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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF US\$100 MILLION TO

THE REPUBLIC OF ALBANIA

FOR THE

FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

February 13 , 2017

Finance and Markets Global Practice
Europe and Central Asia Region

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ALBANIA - GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of February 9, 2017)

Currency Unit	Albanian Lek
US\$1.00	ALL 127.25

ABBREVIATION AND ACRONYMS

ADIA	Albania Deposit Insurance Authority
AFSA	Albania Financial Supervisory Authority
BoA	Bank of Albania
CPF	Country Partnership Framework
CU	Credit Union
DPL	Development Policy Loan
EC	European Commission
EFF	Extended Fund Facility
EU	European Union
FDI	Foreign Direct Investment
FSAG	Financial Stability Advisory Group
FSAP	Financial Sector Assessment Program
FSM DPL	Financial Sector Modernization Development Policy Loan
GDP	Gross Domestic Product
IMF	International Monetary Fund
MoF	Ministry of Finance
MoJ	Ministry of Justice
NBFI	Nonbank Financial Institution
NPL	Nonperforming Loan
NSDI	National Strategy for Development and Integration
PBG	Policy Based Guarantee
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PIE	Public Interest Entity
POB	Public Oversight Board
SCA	Savings and Credit Association
SECO	Swiss State Secretariat for Economic Affairs
TA	Technical Assistance

Vice President: Cyril Muller

Country Director: Ellen Goldstein

Senior Practice Director: Ceyla Pazarbasioglu

Practice Manager: Mario Guadamillas

Team Leaders: Michael Edwards, Bujana Perolli

REPUBLIC OF ALBANIA

FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

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The Financial Sector Development Policy Loan was prepared by an IBRD team consisting of Michael Edwards (Lead Financial Sector Specialist/TTL, GFMDR); Bujana Perolli (Senior Financial Sector Specialist/TTL, GFMDR); Keler Gjika (Short Term Consultant, GFMDR); Juan Buchenau, Pamela Lintner, Andres Federico Martinez, and Juan Ortiz (all Senior Financial Sector Specialists, GFMDR); Andrei Busuioc (Senior Financial Management Specialist, GGODR), Barbara Cunha (Senior Economist, GMFDR), Hilda Shijaku (Economist, GMFDR), and Kozeta Diamanti (Program Assistant, ECCAL).

SUMMARY OF PROPOSED LOAN AND PROGRAM
ALBANIA
FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

Borrower	Republic of Albania
Implementation Agency	Bank of Albania (BoA), Albania Financial Supervisory Agency (AFSA), Ministry of Finance (MoF), Ministry of Justice (MoJ), Albania Deposit Insurance Agency (ADIA)
Financing Data	IBRD loan <i>Terms:</i> Fixed spread, 31 years maturity, 8 years grace period, USD\$ <i>Amount:</i> US\$100 million
Operation Type	Single tranche stand-alone Development Policy Loan
Pillars of the Operation and Program Development Objective(s)	<p>The program development objective is to strengthen the resiliency of the banking sector and the regulation and supervision of nonbank financial institutions.</p> <p>The DPL is structured around three pillars: (a) adopting policy measures to reduce nonperforming loans (NPLs) and enhance the financial safety net, (b) strengthening regulation, supervision, and resolution regime of banks and Savings and Credit Associations (SCAs), and (c) strengthening the regulation and supervision of investment funds.</p>
Result Indicators	<p>By March 2018:</p> <ol style="list-style-type: none"> 1. The ratio of NPLs to total loans declines to 16 percent or less of total loans. 2. A functional, and funded Public Oversight Board (POB) is established, with adequate staffing and funding as required by the EU Statutory Audit directive, and with the capacity to improve the audit quality of Public Interest Entities (PIEs). 3. 100 percent of eligible legal entities' deposits are insured up to the limit of 2,500,000 lek. 4. A dedicated resolution unit is established in Bank of Albania (BoA). 5. Systemic banks submit annual recovery plans in accordance with the new enhanced Regulation for "Guidelines on Recovery and Resolution Plans" issued by BoA. 6. The sector of Savings and Credit Associations (SCAs) has consolidated from 108 to less than 20 SCAs, and half of SCAs have been subject to BoA's on-site inspections based on the new regulatory framework. 7. In excess of 10 percent of assets of investment funds are in liquid form, and all licensed asset management companies and the respective authorized investment funds have been subject to on-site inspection by the AFSA.
Overall risk rating	Moderate

