Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 “On the Bank of Albania”, as amended, and Article 8 of the Law No. 9962, dated 18 December 2006 “On banks in the Republic of Albania”, as amended, to inform the Assembly of the Republic of Albania and the Council of Ministers, and draw the attention of financial institutions and of the public on the Albanian financial system situation and the potential risks that may jeopardise its stability, the Bank of Albania releases this periodic statement. This statement is an integral part of the Financial Stability Report for the same stated period.

The Financial Stability Report and the Statement prefacing it assess the exposure of the banking sector to risks arising from its interaction with the external and internal economic environment, real economy agents, financial markets in Albania, as well as operational risks in the activity of the banking sector. In addition, these risks face the financial situation of the banking sector and are stressed through stress test exercises to assess the banking sector’s resilience.

The Bank of Albania deems that the activity of the banking sector and of the overall financial system was stable in 2017 H1 and its resilience to activity risks is good.

Overall, the performance of macroeconomic indicators and developments in the economic environment at large provided better support for the activity of the financial system. In the banking sector, indicators of the financial performance, capitalisation and liquidity of the activity, improved overall. However, the analysis of determinant factors and stress test exercises suggest the need for ongoing monitoring of their performance over time. Developments in the banking sector during the period showed a significant improvement of the credit quality and affirmed the importance for the continuation of such process.

**HIGHLIGHTS IN THE ECONOMIC AND FINANCIAL ENVIRONMENT**

Overall, developments in the global economy were positive in 2017 H1. Economic growth accelerated, driven mainly by favourable financing conditions and continuation of stimulating policies, both in the advanced and in some of the emerging economies. The stable oil prices have contributed to dampening the adverse effects on exporting countries from the earlier price fall. In the euro area, a larger number of member states experienced growth, driven by the growth in private consumption, benefiting from the improvements in labour market
conditions, income growth and stable crediting, especially for households. In the European banking sector, the need for reducing non-performing loans remains high, despite the progress made in this regard. Inflationary pressures remain overall below central bank targets. The developments in the Western Balkans have been similar to those in the global economy. During the period, the countries in this region experienced faster growth, mainly attributable to domestic demand following the downward movement of the unemployment rate. Lending continues to be overall weak mainly concentrated in the households segment, despite the accommodative monetary conditions and the gradual improvement of the asset quality. As a result, the inflationary pressures during the period were contained. In line with stimulating financial policies and other economic reforms, the International Monetary Fund (IMF) projects the global output to grow by 3.5% - 3.6% in 2017-2018, with positive contribution from both advanced and emerging economies. The normalisation of the monetary policy in advanced economies and the possibility of added market volatility are currently the main risks for the global economy perspective.

In Albania, the annual pace of economic growth rose to 3.94% at the end of the first quarter. Services, manufacturing and agriculture contributed to economic growth, especially the branches of trade, construction, transport and industry. The growth in aggregate demand was supported by the expansion of the final consumption of the population (with the main share), growth in government consumption and fixed capital formation. Moreover, the narrowing of the current account deficit in the balance of payments contributed also positively to the expansion of demand, mainly due to the expansion of the positive balance in the services account. In the labour market, the unemployment rate stood at 14.2%, almost unchanged from the end of 2016 and 2.4 percentage points lower than in the first quarter of the previous year. During the period, following subdued inflationary pressures, the monetary policy continued to be accommodative, underpinning the expansion of economic activity. The positive budget balance reflected the continuation of the fiscal consolidation process. But, the value of the budget surplus was lower than in the same period a year earlier, as a result of faster realisation of expenditures than the collection of revenues.

In the domestic financial market, during the period, the average yield on investments in government debt securities rose slightly. The short-term debt securities contributed most to this performance. For these securities, the level and the increase in issues were higher than for the long-term debt securities. The participation of investors in government debt securities auctions has been steady, and their preference is higher for longer-term maturities. In the interbank market, banks have traded overall low volumes at rates constantly below or close to the policy rate level, thus reflecting a stable liquidity situation. In the foreign exchange market, the Albanian lek appreciated against the euro and the US dollar. This performance reflected the more positive developments in the balance of payments with foreign countries. In the real estate market, data and surveys point to a fall in house prices, mainly following the increase in housing
capacities. In this market, the operators’ expectations for the performance of the real estate prices remain positive.

