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

FINANCIAL INTERMEDIATION ANALYSIS

2013 Q2

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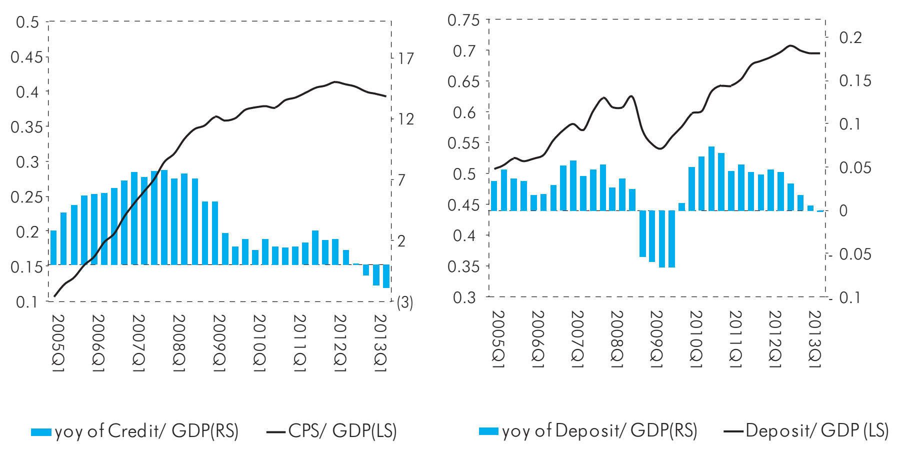
C O N T E N T S

1. BANKS AND INTERMEDIATION ACTIVITY

The financial system in Albania is dominated by the financial activity of commercial banks, which play an important role in intermediating funds in the economy. After the 2008 global financial crisis, banks in Albania and other countries in the region were reluctant to deepen their intermediation role in face of the weaker demand of the economy for money and the more prudent bank lending policies. Credit-to-GDP ratio was 41% in May, trending down since 2012 Q1 and reducing by 1.6 percentage points, y-o-y. The performance of this ratio seems to have been driven by the absent growth in the loan portfolio.

The sluggish bank lending activity has led to lower creation of money in the economy, yielding, in turn, lower deposit growth rates. The latter were also affected by the lower increase in disposable income and placement of savings outside the banking system. Deposit-to-GDP ratio stood at 69.5% at end-May, similar to 2013 Q1, or 1.2 percentage points lower than its peak level at end-2012 Q3. In the meantime, monetisation of the economy remained high. The ratio between money supply in the economy and GDP was 84% at the end of May, or 0.6 percentage points higher than in March, hence confirming the dominant role of the banking system in the economy.

Chart 1. Lending to the economy and deposits as a percentage of GDP (in %)

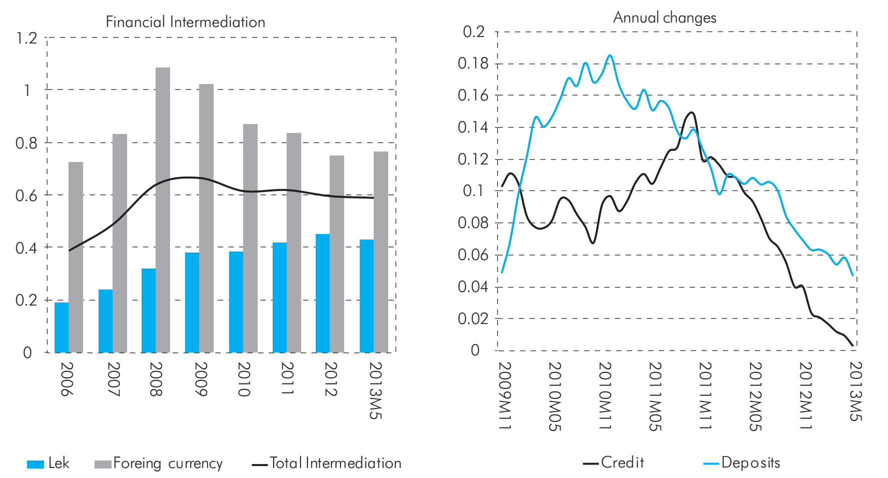


Source: Bank of Albania.

