FINANCIAL SECTOR ASSESSMENT PROGRAM

ALBANIA

PUBLIC DEBT MANAGEMENT

TECHNICAL NOTE

FEBRUARY 2014

This Technical Note was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program mission in Albania during October - November 2013. The note contains technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx, and www.worldbank.org/fsap.

THE WORLD BANK
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY
EUROPE AND CENTRAL ASIA REGIONAL VICE PRESIDENCY

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GLOSSARY

AFS	Available For Sale
AFSA	Albanian Financial Supervisory Authority
ALFMIS	Albanian Financial Management Information System
DeM	Debt Management
DMO	Debt Management Office
DvP	Delivery Versus Payment
DPI	Debt Performance Indicator
DSA	Debt Sustainability Analysis
DMFAS	Debt Management and Financial Analysis System
GDP	Gross Domestic Product
GDB	General Directorate of Budget
GDT	General Directorate of Treasury
GOA	Government of Albania
GOS	Guarantee, On-lending and Sub-national Borrowings (Division)
GDPDM	General Directorate of Public Debt Management
HTM	Hold To Maturity
IMF	International Monetary Fund
MoF	Ministry of Finance
MTBP	Medium Term Budget Plan
T-bill	Treasury Bill
T-bond	Treasury Bond
WAY	Weighted Average Yield
RDS	Registration and Debt Service (Directorate)
SOE	State-Owned Enterprise
SPC	Strategic Planning Committee
SR	Strategy and Risk (Directorate)
TSA	Treasury Single Account
WBG	World Bank Group

I. EXECUTIVE SUMMARY[1]

1. **Government debt continues to expand, reaching over ALL 872 billion, approximately 62 percent of GDP, as of end-September 2013.** Domestic debt accounts for 57 percent of the debt stock or 36 percent of GDP and external debt accounts for 43 percent of the debt stock or 26 percent of GDP. Albania's high public debt could pose significant challenges going forward, as rollover risk could worsen because of large financing needs, which banks may be unable to cover, and/or inward shocks to the domestic debt market. These problems could also have feedback effects on banking stability given the large portion of banks' assets is held in public debt.

2. **Domestic debt grew sharply in the first half of 2013, emanating largely from poor tax revenue performance, together with the accumulation of a large stock of unpaid bills and arrears.**[2] Market risks are mainly in the form of interest rate risk and rollover risk due to a large share of short-term debt (65 percent will mature within 12 months, as of end-September 2013) that is further exacerbated by a narrow investor base consisting mainly of banks, and the pressure on foreign-owned banks may be magnified by the forthcoming Comprehensive Assessments of most European parent banks by the European Central Bank. The rollover risk is mitigated to an extent mainly due to the easing of monetary policy, low inflation and risk averse commercial banks that have opted to buy government paper rather than lend to the private sector.

3. **External debt creditors comprise multilaterals, bilateral creditors, and private creditors**. The maturity profile of external debt is relatively even with the exception of the country's debut €300 million Eurobond maturing in 2015. External debt is mainly exposed to Euro (69 percent) and U.S. dollars (20 percent) and other currencies (11 percent). Non-concessional external debt continues to increase and is now almost at par with concessional debt. The interest rate structure is predominantly fixed interest (74 percent).

4. **The relatively high capacity in public debt management is now threatened by public sector wide staff reductions.** In 2008, the General Directorate of Public Debt Management was set up as a designated unit within the Ministry of Finance to take the lead in all borrowing activities, to promote the development of the domestic debt market, and to prepare a medium-term debt management strategy with annual updates on a rolling basis. It is organized in accordance with sound principles by having separate front-, middle- and back-office functions and direct reporting to a Deputy Minister. Austerity measures directed across the government to reduce the size of the fiscal deficit are expected to result in two-fold changes for the General Directorate of Public Debt Management. Firstly, it will see its staff cut by 50 percent and the General Directorate

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[1] This Technical Note has been prepared by Thor Jonasson and Olga Akcadag, both WBG. It was prepared in the context of an FSAP assessment mission led by Michael Edwards, World Bank and Erik Oppers, IMF which was overseen by the Financial and Private Sector Development Vice Presidency, World Bank and the Monetary and Capital Markets Department, IMF.

[2] By end-June 2013 the domestic borrowing authorized by the fiscal budget was 95 percent utilized. Following the passing of normative fiscal legislation the domestic borrowing was increased from Lek 28 billion to Lek 52 billion.

will be merged with the General Treasury Directorate into a new directorate, the Financial Services General Directorate. These changes have the potential to undermine the effectiveness of public debt management unless proper measures are introduced to ensure that the debt management strategy is formulated and implemented, and critically, the necessary capacity is retained to undertake the functions of public debt management within its internal structure. These changes, announced in early November, would revert the public debt management function to the previous organization of Public Debt Management and Treasury that was in effect until 2008. Previous experience in Albania with this approach was inadequate in that the priority attached by the government to public debt management was not realized.

5. **The concentrated nature of the investor base and the high domestic debt stock limit the choices available to debt management, particularly with regards to extending the maturity of the domestic debt.** Recent developments to reduce the reliance on banks have sharply grown the retail investor segment, which now holds 13 percent of the domestic debt. Other developments include the introduction of an investment fund that now holds 6 percent of the domestic government debt securities; and accumulation of assets with the Deposit Insurance Agency that holds over 3 percent of the domestic government debt securities. Despite positive trends, the pool of long-term investors is still limited, and commercial banks continue to dominate holdings of government securities, with 25 percent of their assets invested in government securities.

6. **Public debt management in Albania follows an organized process but would benefit from a number of technical changes.** These include using up to date macroeconomic assumptions and cash projections in the preparation of the debt management strategy and the annual borrowing plan.

7. **The domestic borrowing plan has been revised frequently due to unexpected flows in the Treasury Account.** Arguably, one of the greatest challenges to debt management is Treasury's cash management, as there is chronic lack of a clear system for commitments of expenditure, which can lead to cash rationing. Improving the technical aspect of cash flow projections would only present a partial solution, since a comprehensive, robust program of budget control and commitments is necessary.

8. **In an environment of volatile Treasury balances, cash flows safety nets or minimum cash buffers should be implemented.** Currently, there is no concept of a target balance in the Treasury account but a low balance is usually the outcome. This makes the Treasury vulnerable as has been illustrated with periodic challenges in the repayment of government securities at maturity. Maturing debt has to be paid by the General Directorate of Treasury before market participants can pay for their purchase in the primary auctions.[3] The anticipated introduction of a net-payment system is likely to solve the intra-day payment problem once fully implemented. However, given the limited development of the money market, the most appropriate solution would be to establish a higher minimum balance on the Treasury account. In the medium-term, issuance of ad-

[3] This occurs during times when liquidity in the TSA is low and this results in a payment system gridlock that required coordination among market participants where they obtain an intra-day loan to make their payment to the GDT which in turns pays the maturing government securities.

hoc cash management Treasury bills, by the GDPDM, outside of the normal auction program could be introduced to meet short-term funding needs.

9. **Debt management systems are antiquated and should be upgraded.** The pending upgrade would integrate the management of the domestic and external debt portfolios with a connection to the ALFMIS system, which would reduce operational costs, reduce time spent on debt recording and contribute to more accurate data. This upgrade is very much needed and should be programmed for installation in the first half of 2014.

10. **A number of initiatives are recommended to improve the transmission of price signals in the primary market – overall this will provide incentives for secondary market development.** The primary market has a number of shortcomings owing to lack of price signals that can be transmitted to the market due to the low share of competitive bids in the Treasury bill auctions. The heavy participation of the BoA and retail investors alike that bid on a non-competitive basis does not foster price discovery. While the rollover of Treasury bills held by the BoA can simply be detached from the primary auctions, the participation of retail investors should migrate to commercial banks. A first step would be to limit maximum amounts a single investor can bid at non-competitive price to, say ALL 5 million, as high-value investors should have the ability to either bid at a competitive price or through an intermediary. Efforts to encourage retail investors for Treasury notes should continue, in addition to designating a few banks as intermediaries, following a competitive selection. In the medium-term, retail investors should withdraw entirely from placing direct bids.

11. **The limited number of bids that can be submitted by each bidder in the primary auctions subdues demand and limits choice of the debt manager.** By allowing banks to effectively submit an entire demand schedule, they could test various price levels, which would enhance the price discovery process and could, at the margin, encourage an increase in volumes bid. This could also encourage other institutions to submit bids through the banks, again at the margin, as they can be more selective of the price at which the bid is made, adding to demand. Finally, it would also reduce the government's execution risk, allowing finer discrimination between bids to be accepted and rejected. As a general rule, auctions should be allowed to clear, i.e. the target amount should be accepted.

