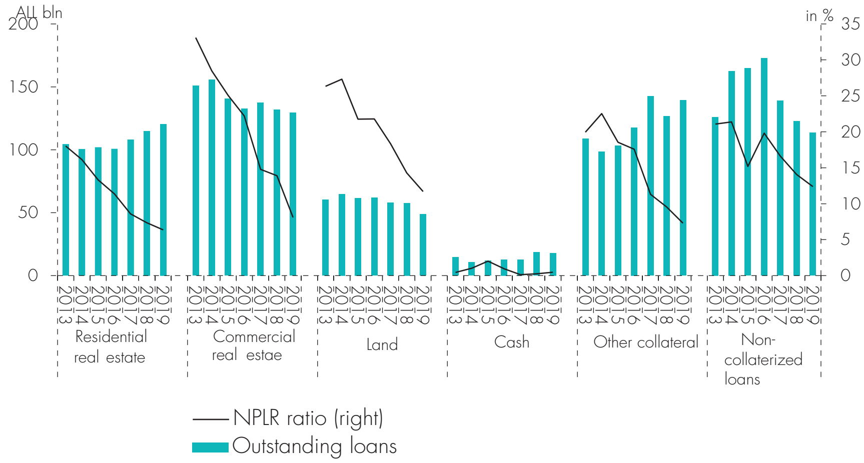
The collateralized credit quality, defined by the performance of loans collateralized with real estate, improved during the period. NPLs ratio for collaterized loans was 7.5% at the end of the year, from 10.5% in the previous year. The decline in non-performing loans stock for collateralized loans has started since 2016. Compared to the end of 2018, the non-performing loan ratio for loans collateralized with commercial real estate marked the most rapid decline by 5.8 percentage points, at 8.1%. This is the lowest level reported in the last ten years. The quality of credit is constantly improving for other loans collateralized with real estate as well, recording the lowest levels of non-performing loans since 2013. Loans collateralized with cash, continue to maintain the lowest level of non-performing loan ratio (0.5%). The quality of non-collateralized loans also improved compared with the end of the previous period and with the previous year. However, this type of loan holds the highest level of non-performing loan ratio (12.4%).

36 Non-performing loans after the deduction of provisions.

37 As a result of the contraction in outstanding net non-performing loans by nearly 18% and the expansion of regulatory capital by around 1.2%, the "net non-performing loans/regulatory capital" ratio decreased to 14%, from 17% in June 2019.

38 Collateral in the form of real estate (residential, commercial or land), cash etc.

Chart 87 Outstanding loans and non-performing loans ratio by collateral



Source: Bank of Albania.

4.1.2.2 Liquidity risk

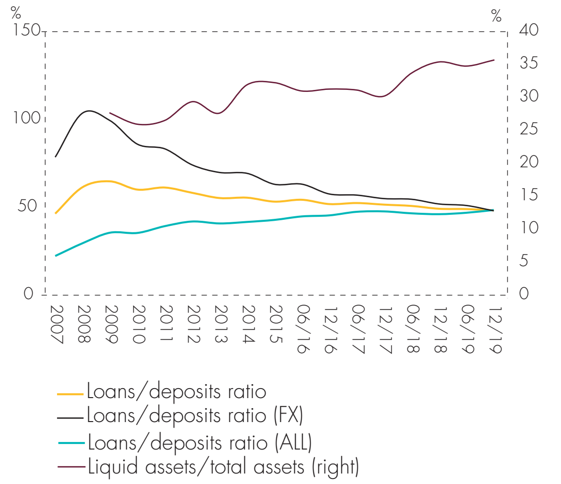
The liquidity position of the banking sector continued to maintain good levels and remains significantly above the regulatory limits.
The abundant presence of liquid assets mitigates the risk signals coming from negative values in the maturity gap between assets and liabilities in the short -term.

The liquidity position of the banking sector has continued to maintain good levels. The liquidity indicators, both in Lek and foreign currency, stand notably above the minimum regulatory ratios. Deposits remain the main source for funding bank activity, and they cover almost twice the volume of sectors' loans. At the end of 2019, the loans/deposits ratio registered 48.3%, a slightly lower value compared to the previous year. By currency, this ratio stands at 48.5% for the national currency and 48% for foreign currency. The "loan / deposit" ratio for the Lek is higher compared to the values of 2019 H1 and the previous year. The same ratio for the foreign currency shows a decrease against both periods. During 2019, loans in national currency have grown at a higher rate than the deposit base. During 2019 H2, foreign currency loans declined slightly, while foreign currency deposits expanded by about 5%. These developments have resulted in a decline in the foreign currency index from 51% at the end of the first half of the year to 48% at the end of the year.

Liquid assets in banks' balance sheets remain high, reflecting the possibility for the increase of lending activity. At the end of December 2019, the ratio of liquid to total assets of the banking sector was 36% or around 1 percentage points higher than the end of the previous half of the year. This performance reflects the faster growth of liquid assets in banks' balance sheets compared to the expansion of total assets. Liquid assets to total short-term liabilities also increased by 2 percentage points, up to 49%. Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities by segment of residual contractual maturity, vis-a-vis the total assets in the short-term, remains high.

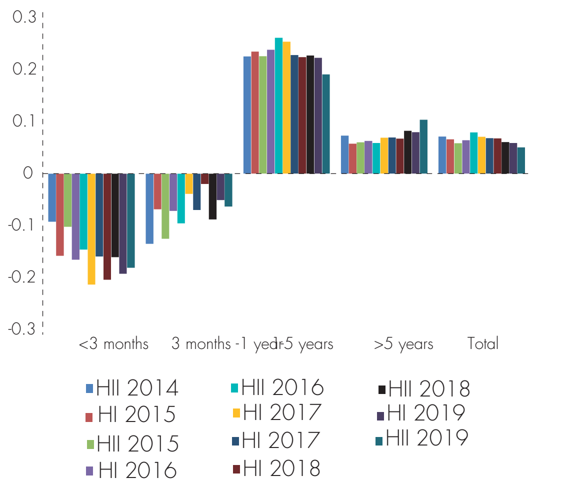
The negative gap between assets and short-term liabilities by segments of residual contractual maturity[39] for the period up to 3 months has narrowed slightly during the period. The overall gap[40] continues to be positive and has also narrowed, toward the end of June 2019, from 6% to 5% of banking sector assets. On the other hand, the gap between assets and liabilities for the period of 3 months - 1 year, during the period, expanded by about 30% and reached 6% of total assets from 5% six months ago. Negative values generally indicate an accepted characteristic of the banking activity, where the average term of investments (securities, deposits, loans) is longer than the average term of liabilities that fund these investments (deposits from the public).

Chart 88 Liquidity indicators



Source: Bank of Albania.

Chart 89 Maturity mismatch between assets and liabilities

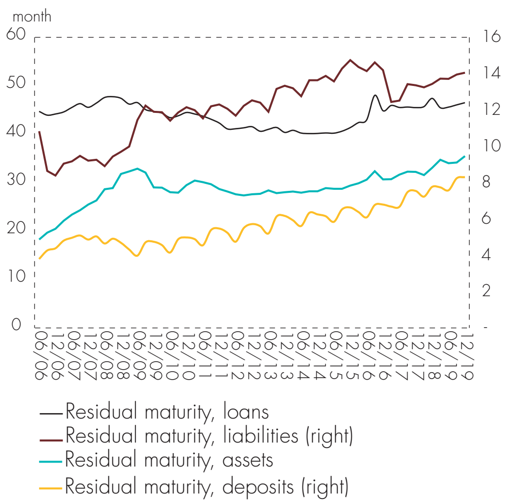


Source: Bank of Albania.

In Albania, the presence of liquid assets in high values, serves to mitigate the signals transmitted by the mismatch in the balance sheet by maturity terms.

During the period it was observed an increase in the mismatch of average maturity of assets and liabilities. At the end of December 2019 this mismatch was around 21.4 months, from 20.3 months in June. Deposits' residual maturity, which represents the most significant category of liabilities, has increased by 8.3 month from 7.6 months. The residual credit maturity also increased at 46.5 months from 45.6, reflecting the banks propensity to grant credit for longer-term periods. Unlike the previous six months, the banking sector did not report the use of funding lines by the parent groups.

Chart 90 Average residual maturity



Source: Bank of Albania.

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

[40] *Off-balance assets and liabilities are also included.*

4.1.2.3 Market risks

EXCHANGE RATE RISK

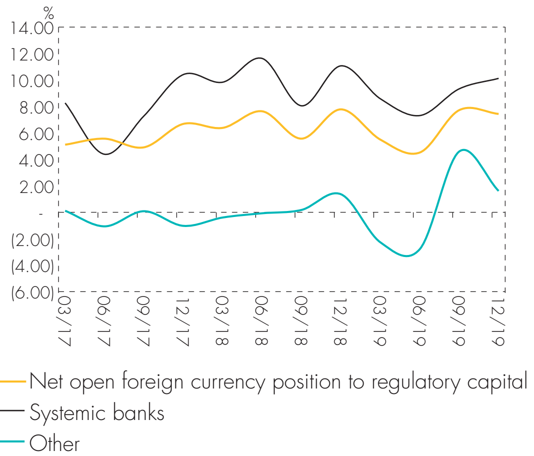
Net open foreign currency position of the banking sector, despite an upward trend, remains at limited levels and significantly below the regulatory limit.

The banking sector's exposure to indirect exchange rate risk also decreased, with the main contribution from the group of banks of systemic importance.

The levels of the net open foreign currency position indicate an increasing but still limited exposure to the direct impact of the exchange rate fluctuations on the balance sheet. The aggregate indicator for all banks, as well as the indicator for group of banks by size, has very low values compared with the upper limit of 30% of regulatory capital defined by the respective regulation.

During the second half of the year, the open foreign currency position increased by about 3 pp reaching 7.4% of regulatory capital. Compared to a year ago, the indicator was about 0.3 pp lower. The performance of the indicator is dictated by the group of systemic banks, which have maintained an open foreign currency long position. This position was as much as 10% of the regulatory capital, a value higher than the 7% of the end of previous period, but lower than the 11% of the end of the previous year. The group of other banks (non-systemic) presents a lower exposure to the exchange rate, with a net open foreign currency long position less than 2% of regulatory capital. During the first half of the year, non-systemic banks recorded a net short position of 3% of their regulatory capital.

