

## FINANCIAL STABILITY STATEMENT FOR 2023 H1

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 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 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 (BoA) 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 by means of the stress testing exercise and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

*The Bank of Albania deems that in 2023 H1 (hereinafter 'the period'), operations of the banking sector were stable. Overall, deposits and loans grew, but at a quite slower pace than in the previous periods, reflecting the impact of the significant appreciation of lek exchange rate. Amid higher interest rates, credit quality declined slightly. Overall, the exposure of the banking sector to risks appeared contained, but both market and credit risks needs to be on a continuous monitoring*

*Banking sector's resilience to withstand risks is assessed as robust, as capitalisation indicators remain at adequate levels, while financial performance improved considerably. Economic developments during the period were positive, affected by the good performance of consumption and investments, and particularly by the improvements in the current accounts of the balance of payments. Economic growth was accompanied by a fall in unemployment and an increase in both employment and wages.*

*Fiscal policy maintained a consolidating trend under the significant growth in fiscal revenues. Inflationary pressures have been declining, though inflation rate remained above the Bank of Albania's target, increasingly reflecting the contribution of domestic economic factors. The Bank of Albania continued the normalisation of monetary policy, by highlighting that its further reaction will reflect the development in the determinant factors of inflation. Risks to the economic and financial developments in Albania remain present. These risks relate to the uncertainty stemming from the geopolitical developments and international markets, the performance of inflation, and the impact of market risks. Against this backdrop, it remains important that economic policies aim*



*at safeguarding the macroeconomic stability, while financial institutions and supervisory authorities undertake the necessary actions to enhance the resilience of the financial system.*

In more concrete terms, the developments over the period showed that:

**Global economic activity expanded over the period, with the main contribution from services and consumption, as production and supply chains recovered, despite the continued tightening of financing conditions in most countries.** Inflationary pressures have been declining driven by the fall in commodity, energy and food prices. However, they have remained above the target levels of central banks, which continued the normalisation of monetary policy, by maintaining tighter financing conditions. Volatility in the financial and securities markets was high, thus arising a resilience-related concern for the economic agents and financial institutions.

The economic performance in the euro area has been similar to that of the global economy. Economic expansion was slow and has been supported by the good performance in the services and transport sectors. Labour market has been relatively tight and the growth in income, though somewhat mitigating the dampening effect of inflation, has mostly spotlighted the contribution of domestic factors on price hike. As a result, inflation rate remained above the European Central Bank's target, which has continued with the normalisation of monetary policy. This rate was followed by the overall increase in interest rates in the market and financial products.

The Western Balkans economies expanded, but at a relatively low average rate, up to the first quarter of the year. The good performance in net exports (supported by tourism services) and investments have impacted this trend. Fiscal indicators improved significantly. Despite the decline in inflationary pressures, inflation rates remain above the targets of central banks. Under the normalisation of monetary policy, interest rates have been increasing, whereas credit growth has slowed down. Credit quality remained stable across the region, and non-performing loans stand at relatively low levels. However, the surge in interest rates may drive credit quality to moderately decrease. Overall, regarding future developments of the global economy, uncertainty remains high. This is dictated by the persistence of inflationary pressures, the tightening of financial conditions and the escalation of the war in Ukraine. These factors will continue to weigh on consumption and investment, driving the global economy to expand at a slower pace. In parallel, forecasts are becoming more and more difficult due to the appearance of numerous structural impacts resulting from the climate change and the technological developments.

***The Albanian economy continued to expand during the period.*** The annual growth rate of Gross Domestic Product (GDP) was 3.2% as at end of 2023 Q2. From the sectoral perspective, economy showed a broad-based growth. The sectors of production and services contributed by 1.9 and 1.1



percentage points, respectively, in the annual growth rate. On the demand side, the final consumption of the population, investments of private sector and the narrowed current account deficit supported the economic activity. Positive developments, as the rise in employment, the fall of unemployment rate and the increase in wages characterised the labour market. Fiscal policy remained on the consolidating side throughout the period, as fiscal revenues grew at a higher pace than expenditures. Inflationary pressures have been declining, but inflation rate persisted above the Bank of Albania's target. Accordingly, the Bank of Albania continued the normalisation of monetary policy, by increasing the policy rate to 3%, in March 2023.

