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Report No 86955-AL

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF EQUIVALENT TO US$100 MILLION

TO THE REPUBLIC OF ALBANIA

FOR THE

FINANCIAL SECTOR MODERNIZATION LOAN

March 31, 2014

Finance and Private Sector Department
South East Europe Country Unit
Europe and Central Asia Region

Albania - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of March 23, 2014)

Currency Unit	Albanian Lek
US$1.00	0.01

Weights and Measures
Metric System

ABBREVIATION AND ACRONYMS
(As applicable, plus others)

AAB	Albanian Association of Bankers
ADIA	Albania Deposit Insurance Authority
AFSA	Albanian Financial Supervisory Authority
BoA	Bank of Albania
CAD	Current Account Deficit
CAS	Country Assistance Strategy
CDS	Credit Default Swaps
DB	Doing Business
DPL	Development Policy Loan
EBA	European Banking Authority
ECB	European Central Bank
EFF	Extended Fund Facility
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
EU	European Union
FIRST	Financial Sector Reform and Strengthening Initiative
FSAP	Financial Sector Assessment Program
FSAG	Financial Stability Action Group
FSVC	Financial Services Volunteer Corps
FSML	Financial Sector Modernization Loan
GDP	Gross Domestic Product
GIZ	Gessellschaft fur Internationale Zusammenarbeit (German Society for International Cooperation)
GNP	Gross National Product
HIPC	Heavily Indebted Poor Countries
IADI	International Association of Deposit Insurers
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IEF	Index of Economic Freedom
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
JSAN	Joint Staff Advisory Note
LDP	Letter of Development Policy
MDGs	Millennium Development Goals
MOC	Memorandum of Cooperation
MoF	Ministry of Finance
MoJ	Ministry of Justice
MTBP	Medium-Term Budget Plan
MTEF	Medium-Term Expenditure Framework
MTPL	Motor Third Party Liability
NBFI	Non-bank financial institutions
NPL	Non-Performing Loans
NSDI	National Strategy for Development and Integration
PER	Public Expenditure Review
PHRD	Japan Policy and Human Resources Development Trust Fund
PRGF	Poverty Reduction and Growth Facility
ROSC	Report on the Observance of Standards and Codes
SDR	Special Drawing Rights
SOE	State-Owned Enterprise
TA	Technical Assistance
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value-added tax

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REPUBLIC OF ALBANIA
FINANCIAL SECTOR MODERNIZATION LOAN
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REPUBLIC OF ALBANIA
FINANCIAL SECTOR MODERNIZATION LOAN

Borrower	Republic of Albania
Implementation Agency	Bank of Albania (BoA), Albanian Financial Supervisory Agency (AFSA), Ministry of Finance (MoF), Ministry of Justice (MoJ), Albanian Deposit Insurance Agency (ADIA)
Financing Data	IBRD loan *Amount:* €72,600,000 (US$100 million equivalent) *Terms: S*even year grace period, 22.5 years maturity, with a capitalization of the front-end fee, level repayments, a Fixed Spread and with all conversion options remain open for the life of the loan.
Operation Type	Development Policy Loan
Pillars of the Operation And Program Development Objective(s)	The PDO is to strengthen the financial sector regulatory and supervisory regime and mitigate key vulnerabilities of the bank and non-bank financial sectors. The DPL is structured around three pillars: (i) strengthening regulation and supervision of the banking sector and financial safety net; (ii) expediting resolution of non-performing loans (NPLs); and (iii) strengthening regulation and supervision of Nonbank Financial Institutions (NBFIs).
Results Indicators	The following outcome indicators will be used to measure results achieved in this DPL: *Pillar I – Strengthening regulation and supervision of the banking sector and financial safety net* 1. By end-March 2015, inspections of five of 16 banks are conducted in accordance with the new Risk Based Supervisory Manual and the new Supervisory Operational Policy, including at least two systemic banks. 2. By end-March 2015, all banks determined as systemically important submit enhanced Recovery Plans to BoA, in line with the new BoA Instruction that formalizes content that must be included in banks' Recovery Plans. 3. By end-March 2015, ADIA completes assessment of compliance of eligible SCAs with the legal and technical requirements of ADIA in order to ensure that eligible SCAs enter the deposit insurance scheme by end-2015. 4. By end-March 2015, ADIA approves its own budget without BoA ratification. *Pillar II – Expediting resolution of NPLs* 5. By end-March 2015, the ratio of NPLs/total loans declines to 20 percent or less, with the write-off of at least 20 billion of NPLs. *Pillar III – Strengthening regulation and supervision of NBFIs* 6. By end- March 2015, AFSA's Board adopts its own organizational structure and market-based salary scale independently from Parliament, allowing it to regulate and supervise NBFIs more effectively 7. By end March-2015, funding of the MTPL Compensation Fund is replenished in the amount of Lek 430 Million to enable payment of pending insurance claims.
Overall risk rating	Substantial
Operation ID	P146280

IBRD PROGRAM DOCUMENT FOR A
PROPOSED LOAN TO THE REPUBLIC OF ALBANIA

I. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed Development Policy Loan (DPL) aims to strengthen the financial sector regulatory and supervisory regime and mitigate key vulnerabilities of the bank and non-bank sectors.** The proposed operation is designed to support the Government's reform agenda to address key challenges across the financial sector. The operation is structured around three pillars: (i) strengthening regulation and supervision of the banking sector and financial safety net; (ii) expediting the resolution of NPLs; and (iii) strengthening the regulation and supervision of NBFIs. This is a standalone operation in the amount of US$100 million.

A. COUNTRY CONTEXT

2. **Domestic and external vulnerabilities are high and continue to pose risks to macroeconomic stability.** Public debt and fiscal financing needs are among the highest in the region. Heavy trade, financial and remittance dependence on Italy and Greece remain important potential sources of vulnerability. The country's limited export base and vulnerability to shocks pose additional external risks. Insufficient fiscal consolidation efforts or slow progress on structural reforms could undermine investor confidence and increase rollover risks for government debt.

3. **Albania's sustained high economic growth in the decade prior to the 2008 global financial crisis helped it achieve a middle income status and reduce poverty**. During 1998-2008, annual growth averaged 6 percent in real terms with a fivefold increase in per capita GDP to above US$4,000. Although this period of strong growth was not matched by the same level of employment creation, it was successful in terms of poverty reduction. Absolute poverty halved from 25 percent in 2002 to about 18 percent by 2008.

4. **However, Albania was hit hard by the global crisis, although it was able to avoid a recession.** The crisis led to lower remittances and other flows, which in turn contributed to lower growth, particularly in the construction sector. GDP grew by an average of below 3 percent between 2009 and 2012. The Eurozone crisis further compounded the challenge of recovery, as Albania has close links to the Greek and Italian economies via exports, remittances, and financial flows. The economy has been slowing significantly since 2012, as weak credit growth and rising government payment arrears have contributed to weaknesses in domestic demand. External demand has been the primary driver of growth in the last two years, but remains limited due to continued weaknesses in the Eurozone, including in the trading partners, and a narrow export base. In 2013 growth is estimated to slow to 0.7%, and averaging 2 percent between 2013 and 2016.

5. **Albania made significant progress in poverty reduction up until 2008, which has since been reversed.** Albania was propelled from being one of the poorest countries in Europe in the 1990s to middle income status in 2008. Between 2002 and 2008 alone, Albania's poverty was halved, falling from 25.4 percent in 2002 to 12.8 percent in 2008. Since 2008 poverty has, however, been on the rise. Results from the 2012 LSMS data show an increase in poverty to 14.3

percent. This increase translates into 28,900 people being pushed into poverty. Extreme poverty, defined as having difficulty meeting even basic nutritional needs, decreased from about 5 percent in 2002 to 1.2 percent in 2008, but increased to 2.2 percent in 2012. Most of the poverty increase was in urban areas, narrowing the gap in living standards between rural and urban areas.[1]

6. **Similarly, shared prosperity - consumption growth of the bottom 40 percent - improved between 2005 and 2008, but has since deteriorated.** Household expenditure[2] increased from 2005 to 2008 across all percentiles, but particularly for those in the bottom 40 percent. The mean expenditure of the bottom 40 percent grew at an annualized rate of 2.6 percent, exceeding the growth rate of the country's average household expenditure of 1.3 percent. Between 2008 and 2012 consumption growth declined for all economic groups (-1.3 percent), including those in the bottom 40 percent (-1.2 percent), as growth slowed down.

7. **The new Government is committed to correct economic imbalances and undertake key reforms to restore sustainable economic growth**. The strong election mandate augurs well for political stability in the period ahead, as the authorities are keen on launching upfront policy and structural reforms. Since the early 2000s, Albania has implemented a range of institutional and structural reforms that has moved it closer to EU membership. After parliamentary elections, the European Commission recommended in October 2013 that Albania be granted a candidate status conditional on the completion of key judicial and public administration reforms. On December 13, 2013, the Dutch parliament, however, vetoed the candidate status, which will be reconsidered in the summer of 2014.

B. FINANCIAL SECTOR CONTEXT

8. **Following the 2008 global financial crisis, the banking sector has remained stable with adequate capital and liquidity, though key channels of vulnerability remain.** High financial euroization, strong financial links between banks and government debt holdings, and the dominant presence of subsidiaries of foreign banks increase the banking sector's vulnerabilities to potential shocks. NPL ratios are amongst the highest in the region, leading to a sharp slowdown in credit growth as banks take a conservative approach to lending. Risks to the banking sector may be exacerbated in the event of further Eurozone financial stress or deleveraging, which could hurt the economy through spill-over effects (through trade, investment and remittances channels), and thus could negatively impact financial stability.

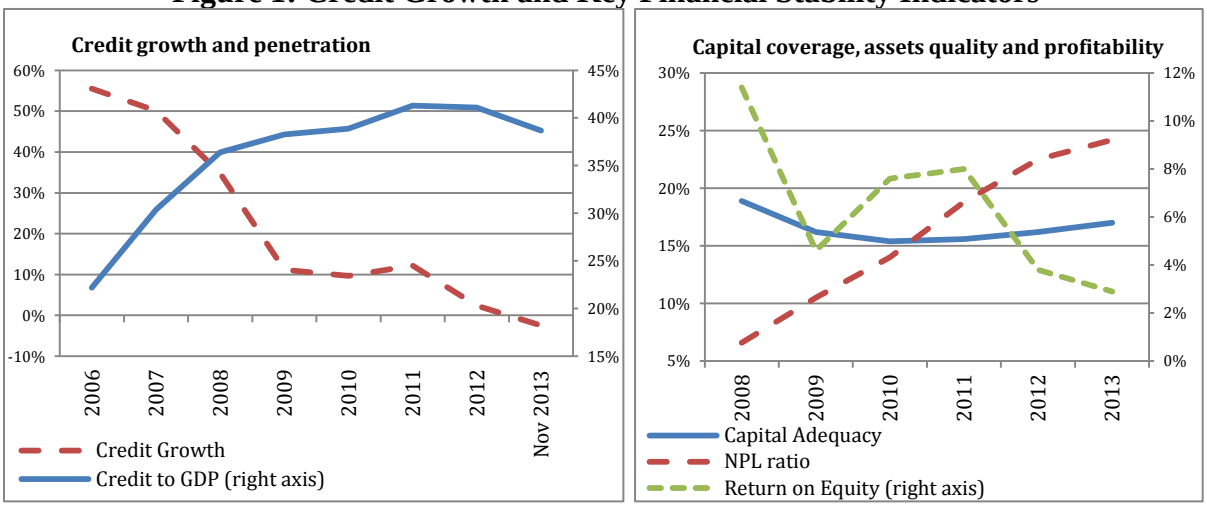
9. **The decline in bank profitability and the high NPL rates present key risks to the banking sector, and undermine credit growth.** Bank profitability has declined sharply with the return on equity falling from over 20 percent in 2007 to below 6.4 percent in 2013. NPLs have increased from 3 percent at end-2007 to more than 23 percent at end- 2013, and provisions covered 65 percent of NPLs at end-2013. NPLs have risen significantly due to a combination of factors, including past poor credit underwriting practices by banks, the credit boom experienced prior to 2008, the general economic slowdown, the rise in government arrears (as a result of poor

[1] In 2012, poverty is higher for male-headed households (15 percent) than for female-headed households (10 percent). These estimates, however, mask self-selection, as women heading households (less than 9 percent of all household heads) tend to have different characteristics than other women.

[2] Expenditure includes consumption and non-consumption expenditures as a proxy of household income.

tax revenue performance and continued infrastructure spending), and a protracted, unreliable collateral execution regime. Due the large hangover of NPLs in the banking system, credit growth turned negative at end-November 2013, declining by 2.4 percent (year-on- year) (Figure 1).

Figure 1: Credit Growth and Key Financial Stability Indicators



Source: IFS, BoA

10. **High financial euroization and significant foreign bank presence increase the vulnerability of the financial system to external shocks**. There are potential risks connected with the widespread use of the euro. About half of banks' loan portfolio is denominated in foreign currency and unhedged, which in combination with large maturity mismatches, could create further risks in case of a depreciation of the lek. In addition, the largely foreign-owned structure of the banking sector with Austrian, Greek, Italian, and Turkish banks presents additional risks. Financial difficulties in parent banks can affect the Albanian subsidiaries through direct contagion due to spill over fears or defunding pressures when parent banks are unable to provide capital support to the local subsidiaries. The conversion of bank branches to subsidiaries in 2012 was a timely step that served to limit deleveraging, as prudential limits on capital adequacy and liquidity were set at the level of the subsidiary rather than the group.

11. **The strong financial links between banks and the government further increase the vulnerabilities**. A large share of bank assets is invested in government securities, representing more than 60 percent of government debt. This significant interdependence presents systemic risks for banks, which are vulnerable to changes in the value of longer term debt securities, and for the government, which depends on regular roll over of debt by banks. The risk is heightened by the lack of a well-functioning secondary market and the emergence of investment funds, which are attracting new investments, and face significant liquidity risk and challenges regarding asset valuation. On the government side, public debt management capacity has been undermined by staff reductions at the Ministry of Finance Public Debt Management Department.

12. **The nonbank sector is small but new risks have emerged, coupled with a regulatory and supervisory framework that can be significantly strengthened.** Investment funds have grown considerably since 2012, but while these funds have helped diversify the ownership of government securities, their emergence has not been matched with an adequate regulatory and

supervisory regime. Moreover, given the close links of the investment funds with banks, redemption pressures may spill over onto banks. The insurance market also faces significant challenges as insurance companies are not financing outstanding liabilities in full. The underwriting performance of non-life insurance sector has been negative in recent years with a major deterioration in 2013. Due to the need of major institutional reform to achieve financial and operational independence of the nonbank regulator, the regulation and supervision of the sector has lagged behind.

13. **The deposit insurance framework, managed by the Albanian Deposit Insurance Agency (ADIA), broadly conforms to international best practice.** ADIA was established in 2002 pursuant to the Deposit Insurance Law, as amended in 2009 and 2012. ADIA protects deposits of natural persons up to the maximum of 2.5 million Lek (about $25,000) per bank depositor, and it ensures approximately 58 percent of deposits in the banking system. ADIA has made impressive progress in improving its operations and building its organizational structure. The ADIA law was amended in 2012 to address a key set of reforms to extend coverage to Savings and Credit Associations (SCAs), facilitate a prompt pay-out after BoA intervention, and expanding ADIA powers to contribute to a purchase and assumption or bridge bank resolution.

14. **In sum, the financial sector authorities have undertaken significant measures to minimize vulnerabilities in the financial sector, and are currently working on the implementation of several other key reforms to further mitigate risks.** Amendments to the Banking Law adopted in 2011 provided the BoA with more options for bank resolution. BoA also strengthened its crisis management framework by enhancing its monitoring and analytical tools for assessing financial stability. Additionally, key amendments to the Civil Procedure Code adopted in 2013 enhanced the collateral execution process.

II. MACROECONOMIC POLICY FRAMEWORK

A. RECENT ECONOMIC DEVELOPMENTS

15. **The global financial crisis and the subsequent Eurozone crisis have led to a significant slow-down in Albania's growth.** In the years preceding the global crisis, 2005-08, the economy grew at an average annual rate of 6.2 percent enabling an increase in household expenditures of the bottom 40 percent by 2.6 percent per year. Growth was driven primarily by domestic consumption followed by investment. With expanding imports, net exports had negative contribution to growth during this period. On the production side, services were the largest contributor to economic growth, followed by construction. The global financial crisis in 2008 and the subsequent Eurozone crisis slammed the brakes on Albania's growth. Albania was able to avoid a recession but GDP growth slowed to less than 3 percent on average between 2009 and 2012 as exports, remittances and inflows suffered, in particular from Albania's close ties to the Greek and Italian economies.

16. **Large external imbalances that accumulated in the years preceding the crisis have been slowly correcting.** The current account deficit which reached 15.5 percent of GDP in 2008 has subsequently improved and declined to 9.0 percent of GDP in 2013 (Table 1). The improvement has been due to favorable weather and the resulting hydroelectricity exports (in

2010 and 2013) and crude oil exports (in 2011), which combined, have helped exports to increase by 34.5 percent since 2009. In parallel, imports have declined since 2009 due to weak domestic demand.