In parallel with these developments, loan-to-deposit ratio continued to shrink. At end-May, it reached 59%, down by 0.6 percentage points from Q1 and 2.1 percentage points, y-o-y. This ratio has been falling since 2012 Q3, primarily due to lower crediting to the economy.

The performance of intermediation indicators was largely affected by the rapid deceleration in the annual growth rates of lending to the private sector, which hit a negative rate of 0.2% in May. At end-May, it remained similar to December 2012, but shrank by ALL 2 billion from the previous year. Economic growth rates in Albania have slowed down and currently stand markedly below potential. Coupled with the high perceived uncertainty of economic agents, this performance generated lower demand for borrowing. In parallel with these developments, the banking system remains highly selective in financing projects, despite its sound profitability and capital figures.

Chart 2. Intermediation indicators of the banking system



Source: Bank of Albania.

Total deposits grew at an annualised rate of 4.7%, hence confirming the decelerating trend shown since summer 2012. Deposits grew ALL 10.2 billion in the first five months of 2013, driven primarily by the increase in household lek deposits and business demand deposits. The latter seem to have also reflected the increasing fiscal sector activity. The annual growth rates of total household deposits continued to slow down, reflecting the shift of savings toward other non-bank financial institutions, in addition to the lower disposable income.

Besides the factors relating to economic activity in Albania, the performance of banking intermediation has also reflected banks' policies and strategies. The Albanian banking system is dominated by foreign-owned banks, which account for about 90% of the total banking system. Consequently, the lending policies applied by banks operating in Albania are also influenced by those applied by their parent banks, particularly those originating from Europe. In May, financial intermediation by banking groups confirmed the last two-three years' performance.

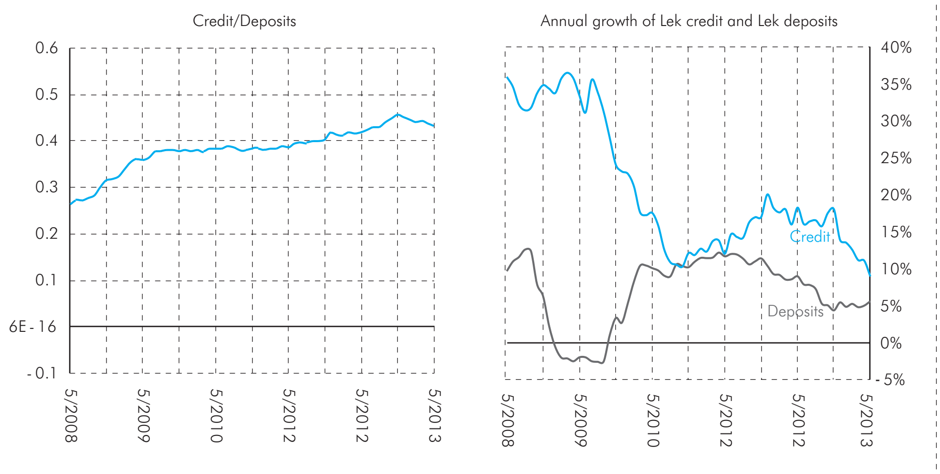
2. INTERMEDIATION

Intermediation in lek fell in April and May, while that in foreign currency showed sluggish performance. Lending to the economy slowed down further in face of economic agents' low demand and banks' conservative approach to lending to businesses. The intermediation margins increased slightly from 2013 Q1, reflecting the sharper decrease in deposit rates. They, however, fell on a year earlier. The analysis of lending standards for 2013 Q2 shows that some non-price criteria eased or were tightened less.

2.1 INTERMEDIATION IN LEK

The intermediation ratio in the Albanian lek maintained the downward trend of Q1 in April and May. At the end of May, loan-to-deposit ratio in lek stood at 43.1%, down by 1.2 percentage points from end-Q1. The lower intermediation ratio in lek during April and May was attributable to the deceleration in lek lending, whereas lek deposits improved their growth rates. The intermediation ratio in lek stood about 1.3 percentage points higher, y-o-y.

