Bank of Albania

FINANCIAL INTERMEDIATION ANALYSIS

2014 Q1

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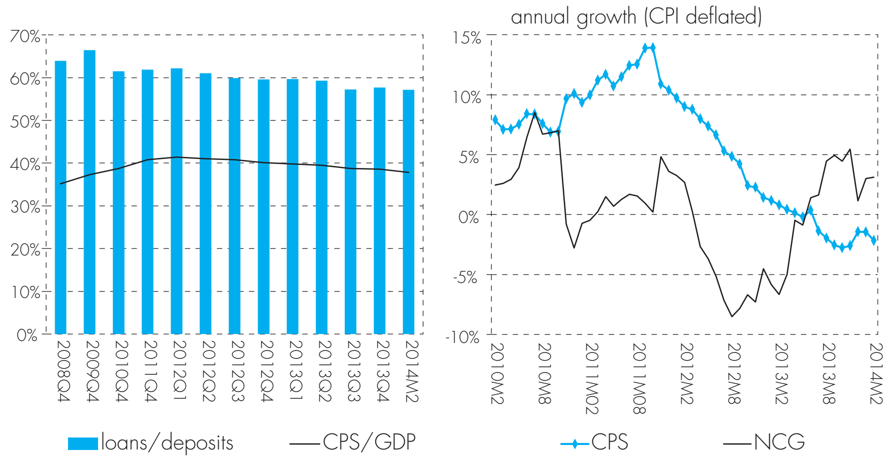
The views expressed herein are solely of the authors and do not necessarily reflect those of the Bank of Albania.

C O N T E N T S

1. FINANCIAL SECTOR AND BANKS

The activity of commercial banks dominates the financial system in Albania, being the main player in financial intermediation in the economy. As at end-December 2013, banking system assets accounted for about 91.3% of total financial assets, compared to 92% at end-September. In addition to the banking sector, other financial institutions' role in the growth of the Albanian financial system has been upward. Their activity was mainly focused on the intermediation with funds of the fiscal deficit and attracted the interest of economic agents at home. The interest of households increased mainly due to two main developments. The launch in 2013 of a private investment fund and new financial instruments at longer maturity terms provided for the diversification of households' financial portfolio. Also, the implementation of an easing monetary policy by the monetary authority and its full transmission to the deposit market contributed to households shifting a part of their savings held with banks to longer-term and more favourable interest rate instruments.

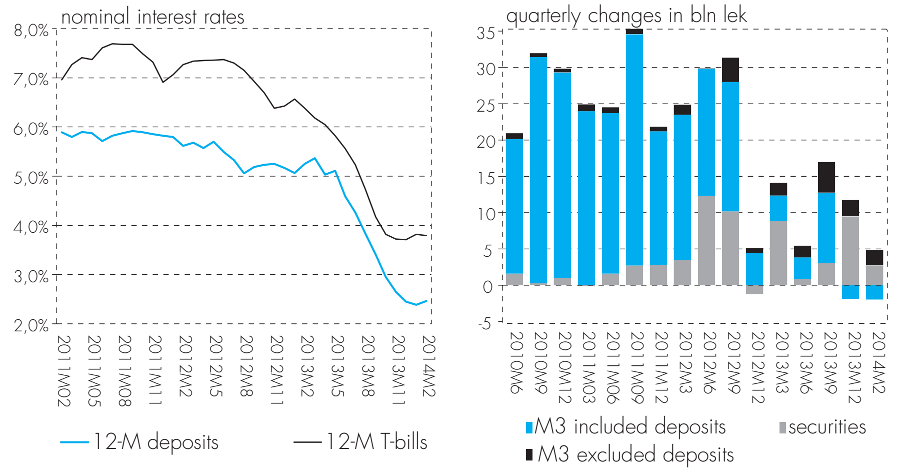
Chart 1 Intermediation ratio



Source: Bank of Albania.