Chart 91 Open foreign currency position to regulatory capital for the sector and groups

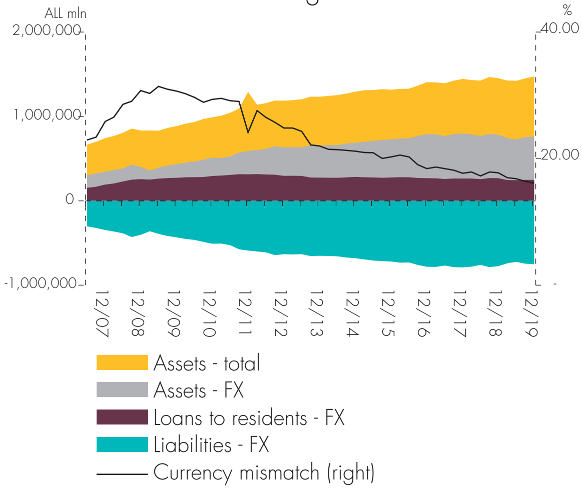


Source: Bank of Albania.

The exposure of the banking sector to the indirect exchange rate risk decreased compared to the previous six months and the previous year. At the end of the period, the foreign currency mismatch[41] for all currencies was equal to 16% of total assets, from 17% and 18% at the end of 2019 H1 and at the end of 2018. Foreign currency assets and liabilities marked the same growth rate (about 6%), but the main impact on the decline of the indicator was given by the increase in bank assets. Due to the significant share in the balance sheet and activity of banks compared to other currencies, the European currency has a much higher contribution and correlation with the overall index. However, the main contribution to the decline in the value of the index during the period was given by the decline by 0.5 pp of the US dollar index at the level of 0.1%. The Euro index fell slightly during the period and marked 16% at the end of the year. At the end of last year, the index values for the Euro and USD were 17.5% and 0.8%, respectively.

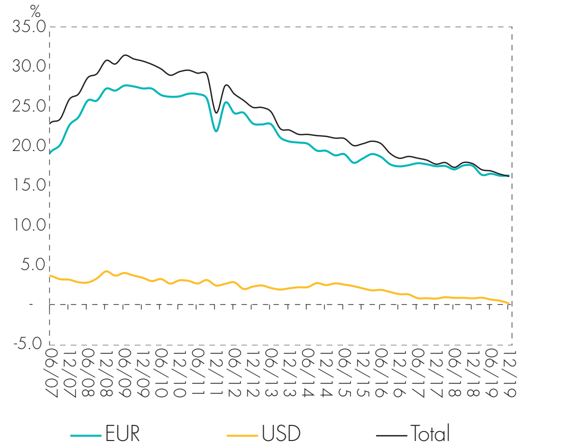
[41] *The foreign currency mismatch indicator measures the hedging rate of the banking sector's liabilities with assets set off by resident credit in foreign currency. A low value of this indicator's ration to assets shows a low exposure to fluctuations in the exchange rate. The methodology for calculating the mismatch indicator has been published in the Financial Stability Report 2016 H1.*

Chart 92 Performance of Indexes components for the banking sector



Source: Bank of Albania.

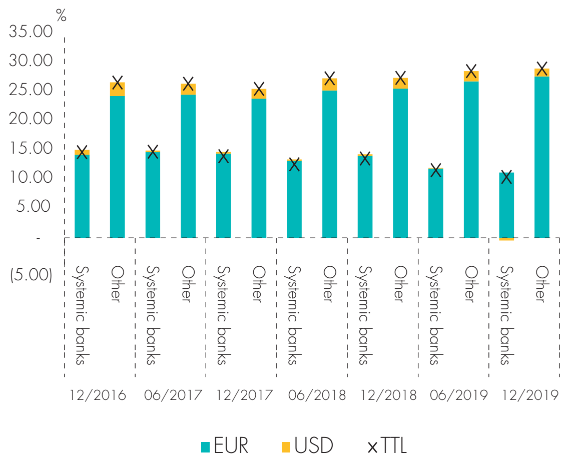
Chart 93 Performance of foreign currency mismatch indicator by currencies



Source: Bank of Albania.

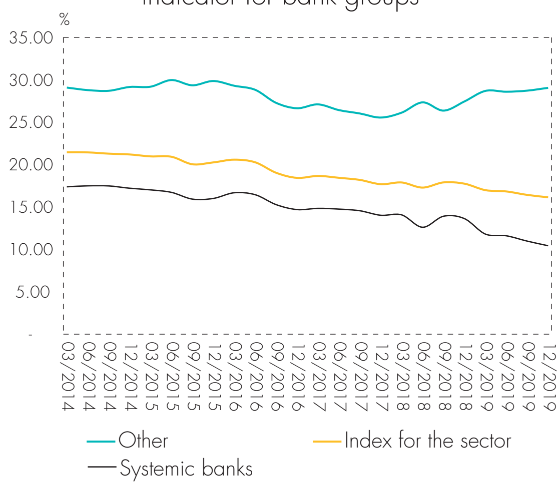
By groups, the performance of the currency mismatch index during the period was influenced by the decrease in the values of the indices for the group of systemic banks. The group of systemic banks records lower index values compared to the group of non-systemic banks. At the end of the period, the total index for systemic banks was as much as 10% of the group's assets, from 12% and 14% at the end of 2019 H1 and the end of last year. The main contribution came from the decline of the index in the European currency by 0.7 pp to about 11%. Other banks show a higher exposure to the indirect exchange rate risk. The mismatch index for this group was 29.1%, about 0.5 and 1.5 pp higher than the level of the previous six months and the previous year. The main contribution came from the similar growth rate of the Euro index.

Chart 94 Currency mismatch by groups and currency



Source: Bank of Albania.

Chart 95 Performance of foreign currency mismatch indicator for bank groups



Source: Bank of Albania.

INTEREST RATE RISK

Although increasing, the banking sector's exposure to interest rate risk remains limited and at low levels to regulatory capital, and significantly below the regulatory limit.

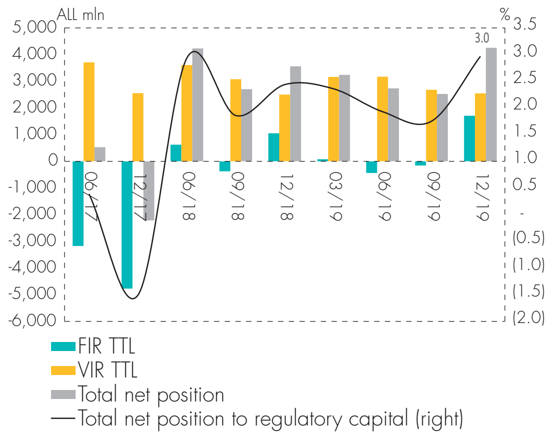
However, the banking sector shows an increased sensitivity to possible interest rate fluctuations for the net position in the national and long-term currency.

The banking sector exposure to the interest rate risk increased during the period, but remains at limited levels. The weighed total net position in the bank's balance sheet against regulatory capital of the banking sector stands at low levels, about 3%, close to the level of a year ago. The weighted spread of assets with fixed interest rate liabilities (FIR)[42] at the end of the period, shifted toward a positive direction. On the other hand, the net position with variable interest rate (VIR) declined in semi-annual and annual terms, but continued the positive direction of the last two years.

When the total net position is positive, i.e. the volume of claims that collect interest is greater than the liabilities for which interest is paid, the banking sector would be exposed to an immediate decline in interest rates. However, under conditions where the regulatory capital hedging of these positions remains high and having limited room for further decrease of interest rates, the cost that may come to the banking sector due to the further decrease of interest rates can be easily absorbed.

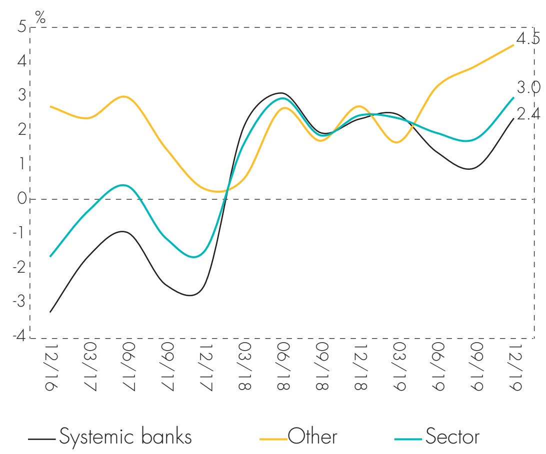
By groups of banks classified by importance, the group of other banks (non-systemic) exhibits higher exposure compared to the group of systemic banks. The second of half of 2019 was characterized by an increase in the exposure of other banks, as the exposure indicator reached the highest level of recent years, about 4.5% of regulatory capital. Systemic banks have expanded their exposure by 1 pp compared to the previous six months, at 2.4% of regulatory capital, but the indicator is at a comparable level with last year. The performance of the banking sector indicator is driven mainly by the systemic banks. The latter have higher exposure in the spread between assets and liabilities with variable

Chart 96 Weighted total net position in bank's balance sheets against regulatory capital, in %



Source: Bank of Albania.

Chart 97 Performance by groups of weighted net position against regulatory capital, in %



Source: Bank of Albania.

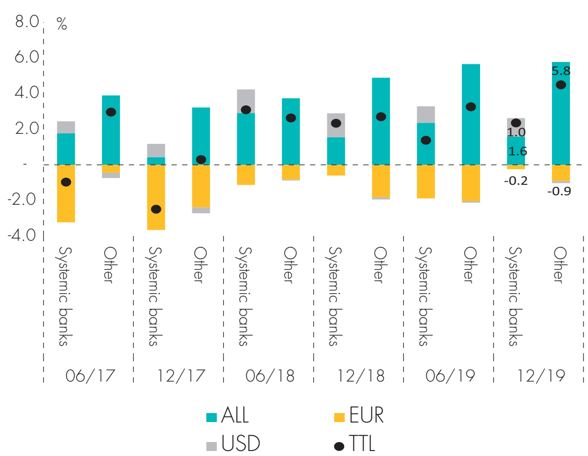
[42] *Positions sensitive to interest rate are classified in positions with fixed interest rate (FIR) and positions with variable interest rate (VIR), by maturity and currency.*

interest rate (VIR) and this position is as much as 1% of regulatory capital. For other banks, exposure is higher in assets and liabilities with fixed interest rate (FIR) and this position was 5.4% of regulatory capital at the end of the period.

