Bank of Albania

TRENDS IN LENDING

2014 Q2

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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

This analysis aims to present a detailed overview of the most recent lending developments in Albania. To this end, the document analyses the monetary data for the loan portfolio by economic agents, and the lending standards. In more details, lending standards will be addressed in both price - interest rate - and non-price terms. In addition, this analysis presents a summary of lending trends in Central East and South East Europe (CESEE) countries. The spillover effects of the global financial crisis in the CESEE countries and its consequences on Albania have often been the subject of our periodic analyses. In this context, regularly updating such information becomes crucial, in order to better understand the impact of both domestic and external factors on the performance of financial indicators in general and of lending in particular.

The main statistics taken into account in this analysis are:

- Monetary data[1] for the volume of bank lending in the two main portfolios, businesses and households.
- Qualitative data from the bank lending survey, with a special focus on analysing lending standards and demand, and the factors affecting them. Moreover, based on survey results, non-price elements are analysed.
- Statistics on credit price, represented by the average interest rate weighted with the amount of new credit, denominated both in lek and in euro. The intermediation margin applied by banks to the cost of funds is also analysed.
- Monetary data on the volume of credit for the countries of the region include data from: Bulgaria (BU), Croatia (CR), Romania (RO), Serbia (SR), Poland (PL), Hungary (HU), the Czech Republic (CZ), and Former Yugoslav Republic of Macedonia (MK).

The analysis covers data published as at 20 July 2014, which include information for monetary and financial data for May 2014 and data from the bank lending survey 2014 Q2.

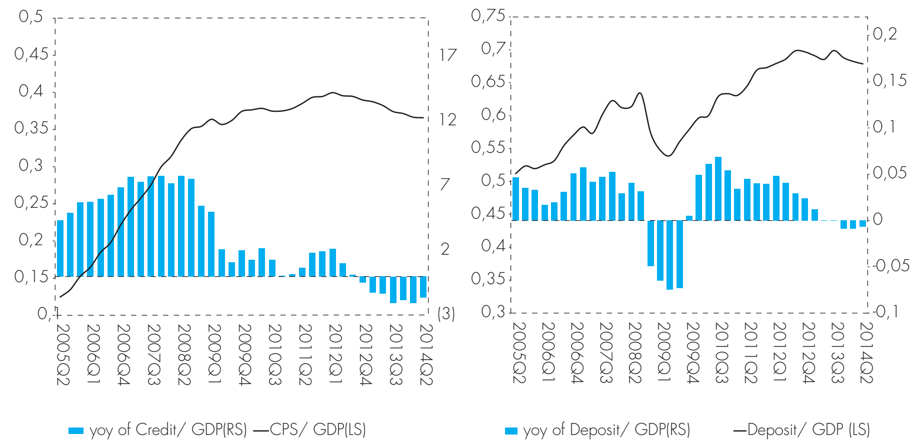
[1] *The monetary methodology is based on the resident and non-resident concept, and loan data include only loans to residents. For more information, refer to "Monetary and Financial Statistics Manual" of the International Monetary Fund, 2000 ed.*

1. BANKS AND INTERMEDIATION

During the second quarter of 2014, the banking system conducted its activity amid a more favourable macroeconomic setting than in the first quarter. Indirect data show that the Gross Domestic Product continued to grow in the second quarter of 2014. Consumer and business confidence has improved and preliminary data point to added trade activity, signalling thus a recovery of consumption. The fiscal authority has pursued a consolidating policy and has paid up most of arrears, contributing to the circulation of liquidity in the economy and improvement of businesses' financial situation. Despite the poor performance of available income, households financial standing has been improving for more than a year. The monetary authority has implemented an accommodative policy, further lowering the key interest rate by 0.25 p.p. to the new 2.5% record low, at the end of May. However, the creation of money in the economy remains sluggish, affected both by the cyclical weakness of the economy and conservative intermediation policies implemented by banks.

As at the end of March 2014, banking system assets accounted for about 90.8% of total financial assets, from 91.3% at the end of 2013 and 92.6% in the same period a year earlier. While banks dominate the financial sector, their share in the total system has been downward, due to the increasing financial activity of non-bank financial institutions. In the meantime, bank assets stand 4.2% higher than in the previous year. Banking activity increased driven by both collection of funds and funding of government needs and placements abroad. The gradual improvement of economic activity at home and of

Chart 1 Lending and deposits against GDP



Source: Bank of Albania.

economic agents' confidence is yet to be reflected in higher credit demand from the private sector. Banking activity was characterised by improved liquidity and profitability, whereas capitalisation ratios remained significantly above the required regulatory level, reflecting the sluggish lending activity.

The loan portfolio continued to contract by 1.7%, albeit slightly improving its pace by contracting 0.6 percentage points less than in the first quarter of 2014. Empirical studies suggest that, especially after financial crises associated with a "credit crunch", lending improves with a lag to the rebound of the economy (Calvo et al (2006)).

In parallel, the performance of deposits was weaker than in the previous quarter. Their annual growth rate slowed down to 0.9%, mainly driven by developments in lek deposits. The latter has been affected by the shift of households savings towards investment products with higher return rates, while deposit interest rates continue to drop. During the second quarter, households continued to invest in government securities of longer-than-three-years maturity term and in bank deposits of longer-than-two-years maturity term.[2] Total deposits accounted for 67.9% of the GDP, down by 0.4 p.p. from the first quarter. A year earlier, deposits stood at 68.6% of the GDP.