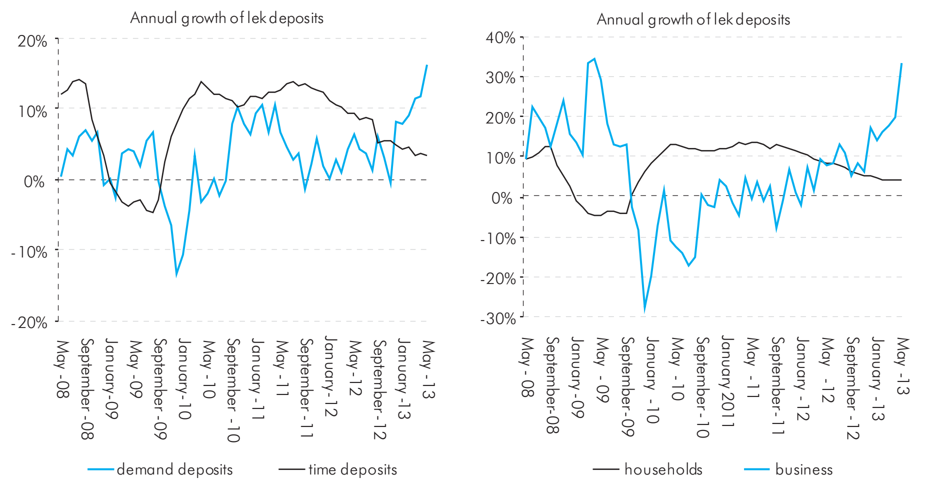
Chart 3. Intermediation in Lek



Source: Bank of Albania.

Lek deposits showed better performance than in the previous quarter, registering an annual growth of 5.6% in May, from 4.8% at the end of March. The higher creation of lek was primarily driven by the growing public sector demand for borrowing and lek lending to the private sector, albeit to a lower degree. In absolute terms, lek deposits grew by about ALL 14.2 billion during this period. The positive performance of lek deposits was driven by both household and business deposits. The latter, however, showed higher volatility during the year. By term to maturity, both time and demand deposits made an almost equal contribution over the period under review.

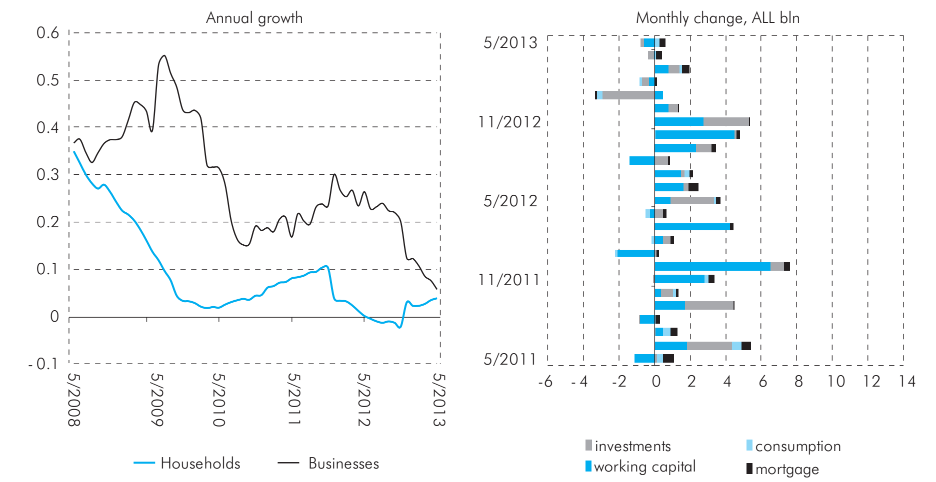
Chart 4. Lek deposits by economic agents and term to maturity



Source: Bank of Albania.

Lending in lek, the main driver of credit growth in 2012, has slowed down markedly since early 2013. After the registered fall in Q1, it grew by only ALL 0.4 billion in April and May. Lending in lek grew at an annualised rate of 9% in May, down by 2.2 percentage points from 2013 Q1 and reducing by half from a year earlier. The deceleration in lek lending was attributable to the sluggish performance of business lending, whereas lek lending to households improved during 2013.