By currency, the value of total net position against regulatory capital is affected by the narrowing of the negative position in the European currency by 1.5 pp, at (-0.4%) of regulatory capital. Net position in euro has negative values for both, the group of systemic banks (-0.2%) and the group of other banks (-0.9%). Both bank groups have the highest exposure to interest rate fluctuations, in the national currency, the position in which was at about 3% of regulatory capital. Compared to the last six months, the indicator has fallen by 0.5 pp, but remained at the same level of last year. The US dollar position is positive for systemic banks and relatively stable over time, about 1% of regulatory capital. For the group of other banks, this exposure is very small and negative.

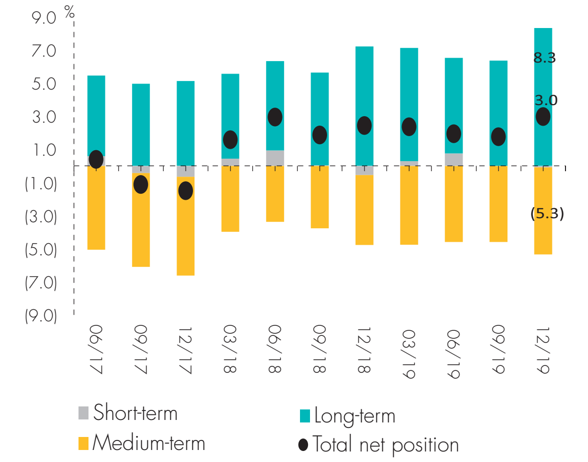
By maturity, the value of the total net position to the regulatory capital has been affected by the expansion of the position for long-term maturity. At the end of the period, the weighted net position for long-term maturity was as much as 8% of regulatory capital, upward compared to the previous six-months and previous year[43]. The main contribution to this development was given by the increase by ALL 3.7 billion of the weighted net position in Euro. Medium-term maturity continues to hold a negative position between assets and liabilities sensitive to the interest rate. This indicator was as much as 5% of the regulatory capital at the end of the period and expanded by about 1 pp compared of the previous six-months and previous year. The short-term gap held the lowest level of exposure (0.1%) and did not registered significant changes in the recent years.

Chart 98 Gap by group and currency against regulatory capital, in %



Source: Bank of Albania.

Chart 99 Weighted net position by maturity against regulatory capital, in %

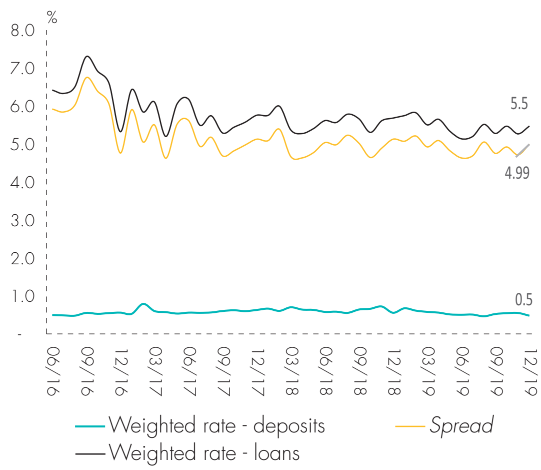


Source: Bank of Albania.

43 Respectively 5.8% and 7.2% of the regulatory capital.

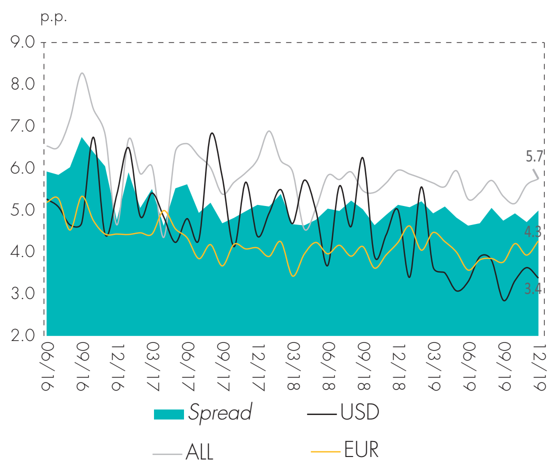
Indirect risk to interest rate change[44] increased during the period. The weighted interest rate on credit increased by 0.3 pp compared to six months ago, while the weighted deposit rate did not change significantly. Compared to the last value of the first half of the year, the overall spread expanded by 0.4 pp. Spread has expanded for all three currencies, but the main contribution to the expansion of the overall spread came from the interest rates in national currency. At the end of 2019, the spread between credit interest rates and new deposits interest rates in the banking sector was 5.7 percentage points for the Lek, 4.4 percentage points for the euro and 3.4 percentage points for the US dollar.

Chart 100 Loans and term deposits weighted interest rates and interest rates spread, in %



Source: Bank of Albania.

Chart 101 Spread of weighted interest rates of loans and term deposits by currency, in p.p.



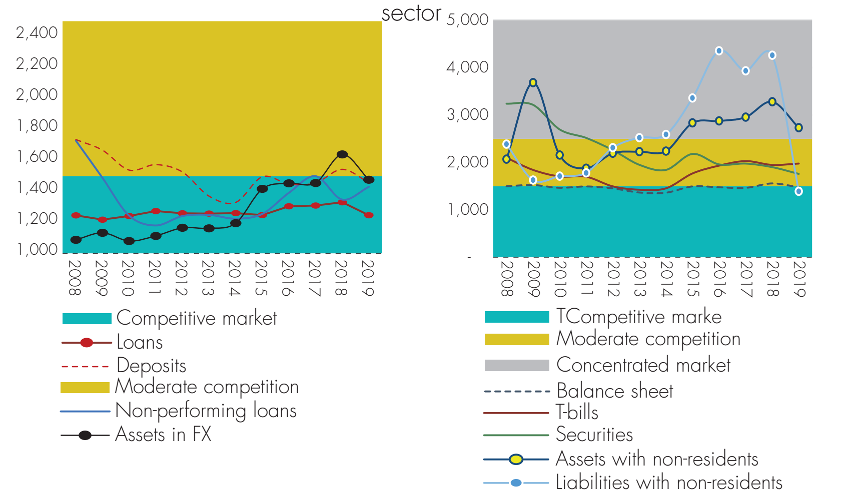
Source: Bank of Albania.

[44] *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).*

BOX 8 INDICATORS OF CONCENTRATION FOR THE BANKING SECTOR

The domestic banking sector continues to be a competitive market in terms of the main financial intermediation activities, which are the receipt of deposits and the granting of credit. Credit activity has the lowest concentration rate compared to all the other activities of the banking sector, and the concentration indicator for this activity has maintained stable and low levels throughout the last decade. The concentration indicator for the excess of non-performing loans records levels comparable to the concentration indicator for loan, but has shown higher volatility, especially during the period of financial crisis and during periods of restructuring within the banking sector. The banking sector has a good level of competition also for the activity of receipt of deposits, but the concentration rate is slightly higher compared to the lending activity, remaining, however, below the lower limit of the area indicating moderate competition (1,500 - 2,500 points).

Chart 102 Concentration indicator (HHI) for the main activities of the banking sector



Source: Bank of Albania.

*Indicators for which the concentration rate is particularly high are assets and liabilities to non-residents, while for the activity of banks in the securities market and treasury bills and for foreign currency assets, concentration indicators signal for a moderate competition. The rate of concentration of liabilities to non-residents*recorded particularly high values during 2015-2018, but at the end of 2019 it dropped significantly, falling in the area that implies competitive market. For assets with non-residents, which shows the claims of domestic banks to non-resident entities (loans for non-residents and deposits held abroad) and accounts for about 24% of total assets, the concentration indicator remains high, but has dropped significantly from 2018 to 2019 as a result of structural changes in the banking sector.*

Table 11 Indicators of concentration and connection between bank size and profit

	2015	2016	2017	2018	2019
Coefficient p: Assets/net result	0.67	0.51	0.89	0.81	0.87
Correlation coefficient: Assets/Interest income	0.99	0.99	0.99	0.99	0.98
Herfindahl–Hirschman Index Total assets	1.496	1.477	1.465	1.558	1.478
Number of banks	16	16	16	14	12

Source: Bank of Albania.

A more complex analysis of the concentration and efficiency of the financial institutions address the correlation between the size of banks and the size of the financial result. In general, the analysis of the Bank of Albania finds that proportionality between profit distribution and size distribution is relatively high. This means that at average levels and under normal conditions, banks' profits are in direct proportion to their size. During 2015-2019, the linear correlation between the banks' share in the banking sectors' total assets and the banks' share in the net interest result was stronger than the correlation measured for the years 2008-2014. The Spearman indicator (coefficient p) that measures the correlation between rankings for asset size and net result 6 shows that the ratio between bank size and their profitability is positive, and that this ratio has been particularly strong starting from 2017. It is generally estimated that the domestic banking sector is competitive and has a low concentration on key indicators of banks'' balance sheet and activity. At the same time, the distribution of profits between banks is in direct proportion to their size and the relation between the two indicators has been strengthening with the number of banks reducing and the banking sector consolidating over the past 2-3 years.

Chart 103 The ratio between bank size (bank's assets / sector's assets, (in %) and the net interest income (net interest income for the bank / net interest income for the sector, (in %)

Source: Bank of Albania.

* *Liabilities to non-residents at the end of 2019 accounted for less than 3% of the overall liabilities of the banking sector.*

4.1.3 BANKING SECTOR RESILIENCE

To assess the banking sector resilience the resilience test exercises are carried out, assessing the reaction of banking sector's key indicators to the proposed scenarios.

This time, the exercise does not contain the previous model of resilience test, but it is focused on assessing the degree of interconnectedness between banks, and between banks and the largest borrowers in the sector, as well as on analysing the liquidity situation. This change was driven by the following factors:

a) at the end of 2019, the results of the resilience test exercises continue to show good situation of financial capacity of the banking sector able to cope with the risks. However, the existing model of resilience test exercises, calibrated against conventional risks, needs to be reviewed and recalibrated under the conditions of an unconventional event, such as the pandemic that the world is currently facing is being outlined. The process of recalibrating the model itself is complicated by the fact that the assessment of the impact of pandemics on the economy currently has many unknowns and a high degree of uncertainty. For this reason, the recalibration process that will be carried out by the Bank of Albania for the existing models of resilience test exercises will require more time, so that the assessments obtained from the exercise are supported by experts as well.

