B a n k   o f   A l b a n i a

ANALYSIS OF FINANCIAL INTERMEDIATION

2012 Q4

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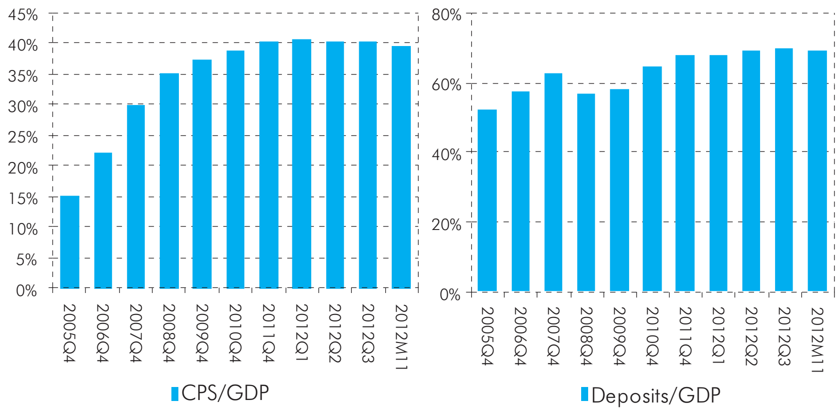
C O N T E N T S

1. BANKS AND FINANCIAL INTERMEDIATION

Banking sector continued to dominate the Albanian financial system at the end - 2012. Banking sector is composed of 16 private banks, denominated by foreign capital banks, sharing about 90% of the system's total assets. Loan portfolio to private sector, at the end of November 2012, shares about 42.7% of banking system total assets, whereas deposits about 75% of liabilities.

Overall, financial intermediation indicators in the last quarter[1], have triggered a declining trajectory versus a quarter earlier. The private sector credit-to-GDP ratio, at the end of November, stood at 39.4%, or 1 percentage point lower, compared to end of September. These developments reflected the weaken performance of lending activity of private sector over this period. The banking system remains well-capitalized and amply liquid. Notwithstanding the increasing monetarisation, banking system has slowed down the intermediation of these funds through the lending channel. Low credit demand and the cautious lending policy applied by banks impacted the further slowdown of loan growth rates to private sector, both to households and businesses.

Chart 1 Private sector credit and deposits as a percentage of GDP*, (in %)



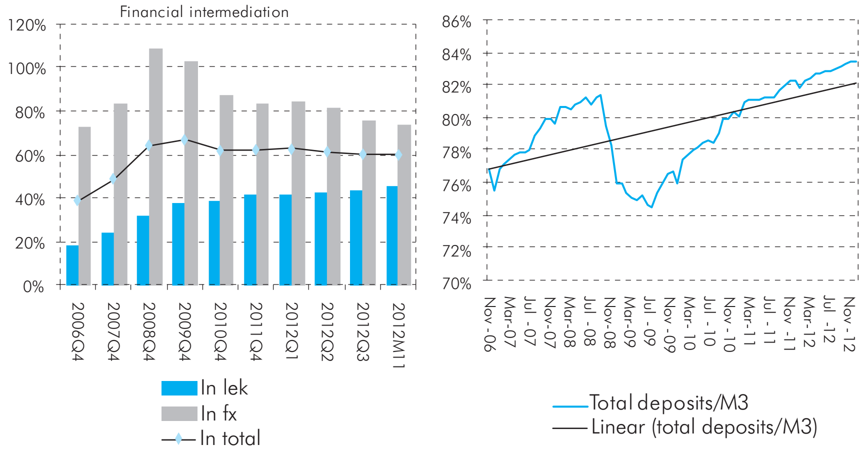
*According to an approximate estimation of nominal GDP for November, this is based on the GDP published by INSTAT and on Monetary PolicyDepartment's estimates. The latest publication of GDP by INSTAT is published January 2013.
Source: Bank of Albania.

