Bank of Albania

ANALYSIS OF FINANCIAL INTERMEDIATION

2012 Q3

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The views expressed in this material are those of the authors and do not necessarily reflect those of the Bank of Albania.

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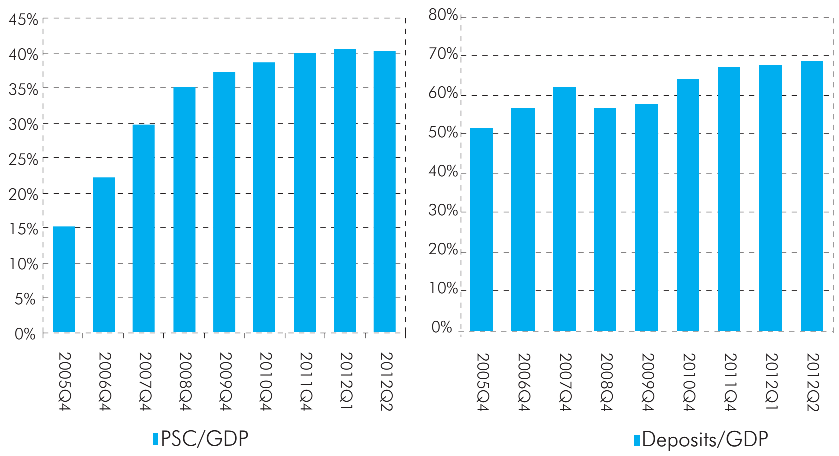
1. BANKS AND FINANCIAL INTERMEDIATION

Financial intermediation through the banking system plays a key role in facilitating commercial relationships between economic agents in Albania. Individuals are the main savers in the economy. By placing their funds into the banking system, they allow the intermediation of these funds in the form of lending to businesses and other individuals. In our periodic analyses, particularly in the last 2-3 years, we have continuously drawn the attention to households' general tendency to save more and consume less. This tendency is not only confirmed by the higher deposit-to-GDP ratio, but also by the periodic consumer surveys carried out by the Bank of Albania. Deposit-to-GDP ratio continued to increase during the second quarter of 2012, standing at 68.7% in June[1].

Chart 1 Private sector credit and deposits as a percentage of GDP



Source: Bank of Albania.

The banking system remains well-capitalized and amply liquid. However, the intermediation of funds through the lending channel has been slow. The low private economic agents' demand for borrowing has been driven by the sluggish economic activity in Albania and the uncertainty surrounding the outlook, hence generating a moderate growth of credit. On the supply side, against a background of an increasing non-performing loan portfolio, banks have generally applied cautious lending policies. All these developments have lowered the private sector credit-to-GDP ratio. At the end of the second quarter, it stood at 40.4%, compared to 40.7% at the end of the first quarter[2].

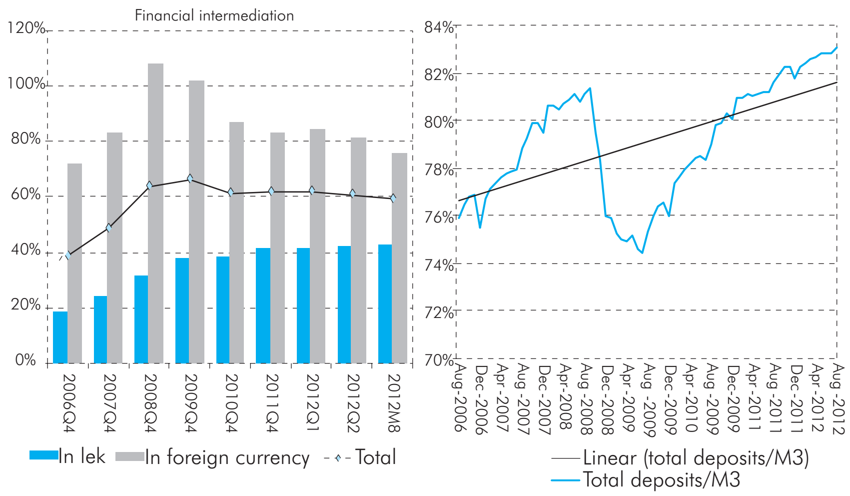
[1] *According to an approximate estimation of nominal GDP, which is based on the GDP published by INSTAT and on Monetary Policy Department's estimates.*

[2] *Besides the performance of financial ratios, this ratio has also reflected the revision of GDP series. The GDP was last revised in October 2012 by INSTAT.*

The low use of banking liquidity to intermediate funds through the lending channel has kept funds in the form of net foreign assets outside a considerable number of banks.