Climate and disaster risks (required for IDA countries)	(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
Operation ID	P152064

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed stand-alone Financial Sector Development Policy Loan (FS DPL) in the amount of US\$100 million supports the Government’s reform agenda and aims to strengthen the resiliency of the banking sector and the regulation and supervision of nonbank financial institutions.** The operation is structured around three pillars: (a) adopting policy measures to reduce nonperforming loans (NPLs) and improve the financial safety net, (b) strengthening regulation, supervision, and resolution regime of banks and Savings and Credit Associations (SCAs), and (c) strengthening the regulation and supervision of investment funds. This proposed operation builds on the achievements of the Financial Sector Modernization DPL delivered in 2014. It provides a signal on the importance of the cross-cutting reform agenda in the financial sector and the collaboration among multiple stakeholders, such as the EU and the IMF. Overall, the DPL takes into account factors such as projected future financing needs, structure of public debt, and debt sustainability issues.

2. **After having emerged from the collapse of communism as one of the poorest countries in Europe, Albania experienced a rapid annual growth of nearly 6 percent, becoming a middle-income country by 2008.** Albania transitioned from being one of the poorest countries in Europe in the 1990s to gaining middle-income status in 2008. The rapid pace of growth helped the country narrow the per capita income gap with the rest of Europe, from 18 percent of average European Union (EU) incomes in 1998 to 30 percent by 2012, and fueled aspirations to join the EU. Growth successfully halved poverty from 25.2 percent in 2002 to 12.5 percent in 2008. Growth before 2008 was largely due to rising domestic consumption, fueled by a real estate boom on the coast, and by remittances reaching as much as 10.8 percent of gross domestic product (GDP) from high levels of out-migration.

3. **However, in the aftermath of the global financial crisis, Albania’s growth decelerated, and progress has since been reversed.** Since 2008, Albania’s real GDP growth has slowed down significantly, triggered by the global financial crisis and the subsequent anemic euro area growth. The country is struggling to recover, particularly given its historic ties to Europe’s poorer performing economies. Although the country avoided the recession seen elsewhere in Europe, the dramatic slowing of growth coupled with fiscal indiscipline and reform paralysis exposed severe macroeconomic imbalances, with a rapid escalation in public debt and arrears, unsustainable deficits in the energy sector, and a sharp increase in NPLs in the banking sector. Albania’s economic growth averaged less than 3 percent a year in real terms between 2009 and 2012, sinking to an average of 1.9 percent a year during 2013–2015. The poverty rate stood at 14.3 percent by 2012, with poverty increases particularly in urban areas. Adjusted for purchasing power, per capita income was US\$8,123 in 2013, leaving Albania as the fourth poorest country in Europe, with 7 percent of the population living below the US\$2.50-a-day poverty line. Similarly, shared prosperity—consumption growth of the bottom 40 percent compared with the average increase in consumption—improved between 2005 and 2008 but has largely stagnated since then. Between 2008 and 2012, consumption¹ fell by 1.3 percent per year, including by 1.2 percent for those in the bottom 40 percent, as growth slowed down.

4. **In this unfavorable context, a reformist government took office in 2013 on a platform aimed at accelerating growth, creating jobs, restoring trust in the government, and furthering progress toward EU accession.** Since the early 2000s, Albania has implemented a range of institutional and structural reforms that have moved it closer to the EU membership. Albania was granted EU candidate status in June 2014. Although Albania has obtained candidate status, further progress, especially in

¹ As measured by the Living Standards Measurement Survey.

administration and judicial reform, fight against corruption, and organized crime, is needed to move forward in the EU integration process.

