

FINANCIAL STABILITY STATEMENT FOR H2 2020

Pursuant to provisions under Article 69 of Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of 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 2020 H2 (hereinafter 'the period'), operations of the banking sector were stable. Financial intermediation proceeded with good pace, credit quality was maintained at acceptable levels, deposits grew considerably and other financial stability indicators remained at appropriate levels. The public measures undertaken in the fiscal, monetary and prudential areas helped the performance of lending, mitigated the pandemic shock and helped to control risks. Uncertainties continue to be considerable despite the expectations for a more stable performance while approaching the exit from the pandemic. Banks should remain vigilant particularly in relation to monitoring closely the solvency of their borrowers. As it has previously, the Bank of Albania stands ready to undertake all necessary actions according to the law, in order to support banking activity and contribute to the stability of the financial system.

Developments in this period revealed the following:

The evolution of the pandemic dictated economic developments around the world. Economic activity, both globally and in the Euro area, recovered during the third quarter of the year, but remained weak towards its end due to the return of restrictions related to the Covid-19 pandemic. Financing conditions remained favourable and many countries continued to support their economies with special fiscal packages. Inflationary pressures remained subdued given the deceleration of consumption and investments in the private sector. Similar developments were observed in the Euro area and the Western Balkans.



Assuming that acceleration of vaccination will bring the pandemic situation under control, the global economy is expected to take the road of a more sustainable recovery in H2 2021.

The economy of Albania contracted during 2020, but performance in the period was better, attributable to an increase in private consumption and investments. The contribution of the external sector of the economy was negative due to the expansion of current account deficit on the balance sheet, by around 2% in annual terms. Inflationary pressures were low and the accommodative monetary policy supported liquidity in the market. Fiscal policy played an active role in withstanding the shocks to the economy in the previous year, at first due to the consequences of the November 2019 earthquake, and then the pandemic. The measures undertaken included an extension to tax obligations; issuance of sovereign guarantees to protect employees' income and mitigate credit risk to borrowers; an increase in public spending focused on reconstructing buildings damaged by the earthquake and on meeting public health needs. As a result, similar to the experience of other countries, fiscal deficit and public debt recorded a rapid increase throughout 2020. In spite of expectations for a fast vaccination process and a gradual recovery of economic activity, the pandemic and its lingering effects of uncertainty are still evident in the economic environment. In these conditions, stimulating public economic policies are necessary, adapting to expectations for economic growth. In relation to fiscal policy, in the short run, it is efficiency and the financing method of fiscal stimulus that takes precedence, while in the long run, it will be necessary to preserve engagement and undertake measures for fiscal consolidation. The latter is necessary to mitigate risks related to high levels of debt and all which that entails.

Markets carried on their activity as normal, but with lower trade volumes.

The level of government debt securities issued in lek was lower than in the first half of the year, while the average interest rate remained unchanged. The yield curve of the market had a normal slope. Activity in the secondary market of government debt securities was down in value and in volume of transactions. Investors started to show a preference for holding securities to maturity. The volume of transactions decreased in the interbank market. Interest rates fluctuated close to policy rate, reflecting the unlimited liquidity injection by the Bank of Albania. In the foreign exchange market, the lek exchange rate was stable, having a positive impact on reduction of financial stress in the market. The performance indicators of the real estate market have given mixed signals in relation to supply and demand performance in H2 2020. The real estate market had fewer transactions and a pessimistic outlook, given the impact of uncertainty caused by the pandemic. However, the periodic survey on real estate market shows that real estate agents reported higher sale prices compared with 2020 H1 and from the previous year.

The basic infrastructure for the clearing and settlement of payments in lek continued to function in a safe and efficient manner. During the period, it



was noted that there was an increase in the number and volume of small- and large-value transactions and the use of payment instruments.

Households and enterprises expanded their savings. Households recorded a further expansion of their financial position as net creditors and simultaneously, enterprises tightened their debtor position. The significant increase of bank deposits in lek and foreign currency was the main contributor for both groups. Survey data suggest that households' solvency slightly improved compared with 2020 H1, but it is weaker than last year. Households' loan demand may be higher in the first part of 2021. The survey data on enterprises show that the pandemic considerably affected their activity, by triggering more difficulties to market preservation and competition. Half of the enterprises declare that they financed their activity during this period through sales. The propensity to combine several sources of funding continues to have represented a considerable share during the period, but it decreased for all types of enterprises. Around 40% of total responding enterprises declare that they currently have loans to settle and this indicator increased during the last year. The total loan value is close to half of the capital value of enterprises for around 80% of the total borrowing enterprises and almost equal to the capital value for 9% of them. The majority of borrowing enterprises declare that loan payment reaches up to 20% of their income. In relation to borrowing plans in the upcoming six months and based on the responses of enterprises, it looks like credit demand is showing slight signs of recovery, even though decision-making regarding this objective is less certain.

A slight increase in the share of financial system assets³ to Gross Domestic Product (GDP) was observed during the period. At the end of September, this share reached 119.4%. This performance was affected by the contraction of GDP, but also by the expansion of financial system activity, where the banking sector provided the main contribution.