12. **Improved secondary market liquidity is not a guaranteed outcome as additional steps are needed to provide incentives to market participants.** There is almost no activity in the secondary market, which prevents market participants from using government securities to manage their liquidity positions. In the current market environment the main intermediaries are expected to be commercial banks, as the main holders of government securities. Banks hold government securities on a hold-to-maturity basis in the absence of a daily valuation framework. This should be addressed by preparing a valuation framework that would use the most recent primary market results as well as secondary market activity as it increases. Marking government securities assets to the primary market yield curve has clear limitations and should be regarded as a transition measure.

13. **To support the development of the secondary market the General Directorate of Public Debt Management should modify its issuance program and focus on key maturities on the yield curve.** It is suggested that the issuance program takes a small step in this direction by limiting the number of tenors and focusing on e.g., 2, 5, 7 and 10-year Treasury bonds as well as increasing the frequency of 5 and 7-year maturities from quarterly to bi-monthly. This would provide more frequent price discovery in the primary market that would support portfolio valuation. A subsequent step is to strengthen the regulatory framework for the secondary market by extending price reporting from licensed participants in the Government Securities Retail Market (GSRM) to all commercial banks, regardless of counterparts, and disclose transaction information in summarized form on the AFSA website. Other reforms, such as the BoA's introduction of a central securities depository system should be supported.

14. **A dealer arrangement for government securities will become feasible in the medium-term.** The preconditions for a dealer arrangement for government securities would depend on successful implementation of the short- and medium-term recommendations in this Technical Note as well as further diversification of the investor base with incentives to manage their interest rate and liquidity risk using government securities. Once these conditions are met, a dealer arrangement - where a number of dealers are appointed to undertake primary dealer obligations and privileges in the Albanian government securities market - can be developed. Before implementing a primary dealership system, a full analysis of the government securities market should be carried out to ensure that a well-balanced set of responsibilities and privileges is defined and is in line with specific market characteristics and the stage of development.

Table of Recommendations

Recommendation	Time horizon *	Level of difficulty **	Implementing institution
Ensure that the institutional arrangements; internal organization; and staff resources for public debt management are sufficient to formulate a Debt Management Strategy and manage the public debt.	ST	H	MoF
Upgrade to new version of DMFAS to allow for integrated recording and management of domestic and external debt as this will reduce workload and operational risk.	ST	M	GDPDM
Develop the cash forecasting function within the GDT to improve the predictive accuracy of these forecasts.	LT	H	GDT
Take steps to rough tune cash flows during the planning stage to reduce concentration.	MT	M	GDT
Gradually change the pattern of T-Bill issuance to better reflect government cash flow patterns in order to reduce the level of pre-financing and size of idle balances in the TSA at certain times of the year.	LT	M	GDT, GDPDM
Use up to date macro framework and fiscal table to guide the formulation of the debt management strategy.	ST	M	GDT, GDPDM, GDB
Debt portfolio targets such as the profile (fixed/floating), and the share of debt to be refixed in one year should be expanded and expressed as a range.	ST	M	GDPDM
The Annual Borrowing Plan should be explicitly presented in the debt management strategy document, specifying the amount to be borrowed as well as types, tenors, and target	ST	L	GDPDM

Recommendation	Time horizon *	Level of difficulty **	Implementing institution
sizes for the instruments.			
Increase the cash buffer to meet unexpected expenditure and abolish the unofficial maximum balance so that cash can be accumulated ahead of large outflows.	MT	M	GDY
Continue to lengthen maturity of domestic debt to reduce rollover risk.	Ongoing	H	GDPDM
Allow auction participants to submit multiple bids, both on their own account and on behalf of clients, to help improve price discovery.	ST	L	GDPDM, BOA
Limit the number of dealers that are allowed to accept retail bids from customers to five.	MT/LT	M	GDPDM, BOA
Separate the BoA's participation in T-Bill auctions from the other bidders by reducing the offered amount by BoA roll over requirements prior to each auction and ex ante announcements.	ST	L	BOA
Close primary auctions within a reasonable time, such as two hours.	MT	M	GDPDM, BOA
Reduce the number of key maturities of T-notes offered by issuing in e.g., 2-year, 5-year, 7-year and 10-year maturities and increasing the frequency of 5-year and 7-year T-bond auctions to 6 times each year.	ST	L	GDPDM
Improve price transparency in the secondary market for government securities by requiring banks to report information on secondary market activity to AFSA and publish this information on the AFSA website.	ST	M	AFSA
Establish an ANNA numbering agent in Albania to add ISIN numbers to domestic government securities.	MT	M	BOA
Introduce a code of conduct both for licensed brokerage companies and banks that sets out prudential norms for dealing in government securities and supervise the code of conduct.	MT	M	AFSA
Undertake work in collaboration with banks and NBFIs that are subject to mark-to-market valuation in order to produce a set of valuation principles that can serve as temporary step and a yield curve is calculated on a daily basis.	MT	H	BOA, AFSA
Introduce a Central Securities Depository in the BoA.	ST	H	BOA

* Term refers to the expected time of completion, with short term (ST) referring to 1 year, medium term (MT) to 1-3 years, and long term (LT) to more than 3 years.
** High, medium or low

II. GOVERNMENT DEBT MANAGEMENT[4]

A. Institutional Arrangements for Public Debt Management

15. **Since 2008, the Albanian General Directorate of Public Debt Management (GDPDM) has been organized in a General Directorate under the Ministry of Finance.** The GDPDM is divided in a front-, middle-, and back-office in line with sound practices. Under this structure, the GDPDM has been headed by a General Director, who reports to the Deputy Minister of Finance. GDPDM functions as both the principal debt management entity and the principal guarantee entity of Albania. Among its responsibilities are to manage central government debt (both domestic and external).

16. **Borrowing in the domestic market is undertaken by issuance of Treasury bills and Treasury bonds through an auction process managed by Bank of Albania as agent for the Ministry of Finance**. The approval of bids received in the auctions, however, is always decided by the General Director of GDPDM and the Minister of Finance. Formally, the Minister approves all borrowings.

B. Internal Organization of Public Debt Management

17. **The internal organization of GDPDM follows sound practice**. It is organized into three directorates/departments, each headed by a Director. These are the Borrowing Directorate (front office), the Strategy and Risk Directorate (middle office), and the Registration and Debt Service Directorate (back office). Its responsibilities include to annually prepare a medium-term debt management strategy on a rolling basis, prepare the annual debt management report to the Assembly, monitor and approve local government borrowing, issue loan guarantees, and on-lend borrowed funds.

18. **There is 22 staff in GDPDM and turnover has been low in recent years.** Job descriptions are available for each staff member and are updated to reflect changes in responsibilities of the staff member and/or those of the division.

19. **Within the Borrowing Directorate, the Domestic Borrowing Division is responsible for domestic debt issuance, and the external borrowing division is responsible for negotiating external loans.** Registration and Debt Service Directorate (RDS) is responsible for both recording government debt and arranging payments. Within RDS, different staff members are responsible for arranging payments and for recording these payments in DMFAS.

20. **A separate directorate, the Strategy and Risk (SR) Directorate, is responsible for risk monitoring and compliance**; it reports directly to the Director General of GDPDM. Within SR, the Portfolio and Risk Control division is responsible for evaluating and monitoring risks and compliance of government's entire debt management

[4] This Technical Note has been prepared by Thordur Jonasson and Olga Akcadag, both WBG. It was prepared in the context of an FSAP assessment mission led by Michael Edwards, World Bank, and Erik Oppers, IMF which was overseen by the Financial and Private Sector Development Vice Presidency, World Bank and the Monetary and Capital Markets Department, IMF.

operations. It is also in charge of preparing the medium term debt management strategy while the Risk Division is responsible for monitoring and evaluating risks from the government's guarantee and on-lending activities and from local government borrowing.

C. Integration of Public Debt Management with the Treasury

21. **The internal organization of Debt Management is expected to remain broadly intact although all functions have yet to be accounted for.** Division into front-, middle- and back office would be retained but the organization of the front office would not be divided into domestic and external sub-units. Additionally, the risk monitoring for on-lending, guarantees and local authorities borrowing does not appear to have been included. It is suggested that adequate reporting lines are developed to ensure debt management continues to be closely followed by senior Ministry Officials.

22. **In many countries the debt management function is integrated into the Treasury.** If this course is taken in Albania it is important to continue to ensure a strong debt management function to carry forward transparency and accountability both between different government functions, the central government and the monetary authority. Furthermore, retaining the ability to concentrate and to develop expertise in public debt management is essential to employ the more sophisticated tools of financial management. The benefits of specialization and control of operational risk are part of this. There are nonetheless several issues that should be considered (See Box 1).