*In financial markets, the interest rates, overall, have decelerated considerably the increasing speed, while recoding a fall across certain segments compared to the previous six-month period.* Despite the increased volume of issuance during the period, the average yield on government debt securities declined. In 2023 H1, the issuance of the domestic debt securities of Government amounted to around ALL 230 billion. The whole issuance was dominated in the domestic currency. This volume was higher compared to the previous six-month periods, mainly due to the increase in the issuance of long-term securities.

During the period, the weighted average yield on all maturities of securities issued in lek reduced by 0.3 percentage point, reaching at 4.4%. By maturity term, the average yield on short-term securities reduced by 0.3 percentage point to 4.1%; while the average yield on long-term securities reduced by 0.7 percentage point to 5.1%. The bidders' offer was high and in most cases it has met the government's borrowing needs. The fall in yields in most securities has led to a reduction in the Government debt and has reflected the investors' expectations for a gradual decline in inflation rate. The volume of transactions carried out in the secondary markets of securities remain low. During the period, the volume of financing transactions in the interbank market grew considerably. The increase of the volume of one-week transactions provided the main contribution in this regard. The interest rates on interbank transactions increased slightly, by closely following the performance of the policy rate and reflecting the monetary policy decisions of the Bank of Albania. In line with the performance of foreign currency flows in the balance of payments, with a pronounced contribution of inflows from tourism services, the lek exchange rate appreciated considerably and in a fast manner during the period. The Bank of Albania has continued to hold auctions for euro purchasing, pursuant to the scheduled published priority, to increase the foreign reserves.

**In the residential real estate market, prices increased as the demand remained stable.** According to the tailored-made survey of the Bank of Albania with the agencies of real estate and construction companies, it results that sales have been high compared to the two previous six-month periods, while the number of properties sold has declined. The continued increasing bank credit - though at a slower pace from the previous six months - supported the demand.



During the period, banks eased the overall conditions on this credit. Demand from non-residents was present, remaining relatively stable in the last two years.

Overall, assessments show the supply has fluctuated during the period, though in short terms it has remained stable. Outstanding credit for construction has not shown significant changes during the period. Construction costs as expenses for energy, construction materials and wages picked up. The Survey shows that the Fischer House Price Index at country level rose by 11.6% in semi-annual terms, returning to the average level of the previous year. Prices of houses in Tirana have shown the same performance. Reports of agents on the conducted transactions show that the share of transactions for which the selling price is equal to the asked price has trended upward. Also, rent prices increased. Agents maintain a positive attitude regarding the performance of the housing market in the short term, and remain optimistic about its performance in the longer-term horizon.

***The core infrastructure for the clearing and settlement of payments continued to operate effectively and securely.*** AIPS and AECH recorded a considerable growth in both the number and value of transactions in lek processed through them. The number and value of banks customers' payments increased compared to the same period of the previous year. Meanwhile, payments by cards have become the main instrument in payments and have increased considerably in terms of both number and value. In the first half of 2023, the values of payments processed in the new AIPS-EURO have known a significant increase. This system processes payments denominated in the euro only for clients within Albania. In turn, benefits in the form of reduced costs of these payments for the users of the system, have been augmented.

***Indicators on the financial situation and debt burden of enterprises and households have displayed no significant changes.*** During the period, interest rates on loans to enterprises increased, while the lek exchange rate appreciation has contained the increasing rate of this loan and has somewhat changed its composition by sector. Loan demand from enterprises appeared somewhat subdued while the needs for liquidity and to refinance debt, as interest rates went up, bolstered this demand.

In the second quarter, banks tightened the overall terms and conditions on new loans to enterprises, particularly on risky loans. Nevertheless, banks reported optimistic expectations about the overall demand for loans from enterprises for the rest of year. According the Bank of Albania's survey, most enterprises reported financial profits during the period, but the performance of sales and financial result is assessed somewhat weaker than in the previous six months. Expectations of enterprises regarding the performance of investments and the activity continue to remain optimistic, despite the problems related to finding the market, the increase in production and labour costs, as well as finding of qualified staff. The share of borrowing enterprise declined slightly during the period. The debt burden, in the form of debt/equity ratio and in the form of



its servicing to the income of the enterprise, is estimated at affordable levels for most of enterprises, and with no significant changes from the previous six months. Nevertheless, enterprises expect a deceleration of loan demand in the second half of 2023. In a longer-term view, statistics of financial accounts up to 2021, show that enterprises in years have narrowed the debtor position to the banking sector. Enterprises, to finance the activity, preferred other sources, amid which the increase of liabilities (in the form of foreign direct investments) to non-resident sector is more pronounced. Households maintain a pronounced positive balance between their financial assets and liabilities.