Financial intermediation measured as credit to total deposits ratio in the banking system, manifested deceleration sings over 2012, especially during the second half of year. In November, this ratio stood at 59.6%, from 59.9% at the end -2012 Q3, and about 2.3 percentage points lower than the end-2011. The slowdown of stock deposits increase in October and November

[1] *The latest analysed monetary data belong to November 2012.*

2012, impacted the slight fall of their ratio to GDP, compared to the third quarter, pointing at 69.1%.

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



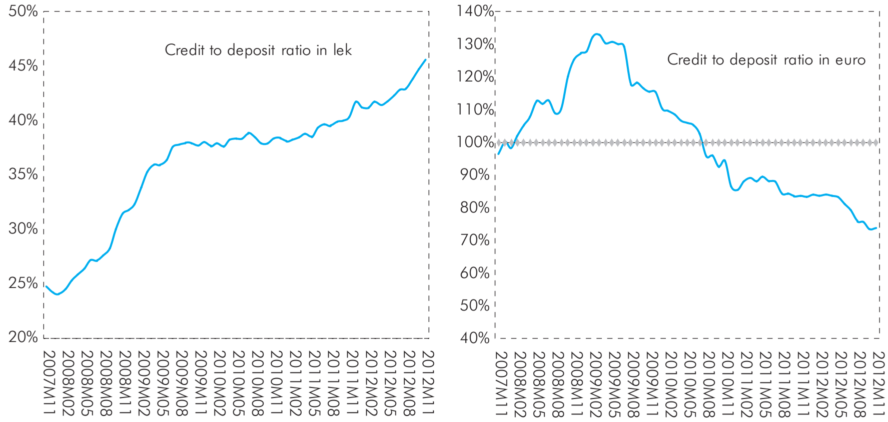
Source: Bank of Albania.

2. INTERMEDIATION

Fourth quarter indicators show a deepening of banking system intermediation role in the domestic currency. Loan-to-deposits ratio in lek stood at 45.6% or 1.7 percentage points higher than in the previous quarter, and about 3.8 percentage points higher compared to the end-2011. Also, this indicator marked the highest quarterly increase for the year 2012. This positive performance is supported by the lending policies direction toward the domestic currency, and by the main purpose of loan use, granted to economic agents. Deposits recorded a positive performance, albeit maintaining the slowing trend of the annual growth rates.

Foreign currency intermediation in 2012 Q4 contracted at lower rates than in the three other quarters of 2012. Hence, the loan-to- deposits ratio in foreign currency of 73.9%, is about 2 and 10 percentage points lower, compared to 2012 Q3 and end-2011, respectively. This performance is determined not only by the decrease of loan portfolio since April, but also by the good performance of foreign currency deposits, as a response to the foreign currency inflows. The fall in foreign currency deposits, in November, compared to third quarter helped to limit the tightening rates of foreign currency intermediation ratio.

Chart 3 Intermediation in lek and foreign currency

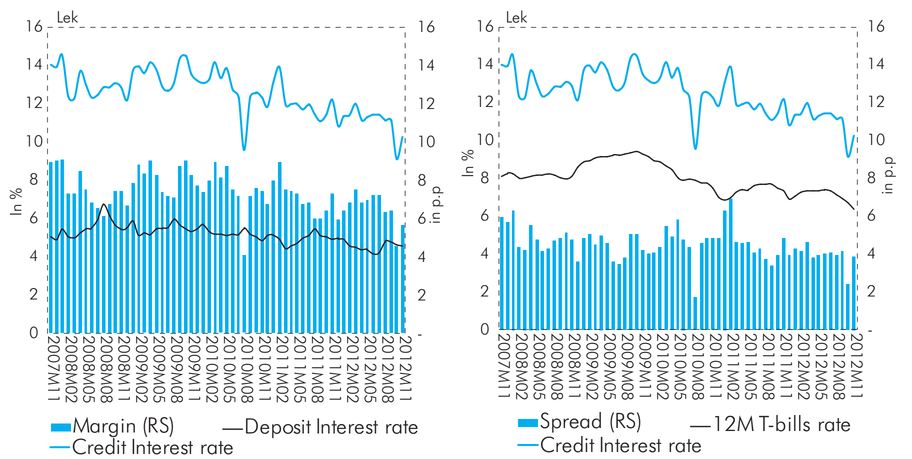


Source: Bank of Albania.

