1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

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

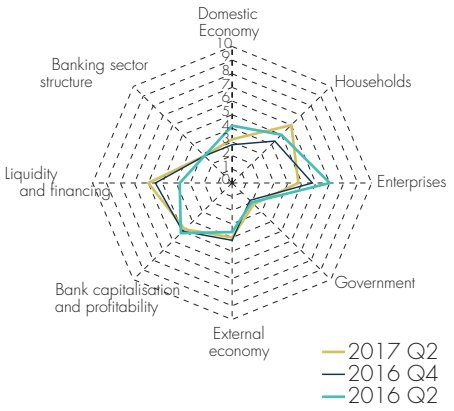
(1) As at end of 2017 H1 (hereinafter referred as "the period"), compared to the previous year, ***the financial stability map shows, overall, a decrease of risks in the external and internal environment, and identifies different developments in risks of the banking sector and of the real economy agents.*** The decrease of risks in the overall economic environment mainly reflects the higher economic growth rates and the overall macroeconomic stability. Their different exposure against risk in other factors reflects their peculiarities regarding the financial performance, the financing structure as well as the debt performance and level.

(2) In more concrete terms,

- In the overall economic environment:
  - Risk from "the domestic economy" is assessed as "low", following the improvement in the narrowing of the output gap; the fall in the size of the external debt; and the level of external financing requirement;
  - Risk from the "external economic environment" is assessed as "low" and downward over the period, mainly driven by the positive economic performance of our trading partners and an environment with low financing rates.

- Real economy agents:
  - Risk from "households", is assessed as "moderate" and upward attributable to developments in the housing market and lower households' expectations;
  - Risk from "enterprises", is assessed as "average" and downward, given the improved quality of the loan portfolio to this category, developments in the production volume index and the upward expectation of the private sector;
  - For the "government", risk continued to be assessed as "low" and unchanged during the period under review, based on the stability of sovereign risk premia, low level of debt cost and the better performance of tax revenues.

Chart 1.1 Financial stability map



*Risk is rated: 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 farther from the center, the higher the risk.

Source: Bank of Albania, Financial Stability Department.

o While in the banking sector activity:

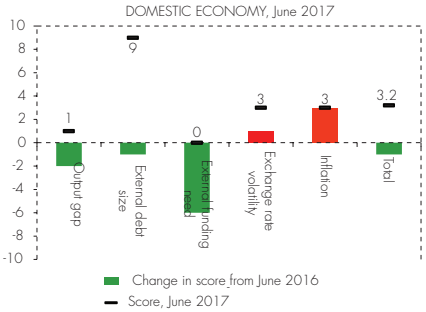
- Risk from "capitalisation and profitability", is assessed as "average" and unchanged during the period. Capitalisation level and loan quality improved, contributing to the decrease of risk from this category, while income from interests provided a downward contribution to the overall level of profitability;
- Risk form "liquidity and financing" is assessed as "moderate" and again upward, reflecting the deepening of the banks' assets and liabilities mismatch up to three months[3], and a lower growth of households' deposits. The continuation of the fall in the values of liquidity indicators, signals an improvement of intermediation by the banking sector and a higher commitment in orienting the financial sources toward lending to the economy. In the long run, the more effective allocation of banking sector's financial sources is expected to further support the economic activity at home, and to affect positively the capitalisation and the financial performance of the banking sector;
- Lastly, the risk related to "banking sector structure" continues to be assessed as "low", supported by a better diversification of financing funds and the improved allocation of credit in the banking sector, somewhat offsetting the risk from the still high credit concentration in the "enterprises" segment.

[3] *Within this category, which overall is assessed with low risk, this is a result of the change in the definition of the proper term, for purposes of more detailed analyses by the supervisory authority.*

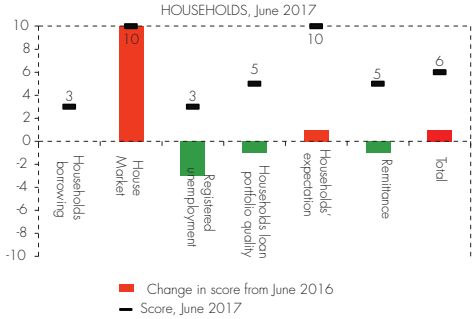
Box 1.1 shows the Financial Stability Map components over 2017 H1, the score for each risk level and comparison with the scores in the previous year.