At the end of August 2012, loan-to-deposit ratio reduced to 59.4%, compared to 61% at the end of June. This performance reflects the low lending and households' tendency to save. The higher lek loan-to-deposit ratio provides evidence for the slight improvement of intermediation in lek, while that in foreign currency deteriorated during July and August.

Chart 2 Loan-to-deposit ratio and deposits to broad money

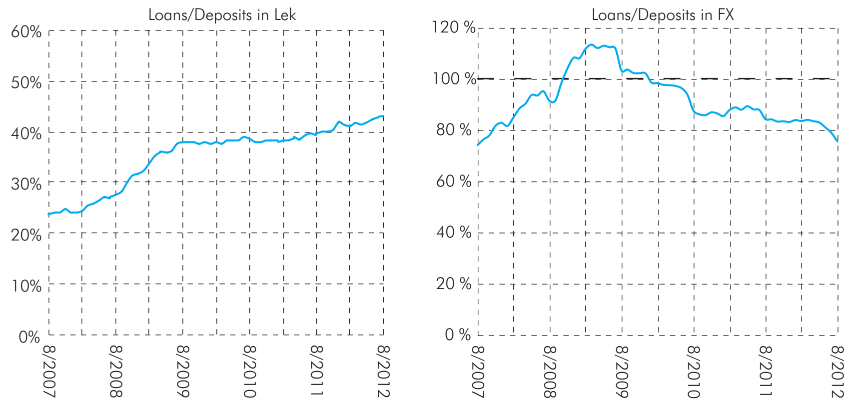


Source: Bank of Albania.

2. INTERMEDIATION

Lek intermediation increased in the third quarter of 2012 at a higher rate than in the previous quarters. At the end of August, loan-to-deposit ratio in lek stood at 42.9% or 0.7 percentage points higher than at the end of June. This increase owed mainly to the contraction of lek deposits during July and August. Lek loans registered a positive flow during this period, albeit lower than in the previous quarters. Loan-to-deposit ratio in lek increased by 3.4 percentage points, y-o-y. Its performance over the last 12 months has been determined by the maintenance of high lek credit growth rates at a time when lek deposits have slowed their growth rates during 2012.

Chart 3 Intermediation in lek and foreign currency



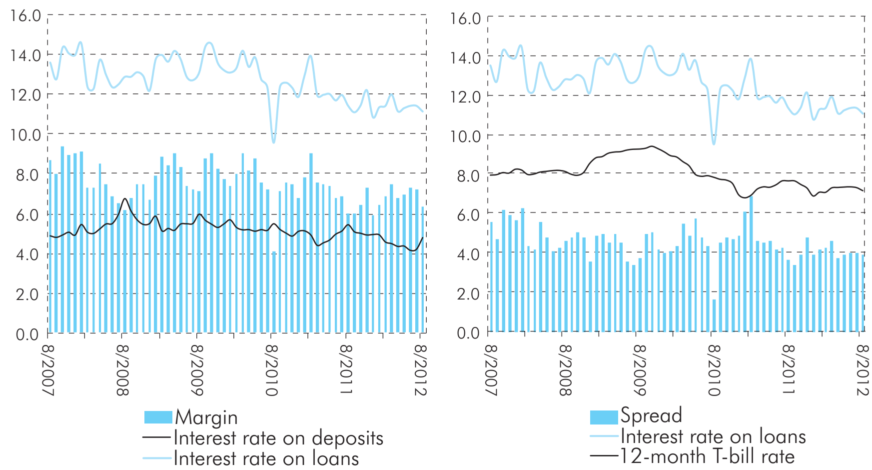
Source: Bank of Albania.