As at end-February, 57.1% of total deposit stock in the banking system was intermediated as credit to economy. Intermediation was down compared to December 2013. Credit outstanding to deposit ratio was 57.7%, down about 2 percentage points compared to the previous year. The sluggish lending to private sector, owing to both low demand and still tight supply by banks, conditioned the banking sector intermediation. Slow economic activity and weak consumption, together with lower investments by businesses during this period, determined the private sector low demand for financing. Also, banks continued to implement prudent lending policies. Notwithstanding the easing standards to certain market segments and the stimulating monetary policy, the high interest rates continue to reflect the high risk premium. In addition to lower flows of new loans granted during this period, the credit stock reduction was also influenced by considerable settlements of the portfolio and partially by banks'writing off their bad loans from their balance sheets.

Chart 2 Financial instruments interest rates; annual stock changes to households



Source: Bank of Albania.

The lower lending activity by banks led to lower money creation in the economy. Deposits slowed down their increasing rate in January and February. At the end of the period, their total stock was about 1.4% higher than in the previous year, reflecting, among other things, the partial shift of deposits to other forms of savings outside the banking system, and the lower foreign currency inflows during the period under review. Meanwhile, deposits not included in the broad money[1] recorded faster growth during the last months, confirming households'preference for shifting deposits to longer maturities. Deposit ratio to GDP at end of December[2] was 70.1%, recording a slight fall from the previous year.

[1] *In our materials and reports, we refer to analyses of the stock of deposits included in calculating the broad money, which, according to International Monetary Fund's definition consists in two-year time deposits and excludes the time deposits with maturity of over two years.*

[2] *According to an approximate estimation on nominal GDP, which is based on INSTAT's figure of GDP and Monetary Policy Department's calculations.*

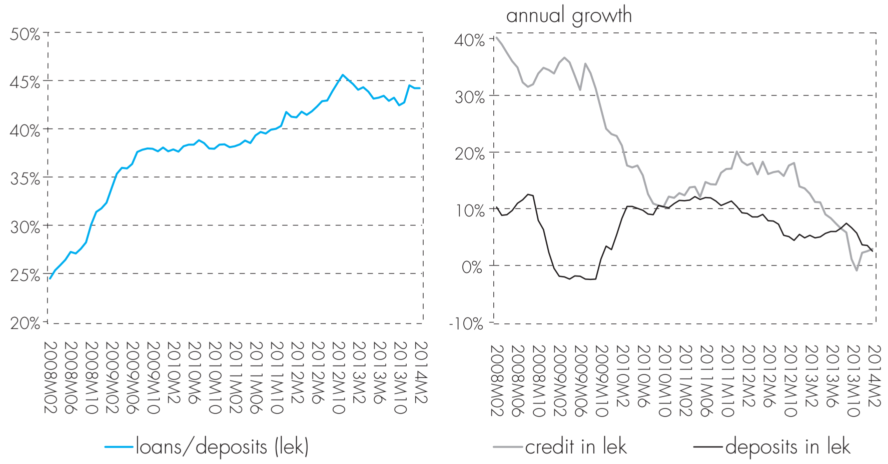
2. FINANCIAL INTERMEDIATION IN THE BANKING SYSTEM

In January and February, intermediation by the banking system maintained almost the same rates, averagely, compared to the past quarter. The seasonal increase of lending in December and the reduction in deposits stock in the last quarter drove intermediation up at the end of the previous year. Intermediation rates fell gradually in January and February compared to the end of 2013, while deposits stock reduced at a lower rate during this period. Loan increase in December was temporary and credit outstanding shrank further in the following months. These developments determined the downward intermediation against the last month of the year, thus maintaining, averagely, the last quarter's rates.