BOX 1.1 FINANCIAL STABILITY MAP COMPONENTS

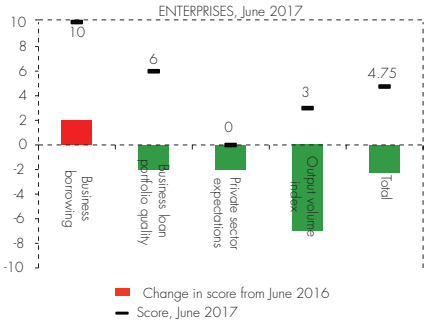
Risk from "domestic economy" is rated as "low" and downward, following the improvement of output gap, size of external debt and needs for external financing.



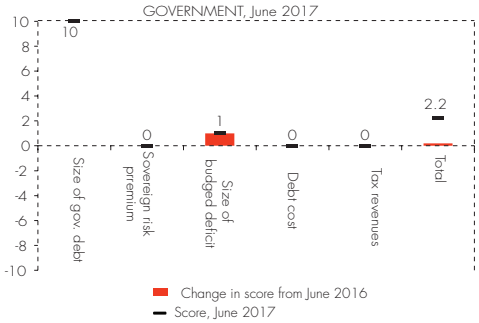
Risk to "households" is rated as "moderate" and upward, due to the fall of households' expectations and developments in the housing market.



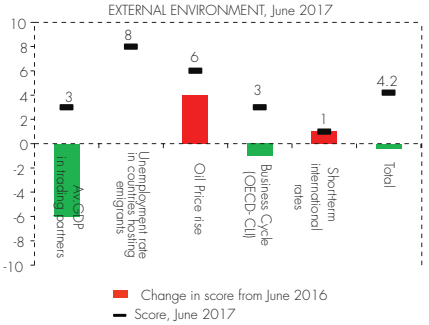
Risk to "enterprises" rated as "average" and downward, reflecting the improvement in the credit quality, enterprises' expectations and production volume index.



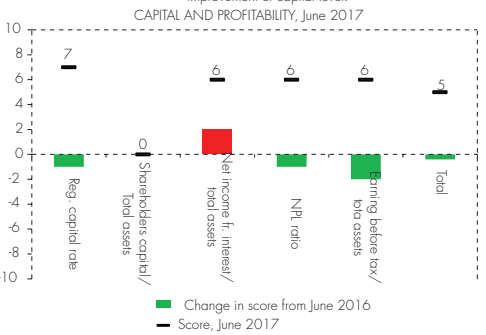
Risk from "Government" rated as "low" and unchanged, based on the sovereign risk premia, debt cost and the performance of tax revenues.



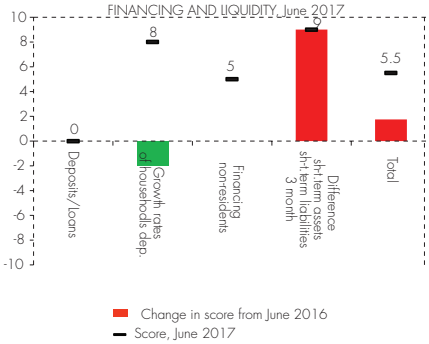
Risk from "external environment" rated as "low" and downward compared with June 2016, affected by the improved economic growth of trading partners and the performance of total CLI index. The increase in oil prices and the performance of international short-term rates contributed in the increase of this risk.



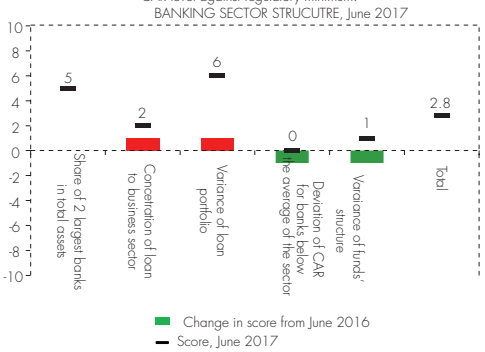
Risk from "capital and profitability" rated as "low" and unchanged, over the period. The increase of risk from the fall of interest income is offset from the improvement of other indicators, such as the fall of NPLs and the improvement of capital level.



Risk from "financing and liquidity" resulted again "moderate" and upward during the period, due to the deepening of the gap between short-term, up to three months, assets and liabilities.



Risk related to the "banking sector structure" continued to be low and unchanged, given the increase in the diversification of its financing funds and CAR level against regulatory minimum.



Source: Bank of Albania, Financial Stability Department.