3. INTERMEDIATION COST

The deepened lek intermediation in Q4 is supported also by the reduced cost of intermediation activity. The average intermediation cost at the end of November was 5.1 percentage points, from 6.6 percentage points in 2012 Q3. The average lek intermediation margin is 0.5 percentage point lower, compared to the average of 2011. The lower intermediation cost in Q4 is attributed to the significantly higher decrease of interest rate on lek loan (1.52 percentage points), while the average interest rates remained similar to the third quarter. Nevertheless, the interest rates' performance on lek loan is influenced by a high amount of preferential loan granted to public enterprises. Avoiding this effect, lek loan interest rates will be slightly lower than previously. Whereas, the spread between the lek loan interest rate and 12-month T-bill yield is 1 percentage point lower than the the average rate of 4.1 percentage points in the previous quarter.

Chart 4 Intermediation cost in lek*



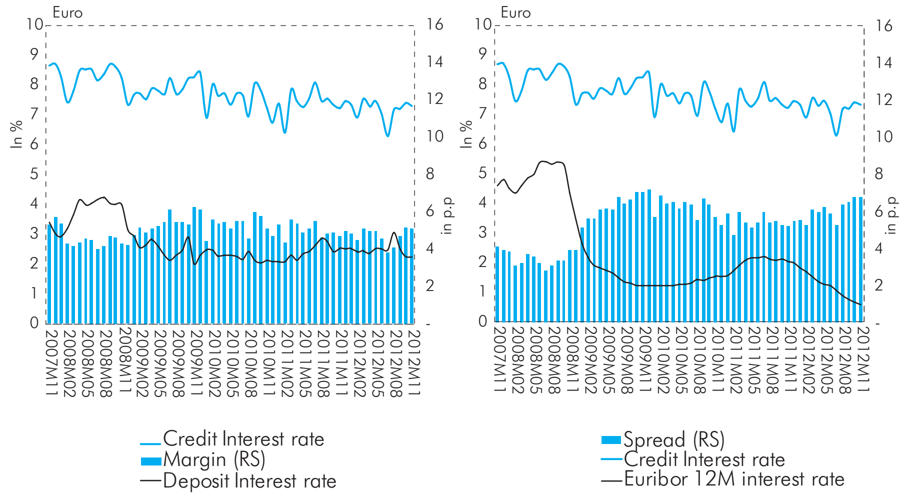
*The margin is calculated as the spread between loan and deposit interest rates. Spread is calculated as the difference between credit/deposits interest rate and the reference one. Source: Bank of Albania.

Intermediation cost in euro[2] increased in October and November compared to the previous quarter, averagely standing at 5.1 percentage points, compared to 4.2 percentage points in the third quarter. This performance is triggered by the slight increase in interest rates loan both in euro and lek and by the decrease in interest rate of euro denominated deposits, owing to the end of third quarter promotional offers. The 2012 Q4 developments appears to have returned the intermediation margin close to the average of year 2012, by excluding the temporary fall it manifested in 2012 Q3. Intermediation margin in November maintains the same rates with end-2011.

[2] *Foreign currency activity of banks is denominated from their activity in EUR, which shares more than 80% of foreign currency activity.*

Average interest rate spread of loan to international market reference rate, 12-month Euribor, excluding the temporary contraction of two summer months, pursued the increasing trend observed since in the end of previous year. This indicator was considerably impacted by the decrease of interest rate in international market. On the other hand, this performance continues to reveal the divergence between the euro-deposits interest rate in Albania against the international market rate, reflecting the increased risks premium required by banks for the foreign currency intermediation.

