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

# ANALYSIS OF FINANCIAL INTERMEDIATION

2013 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.*

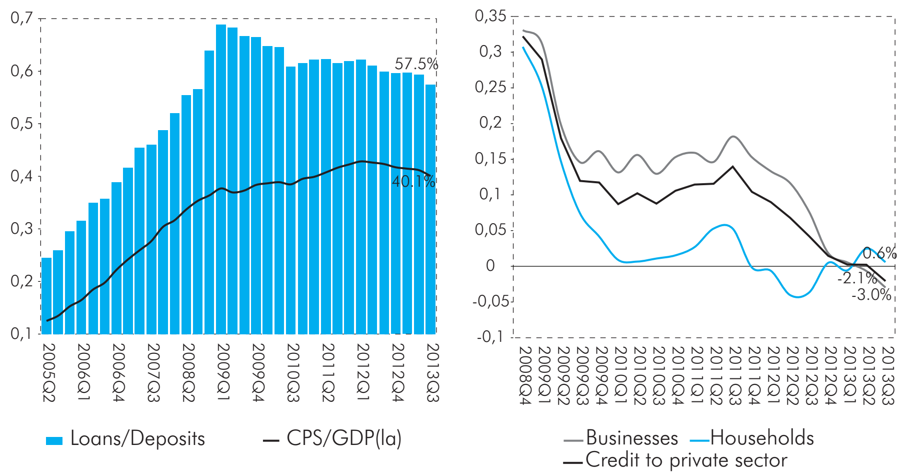
# C O N T E N T S

# 1. BANKS AND INTERMEDIATION ACTIVITY

The banking system is the most developed and dominant financial sector segment in Albania. As of the end of August 2013, its assets accounted for about 93% of total assets of financial institutions operating in Albania, hence maintaining a similar level to 2012. The ratio of banking system assets to GDP stood at 95.6%, up about 2 percentage points from 2013 Q2. Banking sector domination of financial markets makes the former the main segment contributing to the financial development and transmission of monetary policy decisions to the economy and inflation. Its response to macroeconomic conditions and perceived risk, in particular, plays a special and important role in Albania's macroeconomic stability. As in other countries, Albanian economic policy-makers' attention, after the global financial crisis, turned back to the conventional functioning of banking institutions and their support to recovering the economies.

The third quarter of 2013 saw lower banking system intermediation in Albania, reflecting not only the sluggish cyclical performance of economic activity, but also banks' cleaning up their balance sheets from non-performing loans. The latter seems to have prompted the loan portfolio shrinkage, making, in turn, the weakness in private sector demand for borrowing even more pronounced. In August, banks' loan portfolio was about 2% lower than a year earlier, with its growth rates moving into negative territory after July. If we exclude banks cleaning up their balance sheets, the annual fall of private sector credit would be 0.6%. After the positive growth rates at the end of 2013

Chart 1 Banking system intermediation figures (lending)



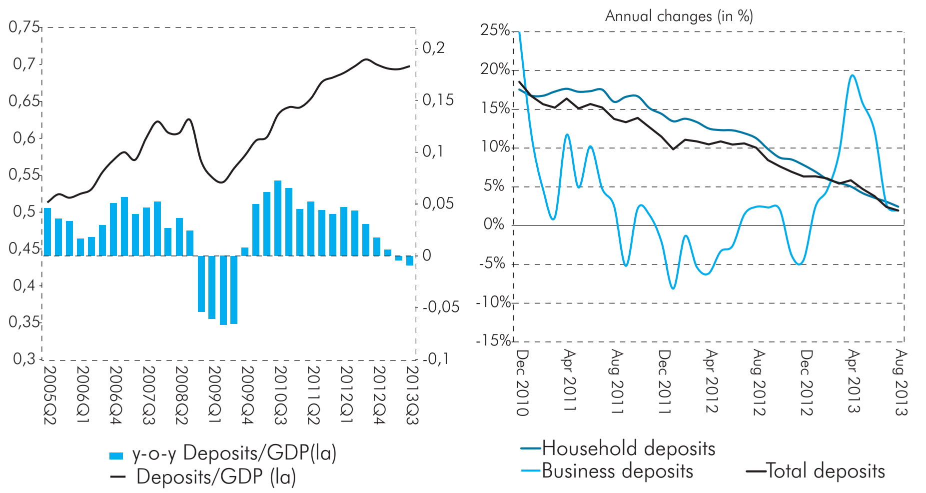

Source: Bank of Albania.