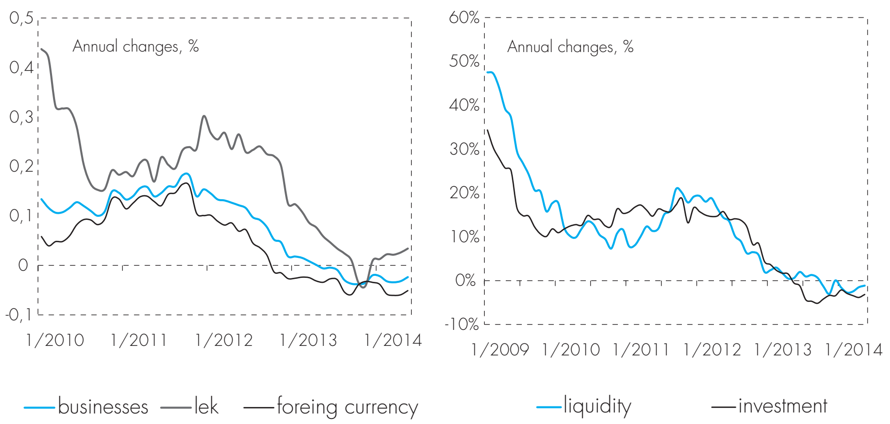
[2] *According to the methodology of monetary statistics, such deposits are not included in total deposits.*

2. LENDING TO BUSINESSES

Lending to businesses continued to perform poorly in April and May, across all its segments. In May, it recorded a low increase in monthly terms, and continued to contract, but at lower rates, compared to the previous year. Moreover, banks report easing standards and upward demand in the second quarter. These positive signals are expected to continue in the third quarter of 2014. They are also in line with the responses of the businesses survey. These indicators show an improvement in the banks' approach to business credit and business confidence, and are expected to materialise in a better performance of lending to businesses in the months ahead.

Lending to businesses continued to contract, in annual terms, in April and May. At the end of May, its annual change was -2.4%, from -3.4% at the end of the first quarter. Lending to businesses was sluggish for both segments: for investment and liquidity purposes. Loans for investment purposes contracted the most, by 3.2% in annual terms, as at May, whereas loans for liquidity purposes contracted more moderately, by 1.2%. By currency, foreign currency lending to businesses continues to shrink, mainly due to the weak performance of loans for investment purposes. Lek lending maintained the positive pace of annual growth, as lek loans for investment purposes increased at the end of the last year and beginning of the current year.

Chart 2 Annual increase of lending to businesses, by currency and purpose



Source: Bank of Albania.

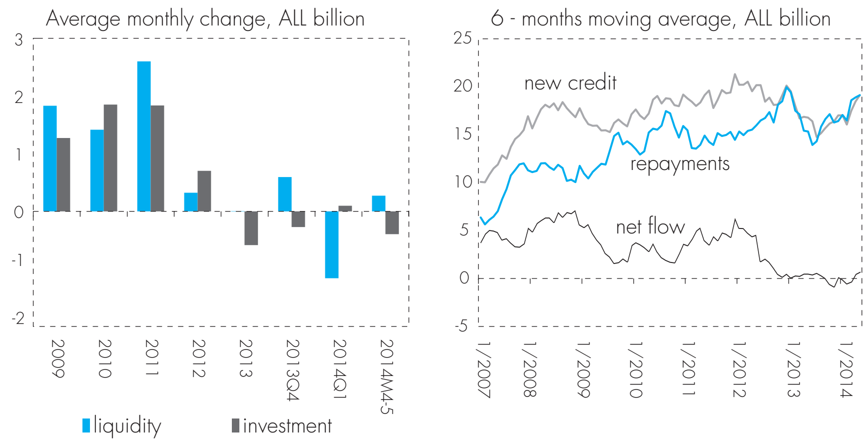
Table 1 Portfolio structure of lending to businesses

	2008	2009	2010	2011	2012	2013	2014 M5
% lek	20%	26%	26%	30%	33%	34%	34%
Liquidity	49%	50%	49%	50%	49%	50%	50%
% lek	23%	33%	34%	37%	44%	45%	44%
Investments	51%	50%	51%	50%	51%	50%	50%
% lek	19%	20%	21%	24%	27%	29%	30%

Source: Bank of Albania.

During April and May, lending to businesses was up by about ALL 1 billion, as lending for liquidity expanded, while lending for investments contracted. Changes in the credit stock, especially during 2013, were also affected by the write-off or sale of loans by banks, in the context of cleaning their balance sheets. Also, new credit recorded low levels. Excluding overdraft[3] loans, new loans to businesses have been in constant decline. On average monthly terms, new credit (excluding overdraft), during April-May, stood about 17% lower than in the first quarter and about 23% lower than in 2013.