Chart 5 Intermediation cost in euro



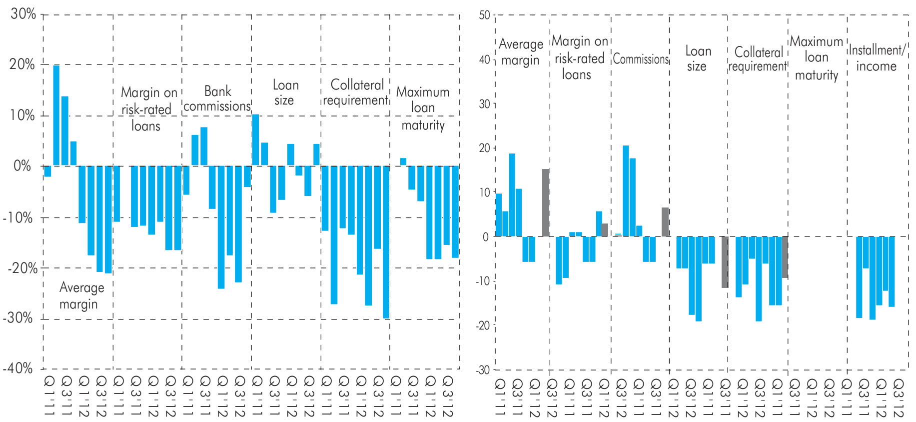
Source: Bank of Albania.

4. NON-PRICE CRITERIA IN INTERMEDIATION

The lending standards applied to businesses tightened further while those applied to households remained unchanged, in 2012 Q4. Most non-price criteria continue to tighten.

Lending standards applied to businesses tightened further in the fourth quarter of 2012 to the same extent as in the previous three quarters. Excluding the condition on loan amount, which is eased in this quarter, the collateral requirement enhanced and maximum maturity decreased, thus impacting the tightening of the overall lending standards applied to businesses in this quarter.

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



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

For the third quarter in a row, lending standards applied to households remained unchanged in the fourth quarter of 2012. The eased price criteria to lending to households balanced the tightening of loan amount and the collateral requirements. The standards applied on maximum loan maturity[3] and those on instalment/income ratio remained unchanged in the two last quarters.

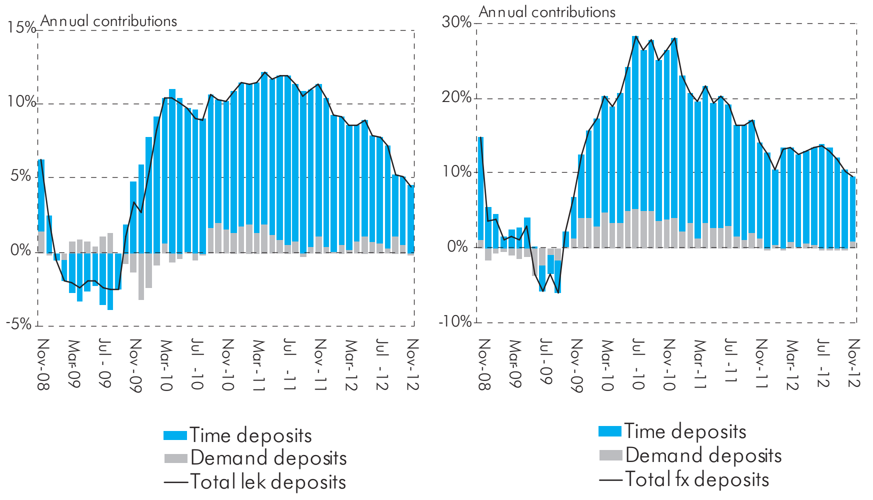
[3] *Standards applied on loan maximum maturity to households remained unchanged in the last two years.*

5. DEPOSITS

The ratio of total deposit stock to broad money remained almost unchanged, compared to the previous quarter, standing at 83.3%, at the end of November. This ratio is about 1.6 percentage points higher than in the end-2011, recording one of its highest historical rates. The positive developments during the year are broadly supported by households' tendency to save. At the same time, high foreign currency flows from external sector, mainly during the summer months, have also affected the increase of deposits against GDP, compared to end- 2011.

A more contained increase of deposits is observed in October and November compared to 2012 Q3. Total deposit stock increased by 7.3% in average annual terms during this period, from 9.7% in the previous quarter. Nevertheless, their total stock remains almost equal to the end of September.