23. **The combination of institutional changes and staff reductions entail risks for public debt management that need to be carefully monitored.** In 2008, the General Directorate of Public Debt Management was set up as a designated unit in the Ministry of Finance to take the lead in all borrowing activities, promote development of the domestic debt market, and to prepare a medium-term debt management strategy with annual updates on a rolling basis. It is organized in accordance with sound principles by having separate front-, middle- and back-office functions and direct reporting to a Deputy Minister. Austerity measures directed across the government to reduce the size of the fiscal deficit are expected to result in two-fold changes for the General Directorate of Public Debt Management. Firstly, it will see its staff cut by 50 percent and the Directorate will be merged with the General Treasury Directorate into a new directorate, the Financial Services General Directorate. These changes have the potential to undermine the effectiveness of public debt management unless proper measures are introduced to ensure that the debt management strategy is formulated and implemented, and critically, the necessary capacity is retained to undertake the functions of public debt management within its internal structure. Debt management should be retained as a significant function with its own specific objectives within the new directorate, Financial Services General Directorate. Otherwise, these changes announced in early November, would revert the public debt management function to the previous organization of Public Debt Management and Treasury that was in effect until 2008. Previous experience in Albania with this approach was inadequate in that the priority attached by the government to public debt management was not realized.

Box 1. A Debt Management Office Inside a Treasury? – Considerations for Albania

A number of options are available on where to locate the DMO. In some countries the DMO is set up as a separate agency or corporate body outside the Ministry of Finance (e.g., Germany, Hungary, Portugal, Sweden and the U.K.), while other countries have decided to establish the DMO within the Ministry of Finance (e.g., Belgium, Colombia, France, the Netherlands and New Zealand). Whatever organizational model is used, it is important that the DMO is close to the market. This is the reason why the U.K. DMO is located in the City instead of Whitehall, and why the Dutch DMO is located in Amsterdam instead of Hague, in spite of it being part of the Ministry of Finance whose other functions are centralized in Hague.

A DMO could be established within a larger treasury organization of the Ministry of Finance. In practice, however, this is far from the optimal solution, and there is a clear trend to separate the debt management function from the set of core treasury functions, i.e., budget execution, cash flow forecasting, and budget accounting. The reasons are the following.

Historically, while debt management was limited to funding, it could very well fit into the other functions of a treasury. Today, however, with the new focus on government debt management and its development into a policy area with its own long-term objectives, there is hard to find any advantages of having the debt management function within the Treasury Department/Administration. On the contrary, the skill set needed, the system support, and the culture within a professional DMO is different from what is found within a typical treasury function. Because of its focus on cost/risk analysis and trade-offs, strategy development based on sensitivity and scenario analysis (sometimes including stochastic simulations), borrowings in both domestic and international capital markets, and market transactions such as derivatives, buy-backs and switches, staff must have basic financial as well as financial analytical skills, a skill set that is not needed for budget execution and accounting.

The culture within a professional DMO reflects the daily contact with the financial markets and the market risks embedded in the debt portfolio, while a treasury function is more focused on budget cash flow streams, cash flow forecasts, financial controls, and accounting.

Another important advantage of setting up the DMO outside the treasury department/administration is that the top management will be better focused on government debt management. In a treasury department/administration, the core activity will by nature be budget execution and accounting, and in case of Albania, even budget preparation. The debt management function, consequently, may receive secondary priority from top management.

A dedicated management team of the DMO is essential, not least because of the attractiveness of the trained debt managers to the private market. Thus, it is particularly important to create an attractive work place for the debt management staff, including continuous preparing of structured training plans for all staff members, and performance-based salaries.

24. **Integrating the front office for debt and cash management would improve efficiency in having a single point in the Ministry of Finance conducting financial market transactions.** In this context cash management is defined as the strategy and associated processes for managing cost-effectively the government's short-term cash flows and cash balances, both within the government, and between government and other sectors. In other words, cash management encompasses the operational aspects of managing the government sector's liquidity—placing surplus funds or raising short-term funds on a daily basis (i.e. the responsibilities of the existing TSA management section in the GDT) as well as associated management of foreign currency transactions.

D. Risk Profile of Government Debt

25. **Government debt is high at ALL 872 billion or at 62 percent of GDP[5]**. The debt to GDP ratio is among the highest in the region. Domestic debt accounts for 57 percent of the debt stock or 35.5 percent of GDP and external debt accounts for 43 percent of the debt stock or 26 percent of GDP. Table 1 shows a breakdown of the public debt.

Table 1. Risk Indicators (September 30, 2013)

		External debt	Domestic debt	Total debt
Central government debt stock (ALL, million)		371,629	500,228	871,858
	Central government debt (ALL, million)	338,624	480,205	818,829
	Guaranteed debt (ALL, million)	33,006	20,023	53,029
Central government debt stock (USD, million)		3,547	4,775	8,322
Central government debt as % of GDP		26.41	35.55	61.97
Cost of debt	Weighted avg. interest (%)		7.15	5.87
Refinancing risk	ATM (years)		1.28	
	Debt maturing in 1 year (%)	4.62	62.6	37.89
Interest rate risk	ATR (years)		0.87	
	Interest re-fixing in 1 year (%)	27.50	34.52	31.53
	Fixed rate debt (%)	72.50	65.48	68.47
FX risk	FX debt (%)	100	1.20	43.32

Notes: 1/ Total public debt stock (ALL 872,235 million) comprises central government debt (ALL 871,858 million) and local government debt (ALL 377 million).
2/ ATM is average time to maturity and ATR average time to re-fixing.
Source: Ministry of Finance, Debt Indicators as of Sept. 30, 2013 and staff calculations.

Domestic debt

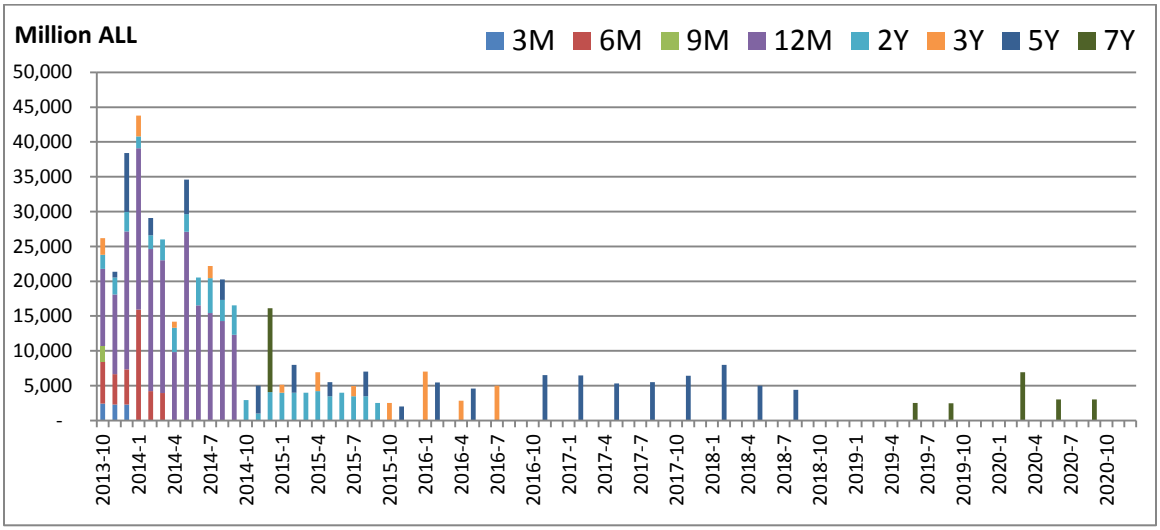
26. **Domestic debt grew sharply in the first half of 2013—emanating largely from poor tax revenue performance, together with the accumulation of a large stock of unpaid bills and arrears.[6]** By end September 2013, domestic debt amounts to ALL 500.2 billion and constitutes a little more than half (57 percent) of total central government debt. Majority of domestic debt consists of marketable debt (96 percent), while a small part is guaranteed debt (4 percent). Domestic marketable debt is issued as either T-bills or T-bonds, which each constitutes about half of the stock (53 percent and 47 percent respectively). Almost all domestic debt securities are in local currency, except for three euro denominated T-bills totaling 1.25 percent of domestic debt securities. Most of Albania's marketable debt is short term and 65.2 percent matures within a year. Albania's high public debt could pose significant challenges in the current environment. Rollover risk could worsen because of large financing needs, which banks may be unable

[5] This excludes arrears that have been estimated at 4 percent of GDP.
[6] By end-June 2013 the domestic borrowing authorized by the fiscal budget was 95 percent utilized. Following the passing of normative fiscal legislation the domestic borrowing was increased from Lek 28 billion to Lek 52 billion.

to cover, and inward shocks to the domestic debt market. These problems could also have feedback effects on banking stability.

27. **T-bills are issued as discount instruments and are usually with a maturity of 3, 6, or 12 month at issuance**.[7] By end September 2013, outstanding T-bills amount to ALL 249.2 billion.[8] Outstanding government bonds total ALL 231.0 billion[9], of which 65.5 percent consists of fixed rate bonds and the remaining 34.5 percent is floating rate bonds with semi-annual interest re-fixing. The average yield 7.15 percent and the average time to maturity 1.3 years. Figure 1 shows the maturity profile of the marketable debt stock.

Figure 1. Monthly Maturity Profile for T-bills and T-Bonds (September 30, 2013)



Source: Ministry of Finance, Debt Indicators as of Sept. 30, 2013.