Chart 3 Developments in lending to businesses



Note: Net flows in the right chart are adjusted for balance sheet clean-up, such as loan write-off and sale

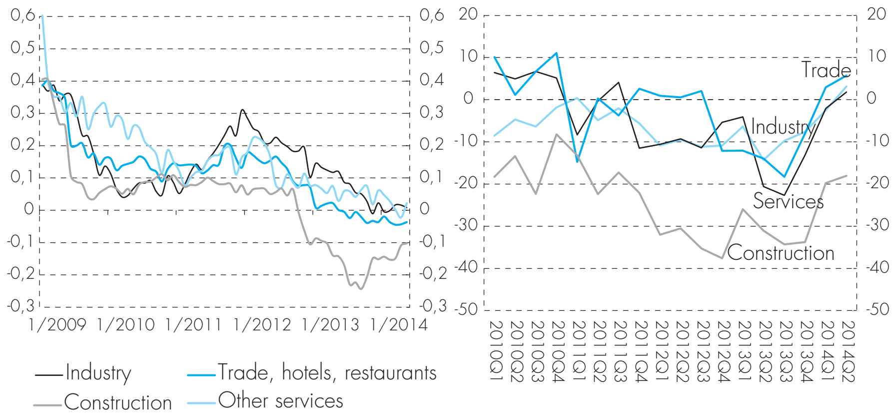
Source: Bank of Albania.

From a long-term perspective, deterioration of lending to businesses is present across all the sectors of the economy. It is more pronounced in construction, in line also with the poorer performance of its economic activity. In April and May, lending expanded for businesses operating in the extractive industry and energy, construction and trade. Loans for transport, and financial and processing industries contracted.

Lending standards for businesses have been tightening until the first quarter of this year, in parallel with the downward demand for loans. In the second quarter, banks report easing of lending standards and upward demand, stating, at the same time, their optimism for the performance of credit demand

[3] *Overdraft loans are characterised by consecutive closure and renovation, and increase the new loans artificially by including renovations of existing loans.*

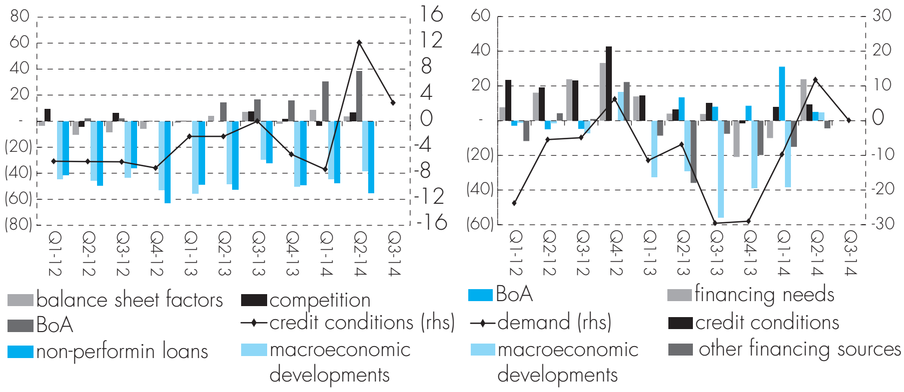
Chart 4 Annual increase of loans by sector (left, %) and business confidence indicator (right, p.p.)



Source: Bank of Albania.

and supply over the third quarter. Both lending standards and credit demand appear improved across all the segments, but mostly in those for working capital and small and medium-sized enterprises. The easing of standards for the latter would be a welcomed development, as they are an important pillar for the sustainable recovery of economic activity.[4]

Chart 5 Changes in supply (left) and demand (right) for business loans and factors affecting them, response balance, p.p.



Note: Positive/negative balance means easing standards (upward demand) / tightening standards (downward demand). In the supply-side factors, balance-sheet factors are calculated as a simple average of the results for the situation of liquidity and of capital. Similarly, macroeconomic developments represent the average of the balances for macro developments in general and those in particular sectors. Among the demand-side factors, need for loans averages the need for liquidity and need for funding investments.

Source: Bank of Albania.

While bank balance sheets do not represent any limitations as to the further credit expansion, uncertainty for the future, in general and in certain sectors, high level of non-performing loans, and policies of parent bank groups in home countries are among factors reducing banks' willingness to lend to businesses. According to the bank lending survey, the accommodative policy

4 *In developing countries with low capital base, small and medium-sized enterprises are considered as the drivers of economic development and employment. They also provide more competitive and efficient markets, and contribute to lowering the poverty level.*

of the Bank of Albania has contributed both to easing credit supply and boosting credit demand. Additionally, the increased need for funding business projects, related to expectations for improved macroeconomic situation in the country, has contributed to the expected upward demand. The enhanced business confidence on the economic outlook is also confirmed by the business confidence survey. The confidence index for all the sectors of the economy has improved significantly and, besides construction, they returned to positive values after being in negative territory for several years.

