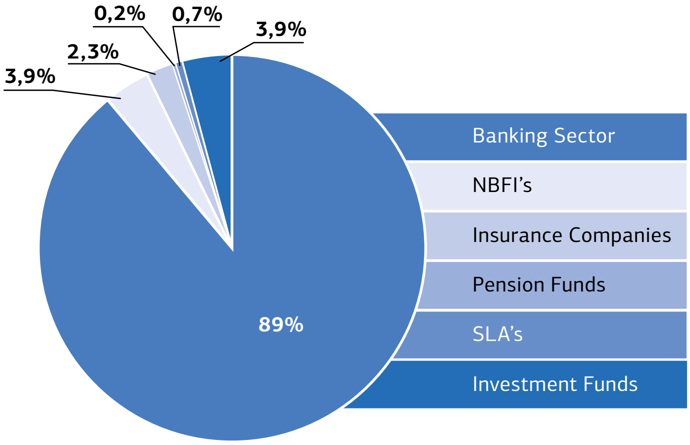
Black Sea Trade & Development Bank

Overview of the financial sector in Albania

The financial sector in Albania mostly consists of banks that account for close to 90% of the total financial sector assets. Shares of non-bank financial institutions, investments funds, pension funds, etc. are negligible. So, to understand the health of the financial system and recent trends focus should be made on commercial banks.

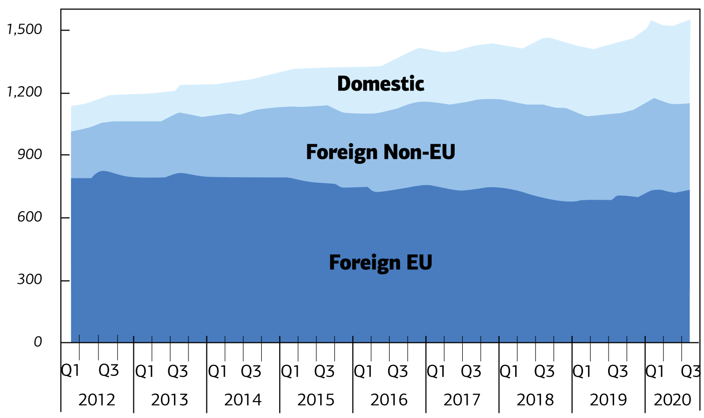
Figure 1. **Structure of the financial sector in Albania, June 2020**[1]



Source: Bank of Albania, Albanian Financial Supervisory Authority

Currently 12 banks operate in Albania and most of them have non-resident ownership. The share of domestic shareholders' in the total banking sector assets is around 30%. The rest 70% is owned by non-residents, out of which around 50 percentage points is from the EU countries and the rest 20 pp from non-EU countries.

Figure 2. **Banking system ownership structure (Lek billion, Total assets)**



Source: IMF Staff Report on Albania, November 2020

[1] Financial Stability Report, 2020 H1, Bank of Albania

Concentration in the banking sector is not high. 5 banks account for around 80% of the total banking sector assets, with individual market shares of these banks ranging from 10 to 30%. So, no single bank has the dominant position in the market. These 5 banks are treated as systemic banks by Bank of Albania. As a result, the HHI index is relatively low pointing to the low level of concentration in the banking system.

Table 1. **Herfindahl-Hirschman Index (HHI) of assets, deposits and loan concentration**

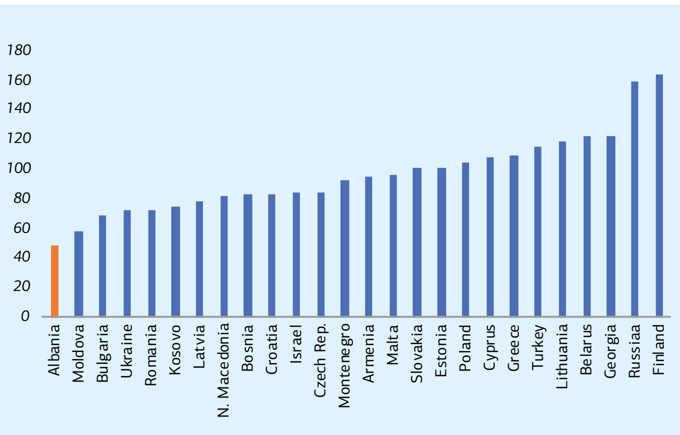
Indicators	2014	2015	2016	2017	2018	2019
Index H (assets)	0.14	0.15	0.15	0.15	0.16	0.15
Index H (deposits)	0.14	0.15	0.14	0.15	0.15	0.15
Index H (loans)	0.12	0.12	0.13	0.13	0.13	0.12

Source: Annual Supervision Report 2019, Bank of Albania

The banking sector in Albania is well capitalized. The regulatory capital equals 18% of risk weighted assets as of December 2020, well above the required minimum of 12%. Banks keep the high capital position for many years already which points to the strong loss absorption capacity of the system.