Q2, new loans[1] restored the annual negative rates of around 10% in July and August, hence confirming the sluggish household and business demand for borrowing.

Credit-to-GDP ratio was estimated at around 40% at the end of August, or 1.2 percentage points lower y-o-y, driven by the significant shrinkage of the loan portfolio in the last two months. On the other hand, the growth rates of economic activity in Albania have slowed down and currently stand markedly below potential. This performance, coupled with the high perceived uncertainty of economic agents, generated lower demand for borrowing. In parallel with these developments, the banking system remained highly selective in financing projects, despite its sound profitability and capital figures.

The significant shrinkage in lending was also followed by lower money creation in the economy. In addition, foreign inflows reduced, triggering as such the weak performance of foreign currency deposits, particularly in 2013 Q3. This performance has led to slower growth rates in deposits, yielding in turn lower deposit-to-GDP ratio. The latter was estimated at 69.8% in August, from 70.7% a year earlier. However, the reduction in the deposit-to-GDP ratio across 2013 has been volatile and more moderate than the credit-to-GDP ratio, due to the more active role of banks in collecting deposits, and money creation through bank lending to the Government.

Chart 2 Banking system intermediation figures (deposits)




Source: Bank of Albania.

In August, total deposits were 1.9% higher than a year earlier, hence maintaining the decelerating trend shown since summer 2012. Deposits grew ALL 17.3 billion from end-2012, driven primarily by the increase in household lek deposits and business demand deposits. The latter seem to have also reflected the increased fiscal sector activity. The annual growth rates of household deposits maintained the downward trend. This performance

[1] *New loans disbursed over the months are used to proxy customer demand for borrowing from the banking system.*

has reflected not only the contraction of disposable income, but also the lower remittance inflows.[2] The shifting of savings toward non-bank financial institutions was less present than in the first half of the year.

In parallel with these developments, loan-to-deposit ratio continued to shrink. As of the end of August, it dropped to 57.5%, from 59% at the end of Q2, or about 2 percentage points lower y-o-y.

Besides the factors relating to economic activity in Albania, the performance of banking intermediation has also reflected banks' strategies. The Albanian banking system is dominated by foreign-owned banks, which account for about 90% of the total 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 July and August, financial intermediation by banking groups confirmed the last two-three years' performance.

[2] *Second-quarter data show that remittances recorded sharp contraction (-39%) from a year earlier.*