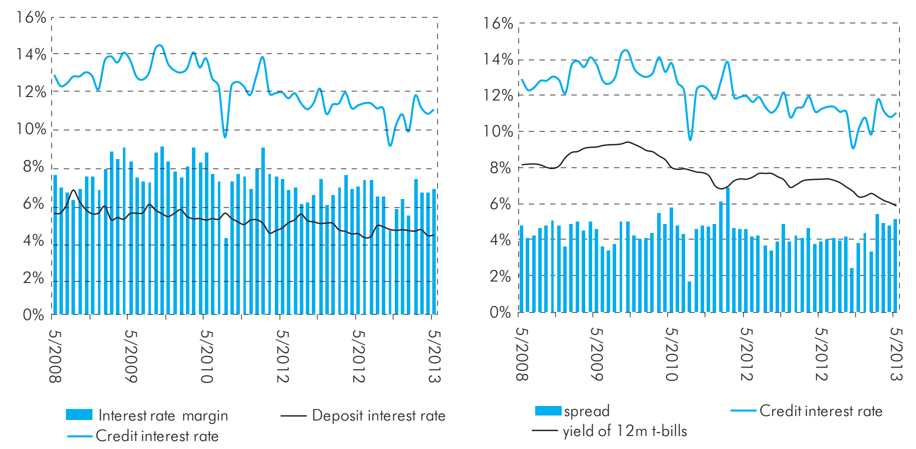
Chart 5. Lending in lek



Source: Bank of Albania.

The intermediation cost in lek increased slightly to 6.67 percentage points in April and May, or 0.3 percentage points higher than the first quarter's average. This increase was attributable to the similar decrease in the average deposit rate to 4.3%. Average lending rates remained unchanged at 10.9%. The intermediation cost dropped by about 0.3 percentage points y-o-y, primarily due to the lower loan rates.

Chart 6. Intermediation cost in Lek*



Source: Bank of Albania.

*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).

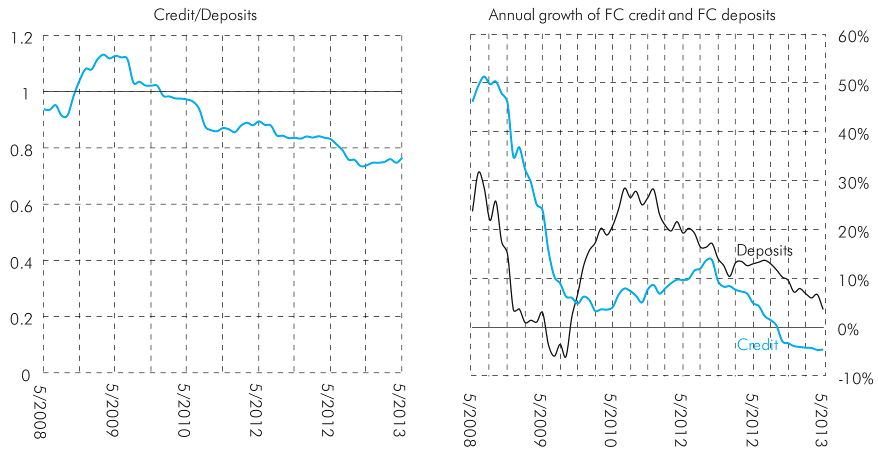
Loan rates did not show similar performance to Government security yields; indeed, their spread increased in April and May. Given the stable loan rates, the decrease in the 12-month yield by 0.4 percentage points on average was reflected in the similar increase of the spread. From a longer-term perspective, their spread widened as the loan rates did not fall at a rate similar to Government security yields.

2.2 INTERMEDIATION IN FOREIGN CURRENCY

The intermediation ratio in foreign currency maintained a similar performance to the previous quarter, driven by the moderate financial activity in foreign currency during the period. The lower foreign currency lending to private economic agents, coupled with the reduced foreign inflows from abroad, were the main factors behind the low creation of foreign currency in the Albanian economy. On the liability-side of the banking system, this performance was translated into lower net inflows of foreign currency deposits. The reduced banks' foreign currency liabilities have also reflected the placement of household savings with non-bank financial institutions.

Loan-to-deposit ratio in foreign currency stood at about 76.6% in May, from 76.1% at end-Q1. This slight improvement has reflected the lower contraction in foreign currency loan portfolio vis-à-vis the higher reduction of net foreign currency deposit flows during April and May.