Foreign currency intermediation contracted in the third quarter of 2012. At the end of August, loan-to-deposit ratio fell to 76%, down by 5.4 percentage points from the end of the second quarter and 7.5 percentage points from end-2011. The lower intermediation ratio in foreign currency was mainly determined by the performance of foreign currency lending. The latter contracted in July and August, reflecting in turn in its fast reducing annual growth rates during these two months. The performance of foreign currency deposits has also triggered the fall in the loan-to-deposit ratio in foreign currency. Being broadly in line with their seasonal performance, they registered positive net flows, particularly in August.

3. INTERMEDIATION COST

Average intermediation cost in lek fell in the third quarter of 2012, hence recovering the upward trend of the previous two quarters. It stood at 6.76 percentage points, down by 0.22 percentage points from the second quarter's average. However, it did not reach the low levels of the second half of 2011. The lower intermediation cost in the quarter under review owes to the higher interest rate on lek deposits, particularly in August. On the other hand, average interest rate on lek loans remained similar to the previous quarter. The spread between the loan interest rate and 12-month T-bill yield maintained the previous quarter's level of 4.0% on average.

Chart 4 Intermediation cost in lek* (in p.p.)



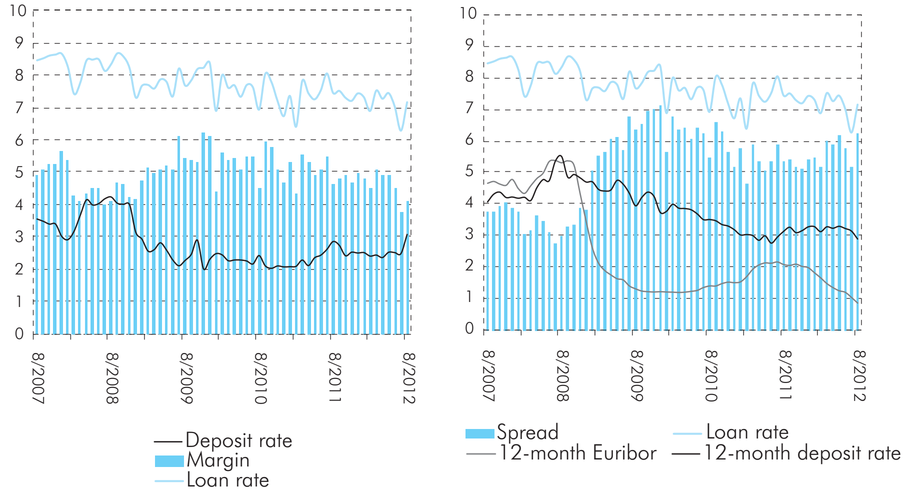
*The margin is calculated as the spread between loan and deposit interest rates. The spread is calculated as the difference between loan/deposit interest rate and the reference rate (12-month T-bill yield for the lek and 12-month euribor for the euro).
Source: Bank of Albania.

Intermediation cost in euro[3] fell in July and August to an average of 3.95 percentage points. Its fall in July was due to the unusual decrease in the loan interest rate[4]. The return of the loan interest rate in August to the previous quarters' level was also coupled with the significant increase in the deposit interest rate due to the promotional offers characterizing this month. The decrease in the euro intermediation cost during this period of the year is particularly high also due to temporary factors. However, looking back in time, it began to gradually decline starting from the second half of 2011.

[3] *Banks' activity in foreign currency is dominated by that in euro, which accounts for more than 80% of foreign currency operations.*

[4] *The performance of the interest rate on euro loans in August was influenced by a high amount preferential loan granted by a bank in the system at a very low interest rate.*

Chart 5 Intermediation cost in euro (in p.p.)