The banking sector assets are around 100% of 2020 GDP, close to the average of BSTDB member countries. The share of loans in total assets is relatively low accounting for only 40%, while liquid assets comprise more than 50% of the total assets. So, banks maintain large liquidity buffers that guard them well from possible liquidity shocks. At the same time, excess liquidity may also point to low efficiency of financial intermediation in the country. Banks are funding their lending activities almost entirely with deposits that contribute to around 90% of the total banking sector's liabilities. This translates to a very low level of loan to deposit ratio which is around 50%. This indicator is the lowest across the wider region and among the BSTDB member countries, indicating the difficulties that banks face in using the attracted funds to increase the credit portfolio.

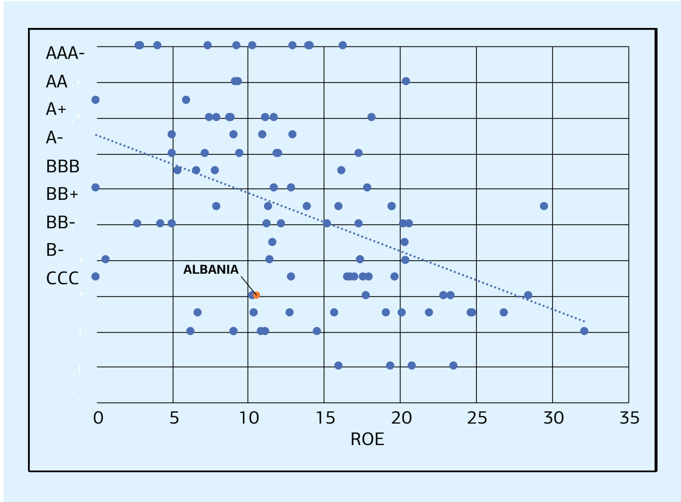
Figure 3. **Loan to deposit ratio as of end 2020 (%)**



Source: Financial Soundness Indicators, IMF database

A low level of loan to deposit ratio together with large liquidity buffers put downward pressure on banks' profitability. Return on equity of the banking system averages around 10% for the last 7 years, which is somewhat low compared to countries with similar creditworthiness characteristics. In 2020 ROE declined relative to the previous year and equaled 11%.

Figure 4. **ROE of banking sector for 2020 and sovereign credit rating**

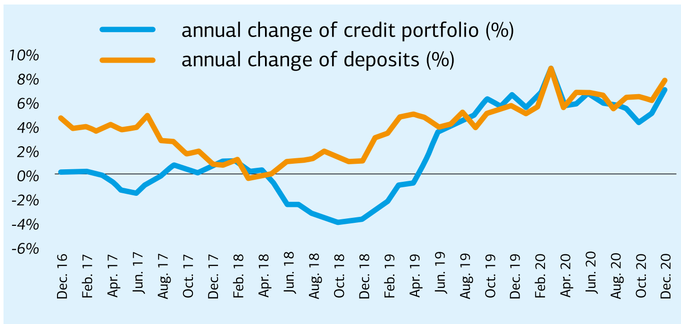


Source: Financial Soundness Indicators, IMF database

Lending to the economy was flat for almost 2 years before it started to grow in 2019. By the end of 2019 and for the whole of 2020 credit growth in nominal terms was in the range of 7-8% per year. Although credit growth accelerated in 2019-2020 it is still not high considering a lower starting base and compared to peer countries.

Contrary to the loan portfolio, deposit growth was above 6% per annum for the last 4 years, while reaching 8% by the end of 2020. Considering that deposits are twice as much in volume as loans, high growth in deposits have led to accumulation of large liquidity buffers in the system.

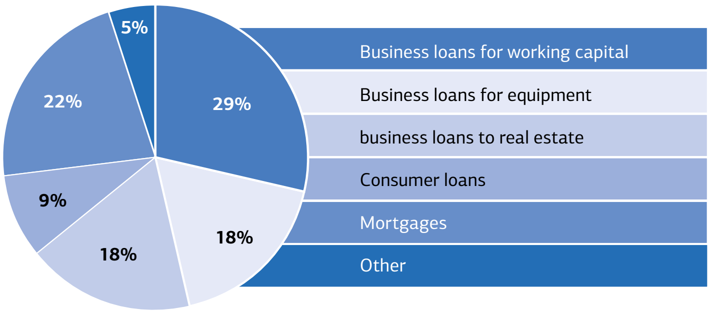
Figure 5. **Annual growth of credits & deposits (%)**



Source: Bank of Albania

The credit portfolio of the banking sector in Albania is well diversified. As of the end of 2020 around two thirds of the portfolio is invested in business loans. 29% of the portfolio is used for working capital financing, out of which around half is domestic currency denominated and the other half mostly euro denominated. 18% of the portfolio is used for financing new equipment half of which is domestic currency denominated loans. Another 18% of loans are channeled to the real estate sector where the share of the euro denominated loans is high at 70%. Mortgages constitute 22% of the total credit portfolio and around 45% of it is domestic currency denominated while the rest is mostly in euros. Consumer loans are granted almost entirely in domestic currency and account for 9% of the credit portfolio.