The same process needs to be performed in parallel by the banks for the models or analyses they use to assess their capacities for risk measurement. To this end and referring to the current situation, it is necessary that banks:

- Increase the priority and frequency of these exercises, adapting the nature, severity and complexity of the scenarios;
- Assess the suitability of the capacities they own, to withstand the eventual shocks produced by those scenarios, not only in the short-term but also in a longer term;
- Provide a quick and effective decision-making process to strengthen these capacities. The focus should be on taking actions that not only maintain but also further improve the situation of capital and liquidity reserves;
- Strengthen communication with the Bank of Albania, for the analysis of developments and results.

b) The interaction is assessed as a structural element in the financial activity, and as such, it makes a stable and important contribution to risk monitoring. For this reason, the Bank of Albania has worked on to build models and assesses the spill-over of financial risks in the banking sector. The analysis can be found below.

The exercise to assess the resilience of the banking sector against the liquidity shocks is conducted once a year, and has previously been part of the financial stability reports for the end of the year.

4.1.3.1 Contagion risk[45] and financial interconnectedness[46]

The recent global financial crisis, in addition to the impact on the local economy, had its impact on the economies cross-border. It affected international financial markets, where the banking sector played a key role in the transmission of this phenomenon. The negative impact of these shocks was multiplied through the effect it had on the financial performance of bank balances sheet- the so-called "balance sheet effect" - causing significant losses up to bankruptcy.

This phenomenon prompted a wave of research to better understand the sources of systemic risk and potential determinants of financial crises, oriented in two directions. The first emphasizes the identification of risks that are accumulated over time and that are monitored through "leading indicators". Whereas, the second investigates the interbank dimension of risk spread. In the case of banking crises, it is essential to assess not only the transmission mechanism of economic or financial shocks, but also the level of vulnerability of the banking sector thanks to its financial interconnections, in the form of various domestic or cross-border exposures.

The analysis of financial interaction and the contagion risk is an important part of a country's financial stability and assessment of its systemic risk. Given the central role that the banking sector plays in mediating funds for the real economy, our focus is on the banking sector in the country. Its exposure to various types of risks - as a direct holder or their mediator - is assessed through a "macro-network"[47] of financial interaction. The macro-network visually presents a map of exposures in the banks' balance sheet and the direction of the transmission of the financial risks that accompany it.

More concretely, the analysis of the financial interaction between the banks in the country and the possibility of risk transmission was done based on the data of:
- direct balance sheet exposures against a sample of 5 borrowers - the largest in terms of regulatory capital in each of the individual banks, based on the balance sheet data as of November 2019;
- direct exposures to the balance sheet of each bank against all other banks, based on data as of 23 December 2019.

The above macro-network tracks the implications that arise from a stress event in terms of credit and financing, on the entities selected as part of the sample. Stress events from the viewpoint of credit, are analysed through ''failure'' of entity ''A'', and the consequence that this brings to the entity ''B'' (and other

45 *The contagion risk, as a type of systemic risks, is defined as the risk that financial difficulties at one bank spill over to other banks, to the financial system itself or beyond, to the real economy as a whole.*

46 *The term "financial interconnectedness" implies the network of relations between financial agents, mainly in the form of credit exposures, securities, deposits or trade relations and other dependence relations between them. Financial interconnectedness is considered an important mechanism in risk observation.*

47 *The construction of macro-network is based on Espinosa-Vega dhe Sole, (EVS), 2010 method: For more information see: Espinosa-Vega, Marco A. and Sole, Juan A., "Cross-Border Financial Surveillance: A Network Perspective" (April 2010). IMF Working Papers, Vol. 10/105..*

entities of the sample), which has claims against entity ''A''. Meanwhile, Stress events in terms of financing are analysed through the implications of a "failure" of the entity "A" and how it will affect the entity "B" that has obligations to "A", to find alternative sources of financing. The algorithm tracks the implications of failure through several phases, until there are no more such events.

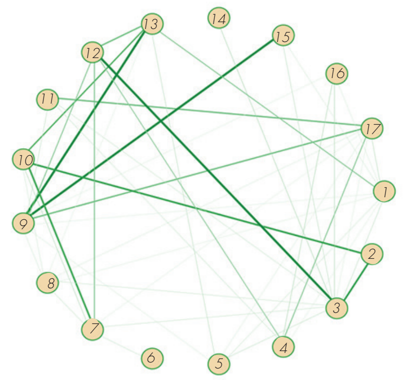
RESULTS

The following matrix presents the exposures of each of the sector's banks against 11 other banks and at the same time the balance sheet exposures of each bank against the five largest individual borrowers.

In the above macro-network, the interaction between banks or between banks and larger borrowers are shown through the green lines, the thickness of which is related to the level of interaction.

The low interaction level is reflected by the fact that only a few entities appear to have relatively stronger interaction to others, while the rest of the map displays a relatively low interaction level.

Chart 104 Large and interbank exposures, 2019



Note: The numbers from 1-12 belong to the banks and are randomly assigned. While the numbers from 13-17, despite being marked as "bank", belong to the five largest non-financial borrowers; these numbers are randomly assigned as well.

Source: Bank of Albania.

Chart 105 Macro-network analysis of exposures and shock / failure tracking process

a. for the 5 largest borrowers

b. for the largest borrower

Source: Bank of Albania.

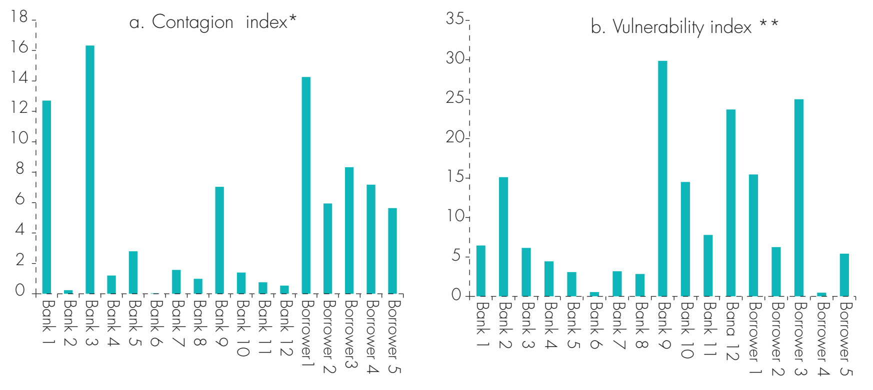
Individual banks feel the shock over different phases, based on the assumption that in the event of a stress event, the losses experienced will have to be absorbed only by using the additional capital above the required regulatory minimum, i.e. above the minimum level of 12%. We emphasize that, in terms of regulatory capital, large and interbank exposures remain relatively low.

The above chart assumes two scenarios:

a. simultaneous failure of the five largest borrowers. In this extreme scenario, their failure affects the banking sector, through the higher sensitivity that a sector's bank presents due to its exposure to these borrowers. In this case, the additional capital over the regulatory one is lower than the total exposure of this bank to these borrowers. In this scenario, loss and shock in the regulatory capital materialize in a single phase.
b. failure of the largest borrower. In case of the failure of this borrower, a bank is again affected in the conditions when its exposure to this borrower is significant and the weight of this exposure in the bank's additional capital is high. In this case, the effect of this shock is transmitted in two phases, affecting another borrower owing to the fact that the bank's claims against this borrower exceed the company's capital. For this second phase, it is assumed that the bank, under conditions of stress, intensifies efforts to collect the claim it has against the second borrower and the latter finds it impossible to quickly find another bank to refinance the obligation to the stressed bank, thus being forced to restructure the activity. The exercise shows that transmission of stress to other borrowers, in this case, is irrelevant.

The summary of the results of the macro-network analysis is illustrated through two indices, the contagion and vulnerability index. Specifically, the "contagion index" identifies the impact (in percentage) on the additional capital of the banking sector or on the share capital of non-bank entities, in case of failure of one of the entities (bank or non-bank entity); whereas, the "vulnerability index" identifies the average level (in percentage) by which the capital of each entity is affected in case of failure of other entities individually.

Chart 106 Risk transmission analysis (cascade effect)



*The contagion index represents the ratio between the total losses in the sample additional capital to their total additional capital, not including the failed entity.

**The vulnerability index represents the average loss of each entity in terms of its additional capital, in case of failure of all other entities in the sample, individually.

Source: Bank of Albania.

From the graphical presentation, it results that the contagion and vulnerability indices show low transmission of risk. Currently it is estimated that banks with higher contagion index (bank 3), causes greater loss of entities' capital in the event of its bankruptcy (16%). On the other hand, the vulnerability index was higher for bank 9, which suffers an average shock in its additional capital by about 30%.

Focusing on interbank exposures, they are estimated to be minor compared to the banks' capitalization levels. For each bank, the total gross exposure to the rest of the banks is smaller than their regulatory capital. For this reason, a single failure of a domestic bank would not cause the failure of another bank and consequently, no "cascade effect" would happen in this representative sample.

4.1.3.2 Liquidity Stress test

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 particular currencies, instruments or time periods; assess banks' readiness to cope with extreme liquidity shortfall scenarios; as well as assisting the supervision authority to undertake specific policies that address liquidity management, including measures aimed at reducing exposures or creating specific reserves.

The results of the liquidity stress test show that the banking sector resilience to potential liquidity shocks is assessed strong and better compared to the previous year.

The liquidity stress test is implemented according to the "top-down" approach, with data reported by banks annually, at the end of the year. The exercise uses data on inflows and outflows forecasts of money 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, Euro and US dollar and is supported on the condition that the liquidity outstanding on a currency may not be used to cover the liquidity shortfall in other currencies, due to the probability of fast depreciation of the exchange rate over liquidity crises. In real situations, this is not a limiting element.

For the calculation of the liquidity gap are used specific coefficients 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 customers. For money inflows, the reinvestment coefficient means that part of the amount rights that mature in the relevant basket, which will be converted in money inflow and will not be reinvested by the banks.

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

RESULTS

The results of the stress test show that the resilience of the banking sector to possible liquidity shocks according to the data of November 2019, for the time horizon up to 2 years, is assessed as strong and appears better compared to the previous year.