28. **Measured by original maturity, short-term bonds (two and three years) constitute almost half of the bond stock, whereas the remaining bonds are in medium term maturities (five and seven years).** Table 2 shows development of the bond stock over the past five years divided in maturities at issuance.

29. **Albania faces high rollover risk for domestic public debt.** Most of Albania's domestic debt is short term, and the debt is largely held by commercial banks. The rollover risk is mitigated mainly due to the easing of monetary policy, low inflation and risk averse commercial banks that have opted to buy government paper rather than lend to the private sector. However, given the predominance of foreign-owned banks in the Albanian banking sector, stress in European parent banks can potentially spillover to Albanian subsidiaries, making it difficult for the government to rollover or issue new debt.

[7] MoF may issue T-bills with flexible maturities depending on liquidity needs.
[8] Based on the purchase value (used throughout the note).
[9] Based on nominal value (used throughout the note).

Table 2. Bond Stock by Original Maturity (2003 to Q3:2013)

Maturity	2008	2009	2010	2011	2012	Q3 2013
Bond stock (million ALL)						
2 Year	65,730	65,247	70,957	75,141	76,742	77,442
3 Year	21,100	15,600	15,613	19,387	22,625	30,683
5 Year	45,910	60,315	71,815	82,012	87,994	92,898
7 Year	12,079	12,000	12,000	12,000	16,982	29,934
All	144,819	153,162	170,385	188,539	204,343	230,956
Percent of total bond stock						
2 Year	45.4	42.6	41.6	39.9	37.6	34.4
3 Year	14.6	10.2	9.2	10.3	11.1	13.0
5 Year	31.7	39.4	42.1	43.5	43.1	40.6
7 Year	8.3	7.8	7.0	6.4	8.3	11.9

Source: Ministry of Finance.

External Debt

30. **External debt amounted to ALL 371.6 billion by end September 2013 and constitutes 43 percent of central government debt.** In addition to the Eurobond issued in October 2010, external debt creditors comprise multilaterals, bilateral creditors, and private creditors. External debt is mainly exposed to Euro (69 percent) and U.S. dollars (20 percent) and other currencies (11 percent). Non-concessional external debt continues to increase and is now almost at par with concessional debt. The interest rate structure is predominantly fixed interest (74 percent).

31. **External borrowing follows a well-defined process for multilateral and bilateral loans.** External commercial loans, however, would benefit from a constitutional interpretation on whether parliamentary approval is needed to avoid delays once decision is made on issuance. The transformation of the external debt portfolio toward non-concessional debt marks a trend where Albania needs to become more proactive and will face increasing choices with regards to currencies, interest rates and repayment terms. In this process a robust debt management strategy is necessary to guide the choices and maintain the portfolio structure, as are financial market and analytical skills within the GDPDM.

E. Debt Management Strategy

32. **A medium-term debt management strategy for the total central government debt has been prepared annually on a rolling basis since 2006.** The current strategy was approved in December 2012 and covers three years. The Strategy development is the responsibility of GDPDM, particularly its Strategy and Risk Directorate, and is based on both quantitative and qualitative analyses. The macroeconomic assumptions are based on the 2012 budget figures and the 2013-2015 medium term budget. The strategy is prepared in close cooperation with both the General Directorate of Macroeconomic and Fiscal Policies, and the Budget Directorate. In addition, the strategy proposal is submitted to Bank of Albania for comments. The Bank of Albania is given at least one month to provide its input, and after considering its comments, the final draft is sent to the Minister of Finance for his/her approval, and thereafter to the Council of Ministers for the final

approval. Once approved, the strategy is published on the web site of the Ministry of Finance.

33. **In the strategy document for 2013-2015, four alternative strategies were prepared.**[10] The first is focused on short-term domestic borrowing denominated in ALL, the second on long-term domestic debt denominated in ALL, the third on new borrowing to be covered only by foreign borrowing, and the fourth on short-term and long-term domestic borrowing supplemented by long-term foreign borrowing. These four alternatives were then tested against a macroeconomic base-case scenario and a stress scenario.

34. **Although in most respects the strategy document follows sound practice the comparison of prospective strategies would benefit from a refinement.** The strategy document presents four borrowing strategies without highlighting one as the selected strategy and the others as part of the analysis to understand the impact of the borrowing alternatives on the composition of the debt portfolio in terms of cost/risk tradeoffs. The analysis does not have to be part of the strategy document which could only describe the selected strategy with or without indicative targets while the analysis itself can either be explained in an appendix or a separate report. Also, although costs are calculated for the strategies compared, there are limited references to risk such as variability of interest rate payments or the resulting debt level at period end compared to GDP. Also, stress tests applied should be separated in different types of shocks to illustrate the effects on the debt portfolio instead of applying only a combination shock. Finally, an up to date macro framework should be used to guide the analysis, as currently the macro framework and the final fiscal table is not available until late in the strategy formulation process.

35. **Debt portfolio targets, presented in the debt management strategy, should be expanded and expressed as a range.** The role of debt portfolio targets is to guide the debt manager in the process of implementing the debt management strategy. The current strategy has target levels for the ratio of short-term and long-term instruments, the duration of the domestic portfolio, and the share of foreign debt. However, it would benefit from including a target level for interest rate risk and the share of domestic debt maturing in one year. In addition, the target levels should have sufficient flexibility for the debt manager to implement the debt management strategy under changing market conditions and as such the target levels should be presented as a range.

36. **The annual borrowing plan (ABP) should be presented more explicitly in the debt management strategy, or it should be prepared as a separate document in line with the strategy, which is typically the case in other markets.** Currently, there is no separate ABP document and this information is too deeply embedded within the text of the document and should be brought out more clearly under a separate ABP heading. The ABP should outline the types of instruments to be issued, the tenors, and the projected amount for each instrument. While acknowledging that predictability is an important feature of the borrowing program, the ABP would benefit from more specifics on the size and timing of new borrowing, however, the current auction calendar states more

[10] The Strategy and Risk Directorate has developed its own analytical tool to quantify the cost and risk of alternative debt management strategies.

information than what is necessary. It would be sufficient to announce the projected annual borrowing amounts in each tenor within ranges together with an indicative auction calendar. This information should be then supported by additional information on instruments on a quarterly basis, while the projected amounts should be offered 7 days ahead of the auction. By providing the more detailed information closer to issuance, deviations from earlier announcements can be limited.

F. Debt Management Systems

37. **RDS is responsible for maintaining up to date records of all central government debt. The debt recording system is DMFAS version 5.3 for external debt and Excel files for domestic debt, on-lending, and guarantees.** All central government's debt records are thus kept electronically, but since the current version of DMFAS does not allow for recording of domestic debt the electronic records are not kept in integrated fashion and the domestic debt is subject to a higher degree of operational risk due to lack of system controls.

38. **The upgrade of the Debt Recording System would enable integrated recording of domestic and external debt.** The proposed upgrade from UNCTAD would include a connection of DMFAS to ALFMIS for straight-through-processing of debt service payments, training of IT officials and system users.[11]

G. Debt and Cash Management

Cash flow projections

39. **The Law on Management of the Budgetary System defines the process for fiscal planning.** The General Directorate of Budget (GDB) and Macroeconomic Directorate, within the Ministry of Finance, are responsible for preparing the medium-term budget framework, which comprises the forthcoming fiscal budget and the Medium-Term Budget Plan (MTBP) for the following three budget years. The framework along with the Debt Management Strategy is approved by the Council of Ministers and published as part of the budget documentation. Based on intermediate fiscal table, the GDB prepares a monthly fiscal table based on inputs from line ministries forecasts of cash flows. This table presents forecasts of aggregate receipts, expenditures, and cash balances at the time of the budget and is sent to BoA and GDT. The GDT, which is responsible for cash management, then further revises the table based on nuances in revenue and expenditure flows and is updated by GDT on a regular basis throughout the year. The GDT then breaks the forecasts into daily and monthly steps and prepares a rolling 12 month forecast.

Cash management

40. **The Bank of Albania supplies a number of services to the GoA and these are outlined in service level agreements that are publicly available.** Two important services include auctions of the treasury bills and bonds in the domestic market and maintaining the Treasury Single Account (TSA) at the BoA. In addition, the BoA is

[11] The MoF had assigned funding for the upgrade in the fiscal budget but was withdrawn due to spending cuts.

authorized by the Law on Bank of Albania (1997) to extend credit to GoA against the issuance of Treasury bills with a tenor of six months. This facility is, however, subject to the approval of the BoA which has restricted the GoAs access in the past and thus this facility cannot be regarded as back-up liquidity for the Treasury.

41. **Cash balance management is limited with the TSA in the BoA.** GDT can place time deposits with the BoA but this is for a minimum of 7-days or 30-days and take two days to arrange.[12] Minimum cash buffers have been determined and these are for two levels. Firstly, a mandatory cash reserve of ALL 500 million to protect against settlement failure in the Automated Clearing House (ACH). Secondly, there is a target balance of ALL 1 billion in the TSA but also an unofficial maximum of ALL 3 billion[13]. Deposits in excess of ALL 3 billion can be placed with commercial banks but this is not implemented.