17. **Inflation has remained low.** The Bank of Albania maintains an inflation-targeting monetary policy and a flexible exchange rate regime with relatively little intervention. These policies, along with flexible wage setting, have been effective in containing inflation and unit labor costs. Inflation was 2 percent in 2012 and 2013, and the Lek-euro value was largely flat in 2011 and 2012. The IMF assessed in January 2014 that the exchange rate appears broadly in line with fundamentals using the Equilibrium Real Exchange rate approach, but modestly overvalued using other methodologies.

Table 1: Key Macro-economic Indicators**

				Est.	Projected			
	2010	2011	2012	2013	2014	2015	2016	2017
	Annual percentage change unless otherwise indicated							
Nominal GDP in billions of lek	1,222	1,282	1,326	1,358	1,418	1,502	1,595	1,697
GDP in constant prices	629	637	635	639	653	675	698	723
Real GDP	3.8	3.1	1.6	0.7	2.1	3.3	3.5	3.5
Contributions								
Consumption	*3.5*	*5.2*	*-0.9*	*-2.0*	*0.8*	*4.5*	*6.0*	*2.2*
Public investment	*-2.8*	*0.1*	*-0.9*	*0.9*	*-1.6*	*0.2*	*0.2*	*0.2*
Private Investment	*0.5*	*0.8*	*-0.4*	*-2.7*	*1.2*	*1.1*	*1.5*	*0.6*
Net exports	2.5	-3.0	3.8	4.5	1.7	-2.4	-4.1	0.5
Unemployment rate*	13.5	13.3	13.5	16.9				
GDP Deflator	2.6	3.5	2.1	1.7	2.3	2.5	2.7	2.8
CPI (period average)	3.5	3.4	2.0	1.9	2.7	2.8	3.0	3.0
Fiscal accounts	Percent of GDP unless otherwise indicated							
Expenditures	29.9	29.3	28.4	30.1	32.1	31.3	31.1	29.9
of which: arrears clearance					2.5	1.3	1.1	
Revenues	26.1	25.8	24.9	24.0	25.4	25.3	25.2	25.2
Unidentified fiscal measures						1.2	2.4	3.3
General government balance	-3.8	-3.6	-3.5	-6.2	-6.7	-4.8	-3.4	-1.3
PPG General Government Debt	58.5	60.3	62.4	70.5	71.7	71.2	69.3	66.5
Selected monetary indicators	Annual percentage change unless otherwise indicated							
Base money	-0.5	2.2	2.7	4.3	4.1			
Credit to non-government	10.1	10.4	1.4	-3.0	2.6			
BOA repo rate (in percent)	5.0	4.8	4.0	3.0				
Balance of payments	Percent of GDP unless otherwise indicated							
Current account balance	-10.0	-9.6	-9.3	-9.0	-10.3	-12.4	-14.8	-13.0
Imports	53.9	57.6	52.4	50.9	51.2	53.0	55.7	54.0
Exports	33.0	34.5	33.4	33.8	34.2	34.7	34.9	35.1
Foreign direct investment (net)	9.3	7.9	7.6	7.7	8.4	11.1	15.0	18.0
Gross reserves:								
in billionsof US$, eop	2.5	2.6	2.6	2.6	2.7	2.7	2.8	2.9
in months of imports of G&S**	4.4	4.5	4.8	4.8	4.5	4.1	4.0	4.1
relative to external debt service	16.0	7.0	21.0	18.0	16.0	14.0	4.0	12.0
Terms of trade (percent change)	5.8	0.3	-0.1	-1.1	-0.4	-0.6	-0.3	-0.2
Exchange rate (Lek/US$, average)	103.9	100.9	108.0	105.7	105.7	105.7	105.7	105.7
Other memo items								
Nominal GDP (in millions of US$)	11,762	12,706	12,282	12,854	13,420	14,210	15,098	16,057

*According to ILO definition. **G&S refers to goods and services

Source: Albanian Ministry of Finance and Bank of Albania; Staff estimations and projections.
**General government balance is on cash basis. The 2013 general government debt stock includes arrears.

18. **Albania's fiscal deficit widened significantly in 2013 to an estimated 6.2 percent** (Table 2). Its fiscal deficit averaged 3.4 percent between 2005 and 2012, except in 2008 and 2009, when it deteriorated sharply. Revenues as a share of GDP climbed from 25.1 percent in 2005 to 26.7 percent in 2008 but declined to 24 percent in 2013 due to a reduction in the corporate income tax rate in 2009, increases in VAT exemptions and declining revenue collection. As revenues fell, so did budgeted spending. Personnel expenditures declined from 6.1 percent in 2008 to 5.3 percent in 2013. Capital expenditures also contracted. However, social transfers as a share of GDP have risen steadily since 2000, reaching 8.6 percent in 2008 and then 9.4 percent in 2013. The pension system deficit, including rural subsidies, reached 3.6 percent of GDP in 2012 largely as a result of contribution rate cuts in 2006 and 2009, unfunded increases in benefits, and perverse incentive effects that threaten the longer term financial stability of the system despite the relatively young population. In 2013, a slowdown in the economy together with general elections in June 2013 led to an expansionary fiscal policy during the first half of 2013. In addition to higher expenditures, tax revenue underperformed considerably. The sharp deterioration in revenues pushed the fiscal deficit up to 6.2 percent of GDP from 3.5 percent planned initially.

Table 2: Fiscal Operations of the General Government (Percent of GDP)*

			Est.		Proj.			
	2010	2011	2012	2013	2014	2015	2016	2017
Total revenues (and grants)	**26.1**	**25.8**	**24.9**	**24.0**	**25.4**	**25.3**	**25.2**	**25.2**
Tax revenues	23.6	23.7	22.7	21.6	23.3	23.3	23.3	23.3
Non-tax revenues	2.1	2.1	1.8	1.8	1.8	1.5	1.5	1.5
Grants	2.5	2.1	2.2	2.4	2.1	2.0	1.9	1.9
Expenditures	**29.9**	**29.3**	**28.4**	**30.1**	**32.1**	**31.3**	**31.1**	**29.9**
Current Expenditures	24.5	23.8	23.6	24.5	24.4	25.3	25.3	25.2
Wages and compensation	5.4	5.3	5.2	5.3	5.2	5.2	5.3	5.3
Goods and services	2.7	2.6	2.4	2.6	2.5	2.5	2.5	2.5
Interest payments	3.4	3.2	3.1	3.0	3.4	4.1	4.1	4.0
Current transfers	13.0	12.8	12.8	13.6	13.2	13.4	13.5	13.3
Capital expenditures	5.9	5.5	4.6	5.7	4.7	4.7	4.6	4.7
Reserve fund	0.0	0.0	0.0	0.2	0.3	0.1	0.1	0.1
Clearance of arrears	0.0	0.0	0.0	0.0	2.5	1.3	1.1	0.0
Unidentified fiscal measures					0.0	1.2	2.4	3.3
Overall Balance	**-3.8**	**-3.6**	**-3.5**	**-6.2**	**-6.7**	**-4.8**	**-3.4**	**-1.3**
General government financing	**3.8**	**3.7**	**3.5**	**6.2**	**6.7**	**4.8**	**3.4**	**1.3**
External (net)	2.4	1.7	1.2	0.7	1.9	1.9	-1.0	-1.0
Domestic(net)	1.4	2.0	2.3	5.4	4.8	2.9	4.4	2.4
of which privatization	0.0	0.0	0.1	0.9	0.0	0.0	0.0	0.0

Source: Albanian Ministry of Finance; Staff estimations and projections.
*On cash basis.

19. **Public debt has surged since the 2008 crisis**. In 2008, Albania amended the Organic Budget Law to include a legal limit on public debt equal to 60 percent of GDP. At that time, public debt was about 54.7 percent of GDP but loose fiscal policy, combined with a depreciation of the Lek, caused public debt to climb to 60.3 percent by 2011. Fiscal pressures rose further during the energy shortage in 2012 as the government provided support to the power generation company KESh in the form of guarantees. Ad-hoc increase in pensions and declining revenues have also added to a widening of the fiscal deficit. In the run-up to elections the government

requested Parliament to revoke the 60 percent of public debt-to-GDP limit. In December 2012, the Parliament did so, without proposing any other fiscal or debt anchor. Public debt has since increased by more than 8 percent of GDP, reaching 70.5 percent at end-2013 due to a large fiscal deficit in the run-up to elections, recognition of the stock of payment arrears, and a downward GDP revision.[3]

20. **High and growing public debt poses both interest rate and rollover risks, highlighting the need for fiscal consolidation.** Spending on interest, at about 3.2 percent of GDP in 2013, is much higher than in other countries of South East Europe. In 2013, about 58.9 percent of Albania's public debt was domestic and about 16.4 percent of domestic debt had floating interest rates. In 2012, the implied interest rate on domestic debt was 7.6 percent. Further, over 55 percent of domestic debt (almost 30 percent of GDP) needs to be rolled over within a year, exposing the government to changes in market conditions. Commercial banks are the main holders of Albania's domestic debt, with Raiffeissen Bank and the Bank of Albania holding 35 percent of it. With some European banks recently taking steps to reduce their exposure due to the Eurozone sovereign debt crisis and the weak European growth outlook, concerns about rollover risk have risen. Increased public borrowing also damages growth prospects by crowding out the private sector. Fiscal consolidation has now become imperative to reduce the risks of high public debt—rollover risks, high interest expenditures, and crowding out of private sector borrowing—and ensure Albania's fiscal sustainability and macroeconomic stability.

21. **The government has accumulated significant budgetary arrears.** Despite declining public investment budgets in the wake of the 2008 crisis, contractors continued implementing multi-year public works projects as planned, often by drawing on commercial loans and thereby contributing to a buildup of government payment arrears, driving up NPLs and eroding private sector liquidity. In addition to arrears related to public works, there are budgetary arrears related to health (mostly drugs), education, water, VAT refunds, corporate income tax (CIT) repayments, electricity bills and social benefits. The stock of payment arrears is estimated at about Lek 72.5 billion or 5.3 percent of GDP. Serious efforts are now needed to audit and pay the arrears and institute a commitment control system in the treasury to prevent their recurrence.

22. **The energy sector poses significant fiscal risks.** About 98 percent of Albania's energy is generated from hydropower, and recurrent energy shortages due to fluctuations in rainfall, coupled with persistently high distribution losses (about 43 percent in 2013) and regulated tariffs below energy costs, have resulted in sustained fiscal support from the government, in the form of guarantees and liquidity injections, to the energy generation company KESh.[4] In the distribution sector, the low collection rates from households, businesses and public institutions (84 percent in 2012) have contributed to the financial woes of the former private distribution company, CEZ Sh, and now the distribution sector operator. Because of an ongoing legal dispute between the government and the private distribution company (CEZ Sh), the Albania energy regulatory

[3] About 5.8 percent of GDP was due to a GDP revision that resulted from a methodological change in the treatment of implicit subsidies to the energy sector, while the remainder was due to the fiscal deficit. The revision affected GDP in 2011, 2012 and 2013.

[4] As of spring 2013, the guaranteed overdraft of KESh was estimated at about US$200 million (or 2 percent of GDP).

agency, ERE, in January 2013 revoked the CEZ Sh. license and appointed a temporary state administrator to run the distribution system. Consequently, the distribution losses, amounting to an average of euro 100 million/yr, are now effectively part of the state's obligations to the sector, thus increasing the fiscal risks coming from the sector. Serious reform efforts are needed in the energy sector to reduce the risks to the budget as well as to growth (through possible power shedding due to shortages).

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

23. **Growth is expected to increase gradually over the medium term.** Real GDP growth is projected to rise moderately from 0.7 percent in 2013 to 2.1 percent in 2014, 3.3 percent in 2015 and 3.5 percent in 2016. Improvements in the external environment through increased demand and remittances are expected to be the main drivers of growth over this period. Private investment is expected to gradually pick up in response to arrears clearance and credit expansion as well as sustained improvements in the business climate. As the government seeks to contain over-commitments and arrears and introduce improved budget planning and public financial management, the contribution of public investment to growth is expected to slow down somewhat in the medium term. As domestic demand picks up and FDI accelerates, imports are also expected to increase. Inflation is expected to increase to 3 percent by 2016, which is consistent with the Bank of Albania's target range.

24. **The current account is projected to widen over the medium term due to FDI-related imports** (Table 3). The current account deficit is expected to increase due to FDI related imports, especially for energy-related investments. The repayment of government arrears will also contribute to a widening of the fiscal and current account deficits. The current account is projected to peak in 2016 and then to narrow to 9.6 percent in 2018 and 7.9 percent in 2019. External debt as a share to GDP is projected to peak at 43.1 percent in 2015 before trending downwards.

Table 3: Balance of Payment Financing Requirements (in percent of GDP)

					Est.	Projection			
	2009	2010	2011	2012	2013	2014	2015	2016	2017
Current account	-14.1	-10.0	-9.6	-9.3	-9.0	-10.3	-12.4	-14.8	-13.0
Balance of goods and services	-24.7	-20.9	-23.1	-19.0	-17.1	-17.0	-18.4	-20.8	-18.9
Exports	28.7	33.0	34.5	33.4	33.8	34.2	34.7	34.9	35.1
Imports	53.4	53.9	57.6	52.4	50.9	51.2	53.0	55.7	54.0
Income balance	-1.0	-1.0	0.5	-0.9	-0.5	-0.8	-1.1	-0.9	-0.7
Private transfers	11.0	9.9	10.0	8.9	7.1	6.6	6.3	6.1	5.9
Official transfers	0.7	2.1	2.9	1.7	1.4	1.0	0.9	0.8	0.7
Financial account	11.2	13.1	10.3	8.8	8.2	8.2	10.6	13.0	13.4
Direct investment	7.7	9.3	7.9	7.6	7.7	8.4	11.1	15.0	18.0
Other capital	-0.4	1.4	0.8	-0.3	-0.5	-1.4	-1.6	-1.7	-3.7
Medium- and long-term loans	3.9	2.3	1.6	1.5	1.0	1.2	1.1	-0.3	-1.0
Commercial debt	2.2	3.4	0.0	0.0	0.0	0.0	2.8	0.0	0.0
Errors and omissions	2.3	0.4	-1.1	1.6	1.5	0.0	0.0	0.0	0.0
Net balance	-0.5	3.6	-0.4	1.0	0.7	-2.1	-1.7	-1.8	0.4
Available financing	0.5	-3.5	0.4	-1.0	-0.7	-0.4	-0.3	-0.5	-0.4
Change in net reserves (inc. = -)	0.5	-3.5	0.4	-1.2	-0.7	-0.4	-0.3	-0.5	-0.4
Financing gap	0.0	0.0	0.0	0.2	0.0	2.5	2.1	2.2	0.0
World Bank						1.4	0.7	0.6	
IMF						1.0	0.9	1.1	
Residual financing (e.g. EU)						0.0	0.5	0.4	
Memorandum item									
External Debt /GDP	33.7	34.1	35.3	37.3	38.4	41.3	43.1	43.0	40.1

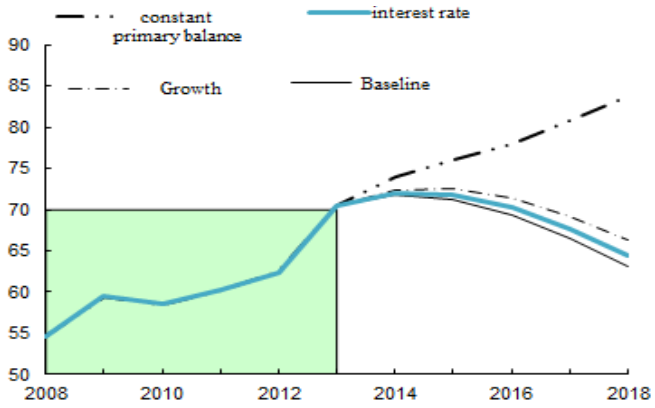
Source: Bank of Albania; Staff estimations and projections.

25. **The fiscal deficit for 2014 is projected to reach 6.7 percent of GDP as the government clears arrears equal to 2.5 percent of GDP.** The government has started the arrears clearance process and is committed to proceed in a transparent manner to ensure its credibility. The Council of Ministers approved an arrears clearance and prevention strategy in February 2014, which details: (i) stocktaking and verification of claims; (ii) clear and transparent criteria for the order of settling the claims; and (iii) scheduling and monitoring of the payment process. Arrears are expected to be cleared in up to three years across all sectors to spread the fiscal impact. The clearance will likely help reduce the stock of NPLs and unlock credit to the private sector, providing a basis for renewed private sector growth.

26. **In parallel, the government will proceed with fiscal consolidation.** The budgeted fiscal deficit without arrears is 4.2 percent in 2014 which compares to a budget deficit of 6.9 percent in 2013. With respect to revenues, the budget raises the corporate income tax (CIT) rate from 10 to 15 percent; excises rates on cigarettes, tobacco, beer, wine, alcoholic drinks and coffee; circulation tax, equivalent to an increase in gasoline and diesel fuel prices of about 6.6 percent; and property tax rates paid by businesses (local tax). Revenues from CIT, excise taxes and other taxes as a share of GDP are projected to be 0.5 percent, 0.4 percent and 0.5 percent higher, respectively, in 2014 than in 2013. To limit the impact of these tax increases on lower income Albanians and small businesses, the government has introduced a progressive income tax system, abolished the small business tax (local tax), and reduced the rate for the simple tax on profit for small businesses to half the corporate tax rate.[5] A foreign consultant (Crown Agents) is already assisting with tax collection at customs. On the expenditure side, the budget freezes public sector salaries in 2014, with the exception for police officers; and limits pension increases to around 2 percent.