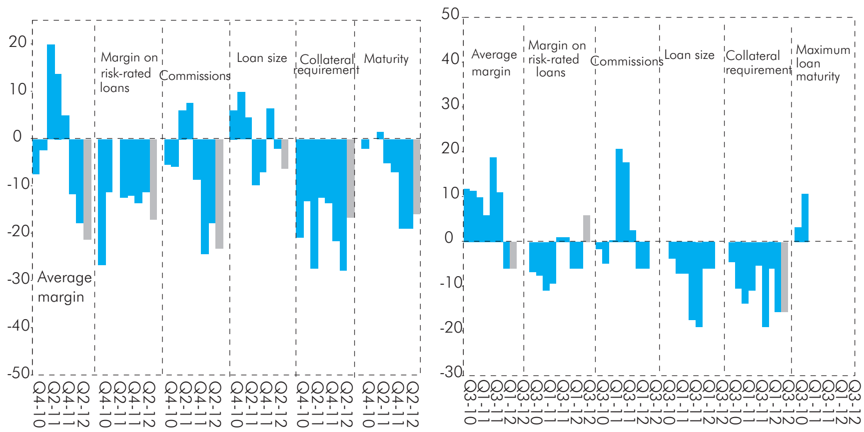
Source: Bank of Albania.

Euro interest rates in Albania remain significantly higher than in the international markets. The sharp downtrend in euribor rates, which emerged in early 2012, has not been reflected in the Albanian market interest rates. Consequently, the spread between them has increased in the recent months. The low sensitivity of euro interest rates in Albania to interest rate fluctuations in the international markets is also driven by structural concerns facing the Albanian financial system. Against a background of limited foreign financing, the provision of ample and stable foreign currency liquidity by banks can be mainly achieved only through the increase in foreign currency deposits.

4. NON-PRICE CRITERIA IN INTERMEDIATION

According to the bank lending survey carried out in the third quarter of 2012, the lending standards applied to businesses tightened further while those applied to households remained unchanged. Most non-price criteria applied to households improved, while those applied to businesses continue to tighten.

Chart 6 Lending standards applied to businesses (left) and households (right)*



*Net balance of responses in this survey.
Source: Bank of Albania.

Lending standards applied to businesses tightened further in the third quarter of 2012 to the same extent as in the previous two quarters. In addition to tightening the standards related to the loan price, banks also tightened all non-price criteria. Among the latter, collateral requirements and maximum loan amount tightened the most. Banks have reduced the loan amount, hence tightening this lending standard further compared to the previous quarter, though to a lower extent than other lending standards.

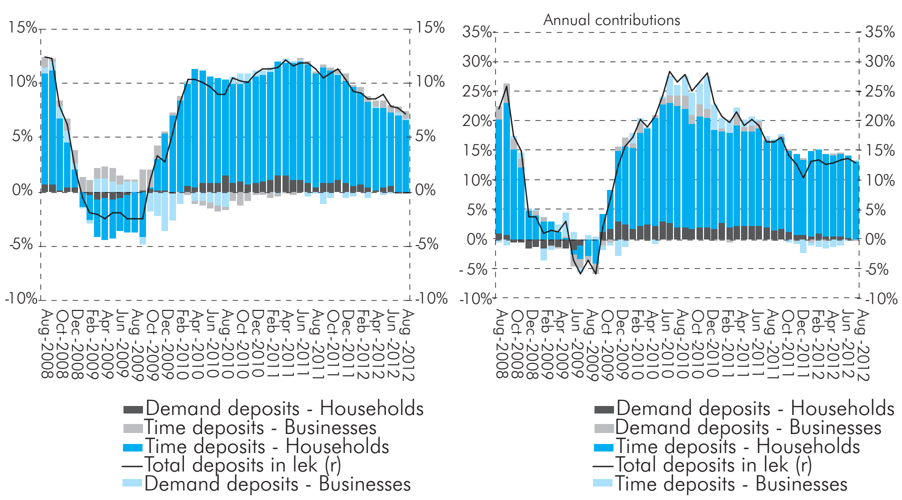
For the second quarter in a row, lending standards applied to households remained unchanged in the third quarter of 2012. They were maintained at a similar level mainly through the loan amount and the maximum loan maturity. Collateral requirements tightened further to a similar extent to the second quarter of 2012. They remain one of the non-price criteria with the highest tightening effect on household loans.