During the period, the creditor position\(^2\) of households and the debtor position of enterprises decreased. For households, the effect came from the increase in lek credit and decrease in deposits, mainly in foreign currency; for enterprises, the effect came from the faster decrease in foreign currency credit than the decrease in deposits. Credit to households grew 2.8% during the period. Growth owes almost entirely to the growth in lek credit for residents. Credit to enterprises contracted during the period by 2.3%; the main contribution came from resident entities, whereas credit to non-residents grew. The credit quality improved for both households and businesses. During the period, the values of outstanding credit and deposits of entities with the banking sector were significantly affected, on the downside, by the appreciation of the Albanian lek against the major currencies.

The share of the activity of the financial system in the Gross Domestic Product (GDP) is estimated to have decreased to 101.9% at the end of the period, but the main financial indicators were overall improved. The decrease in the share of the financial system was driven mainly by the decrease in the share of the banking activity, which fell to 91.9% of the GDP. The non-banking sector retained its share in the GDP, and non-bank financial institutions, private pension funds and investment funds made positive contribution to its activity. In the activity of the banking sector, which contracted by 1% over the period, on the assets side of the balance sheet, the largest change was noted in transactions with securities, mainly with non-residents (down), transactions with the treasury (down) and interbank transactions, mainly in the form of deposits with non-resident entities (up). On the liabilities side, the largest change was noted in client deposits (down) and capital (up). From a year earlier, the activity of the banking sector increased by 4.8%, with deposits growing by 3.5%, outstanding credit remained unchanged and net creditor position with non-residents increased by 11.7%. The outstanding credit reflects the write off of loss loans from the balance sheets of the banking sector, and a still sluggish credit demand, as reflected in the relevant surveys of the financial situation of households and enterprises. The direct exposure of the banking sector to the non-banking sector is estimated as low, whereas the banking sector stability remains a critical factor for the activity and stability of the non-banking sector.

**BANKING SECTOR’S EXPOSURE TO ACTIVITY RISKS**

The Bank of Albania assesses the activity risks that the banking sector is faced with, as follows:

a) Credit risk fell significantly during the period as well as against the

\(^2\) The spread between deposits and credit to households in the banking sector.
same period in the previous year. Non-performing loans fell by 15.2% during the period and by 22% from the previous year. As a result, the ratio of non-performing loans fell by 2.7 percentage points during the period, to 15.6%. Banks actions to collect, restructure, and write them off from the balance sheet contributed to the reduction of the non-performing loans. Non-performing loans were also reduced across all the constituting categories, with each recording a decrease in the value. Among the existing non-performing loans, the lowest quality is noted in the foreign currency credit, credit to enterprises and credit with longer-term maturity. The reduction of non-performing loans is accompanied by the improvement of their coverage with reserve funds (provisions) and capital, while the level of credit collateralisation improved slightly.

The reduction of non-performing loans during the period is a notably positive development, which will release resources of banks engaged in the management of non-performing loans, gradually improve the perception of the banking sector on the credit risk, and eventually give a stronger boost to credit growth in the period ahead. In the process of resolving the non-performing loans, banks appear more active with regard to early restructuring. As a result, this will better contribute not only to reducing the stock of non-performing loans, but also to keeping their new flows under control. Moreover, the process will be useful for identifying financially-valid projects faster, thus allowing banks to act quicker on collecting a loan from a poor-performing borrower. On the other hand, the process should be carried out in a prudent and professional manner, in order for the restructuring to be effective, the chances for improving the borrower’s repayment capacity to be real and incentives for a regular credit repayment to remain strong. Regardless of the significant improvement, the level of non-performing loans in the banking sector is estimated as still high. This situation requires the banks to be fully and constantly engaged in this process.

b) Liquidity risk in the banking activity is considered as low. The liquidity ratios, both in lek and foreign currency, stand significantly above the minimum regulatory requirements. Deposits are the main source of financing, covering almost double the volume of the sector’s credit. Reliance on foreign credit lines is very low.

Yet, the negative gap between assets and liabilities by segment of residual maturity, vis-à-vis the total assets in the short term, is considered as high and has increased against previous periods. The change in the structure of liabilities, in which the share of time deposits continues to lessen against other non-term alternatives, contributes to maintaining this gap. Such structure of liabilities imposes the need for the banking sector to maintain high level of liquid assets, and seek higher return through longer-term investments. This feature is related to the actual stage of the financial cycle and should gradually change at a time
when macroeconomic developments require an increase in interest rates, which leads to higher opportune cost of the public for maintaining their savings in more liquid forms.

c) The banking sector’s exposure to market risks remains important. The banking sector’s net open position in foreign exchange to regulatory capital ranged within long-term levels, pointing to a limited and downward exposure of the banking sector to the direct impact on the balance sheet, from the exchange rate volatility. During the period, the unhedged foreign currency credit remained stable in terms of both total credit and foreign currency credit. At the same time, its quality improved. Overall, these developments show that, during the period, the banking sector has controlled the direct and indirect exposure to exchange rate fluctuations; however, the exposure is assessed to be still high and actions need to be taken more actively for reducing it further. The Bank of Albania believes that the measures proposed in the framework of the strategy for reducing the usage level of foreign currencies in the Albanian financial system and economy, will contribute toward achieving this objective. These measures have been discussed with the banking industry and work has started for preparing the necessary regulatory acts.