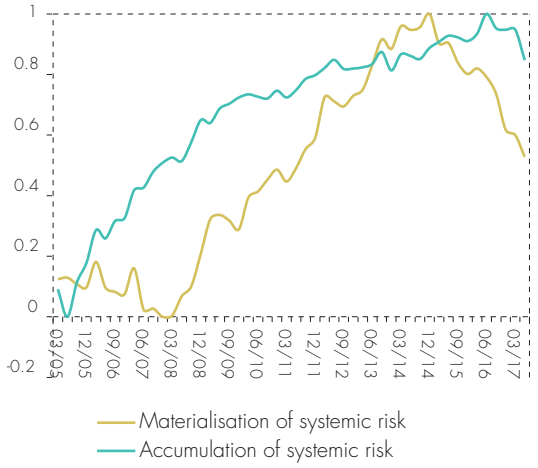
1.1 SYSTEMIC RISK[4]

To assess the banking sector's exposure to systemic risk, the performance of indicators related to: a) the materialization and accumulation of the systemic risk; b) the stress level in the financial system; c) the perception of the banking industry regarding the exposure to systemic risks, is analysed. The materialisation of the systemic risk assesses the actual level of the risk, whilst indices of the risk accumulation, financial stress, and the banking industry perception on it, focus mainly toward the future.

(3) Materialisation of systemic risk has been downward over the period and compared with the previous year. The improved credit quality to households and enterprises, the decline in the unemployment rate at home, and the diminishing exchange rate volatility have contributed to the performance of this index (see Chart 1.2.).

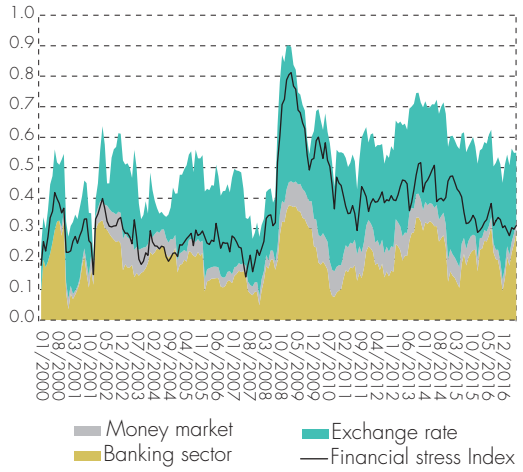
(4) Accumulation of systemic risk and financial stress index also were downward. The reduction of enterprises' debt, the decrease of public debt and the narrowing of the current account deficit provided the main contribution to the decrease of risk accumulation. Financial stress index was down. The further decrease of depreciating pressures of the domestic currency and the developments in interbank market also contributed to this fall (see Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk



Source: Bank of Albania, Financial Stability Department.

Chart 1.3. Financial Stress Index



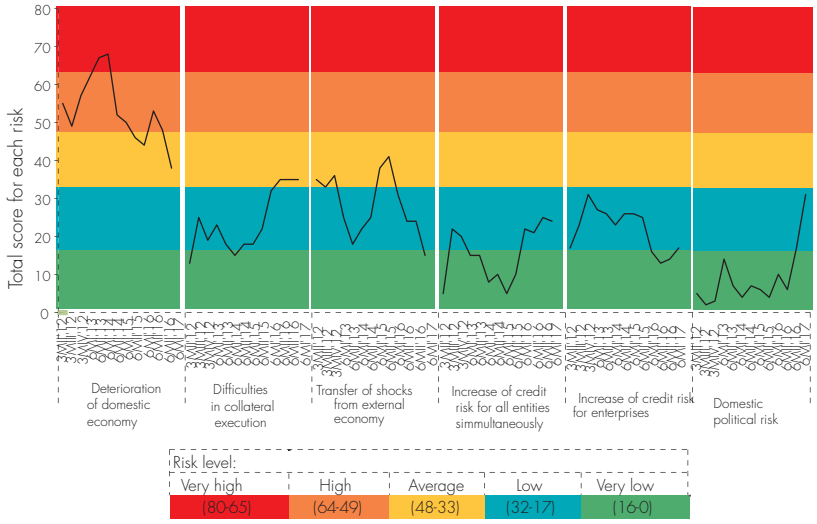
Source: Bank of Albania, Financial Stability Department.

(5) Banks' perception shows a more positive assessment of systemic risks performance over the period. Hence, the potential risk from "Deterioration of the domestic economy", albeit continuing to be considered as the main systemic risk at home, is perceived considerably lower due to higher economic

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

growth in Albania. Risk perception from the "difficulties in the execution of collaterals" remains relatively high and has been unchanged over the period. Unlike in the previous period, in 2017 H1, banking sector's sensitivity against "political risk at home" increased, mainly driven by the temporary uncertainty on the eve of June 2017 general elections. Risks related to the credit process continue to be classified as the most important systemic risks, given that the non-performing loans portfolio, though considerably improved, remains high. Finally, the banks' assessment regarding risk from "external shocks" has trended downward, since a year earlier (see Chart 1.4).

Chart 1.4 Banks' assessment of main systemic risks



Source: Bank of Albania, Financial Stability Department.