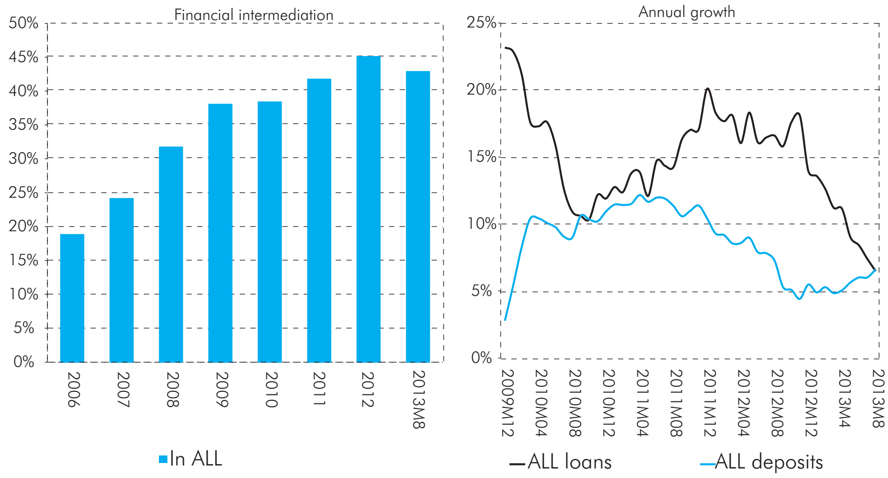
# 2. INTERMEDIATION

Intermediation in lek and foreign currency contracted in July and August, due to the loan portfolio performance. The contraction was sharper in foreign currency intermediation. Banks remained conservative in their lending policies, driven by both domestic and external factors. The intermediation margins were volatile due to the preferential and selective bank policies for individual clients. From a longer-term perspective, they have remained broadly unchanged, thus limiting the transmission of the easing monetary signals to the credit channel, and further on to the economy and inflation.

## 2.1 INTERMEDIATION IN LEK

In July and August, the intermediation ratio in the Albanian lek maintained the downward trend of 2013 Q2. As of the end of August, loan-to-deposit ratio in lek stood at 42.9%, down by 0.4 percentage points from end-Q2. The lower intermediation ratio in lek during July and August was, on the one hand, attributable to the marked slowdown of lek credit growth rates and, on the other hand, to the improved growth rates of lek deposits during this period. It, however, remained unchanged from a year earlier.

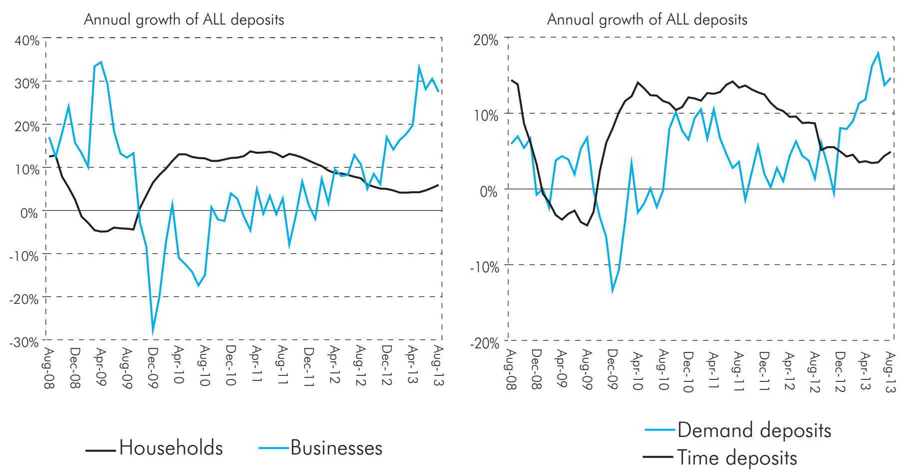
Chart 3 Intermediation in lek




Source: Bank of Albania.

In 2013 Q3, lek deposits continued to pursue an increasing trajectory in annual terms. As of the end of August, total deposits were 6.6% higher than a year earlier, driven by the higher money creation in lek, which was attributable to the added Government activity in the domestic market and higher lending to the private sector in lek than in foreign currency. However, the performance of lek deposits in shorter terms provides evidence for their contraction in July and lower growth in August. As of the end of this period, the deposit stock was about ALL 0.3 billion higher than in June. This performance was driven by the contracted fiscal activity during these months compared to 2013 Q2. It was also partly attributable to the lower bank lending to private economic agents in lek over the same period. Business time deposits, which are generally highly volatile, made positive contribution to increasing lek deposits. In the meantime, household deposits shifted to lower terms to maturity.