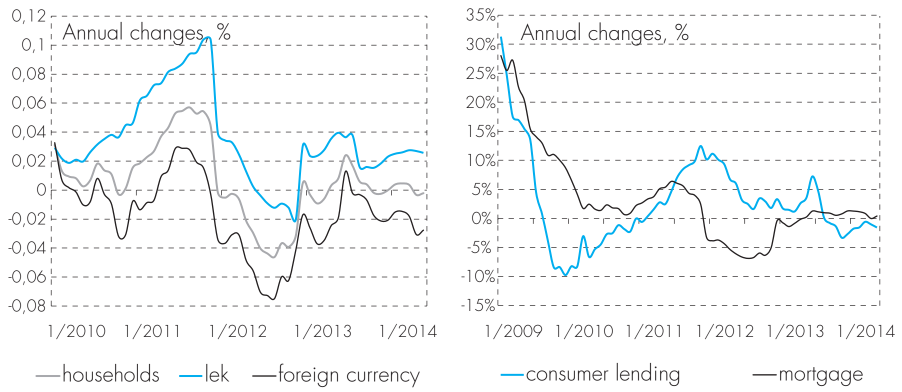
Filtered information from the bank lending survey provides positive signals; however, as of May, they were not materialised in the performance of lending to businesses. If these signals are actually a turning point in the banks behaviour and business confidence rather than a short-term improvement, then they are expected to be reflected in credit expansion during the next months.

3. LENDING TO HOUSEHOLDS

Lending to households continues to be sluggish. In April and May credit expanded more than in the first quarter; however, on a year earlier, lending to households is almost unchanged. Both lending standards and credit demand improved in the second quarter, and this trend is expected to continue in the next quarter. Combined with data from the consumers survey, this information sustains the expectations for a better performance of lending to households in the months ahead.

Lending to households did not change significantly in April and May. Its annual growth has been fluctuating around 0% since the second half of the past year - at the end of May it stood at around 0.2%. The annual performance of lending to households has reflected the low growth of mortgage loans and the further shrinking of consumer loans. At end-May, the annual changes in both portfolios were 0.4% and -1.6%, respectively. Lending to households is oriented towards the domestic currency, stimulated by the increased lek loans for real estate. Foreign-currency lending continues to shrink both for the consumer and mortgage loans.

Chart 6 Annual increase of lending to households, by currency and purpose



Note: The above annual changes are affected by the reclassification of a part of the portfolio from lending to households to lending to businesses in December 2011. The effects of this classification extend to November 2012 and affect annual changes of foreign currency loans for households, mortgage loans and total loans for households.
Source: Bank of Albania.

Table 2 Portfolio structure of lending to households

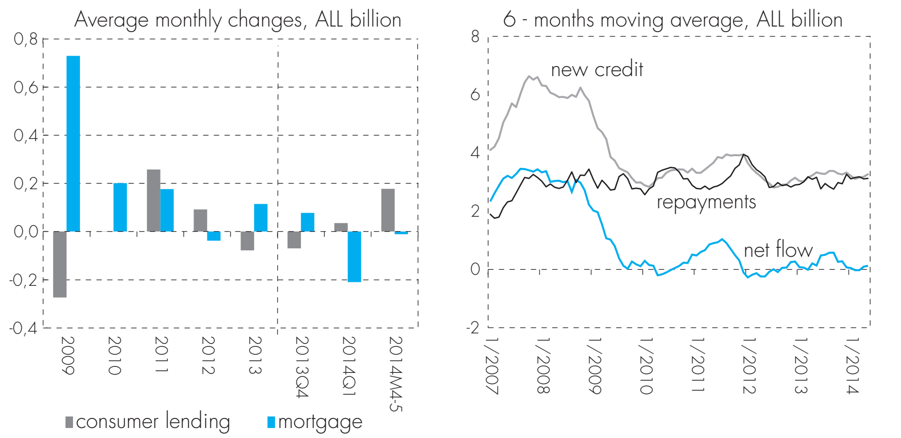
	2008	2009	2010	2011	2012	2013	2014
% lek	43%	43%	44%	46%	47%	48%	49%
Consumer	25%	22%	21%	24%	24%	24%	24%
% lek	74%	77%	80%	80%	77%	77%	78%
Mortgage	75%	78%	79%	76%	76%	76%	76%
% lek	30%	30%	31%	32%	34%	36%	37%

Source: Bank of Albania.

In April and May, lending to households was up by about ALL 0.3 billion, the entire amount to finance consumption in Albanian lek. The structure of consumer credit in this period reveals lending increased for financing durables purchase. This development bears positive signals on the performance of consumer demand and is in line with the results obtained from the consumer survey.

Similarly to lending to businesses, the low increase of lending to households reflects overall the low levels of new credit. In April and May, however, new credit to households improved - its average monthly level, excluding overdrafts, stood at 25% higher than in the first quarter and about 6% higher than in 2013. Also, the clean-up of balance sheets has affected the performance of lending to households negatively, albeit less than lending to businesses.

Chart 7 Developments in lending to households

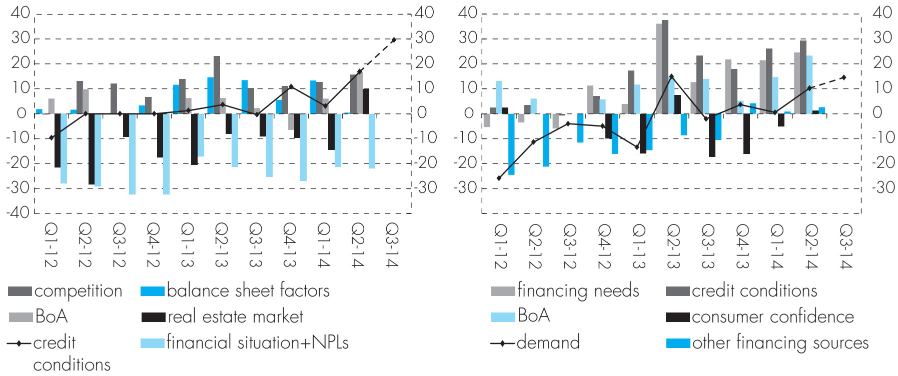


Note: Annual change does not include the effect of reclassification. In addition, net flows in the right chart are adjusted for balance sheet clean-up, such as loan write-off and sale.
Source: Bank of Albania.