About the impact of movements in the interest rate, the banking sector remains exposed to fluctuations in the interest rate, at a time when the gap between assets and liabilities, sensitive to interest rate according to re-pricing periods, is relatively high. The current environment with relatively low interest rates suggests the need for the banking sector and other non-bank financial institutions, such as life insurance companies, private supplementary pension funds and investments funds, to evaluate regularly direct and indirect implications, which could result on their activity from unfavourable movements in the interest rates.

d) Some of the European banking groups that operate in Albania are still undergoing a restructuring process for improving their financial situation. This process includes operations such as: restructuring the network, change of shareholders and merging with other institutions. Developments in the European legislation regarding the recovery and resolution of banks have rendered these processes more effective and unfelt for the banks’ clients. At the same time, such legal definitions and operational actions highlight the importance of coordination between relevant authorities in the countries where the banking group under restructuring operates. In this regard, the Bank of Albania remains committed to monitoring the developments and coordinate potentially necessary actions with the relevant domestic and foreign authorities, in order to achieve the ultimate objective of safeguarding the stability of the financial system.
RISKS TO FINANCIAL STABILITY

To assess systemic risks, the performance of indicators related to the materialization and accumulation of the systemic risk is analysed against the stress level in the financial system and the perception of the banking industry regarding its activities’ exposure to systemic risks. Also, the financial stability map provides a consolidated approach of risk assessment to financial stability.

Indices for the materialisation and accumulation of systemic risks show that risks to financial stability have fallen during the period. The improvement of economic growth, positive developments in the labour market, narrowing of the current account deficit in the balance of payments, continuation of the fiscal consolidation and decrease in the level of debt to enterprises, have contributed positively to the macroeconomic framework; the reduction in non-performing loans, improvement of the financial performance and good capitalisation and liquidity levels have contributed positively to the performance of the banking sector. Surveys show also that the perception of systemic risks by the banking sector is at lower levels, mainly due to the acceleration of economic growth and improvement of the credit quality. Nevertheless, the banks sensitivity about remaining uncertainties that surround the collateral execution process remains considerable.

BANKING SECTOR’S ABILITY TO WITHSTAND RISKS

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

At the end of the period, the banking sector’s capital adequacy ratio was 16.3%, around 0.3 percentage point higher than at the end of 2016, and notably higher than the 12% level of the minimum requirement. The financial result of the sector improved during the period. The profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.6% and 16.7%, standing 0.9 percentage point and 8.7 percentage points, respectively, higher than in the same period in the previous year. However, the positive contribution to the financial sector’s performance has come from the decline in credit risk provisions, reiterating the sensitivity of the banking sector to the continuation of this process. Meanwhile, the financial result from the core activity of financial intermediation, as reflected in net interest income continued to decrease. The net interest income decreased due to return on investments falling faster than the relevant expenditures, against the backdrop of operating in an environment of low interest rates for a relatively long period of time. On the other hand, the improvement in the capital adequacy ratio reflects the contraction in risk-weighted assets, as a result of the subdued credit activity and regulatory amendments regarding investments in non-resident financial
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Institutions. Under these conditions, the very good levels of the above-stated ratios may show a higher volatility in the future and their stability over time should be carefully assessed.

The adequacy of the above indicators was assessed during stress tests, with scenarios that assumed adverse changes in macroeconomic and financial indicators for the period 2017-2018. Similar to before, among extreme assumptions with a low probability of occurrence, the adverse scenario included the contraction of the economy, contraction of credit, rapid growth of interest rates and strong depreciation of the exchange rate. The results of the stress test show that in the baseline and the moderate scenarios, the banking sector remains capitalized, whilst in the adverse scenario it would need to raise the level of capital.

Based on this analysis, the Bank of Albania deems that capitalization and profitability of banks is actually adequate to withstand the activity risks. But their performance needs to be monitored continuously by the banks, and actions need to be taken to ensure the stability of the indicators at adequate levels for supporting their activity.

The next chapters will present in greater detail the report on financial stability for the first half of 2017.