The improvement of the resilience of the banking sector was influenced by the significant increase (by about 20%) of the expanded liquid assets (counterweighting capacities), while the expected inflows and outflows of money for the three currencies and the gap between them remained almost unchanged compared to the previous year. The gap between inflows and outflows continues to be negative, and the highest negative values are recorded in the baskets' up to 1 day ',' 1 to 2 months' and '6 to 12 months', while for the basket' 1-2 years' expected inflows are higher than outflows.

The resilience of the banking sector to liquidity shocks depends on currency. The ability of the banking sector to face liquidity shocks is assess as "very good" for lek and US dollar and "good" for euro. The simple gap between the inflows and outflows in Lek is generally higher compared to that in Euro, but the extended liquid assets of banks in the Lek are about 2 times higher compared to those in the Euro. For the US dollar activity accounting for less than 10% of total money inflows and outflows, the gap between inflows and outflows is positive and the banks' resilience is quite good.

The number of banks that continue to record a negative liquidity gap compared to a year ago has not changed for Lek and US dollar, and has slightly decreased for the Euro, while the maximum value of the liquidity gap in relation to banking sector assets ranges from 0% (Lek and USD) to 3% (Euro). But using extended liquid assets helps close the liquidity gap.

Compared to a year ago, the strengthening of resilience in Lek is related to the increase of the volume of expanded liquid assets, available for liquidation to fill the gap (as counterweighting capacities). On the other hand, the improvement of the Euro is related not only to the increase in the volume of counterweighting capacities, but also to the expected improvement in money inflows and outflows that mainly reflect credit inflows and deposit outflows.

4.2 NON-BANK SECTOR

4.2.3 MAIN DEVELOPMENTS IN THE NON-BANKING SECTOR

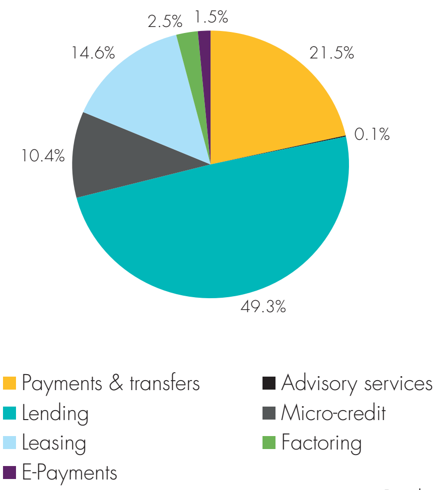
4.2.3.2 Institutions supervised by the Bank of Albania.

During the period, non-bank financial institutions (NBFIs) expanded their activity due to the positive performance of lending activity and investments in the form of current accounts in banks. At end-2019, the financial system contained 32 NBFIs, with total assets of ALL 65 billion. Their balance was 9% and 23% higher compared to June 2019 and the end of the previous year. Domestic capital dominates by 88% the total shareholders' equity of NBFIs, where the NBFIs that carry out lending activities account for the main share, followed by those that carry out payments and transfers. NBFIs are more active in lending to service activities (about 30%) and wholesale and retail trade (16%) NBFIs ended 2019 with a positive financial result (about ALL 3 billion), higher compared to the previous year. The activity capitalisation of these entities continued to remain at satisfactory levels. The portfolio quality of loans declined slightly, since the ratio of non-performing loans at the end of the year, was 10% from 9% and 9.5% in the previous six months and year.

Non-bank financial institutions (NBFIs) expanded their activity following the intermediation increase in the lending activity. The positive financial result is upward and has contributed to the satisfactory level of activity capitalization.

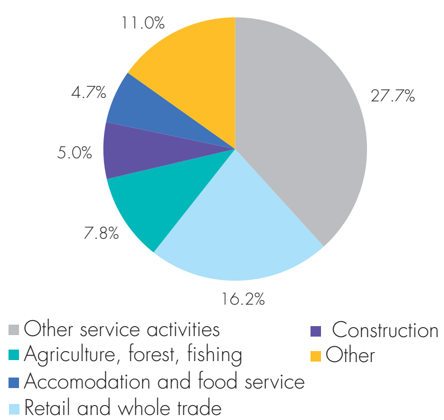
However, the quality of portfolio should be monitored when non-performing loans record higher values than the level of the banking sector.

Chart 107 The NBFIs structure by type of activity, December 2019



ource: Bank of Albania.

Chart 108 The Portfolio structure of loans by economy sectors, December 2019



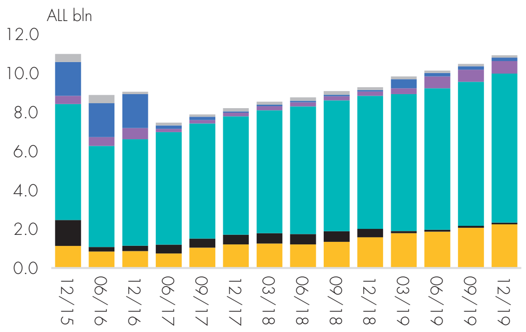
Source: Bank of Albania.

The activity of Savings and Loan Associations (SLAs) expanded in semi-annual and annual terms, supported by the growth of net loan (activity of the members) and the growth of investments in the banking sector in the form of current accounts. The financial result of the SLAs was positive and improved compared to the previous year, when this segment of the financial system did not report profit. Net loans to members and investments in banks represent the main items of these institutions' assets. The sector with the largest funding from the activity of the members is the agricultural sector, followed by service activities. The quality

The activity of Savings and Loan Associations (SLAs) was positive in terms of lending and financial result of the period. The quality of loan portfolio continued to improve, leading to the decrease of non-performing loans.

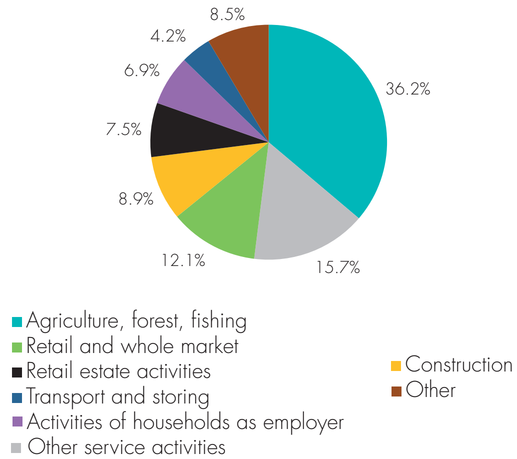
of the loan portfolio improved further and the ratio of non-performing loans at the end of the year decreased to 4.7% from about 5.0% in the previous six-months and the previous year, respectively. At the end of 2019, fourteen Savings and Loan Associations and one Union operated in the Albanian market.

Chart 109 The assets' structure of Savings and Loan Associations



BaSource: Bank of Albania.

Chart 110 Loan portfolio structure by economy sectors, December 2019



Source: Bank of Albania.

4.2.3.3 Institutions supervised by the Albanian Financial Supervision Authority

The activity of the insurance companies supervised by the AFSA reflects a more volatile performance. Despite the expansion in terms of assets and the number of entities licensed in the insurance companies and supplementary private pension funds, the investment funds contracted.

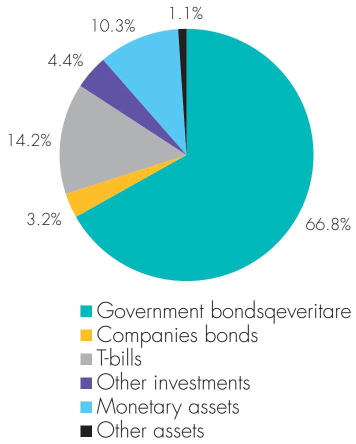
The activity of insurance companies increased during the period, supported by the increase of technical provisions, stocks and time deposits in banks. There are 12 licensed insurance companies operating in the domestic market that carry out life insurance (4 companies) and non-life insurance (8 companies). The assets of these institutions[48] grew by 4% annually, reaching ALL 34 billion. Investments in banks held the main share (around 32%) in insurance companies' balance sheets. Gross written premiums[49], with the main contribution from non-life premiums (92%), which represent the main funding source for the insurance companies activity, expanded by 4% in annual terms.

The activity of investment funds[50] contracted during the period as a result of the decrease of investments in government securities in the form of T-bills and deposits in banks. The value of net assets declined at ALL 67 billion, from ALL 69 billion at the end of June 2019. Currently, five investment funds operate in the Albanian financial system and one new fund, licensed in 2019, which is expected to report its activity regarding collective investment. The investment fund market is market with relatively high concentration, where two of the investment funds own about 80% of the total net assets of funds. Investment

48 *The insurance companies' balance sheets belong to 2019 Q3.*
49 *AFSA, Statistical Report, 2019. Published on 28 January 2020.*
50 *AFSA, "Collective investment undertakings market'', 31 December 2019, published on 24 January 2020.*

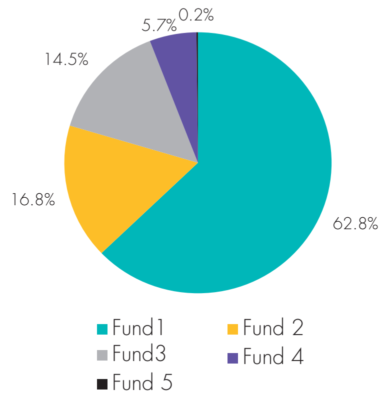
fund' assets are mainly invested in bonds issued by the Government of the Republic of Albania, with higher return, compared to alternative investments.

Chart 111. Structure of the assets of investments' funds, December 2019



Source: Bank of Albania.

Chart 112. Share of investments' fund in the market, according to assets' net value, December 2019



Source: Bank of Albania.

Supplementary Private Pension Funds[51] have expanded their activity during the period. In Albania, three supplementary private pension funds operate in the financial market, and one new fund, licensed in October 2019, which is expected to report its activity regarding supplementary private pensions. The assets of these funds, at the end of 2019 registered ALL 3 billion, or 13.5% more compared to end-2017. The activity of pension funds is dominated by investments in government debt securities.

The activity of the Albanian Securities Exchange (ALSE), during the period, consisted in transactions with government debt securities. The ALSE counts 4 members which are banks and one Brokerage Company. According to the statistical data of the AFSA[52], the value of traded bonds was about ALL 2 billion and the value of T-bills about ALL 0.3 billion. Regarding the instruments traded in AFSA, both in number and value, the transactions conducted for the account of customers, are dominant.