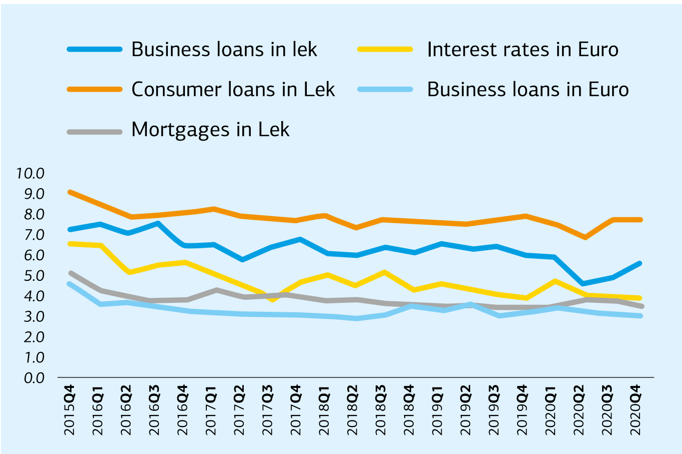
Figure 6. **Composition of banks' credit portfolio as of December 2020**



Source: Bank of Albania

Interest rates on loans have been declining for the last 5 years both for local currency and euro denominated products and continued to decline in 2020. The spread on interest rates for domestic versus euro denominated loans for similar products is relatively low compared to peer countries pointing to the low inflation and exchange rate risk.

Figure 7. **Interest rates for loans (%)**



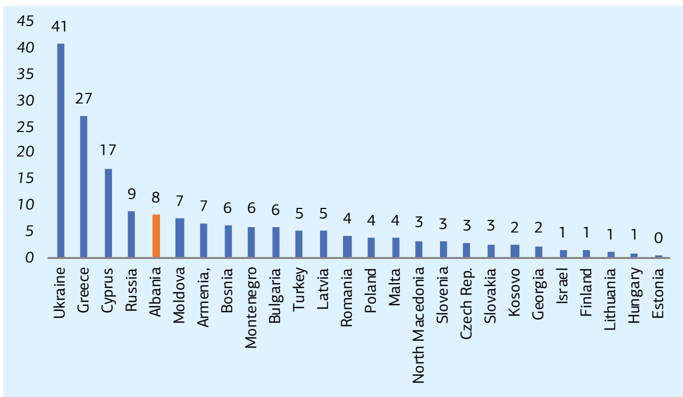
Source: Bank of Albania

One of the challenges of the banking sector in Albania is high dollarization (or Euroization) of loans. Around half of the total credit portfolio is FX denominated, mostly Euro denominated. Particularly important are loans to households as 45% of total outstanding volume of mortgages are FX denominated. Households are particularly vulnerable to the exchange rate risk since their income is mostly in local currency and if exchange rate depreciates, they will find difficulties to repay the debt that translates into credit risk for banks. This is especially the case for mortgage loans that are usually long term and large in volume. High level of euroization of around 70% for loans granted to companies operating in real estate sector is also noteworthy.

Another important challenge for the banking sector in Albania is the persisting high level of NPLs. In 2014 NPLs reached 25% of the total loans but since then it has steadily declined and by the end 2020 it came down to 8%. Although the financial sector health has improved significantly over the course of the last 5 years, this level of NPL is still on the high side compared to other countries in the region and in the BSTDB Region. It should be noted that this figure does not include loans that will become nonperforming due to the Covid19 related crises. In 2020 Bank of Albania temporarily relaxed loan classification and provisioning rules to provide banks with the necessary time to assess asset quality and strengthen resilience. As a result, current figures of NPL may not show an accurate picture.

On the positive side it should be noted that since the banking system capitalization is quite high, banks have enough capital buffers to withstand significant deterioration in the asset quality. Even if NPLs double from the end 2020 level, banking system capital buffers in excess of regulatory requirement are enough to cover losses even in this scenario.

Figure 8. **NPL to total loans in 2020 (%)**



Source: Financial Soundness Indicators, IMF database

To sum up the banking sector in Albania represents most of the financial sector. Banks have high capitalization and large liquidity buffers that makes them resilient to possible negative developments. At the same time, compared to other countries with similar characteristics, volume of outstanding credit is very low. Banks attract deposits from the private sector but are less successful in using these funds to increase the loan portfolio. NPL's are relatively high but at the same time banks have large capital buffers that are enough to cover additional losses from potential loan deterioration.