2.1 INTERMEDIATION IN LEK

In January and February, intermediation by the banking system in lek maintained the upward trend noted at the end of the past quarter. As at end-February, loan-to-stock deposit ratio in lek in the economy was 44.2%, about 1 percentage point higher than the average of the previous quarter. This ratio was attributable to the better lending in lek compared to lending in foreign currency, which is affected by both supply and demand factors. The eased monetary policy implemented by the Bank of Albania contributed to reducing lek lending costs, while economic agents are more aware related to exposure against exchange rate and, consequently, more attracted to lek credit. In the meantime lek deposits improved, thus mitigating the reduction, in monthly terms, compared to the past quarter.

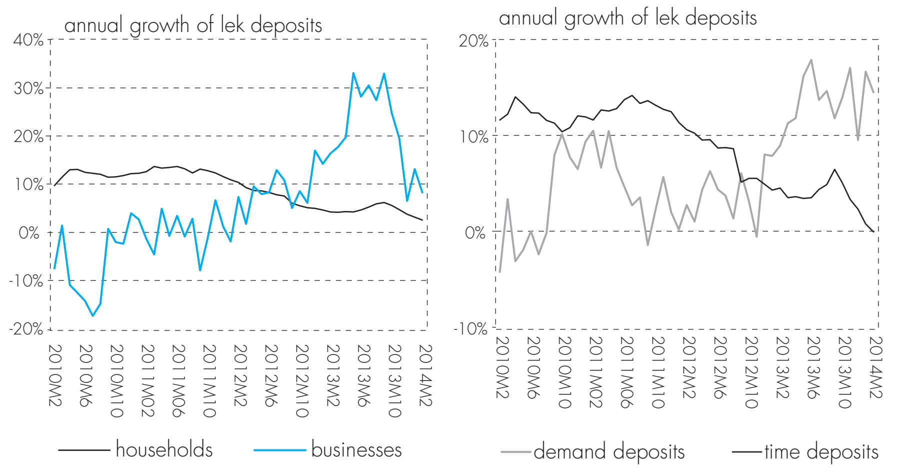
Chart 3 Intermediation in lek



Source: Bank of Albania.

Lek deposits, as at end-February, recorded an annual growth rate of 2.5%, from 3.7% at end-2013. Lek deposit performance shows that less money is created in the domestic currency, and indicates the form in which households hold their savings. A shift of deposits to two-year maturity term, which are excluded from the broad money deposits stock, and to other non-bank financial instruments that also provide higher maturities and more favourable interest rates, is noted during the period under review. Demand deposits in lek increased at rapid paces, while outstanding time deposits were almost at the same level of the previous year. Households' deposits maintained the positive growth rate, albeit showing a slowdown since October. As at end of February, households' deposits in lek recorded an annual growth rate of 2.6%. Meanwhile, businesses' deposits are characterised by a high volatility, reflecting businesses' activity and their short-term needs for liquidity.

Chart 4 Lek deposits annual changes by economic agents and maturity structure

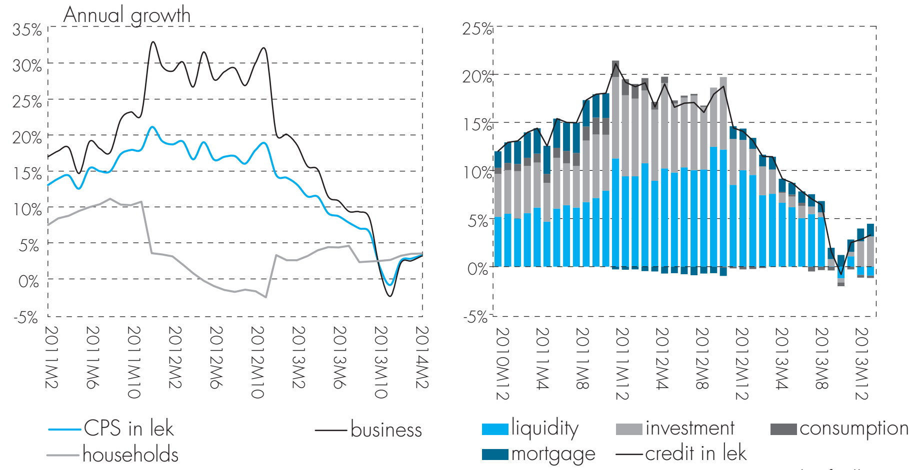


Source: Bank of Albania.