Unlike lending to businesses, banks have adopted a more positive approach towards lending to households. Lending standards have been on the easing side since the second half of the previous year. Standards eased stimulated by Bank of Albania's policy and interbank competition, which has been more pronounced in this segment of loans. In the meantime, the households financial situation and the level of non-performing loans continue to dictate banks' prudent approach towards lending to households. According to the banks, the more favourable situation in the real estate market has contributed to the easing of standards in the second quarter.

Households credit demand increased in the second quarter of the year. Banks state that all the conditions are in place for households to apply for more loans to support their consumption and investments. The accommodative policy of the Bank of Albania has helped stimulate credit demand. In addition, banks pick out the consumers' confidence on economic outlook as a factor that has not prevented demand from growing in the second quarter.

Chart 8 Changes in supply (left) and demand (right) for lending to households and factors affecting them, balance of answers, p.p.



Note: Positive/negative balance means easing standards (upward demand) / tightening standards (downward demand). Amid the supply-side factors, balance-sheet factors are calculated as a simple average of results for the situation of liquidity and of capital. Similarly, changes of two factors have been averaged: financial situation of households and non-performing loans, which have a similar performance. Amid the demand-side factors, need for loans averages the needs for funding consumption and needs for funding real estate transactions

Source: Bank of Albania.

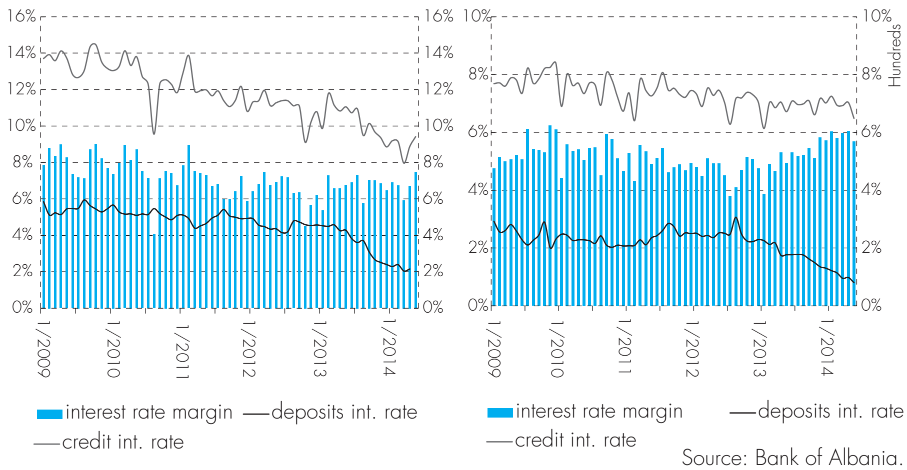
As with lending to businesses, survey results showing easing lending standards and increased credit demand in the second quarter have not been completely reflected in the actual performance of credit, as of May. Consumer survey indicators provide positive signals for upcoming developments regarding consumers' demand. Moreover, banks expect credit demand and supply for households to be more favourable in the third quarter. All these signals, if stable, may be reflected in recovery of lending to households in the months ahead.

4. CREDIT PRICE AND OTHER STANDARDS

Credit interest rates have been downward, but their margins against deposit interest rates have expanded, due to the faster decline of the latter in the second quarter of 2014. From a longer-term perspective, interest rates have fallen more on the lek than on the euro and their spread has narrowed, contributing therefore towards lending in the domestic currency. Information obtained from the bank lending survey suggests that the slow decline of credit interest rates is due to the application of higher margins for high-risk loans. Other lending standards, unlike before, were widely used by banks to ease credit supply.

Given the low levels of new credit, its average interest rate is affected significantly by the interest rate of some non-representative (atypical) loans, thus it fluctuates over the months. Beyond the monthly volatility, credit interest rates have been on the down side, especially for lek loans.
The average interest rate on lek loans in April-May was 9.1%. It is up from the

Chart 9 Interest rates on loans and deposits in lek (left) and euro (right)



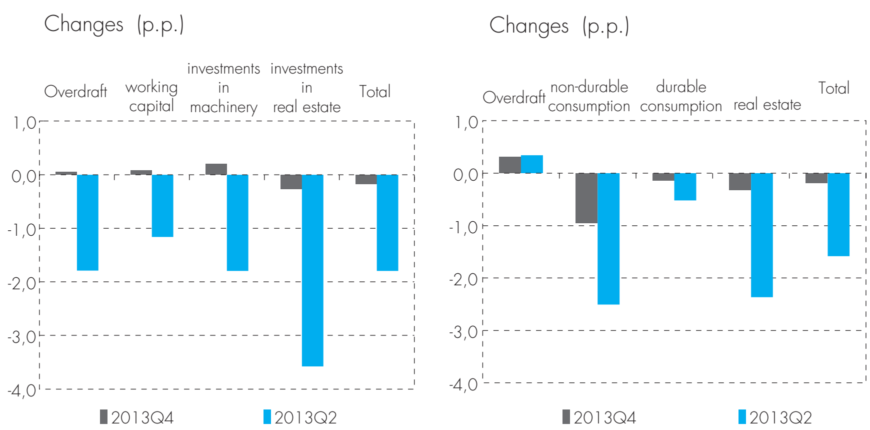
Source: Bank of Albania.