27. **The fiscal deficit is projected to decline further to 4.8 and 3.4 percent of GDP, respectively in 2015 and 2016**, reflecting a gradual ending of the arrears clearance process coupled with continued fiscal consolidation. Under the baseline, revenues and all expenditure items, with the exception of interest payments, are expected to remain constant as a share of GDP over the medium-term. Fiscal consolidation measures of 1.2 percent of GDP in 2015 and 2.4 percent in 2016, which are not specified under the baseline, will be achieved through spending constraints combined with further tax measures and pension reform. The government approved a Medium-Term Fiscal Framework in February 2014, which imposes expenditure ceilings on all line ministries for 2015 and 2016 in line with the fiscal deficit targets. According to this

Figure 2: Public Debt-to-GDP scenarios



[5] The government also plans to refund the VAT paid on agricultural inputs, exempt medicines and medical services from VAT in line with EU regulations, and improve tax administration.

framework, about half of the fiscal adjustment would fall on revenues and the other half on expenditures

28. **Albania's public debt is projected to peak at 71.7 percent in 2014 and decline to 69.3 percent of GDP by 2016.** Assuming medium-term fiscal targets are achieved, gross public debt is projected to decline to 63.1 percent of GDP by 2018. Debt sustainability analysis indicates that the debt trajectory is particularly vulnerable to primary balance shocks, increased pension expenditures as well as realization of contingent liabilities in the energy sector. Still, the public debt to GDP ratio trends downward under most scenarios with the exception of the constant primary balance scenarios. In the latter case, the debt to GDP ratio is projected to approach 85 percent by 2018 (Figure 2).

29. **Downside risks to the macroeconomic outlook are substantial.** Slow progress of energy sector reforms could mean accumulation of contingent liabilities which could hit the budget and thereby negatively affect fiscal indicators and growth. Rainfall sharply affects the supply of electricity which has a direct impact on import needs and the cost of electricity. These fluctuations have had significant (positive and negative) effects in the past and will almost certainly recur, although the impact--especially the fiscal impact--could be significantly dampened by appropriate policies. In addition, the country faces significant external risks. A slower than projected pace of recovery in the Euro area could lead to lower than expected growth, revenue collection and fiscal consolidation.[6] Domestic recovery could also be endangered by a continuation of the credit crunch in the context of deleveraging pressures from parent banks on the 90 percent foreign-owned banking sector. Although high capital adequacy requirements have thus far been met through capital increases, further deterioration in the portfolio asset quality could force banks to shift their holdings into low risk assets and reduce credit to the private sector.

30. **The macroeconomic policy framework is considered adequate.** The government is committed to fiscal consolidation, as well as arrears clearance, putting public debt on a downward trajectory. The 2014 budget includes significant fiscal consolidation measures with immediate effect. Fiscal policy is calibrated to accommodate a gradual recovery of real sector growth while steadily reducing public sector debt from 2014 onwards. Achieving a public debt ratio below the 60 percent of GDP already in the medium term would entail even deeper fiscal consolidation that is not feasible in the context of arrears clearance, and not recommended due to negative growth and poverty effects. The planned pace of fiscal consolidation is also supported by structural policies in support of growth, such as reforms of the energy and financial sector as well as improvements in the business climate.

31. **In parallel to the preparation of the Financial Sector Modernization DPL, the proposed 'sister' First Public Finance and Growth DPL is the first in a series of two programmatic development policy loans that aim to minimize the macroeconomic vulnerabilities, by improving Albania's public finances and sustain poverty-reducing growth.** The series focuses on addressing weaknesses in public finance management that have

[6] Albania has a relatively high exposure to developments in neighboring countries, especially Greece and Italy, through remittances, exports and foreign investment.

resulted in the accumulation of general government arrears and improving Albania's fiscal outlook through revenue-enhancing measures, pension, and energy sector reforms. Arrears and high public debt are now weighing heavily on Albania's growth prospects and threatening to reverse the significant progress that has until recently been made on reducing poverty. The government recognizes that steps to strengthen public financial institutions and reduce fiscal vulnerabilities are critical for Albania to protect the fiscal space for growth-enabling investment and poverty-alleviating social services. In addition, the IMF's program complements these reforms by supporting fiscal consolidation and prevention and clearance of government arrears to enhance macroeconomic stability, as well as structural reforms to improve the business environment.

32. **Reducing large public arrears and beginning to execute on a time-bound plan to tackle the longstanding energy sector reforms will yield positive effects on the business environment and enterprises alike.** Together, if well implemented by the authorities, these parallel initiatives could have a catalytic effect to spur new domestic and foreign investment, thereby stimulating economic growth. These and related measures supported through World Bank lending operations under preparation will positively impact the banking sector, as corporate (particularly infrastructure) borrowers would receive overdue payments necessary to better fulfill obligations to the banking sector, and manufacturing firms would be less effected by periodic power outages.

C. IMF RELATIONS

33. **Albania has reached an agreement for an Extended-Fund Facility (EFF) with the International Monetary Fund (IMF).** The EFF was approved by the IMF Board on February 28, 2014 (see Annex 2 for press release). The arrangement is intended to provide budget support in the amount of EUR 330.1 million (about US$457.1 million) over a three-year period. The World Bank and the IMF are collaborating closely on the reform program to ensure complementarity of key fiscal and financial sector policy measures.

III. THE GOVERNMENT'S PROGRAM

34. **The National Strategy for Development and Integration (NSDI) for 2007-2013 outlined the Government's economic and social development program.** The strategic goals of the NSDI were: (i) integration to the European Union (EU) and NATO; (ii) strengthening the rule of law and democratization; and (iii) achieving rapid and sustainable economic and social development. The authorities have made progress towards the NSDI goals. First, Albania joined NATO in 2008 and submitted its application for EU membership in 2009. In October 2012, the EU first recommended Albania as an official candidate for admittance into the economic block[7]. Second, its GDP growth continued throughout the global financial crisis, while poverty continued to decline. However, despite adopting some business environment reforms, Albania decined in its overall ranking on the World Bank's 2014 Doing Business (DB) Indicators to the 90th position.

[7] http://ec.europa.eu/enlargement/countries/detailed-country-information/albania/index_en.htm

35. **The Government is in the process of finalizing the National Strategy for Development and Integration (NSDI) for 2014- 2020.** The NSDI for 2014- 2020 is expected to be finalized by end-2014. The current draft, which is undergoing a consultative process, has three broad pillars or overarching goals: (i) growth through fiscal stability and increased competitiveness; (ii) sustainable growth through efficient use of resources; and (iii) investing in people. Improving good governance and the rule of law forms its foundation. The strategy will be the basis for the design of medium-term budget programming and the orientation of donor funding, especially from the EU's Instrument for Pre-accession Assistance (IPA).

36. **The Albanian financial sector authorities have undertaken significant reforms in recent years to address vulnerabilities in the financial sector.** Amendments to the Banking Law in 2011 provided the BoA with more options for bank resolution, through the establishment of bridge bank and purchase and assumption transactions, and allowed for the transformation of branches of foreign-owned banks into subsidiaries. The BoA also enhanced its monitoring and analytical tools for assessing financial stability and widened the list of collateral for Emergency Liquidity Assistance. Additionally, key amendments to the Civil Procedure Code were adopted in 2013 to shorten and simplify collateral enforcement procedures. In addition, ADIA law was amended in 2012 to address a key set of reforms to extend coverage to Savings and Credit Associations (SCAs), facilitate a prompt pay-out after BoA intervention, and expand ADIA powers to contribute to a purchase and assumption or bridge bank resolution. To better assess market developments and identify emerging risks in the financial sector, in 2012 the authorities re-constituted a high level Financial Stability Advisory Group (FSAG) composed of the MoF, BoA, FSA, and the ADIA, which meets on a quarterly basis to monitor developments and risks to the financial system.

37. **The authorities are committed to continue a series of short to medium term reforms to encourage the development of the financial sector, complementing and building on the reforms supported by the proposed operation.** The reforms are in the following areas: (i) NPL management and resolution; (ii) resolution regime for SCAs; (iii) enhancement of the deposit insurance framework; (iv) insurance market development; (v) pension reform; (vi) public debt management and government bond market development; (vii) regulatory framework for investment funds; and (viii) corporate financial reporting. The authorities have requested World Bank Group assistance with the implementation of these reforms.

38. **The authorities to continue their efforts to strengthen NPL management and resolution.** With TA from the Financial Sector Advisory Centre (FinSAC) beginning in 2012, key Civil Procedure Code changes were approved by Parliament in 2013 that removed key impediments to speedy enforcement of collateral executions. The authorities recognize the complexities and need to adopt measures that in the medium term would contribute to the reduction of NPLs. FinSAC will continue to provide TA to BoA to develop the Recovery and Resolution (RRP) framework in line with new EU regulatory initiatives in this area, including on enhancing the legal and regulatory framework, integrating the RRP assessment within the supervisory review process, and improving the supervisory capacity in the RRP review. To further enhance the NPL resolution framework, BoA also plans to modify its regulatory and supervisory approach towards non-bank financial institutions (NBFIs) to facilitate the sale of NPL portfolios to specialized bad debt collection companies. In addition, the authorities are keen to improve the insolvency and debt resolution system would also contribute to reducing NPLs. In

this context, the IFC has designed a comprehensive three year Debt Resolution and Business Exit Project for the Ministry of Justice, which aims to improve the insolvency legislation, debt restructuring, and institutional practices of the Bankruptcy Supervisory Agency.

39. **The authorities are also working to enhance the deposit insurance framework.** ADIA has secured a back-stop funding facility from the European Bank for Reconstruction and Development (EBRD) in the amount of 100 million euro, to be called upon if needed to fulfill ADIA's obligations to insured depositors. The facility will be finalized once approved by the Ministry of Finance. Additionally, in order to incorporate SCAs within the deposit insurance scheme to provide protection to small depositors at such institutions, the BoA will amend the SCA Law in 2014 to provide for a resolution framework for those SCAs which will not qualify to join the deposit insurance scheme in 2015.

40. **Significant reforms are also a priority in the areas of insurance market development, pension reform, public debt management and government bond market development.** TA in these areas is expected to be provided the authorities with support from the FIRST Initiative. TA in these areas compliment the proposed DPL, as some are relevant to Pillar III of the operation that focuses on strengthening the regulatory and supervisory framework for NBFIs. More specifically, areas of TA include assisting the AFSA to: (i) develop actuarially sound MTPL claims reserving requirements; (ii) draft the law on National Earthquake Insurance; (iii) develop specific insurance regulation and supervision manuals; (iv) strengthen the supervision of private pension funds through the implementation of risk based supervision and expand third pillar pension coverage; and (v) enhance its enforcement capacity. In addition, a separate FIRST Initiative TA grant facility is slated to assist the government to implement reforms for improving public debt management and developing the government securities market.

41. **In addition, the authorities recognize the need to strengthen the regulatory and supervisory framework for investment funds**. TA from the World Bank has been requested in this area, centered on developing regulations for liquidity, capital adequacy, and consumer protection provisions. This TA will be undertaken in close collaboration with the IMF, which will provide technical assistance to develop the methodology for the calculation of investment funds' unit values on mark-to-market principle.

42. **The government also aims to also implement reforms in corporate financial reporting.** It has requested the World Bank's Centre for Financial Reporting Reforms (CFRR) to further such reforms. A national Corporate Financial reporting Enhancement Project is being implemented to: (i) upgrade financial reporting legislation closer to the EU standards, with a roadmap for further legislation modernization; (ii) enhance capacity of national standards setters to translate and adopt International Financial Reporting Standards (IFRS) and develop national accounting standards for SMEs; (iii) establish audit oversight and quality assurance systems; (iv) initiate reforms in accountancy education and certification curricula. The potential second phase of the project in 2014-2017 will expand the activities of institutional capacity building, including enforcement activities by financial sector regulators.

43. **In addition to the reforms proposed in this DPL and others outlined above, the agenda for undertaking comprehensive reforms to strengthen financial sector stability and**

development remains broad. The FSAP 2013 highlighted steps to enhance for financial sector stability and development going forward. The reforms supported by this DPL and outlined above will advance selected key short and medium term recommendations of the FSAP. However, the longer term agenda for financial sector development is broad. Thus, a follow-on financial sector DPL operation would further improve, *inter alia*: risk-based supervision, consolidated supervision, the macro-prudential framework, monetary operations, crises preparedness, the capacity of the non-bank regulatory authority, public debt management, private pension reform, and enterprise financial reporting.

IV. THE PROPOSED ALBANIA FINANCIAL SECTOR MODERNIZATION LOAN

A. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

44. **The proposed Financial Sector Modernization DPL program supports the Government's pillar 1 of growth through fiscal stability and increased competitiveness, as outlined in the draft NSDI for 2014 – 2020.** The draft NSDI emphasizes harnessing the potential of the financial sector as a key objective in pillar 1 to help businesses gain access to capital needed to support medium and long-term investment. Objectives outlined in this pillar are directly supported by the proposed operation and include: (i) creating an enabling environment for private banks to expand credit to the private sector and to substantially reduce non-performing loans; (ii) enhancing the supervisory capacity of the Albanian Financial Supervisory Authority (AFSA); and (iii) further developing the non-bank financial sector.

45. **The proposed DPL measures of strengthening and further developing the financial sector contribute to poverty reduction and shared prosperity.** Higher levels of financial sector development result in a faster decline and lower incidence of poverty. In addition, measures supporting financial stability reduce the impact of financial crises that take a huge toll on economic growth and poverty alleviation.

46. **The proposed operation has incorporated lessons from the World Bank's experiences in the 2008-2009 crises, as well as in previous economic and financial crises.** A relatively recent comprehensive review of the World Bank's responses to financial crises[8] underscored the following lessons:

- ***Need for focus.*** In responding to an uneven and uncertain external environment, it is crucial that the operation focuses on selected key areas for good outcomes. The proposed operation incorporates this lesson by focusing on a main challenge recognized by the Government and the BoA, namely, addressing key regulatory and supervisory gaps for the bank and non-bank sectors, reducing the stock and flow of NPLs and strengthening the deposit insurance regime, so the entire financial sector can be more resilient to cope with possible future shocks, and preparing the authorities in the event of spillover.

[8] "Lessons from Past Financial Crisis" Independent Evaluation Group, the World Bank, 2009.

- ***Government ownership.*** The proposed reforms need to support the authorities' priorities and require an extensive dialogue to ensure ownership of the technically complex and politically sensitive reforms in the financial sector. This operation was prepared in direct collaboration with the top leadership of the MoF, BoA, AFSA, ADIA and other key stakeholders.

- ***Timing matters.*** The current government was elected in mid-2013 and the next elections will only take place in 2017. This time will give the government the ability to tackle some key financial sector reforms, especially as it regards adopting measures to mitigate the level of NPLs and enhance the independence and capacities of the AFSA, or non-bank regulatory authority.

- ***Communication strategy.*** The operation should promote the understanding of, and the appropriate popular support for the financial sector related reforms through a carefully planned and implemented communication strategy by the Government and the World Bank. Staff at the World Bank Tirana office has ensured consistent and timely communication with key stakeholders. The Bank also keeps civil society and the general public informed of its position on critical issues through interviews with national media and press releases.

- ***Coordination among development partners.*** Coordination is critical since a coordinated approach brings better results. This operation incorporates this lesson by working closely with the IMF, EC, and IFC.

B. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Prior actions and results

Pillar I. Strengthening regulation and supervision of the banking sector and the financial safety net

47. **The prior actions in Pillar 1 aim to strengthen the regulatory and supervisory framework of the banking sector and financial safety net.** The operation will support reforms that would progress the transition from compliance-based to risk-based supervision, improve crisis preparedness by supporting the preparation of recovery plans by systemic banks, and enhance the deposit insurance framework.

Prior Action #1: BoA Supervisory Council adopts a new comprehensive Risk Based Supervisory Manual and a new Supervisory Operational Policy to increase effectiveness of banking supervision.

48. **The adoption of a risk-based supervisory framework will result in more efficient utilization of supervisory resources, and hence will increase the quality of banking supervision and contribute to the stability of the financial system.** The present bank risk assessment methodology for banks is mostly compliance based, as it does not take sufficiently into account the risk profile of banks. In a banking system with systemic banks and other banks with a moderate risk profile, supervisory resources could be better allocated during the annual

planning process to improve efficiency and effectiveness of supervisory actions by the BoA.

49. **Although BoA has begun the process of moving towards a risk-based supervisory approach, the elements are not utilized in the most efficient and comprehensive manner.** A transformation to a risk based supervisory framework would improve the quality of supervision and would eliminate inefficiencies. A comprehensive, new Risk Based Supervisory Manual will be issued to address, *inter alia*, strategic risk, credit risk, market risk, liquidity risk, interest rate risk, operational risk, as well as cross-cutting issues of governance and control systems, profitability and capital adequacy. Based upon the introduction of this new risk-based supervisory methodology, a new bank rating system will be introduced in 2014.