42. **In addition to the TSA in ALL the GDT keeps accounts in Euro and $US with BoA**. As GDT is required to supply its own foreign currency to meet external debt service payments these must either be built up on in the BoA prior to payment dates or purchased from commercial banks through foreign exchange auctions or outright market transactions.

43. **The low target balance in relation to expenditure makes the Treasury vulnerable to backlogs of payments if the timing of resources, either revenues or new borrowing, is imperfect.** Problems repaying government securities at maturity have been observed, as maturing debt has to be settled by the GDT before market participants can meet their payment obligations for their purchases in the primary auctions.[14]

44. **The debt issuance could be evened to mirror the pattern of the intra year borrowing requirement, distinguishing between short term and structural borrowing needs**. This can avoid situations where large balances are observed on the TSA at different times of the year as funding operations are imperfectly matched with trends in cash flow patterns over the course of the year. Nonetheless a valid argument is that due to market imperfections large scale expenditures need to pre-fund using a smoother issuance pattern over the course of the year to ensure funds are in place. This is a strong argument, given the volatility and bunching of expenditures witnessed over the course of the year end it is clear that it will necessitate a soother pattern of expenditure issuance and a gradual shift and flexibility in T-bill issuance patterns over time to better integrate short-term debt issuance with the pattern of outflows from the TSA. A part of this effort should also be extended to the State Control Audit to ensure their understanding of the indicative nature of auction calendars and need for more flexible T-bill issuance patterns.

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[12] These deposits are also subject to a maximum of Lek 10 billion. The rate of remuneration is a market based rate, determined by interpolation between the one-week repo rate and the yield on three month treasury bills, subject to a ceiling of 25 basis points above the one-week repo rate.

[13] When the balance exceeds Lek 3 billion the BoA actively encourages the GDT to reduce it through spending.

[14] This occurs during times when liquidity in the TSA is low and this results in a payment system gridlock that has needed coordination among market participants where they obtain an intra-day loan to make their payment to the GDT which in turns pays the maturing government securities.

III. PRIMARY AND SECONDARY MARKETS FOR GOVERNMENT SECURITIES

A. Debt Instruments and Auction Mechanism

45. **Treasury bonds are issued with either fixed or variable coupon and in either ALL or a foreign currency.** Until October 2013, MoF issued bonds with 2, 3, 5, and 7 years maturity, of which the shorter maturities (2 and 3 years) are issued with fixed coupon and the longer maturities (5 and 7 years) are issued with both fixed and variable rates. End October 2013, the government issued two 10 year bonds with fixed rates at 9.25 percent and floating rate at a margin of 2.75 percent over the 1-year Treasury bill. Treasury bills are issued in 3, 6, 9 and 12-month maturities at a discount.

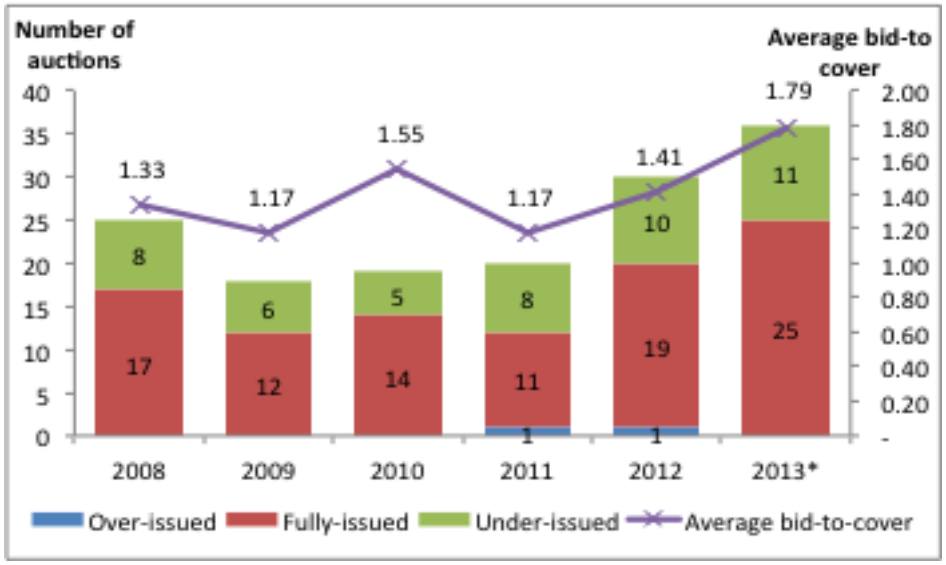
46. **Government securities auctions are regular and organized by BoA on behalf of MoF.** 2-year bonds are offered on a monthly basis, whereas 3, 5, and 7-year bonds are auctioned on a quarterly basis. In the period from 2008 to 2012, there has been an average of 22 bond auctions a year with more than half of the auctions in the 2-year bond segment. However, within the first ten month of 2013, 36 auctions have already been held and a larger share has been in the longer maturities than previously.

Treasury bond auctions

47. **Since 2008, demand has been sufficient to cover the amount offered in most bond auctions**. During the period from January 2012 to October 2013, in 77 percent of the auctions the bid amount has been higher than the announced offer amount, and in 4 percent of the auctions demand has exactly matched the announced offer amount. In the remaining 19 percent, demand has not been sufficient to cover the announced offer amount. During the same period, the average bid-to-cover ratio, the measure of how subscribed the auction, was 1.45. This is the ratio of bids received to the value of the bids accepted (issued amount).

48. **Frequent deviation in the issuance amount from the indicative target results in uncertainty among auction participants regarding the volume that will be available in the market after the auction**. In turn, such uncertainty may lead to a higher premium on the auction bids and to higher funding costs due to the uncertainty on supply. Overall, 98 auctions (66 percent) were fully-allocated meaning that the issued (nominal) amount has been equal to the announced amount (fully-issued), while in 32 percent of the auctions (48 auctions) the issued (nominal) amount was smaller than the announced amount (under-issued). There were also 2 instances (1 percent) of over-issuance. Figure 2 shows the auction performance for each year.

Figure 2. T-Bond Auction Performance (January 2008-October 2013)

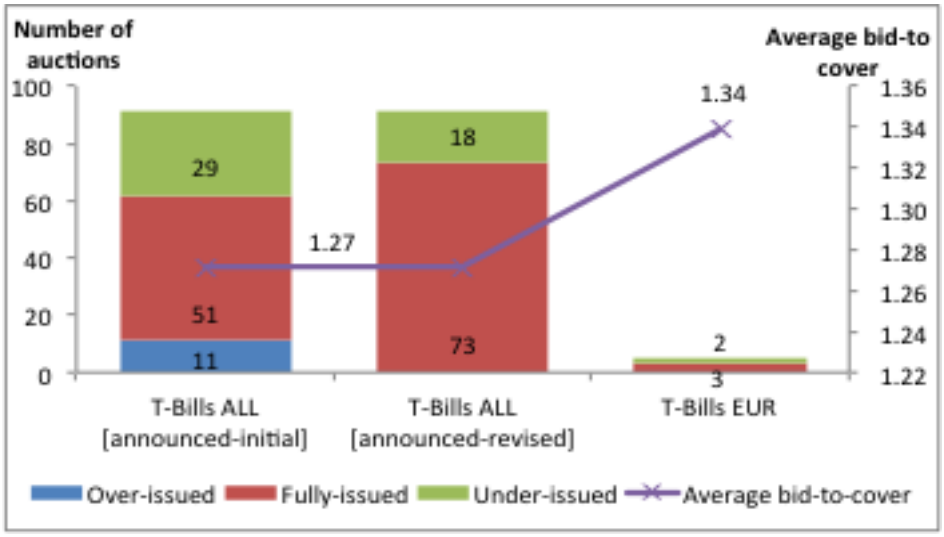


Source: Ministry of Finance and WBG staff calculations
Note: Bid-to-cover is the ratio of the value of bids received to the value of the bids accepted (issued amount)

Treasury bill auctions

49. **Treasury bill auction performance shows significant variability as only 56 percent of the auctions are issued according to the amounts announced prior to the auctions.** Through 2012 and the first ten month of 2013, 96 T-bill auctions have been held, of which five were Euro-denominated. Based on the initially announced amounts, the performance of the ALL T-bill auctions is variable as in 32 percent (29 auctions) of the auctions less funds were raised than planned (under-issued), and in 12 percent (11 auctions) of the auctions the announced amount was exceeded (over-issued). Only in 56 percent (51 auctions) of the auctions the GDPDM accepted the target amount that was announced (fully-issued). 3 out of 5 Euro-denominated T-bills (60 percent) were fully-issued and 2 (40 percent) were under-issued. Based on the revised amounts (structure's changes), 80 percent (73 auctions) of the ALL T-bill auctions were fully-issued and the remaining 20 percent (18 auctions) were under-issued. During the same period, the average bid-to-cover ratio was 1.27 for ALL- and 1.34 for Euro-denominated T-bill auctions. (See Figure 3).