average rate recorded in the first quarter, but the latter was especially low, due to preferential rates on such loans. Compared with the fourth and second quarters of the previous year, it fell, by 0.2 p.p. and 1.7 p.p., respectively. The margin of interest rates on lek loans against those on deposits expanded during the period, due to the faster decline of deposit interest rates. In April and May, they averaged 2.0% from 2.4% in the first quarter.

The interest rate on euro loans averaged 6.8% in April and May, standing slightly down compared to both the first quarter of the current year and the previous year. Moreover, interest rates on euro deposits have trended down, starting from the second half of 2013. In April and May, they averaged 1.0% from 1.8% a year earlier. Interest rates on deposits declined faster due to the ample accumulation of liquidity in this currency in the preceding years, given that alternatives for investments in euro are more limited. The simultaneous developments in euro interest rates led to significant increase of the interest rate margin in this currency, by about 1 p.p. from a year earlier. From the risk perspective, the increased margin on foreign currency loans reflects also higher risks facing such loans, as a result of the exchange rate volatility.

From a historic perspective, interest rates on euro loans have been lower than those on lek ones, and their decline is more gradual. As a result, the spread between rates on lek loans and those on euro loans has narrowed significantly. For the first five months of 2014, it averaged 2.0 p.p., from 3.4 p.p. in 2013. This development favours the orientation of borrowers towards borrowing in the domestic currency, contributing to financial stability and improvement of the transmission mechanism.

Chart 10 Change of interest rates on lek loans to businesses (left) and households (right)

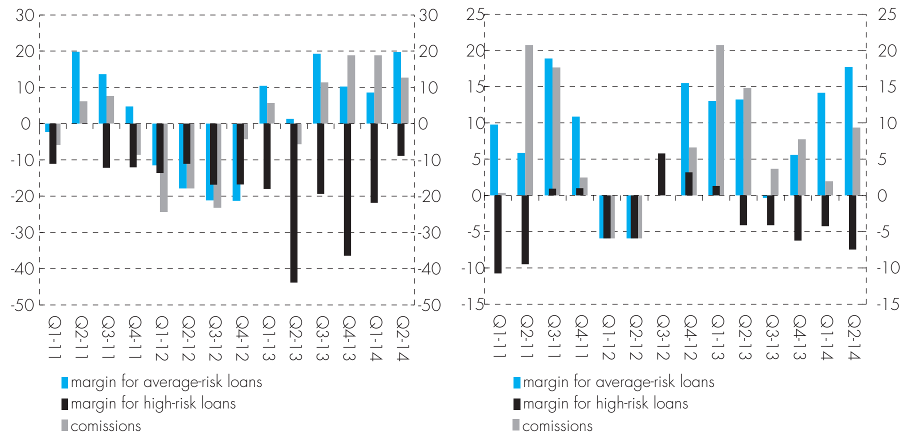


Source: Bank of Albania.

Turning to lek interest rates, the analysis by client and purpose of use shows they fell across almost all the segments during the last year, but exhibit two-way volatility compared to the end of 2013. Interest rates for business loans fell on average by about 1.8 p.p. from a year earlier, with the highest decline recorded in loans for real estate investment. In the same segment, interest rates fell compared to the last quarter of 2013, whereas other interest rates have fallen only slightly. Interest rates on households loans dropped by 1.6 p.p. and 0.2 p.p. on average from those noted in the second and fourth quarter of 2013, respectively. The interest rates fell more pronouncedly for non-durable consumables and for real estate; in contrast to the overall trend, the interest rates on overdrafts increased slightly.

Banks report reduction of interest rates on normal-risk rated credit. They continue to be even more prudent on risk price, applying higher interest rates on high-risk loans. This is especially apparent in the segment of business loans. The diverging performance of interest rates according to the risk level explains why the average interest rate on loans, analysed above, is characterised by slower decline compared to other interest rates: it also incorporates the upward rates for high-risk loans. Lastly, while not related directly to the credit price, commissions were down, contributing to the easing of lending standards.

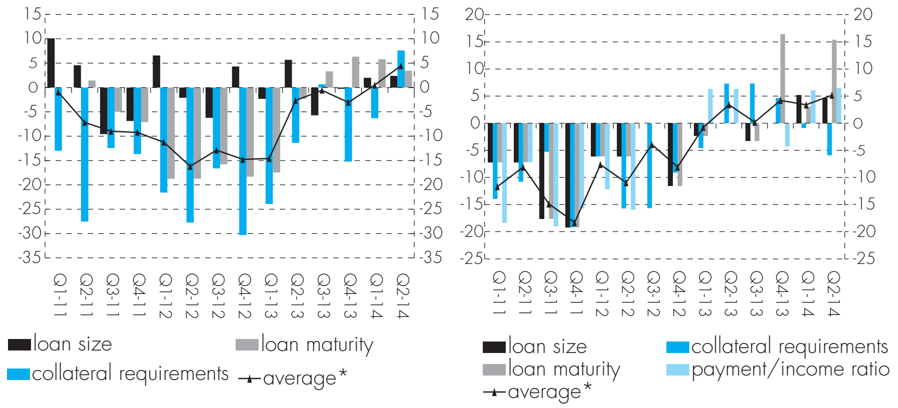
Chart 11 Bank lending survey results: Cost of lending to businesses (left) and households (right), p.p.