5. DEPOSITS

Monetization of the economy, as measured by the ratio of total deposit stock to broad money, stood at 83.1% at end-August. The increasing monetization and households' tendency to save, as in the first half of 2012, reflects the performance of deposits during July and August. Total deposits grew at stable rates during the period under review, up by about 10.3% y-o-y, compared to 10.6% in the second quarter. In absolute terms, total deposit stock increased by about ALL 24.9 billion in July and August.

The growth in deposits was mainly in the form of foreign currency deposits, which were impacted by the high foreign inflows characterizing the summer season. Foreign currency deposits grew by about 13.4% y-o-y, compared to 13% in the previous quarter. The growth in foreign currency deposits by about ALL 27.3 billion during this period has entirely offset the contraction of lek deposits. The ratio of foreign currency deposits to total deposits has consequently increased further to 49.7% from 48.1% at the end of the second quarter. The increase in foreign currency deposits was in the form of household time deposits. There has also been an evident increase in business foreign currency deposits, which is supported by the higher exports during this period.

Chart 7 Deposits by currency

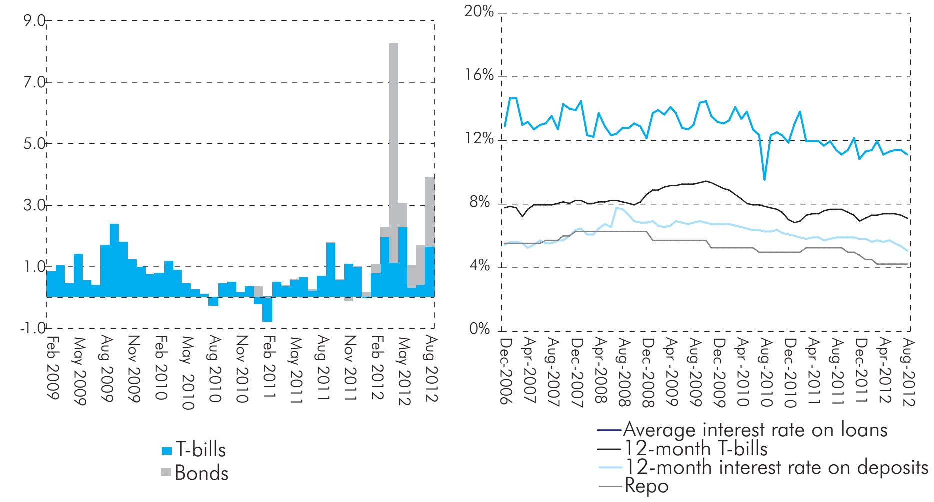


Source: Bank of Albania.

Lek deposits contracted by ALL 2.4 billion in July and August, slowing the annual growth rate to an average of 7.5%. This performance has mostly reflected the developments in lek time deposits. The latter reduced by about ALL 4 billion in July and August. 12-month deposits have a considerable share in total time deposits. The annual growth rate of lek time deposits slowed to

8.7% in July and August, compared to 9.3% in the second quarter. The signs of this deceleration first emerged in June. Lek demand deposits grew by about ALL 1.5 billion in July and August, recording an average annual growth rate of 3.7%.

Chart 8 Monthly flows of household investment in securities (ALL billion) and lek interest rates



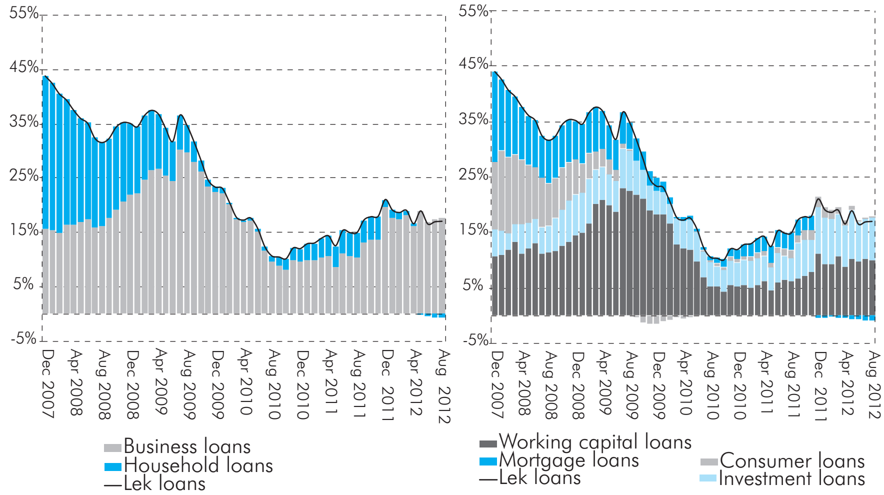
Source: Bank of Albania.