The non-banking segment of the financial system had an overall good performance. Non-banking financial institutions and investments funds had the highest growth. Trade, services and agriculture sectors continue to represent the main economic activities that attract credit by non-bank and savings and loan associations. Loan quality granted by these entities until the end of the third quarter was relatively good, despite declining somewhat compared with last year. The exposure of the banking sector to the non-banking sector remains limited and unchanged during this period. The exposure of the non-banking sector to the banking sector remains high, as placements of non-banks in the banking sector in forms of deposits and capital instruments account for around 19% of non-banks' balance sheets.

³ The financial system consists of the banking sector and non-banking sector (non-bank financial institutions, credit savings associations, pension funds and investments funds). The database for the non-banking sector and GDP data are from 2020 Q3.



The banking sector continued to support the economy with financing and other services despite the difficult situation created by the pandemic. Asset growth was underpinned by interbank investments and lending to the economy. The share of foreign currency activity decreased, but remained balanced on both sides of the banking sector's balance sheet. This fall reflected a faster growth of credit and deposits in Albanian lek. The statistical effect of the exchange rate on the equivalent value of the foreign currency balance had a non-significant impact. Deposits and own funds continued to be the main funding source of the banking sector's activity. Reliance on external funding sources remains at low levels. Assets placed with non-resident entities decreased during the period, due to the contraction of placements in the form of loans and current accounts with banks, financial and credit institutions. This has driven to the contraction of the net creditor position of the banking sector, by around 2 percentage points (pp) during the period.

The banking sector closed the year with a good level of capitalisation. The Capital Adequacy Ratio for the entire sector rose to 18.3% from 18.1% in the previous six months. The indicator was higher during the period due an increase of regulatory capital and a decrease of risk-weighted assets. In comparison with the previous year, this ratio was 0.4 p.p. lower and the decrease reflected a higher level of risk-weighted assets. Banks with European capital and systemically important banks show the highest level of Capital Adequacy Ratio. Banks with Albanian capital have the lowest level of Capital Adequacy Ratio; this ratio decreased slightly in 2020. The banking sector closed 2020 with a positive financial result of around ALL 17 billion. This result was 15% lower compared with the previous year. The increase in expenditure for loans provision provided the main contribution to the fall of the banking sector's profit. Meanwhile net interest income and other activities income were somewhat higher. The decrease in the profit of the sector is also reflected in the fall of the profitability indicators of the banking sector: RoA and RoE declined to 1.1% and 10.7%, respectively.

At the end of 2020, outstanding loans totalled approximately ALL 610 billion, higher by 3% over the period, and 6% from the previous year. The expansion of loan stock was mainly affected by an increase of new loans flow, used mostly by enterprises for short-term purposes. The higher level of credit stock was affected by the accumulation of unsettled liabilities, due to actions of banks for credit restructuring, in response to the accommodative measures of the Bank of Albania. A particularly good performance in the credit stock, over the period, was registered for credit portfolio of long-term maturity; loans in domestic currency and loans to enterprises. At the end of 2020, loans in foreign currency were 4% higher than the previous year, but maintained almost the same unchanged level over 2020 H2. By residence, credit growth over the period was affected almost entirely by an increase of loans to resident entities, which account for almost 96% of outstanding loans.



In 2020, the volume of written off loans from the banking sector's balance sheet was relatively low. A total of ALL 3 billion worth of loans was written off from the balance sheet, but more than half of them were realised in December 2020. The value of restructured loans, during 2020, was around ALL 23 billion, 90% of which was realised in the second half of the year. In most cases restructuring was realised upon client's request. The restructured credit, during the period, accounted for approximately 3% of total outstanding loans and around half of the non-performing loans stock.

Deposits held in the banking sector recorded high rates of growth over the period. The growth is distributed almost equally between households and enterprises and between lek and foreign currency deposits. Time deposits continued to contract, while the largest growth over the period in deposits by maturity was registered in current accounts followed by demand deposits. At the end of December, deposits registered around ALL 1,286 billion, up by ALL 56 billion during the period, and ALL 93 billion compared with the previous year. Around half of the overall stock of deposits is composed of time deposits, which decreased by around ALL 14 billion during the period. The share of time deposits to overall deposits stock continued to fall, favouring demand savings instruments. The average interest rates for time deposits both in lek and in foreign currency remain at low levels and their average ratio did not record significant changes during the period.

Overall, the risks to the Albanian economy increased in the period due to the impact of the pandemic.

According to the financial stability map, the main contributors to this performance were contraction of the domestic economy; weak progress of the international economy; and deterioration of the fiscal indicators related to public debt and budget deficit. Although the contribution of the fiscal policy in countering the effects of the pandemic mitigated its first impact on the financial situation of households and enterprises, the latter's' risk perception appears to be rising. The indicators of the financial system and the banking sector stand at good levels, showing an almost unchanged perception of risk. Over the period, entities were supported by the fiscal and monetary measures to counter the economic downfall, thus affecting a decrease in the indicators related to the materialisation of systemic risk and of financial stress. But the expectation of the longer-term impact of the pandemic on the economic, fiscal and financial indicators has led to a rise on the risk accumulation index. Banks share similar assessments related to risks driven by economic developments, probability of loan quality deterioration and the political climate related to the parliamentary elections.