50. **To build upon the forthcoming introduction of a new risk-based supervisory framework, BoA will revise its Supervisory Operational Policy (SOP)[9] to align its bank examination cycle with a new risk rating system of banks.** As the current examination cycle does not consider the risk profile and systemic relevance of individual banks, changes to the SOP are needed to address this issue, by differentiating the inspection cycle of banks by risk profile and/or systemic nature. The revisions to the SOP will also provide linkages to the new bank rating system, as the old rating methodology does not reflect the true risk profile of a bank on an on-going basis. The revision of the SOP will better align supervisory processes with enhanced supervisory and enforcement tools.

51. ***Results.*** By end-March 2015, inspections of five of 16 banks are conducted in accordance with the new Risk Based Supervisory Manual and the new Supervisory Operational Policy, including at least two systemic banks.

Prior Action #2: BoA Supervisory Council issues new Instruction for designated systemic banks to adopt Recovery Plans to demonstrate their ability to operate during periods of stress.

52. **The 2008-2009 financial crises highlighted the need for authorities to have more effective tools and information to enable the orderly recovery and resolution of financial institutions.** One of the essential instruments for effective crisis preparedness and management is the availability of bank-specific Recovery and Resolution Plans (RRPs) for systemically important banks or banking groups in the event of severe stress. The topic is quite relevant in Albania, wherein deleveraging pressures from Eurozone parent banks continue. BoA and banks have to be better prepared to appropriately mitigate potential idiosyncratic and/or systemic shocks if such should occur. Using its methodologies, the BoA has identified 5 to 7 banks to be considered as systemic for RRP purposes.

53. **The formal adoption of a new mandatory Instruction for the preparation of bank specific recovery plans would increase the resiliency of the banking system and allow BoA to better utilize its supervisory resources and resolution powers.** Recovery plans for designated systemically important banks are contingency plans that banks prepare *ex ante* to demonstrate their ability to maintain operations during stressful times. This instrument will significantly enhance banks' risk management practices and will provide sufficient information

[9] Supervisory Operational Policy is the BoA's internal guideline on how to plan and conduct on-site inspections at the banks.

to the authorities to better understand potential barriers for bank resolution. Based on banks' recovery plans and other relevant information collected from banks' parent groups, the BoA will thereafter begin preparation of bank- specific resolution plans.

54. ***Results***. By end-March 2015, all banks determined as systemically important submit enhanced Recovery Plans to BoA, in line with the new BoA Instruction that formalizes the content that must be included in banks' Recovery Plans.

Prior Action # 3: Amendments to the Law on Deposit Insurance are accepted by Cabinet of Ministers and submitted to Parliament, to better align the legislation and operations of ADIA with the Core Principles for Effective Deposit Insurance Systems.

55. **Albania's deposit insurance system is largely based on modern principles, and recent reforms have strengthened the legal framework in compliance with EU guidance.** The ADIA law was amended in 2012 to address a key set of reforms: (i) to extend coverage to Savings and Credit Associations (SCAs) with an initial Government contribution of Lek 50 million for a separately administered deposit insurance fund[10]; (ii) to eliminate the practice of setting off any insured deposit payment against any liabilities owed to the bank, thereby facilitating a prompt payout after intervention by BoA; (iii) to exempt ADIA from public procurement policies when exercising its compensation function; (iv) to provide ADIA with the authority to levy a special contribution on banks if needed to replenish its fund; and (v) to expand ADIA's powers to include the ability to contribute to a purchase and assumption or bridge bank resolution. Subsequently, ADIA issued a regulation setting forth the process by which SCAs would apply to become members of the deposit insurance scheme, and has begun an assessment of the SCAs to determine which ones would become insured members of the scheme by end-2015.

56. **However, ADIA's compliance with the Core Principles for Deposit Insurance[11] needs to be further improved by amending the Law on Deposit Insurance.** To fulfil international best practice, ADIA should be provided greater autonomy in its operations in accordance with Core Principle 5 (Governance). ADIA should be able to diversify its reserve management to include foreign debt holdings and enter into information sharing arrangements with relevant regional deposit insurance agencies. In addition, the ADIA should have full legal protection, including a provision for defense costs on an *ex ante* rather than *ex post* basis to ADIA staff, as well as for those acting at its direction. Better cooperation and information sharing between the ADIA and BoA is necessary to ensure the ADIA can efficiently fulfill its legal mandate. Therefore, the proposed operation supports amendments to the Law on Deposit Insurance to, *inter alia*, enhance: (i) ADIA's budgetary independence and enforcement powers; (ii) its efficiency in deposit payout; (iii) its reserve management requirements; (iv) legal protection for ADIA staff; and (v) to define the level of coverage and premiums for Savings and Credit Associations (SCAs).

[10] The inclusion of SCAs was a significant step to bring ADIA in line with the Core Principles for Effective Deposit Insurance Systems. The government has included in the 2014 budget an allocation of the initial capital of 50 million lek as seed funding for the deposit insurance fund for SCAs.

[11] As assessed as part of the November 2013 FSAP in accordance with the core principles established by the International Association of Deposit Insurers (IADI).

57. ***Results***. By end-March 2015, ADIA completes assessment of compliance of eligible SCAs with the legal and technical requirements of ADIA in order to ensure that eligible SCAs enter the deposit insurance scheme by end-2015. In addition, by end-March 2015, ADIA approves its own budget without BoA ratification.

Pillar II. Expediting resolution of NPLs

58. **Reducing the large stock of existing NPLs is of utmost priority for the authorities.** Although the legal framework for creditor/debtor relationships is modern and rather comprehensive, debt resolution mechanisms, businesses reorganization and bankruptcy proceedings are not working effectively. In this respect the BoA coordinated with other stakeholders to put forward key reforms in the collateral execution regime, wherein key Civil Procedure Code changes were adopted in early 2013. Moreover, further efforts are necessary to improve the regulatory framework to strengthen credit standards, resolve tax ambiguities to enable banks to write-off NPLs in protracted litigation, establish adequate incentives for private bailiffs to execute collateral with speed and efficiency, and further reform the insolvency and collateral execution regime. Arrears clearance would also help the reduction of NPLs. Reforms in BoA's regulatory framework would need to be supplemented by more effective risk-based supervision, focusing on the quality of banks' credit policies and underwriting standards to ensure that newer loans are of better quality. There is additional scope for BoA to provide more detailed supervisory expectations for NPL management, forward guidance, and enforcement actions to better shape banks' incentives for proper actions and to encourage more forward-looking NPL-related policy discussions and macro-prudential considerations at the FSAG.

59. **Results.** All the five prior actions in Pillar 2 (#4, #5, #6, #7 and #8) are to cumulatively contribute to the reduction of the 23.5 percent NPL ratio as of end-2013 (stock of Lek 132 billion)**.** The expected result is that by end-March 2015, the ratio of NPLs/total loans declines to 20 percent or less, with the write-off of at least Lek 20 billion of NPLs.

Prior Action # 4: Cabinet of Ministers submits draft amendments of tax law No. 8438 to Parliament to resolve key NPL tax ambiguities to enable banks to write-off NPLs in protracted litigation.

60. **Banks' efforts to resolve problem loans are hindered*, inter alia*, by ambiguities in the tax regime.** By BoA estimations, owing to longstanding uncertainties in the taxation regime, banks continue to keep a significant portion of older, unrecoverable NPLs on their balance sheets. In an earlier bid to resolve the tax deductibility issues surrounding the write-off of NPLs, the Minister of Finance issued a Directive to clarify Guideline No. 5 on Income Tax in May 2013, but it did not have the desired effect, as tax enforcement remains uneven. The main uncertainty regards the tax deductible treatment for older NPLs, wherein legal actions were initiated several years ago, and are still not completed. As a result of the uneven treatment of the tax deductibility, banks' generally did not write-off older NPLs as envisaged. Doing so would help lower NPL rates and could foster the sale of some banks' NPL loan books.

61. **In order to resolve the tax ambiguities, necessary amendments to the tax code were submitted to the Cabinet of Ministers in early February 2014**. A Working Group consisting of the MoF (on behalf of the Tax Authority), the BoA and key stakeholders was formed in November 2013 to determine key changes required in the tax code to remove tax ambiguities

that would enable banks to write off NPLs in protracted litigation. Parliamentary consideration is forthcoming.

Prior Action # 5: BoA Supervisory Council adopts amended regulation on "Credit Risk Administration" for the obligatory write-off of stale-dated NPLs following a fixed period of time classified in the "loss category."

62. **To facilitate the write-off of stale-dated NPLs, BoA will introduce changes to the regulation "On Credit Risk Administration" to define a maximum period of holding loss loans in the balance sheet on the bank.** Because of the tax ambiguities towards inconsistent application of tax legislation referenced above, banks have been unwilling to write off the stock of old NPLs. With the BoA's amendments to its regulation, banks will be obliged to write-off those loans which have been in the "loss" category after three years' time, regardless of the status of pending legal actions. This prudential measure, in combination with tax legislative changes to remove tax ambiguities, will enable banks to write-off stale dated NPLs. This would contribute to significantly reduce the present stock of NPLs over time.

Prior Action # 6: BOA issues three sets of guidelines on: (i) loan restructuring for businesses; (ii) loan restructuring for individuals; and (iii) real estate appraisal, based on international good practice.

63. **BoA has published debt restructuring guidelines, based on international best practice, in order to encourage a more active approach to loan restructuring that would enable borrowers to fulfill their contractual obligations**. BoA has published important guidelines on loan restructuring for businesses and for individuals. The objectives were to establish principles that allow cooperative borrowers (individuals and businesses) who are in financial difficulty to fulfill their contractual obligations, and to prevent as much as possible the enforcement of collateral, which involves a long and costly procedure for the lender. The guidelines aim to encourage a common standard around debt restructurings in Albania, which has many benefits, including providing companies with the option to continue operating and to successfully overcome the difficult times, providing individuals with an opportunity to keep their homes, enabling creditors to reduce losses, reducing the strain on courts, and avoiding negative social and economic effects that can be caused by foreclosing on collateral.

64. **In addition to the restructuring guidelines, BoA published guidelines on real estate appraisals to encourage real estate valuations using a common set of standards within financial institutions and across the financial system.** Such standards provide useful guidance to all parties (lenders, borrowers, and appraisers) as to the required scope of a real estate valuation**.** A better understanding of and adherence to these standards should help all appraisers reach convincing conclusions, increasing confidence in the marketplace, and improving the climate for NPL resolution by reducing challenges to valuations in the credit restructuring or foreclosure processes.

Prior Action #7: BoA Supervisory Council adopts a new regulation on "Risk Administration for Banks' Large Exposures" to strengthen credit underwriting practices and NPL recovery and resolution for large borrowers.

65. **In recent years BoA has adopted numerous supervisory and regulatory decisions to**

strengthen the NPL resolution framework, yet took relatively fewer actions focused on improving banks' management of NPLs. Given the high NPL ratio and a large pool of "watch loans,[12]" the authorities will adopt additional measures to encourage the resolution of the stock and flow of NPLs, by improving banks' credit risk management and underwriting going forward.

66. **In order to reduce the NPL stock, BoA will amend its regulations to strengthen banks' NPL management and reporting requirements for large borrowers**. Large borrowers constitute a significant portion banks' total loan portfolios. The BoA has introduced new regulatory requirements to increase banks' Steering Council members' responsibilities towards NPLs and keep them more directly involved in the 'decision chain' regarding large loan exposures, including loan approvals, restructurings and NPL management[13].

67. **To address the flow of new NPLs, the BoA has revised its credit underwriting regulation, focusing initially on large borrowers.** Banks will gradually be required to consider audited financial statements for large credit decision purposes, in contrast to the current practice of credit underwriting staff frequently relying on unaudited management accounts. Going forward, it is expected that banks will significantly improve their underwriting standards, and hence will gradually encourage better underwriting standards towards smaller loans.

Prior Action #8: MoJ and MoF issues new instructions to provide market based incentives for private bailiffs' compensation.

68. **The resolution of NPLs is also hindered by weaknesses in the private bailiff regime supporting the collateral execution framework.** Currently private bailiffs are *de facto* paid in full by creditors at the beginning of the collateral execution process, irrespective of their success. As such, the incentive for private bailiffs to promptly fulfill their collateral execution mandate may not be well aligned with a speedy collateral execution process. The current Instruction No. 1240 of 2009 by MoF and MoJ on "Determining tariffs for the services of private bailiffs" and the Sample Contract between bailiffs and creditors (issued by instruction No. 8543/2 in 2010) have unclear and contradictory provisions with regard to the compensation of private bailiffs.

69. **New MoJ and MoF instructions issued to provide more transparency and consistency.** It is necessary to permit negotiations between private bailiffs and creditors, especially on larger obligations, to provide private bailiffs a 'success fee' or similar incentive upon completion of the collateral execution process. This will result in increased competition and improved incentives to promptly execute on collateral, a necessary prerequisite to the reduction of NPLs.

Pillar III. Strengthening regulation and supervision of the NBFI sector

[12] Watch or Category 'II' loans are not included in the published NPL figures.

[13] To further enhance banks' NPL management process, with FinSAC implementation support TA, the BoA will also require banks to prepare NPL recovery and resolution plans for their largest borrowers, which should be revised on a periodic basis. Banks will then be asked to commit to work-out targets supported by quantitative objectives, with a view to resolve the NPL legacy stock over an agreed time period, as practiced in EU crisis countries. This will result in a requirement for banks to prepare recovery and resolution plans for at least the 20 largest NPLs (and related borrowers) in each bank.

70. **The effectiveness of the AFSA as the non-bank regulatory authority is impeded by a weak regulatory framework that does not comply with international best practices.** With new insurance and investment funds complexities arising, it is essential to improve the operational and financial capacity of the AFSA. There are weaknesses in the regulation and supervision of NBFIs, owing largely to the AFSA's lack of independence, restrictions in effective use of its financial resources, and acute shortage of qualified personnel. As a result, insurance supervision and regulation is only partially compliant with the IAIS core principals.

71. **Significant legal reforms are necessary to achieve AFSA's financial and operational independence and turn it into an effective insurance regulator.** Insurance supervision has been constrained by the rigid rule-based Insurance Law, which prevents the AFSA from issuing risk based insurance by-laws to address the evolving needs of insurance supervision. The current supervisory regime does not provide the AFSA with the ability to undertake timely interventions and makes it difficult for the agency to adopt enforcement measures. Adoption of a new Insurance Bill and amendments to the FSA Law, the Law on Salaries of Independent Institutions, and the Civil Servant Law are necessary.

Prior Action # 9: To ensure the financial and operational independence of the AFSA, the Cabinet of Ministers accepts and submits to Parliament: a new Insurance bill, and amendments to AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law.

72. **Due to the absence of a proper risk-based insurance regulatory framework, the AFSA does not have the authority to require contingency plans and/or assess the operational risk management framework of insurers.** The AFSA's ability to carry out effective risk-based insurance supervision, reflecting the nature, scale and complexity of individual insurers, is severely compromised.[14] Furthermore, the AFSA under the current law cannot properly undertake risk based supervision. Adoption of the new Insurance bill will allow the AFSA to introduce a new risk based supervision approach, provide for risk ratings, early warnings and a suitably flexible on-site inspection mandate.

73. **Thus, the AFSA Law needs to be amended.** Amendments would *inter alia*: (i) abolish the requirements for the AFSA to have its organizational structure approved by the Parliament; and (ii) remove the AFSA from the civil servants' compensation and benefits structure, so it has the ability to attract and retain sufficient experienced technical staff. The legal protection of AFSA's Board and staff must also be strengthened by giving them legal protection for the *bona fide* discharge of their governmental, regulatory and administrative functions and powers. The Law on Salaries of Independent Institutions should exclude the AFSA from the list of institutions subject to this Law and should specify that compensation for AFSA employees is set pursuant to the Law on the AFSA. In addition, the Law on Civil Servants should be amended to explicitly exclude the AFSA from the scope of this law.

[14] The current law does not require, *inter alia*, insurers to have proper risk management policies in place to either outline the management of material risk categories, the insurer's business strategy or to describe the relationship between the insurer's tolerance limits, regulatory capital requirements, and the processes and methods for monitoring risk. Moreover, the FSA is unable to enforce an explicit asset-liability management (ALM) policy requirement or link its relationship with insurance product development, pricing functions and investment management decisions.

74. ***Results.*** By end- March 2015, AFSA's Board adopts its own organizational structure and market-based salary scale independently from Parliament, allowing it to regulate and supervise NBFIs more effectively.

Prior Action # 10: The AFSA adopts market stabilization measures to issue: (i) a regulation on minimum MTPL reserving standards; and (ii) a time-bound plan to replenish funding of the Compensation Fund.