Figure 3. T-Bill Auction Performance (January 2012 - October 2013)



Source: Ministry of Finance and WBG staff calculations
Note: Bid-to-cover is the ratio of the value of bids received to the value of the bids accepted (issued amount)

B. Auction Procedures

50. **Government securities auctions are open to natural or legal persons within Albania and abroad.** Each entity is allowed to submit a maximum on three bids in T-bonds auction and a maximum of five bids in T-bill auctions. The minimum amount bid is ALL 1 million (or EUR/USD 7,000) for T-bonds and ALL 300,000 (or EUR/USD 2,000) for T-bills in each auction. Maximum amount for T-bills is high, at ALL 30 million (or USD 300,000).

51. **An important feature of the government securities auctions is the large share of non-competitive bids that are submitted by the Bank of Albania and individual investors.** In extreme cases the share of the BoA could be up to 70 percent of auctions in 3 and 6 month T-bill auctions with the remaining half allocated to evenly between individuals and competitive bidders. On average, however, the situation is marginally better with approximately 60 percent of the bids being competitive for T-bill auctions and a T-bond auctions being almost entirely comprised of competitive bids.

52. **The limited number of bids that can be submitted by each bidder is restrictive.** By allowing banks to effectively submit an entire demand schedule, they could test various price levels, which would enhance the price discovery process and could, at the margin, encourage an increase in volumes bid. This could also encourage other institutions to submit bids through the banks, again at the margin, as they can be more selective of the price at which the bid is made, adding to demand. Finally, it would also reduce the government's execution risk, allowing finer discrimination between bids to be accepted and rejected.

53. **The competitive segment should be maximized to preserve the pricing integrity of the auctions.** This can be accomplished firstly by separating the BoA participation in the T-bill auctions from the other bidders as it seeks only to roll over its T-bills by announcing separately the maturing amount and rolling it over based on the

weighted average price. Secondly, the maximum amount for an individual to participate on a non-competitive basis should be lowered from the ALL 30 million to a more moderate amount such as ALL 3 million which would be more in line with standard practice. High value purchases of individual that are currently made on a non-competitive basis would need to be done either directly on a competitive basis or through a securities trader licensed by the Albanian Financial Supervisory Authority (AFSA).

54. **In the medium-term, non-competitive bids should be reduced to 25 percent to allow competitive forces to play an even larger role in the auction.** This does not imply that individual investors should be excluded from the auction procedure but rather be turned to commercial banks that would bid on their behalf and safe keep their assets (See also section III-E).

55. **Bond auctions are sealed bid auctions with uniform prices, whereas T-bill auctions are multiple price auctions**. Bidders are allowed to submit non-competitive bids for both bonds and T-bills. For bonds, 20 percent of the offered amount is reserved for non-competitive bidding, whereas the remaining 80 percent are sold through competitive bidding.

56. **Two days prior to the auction MoF announces the final terms such as amount, auction date, issuance date, indicative coupon in the case of fixed coupon bonds and floating interest rate in the case of variable coupon bonds.** The announcement is published on the Reuters system, MoF's website, BoA's website, as well as in a national newspaper and television.

57. **The auction procedure follows a well-organized process but takes too long to complete.** An Auction Board organizes the auctions (consists of three members – one from MoF and two from BoA), and bids can be submitted either in written or electronic **form.** Bids are accepted until 9 am on the day of the auction. After bids have been submitted, the Auction Board no later than 11 am submits a document to MoF with name, amounts, and yields for competitive bids as well as the total amount of non-competitive bids (12 pm for T-bill auctions). MoF then have until 1 pm to finalize the auction result and inform the BoA on the result including type of issued bond, the amount sold, the issuance date, the accepted yield/margin, and is applicable pro-rata on both competitive and non-competitive bids (3 pm for T-bill auctions). As a final step, BoA drafts the auction announcement that is published within the auction day. Closing an auction within a seven hour timeframe takes too long and should be reduced to a reasonable time, such as two hours.[15]

De-fragmentation and benchmark issues

58. **Although re-openings have been used intermittently over the last three years in the 3, 5, and 7 year segments, the outstanding debt remains fragmented with a high number of small bond series and no clear reference bonds.** The GDPDM is considering adopting such a policy to develop the domestic market. To develop the yield curve the GoA should focus on fewer points along the yield curve. The T-bill maturities

[15] Commonly this process from auction close to announcement varies between 5 and 15 minutes in Eurozone countries.

up to 1 year and the 2-year bond provide an anchor for the shorter end of the yield curve. It would be sufficient for the next reference point to be a 5-year maturity, meaning that the 3-year maturity is no longer needed, for instance. Supporting this argument is the recent addition of a 10-year reference point. As a result the GoA should consider defining the key T-note maturities as 2-year, 5-year, 7-year and 10-year. To improve price discovery in the primary market, the auction frequency of the 5 and 7 year might be increased to bi-monthly and a target size of at least ALL 5 billion can be defined for the 5-year, 7-year and 10-year T-bonds. As individual auctions will be smaller than the target size there would be re-openings until the target size is reached.

Market communications

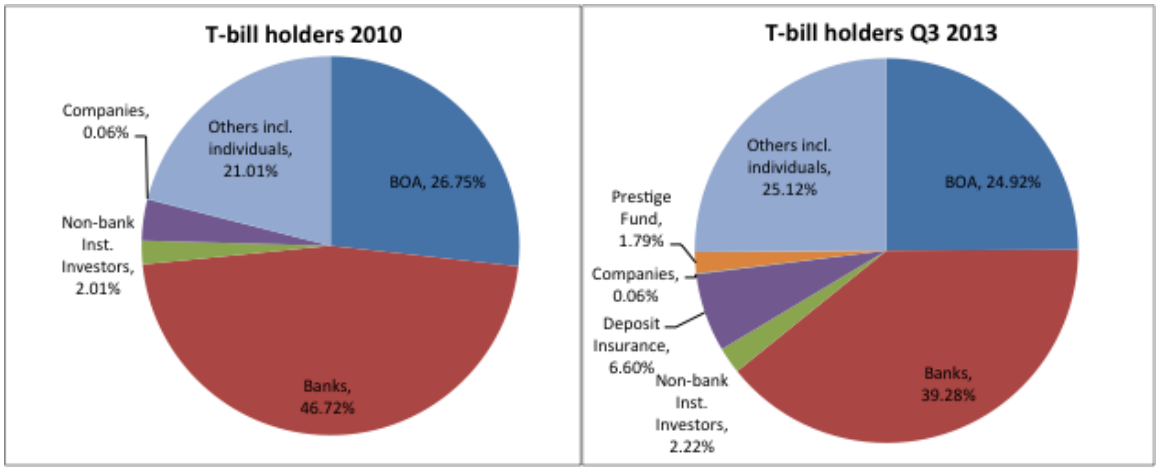
59. **The process used for issuing debt securities in the domestic market can be further strengthened by having a dedicated investor relation unit.** Among the investor relations functions would be to reach out to the market by arranging regular meetings with domestic market participants, keep the website (both the Albanian and the English versions) up-to-date, distributing information material on the debt securities to potential buyers/investors, and preparing press releases. Currently, interaction with market participants is on an ad-hoc basis and mainly through telephone. A regular dialogue with market participants on all aspects of government debt management would be beneficial as it provides two-way communication with the market and a venue to present and examine proposals to develop the domestic market and improve its efficiency. The unit would be expected to contribute to broadening the investor base and increase transparency of debt operations which should, over time, lead to lower borrowing costs.

C. Investor Base

60. **The concentrated nature of the investor base for government securities where they are held by a few key investors with short time horizons naturally limits the volume and structure of the domestic debt portfolio.** That said, the situation has improved slightly over the last 12 months following the introduction of Raiffeisen Investment's Prestige Fund which has grown to almost ALL 42 billion (EUR 300 million) within an 18 month period. An increase in the holdings of other commercial banks has been supported by an accommodative monetary policy stance and retail investors have also increased their share of T-bills.