4.2.4 FINANCIAL SYSTEM INTERACTION

The banking sector's exposure to the non-banking sector in Albania remains limited, unchanged during the year. Whilst, the sensitivity of the non-bank sector to the activity of the banking sector is high and upward during the period.

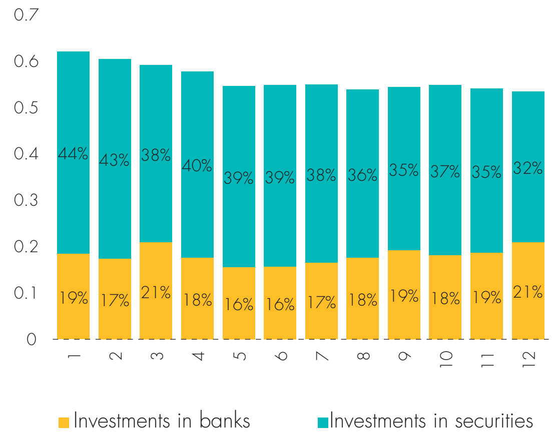
The exposure of the banking sector to non-banking sector in Albania is limited with no changes during the year. This exposure on the side of banks' assets is represented by loans granted to non-bank financial institutions, which accounts for only 1% of the total assets of the banking sector. On the side of liabilities the exposure is in the form of funds collected by banks (various accounts, time

51 *AFSA, Statistical Report "Developments in the private supplementary pensions", 31 December 2019, published on 26 February 2020.*

52 *AFSA, Monthly Publication No. 130, December 2019.*

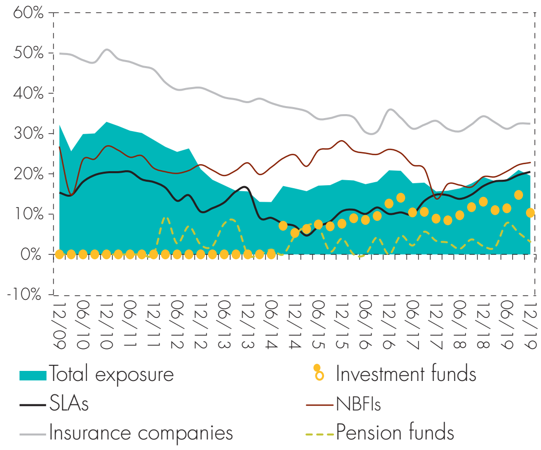
deposits or demand deposits), and accounts for only 2% of the value of assets of the banking sector. This ratio has slightly increased during the recent years,

Chart 113 Investments of non-bank sector in banks and government securities, to total assets of the non-bank sector (share, in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 114 Investments of non-bank sector financial institutions in the banking sector to their total assets (in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

but it is considered very low compared to the threshold-level applied by the Bank of Albania for the monitoring of the risk of exposure and concentration of activity between different segments of the financial system.

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 at the end of third quarter accounted for 21% of the assets of the non-bank sector, compared with 19% at the end of 2018. Insurance companies and non-bank financial institutions (NFBIs) show the highest exposure to the banking sector, since their placements in banks in the form of deposits and capital instruments, account for 33% and 22%, respectively, of relevant assets. Regarding the Savings and Loans Associations, the exposure and sensitivity to the developments in the banking sector increased, given that these entities increased the deposits in the banking sector. The exposure of the non-banking sector to the banking sector is regularly monitored by the Bank of Albania in the context of periodic assessment of systemic risks and monitoring of the fulfilment of the intermediate objectives of macro-prudential policy.

5. MACRO-PRUDENTIAL POLICY AND RISK ASSESSMENT

5.1 RISK ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN THE EU COUNTRIES AND REGION[53]

The following analysis presents the main risks identified in the financial stability reports and the macro-prudential policy instruments implemented in the European Union (EU) and the Region. To this end, several risk assessment reports were analysed, prepared by the European Central Bank (ECB), the European Systemic Risk System (ESRB), the European Insurance and Occupational Pensions Authority (EIOPA), and the International Organization of Securities Commissions (IOSCO), etc. The reviewed reports date from 2018 until 2019 H1. Their experience serves to enrich and implement the relevant policies and instruments in the Bank of Albania.

5.1.1 RISKS ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN THE EUROPEAN UNION

During the period the main risks do not show substantial changes compared to the previous year. However, the risk arising from the activity of the non-bank financial sector (shadow banking) is upward, and therefore the European Central Bank (ECB) has recommended the undertaking of special measures for the monitoring of this risk. The identified risks are interconnected and if one of them escalates in size it would affect the other risks, thus creating a chain-reaction.

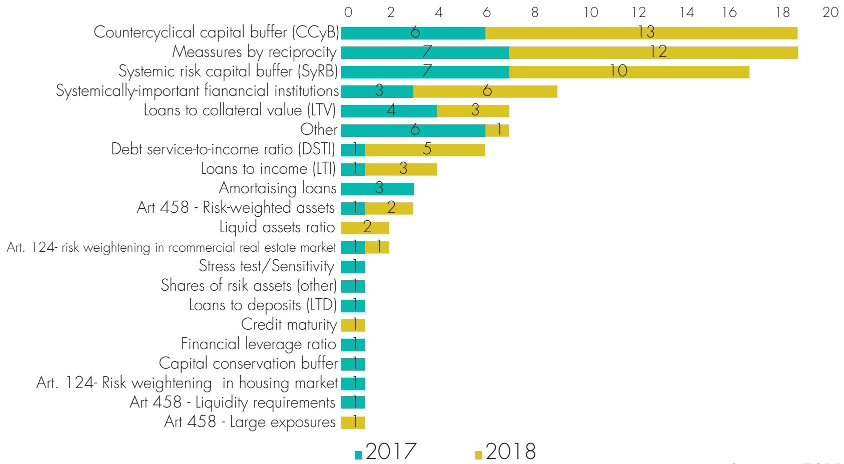
From this perspective, the main risks identified by the EU countries are the following:

I. sudden and non-homogeneous increase of the risk premium, influenced by the reaction of markets to policy uncertainties in EU countries;
II. concern about the sustainability of the debt level, driven by the expansion of economic activity in EU countries;
III. reduction of the intermediate capacities of the banking sector, as a result of the low levels of profitability from the activity, which poses an increased risk for the financial stability of the Euro area;
IV. increase of risk -taking by the non-bank financial sector, accompanied by a risk-increase in terms of liquidity and credit in their investment portfolio.

[53] *For the purposes of this analysis, Italy and Greece are also included in the countries of the Region, in the framework of the exposures of the Albanian banking sector to them.*

In terms of macro-prudential measures taken by EU member countries, there is a significant increase in their total number during the one-year period. Most of the measures taken are tightening and mainly address cyclical risks. The most commonly used macro-prudential instruments are mainly capital-based instruments, in compliance with the regulatory requirements of the European Capital Requirements Directive (2013/36 / EU - CRD IV). The other most applied measure concerns the setting of threshold levels for the "debt service-to-income" ratio (DSTI), with the aim of mainly limiting borrowing from households. A summary of these measures is shown below.

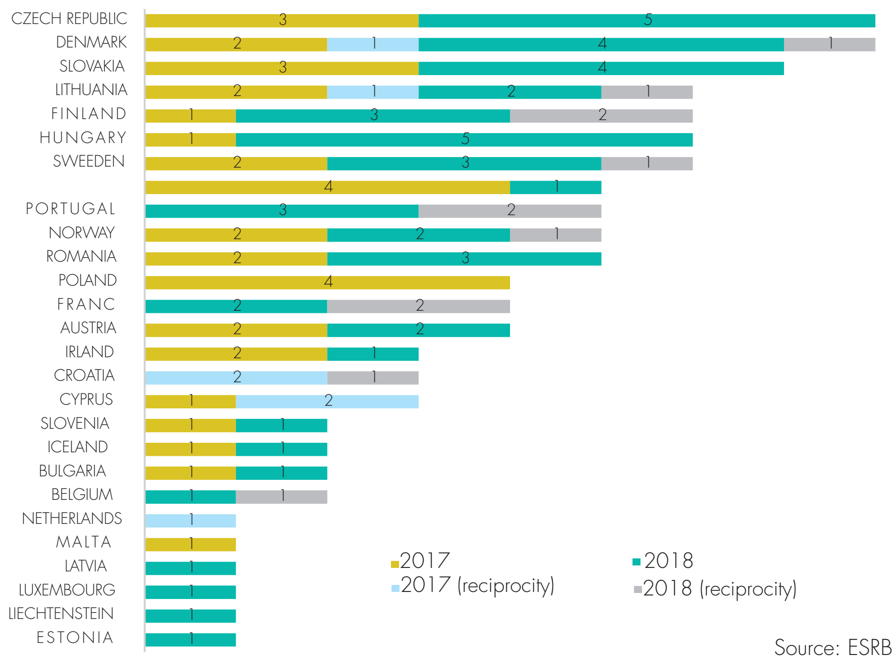
Chart 115 The main measures taken in EU countries, by type



Source: ESRB.

The list of most active countries in the implementation of macro-prudential instruments is leaded by the Nordic countries and the countries of Central and Eastern Europe such as: Czech Republic, Hungary, Denmark, Slovakia, Finland and Sweden.

Chart 116 Number of measures taken by the EU member states



Source: ESRB.

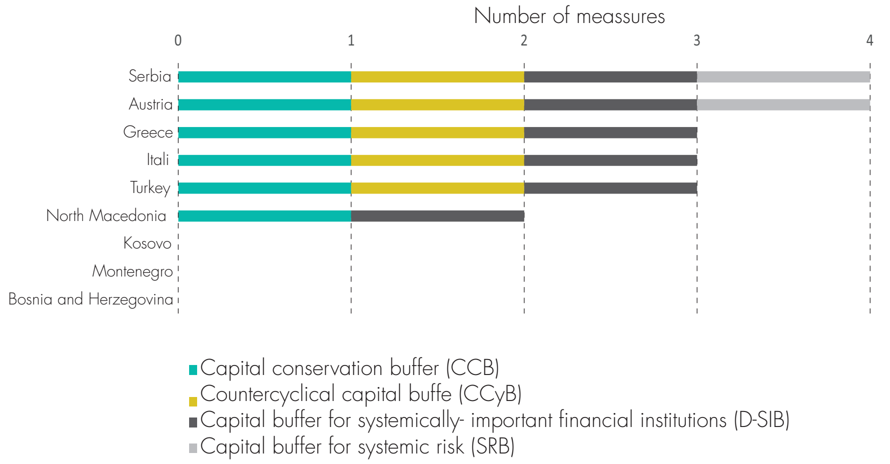
5.1.2 RISK ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN THE REGION

The risks identified by countries of the Region did not change over the one-year time frame. It is worth noting that the risks are very similar to those identified by the Bank of Albania, due to the similarity of economic characteristics between countries. Some of the main risks are:

I. foreign exchange risk;
II. Low profit in the financial system accompanied by relatively high level of non-performing loans;
III. High public debt, albeit slightly down recently;
IV. High concentration of exposures in some sectors of the economy, thus impacting the current level of non-performing loans.