75. **There are serious challenges in the MTPL insurance market.** In the absence of rigorous MTPL reserving standards or their robust enforcement, the on-going price competition will only further undermine the already weak financial fundamentals of the nascent insurance industry. In turn, this will act as a major impediment to the growth and development of the Albanian insurance market. The AFSA has agreed to undertake immediate MTPL market stabilization measures by establishing through regulation minimum reserving standards to ensure a level playing field, adequate claims paying capacity, and the overall solvency of the market. The funding of the MTPL Compensation Fund should be replenished by adopting: (i) a detailed time-bound plan that requires insurance companies to fully finance the (unpaid) claims incurred before 2014, as currently about Lek 1.3 billion is outstanding; and (ii) a financially sound mechanism that will guarantee proper and timely settlement of new claims caused by uninsured vehicles after 2013. Going forward, the aforementioned MTPL insurance market stabilization measures will have to be closely monitored by the AFSA to ensure market compliance. Furthermore, the AFSA should closely cooperate with the Ministry of Interior to reduce the high level of uninsured vehicles, which is currently estimated at 25 percent of total number of registered vehicles in the country.

76. ***Results.*** By end March-2015, funding of the MTPL Compensation Fund is replenished in the amount of Lek 430 million to enable payment of pending insurance claims.

Analytical underpinnings

77. **The Bank has undertaken extensive analytical work and policy dialogue in the policy areas and on each of the prior actions supported by the proposed operation, largely through the late 2013 FSAP and supporting assessments or technical notes.** Table 4 lays out the analytical activities and their linkages to prior actions supported by this operation. In addition, the operation has benefited from the recently concluded FIRST TA on Deposit Insurance, and on-going support provided to BoA for the mitigation of NPLs by the World Bank's FinSAC as of 2012. BoA subsequently requested FinSAC to expand its support in 2013 to provide TA in the following three areas of NPL mitigation: (i) preparation by banks of whole-portfolio NPL reduction strategies; (ii) design of enabling supervisory action by BoA; and (iii) establishment of a cooperation framework among banks and borrowers for voluntary debt resolution. These related exercises, which are intended to further facilitate the reduction of NPLs, are slated to be concluded by the second quarter of 2014.

Table 4: DPO Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar I. Strengthening regulation and supervision of the banking sector and financial safety net	

BoA Supervisory Council adopts new comprehensive Risk Based Supervisory Manual and a new Supervisory Operational Policy to increase effectiveness of banking supervision.	FSAP 2013 and supporting Technical Notes
BoA Supervisory Council issues new Instruction for banks to adopt Recovery Plans to demonstrate their ability to operate during periods of stress.	FSAP 2013
Amendments to the Law on Deposit Insurance are accepted by Cabinet of Ministers and submitted to Parliament, to better align the legislation and operations of ADIA with the Core Principles for Effective Deposit Insurance Systems.	FSAP 2013, IADI Core Principles Report on Standards and Codes 2013, FIRST Deposit Insurance TA 2012
Pillar II. Expediting the resolution of NPLs	
Cabinet of Ministers submits draft amendments of tax law No. 8438 to Parliament to resolve key NPL tax ambiguities to enable banks to write-off NPLs in protracted litigation.	FSAP 2013, FinSAC Non-Performing Loans TA 2012 onwards
BoA Supervisory Council adopts amended regulation on "Credit Risk Administration" for the obligatory write-off of stale-dated NPLs following a fixed period of time classified in the "loss category."	FSAP 2013, FinSAC Non-Performing Loans TA 2012 onwards
BOA issues three sets of guidelines on: (i) loan restructuring for businesses; (ii) loan restructuring for individuals; and (iii) real estate appraisal, based on international good practice.	FSAP 2013, FinSAC Non-Performing Loans TA 2012 onwards
BoA Supervisory Council adopts a new regulation on "Risk Administration for Banks' Large Exposures" to strengthen credit underwriting practices and NPL recovery and resolution for large borrowers.	FSAP 2013, FinSAC Non-Performing Loans TA 2012 onwards
MoJ and MoF issue new instructions to provide market based incentives for private bailiffs' compensation.	FSAP 2013
Pillar III. Strengthening regulation and supervision of NBFIs	
To ensure the financial and operational independence of the AFSA, the Cabinet of Ministers accepts and submits to Parliament: a new Insurance bill, and amendments to AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law.	FSAP 2013, IAIS Core Principles Report on Standards and Codes
The AFSA adopts market stabilization measures to issue: (i) a regulation on minimum MTPL reserving standards; and (ii) a time-bound plan to replenish funding of the Compensation Fund.	FSAP 2013, IAIS Core Principles Report on Standards and Codes.

C. LINK TO CAS AND OTHER BANK OPERATIONS

78. **The proposed operation supports the objectives of the Bank's Country Partnership Strategy (CPS) for FY10-FY13.** The CPS focuses on three strategic Government priorities: (i) supporting a recovery in Albania's growth rates through improved competitiveness, by strengthening macroeconomic and public expenditure management, improving the business climate, addressing infrastructure bottlenecks, and deepening access to credit; (ii) broadening and sustaining social gains by improving education and health services and establishing an adequate safety net; and (iii) reducing vulnerability to climate change by improving water conservation and management and increasing disaster preparedness.

79. **This operation contributes directly to Pillar 1 of the CPS, by supporting reforms that aim to strengthen the banking sector and resolve NPLs, which are an impediment to banks' resumption of lending, necessary for economic recovery.** The CPS progress report highlighted that objectives and pillars of the CPS remain unchanged since its preparation in FY11, but the prolonged volatility in Eurozone economies since 2008 has resulted in increased emphasis on reducing economic vulnerabilities and supporting economic growth. Thus, the CPS program has been adjusted to better help Albania manage the risks arising from internal and external vulnerabilities. In this context, the CPS Progress report envisaged the delivery of the current financial sector DPL to strengthen the resiliency of the financial sector, as soon as the government demonstrated a clear commitment for tackling key fiscal and structural issues.

80. **The proposed Financial Sector Modernization operation is being prepared in parallel to the Public Finance and Growth DPL of US$100 million, the first in a series of two programmatic DPLs that aim to improve Albania's public finances and sustain poverty-reducing growth**. The series focuses on addressing weaknesses in public finance management that have resulted in the accumulation of general government arrears, improving Albania's fiscal outlook through revenue-enhancing measures, as well as pension and energy sector reforms. The government recognizes that steps to strengthen public financial institutions and reduce fiscal vulnerabilities are critical for Albania to protect the fiscal space for growth-enabling investment and poverty-alleviating social services.

81. **Additionally, the proposed operation is being prepared in parallel with a US$160 million Power Recovery project.** Coinciding with the recent sharp slowdown in economic growth, the power sector experienced recurrent energy shortages due to weather related events. A persistent high level of power losses has necessitated government support to its generation and distribution companies to import power and cover operational deficits. The pressure on the sector has mounted over time, with the country's limited hydro-reliant power supply, exacerbated by its inherent vulnerability to weather volatility, weak sectoral governance, a flawed market model, and utility mismanagement. Given these conditions, it is essential that the power sector extricate itself from a *modus operandi* of crisis management towards sustainable operations, which will positively affect businesses and consumers alike.

D. CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

82. **The World Bank has collaborated closely with the IMF on this program.** The World Bank team is coordinating closely with the IMF on financial sector reforms and building on the

Bank-Fund collaboration during the recent 2013 FSAP and subsequently on the delivery of TA regarding investment funds. The IMF's newly approved EFF program in the amount of EUR 330.1 million (around US$457.1 million) will help Albania to meet its external financing needs while providing the necessary support to strengthen fiscal and debt sustainability, lower public financing risks, and put the economy on a sustained growth path.

83. **The World Bank has also consulted other donors on financial sector related reforms, including the European Commission (EC) and USAID**. It has consulted the EC on financial sector related reforms, so that the proposed measures are in line with Albania's commitments towards the EU. The EC is considering providing budget support to Albania, whilst the ECB envisages providing TA to the BoA through EC funding to strengthen banking sector supervision. In addition, the World Bank has consulted with USAID, which is implementing a Country Financial Sector Development Program, which aims to provide technical assistance to BoA, ADIA, and the AFSA. Preliminary recommendations of the 2013 FSAP have been extensively taken into consideration while planning these future interventions.

84. **The financial sector authorities are consulting with a range of stakeholders on the specific measures supported by this DPL.** In particular, the authorities are consulting with the banking industry on issues related to NPL resolution, including on taxation issues and NPL sales. With regards to the NBFI sector, reforms in insurance regulation, supervision and strengthened powers and tools of the AFSA, have been widely discussed with the insurance industry.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. POVERTY AND SOCIAL IMPACT

85. **The reforms supported by this operation contribute to poverty reduction and shared prosperity, through mitigating financial sector vulnerabilities which, if realized would undermine broad-based growth.** As evidenced by the recent Eurozone financial crisis, a malfunctioning financial sector can be detrimental to economic growth and can undermine achievements in shared prosperity. A sound and stable financial sector intermediating funds to the economy is essential for sustained economic growth, which in the long term contributes to poverty reduction and shared prosperity. Moreover, effective financial sector reforms increase the availability of credit and extend the reach of savings, payment and insurance services to the poor, rural dwellers and micro-enterprises alike.

86. **Financial sector reforms supported by this operation would reduce the likelihood of a financial sector crisis, which can be costly to depositors and affect the poor disproportionately, leading to an increase in poverty.** Reforms that support NPL resolution promote financial sector stability and encourage new credit flows to the economy, which would help finance both consumption needs and productive investments, necessary for economic growth. Moreover, a well-functioning insurance sector, which honors its obligations on a timely basis, is in the interest of every policy holder. In addition, reforms that include bringing eligible SCAs into the deposit insurance scheme provide an important new measure of protection for small depositors and the poor in rural areas, who constitute the bottom 40 percent.

87. **The DPL is expected to have neutral or positive gender-differentiated impacts.** No direct gender inequalities in the areas of relevance to this DPL exist. Limited available data, however, suggests that women are less included in the financial system than men in Albania with a lower share having an account, savings or a loan in a financial institution (2011)[15]. Therefore, reforms to strengthen and further develop the financial system may contribute to including underrepresented groups, such as women, in the financial sector through, for instance, an increased availability of credit and a higher coverage of deposit insurance schemes.

B. ENVIRONMENTAL ASPECTS

88. **The proposed DPL measures are not likely to have any significant effects on environment, natural resources and forestry.** The policy measures focus on legal, regulatory, and supervisory reforms to strengthen and further develop the financial sector, with no impact on the environment.

C. PFM, DISBURSEMENT AND AUDITING ASPECTS

89. **Albania has participated in a number of detailed reviews of its public financial management** (PFM)**,** among them two PEFA assessments (2006 and 2011), a Public Expenditure Review (2006), a Public Finance Review (2013), annual EU-SIGMA reviews, and more specific analysis by the World Bank, the IMF, the EC, and other organizations. The various reviews have plotted the progress Albania has made in improving its PFM systems and institutions. The 2011 PEFA assessment concluded that Albania has an adequately functioning fiscal and budget management system, in the sense that the system has enabled the government to finance and execute a budget that delivers public services to the general population. Albania scores relatively well on comprehensiveness and classification of the budget, basic treasury operations (including budget, and payroll controls), financial reporting/transparency and public access to government budget and financial information. Lagging areas identified in the 2011 PEFA assessment include: (i) multi-year perspective in fiscal planning and policy formulation; (ii) internal audit; (iii) implementation of the integrated planning system (FMIS); and (iv) the scope and nature of the external audit function.

90. **The Medium Term Budget Plan (MTBP) and the Annual Budget Law are the two main documents presented for Parliamentary review and approval.** These documents are part of Albania's Integrated Planning System[16] which tries to ensure that the core policy and financial processes of government function in an integrated manner. Still, the process allocating expenditure commitments is fragmented which renders it difficult to ensure that each set of decision makers take all relevant considerations into account. Each has a specific perspective derived from its mandate and mode of operations but operates separately from the other decision making and management agencies. This can lead to such disconnects as approval of more activities and expenditures than the funds available can accommodate, altering the balance

[15] For example, while 34 percent of men held an account in a formal financial institution in 2011, 23 percent of women did. Similarly, 6 percent of women, compared to 9 percent of men, took a loan from a financial institution in the year before the survey (World Bank Findex database, data for men and women 15 years and older, 2011).

[16] The IPS also includes the National Strategy for Development and Integration, the Government Program for European Integration, the Public Investment Program and the planning of external assistance.

between new construction and service delivery or operations, or diverting funds from other priorities without full awareness of the consequences. Though there are processes to screen and approve proposals for investment projects, these functions are not yet fully integrated into the overall budget process and the linkages remain somewhat weak.

91. **Albania has made progress in developing the national treasury system, yet challenges still remain.** A Treasury Single Account (TSA) has been introduced and all central government expenditures are recorded through it, though the recording of expenditure transactions is dependent on the timely submission of accurate information from primary budget institutions. Records and information are produced, maintained and are widely disseminated. The State Treasury is a direct participant in the automated inter-banking system of the Bank of Albania (Albania's Central Bank) and reconciliations between the Central Bank and Treasury are performed on a daily basis. The central Treasury prepares monthly and quarterly budget execution reports for all levels of government, with generally accurate data, broken down by economic and functional classifications and the reports are available one week after the end of the period. The MOF monitors the execution of local government budgets as these accounts are managed by regional (district) treasury offices. Monthly and annual budget execution reports are available to the public – these reports can be found on the Ministry of Finance website. While all contracts are required to be registered with the treasury within 3 days of signing, this has not always occurred in a timely manner, and is one of the factors that have given rise to the accumulation of significant expenditure arrears. In an attempt to strengthen cash management and planning, the treasury system can register multi-year contracts, however the outer year commitments are not currently disaggregated, thereby distorting the actual level of commitments and obligations and impacting effective medium-term budget and financial planning. Revenue receipts (tax and customs collections) are collected outside the TSA and are reported to the treasury on a net basis (taxes levied less refunds). This issue is slated to be resolved in 2014 with the introduction of the multi-annual commitments in Treasury for the outer years.

92. **Although there is no current IMF safeguards assessment of the Bank of Albania[17], the foreign exchange control environment of the central bank is satisfactory.** The Bank of Albania has received unqualified (clean) audit opinions from external auditors (KPMG) for the past three years (2010-2012). In view of this, there are no additional fiduciary safeguards considered necessary as far as management of the foreign exchange is concerned.

93. **While the fiduciary risk for this development policy operation is assessed as substantial, no additional mitigation measures are required.** Although the fiduciary risk is primarily driven by the current PFM environment in Albania, the clean audit opinions of the Bank of Albania (Central Bank) and the combination of the prior actions of the First Public Finance and Growth development policy operation (P147226) and medium-term PFM reform program negate the need for additional measures to be introduced to safeguard the loan proceeds.

94. **Loan proceeds will be disbursed in one single tranche to the existing treasury account in the Bank of Albania** and will form part of Albania's official foreign exchange reserves. The proposed loan will follow the World Bank's procedures for development policy

[17] An updated IMF safeguards assessment will carried out in 2014.

lending. Disbursement will be made upon declaration of loan effectiveness and submission of a withdrawal application to IBRD. It will not be linked to a specific purchase, thus no procurement requirements are necessary. The government shall ensure that upon deposit of an amount of the credit into the foreign exchange account, an equivalent amount is accounted for in the government's budget management system (single treasury account) and reflected in the budget. If loan proceeds are used for ineligible purposes as defined in the Loan Agreement, IBRD will require the Government to refund the amount directly to IBRD. No additional fiduciary arrangements are required. The World Bank will not require an audit of the deposit account but will the Government to provide confirmation to the Bank in the form of an official letter from the MOF on the amounts deposited in the foreign currency account within 30 days of receiving the funds.

D. MONITORING AND EVALUATION

95. **The Bank will continue to work closely with the MoF, BoA and other key stakeholders to monitor and assess reform progress and impacts during the course of this financial sector operation.** Monitoring and evaluation will be supported by the BoA, MoF, the MoJ, the ADIA and AFSA, as well as the Prime Minister's office through legislative and economic data provided by the authorities and verified in official disclosures, directives and regulations. Baseline and updated data are provided by the respective agencies and tracked according to the indicators and outcome measures shown in the monitoring and results framework of the policy matrix (Annex 1).

VI. SUMMARY OF RISKS AND MITIGATION

96. **The overall risk assessment for this operation is substantial.** Whilst risks related to fiduciary, environmental and social, stakeholders and other categories are lower, the operation may be affected by substantial risks arising domestically and/or from the external environment.

97. **An exit from unconventional monetary policy in the United States could trigger a pullback in global risk appetite.** This could reduce foreign funding and increase the rollover risk for the outstanding Eurobond. Given the large external current account deficit, funding pressures could lead to a depreciation of the lek, threatening the solvency of banks due to the presence of un-hedged borrowers. This risk is mitigated by the planned FIRST Initiative TA in support of public debt management and the BoA's strengthening of its systemic liquidity and market operation mechanisms, as recommended by the recent FSAP.