Structure of lending by currency does not differ considerably from end-2013. In January and February, lending in lek increased at positive paces, recording an annual rate of 2.9%, as at end-period. Lek loan share in total stock increased slightly to 40.3%, reflecting the good performance of lek loans to private sector, as at end-February. Its performance was positively affected by the business loan portfolio growth, which was about 3.2% higher as at end-period compared to the previous year. By purpose of use, investment loans increased at fast paces, in annual terms, in January and February, compared to the previous quarter, providing a higher contribution to credit growth. Meanwhile, the slowing lek working capital loans, which had started in the previous quarter, persisted, and outstanding credit fell, as at end-February.

Lek lending to households performed satisfactorily in January and February, maintaining the positive growth rates, and recorded an annual growth of 3.6%, as at end-period. The positive performance of mortgage loans in lek, up by 7.3% at end-February, determined the developments in this portfolio. The upward rate reflected the promotional products of banks to this market segment, through attractive packages and favourable interest rates. Meanwhile, the annual contraction rate of consumer loan to households slowed down and resulted almost unchanged from end-2013.

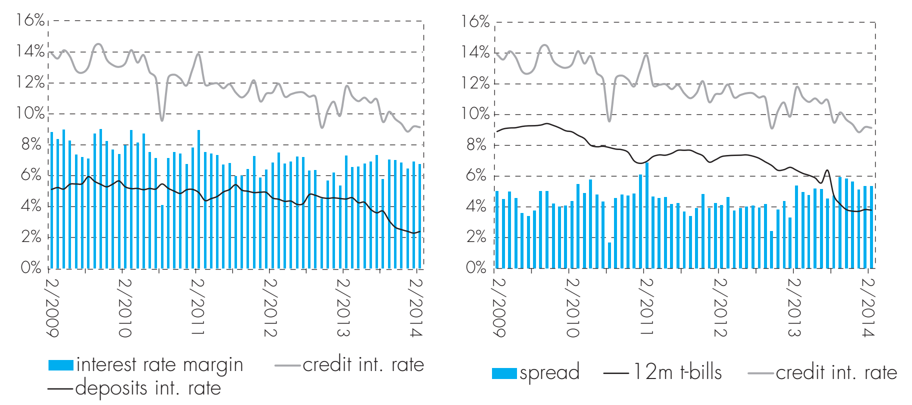
Chart 5 Lending in lek to private sector by economic agents; annual contribution by purpose of loan



Source: Bank of Albania.

Intermediation cost in lek increased again slightly in the first two months of 2014, averaging 6.83 percentage points, from 6.77 percentage points in 2013 Q4. Similar to the previous quarters, the reasons behind the uptrend of intermediation cost is the faster decline in deposit interest rates than in loan ones. Interest rate on deposits fell from 2.5% to 2.3% compared to the previous quarter. Interest rate on loan fell from 9.3% to 9.2%.

Chart 6 Intermediation cost in lek*



The margin is calculated as the difference 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 for the lek and 12-month Euribor for the euro).

Source: Bank of Albania.