Credits from domestic financial corporates account for most of households' liabilities, but their value is many times lower than the value of deposits with banking sector. Loans to households expanded during the period despite the continued increase in the average interest rate. The need for consumption and real estate purchase supported the loan demand. Banks expect this demand to remain stable in the next period.

In the second quarter of 2023, banks maintained the credit terms and conditions unchanged, though they increased the loan rejection rate mainly due to the factors related to the history from the credit registry and the level of disposable income. Results from the Bank of Albania's survey show that, despite the fluctuations, the share of borrowing households and their creditworthiness do not show considerable changes from the previous period. Households assess that their creditworthiness has been reduced due to the surge in prices, but less than in the previous six months. Despite the more optimistic expectations on their creditworthiness in the next six months, households expect their demand for loans to decline in the second part of year due to the increase in interest rates.

**During the first half of 2023, the share of financial system assets to Gross Domestic Product (GDP) fell by around 4 percentage points, to 92.1%.** This performance reflects the fact that the annual GDP growth rate was higher compared to the performance of the balance sheet of the financial system, when the effect of the exchange rate appreciation is also factored in. Banking sector was the main contributor to this decline by almost 4.3 percentage points. Within the financial system, the banking sector continues to dominate accounting for almost 91% of total assets. The exposure of the banking sector to the non-banking sector remains low and stable, while the sensitivity of the non-banking sector to the activity of the banking sector remains high, but has declined slightly during the period. The Bank of Albania regularly monitors correlation indicators within the periodic assessment of systemic risks.

**The balance sheet of banking sector contracted slightly during the period, under the reducing statistical effect of the lek exchange rate appreciation.** Total assets declined by around ALL 14 billion or by 0.7%. By asset items, the fall in the reported value of treasury and interbank operations mainly contributed in this performance, coupled with the contraction of credit, where the use of



foreign currency is relatively higher. On the other hand, the banking sector increased investments in securities and reduced provisions for assets. On the liability side, the main reducing impact of the lek exchange rate appreciation was felt in the reported value of deposits and capital. In annual terms, the total balance appears expanded, by around 3.2%. Despite the impact of the exchange rate effect, the share of assets and liabilities in foreign currency to the total balance has remained stable, at 50-52%. The net creditor position of the banking sector to non-residents remained close to 20%. The banking soundness index indicates a slight improvement in the position of the sector during the period, mainly on the back of the good performance of the financial result. In a longer term, the performance of this index reflects the improvement of the activity of the banking sector in terms of asset quality, capitalization and liquidity.

During the period, outstanding credit declined slightly, while it increased somewhat in annual terms by 2%. The annual growth rate of credit, adjusted for the reducing effect of the lek exchange rate, would have been around 7%. Loans to households and loans in lek, showed a good performance. Loans to residents also were up, though accounting for a low share in the total outstanding credit. Outstanding stock of unhedged foreign currency loans decreased during the period in annual terms. This fall is noted in both absolute and relative values, even more when this portfolio is stated in the original value (foreign currency).

The fall in the unhedged foreign currency loans to enterprises granted mainly for business development and trade provided the main contribution in this performance. Unhedged foreign currency loans to households, mainly oriented towards real estate purchase, increased slightly. The new loans granted during the period were close to the average level of the last year. They reflected a better performance of the loan flow in foreign currency, while the loan flow in the lek did not change. Overall, during the period, banks have been more cautious in granting new loans, as their rejection rates for applicants, both enterprises and households, have increased. Over the last few years, the ratio amid sectors in the flow of new loans has continued to increase in favour of that for households. This loan was used mainly for the purchase of real estates.