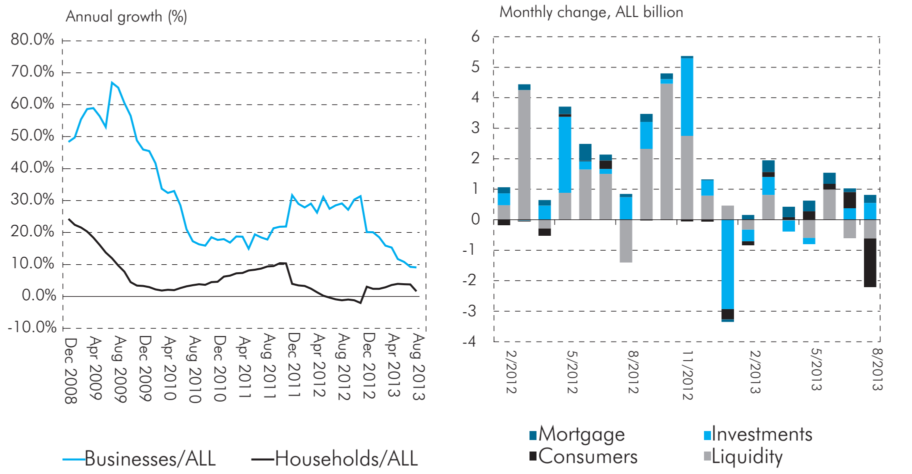
Chart 4 Lek deposits by economic agents and term to maturity




Source: Bank of Albania.

As of the end of August, lending in lek accounted for 39.2% of total lending, hence continuing to increase its share in the banking system's portfolio. However, the growth rates of this portfolio have been decelerating across 2013, down to 6.5% in August, from 8.4% and 14% at end-Q2 and end-2012. Relative to the end of June 2013, outstanding loans in lek were about ALL 1.6 billion less in August. The deceleration of lending in lek, in August in particular, reflected the lower growth rates in consumer loans. This also reflected banks' write-off of loans with no hope of recovery. Lending to businesses in lek maintained stable annual growth rates, at 9.4%. The slower pace of investment loans in lek was offset by the higher growth rate of working capital loans.

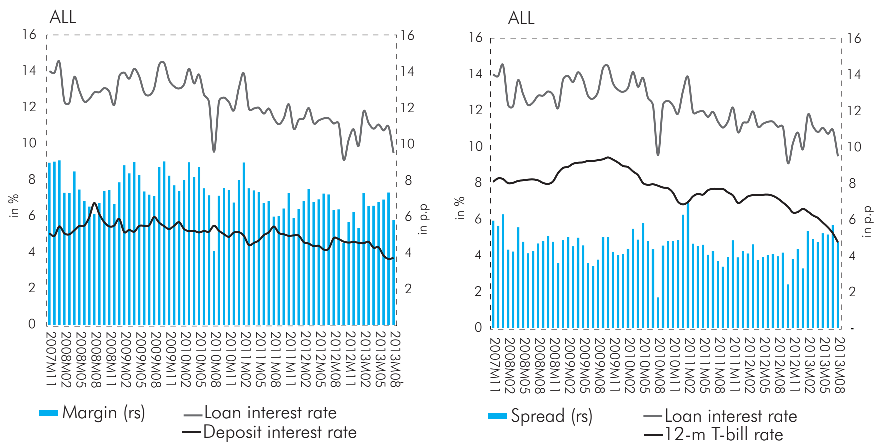
Chart 5 Lending in lek




Source: Bank of Albania.

The intermediation cost in lek showed an upward tendency until July, peaking at 7.3 percentage points for 2013, and then reducing markedly to 5.8 percentage points in August. This performance was attributable to the continuous decrease in deposit rates across the year, while the average interest rate on lek loans was stable at around 11% until July. In August, the average lek deposit rate of 3.7% was accompanied by a sharp fall in the loan rate to 9.48%, which drove the narrowing of the intermediation margin. As of the end of August, the latter was 0.5 percentage points lower y-o-y. However, the interest rate on loans was slightly exposed to one bank's preferential rates applied to individual clients, being pushed by the low level of disbursed loans. If we exclude the performance of rates in August, the average intermediation cost would be slightly higher than the past year's average.