This performance is more notable when comparing the intermediation cost to the previous year. The average interest rate on loan dropped by 1.77

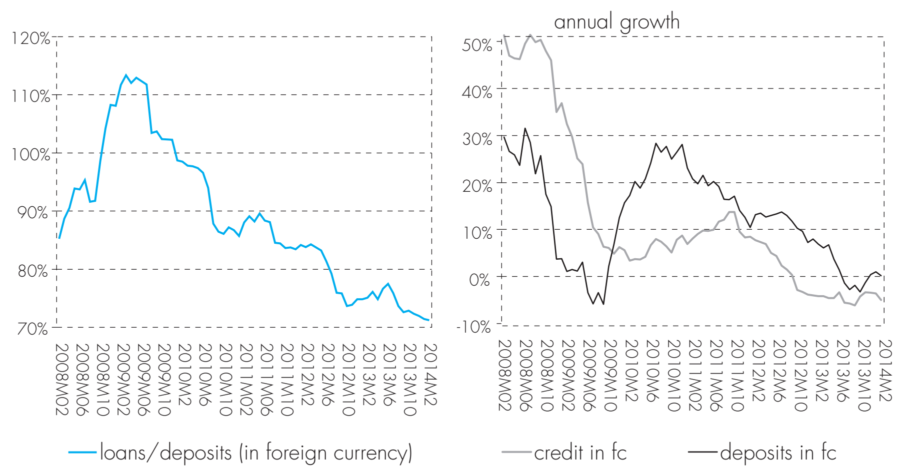
percentage points compared to 2013 Q1, whereas the average interest rate on deposits dropped by 2.19 percentage points. The good liquidity situation in the market has facilitated a rapid transmission of the monetary policy to interest rate on lek deposits. On the other hand, interest rates on lek loans showed higher inertia, thus reflecting the increased risk related to lending to private sector, perceived by banks.

In the first quarter of the year, the reduction of loan interest rate was also reflected in their lower spread to 12-month T-bill yields, which serve as reference rates in setting lek loan interest rate. This spread was 5.36 percentage points, from 5.55 percentage points in the fourth quarter of the previous year. However, T-bills spread remains higher compared to the previous year, reflecting the slower fall of loan interest rates. In 2014 Q1, the 12-month T-bill yield averaged 3.76%, down by 2.62 percentage points from 2013 Q1.

2.2 INTERMEDIATION IN FOREIGN CURRENCY

Intermediation in foreign currency by the banking system dropped. Albeit standing at a higher rate than the lek one, foreign currency loan to deposit ratio fell to 71.2% as at end-February, down by about 0.7 and 3.9 percentage points from a quarter and a year earlier, respectively. This performance mainly reflects the weak lending to private sector, given the anaemic increase of economic activity and still tightened polices applied by banks, particularly to businesses, and the shift of economic agents' preferences for lek borrowing.

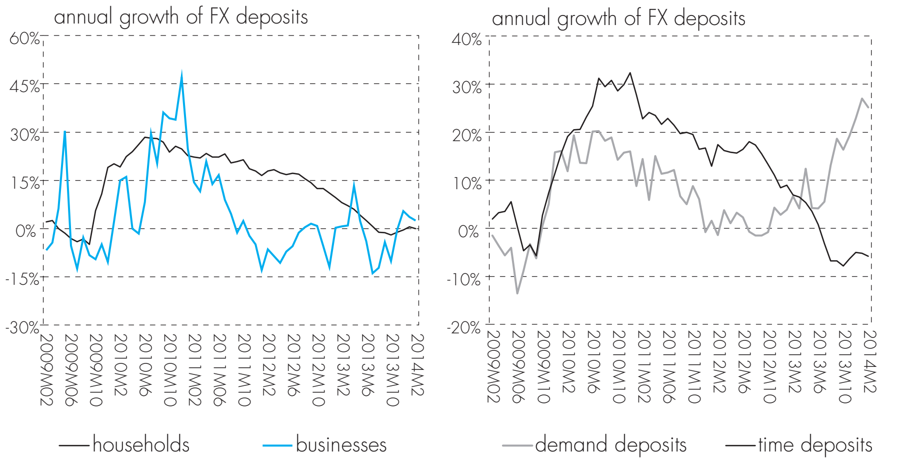
Chart 7 Intermediation in foreign currency



Source: Bank of Albania.