Among the non-EU countries in the region, Serbia and North Macedonia are more active regarding the activation of the demand for additional capital for macro-prudential purposes. The most used instruments in these countries are related to the management of structural systemic risks.

Chart 117 Capital-based macro-prudential instruments by countries of the region



Source: Official websites of the central banks of the reviewed countries.

5.2 RISK ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN ALBANIA

5.2.1 RISK ASSESSMENT IN ALBANIA

The Bank of Albania, in cooperation with other authorities, contributes to safeguarding of financial stability in Albania. As part of this contribution, the Bank of Albania drafts and implements the macro-prudential policy, which analyses and assesses the systemic risk and implements measures to prevent and mitigate it, in two aspects:

I. preventing the accumulation of risks in the financial system, and
II. strengthening the resilience of the financial system.

Regarding the prevention of risk accumulation, the Bank of Albania drafts analyses aimed at identifying financial imbalances based on close monitoring of the performance of indicators that reflect the accumulation of risks, with the main focus on the banking sector. The Bank of Albania has identified a full set of macro-prudential indicators[54] in full compliance with the recommendations of the European Systemic Risk Board (ESRB), which are grouped into four objectives[55], as shown in Table 12.

Table 12 Intermediate objectives and some of the main indicators

Intermediate objective	Explanatory
• *Mitigation and prevention of fast expansion of lending and borrowing*	• *Annual increase of credit volume;* • *Private sector debt load levels;* • *"Credit to Gross Domestic Product (GDP)" ratio and gap;* • *Developments in the real estate market;* • *LTV and DTI indicator, (LTV- Loan to value. DTI.- Debt income), debt financing of banks.*
• *Mitigation and prevention of excessive duration gaps and liquidity shortfall in the market.*	• *"Loan to deposit" ratio;* • *Liabilities structure and maturities distribution;* • *Support on market funding and on the central bank;* • *Liquid assets structure and share to total assets;* • *Liquidity hedging ratio;* • *Sustainable net financial ratio;* • *Stress test on liquidity risk;*
• *Limitation of direct and indirect exposure concentrations*	• *Exposure concentrations by sectors, entities, countries, currencies and maturities*
• *Limitation of excessive carried on risk by financial institutions with systemic importance*	• *Assets to GDP ratio of banks;* • *Volume of deposits and assets;* • *Claims and Liabilities toward other financial institutions;* • *Other indicators that show the size, interconnection, substitutability, complexity and cross-border activity of the banks;*

Source: Macro-prudential Policy Strategy, Bank of Albania.

The analysis of the above indicators shows that at end of 2019 H2, the banking sector continued to maintain good levels of capitalization and liquidity, sufficient to meet the short-term needs. The promotion of lending to businesses, the widening of the negative gap between assets and liabilities by residual

54 *Indicators that best signal the systemic risk, for which the objective is built, are selected for each objective. The monitoring of these risk signals is done by comparing the current value and the timely performance of the indicator to a critical value, exceeding of which may signal the accumulation of risk.*

55 *For more information, please see 'Macro-prudential Policy Strategy", approved by the Decision No.37, dated 02.08.2017, of the Supervisory Council of the Bank of Albania: https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Macro-prudential_strategy/*

maturity, as well as the reduction of the use of foreign currency in the domestic economy continues to be among some of the issues that require special attention. Below you may find a more detailed analysis of each objective:

Objective I. The narrowing of the negative gap of credit to economy to gross domestic product (GDP) signals an improvement in domestic credit, largely influenced by the business loan portfolio. Also, the financial leverage ratio improved over the year, which confirms the maintenance of a good level of capitalization in the banking sector.

Objective II. Liquid assets continued to be at high levels, upward at 36% of total assets or 1 pp more than at the end of the last six months. On the other hand, the negative gap between assets and liabilities for short-term maturities, continued to widen. Also, the spread of the exchange rate for the euro in the interbank market continued the upward trend during these six months.

Objective III. Bank's exposures by sectors of the economy declined this half-year[56], whilst real estate loans increased. Unhedged foreign loans expose the banking sector to exchange rate fluctuations, particularly to the Euro. The analysis by economic activity highlights the concentration of credit mainly in the trade sector, construction and manufacturing industry exposing the sector to possible shocks in these sectors. The use of foreign currency remains high accompanied by negative effects on the transmission channels of the monetary policy and on the management of foreign currency liquidity. For this reason, the Bank of Albania undertook a package of measures to stimulate the use of the domestic currency, in the framework of the Memorandum of Cooperation with the Ministry of Finance and Economy and the Financial Supervisory Authority, signed on 18 April 2017.

Objective IV. The total assets of the banking sector in terms of GDP reached about 96%. Referred to the Herfindal index for the level of concentration of systemic importance, at the end of December 2019, concentration declined. At the same time, non-resident liabilities decreased significantly compared to the previous six months and the previous year, mainly influenced by the break effect in the statistical data, following the structural changes in the banking sector during 2019,

5.2.2 MACRO-PRUDENTIAL MEASURES IN ALBANIA

In view of strengthening the banking sector's resilience, the Bank of Albania drafted the relevant regulatory framework and is calibrating the necessary macro-prudential instruments for this purpose.

[56] *The Herfindahl index method was used to monitor the concentration of exposures at the system level.*

Adoption of the regulation "On macro-prudential capital buffers"[57], enabled the operation and implementation of capital buffers as instruments of the macro-prudential policy. Their implementation aims to strengthen banking sector resilience in Albania against systemic risks of cyclical and structural nature. In accordance with the provisions of this regulation, the Bank of Albania, starting from 2019 Q2, has published quarterly, some decisions of the Governor[58], which announce the requirement for capital conservation buffer, countercyclical capital buffer, as well as the list of systemic banks, and required capital buffers for each of them. For the first time, banks will report the fulfilment of the above requirements starting from 2020 Q1, but the level of fulfilment is expected to be complete under the conditions of good capitalization level of banks activity. In the framework of the pandemics' impact, the possibility of using these countercyclical measures will be assessed. The establishment of macro-prudential capital buffers represents an important achievement in terms of approximation with the relevant European Union standard set out in the European Parliament and Council of Europe legislation, and to the relevant technical standards, published by the European Banking Authority and the European Systemic Risk Board.

In parallel, more attention has been paid to the analysis of the conception of instruments that prevent excessive credit and debt growth, mainly by households. Important in this regard is the development analysis of real estate and consumption credit. A more detailed analysis is given below regarding the latter.

I. DEVELOPMENTS IN CONSUMER CREDIT AND FINANCIAL STABILITY RISKS

Over the past years, consumer credit has grown at a rapid pace in the Eastern and Central European countries, marking similar levels of growth with the period prior to the financial crisis of 2008[59]. Some countries have addressed the risk of excessive credit growth in this segment by adopting macroprudential measures.

These measures mainly intend to limit the share of the loan service relative to the borrowers' income, for example, by setting a cap to loan-to-income ratio, or in the debt service-to-income ratio, but may also include other restrictions such as: maturity limits for the loan contract, amortization requirements etc. This aims to strengthen the borrower's resilience (by reducing the probability of failure) and banks resilience (by reducing the size of loss in case of failure) through limiting the credit service burden and unsustainable levels of credit growth.

[57] *Decision No. 41, dated 5.6.2019 of the Supervisory Council of the Bank of Albania: https://www.bankofalbania.org/rc/doc/Nr_41_2019_14799_7_14903.pdf*

[58] *Can be found in the following link: https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Instruments_of_Macroprudential_Policy/Instruments_and_Decisions/*

[59] *For more information, see the Economic Bulletin of the European Central Bank, No. 7/2017 "Recent trends in consumer credit in the euro area."*

Consumer credit in Albania experienced a rapid growth during 2005-2009, which is related to the increase in the level of financial intermediation in Albania, which started from a relatively low base. Immediately after the materialization of risks, which coincides with the financial crisis, consumer credit shrank, following the general trend of credit contraction in Albania. Consumer credit growth gained momentum at the end of 2014 and lasted up to the first half of 2018, being the most significant contributor to overall household loan growth. However, the growth rate of consumer credit slowed down during 2019[60].

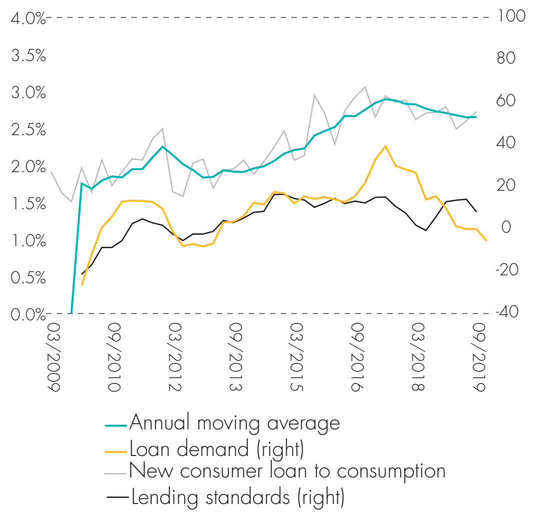
Exposure of banking sector to this segment is low compared to the total loans given to the private sector: consumer loans account for 11.5% of loans granted to private non-financial sector and constitute only 4.2% of the banking system's balance sheet assets . Also, the share of consumer loans to total loans to households has not experienced significant changes, ranging between 23%-37%. This share has been decreasing over the last year, reaching 34% at the end of December 2019.