Note: Positive/negative balance implies easing/tightening of standards.
Source: Bank of Albania.

Other lending standards have widely trended on the easing side. For businesses, for the first time in the second quarter of 2014, all non-cost lending standards eased. After the extension of credit maturity term and increase of credit size in the previous quarters, in the second quarter, banks eased the collateral requirements. The latter have been among the factors contributing most to the tightening of lending standards in the previous quarters.

Chart 12 Non-price lending standards applied to businesses (left) and households (right)



Note: Positive/negative balance implies easing/tightening of standards.
*Simple mean of factors.
Source: Bank of Albania.

In the case of households, a good part of non-price standards started to ease in previous quarters. In the second quarter of the year, banks report more favourable standards for the size and maturity terms as well as the instalment/ income ratio. In the meantime, they tightened collateral requirements again.

5. LENDING TRENDS IN THE REGION

The latest global financial crisis, followed by the public debt crisis in EU countries, brought an end to the rapid credit growth in the countries of Central East and South East Europe (CESEE). The high presence of foreign banking groups in this region implied not only a share of profits arising from their interconnection and well-integration in good times, but also the rapid spillover in times of crisis. The banking system in most countries in the region and beyond faced similar situations and problems. Immediate consequences from the financial crisis appeared in the form of reduction of funds and capital within the group for their subsidiaries in the region, rapid deleveraging; and, subsequently, deceleration and reduction of credit to the economy, that is overall reduction of exposure by these banking groups in the CESEE region.

Lending in the countries of the region

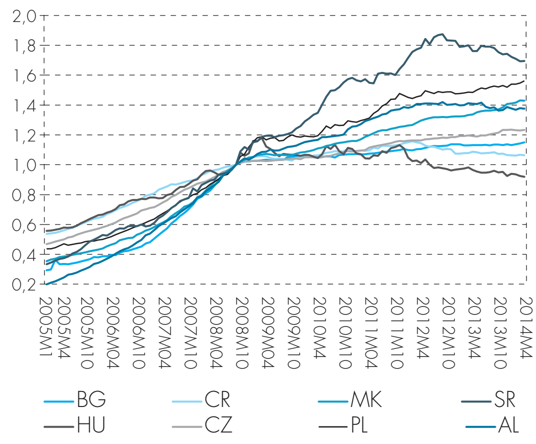
Credit slowed down and declined affected by domestic and foreign demand and supply factors. Economic agents' demand in these countries was conditioned by developments in the broader macroeconomic framework such as deceleration and decline of economic activity in most of them, sluggish labour market and higher jobless rates, and a series of uncertainties related to economic outlook. In the meantime, domestic factors, such as uncertainties about the future, and factoring of high risk premiums, as well as the high level of non-performing loans are considered to have contributed to the low bank lending supply. Some of the external factors conditioning banks' behaviour towards lending include changes to and uncertainties about the international (European) regulatory framework, tightening of capital indicators at group level, developments in non-performing loans at group level, and situation of international markets and access to funds in these markets.

Referring to the latest lending survey in CESEE countries[5], credit appears to recover slowly in the countries of the region. For the six-month period (September 2013 - March 2014), the bank lending survey shows that the overall lending situation has shown signs of improvement. Foreign banking groups in this region continued the restructuring process, by selling assets and/or branches of banks. The use of the financial leverage continued to trend down, although more slowly. The assessment of the banking groups position in the CESEE market and its potential show that this is one of the most profitable markets. It also shows that the presence of foreign bank branches in this market has a significant share in the total of operations of such banking groups. Banks in this region report for credit demand settling at low levels and tightened lending standards. While the high level of non-performing loans and

[5] *CESEE Bank Lending Survey, 2014 H1, European Investment Bank.*

the domestic and international regulatory framework have conditioned the credit supply, banks expect lending standards to ease in the next half of the year. Credit demand has improved slightly for certain types of credit and is expected to recover further for a number of products and maturity terms. Against the backdrop of low crediting, banks report to have sufficient funds for financing their activity, mostly short-term funds obtained through households and business deposits. The increase in non-performing loans is decelerating, especially in the segment of business loans, which are expected to expand more slowly than in that of household loans.

Chart 13 Index of credit to private sector in countries of the region (September 2008 =1)



Source: Respective central banks.