Foreign currency depositing was also sluggish. In February, the annualised total deposit stock remained almost unchanged from the previous year, up by only 0.2%, resembling the weak increase at the end of the past quarter. Low foreign currency inflows and low creation of money in the country were the main drivers of the performance of foreign currency deposits. Short-term developments show a reduction in outstanding deposits during this period, concentrated in February. Excluding the exchange rate effect, which was volatile during the period, this fall was somewhat more moderate. Their maturity structure shows a similar approach to lek deposits, with demand deposits increasing rapidly and time deposits falling. After a fall in annual terms, households' deposits entered a positive territory and at end-February, reached the same level as in the previous year.

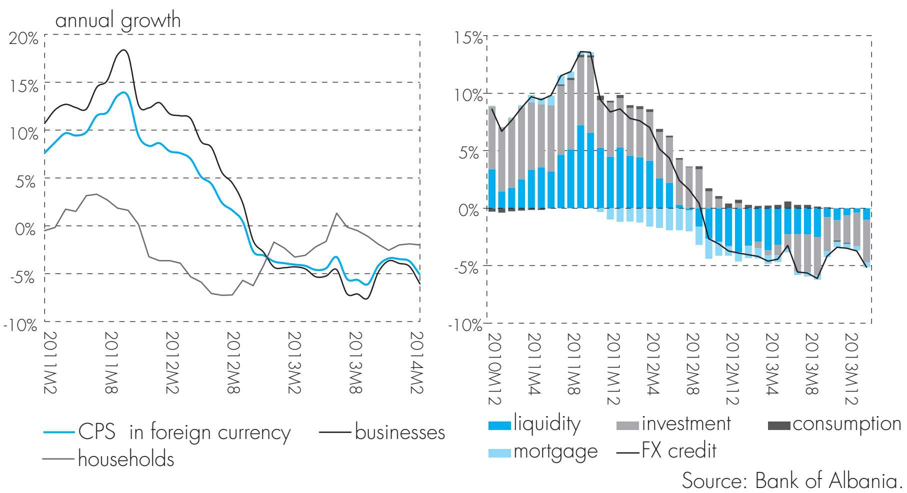
Chart 8 Annual changes of foreign currency deposits by currency and term to maturity



Source: Bank of Albania.

Foreign currency credit outstanding continued to shrink in 2014 Q1, dropping by about 5%, in annual terms, in February. This behaviour has evidenced the further reduction of business financing, whose portfolio dropped further, to about 6.1%, in annual terms. This performance was mainly determined by the reduction of investment loans in foreign currency, which fell considerably, unlike the lek portfolio. Business loans for working capital fell at more moderate pace than for investments.

Chart 9 Foreign currency lending to private sector by economic agents; annual contributions by purpose of use

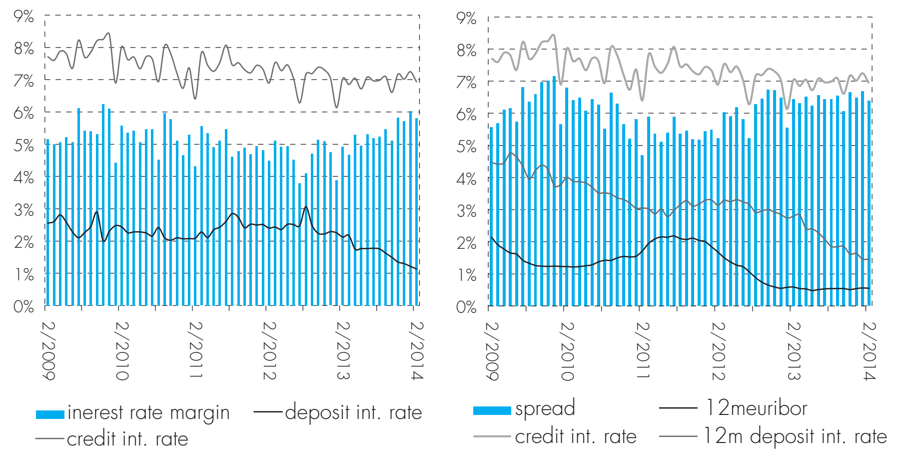


Source: Bank of Albania.