98. **A weak economy, rising interest rates or further deterioration in the domestic fiscal outlook would adversely impact the banking sector.** Given their substantial holdings of government bonds, banks would incur substantial losses if interest rates rise. NPLs could increase further as a result of a persistent weak economy or potentially due to rising Government arrears, requiring additional provisioning and adversely affecting bank profitability. Rising NPLs could threaten banks' capitalization. This risk is partly mitigated by high solvency ratios and stringent provisioning rules. This risk is also partially mitigated by the Government's ambitious reform agenda focusing on addressing domestic fiscal and energy related challenges, including the payment of arrears to the private sector, which should result in an improved economic

outlook. The Government's reform agenda will be supported by an IMF program, in addition to the parallel First Public Finance and Growth DPL and Power Recovery Project, both currently under preparation. This proposed financial sector DPL will support measures strengthening the banking sector and resolving NPLs, thus partially mitigating the risk of further adverse impacts in the banking sector.

99. **Re-emergence of financial stress in the Eurozone could increase deleveraging pressures, and/or result in the exit of a foreign bank from the market.** Stress in European parent banks resulting from the ongoing ECB Asset Quality Review exercise could reduce their ability to re-capitalize Albanian subsidiaries. Such de-leveraging pressures could lead to subsidiaries of affected banks to cut bank lending, or could lead to an exit of foreign banks, undermining public confidence. Although Albania has been relatively successful in protecting itself from the European financial crisis to date, a loss of depositor confidence or a large withdrawal of parent funding could lead to a systemic crisis. If liquidity pressures emerge, the capacity of the BoA to act as a lender of last resort in foreign currency is limited. This set of largely exogenous risks can be mitigated through, *inter alia*, enhancing the operational framework for monetary policy, developing a collateralized money market, establishing an external back-stop facility for the deposit insurer and more broadly enhancing the market for government securities.

100. **Fiscal pressures arising from the energy sector will be substantially mitigated through the proposed Power Recovery Project by supporting implementation of the GoA's Power Sector Recovery Program.** The new program is centered around four main pillars: i) resolving existing legal disputes, particularly with CEZ a.s.; ii) enhancing the security of supply through diversification of generation sources and additional generation acquired through domestic investments; iii) improving system efficiency in the distribution sector to reduce power and to improve cash collection rates and bad debt provisions; and iv) enhancing regional trade by strengthening the interconnection system.

101. **The reform program for the nonbank sector may also be undermined by the limited capacity of the nonbank regulator.** The AFSA is affected by an inability to attract and retain qualified professional staff**.** Given the recent growth experienced in the non-bank sector, it is essential the AFSA be provided sufficient resources, both human and financial, to better fulfill its mandate. The proposed operation aims to address this longstanding deficiency through reforming and modernizing the legal basis of the AFSA. Additionally, TA is envisaged to support the AFSA regarding insurance, private pensions, and investment funds. The proposed operation and supporting TA will enable the non-bank sector to better approximate relevant European Union Directives or guidance towards the insurance, investment fund, and private pension sectors.

102. **Finally, the viability of the Financial Sector Modernization DPL program may be undermined if there is insufficient political consensus to pass in Parliament the underlying five law amendments and the Insurance Bill featured in the Prior Actions, or more broadly implement the financial sector related reforms, which depend upon the continued collaboration amongst the authorities (MoF, BoA, FSA, ADIA, and MoJ).** The authorities have embarked on a challenging reform agenda of fiscal consolidation and financial sector reforms, some of which may prove politically difficult to implement. This risk is partially mitigated by broad and inclusive consultations with the relevant Ministries and regulators. A

Ministerial Committee has been formed to coordinate the implementation of prior actions. There is broad support for strengthening the banking sector, reducing NPLs, and improving the regulation and supervision of the insurance sector and investment funds. The implementation of the reform program supported under this operation will be closely monitored through ongoing policy dialogue and planned financial sector focused technical assistance building on key FSAP findings and recommendations.

ANNEX 1: POLICY AND RESULTS MATRIX

	Prior Actions	Counterparts	Results Indicators
Pillar I. Strengthening regulation and supervision of the banking sector and financial safety net			
1	BoA Supervisory Council adopts a new comprehensive Risk Based Supervisory Manual and a new Supervisory Operational Policy to increase effectiveness of banking supervision.	BoA	By end-March 2015, inspections of five of 16 banks are conducted in accordance with the new Risk Based Supervisory Manual and the new Supervisory Operational Policy, including at least two systemic banks. (Baseline: Currently the Supervisory Manual and Operational Policy are mostly compliance-based)
2	BoA Supervisory Council issues new Instruction for designated systemic banks to adopt Recovery Plans to demonstrate their ability to operate during periods of stress.	BoA	By end-March 2015, all banks determined as systemically important submit enhanced Recovery Plans to BoA, in line with the new BoA Instruction that formalizes the content to be included in banks' Recovery Plans. (Baseline: Systemic banks have submitted initial recovery plans to BoA with no formalized content)
3	Amendments to the Law on Deposit Insurance are accepted by Cabinet of Ministers and submitted to Parliament, to better align the legislation and operations of ADIA with the Core Principles for Effective Deposit Insurance Systems.	ADIA, BoA + MoF	By end-March 2015, ADIA completes assessment of compliance of eligible SCAs with the legal and technical requirements of ADIA in order to ensure that eligible SCAs enter the deposit insurance scheme by end-2015. (Baseline: SCAs are not included in the deposit insurance scheme). By end-March 2015, ADIA approves its own budget without BoA ratification. (Baseline: ADIA budget is currently ratified by BoA)
Pillar II. Expediting the resolution of Non-Performing Loans (NPLs)			
4	Cabinet of Ministers submits draft amendments of tax law No. 8438 to Parliament to resolve key NPL tax ambiguities to enable banks to write-off NPLs in protracted litigation.	MoF + BoA	By end-March 2015, the ratio of NPLs/total loans declines to 20 percent or less[18], with the write-off of at least lek 20 billion of NPLs. (Baseline: At end-2013, the NPL ratio was 23.5 percent

[18] "NPLs / Total Loans" ratio was chosen as is the most common, published and comprehensive indicator for NPL measurement, though many factors are beyond authorities' control (such as credit growth, the flow of new NPLs, etc.) and as such, could unfavorably influence the achievement of the result indicated.

5	BoA Supervisory Council adopts amended regulation on "Credit Risk Administration" for the obligatory write-off of stale-dated NPLs following a fixed period of time classified in the "loss category."	MoF + BoA	(stock of Lek 132 billion)
6	BOA issues three sets of guidelines on: (i) loan restructuring for businesses; (ii) loan restructuring for individuals; and (iii) real estate appraisal, based on international good practice.	BoA	
7	BoA Supervisory Council adopts a new regulation on "Risk Administration for Banks' Large Exposures" to strengthen credit underwriting practices and NPL recovery and resolution for large borrowers.	BoA	
8	MoJ and MoF issues new instructions to provide market based incentives for private bailiffs' compensation.	MoJ + MoF	
Pillar III. Strengthening regulation and supervision of NBFIs			
9	To ensure the financial and operational independence of the AFSA, the Cabinet of Ministers accepts and submits to Parliament: a new Insurance bill, and amendments to AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law.	MoF + FSA+ MoIPA	By end- March 2015, AFSA's Board adopts its own organizational structure and market-based salary scale independently from Parliament, allowing it to regulate and supervise NBFIs more effectively. (Baseline: AFSA organizational structure is currently approved by Parliament and salaries are set in accordance with civil servants' salary scale)
10	The AFSA adopts market stabilization measures to issue: (i) a regulation on minimum MTPL reserving standards; and (ii) a time-bound plan to replenish funding of the Compensation Fund.	FSA	By end March-2015, funding of the MTPL Compensation Fund is replenished in the amount of Lek 430 Million to enable payment of pending insurance claims. (Baseline: Compensation Fund is depleted with no funds to pay pending insurance claims)

ANNEX 2: LETTER OF DEVELOPMENT POLICY

REPUBLIKA E SHQIPËRISË

Dr. Jim Yong Kim
President
The World Bank
1818H Street, N.W. Washington D.C., 20433

20 March 2014

REF: Letter of Development Policy

Albania: Financial Sector Modernization Development Policy Loan

Dear Dr. Kim:

The Government of Albania appreciates the long-standing partnership and cooperation with the World Bank on a range of development issues; in particular we remain cognizant of the crucial development financing and implementation support that the World Bank has provided to Albania's reform program and transition over the last two decades.

Context: Albanian financial sector in the aftermath of the global and Eurozone crises

Albania had a high growth of around 6% in the last two decades up to the onset of the 2008 global crises and it weathered the crisis relatively well. The growth shock was less severe than elsewhere in Europe. Albania avoided an economic recession thanks in part to monetary accommodation and a moderate fiscal stimulus. Inflation remained low and stable. The spillover risk from the presence of Greek and other peripheral euro country banks was contained and relative stability in the financial system was maintained.

Although the Albanian financial system withstood the shocks of 2008 global crisis relatively well, it continues to operate in highly uncertain macroeconomic environment, which triggers increased vulnerabilities in the system. Prior to the global financial crisis, credit growth in Albania was excessive, but it has moved into a downturn and repair stage, as suggested by the slowdown in credit and moderation in house prices, the sharp increase in non-performing loans and the reduction in banks profitability margins. While the Bank of Albania (BoA) has been vigilant in mitigating the risks –through instituting capital adequacy and solvency ratios that are above international norms, and putting in place stringent provisioning rules-- the financial sector remains vulnerable to several risks. Stress tests show that some banks still remain vulnerable to shocks. The decline in profitability, growing non-performing loans (NPLs), substantial level of euroization, continued deleveraging of foreign bank subsidiaries from Austria, Greece, Italy and Turkey and significant investments in government bonds in the absence of active secondary market are the main challenges that banking system faces. Given strong trade and financial links with euro area, the financial system and real sector in general are increasingly vulnerable to external shocks as well.

1

Albania's high public debt poses additional significant challenges for the financial sector's sustainability. Albania's public debt has increased from about 55 percent of GDP in 2008 to about 70.5 percent in 2013 emanating largely from poor tax revenue performance, slower economic growth and continued infrastructure spending, resulting in a large stock of unpaid arrears. Large holdings of government securities present potential systemic risks for banks, making them vulnerable to changes in interest rates and the value of debt securities. At the same time, the government depends on regular rollover of debt by banks. The risk is heightened by the lack of a well-functioning secondary market and the emergence of investment funds, which face significant liquidity risk and challenges regarding asset valuation.

Government's Program

Our main economic objectives over the medium term are to restore robust and sustainable growth that would improve the living standards of our citizens; reduce the macroeconomic risks associated with the rising public debt; and mitigate the financial sector risks so credit can flow again. The National Strategy for Development and Integration 2014-2020 (NSDI), to be finalized within this year, will be the basis for the design of medium-term budget programming and the orientation of donor funding, especially from the World Bank, the IMF, and the European Union's (EU) Instrument for Pre-accession Assistance (IPA). The strategy focuses on achieving the following goals: (i) growth through fiscal stability and increased competitiveness; (ii) sustainable growth through efficient use of resources; and (iii) investing in people. Improving good governance and the rule of law forms its foundation.

We are fully committed to go through several deep reforms during the medium term 2014 – 2017 and achieve the following goals:

- *We are committed to putting our public finances on a sustainable path and lowering public debt over the medium-term.* We have begun the process of fiscal consolidation with 2014 budget, with the goal to achieve a reduction in public debt in 2015. By 2016, we aim to bring public debt down to 69 percent of GDP. We remain cautious about the uncertainties ahead, particularly the risks related with the economic developments in the Eurozone, and we stand ready to make the adjustments necessary to ensure that fiscal consolidation is preserved. We will work closely with our international partners, including the World Bank and the IMF to strengthen medium-term fiscal framework and public financial management.
- *We are committed to taking a proactive role in reforming the business climate to support robust and sustainable growth.* In addition to resolving the problem of arrears, which is critical for reducing the elevated level of NPL and consequently restoring the health of both financial and real private sector, we plan to ensure that business complaints are addressed. Strengthening the revenue administration; fighting the informal economy to reduce the competitiveness distortions; reducing redundant regulatory and procedural hurdles faced by the business community are some of the key measures in this regard.
- *Albania's long-term goal is to join the European Union.* As outlined in the European Commission's 2013 Progress Report for Albania, we have adopted key judicial, public administration and parliamentary reform measures that would allow us to make progress toward EU accession. We have also made strides in the fight against corruption and

organized crime. We intend to further strengthen the independence and efficiency of the justice system, the fight against corruption and organized crime, and reforms in public administration.

- *Another main goal we are committed to achieve, with the highly appreciated assistance of World Bank, is maintaining a stable financial system, and improving the supervisory framework.* We shall take decisive actions to ensure that the level of NPLs on banks enters a declining path and credit in the economy starts to flow. In this regard, in addition of clearing all the government's arrears to the private sector, we shall remove legal ambiguities on tax treatment of NPLs write-offs. We will also make regulatory changes to improve credit underwriting standards and NPL recovery and resolution for large borrowers. We will promptly make the necessary legal amendments to better align the legislation anc operations of Albanian Deposits Insurance Agency (ADIA) with the Core Principles for Effective Deposit Insurance Systems, and particularly to ensure full operational independence of ADIA through passage of the ADIA law amendments. We will improve the regulatory framework on insurance companies and investment funds, to deal with rising risks on their activity through passage of the four laws supporting the AFSA reforms, composed of amendments to the AFSA Law, the Civil Servants Law, the Law on Independent Institutions and the Insurance Bill. The Bank of Albania (BoA), as the regulator of the banking sector, will remain vigilant to identify material weaknesses in the sector and when necessary, require banks to provide sufficient levels of capital and liquid assets as well as introduce substantial improvements in governance and credit risk management. BoA is also advancing toward risk-based supervision, by adopting the best practices in this regard.

Reforms Supported by the Financial Sector Development Policy Loan

The Financial Sector Modernization Development Policy Loan (FSM-DPL) from the World Bank supports our efforts to: (i) expedite the resolution of Non-Performing Loans (ii) strengthening the financial sector supervisory framework and financial safety net; (iii) strengthening the Nonbank Financial Institution (NBFI) sector.

(i) Expediting the resolution of Non-Performing Loans

The level of NPLs in the banking system has increased significantly in the aftermath of the financial crisis. Although the financial sector remained largely stable during the global crises, the highly elevated level of NPLs introduces significant risks to the stability of the sector as well as to its effective and efficient operation. NPLs have increased from 3.4 percent at end-2007 to more than 24 percent in September 2013. The rapid increase of NPLs likely involves a combination of factors, including the economic slowdown, government payment arrears and weak credit underwriting standards during the credit boom before the financial crisis. Also, loss loans are not being cleared from banks' books due to prolonged major difficulties in the execution of collateral for loans in default (e.g., loans in excecution at end-2013 represent around 17 percent of all loans, or more than 2/3 of banks' total NPLs). Thus, accelerating collateral execution process represents a very critical issue, exascerbated by the lack of clarity in the tax treatment of loan write-offs.

Credit to the real economy has stalled. Comparatively strict provisioning requirements and a comfortable capital adequacy ratio have helped to contain the NPLs' negative shocks to the system thus far. However, the large increase in NPLs and deterioration in the economic outlook have caused banks to take a much more conservative approach to lending and contributed to a sharp slowdown in credit growth in the last four years. Annual credit growth turned negative in September 2013 for the first time in the last decade, declining by 3 percent (year-on-year). Although the accumulation of domestic deposits in the banking system has been steady during the last years, the banks continue to pose tight credit supply conditions toward the domestic real sector. Furthermore, the banks have significantly increased investing of domestic savings in foreign assets.

We recognize that as credit risk continues to be a major risk in the financial sector, the rising trend of NPLs in the banking system should be tackled decisively. We have already taken some actions in this regard and, closely collaborating with the World Bank, we remain committed to undertake other measures that will bring down the level of NPLs, reduce credit risk, and help to unleash the crediting potential of the financial sector. In this regard, the BoA enhanced in February 2014 its regulatory framework to strengthen credit standards and provide more guidance on NPL management. The BoA and the MoF, in conjunction with the Ministry of Justice and other related agencies and Albanian Banking Association have submitted to Parliament the legal amendment of the Tax Law to remove legal and technical issues that impede the loan write-offs from banks' balance sheets. In addition, we will prepare (with IFC assistance) changes in the Civil Code and other relevant laws in order to introduce improvements in insolvency requirements. The Ministry of Finance and the Ministry of Justice signed in early March 2014 a new Joint Instruction for private bailiffs to set the payment to bailiffs in line with a success rate (rather than requiring full up-front payment as at present), and aim to further restrict judicial discretion in postponing borrowers' payments or determining priority in collateral claims. Of course, arrears clearance will also help NPL reduction.

More specifically the Government and Bank of Albania are implementing the following key measures with the support of the FSM-DPL:

- Removing ambiguities on tax treatment of NPL write-offs, by introducing legal changes and ensuring a better understanding and appropriate execution by tax inspectors. The respective amendments of tax law No. 8438 will be shortly submitted for approval to Parliament. Such legal changes, will allow BoA to swiftly introduce changes in the regulatory supervisory framework addressing the obligatory write-off of stale dated NPL following a fixed period of time classified in the "loss" category.
- BoA has issued new guidelines related with loans restructuring for businesses and individuals, as well as for real estate appraisals. These will serve as best practice to banks in this regard.
- With continuing assistance of the World Bank (FinSAC), the BoA is designing a comprehensive NPL resolution platform. The main focus of this initiative is to develop the appropriate tools to facilitate, on one hand, the effective enforcement of creditors' rights and on the other hand, to return the operationally viable borrowers to sustainable debt servicing capabilities and enhance new borrowing via appropriate financial and corporate restructuring activities. Therefore, the addressing of impaired loans that could return to sustainable performance status through restructuring actions is expected to

further improve the NPL ratio.