Chart 6 Intermediation cost in lek*




Source: Bank of Albania.

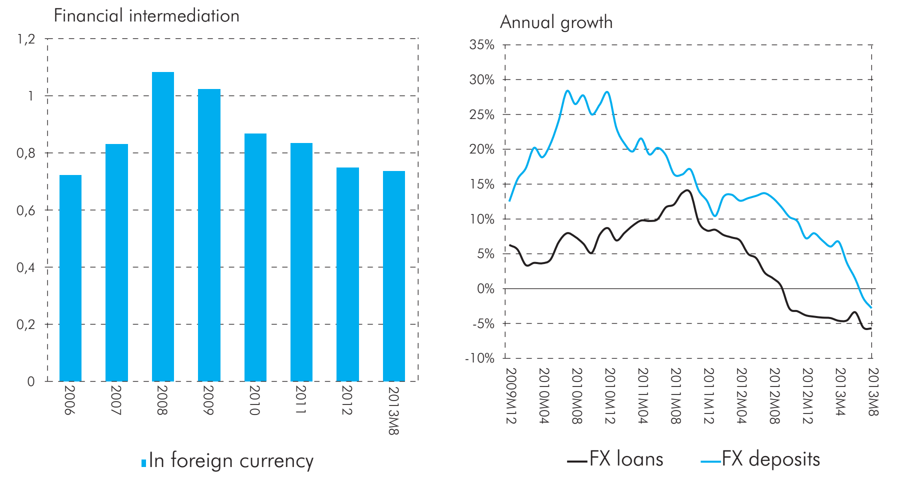
*The margin is calculated as the spread between loan and deposit interest rates. The spread is calculated as the difference between loan/deposit interest rate and the reference rate (12-month T-bill yield for the lek and 12-month euribor for the euro).

Interest rates on lek loans are generally indexed to the 12-month T-bill rate. In July and August, the latter pursued the downtrend begun from early 2013, but at a more accelerated pace. It dropped to 4.73%, falling by 0.83 percentage points in two months. In addition to the lower Government demand for borrowing, this performance also reflected the key interest rate cut by 0.25 percentage points in July. Interest rates on lek loans dropped sharply only in August, being was also reflected in the narrower spread between loan rates and T-bill yield. As of the end of August, this spread stood at 4.75 percentage points, from 5.2 percentage points it averaged in 2013 Q2. In average terms for the entire year, the spread was 0.93 percentage points higher than the average of 2012, as the loan rates did not fall at the same pace as Government securities yields.

## 2.2 INTERMEDIATION IN FOREIGN CURRENCY

The intermediation ratio in foreign currency fell to 73.7% in 2013 Q3, or 1.3 percentage points lower than at end-2012. This fall was driven by the moderate financial activity in foreign currency during this 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.

Chart 7 Intermediation in foreign currency

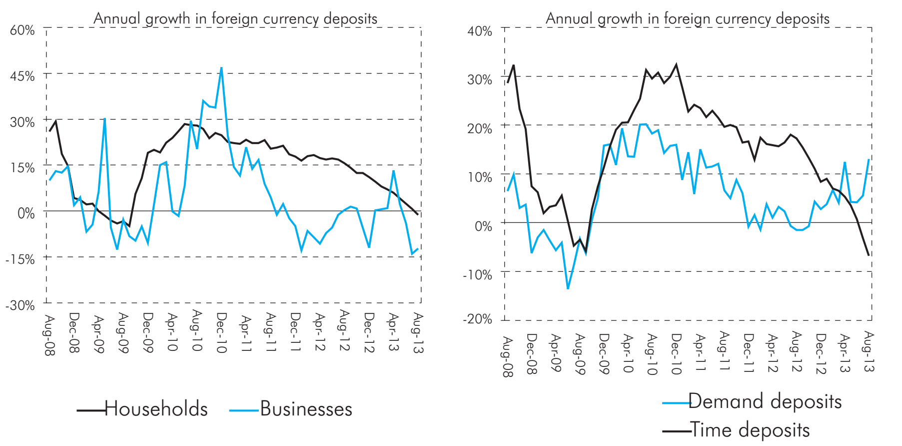



Source: Bank of Albania.