The structure of household loans shows further decline in foreign currency mortgage loan in January and February, standing at -2.1%, at the end of the period. Consumer loan appears more volatile due to the low stock of this loan. Its outstanding slowed the falling rates begun in the last quarter of the previous year.

Intermediation cost in euro[3] continued to increase in January and February 2014, continuing the upward trend begun more than a year ago. It averaged 5.92 percentage points in these two months, from 5.55 percentage points in 2013 Q4. It stands about 1.43 percentage points higher than in the previous year. The increase in euro intermediation cost was mainly driven by the decrease in deposit rates and increase in loan interest rates. Given the ample liquidity and the limited investment possibilities in euro, banks provided an increasingly lower rate for deposits in euro. The average weighted rate of these deposits was 1.18% in the two first months of the current year, down by 0.2 percentage points from the past quarter and 1.0 percentage point from the previous year. This performance is reflected in the narrowing spread between these rates and euro rates in the international markets (Euribor), which fluctuated at stable rates during the past year.

Chart 10 Intermediation cost in euro



Source: Bank of Albania.

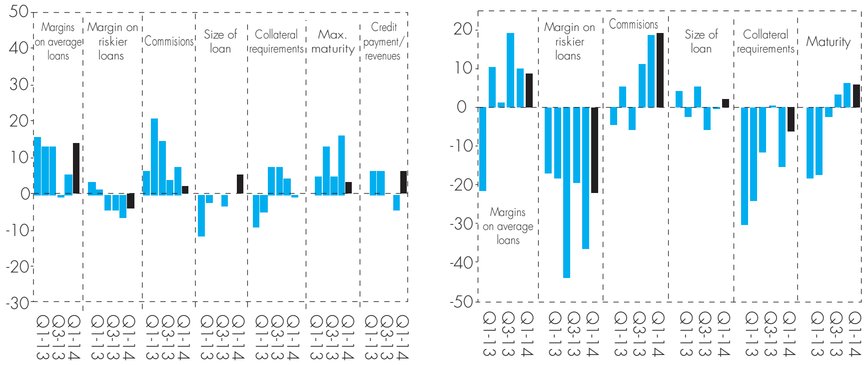
The increase in intermediation cost in euro was impacted by the increase in loan interest rate. It averaged 7.10%, up by 0.16 percentage points and 0.42 percentage points, from the previous quarter and year, respectively. The high interest rate on euro loans reflected banks' high perceived risk, particularly related to long-term investment loans to businesses. The spread between them and the 12-month Euribor rates has fluctuated at 6.4-6.5 percentage points, during the last 12 months.

3 *Banks' foreign currency operations are dominated by those in euro, which account for more than 80% of total foreign currency operations.*

3. LENDING STANDARDS

In first quarter 2014, banks continued to implement different approaches to lending to businesses and households. Thus, they continued to tighten the lending standards applied to businesses, while easing those applied to households. Banks' tight policy was mainly applied through the increase in the interest rate on high risk loans, whereas interest rates on normal risk and commissions were lower. Most non-price criteria on loan acted on the easing side.

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



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

Lending standards applied to businesses tightened further, standing higher from past quarter, reflecting therefore concerns about the overall performance of the economy and of its particular sectors, and the high level of non-performing loans. Among the non-cost loan elements, banks enhanced the collateral requirement, while other elements provided a neutral impact or on the easing side.

The lending standards applied to households eased further in 2014 Q1, lower compared to previous quarter. All non-price criteria acted on easing side, excluding the collateral requirement, which have remained the same in this quarter.