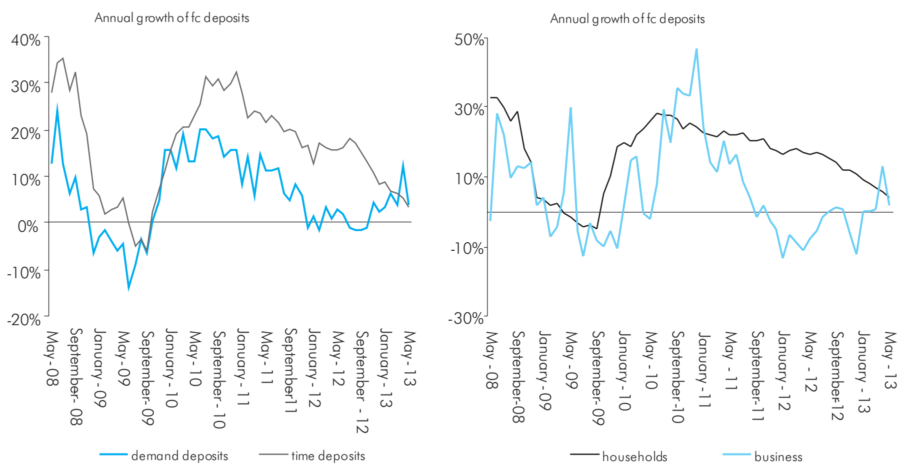
Chart 7. Intermediation in foreign currency



Source: Bank of Albania.

Foreign currency deposits increased at lower rates than in 2013 Q1. Despite the 6.7% growth rate in April, due to a temporary event, the annual growth rate of foreign currency deposits slowed down to 3.7% in May. In absolute terms, foreign currency deposits fell by about ALL 6 billion during this period. In addition to a temporary phenomenon in April, the last months saw the shift of household savings in foreign currency from deposits held with the banking system to other forms of investment with other financial institutions. Business deposits provided major contribution to the growth of deposits during this period - mostly concentrated in April. By term to maturity, business deposits saw a shift toward demand deposits. Household deposits in foreign currency fell in April and May, with major impact on time deposits.

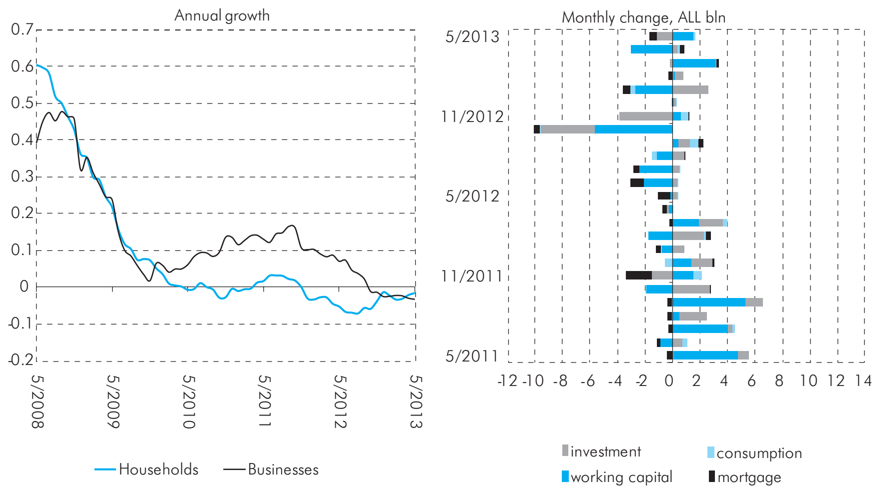
Chart 8. Foreign currency deposits by term to maturity and economic agents



Source: Bank of Albania.

Lending in foreign currency continued to show poor performance in April and May. Outstanding loans shrank by about ALL 2.2 billion in these two months, affecting mostly business loans (investment and working capital loans). Lending in foreign currency continued to shrink at a faster annual rate. At the end of May, it was 4.6% lower, y-o-y. In addition to the low demand and tight lending standards, the poor performance of lending in foreign currency was also driven by the exceptionally low demand for investment loans and shifting of borrowers' preference from foreign currency to the Albanian lek.