In terms of deposits, those denominated in lek grew by around 0.6%, while those in foreign currency contracted by around 2%. Compared to the previous year, deposits by lek and foreign currency grew by around 3%, respectively. The deposits growth rate, corrected for the reducing effect of the lek exchange rate appreciation, would be 5% during the period, and 15% from the previous year. The slower growth of deposits in lek reflected the expansion in the current accounts of enterprises and households. Meanwhile, the performances of demand and time deposits have compensated each-other. The growth in foreign currency deposits, dominated by deposits in the euro, reflects the growth in time deposits of households and current accounts in both sectors. Interest rates on new deposits have continued to increase, though remaining lower than the average interest



rate on the overall stock in lek and foreign currency. Flows of new deposits denominated in foreign currency grew considerably during the period.

Indicators on the capitalisation of the activity appear on adequate levels, while financial results improved considerably. During the period, capital adequacy ratio rose by 0.2 percentage point, to 19%. The fall of risk-weighted assets provided the main contribution in this regard, while regulatory capital contracted. These changes reflect to a considerable extent the diminishing effect of the lek exchange rate appreciation. The financial leverage ratio increased slightly during the period, remaining above the minimum requirement of the regulatory framework.

In order to meet the best standards in the field and strengthen the sustainability of banking activity, the Albanian legislation lays down certain requirements for improving the capital structure of banks. These requirements mainly refer to macroprudential capital buffers for regulatory capital instruments and eligible liabilities. In certain cases, they are translated into higher requirements on capital values against the current values, which should be met in a period of some years. At the end of the period, data show that the banking system, overall, records a sufficient capital surplus to meet the current demands. Nevertheless, the fall in the regulatory capital and the increase in capital requirements to banks drove to the reduction of this surplus in the last 12 months. Bank, to strengthen capital positions during the period, increased reserves from retain earnings, while augmenting the use of subordinated debt. Thus, maintaining sufficient net capital surpluses available to meet the expected levels of the above capital requirements, at the bank level, is important to ensure their implementation as defined in the regulatory framework.

The net result and profitability indicators of the banking sector have recorded a robust increase compared to a year ago, mainly as a result of the significant growth in net interest income, and concentrated in foreign currency business. As at end of 2023 H1, the accumulated net profit of the banking sector amounted around ALL 15 billion, almost twice as high as the profit realized in the previous year. The increase in profit is reflected in higher average profitability indicators of the banking sector, where the return on assets (RoA) was 1.6% and the return on equity (RoE) 16%, against 0.7% and 7.2%, respectively, in the previous year. The increase in net interest income reflected the increase in interest income (from loans, investments in securities) at a more rapid pace than that of expenses for interests (deposits, loans received).

Non-interest income were also upward, reflecting a better performance of investments in financial instruments. The considerable reduction of losses from investments in financial instruments impacted positively the net result of banks. Meanwhile, the growth in total provisions, mainly due to the increase in provisions for credit risk, had a negative impact on the financial result of the banking sector. The much better performance of income compared to the increase in operating expenses improved the coverage level of the latter.



During the period, the operating expenses to income ratio fell sharply, to 53%.

**Overall, the Albanian economy and the domestic financial system displayed a good resilience against the risks of the period, but challenges remain present.** Inflationary pressures - on the back of coordinated economic and monetary policies and a more adequately balanced prices in international markets - have been declining, but the inflation rate persists above the Bank of Albania's target.

The lek exchange rate appreciation reflected the extraordinary performance of tourism, though it generated fluctuations in some financial indicators. Nevertheless, the Albanian economy and financial system performed in a stable manner, even in the context of high interest rates. In national level, the geopolitical developments still maintain a high uncertainty level.

Asked for the assessments on the risks to their activity, banks evidence - alongside to those related to inflation and international developments - also other risks related to the speed of exchange rate fluctuations or cyber protection. Meanwhile, banking sector should maintain a prudential monitoring on its exposure to real estate market and maturity gaps between assets and liabilities, as well as to the impacts from movements in interest rate. Pursuant to the macro-prudential policy, the Bank of Albania is working on strengthening the regulatory framework with a view to the interaction of bank activity with the real estate market. To this end, it is important that economic policies aim at safeguarding the macroeconomic stability, while financial institutions and supervisory authorities maintain a prudential monitoring of developments in the financial activity and undertake the necessary actions for enhancing the resilience of financial system and avoiding risks to financial stability.