- Regulatory changes will continue also to focus on improving credit underwriting standards and NPL recovery and resolution for large borrowers.
    - Supervisory Council of BoA approved by decision No. 22, dated 27.02.2014 some amendments to the regulation on "Credit Risk Administration" that provides for some obligatory requirements to banks related with the write-off process. According to these amendments banks are obliged to write-off the nonperforming loans not later than 3 (three) years after they have been classified in the "loss category".
    - Supervisory Council of BoA approved by decision No. 10, dated 26.02.2014 the new regulation "On the risk management from large exposures of banks" which is in line with the European Union's Capital Requirements Directive IV (CRD IV). This regulation provides for some more qualitative requirements to banks related with the Steering Council responsibilities. In particular, it addresses the decision making process in cases of creation and restructuring of exposures to large borrowers as well as some requirements dealing with i) risk analysis (underwriting practices) of exposures to large borrowers; ii) development of large borrowers' recovery and resolution plans and the frequency of respective revisions; iii) coordination and participation of banks in collective recovery and resolution plans with other banks in case of exposures to the same large borrower (or group of connected borrowers).
- These measures, along with a broader cooperation with the World Bank in this regard, are expected to contribute to the lowering of the NPL ratio below 20%, by the end-of March 2015.

(ii) Strengthening the financial sector supervisory framework and financial safety net

While a number of macro prudential policies were put in place since 2007, BoA remains committed to strengthen further its macro-prudential toolkit. BoA has adopted tighter approach in the earlier stage by converting foreign bank branches into subsidiaries and by tightening liquidity regulations. In 2013, in order to stimulate a credit growth, BoA has eased the liquidity requirements and reduced capital coverage for those banks that expand annual credit growth within a range of 4 to 10 percent, as well as introduced disincentives for banks to hold funds overseas. As the impact of these measures is likely to be limited given the persisting perception of high credit risk by banks, BoA remains vigilant to continually weigh the potential effectiveness of such measures in the near term with the longer term potential costs.

The BoA will continue to strengthen its macro-prudential framework. In this regard, it will gather additional information on the interlinkages between the banking sector and the non-bank financial institutions, and develop its macro-prudential toolkit to address systemic risk issues by end 2014, including its Emergency Liquidity Assistance (ELA) framework. BoA, along with other authorities, will ensure that the meetings of the Financial Stability Advisory Group (FSAG) take place on a quarterly basis as required and focus on financial stability and systemic risk management. We will also introduce monthly meetings at a technical level starting from March 2014. All the authorities will cooperate under the FSAG guidance, to strengthen FSAG legal

support for prevention and management of a systemic financial crisis. We will also take actions in order to ensure that risks from the lack of a secondary public debt market are effectively mitigated.

BoA will further improve its stress-testing toolkit. It will aim at developing sound technical skills in banks over time in order to improve the quality of bottom-up solvency stress-tests. In this regard, BoA will streamline its procedures by September 2014 to ensure that its macro-model and other satellite models are effectively used to determine macroeconomic scenarios and estimate their impact for stress-testing purposes.

Albania's deposit insurance system provides coverage for deposits of natural persons up to 2.5 million lek (approximately US$25,000), which covers 95 percent of depositors and about 58 percent of all system deposits. Albanian Deposit Insurance Agency (ADIA) is largely compliant with 14 of the 18 Core Principles for Effective Deposit Insurance Systems and has made progress in improving its operations and building its organizational structure. However, the absence of coverage for small enterprises is a material weakness in the safety net for depositors. We will equip ADIA with autonomy in its operations in accordance with Core Principle 5. At the same time, ADIA will enhance information sharing arrangements with BoA and will strive to achieve this also with relevant regional deposit insurance agencies and will seek greater latitude for its investments so as to be better able to diversify its funding. We will also take actions to admit eligible Saving and Credit Associations (SCAs) into the deposit insurance system by end-2015

More specifically the Government, BoA and ADIA are implementing the following key measures with the support of the FSM-DPL:

- The BoA will advance toward risk-based supervision, by adopting a Risk-based Supervision Framework which already includes a new Risk Based Supervisory Manual and a new Supervisory Operational Policy, to be both implemented in banks' on-site inspections during 2014. The above two documents were approved by BoA Supervisory Council and by the First Deputy Governor, respectively on 26.03.2014 decision No. 9 and date 27.03.2014, decision No. 590. By end-March 2015, inspections of 5 banks would have been conducted in accordance with this new Risk-based Supervision Framework.
- The BoA issued a mandatory Guideline on Recovery Plans, on 26 February 2014, requiring systemic banks to adopt recovery plans and demonstrate their ability to operate during period of stress. By end-March 2015, banks of systemic importance will have submitted enhanced Recovery Plans to BoA, in line with the this Guideline.
- The BoA, with decisions no.12 and 13 of its Supervisory Council meeting of February 26, 2014 has adopted collateral standards for all its monetary operations (including repurchase and reverse repurchase agreements) and has expanded collateral eligibility to all negotiable securities issued by the government of Albania.
- The Memorandum of Understanding covering operations of the inter-agency Financial Sector Advisory Group (FSAG) has been amended in the FSAG meeting of March 10, 2014 to: (i) require technical-level meetings every month (in addition to the existing three-monthly high-level meetings); and (ii) exclude financial development from the mandate of the FSAG

- We will amend the Law "On deposit insurance" to better align the legislation and operations of Albanian Deposits Insurance Agency (ADIA) with the Core Principles for Effective Deposit Insurance Systems. Such amendments will be approved soon by Parliament, which will allow the ADIA to complete by end-March 2015 its assessment of eligible Saving and Credit Associations (SCAs) in line its legal and technical requirements. This will ensure that compliant SCAs enter the deposit insurance scheme by end-2015. Furthermore, by end-December 2014, the ADIA independence will have enhanced by having the authority to approve its own budget, without BoA ratification.

(iii) Strengthening the Nonbank Financial Institution (NBFI) sector

The NBFI sector still remains a small part of financial system (6 percent of financial system assets), however measures should be taken in order to mitigate emerging risks. As of mid-2013, NBFI sector included 11 insurance companies, two investment funds, 126 savings and credit associations in two unions, two independent SCAs, 3 pension funds, and 21 other non-bank (that is, non-deposit-taking) financial institutions.

We will also strengthen the regulatory framework for the non-bank financial sector. We have moved forward with amendments to the law governing the operations of the Albanian Financial Supervisory Authority (AFSA) in order to strengthen its operational and financial independence, and amend the insurance law in line with recommendations from the recent FSAP. We will also revise by end-June 2014 the regulatory framework for investment funds in Albania to introduce time-bound liquidity and capital requirements (in line with EU directives) and require the calculation of net asset value to be done on a mark to market basis. We have requested technical assistance to determine how to set the market value of these assets, given the lack of a secondary market, and implementation would be based on the outcome of the technical assistance. We will also strengthen requirements for funds' disclosure and consumer protection to align with the FSAP recommendations.

More specifically the Government, BoA and AFSA are implementing the following key measures with the support of the FSM-DPL:

- The AFSA will improve the regulatory framework on insurance companies and investment funds, to deal with rising risks on their activity by end-June 2014. In particular, the regulatory frame work for investment funds on asset valuation, liquidity requirement, and capital adequacy requirement will be enhanced.
- To ensure the financial and operational independence of the AFSA, the Council of Ministers will submits to Parliament by end-March 2014: a new Insurance Law, and amendments to AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law. By end- March 2015, AFSA independence will have enhanced as measured by the adoption of its own organizational structure, allowing it to regulate and supervise more effectively the insurance sector
- The AFSA will adopt by end-March 2014 market stabilization measures to issue: (i) a regulation on minimum MTPL reserving standards; and (ii) a time-bound plan to restore funding of the Compensation Fund.

Finally, the Government of Albania notes that a number of proposed actions entail submission of draft laws and amendments to Parliament for enactment. The Government of Albania provides its utmost high assurances to the World Bank that it will use its best efforts to secure timely enactment of these laws and amendments in question.

Shkëlqim Cani

Minister of Finance

Ardian Fullani

Governor Bank of Albania

ANNEX 3. IMF RELATIONS

IMF Executive Board Approves €330.9 Million Extended Arrangement for Albania
Press Release No. 14/81
February 28, 2014

The Executive Board of the International Monetary Fund (IMF) today approved a 36-month SDR 295.42 million (about €330.9 million, or about US$457.1 million; 492.4 percent of country's quota in the Fund) arrangement under the Extended-Fund Facility (EFF) for Albania in support of the authorities' reform program. The approval allows for immediate disbursement of SDR 23.55 million (about €26.4 million, or about US$36.4 million). The World Bank and the EU are also likely to provide assistance to the authorities' reform program.

Following the Executive Board's discussion on Albania, Mr. David Lipton, First Deputy Managing Director and Acting Chair, stated:

"Albania's economic outlook is expected to improve in 2014, spurred by the planned reduction of underlying risks in the fiscal area, clearance of arrears, tackling of high nonperforming loans (NPLs), and the launch of structural reforms. However, risks are significant and refinancing needs are large. The EFF will help Albania meet its external financing needs while providing the necessary support to strengthen fiscal and debt sustainability, lower public financing risks, and put the economy on a sustained medium-term growth path.

"Albania's high public indebtedness calls for fiscal consolidation that aims to lower the public debt ratio to below 60 percent of GDP in the medium term. This will require significant tax and expenditure policy measures, supported by extensive public financial management and tax administration reforms. Lowering the outstanding stock of arrears and putting in place mechanisms to prevent their recurrence will also be critical.

"Further moderate easing of monetary policy could help to support economic recovery, provided inflation expectations and financial stability remain well anchored. However, this would need to be carefully balanced against risks posed by high unhedged foreign currency exposure.

"Preserving financial stability while promoting access to credit is necessary to facilitate a durable recovery. Reducing NPLs will safeguard financial stability and may help release credit supply constraints by lowering bank risk aversion. Steadfast implementation of the recent Financial Sector Assessment Program recommendations, including those related to lowering risks in the non-bank financial sector, will be important.

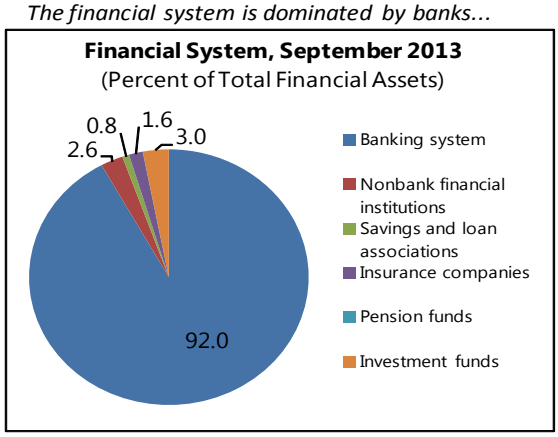
"The authorities' plans to reform pensions, energy, local government finances, public administration, and the business environment are welcome. If implemented properly, these reforms should strengthen Albania's ability to attract investment, improve prospects for sustained medium-term growth, and reduce fiscal risks, Mr. Lipton stated."

ANNEX 4: FINANCIAL SECTOR OVERVIEW

1. **The financial sector in Albania is dominated by banks**. Banks represent about 94 percent of total financial system assets, equivalent to 88 percent of GDP in 2012 (up from 76 percent of GDP in 2005, largely reflecting the strong credit growth prior to the global financial crisis) (Annex figure 1).

Annex **figure 1. Financial Sector Overview**

The financial system is dominated by banks...



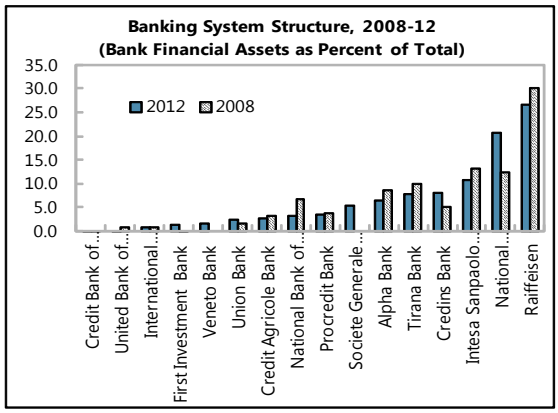
...which have been growing since 2005.

Evolution of the Financial System
(Percent of GDP)

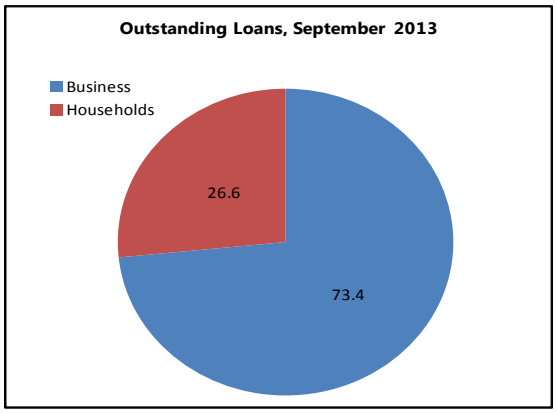
	2005	Sept. 2013
Banking system	75.9	90.8
Nonbank financial institution	1.5	2.5
Savings and loan association:	0.6	0.8
Insurance companies	1.4	1.6
Pension funds	-	-
Investment funds	-	3.0

Source: Bank of Albania

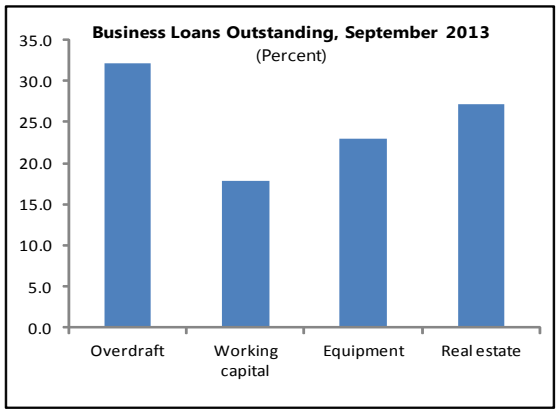
The banking system is primarily foreign owned...



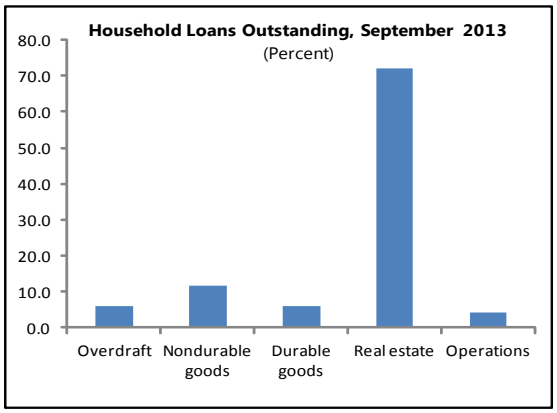
...and credit is concentrated in the corporate sector



While business loans are evenly distributed...



...household loans are skewed towards real estate.



Source: BoA, WB and IMF staff estimates

2. **Out of sixteen banks operating in Albania, two banks are dominating the market with cumulative 46.4% market share.** The subsidiary of Austrian Raiffeisen bank used to historically be market leader with more than 30% market share, though recent deleveraging pressures have significantly changed that trend, enabling local and non-European subsidiaries to expend their market penetration. Nevertheless, of the five largest banks, which collectively hold about three-quarters of total assets, four remain foreign banks with Austrian, Turkish, Italian and Greek ownership. There are six mid-sized players in the market, while the five smallest totaled less than 5 percent of total assets. In sum, subsidiaries of foreign banks represent about 93 percent of total banking sector assets.

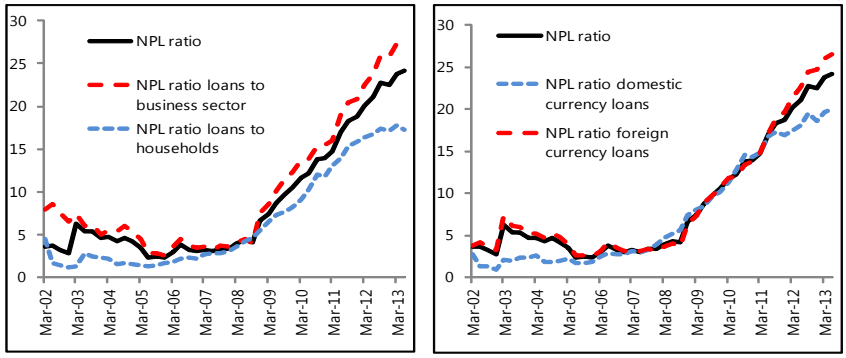
3. Banking services are fairly modern and skewed toward urban areas. There has been a significant increase in bank branches in recent years and 14 banks offer electronic banking transactions through a variety of instruments such as debit and credit cards, ATMs, point-of-service terminals, internet banking, phone banking, mobile/SMS banking, and prepaid cards. Most branches and ATMs, however, are located in urban areas.