In parallel with these developments, there has been an increase in household investment in securities by about ALL 1.7 and 1.9 billion in July and August, hence confirming households' tendency to save despite the financial assets being used for this purpose. Business lek deposits remained volatile and downward during this period, reflecting mostly businesses' needs for liquidity.

6. LENDING

Lending to the economy slowed its annual growth rate to 6.5% in the third quarter of 2012, compared to 10.8% at the end of the first quarter and 12.2% at end-2011. To a large extent, this slowdown reflects the low private sector's demand for borrowing due to the sluggish economic activity in Albania and the uncertainties about the outlook. Despite the satisfactory capitalization and liquidity figures in the banking system, the supply of loans was tight. This is also evidenced by the tight lending standards applied by banks. Banks' cautious and selective approach to lending is a response to the increasing credit risk in Albania and the heightened uncertainties about the future.

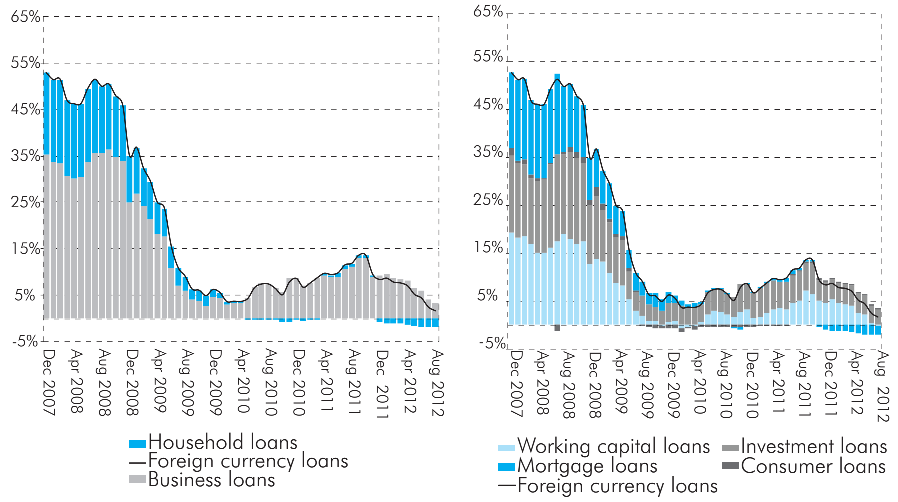
Chart 9 Lek lending by economic agent and purpose of use (contribution in annual change)



Source: Bank of Albania.

Lending in lek continued to display a satisfactory performance in the third quarter of 2012. It grew by 16.6% y-o-y, being entirely driven by the performance of the business loan portfolio. The contribution of household loans to the growth of lek loans has been absent since the first quarter of 2012 and, in the last two months, it has slightly moved into a negative territory. The increase in lek-denominated business loans has been mainly driven by the higher working capital loans rather than investment loans. Loans for liquidity purposes are linked to businesses' working capital to cover daily activity needs.

Chart 10 Foreign currency lending by economic agent and purpose of use



Source: Bank of Albania.

Lending in foreign currency began to slow rapidly in the first quarter of the present year. As at end-August, this type of loan was only 1.5% higher than a year earlier. The fast decline in working capital loans denominated in foreign currency and the negative contribution of foreign currency household loans provided the major contribution to this slowdown. As reported by bank lending surveys, the negative contribution of household loans denominated in foreign currency is related to households' weak demand to invest in the housing market. Foreign currency-denominated working capital loans have been also impacted considerably by their high repayments given their short-term nature. Overall, the performance of lending in foreign currency confirms businesses and households' awareness of the risks associated with borrowing in foreign currency.