In terms of specific risks to banking sector activity, it is estimated that:

***During the period, credit quality declined slightly.*** The stock of outstanding non-performing loans increased slightly, reaching at the level of the previous year, around ALL 37 billion, while the non-performing loans ratio was up to 5.2%. The fall in quality is noted in the category of short-term loans, in business sector, in the credit portfolio denominated in the domestic currency and in foreign currency loans unhedged against the exchange rate. The expansion of the stock of non-performing loans is related to the reclassification of performing loans towards the less performing classes and to a lower volume of write-offs and repayments of non-performing loans. Nevertheless, the new flows of non-performing loans reduced compared to the previous year, due to the increase in their level of repayments. The provisioning coverage ratio for non-performing loans increased slightly during the period, to 65%, as a result of the greater growth in the stock of provisions as a ratio to the expansion of outstanding non-performing loans. Collateralisation of loans appears at good levels and slightly up during the period. By type of collateral, only the loans collateralised in the form of real estate recorded an improvement of credit quality.





The liquidity position of the banking sector remains at good levels and the liquidity indicators continue to remain notably above the regulatory thresholds. Compared to the previous six months and previous year, banks own a somewhat higher volume of liquid assets as a ratio to both total assets and short-term liabilities. During the period, the negative gap between short-term assets and liabilities increased. Meanwhile, the difference between the average maturity of assets and liabilities, decreased, mainly affected by the reduction in the average maturity of assets.

Overall, the exposure of the banking sector to market risks remains contained, but prudential monitoring of these risks is needed. During the period, the exposure of the banking system to direct and indirect risk from the exchange rate has been declining. The foreign currency position has been reduced in terms of regulatory capital and is determined by the narrowing of the open position at systemic banks. Even the indicator that reflects the indirect exposure to exchange rate risk for this group of banks stands below the average value of the banking sector. The exposure of the banking sector to direct interest rate risk has decreased during the period, remaining significantly below the upper regulatory limit. The banking sector is more exposed to interest rate risk for positions in lek, those with variable interest rates and medium-term maturity.

In view of possible continuous increase in interest rates and the impact of higher rates on borrowers' credit worthiness, banks should remain attentive regarding the possibility of interest rate risk transfer into a credit risk. At the same time, the rise in interest rates may also affect the fall in the value of securities portfolio, which are classified as disposable for sale. The tailored-made stress-testing exercises on vulnerabilities suggest that the existing outstanding capitals of banks are sufficient to withstand the effects of a further increase in interest rates, by assumed scenarios. It is crucial that banks test their resilience against unfavourable interest rates movements, carry on the measures that actively manage balance sheet positions which are vulnerable, and act to strengthen its sustainability when necessary.

*The results of the stress-testing exercise support the assessments on the good financial position of the banking sector, though evidencing the increased vulnerability to the assumed stress scenarios.* The Bank of Albania conducts stress-testing exercises on a regular basis, in order to assess the banking sector's resilience against shocks from the real economy or financial markets in the medium-term horizon. The stress tests on capital adequacy or borrowers' solvency shows the degree of resilience of individual banks in terms of capital, and aims to identify their ability to withstand assumed shocks on economic growth, credit, exchange rate, and interest rates.

Overall, the tests carried out for the end of 2022 and extended across the 2023-2025 period, indicate that the banking sector is resilient to the assumed macroeconomic shocks. In addition, results show that specific banks are more vulnerable against assumed shocks. In conclusion, the Bank of Albania assesses



that the financial system and the banking sector have continued to perform in a stable manner in the first half of 2023. However, the uncertainty surrounding the international developments, the vulnerabilities originating from information technology advancements, and the exposures to credit and market risks, still pose challenges to the Albanian economy.

As a result, it is necessary that in the medium term banks strengthen the overall control systems and enhance investments to guarantee the sustainability and safe use of the technologies they employ. In the shorter term, it is pertinent for banks to preserve and strengthen the capitalisation levels of the activity, pursuant to the regulatory requirements to meet the eventual financial losses as signalled by stress test exercises.

As always, the Bank of Albania will carefully monitor the developments in the banking sector and in the macroeconomic and financial indicators. The Bank of Albania, through closely communicating with banking industry, the other public authorities and with the international financial institutions, will act in a proactive manner to safeguard the macroeconomic and financial stability in Albania.