4. **Bank credit is concentrated in the corporate sector**. About 74 percent of the value of loans in 2012 was to the corporate sector, although the vast majority of individual loans (95 percent) were granted to individuals. As of 2012, real estate loans accounted for 40 percent of the total, and overdrafts, equipment purchase, and working capital represented 24 percent, 16 percent, and 14 percent, respectively. Credit to Small and Medium-sized Enterprises (SMEs) increased 29 percent during 2007-12, but its share in total loans decreased from 37 percent to 25 percent over the same period.

5. **Several features of the banking sector increase its vulnerability to shocks.** Low bank profitability and the rapidly rising rate of NPLs are the main risks that banking system faces. The quality of the loan portfolio has deteriorated markedly since the onset of the crisis. At end-2013 gross non-performing loans (NPLs) represented 23.5 percent of total loans, the highest in the region. Foreign currency loans have performed worse than local currency loans, with NPL ratios of 25.7 percent and 19.7 percent, respectively, at end-2013 (Annex figure 2). Most lending is secured by collateral, although the BoA does not allow this value to be subtracted from loan-loss provisions for prudential purposes. Provisioning rules are conservative, and total provisions represented 65 percent of NPLs at end-2013. The profitability has declined sharply and turned negative in 2013, eroding buffers that had previously supported loan provisioning (Annex figure 3) .

Annex figure 2. Developments in Nonperforming Loans

Non performing loans are higher in the corporate sector and in foreign currency.

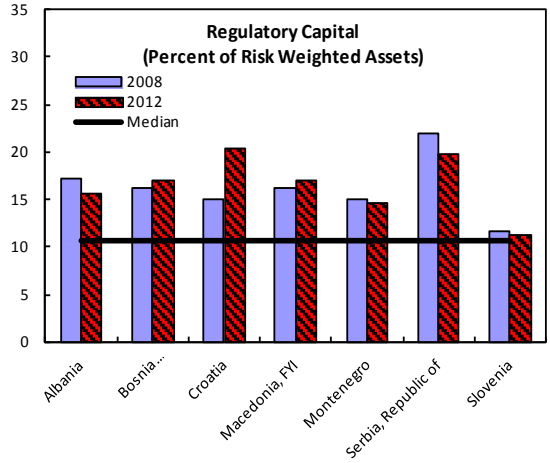


Source: BoA

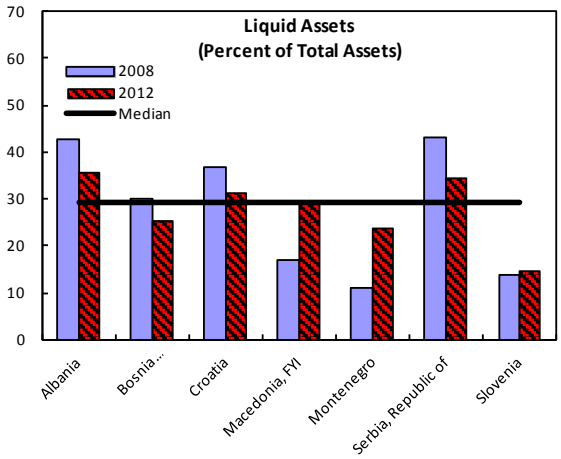
Annex figure 3. Banking Sector Indicators

High financial euroization, low profitability and the increase in non-performing loans are risks to the banking system

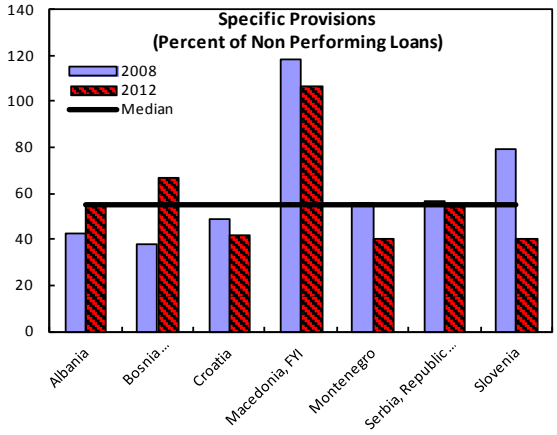
The banking system appears well capitalized…..



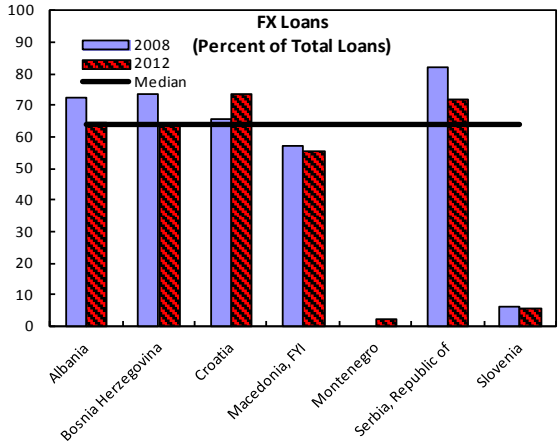
…liquid….



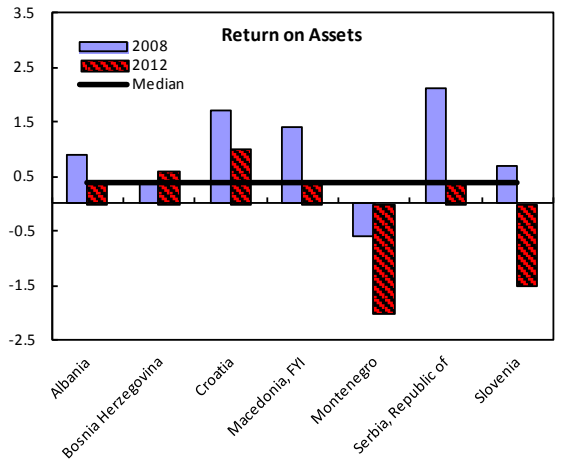
….and provisioning rates have increased.



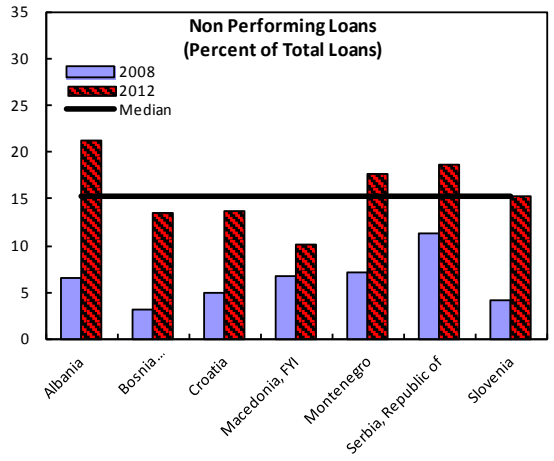
However, financial euroization is high[1]…



…. profitability is low….



…and non-performing loans are the highest in the region.



Source: IMF Staff reports and FSI database.
[1]The Euro is the domestic currency in Montenegro and Slovenia.

6. **High financial euroization contributes to the vulnerabilities in the financial system**. The euro is used pervasively in the financial system. As of end-2013, 63 percent of loans and 53 percent of total liabilities of banks were denominated in foreign currency—mostly the euro. The loan to deposit ratio is lower for the lek segment than for the foreign currency segments, standing at 41 percent and 70 percent, respectively, at end-2013. Although net open positions in the euro are small, risks include: (i) half of loans in foreign currency are unhedged; (ii) there are large maturity mismatches; and (iii) credit risk for euro loans may be underpriced, as indirect exchange rate risk may be difficult to measure. In addition, a sudden stop in FDI would directly affect systemic liquidity in Euros and the BoA has a limited capacity to act as a lender of last resort in foreign currency.

7. **Strong links between investment funds, banks, and the sovereign are another source of systemic vulnerability**. One-third of bank assets consist of government securities, and these holdings represent two-thirds of total government debt. This financial interdependence represents systemic risks for banks, which are vulnerable to changes in the value of longer-term debt securities, and for the government, which depends on regular rollover of debt by banks. In addition, investment funds, which hold mostly illiquid government bonds, present a systemic liquidity risk that affects banks.

8. **Vulnerabilities exist to external shock as well mainly due to strong ties with foreign parents.** Financial difficulties in parent countries can affect Albanian institutions through direct contagion, defunding pressures, or higher NPLs (if domestic borrowers have special links with the parent country). Although the conversion of bank branches to subsidiaries was a timely step that served to limit contagion from foreign parent banks to the Albanian banking sector, delivering pressures may nevertheless continue.

9. **While in comparison with international norms the BoA has conservative capital adequacy and provisioning requirements, stress tests conducted during 2013 FSAP showed**

that banks remain vulnerable to shocks. In severe macroeconomic scenarios, banks suffer simultaneous losses from credit, market, and sovereign risks, and at least 6 banks (representing 21 percent of the assets of the banking system) become undercapitalized. Sensitivity tests also indicate that a lek depreciation would deteriorate the quality of loan portfolios, and that credit risk is exacerbated by the high concentration of loan portfolios. Liquidity stress tests confirm that banks are amply liquid and are able to confront large deposit withdrawals. Direct contagion risk through bilateral domestic interbank exposures is limited.

Macro and micro-prudential framework

10. **The BoA was given a macro-prudential mandate by law and was successfully using its new powers during the crisis.** The modified Banking Law reinforces the general responsibility for financial stability and mandates the BoA to take action to mitigate systemic risk. A set of macro-prudential policies was put in place in late 2011 to limit contagion risks and international spillovers: (i) foreign bank branches were converted into subsidiaries; (ii) liquidity regulations were tightened; and (iii) the regulation on related party exposure was enhanced.

11. **As credit growth dropped significantly in 2011-2012 the BoA has again eased banks' prudential requirements in 2013 to stimulate credit growth.** The BoA eased liquidity requirements from 25 to 20 percent, reduced capital requirements for those banks that expand credit growth within a range of 4 percent to 10 percent, and introduced disincentives for banks to hold funds overseas. The impact of these measures was and is likely to be limited due to the difficulty of effectively targeting measures to stimulate (the credit growth in 2013 turned negative). The use of prudential tools to boost credit carries potential risks to financial stability and going forward the authorities should continually weigh the potential effectiveness of such measures in the near term with the longer term potential costs.

12. **The macro-prudential role of the BoA is complemented by the inter-agency Financial Stability Advisory Group (FSAG).** The FSAG was established in 2006 as a consultative entity to assist in the coordination of policies and to ensure the exchange of information among its members (Article 30 of the FSA law). It is chaired by the Minister of Finance and currently comprises the BoA Governor, and the AFSA Chairperson. Building on the statutory duties of each authority, an MOU signed in 2012 elaborates on the role of each institution in crisis management and enhances cooperation among its members towards three objectives: financial development, crisis prevention and crisis management. The involvement of the ADIA in the FSAG was also initiated through this MOU.

13. **Albania's deposit insurance system is largely based on modern principles.** The mandate of the deposit insurer as a paybox is appropriate for the development and size of the financial sector. The use of a flat rate deposit insurance premium (as opposed to risk-based premia) is prudent given ADIA's relatively recent establishment. However, the absence of coverage for enterprises contravenes EU guidance on coverage. The ADIA has developed procedures for admitting qualified SCAs to the deposit insurance scheme, but it is essential that the initial capital of 50 million lek be funded, which the government has planned to provide in 2014.

14. **The micro-prudential framework and the quality of banking supervision in Albania has improved significantly since 2005, as previous FSAP recommendations were implemented and the regulatory and supervisory framework moved toward alignment with EU standards.** BoA has incorporated many guidelines from the Basel Accords into its legal and regulatory framework, which has served to strengthen and expand the banking supervisory regime. The framework for licensing activities, including evaluating the application for a *de novo* bank, has been strengthened. BoA has established criteria for corporate governance and issued standards for bank management, the internal audit function and several prudential standards.

15. **In spite of these positive developments further improvements to address remaining weaknesses to underpin the necessary improvement in the health of the banking sector is needed.** In particular, supervision continues to be predominantly compliance based and the evaluation of risk management practices in banks can be superficial. Importantly, banks tend not to be challenged thoroughly on the quality of their credit policies and underwriting standards, an issue that underlay in part the deterioration of the portfolio of loans made prior to the crisis. In addition, corrective measures imposed on banks are mostly based on prudential standards rather than focused on addressing risk management issues. Consolidated supervision should be enhanced in light of the establishment of the new investments funds, including by closer information sharing and cooperation with AFSA.

16. **To address these weaknesses, BoA has embarked on a program of risk-based supervision, including full implementation of Basel II by end-2015.** The BoA has developed a detailed road map tailored to the local circumstances (with assistance from the IMF), and a new capital adequacy regulation and guidelines for Pillar 1 and Pillar 2 capital requirements (with the assistance of Bank of Italy). A new risk based supervisory process also will be introduced. The Pillar 2 framework will serve to enhance the evaluation of risk management practices in banks, but its implementation will be challenging as it requires the development of risk evaluation processes, including the Supervisory Review and Evaluation Process and the Internal Capital Adequacy Assessment Process. In addition, the regulations on credit risk and problem loan management should be revised. The Supervision Operations Policy needs to be reviewed as well to adapt fully a risk-focused approach. The BoA is also considering implementation of the liquidity component of Basel III, a move which the WB team supports.

Non-Bank financial sector

17. **The non-bank financial sector in Albania is relatively small, constituting 6 percent of financial system assets**. As of mid-2013, it included 11 insurance companies, two investment funds, 126 savings and credit associations in two unions, two independent SCAs, 3 pension funds, and 21 other non-bank (that is, non-deposit-taking) financial institutions:

a. *Insurance market.* Albania has one of the smallest insurance markets in Europe, with gross written premiums of 8.95 billion lek (€64 million) of both life and non-life insurance in 2012. The development of the sector has been hindered by the lax insurance regulation, low disposable incomes, a poor industry record of claims

performance and the lack of trust in insurance among the public. Despite a very low market penetration rate of about 2,860 lek (€20) per capita, the real growth of insurance premiums from 2009 to 2012 was only 3 percent, falling even below the cumulative GDP growth (7.5 percent) over the same period. Local insurance companies have been engaged in a MTPL price war, which over time has led to reduced growth of premium written, considerably increased risk exposure, an inadequate level of reserves, and weak underwriting performance.

b. *Investment funds.* Investment funds had no presence in Albania before 2012 when Raiffeisen Invest (a separate legal entity fully owned by the Albanian subsidiary of Raiffeisen bank) established an investment fund, the Raiffeisen Prestige Fund. The timing coincided with a withdrawal by the Albanian subsidiary of Raiffeisen from government debt markets as a result of pressures from its parent bank to limit its exposure to the Albanian sovereign. A second fund, the Raiffeisen Invest Euro fund, was subsequently added and these two funds have now grown to a total net-asset value of 316.7 million euro (as of late-October 2013). They have more than 22,000 investors (largely individuals).

c. *Savings and Credit Cooperatives*. The assets of SCAs accounted for about 0.8 percent of financial system assets in 2012. There are two unions (with 124 member SCAs) and two independent SCAs. A considerable share of the unions' assets (30 percent) is invested in bank shares and treasury bills. About 83 percent of assets are directed toward loans to members, mostly in the agricultural sector. SCAs are supervised by BoA.

d. *Pension funds*. The voluntary private pension market ('third pillar') holds less than 0.1 percent of financial system assets and aims at supplementing pensions offered under the government's obligatory scheme.[19] There were three pension funds operating at end-September, 2013, with a net asset value of about US$3.4 million and a total membership of 7,784.

e. *Other nonbank financial institutions*. These hold 2.7 percent of financial system assets and comprise mainly non-deposit-taking lending institutions and leasing, with a share of 65 percent and 30 percent, respectively. Other institutions undertake money transfers services and factoring. Such NBFIs are funded primarily through borrowing (about 60 percent) and their capital (about 35 percent). They are supervised by BoA.

[19] The public pension scheme ('first pillar') is the backbone of Albania's social security system. It is a mandatory pay-as- you-go system with universal coverage. Its management is entrusted to the Social Insurance Institute (SII), an independent public entity under the supervision of the Ministry of Labor and Social Affairs.

Albanian Financial Supervisory Authority

18. **Insurance market, investment funds as well as pension funds are regulated and supervised by Albanian Financial Supervisory Authority.** AFSA is an integrated supervisory authority established in 2006 through merging three separate supervisory authorities. It is a public institution which is funded by the industry and is accountable to the Parliament. AFSA did not receive any state budget financing since 2010, however, the autonomy in setting its budget and its internal organizational arrangements is considerably restricted. As a matter of practice, AFSA is treated as part of executive government and civil servant law does apply. AFSA's all Board decisions can be appealed before a court.

19. **The effectiveness of the AFSA is severely impeded by a regulatory framework that does not comply with the international best practice standards.** The institutional setup of its insurance and investment fund supervision and regulation has proven ineffective owing to its lack of real independence, severely constrained financial resources, absence of representation in the law-making process and the acute shortage of qualified personnel. As a result, insurance supervision and regulation is only partially compliant with the IAIS requirements for a modern and effective insurance supervisory authority and investment and pension funds supervision is similarly constrained.