Chart 9. Lending in foreign currency



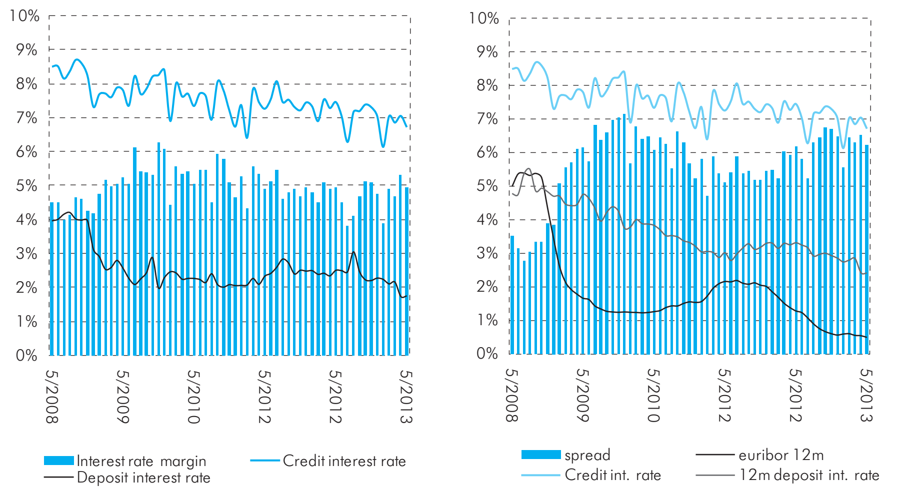
Source: Bank of Albania.

The intermediation cost in euro[1] showed progressive volatility. In April and May, it averaged 5.12 percentage points, up by 0.6 percentage points, driven by the increase in the loan rate and the higher decrease in the deposit rate. From a longer-term perspective, interest rates on euro loans decreased by 0.4 percentage points over the last 12 months. However, deposit rates have decreased to a higher degree, hence resulting in a higher intermediation cost relative to the previous year.

The downward trend of euro deposit rates in the Albanian market was also reflected in the narrowing of their spread to euro rates in the European market. The spread between 12-month euro deposit and 12-month euribor averaged 1.9 percentage points in April and May, from 2.2 percentage points in 2013 Q1. Despite this fact, euro deposit rates remained high in Albania as a reflection of the structural liquidity characteristics in the market yielding, therefore, high interest rates on euro loans.

[1] *Banks' foreign currency operations are dominated by those in euro, accounting for more than 80% of foreign currency operations.*

Chart 10. Intermediation cost in euro



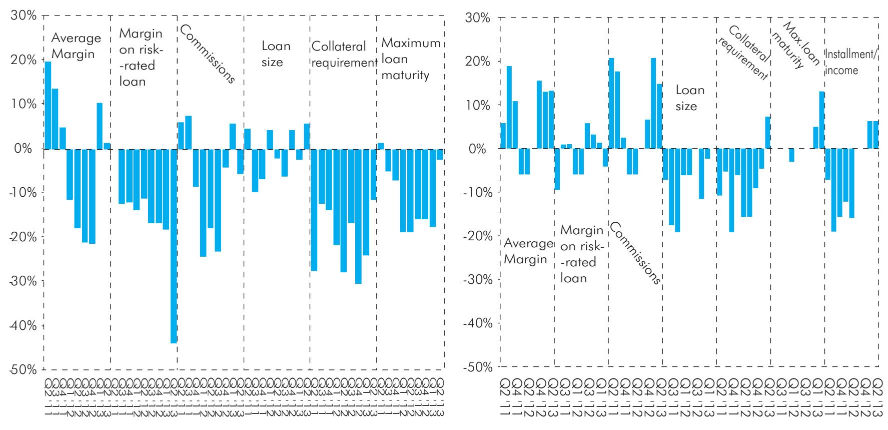
Source: Bank of Albania.

3. NON-PRICE CRITERIA IN INTERMEDIATION

Banks reported further tightening of lending standards applied to businesses for all market segments in 2013 Q2. On the other hand, the lending standards applied to households continued to ease both on mortgage and consumer loans. Relative to the previous quarters, a considerable portion of non-price criteria eased or provided less contribution to tightening in Q2.

The lending standards applied to businesses in 2013 Q2 tightened to the same degree as in Q1. However, unlike the previous quarters, the lending standards were mainly tightened on price criteria, whereas non-price ones eased or were tightened less. More specifically, collateral requirements and maximum term to maturity were tightened less than in the previous months, whereas the loan amount criteria eased.

Chart 11. Lending standards applied to businesses (left) and households (right)*



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

After easing marginally in 2013 Q1, the lending standards applied to households eased further in Q2. In addition to the price criteria (interest rate, commissions), almost all non-price criteria eased during this period. The maximum term to maturity and cost/income ratio eased further for the second quarter in a row. Collateral requirements also eased in Q2, whereas maximum loan amount had a neutral effect.