In July and August, foreign currency deposits fell by 1.4% and 2.8%, respectively, in annual terms. The low creation of foreign currency was also impacted by the reduced foreign currency lending to the private sector and slower foreign flows from the external sector of the economy. In the meantime, foreign currency deposit stock increased in August, thus partly offsetting their fall over the year. This performance was driven by their seasonal behaviour during this period, attributable to the foreign inflows in the form of remittances. It was reflected in the increase in foreign currency household deposits, and mainly in demand ones. Foreign currency business deposits increased in

2013 Q3, particularly in August, in line with the seasonal developments during this part of the year. This performance was largely attributable to the higher activity in tourism-related businesses. The maturity structure of foreign currency deposits, similar to that in lek, shows their shift to shorter maturity, implying growing economic agents' need for more liquid assets.

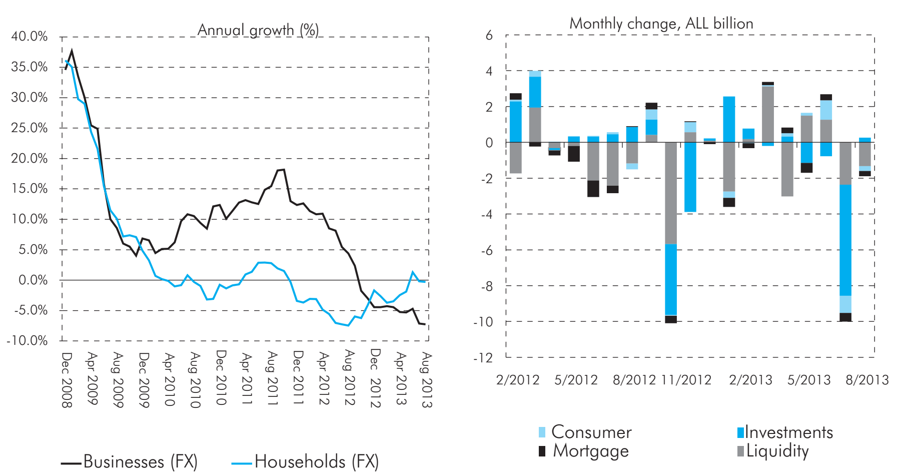
Chart 8 Foreign currency deposits by economic agents and term to maturity




Source: Bank of Albania.

As of the end of August, foreign currency loans were about ALL 9 billion lower than at end-2012. The annual change in the loan portfolio deepened further to -5.7% due to the sharp fall in foreign currency business loans. In addition to the weak economic agents' demand for loans, in particular for investment loans, the negative lending figures also reflected banks' clean-up of their balance sheets from non-performing loans. In parallel with these developments, the lending standards - particularly those applied to business loans - remained tight. This performance seems to have also been driven by banks' policies to lend their clients in the same currency as their income.