Lending to businesses

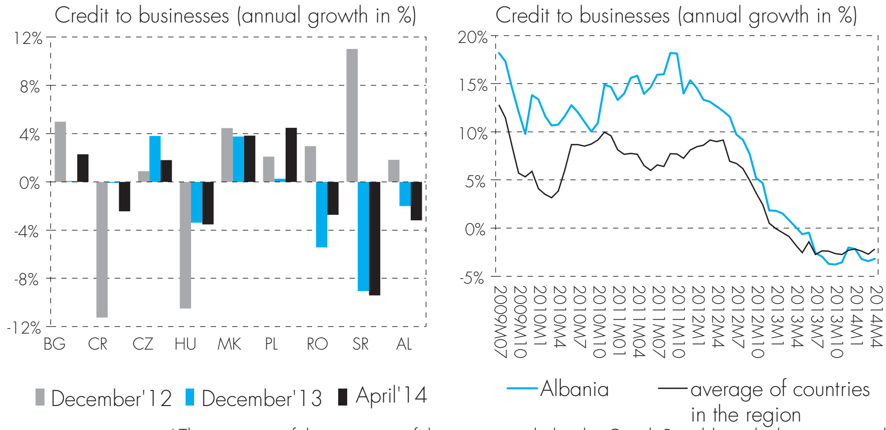
Lending to businesses slowed down significantly during the financial crisis, entering into negative territory in the past two years, both in Albania and in most countries of our region. A simple average of growth rates for the countries in the region reveals that, since 2013, the downward rates have slowed down. This performance has been conditioned mostly by countries with positive and faster growth rates of lending to businesses, such as Poland the Czech Republic, and FYR Macedonia. Nevertheless, at the end of April, the average rate of lending to businesses for the countries of the region was down by 2.2% in annual terms.[6]

The downward credit demand by businesses generally relates to the poor performance of economic activity, below-potential utilisation of production capacities and, subsequently, fewer investments. The bank lending survey in these countries finds that the businesses credit demand has improved slightly during the period (September 2013 - March 2014), although lending standards remain tight, especially the collateral requirements. Regarding the purpose of use, credit was extended mostly for debt restructuring and working capital, while credit demand for investment purposes remains very weak.

Poland, the Czech Republic and Bulgaria are among the countries least affected by the financial crisis and, therefore, experiencing minor consequences on macroeconomic indicators. They have maintained positive rates of lending to the private sector, both for businesses and households. The major share of credit to businesses in these countries was granted for investment purposes. In the Balkans, FYR Macedonia records positive annual growth rates for lending to businesses. Serbia and Romania seem to be the countries experiencing apparent worsening of lending to this segment. In Hungary, however, the situation has improved against 2012, although the rate of expansion of business loans remains in negative territory.

6 *The average of the countries of the region excludes the Czech Republic and Poland. The impact of the financial crisis on these countries is insignificant.*

Chart 14 Lending to businesses in Albania and in the region



*The average of the countries of the region excludes the Czech Republic, which experienced an insignificant impact from the financial crisis.

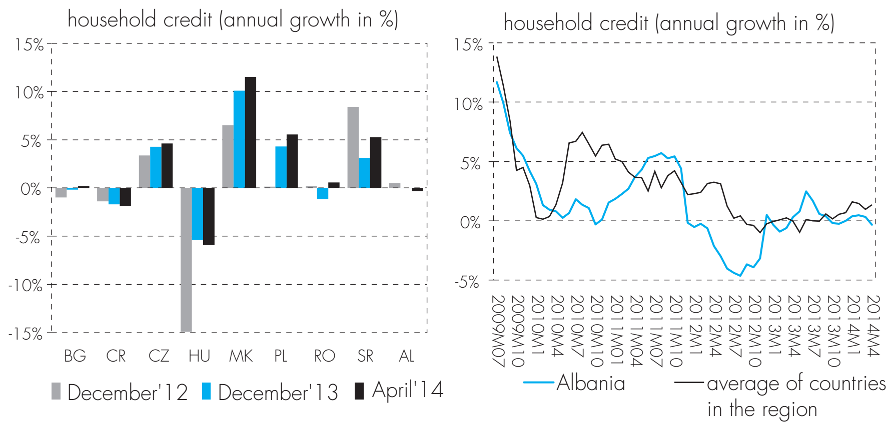
**The latest data for Croatia refer to March 2014

Source: Bank of Albania, respective central banks.

Lending to households

In the countries of the region, lending to households performed better than lending to businesses. The reduction of credit outstanding for households seems to have started decelerating earlier than credit for businesses, since mid-2012. A simple average for the countries of the region and an individual analysis for most of the countries show an improvement of growth rates for lending to households, starting since end of 2013.

Chart 15 Lending to households in Albania and in the region



*The average of the countries of the region excludes the Czech Republic and Poland. The impact of the financial crisis on these countries is insignificant

**The latest data for Croatia refer to March 2014.

Source: Bank of Albania, respective central banks.

On average terms, in April, credit outstanding for households in the countries of the region, excluding Poland and the Czech Republic, was up 1.4% from a year earlier. According to the bank lending survey for CESEE countries, these positive developments reflect mainly the eased lending standards applied for households, especially in the segment of consumer credit, and the higher credit demand by households, compared to the more sluggish recover of businesses demand.

FYR Macedonia, Poland and Serbia, and less the Czech Republic, are the countries with the highest growth rates of lending to households. In Hungary and Croatia, which have consecutively recorded negative annual rates in the past 2-3 years, there is a tendency towards improvement. However, these rates remain in negative territory, especially in the case of Hungary.

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