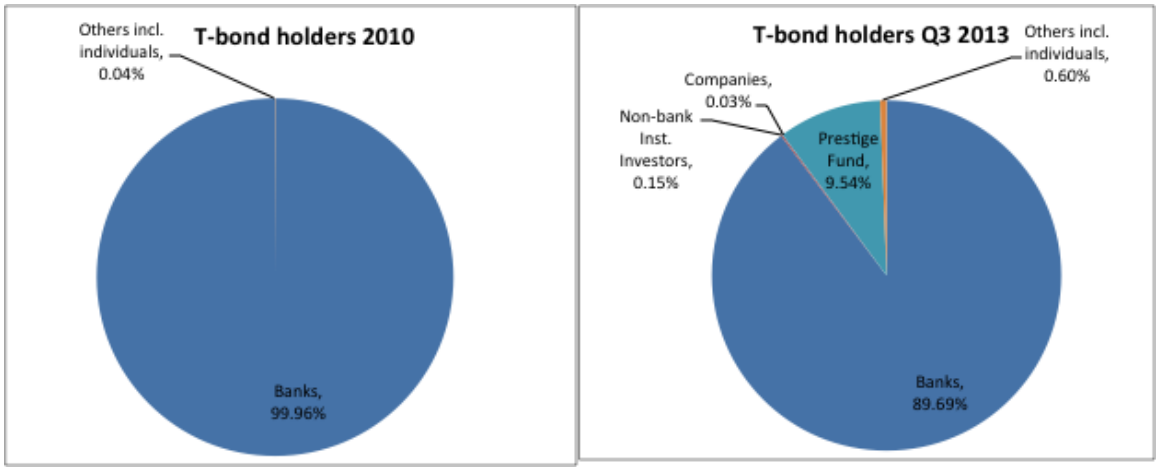
61. **Banks constitute the largest investor group for T-bills but have a less prominent position than for T-bonds**. BoA currently holds around ¼ of the outstanding T-bills, and its share has been somewhat stable over the last three years. NBFIs and individual investors have increased their investor shares over the last couple of years, while banks have decreased their share (See Figure 4). Despite the recent spike in the holdings of NBFIs and individuals, commercial banks continue to dominate holdings of T-bonds, standing at around 90 percent of the total outstanding T-bond stock as of the third quarter of 2013 (See Figure 5).

Figure 4. T-bill Investors (2010 and Q3 2013)



Source: Ministry of Finance

Figure 5. T-bond Investors (2010 and Q3 2013)



Source: Ministry of Finance

Commercial banks

62. **Commercial banks hold approximately 64 percent (ALL 305 billion) of domestic government debt securities.** There are total of 16 commercial banks and 26 percent of their total assets have been invested in government securities. The main liability of commercial banks is deposits (83 percent) that have a short duration. This limits the ability to invest in longer government securities given the lack of secondary market liquidity and interest rate risks. Commercial banks have invested significantly in T-bonds up to 10 years and this constitutes approximately 2/3 of their portfolio which suggests a duration mismatch on their balance sheets. As economic activity increases and credit growth resumes commercial banks would allocate a larger share of their assets to loans which implies that their holdings of government securities would be reduced over the medium term.

Non-bank financial institutions (NBFIs)

63. **The non-bank segment comprises non-bank institutional investors, the Albania Deposit Insurance Agency, companies, and the recently-launched fund**

Prestige, an open ended UCITS compliant investment fund run by Raiffeisen Investment, which currently holds the largest share (6 percent) of total domestic government debt securities in the non-bank segment. Since inception assets held in government securities have grown to approximately ALL 26 billion or 6 percent of domestic government debt securities as of the third quarter of 2013. Many of the Fund's 20,000, all domestic, investors were previously depositors in Raiffeisen Bank. From its inception in March 2012, Raiffeisen has grown by almost ALL 2 billion per month although investment managers expect growth now to decelerate and stagnate at around ALL 65 billion in the next 1-2 years. Prestige has been a strong buyer of medium to long-term T-bonds and its portfolio has duration of 2.7 years.

64. **Prestige has introduced individual investors to investments in longer tenors than commercial bank deposits.** There are nonetheless uncertainties regarding future contributions of Prestige as a long-term investors given that it may need to focus its investments on liquid assets should its growth be reduced in parallel with resumption of economic growth, competition for deposits and rising interest rates. From this perspective a conservative contribution to domestic funding would be warranted.

65. **The Albania Deposit Insurance Agency (ADIA) predominantly invests its premiums in Treasury bills, holding ALL 16 billion of T-bills or 3 percent of total domestic government debt securities as of the third quarter of 2013.** ADIA expects its portfolio to increase by ALL 4.8 billion over each of the next 2 years.

Retail

66. **Around 22,000 retail investors have invested directly in T-bills and hold ALL 64 billion or 13 percent of the domestic government debt securities.** Following an advertising campaign and distribution through post offices retail investments grew further. This share continues to be a stable portion of the investor base and is heavily concentrated in the 12 month T-bill that is the investment benchmark.

Non residents

67. **Nonresident investors are not part of the official statistics compiled by the GPDMD.** Commercial banks have had some interest from nonresidents but this segment of the investor base is not significant. Increasing the participation from nonresident investors would require improving infrastructure such as custody and settlement, assignment of international securities identification codes to local government securities and supporting the development of the secondary market. Several countries in Eastern Europe have successfully been able to attract nonresident investors as their economies have stabilized and moved closer to EU accession.

D. Intermediaries

68. **The Government Securities Retail Market (GSRM) is regulated and supervised by AFSA, and no bank or other entity can carry out retailing of government securities without being licensed by AFSA.** The basis for the operation of the market is set out in Regulation No. 22 issued by AFSA. Currently, 12 securities brokerage companies have been licensed to operate in the GSRM and a key requirement is to report primary and secondary market transactions and to submit indicative prices for

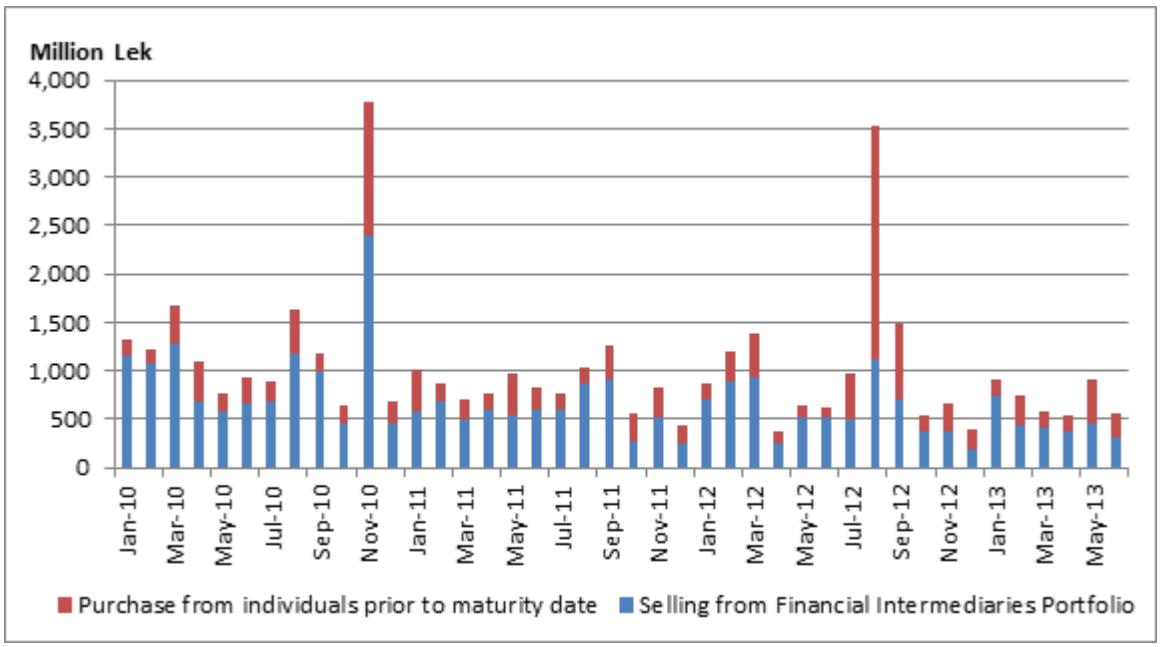
government securities. Daily quotes and transactions are listed on the GSRM, and historical data can be traced based a specific security, day or on a specific transaction type. Furthermore, aggregate quarterly summary statistics are available on AFSA's website.

69. **Secondary market trading in the GSRM market is small and sporadic with monthly trading volumes usually below ALL 1 billion corresponding to approximately 3 percent of domestic debt stock on an annual basis**. This information may understate the overall activity in the secondary market as this omits interbank over-the-counter by banks in the wholesale market. Figure shows monthly trading in government bonds and T-bills from January 2010 to June 2013. AFSA is taking step to extend its reporting requirements to include interbank OTC transactions and this would be an important milestone to ensure that all market activity is consolidated in one place.

70. **Given current and expected levels of activity the market structure is broadly appropriate.** AFSA should expand its Regulation 22 by subjecting licensed brokerage companies to a code of conduct in their dealings with their clients. Furthermore, AFSA should clarify regulatory jurisdiction between AFSA and BoA for supervising the interbank OTC market for government securities as this area is not sufficiently clear.

71. **Most secondary market transactions are in the short term segment, and since 2010 around 70 percent of the traded volume has been in T-bills.** Volume of transactions remains small and is normally less than ALL 1 billion each month which reflects the low frequency and small volumes of these transactions.

Figure 6. Monthly Secondary Market Trades with Individual Investors in Bonds and T-bills (January 2010 to June 2013)



Source: AFSA Quarterly Statistics.