In terms of more specific activity risks to the banking sector, the following is observed:



Credit risk was contained over the period under the impact of accommodative regulatory measures. The non-performing loans ratio showed low fluctuations and stood at 8.1% at the end of the year, around 0.3 percentage points lower than in the previous year. However, the improvement is driven by the faster increase of outstanding credit compared with the increase of non-performing loans stock. In fact, the absolute value of non-performing loans increased by almost ALL 1.6 billion during the period, climbing to ALL 50 billion. Within non-performing loans, the share of lost loans increased. Some complementary indicators that assess the performance of non-performing loans confirmed their increase. As a result, given the faster increase of provisioning reserves compared with the stock of non-performing loans, the provisioning coverage ratio increased to 65% from 59% in the previous year. The change in this indicator was concentrated in the first half of 2020. The collateralisation of the loan value was up to 80% and almost 2/3 of credit is collateralized by real estate.

The liquidity position of the banking sector is assessed as satisfactory. The liquidity indicators, both in lek and in foreign currency, remained significantly above the minimum regulatory ratios. The ratio of liquid assets to total assets of the banks' balance sheet remains high. Liquid assets of the banking system grew by ALL 40 billion, standing at ALL 550 billion. At the end of 2020, its value was 34.9%, and it increased by 1.6 p.p. during the period. The ratio of liquid assets to short-term liabilities increased by 1.4 p.p., standing at 47.5%. Deposits, as the main source of funding bank activity, cover twice the volume of loans of this sector. At the end of 2020, the "loans/deposits" ratio stood at 47.3%, slightly downwards during the period. At year-end, the values of this ratio were 47.6% for Albanian lek and 47.1% for foreign currency. Despite some small changes over the period, these ratios decreased significantly compared with one year before, due to a sharp growth of deposits in 2020.

Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities by residual contractual maturity segment, as a ratio to total short-term assets, remains at high levels. The negative gap between short-term assets and liabilities by residual contractual maturity segments for the period up to 3 months narrowed from 24% to 22% of assets.

During the period, an increase was observed in the average maturity mismatch between assets and liabilities, due to an increase of the average maturity of assets. At the end of the year, this mismatch was around 24 months, from 23.1 months in the previous six months. Deposits' residual maturity, which represents the most significant category of liabilities, remained almost unchanged at 7.7 months. The residual credit maturity increased significantly, from 45.7 months to 50.1 months, reflecting the banks' propensity to grant credit for longer-term periods. Similar to the previous six months, the banking sector did not report the use of funding lines by parent groups.

Market risks did not show significant changes during the period. At the end of 2020, the ratio of open foreign currency position to the regulatory capital of



the banking sector was 8.4%, from 5.3% at the end of the first half of the year. The performance has been dictated by the group of systemic banks, which have maintained a long open position. The exposure of the banking sector to the indirect exchange rate risk slightly decreased compared to the previous six months and to the previous year. The foreign currency mismatch index for all currencies declined. The exposure of the banking sector to interest rate risk has decreased. The weighed total net position in the banks' balance sheet against regulatory capital of the banking sector stood at 4.4% at the end of the year, down by 1.6 p.p. from the previous year. The weighted spread of assets with fixed interest rate liabilities (FIR) provided the main contribution to the decrease of this indicator, while the net position on variable interest rate (VIR) assets and liabilities slightly decreased. Given that the total net position is positive, the sector has relative exposure to a further decrease in interest rates. Currently, the room available for further decrease is limited and its effect on the financial result of the banking sector is assessed as insignificant. Regulatory capital coverage of the total net position of the banking sector is 25 times, whereas 5 times is the coverage provided for in the regulatory framework.

To assess the banking sector's resilience against the real economy or financial markets shocks in the medium-term horizon, the Bank of Albania carries out regular stress testing exercises.

Stress tests on capital adequacy show individual banks' degree of resilience in terms of capital and aims to identify its adequacy to withstand assumed shocks on economic growth, credit, exchange rate levels and interest rates. Stress tests on liquidity show the ability of banks to withstand a shortfall in liquidity capacity by selling liquid assets in a stressed market.

Overall, the stress-testing exercises carried out at the end of 2020 and spanning over 2021-2022 period, show that the banking sector appears resilient to the possible macroeconomic and liquidity shocks.

In conclusion, the Bank of Albania assesses that the financial system and the banking sector were able to withstand the economic shocks caused by the Covid-19 pandemic. The good financial conditions prior to the pandemic and the measures undertaken by public authorities helped to mitigate the shock and control the risks. Nevertheless, the uncertainties related to the pandemic remain present as the effect of supportive measures will eventually end. As a result, banks may face increased pressures in relation to the quality of credit portfolio. Based on these explanations, it is indispensable to actively monitor the solvency of borrowing clients and create the relevant funds in a timely manner. In parallel, it is necessary to assess the capital positions with a view to preserving adequate levels, in compliance with the assessed risks and the regulatory framework.