Chart 7 Deposits by currency



Source: Bank of Albania.

The growth in deposits was mainly in the form of lek deposits in the last quarter, which increased by about 4.7% y-o-y, compared to the average of 6.8% in the previous quarter. In absolute terms, lek deposit stock is about lek 5 billion higher than the end of September. Lek deposits growth is mainly supported by households' deposits and at a lower rate by enterprises' deposits.

While, foreign currency deposits slowed down their annual growth rate, averagely at 10%, or about 2.8 percentage points lower compared to 2012 Q3. Deposits monthly performance confirms a slowing down and a decrease in foreign currency deposits in November. This negative contribution of deposit stock foreign currency component owed mainly to businesses' deposits. Developments in businesses' foreign currency deposits vary according to the economic activity and appear to have supported the growth of imports in certain sectors of the economy.

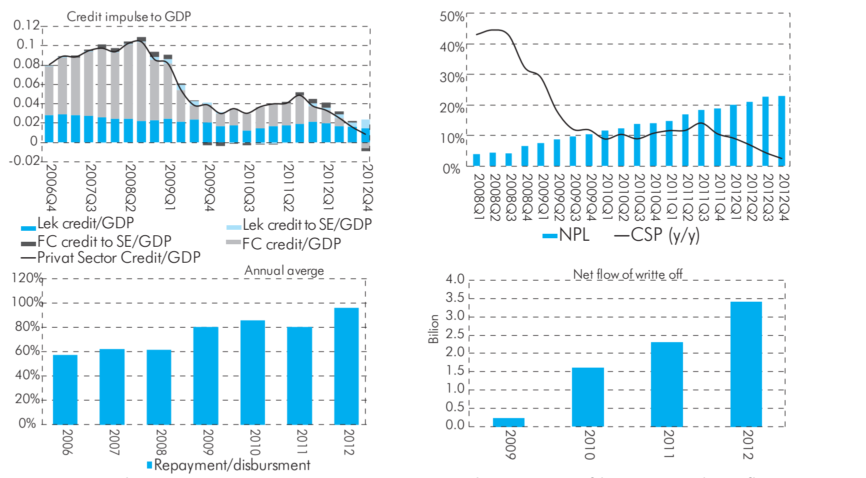
Time deposits provided a higher contribution to the increase in total deposit stock, particularly in the national currency. Total time deposits grew higher than lek 1 billion, against the fall in the demand deposits. The growth in time deposits was mainly in the form of households and businesses' time deposits in the national currency.

6. LENDING

Lending in the fourth quarter confirmed the considerable slowdown of loan growth rates impacted by loan to private sector. After a decrease in October, banks' loan portfolio slightly increased in November. At the end of November, annual loan portfolio growth stood at 4.0%, from 5.6% in September and 10.4% in 2011. The ongoing slowdown in loan portfolio growth rates has reflected the decrease in granted loans compared to the previous year and the settlements in advance of credits, as well as the writing off processes of bad loans from banks' balance-sheets. These phenomena have simultaneously reflected the weak demand of private sector to finance the sluggish economic activity and the more cautions policies of banks against the exposure to credit risk. Owing to the increase in non-performing loans ratio to total, banks continued to maintain tighten standards applied to lending. At the same time, uncertainty about the future has conditioned both bank's clients and banks themselves to be more cautious regarding lending activity.