72. **Attempts to vitalize the secondary market have yielded limited results.** Secondary market liquidity is mainly hampered by the fact that majority of investors hold their government securities to maturity and either have limited needs to adjust their positions in the secondary market, as it is more effective for them use other instruments in their balance sheet. This is slowly changing, but existing practices such as banks applying hold-to-maturity (HTM) classification for their government securities as well as Prestige Investment Fund applying HTM to half of its portfolio limits the incentives to manage interest rate risk.

73. **In the absence of a liquid market for government securities the primary market yield curve would provide information on daily valuation.** Banks should be encouraged hold a share of the government securities as an available-for-sale (AFS) portfolio. In the absence of a liquid market for government securities the valuation would initially need to be based on the primary market government securities yield curve and this information collected and published by either the AFSA or the BoA.

74. **Developing the function of an intermediary in the primary market is feasible.** Bidding on behalf of retail customers is likely to become a viable business for intermediaries once non-competitive bids are capped at ALL 3 million as those bidders are likely to seek advice from banks to assist in processing their bids and custody of their assets. Limiting the number of banks that are allowed to bid on behalf of clients and provide custody services will present a business case to those banks to develop this function and provide additional services such as secondary market transactions. This service would need to be separated by a Chinese wall from the banks' own proprietary trading function but would be a first step to incentivize banks to develop their capabilities as an intermediary.

75. **The BoA should gradually withdraw from providing direct bidding to retail customers.** Accepting direct bids in government securities auctions from a high number of retail participants is not a core central bank function and can be provided by private sector participants provided commissions are kept competitive and the quality of service is good.

E. Market Infrastructure

76. **Current market infrastructure for custody and settlement is based on a registry in the absence of a fully-fledged Central Securities Depository and this arrangement suffers from operational and credit risks.** Although the Albanian Interbank Payment System is a Real-Time Gross Settlement (RTGS) system, the settlement of securities is based on a homemade settlement system, which is not automatically linked to the gross payment system. Settlement of securities is thus not based on a pure Delivery-versus-Payment (DvP) system as securities transfer is done manually by the BoA after receiving a free format Swift message from both trading parties as well as payment through the RTGS with transactions settled at T+2. BoA is working to introduce a fully-fledged Central Securities Depository that will be connected to the RTGS system and will provide DvP type 2 settlement for government securities by July 2014.

77. **The Market Operations Department in the BoA executes securities transfers.** At issuance and maturity date of bonds, BoA registers purchase of government securities in the names of investors and distributes payment to holders at maturity. Investors participating in the government securities auctions must have an account with the registry. Licensed banks can act as custodians for their customers and are required to organize a special department for the security custody activity[16]. The banks then have two dematerialized securities accounts with BoA, one for their own purpose and one for their clients'.

78. **AFSA is the entity responsible for supervision of both the two-level securities registry system for government bonds and the two-level book entry system for T-bills.** The Bank of Albania verifies registry records monthly, both with the banks and then reconciles overall balances with the GDPDM.

F. Strategic Issues for Government Securities Market Development

79. **Government securities market development in Albania is at a crossroads.** Efforts have succeeded in developing the short end of the yield curve and a primary market that functions reasonably well. Communication with market participants has also moved forward and with the forthcoming upgrade of the central securities depository system, payment and infrastructure will be robust. Finally, standard nominal instruments have been issued up to 10-year have been introduced and the regulatory framework will see a few improvements relating to improving price reporting and prudential norms in the short-term.

80. **The agenda for market development will require more attention from policymakers as developing a secondary market that provides investors with an exit mechanism is challenging.** The pace will depend upon a combination of further diversification of an investor base that has the incentives to manage their interest rate and liquidity risk and intermediaries that are prepared to develop a business line based on government securities. This important stage is addressed in this Technical Note by recommending improved price signals in the primary market; a valuation framework for government securities (to facilitate mark-to-market in an available-for-sale portfolio); upgrading secondary market price transparency; and strengthening custody and settlement systems.

81. **After these reforms are well established the next rational step would entail commercial banks allocating a share of their government securities to a trading portfolio.** Gradually evolving from there would be to see expanded services to bank clients such as bidding on their behalf in the primary auctions, two-way-quotes on a best effort basis. Initially, activity levels would be low but as an increasing number of investors would manage their portfolios more actively and business flows pick up.

82. **At that stage, it would become increasingly necessary to revisit the domestic issuance program and concentrate it into fewer larger reference maturities along the yield curve.** Increased depth in individual bonds would serve to concentrate the same

[16] A total of 8 Banks have been licensed as Custodians by AFSA. These are: Tirana Bank, Intesa Sanpaulo Bank; Alpha Bank; Banka Credins; First Investment Bank; Raiffeisen Bank; BKT; and Societe Generale.

level of market activity, leading to an improvement in pricing for the key reference points on the yield curve.[17] At such a stage, a transition to a regular market making where intermediaries would provide meaningful two-way quotes will have taken root. To support this transition a primary dealer system focused on the secondary market obligations of primary dealer with realistic obligations and rights of the primary dealer community but such an arrangement would need to be specified in more detail and well aligned with the market environment. Finally, identifying the role that foreign investors can play is an important one as they have different investment horizons and preferences than domestic investors, which can result in improved demand structure and secondary market liquidity. Notwithstanding possible benefits, introducing foreign investors into an illiquid market can have drawbacks such as volatile capital flows, interest rate, and exchange rate volatility.

[17] Increasing size of benchmark bonds has the potential to increase individual maturities and will need to be carefully coordinated with cash management policy. Furthermore, it may be beneficial to develop liability management instruments such as buybacks and exchanges to manage the rollover risk. Also, this needs to be taken into account in the debt management strategy as it may increase refinancing risk.

Figure 7. A Potential Timeline to Implement Proposed Recommendations for Market Development

	SHORT-TERM: < 1Y	MEDIUM-TERM: 1-3Y	LONG-TERM: 3Y+
PM	**Institutional Organization** ▪ Ensure institutional arrangements, internal organization, and staff resources are sufficient **Medium Term Debt Management Strategy** ▪ Use up-to-date macro framework and fiscal figures in preparation of the MTDS ▪ Include debt portfolio targets as ranges in the MTDS ▪ Refine prospective strategies and state details of each strategy in the MTDS ▪ Apply different type of shocks to prospective strategies in the MTDS ▪ Include an explicit ABP as part of the MTDS **Issuance Strategy** ▪ Reduce the number of key maturities of T-bonds ▪ Apply re-openings to build larger issues ▪ Increase frequency of issuance for 5-year and 7-year T-bonds ▪ Continue lengthening the maturity of domestic debt **Auction Procedure** ▪ Allow auction participants to submit multiple bids in auctions ▪ Separate BoA's participation in auctions ▪ Prepare plan for gradual change of auction procedures to reduce share of non-competitive bids and limit number of direct retail auction participants **Investor Relations** ▪ Introduce open annual meetings with major market participants	**Issuance Strategy** ▪ Continue lengthening the maturity of domestic debt ▪ Implement a benchmark building strategy **Primary Dealership (PD) Program** ▪ Carry out a full market analysis to assess market readiness for implementation of a PD system ▪ Define a well-balanced set of responsibilities and privileges that is in line with specific market characteristics and the stage of market development **Auction Procedure** ▪ Close auctions within a shorter timeframe ▪ Reduce the maximum amount a single investor can bid at a non-competitive price ▪ Designate (through competitive selection) a limited number of banks that are allowed to accept retail bids ▪ Subsequently, abolish direct bids from retail investors **Valuation Framework** ▪ Introduce daily valuation framework based on primary market prices **Investor Relations** ▪ Establish investor relations unit **Cash Management** ▪ Rough-tune cash flows ▪ Increase the cash buffer ▪ Consider issuance of ad-hoc cash management bills	**Issuance Strategy** ▪ Continue lengthening the maturity of domestic debt **Cash Management** ▪ Develop a cash forecasting function within GDT ▪ Prepare pattern of T-bills issuance to reflect cash flow patterns
SM	**Trade Information** ▪ Require banks to report information on all secondary market activity to AFSA ▪ Disclose summarized transaction information on AFSA's website **Regulation** ▪ Clarify jurisdiction between AFSA and BoA for supervision of the interbank OTC market	**Standardization** ▪ Establish an ANNA numbering agent to add ISIN numbers government securities **Regulation** ▪ Introduce code of conduct and supervision of the code of conduct **Valuation Framework** ▪ Undertake work in collaboration with market participants to produce a set of valuation principles	**Valuation Framework** ▪ Introduce valuation framework and calculate yield curve based on secondary market prices on a daily basis
I	**Debt Management System** ▪ Upgrade DMFAS **Depository** ▪ Introduce CSD in BoA	**Debt Management System** ▪ Integrate management of domestic and external debt with connection to ALFMIS	
	2014	2016	2017+

PM: Primary Market, SM: Secondary Market, I: Infrastructure