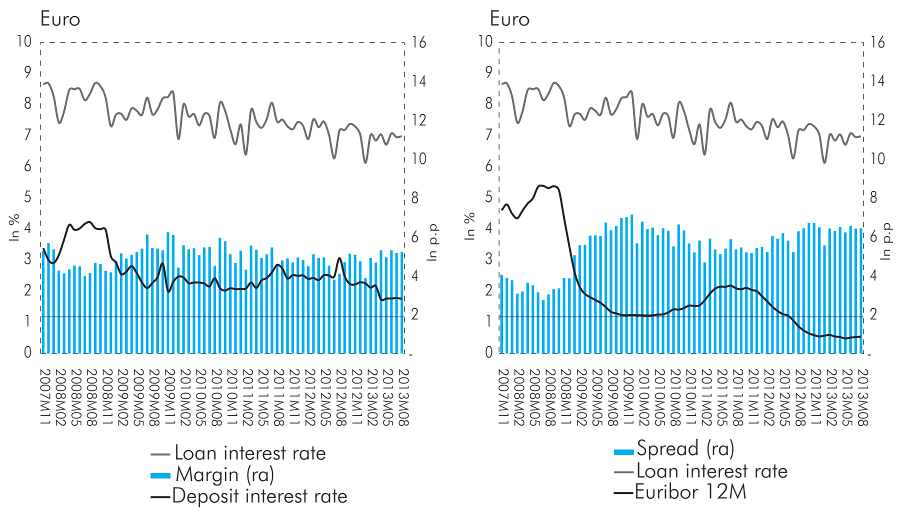
Chart 9 Lending in foreign currency




Source: Bank of Albania.

The intermediation cost in euro[3] remained volatile during 2013 Q3. In July and August, it averaged 5.2 percentage points, remaining close to second-quarter levels. The average euro deposit rate of 1.76% pursued a slight decreasing tendency in 2013 Q3. As of the end of August, it was about 0.7 percentage points lower than a year earlier. For the same period, interest rates on euro loans of about 7% dropped by 0.3 percentage points. The drop in euro deposit rates at a faster pace than that in loan rates increased the intermediation cost in foreign currency by about 0.5 percentage points from the past year's average.

Chart 10 Intermediation cost in euro




Source: Bank of Albania.

The spread between euro loan rate and euribor rate in the international markets widened from a year earlier, due to the high euro loan rates and the low euribor rates.

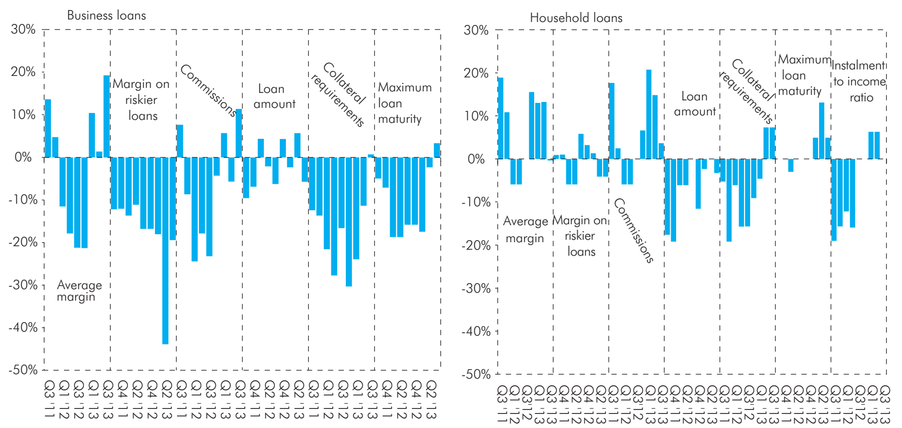
[3] *Banks' foreign currency operations are dominated by those in euro, accounting for more than 80% of activity in foreign currency.*

# 3. LENDING STANDARDS

The lending standards applied to businesses and households remained tight in 2013 Q3, both in terms of price (interest rates and commissions) and non-price criteria.

In 2013 Q3, banks reported that they kept tight lending standards for businesses. This approach reflected their concerns over the macroeconomic situation in Albania - in particular the risk in individual sectors of the economy - and the high level of non-performing loans. Banks applied their tight lending policy mainly by widening the margin on risk-rated loans and reducing the loan amount. On the other hand, they slightly eased the lending standards by narrowing the average margin, reducing the collateral requirements in proportion to the loan amount, lowering commissions and extending the maximum loan maturity.

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




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

Banks reported that they slightly tightened the lending standards applied to households in 2013 Q3, attributable to their concerns over the overall macroeconomic situation and the non-performing loan portfolio, in particular. They applied their tight lending policy on households mainly by widening the margin on risk-rated loans and reducing the loan amount. The rest of the lending standards did not change or were slightly eased.