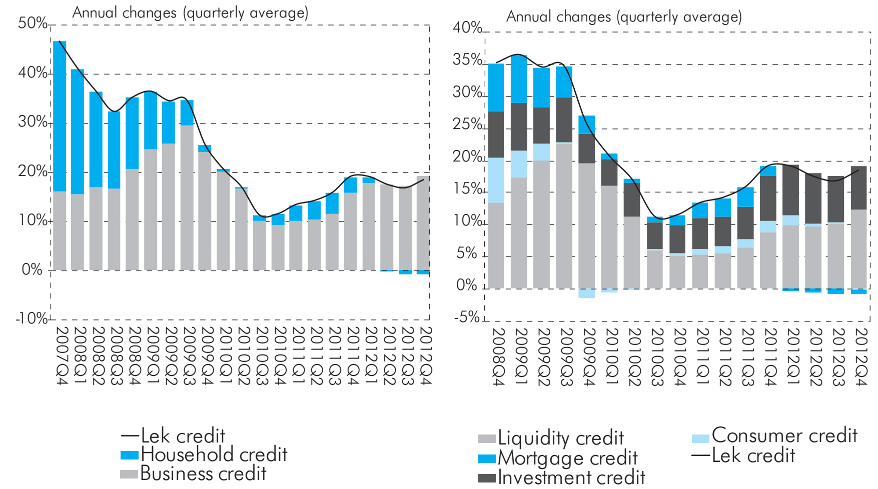
Loan to state-owned enterprises provided a positive impact on loan portfolio performance, by considerably increasing it. Lek lending dominated in 2012 and state-owned enterprises provided an important contribution. Impulse of loan to state-owned banks to GDP for the year 2012 is estimated at 0.7%, compared to 0.9% provided by the private sector.

Chart 8 Developments characteristics in lending*



*Loan impulse to private sector in GDP is measured as a ratio of loan annual net flows to GDP. This indicator is estimated as a signal for the contribution that loan provides to economic growth. The abbreviation SOE refers to State-owned Enterprises.
Source: Bank of Albania.

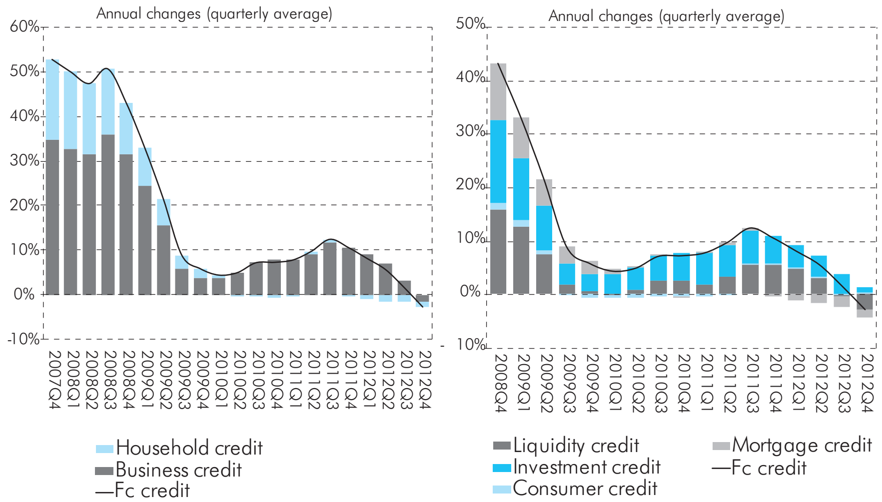
Chart 9 Lek lending by economic agents and purpose of use



Source: Bank of Albania.

Lending in lek during the fourth quarter returned to the positive tendency of annual growth rates. Lek loan portfolio grew by lek 10 billion in October and November, by recording the highest quarterly growth for the year 2012. In annual terms, this portfolio is about 18.1% higher, compared to 15.8% in the third quarter. This positive performance is supported by lending growth for liquidity purposes, mainly driven by the loan granted to state-owned enterprises. Part of this loan served to settle a part of foreign currency loan. Meanwhile, the contribution of loan for investment purposes in lek, averagely by 6.8 percentage points, lowered further in October and November.

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



Source: Bank of Albania.

Lending in foreign currency began to slow at rapidly rates since the first quarter of year. As at end-November, this loan was 3.2% lower than a year earlier, the tightening rate decreased in the last two months. The fast decline in working capital loans denominated in foreign currency and the lack of loans granted for investment purposes to both enterprises and households provided the major contribution to this slowdown. As reported by bank lending surveys, as a whole, the economic agents' demand for this type of loan has been considerably decreased, affected by the macroeconomic situation in Albania, the real estate market and uncertainties for the future. At the same time, banks show more cautious in selecting the investment projects that they finance.