The non-bank financial institutions contributed positively to the performance of consumer credit. The growth of consumer credit increased at double-digit rates, however the outstanding amount of consumer credit provided by this part of the financial system, accounts for just 10% of consumer credit granted by the banking sector.

Consumer loans are typically procyclical, as they support consumption. This procyclicality is obvious in Albania's data, if we look at the performance of the new consumer credit ratio to the consumption of households. In an environment of positive economic growth, new consumer loans increased more than the final consumption of the population, a phenomenon mostly pronounced during 2014-2017. During this period, the indicator increased by approximately 1 percentage point.

Referring to the Bank Lending Survey[62], the increased demand for consumer loans was an important factor to the growth of credit (yellow dashed line in Chart 118). On the other hand, banks have also eased the lending standards for this segment, as shown by the positive values of lending standard index for consumer credit.

Chart 118 Some indicators of consumer loans[61]



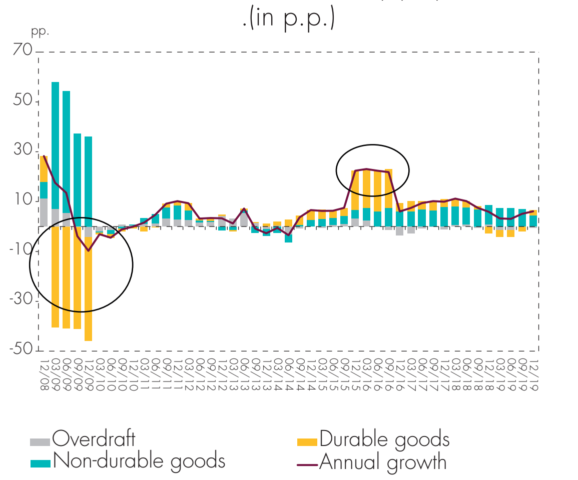
Source: Bank of Albania and INSTAT.

[60] *The annual growth rate of this loan reached 6.9% at the end of December 2019.*

[61] *a) Indicator of the flow of consumer credit to consumption (left axis); Consumer Credit Demand Index and Consumer Credit Lending Standards (right axis); b) On the right axis of the chart, the negative value indicates that banks have tightened the lending standards and vice versa. Also, the positive value shows increase of credit demand, while the negative balance shows decrease of credit demand.*

[62] *For more information, see "Bank Lending Survey" at: https://www.bankofalbania.org/Monetary_Policy/Surveys_11282/Bank_Lending_Survey/.*

Chart 119 Components' contribution to the growth of consumer credit to residents, by purpose of use .(in p.p.)

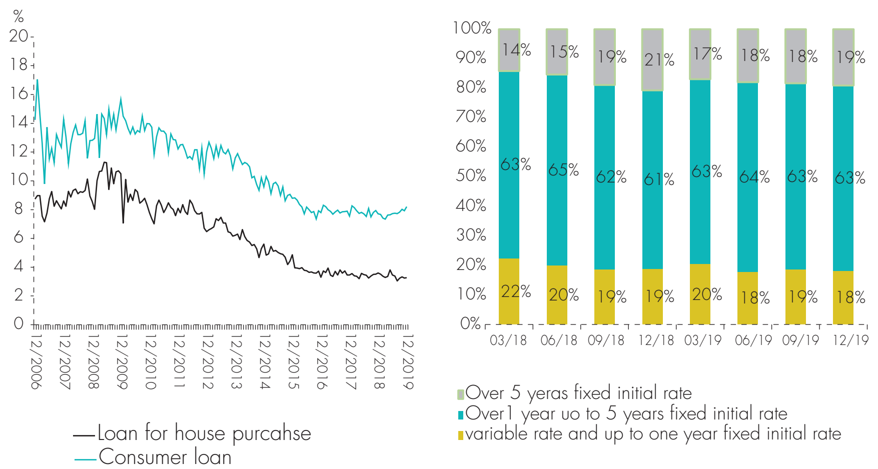


Source: Bank of Albania.

The main component that contributed to the cyclical fluctuations in consumer credit is credit for the consumption of durable goods[63], a phenomenon widely encountered in other countries as well. In the case of Albania, this contribution is evident in both the contraction of 2009, as well as in the intensification of consumer credit growth during 2014-2017.

In terms of cost, in recent years, banks have operated in an environment with historically low interest rates. But interest rates of consumer credit have averaged 1.4 pp higher over the past year. The structure of the initial period of interest rate fixation for new on consumer loans is shown in Chart 120, and it is notable that the dominant part of new consumer loan contracts (about 80%) foresees an unchanged interest rate.

Chart 120 Average interest rate on new loans given to households (left) and structure of initial period of interest rate fixation for new consumer loans (right)



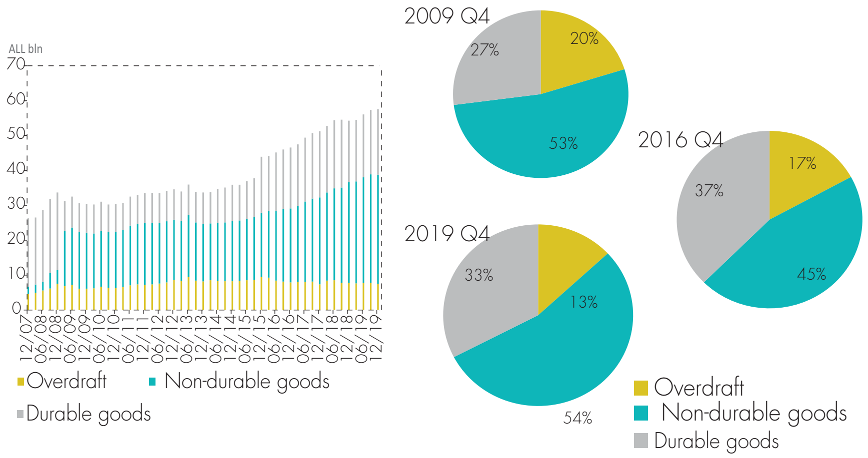
Source: Bank of Albania.

By composition, loans for the consumption of non-durable goods[64] represent the largest share in consumer credit, by 54% at the end of 2019, and this share has been increasing over the past years. On the other hand, "overdraft" loans account for the lowest share in the consumer credit stock at 13% in the end of 2019, and this share has been shrinking. As consumer loans are characterized by a smaller principal and shorter maturities compared to housing loans, the composition of their outstanding stock in the banks' balance sheet may change more rapidly.

[63] *For example: cars, household appliances, electronic devices, etc.*

[64] *Goods that are consumed completely within a year assuming a normal usage, such as food products, office appliances, clothing textiles, most services including vacations, etc.*

Chart 121 Composition of consumer credit by purpose of use (left) and the weight of components in three time periods,* (right)



*2009 Q4, which coincides with the financial crisis, three years ago, and 2019 Q4, respectively

Source: Bank of Albania.

By currency, consumer loans in ALL dominate in the portfolio of banking sector. At the end of 2019, consumer credit in foreign currency accounted for 13.7% of consumer credit. More than half of consumer loans in foreign currency (about 58%) is classified as unhedged against exchange rate risk, however the latter account for only 8% of consumer loan stock. From the borrower's solvency point of view, the risk that comes as a result of unfavourable exchange rate fluctuations remains limited. In terms of credit quality, consumer credit has historically had lower levels of non-performing loans, despite its higher-risk nature. The ratio of non-performing consumer loan has followed a downward trend since 2013 H2, marking its lowest value at the end of 2019. Also, consumer loans contribution to the growth of total non-performing loans stock has been minimal.

Similar to the other countries mentioned at the beginning of this analysis, Albania has experienced an increasing trend of consumer lending from various sectors of the financial system, where the banking sector continues to play a dominant role. Credit demand, especially for the consumption of non-durable goods, played an important role to the expansion of consumer credit. Consumer loans are procyclical in nature, with shorter maturities and higher interest rates. As such, under eventual worsening conditions in the labour market or the economic cycle in general, systemic risks arising from this segment might materialize. However, in Albania, the risks arising from the expansion of consumer credit are mitigated by its low weight. Although the current level of risk remains low and controlled, macroprudential policy actions should be forward-looking, aiming to prevent and mitigate the accumulation of risks that could lead to elevated levels of stress in the financial system.

ANNEX 1 THE MAIN INDICATORS OF FINANCIAL SOUNDNESS

In %	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Capital-based indicators													
Regulatory capital to risk-weighted assets	17.08	17.23	16.17	15.40	15.56	16.17	17.96	16.84	15.72	16.01	17.03	18.66	18.28
Tier 1 capital to risk-weighted assets	16.01	16.31	15.27	14.52	14.30	14.57	14.88	13.79	13.45	14.10	15.53	17.42	17.06
Shareholders equity to total assets	7.62	8.57	9.57	9.40	8.69	8.57	8.37	8.58	9.53	9.73	10.17	10.15	10.45
Asset quality													
Net NPLs to regulatory capital	10.05	21.74	28.24	35.95	52.01	55.62	40.22	38.25	24.28	23.08	15.72	15.51	13.64
NPLs (gross) to total loans	3.36	6.64	10.48	13.96	18.77	22.49	23.49	22.80	18.22	18.27	13.23	11.08	8.37
Profitability													
ROE (annual basis)	20.74	11.35	4.58	7.58	0.76	3.78	6.43	10.53	13.16	7.15	15.71	12.96	13.45
ROA (annual basis)	1.57	0.91	0.42	0.72	0.07	0.33	0.54	0.89	1.20	0.69	1.54	1.32	1.39
FX net open position to captial													
FX net open position to regulatory capital	1.69	4.30	3.89	5.03	3.94	3.98	4.08	8.49	7.66	7.03	6.68	7.78	7.43
FX net open position to Tier 1 capital	1.80	4.54	4.12	5.33	4.29	4.41	4.92	10.37	8.95	8.00	7.34	8.35	7.96
Asset-based indicators													
Liquid assets to total assets	49.77	42.83	27.65	25.95	26.53	29.37	27.64	31.94	32.26	31.29	30.22	34.23	35.68
Liquid assets to sh.t. liabilities (up to 1 year)	73.96	64.86	32.58	30.62	33.15	36.71	34.71	40.36	41.43	40.57	40.79	46.21	49.40
Client deposits to total loans	215.45	162.60	154.32	166.39	163.20	171.62	180.83	180.16	187.78	192.84	194.00	203.25	207.24

Source: Bank of Albania.