5. **The reforms supported under this operation are in line with the World Bank's twin goals of poverty reduction and shared prosperity.** This operation supports the first fundamental priority of maintaining financial stability, as outlined in the Systematic Country Diagnostic,² subsequently endorsed through the Country Partnership Framework (CPF) objective of Focus Area 1 of 'improving financial stability'.

6. **This DPL is one of several other World Bank policy-based lending operations to Albania in recent years, including the 2014 Financial Sector Modernization (FSM) DPL.** These operations have supported a wide range of reforms aiming to restore macro-financial stability and rekindle economic growth. In addition to the 2014 FSM DPL, the World Bank's Board of Executive Directors approved a Public Finance and Growth DPL and a Public Finance Policy-Based Guarantee (PBG) to improve Albania's public finances and sustain poverty-reducing growth. The Public Finance DPL and the PBG focus on addressing inadequacies in public finance management that resulted in the accumulation of general government arrears, improving Albania's fiscal outlook through revenue-enhancing measures and pension and energy sector reforms. In January 2017, the World Bank's Board of Executive Directors also approved a Competitiveness DPL that supports the Government's strategy to enhance Albania's competitiveness and export-orientation in order to achieve higher and more inclusive growth.

1.1 FINANCIAL SECTOR CONTEXT

7. **The financial sector, which strongly supported high consumption before the crisis, was hit with rapidly rising NPLs after the global crisis.** Problems of portfolio quality became apparent in the years after the global crisis, and the NPL ratio climbed from 6.5 percent in 2008 to 24.9 percent by end-September 2014. NPLs decreased to 18.2 percent as of end-December 2015, mostly due to the enforcement of a BoA regulation requiring banks to write off NPLs categorized in the 'lost' category for more than three years, before increasing to 21.3 percent in September 2016. A large un-signaled corporate bankruptcy case and the worsening of the outlook of another large industrial group in the first part of the year caused the deterioration of the NPLs ratio. High NPLs limit further credit expansion.

8. **The sharp rise in NPLs was driven by several factors.** These include, inter alia, large government arrears (totaling over 5 percent of GDP in 2013), overexposure toward sectors such as construction, and loans in foreign currency to unhedged borrowers. In addition, several other factors were key in hindering the decline in the high NPL ratio, such as, tightening of regulatory standards, sluggish credit growth due to low demand for loans, chronic judiciary weaknesses, which prolonged the collateral execution process, and continued deleveraging pressures from foreign banks. Credit supply to the economy slowed from an annual average of 57 percent immediately before the crisis (Q1 2005–Q2 2008) to 9.6 percent in the period Q3 2008–Q1 2014, thus adding a liquidity strain to the already weak balance sheets of the private sector.

9. **Nevertheless, the banking sector has remained resilient, with adequate capital and liquidity, although key channels of vulnerability remain.** The BoA has been vigilant in mitigating risks through

² The five fundamental priorities identified by the Systematic Country Diagnostic are (a) restoring fiscal sustainability and financial stability, (b) establishing a high-quality business environment that promotes firm growth and job creation, (c) providing clean energy efficiently, equitably, and sustainably, (d) formalizing and enhancing the inclusiveness and sustainability of the land market, and (e) enhancing governance, transparency, and accountability of the Government.

instituting capital adequacy and solvency ratios that are above international norms and putting in place stringent provisioning rules. Credit growth returned to positive in the second half of 2014 and continued to be positive in 2016, albeit at low levels, pushed by a higher demand resulting from improved business confidence and liquidity conditions of the private sector. However, the NPL ratio remains among the highest in the region, and the financial sector remains vulnerable to tepid credit demand, a weak insolvency and collateral execution environment, and weak external growth factors. The NPLs ratio increased from 18.2 percent at end-December 2015 to 21.3 percent at end-September 2016, due to a deterioration in the performance of a couple of corporate loans. The modest growth of the total loan portfolio in the first half of 2016 was not sufficient to reverse the deterioration of the NPLs ratio. Loan demand, especially of the corporate sector, remains weak, despite the improvement in economic growth. Notwithstanding the relatively high participation of Greek- and Italian-owned banks, the Albanian financial system weathered the recent Greek turmoil without major consequences.

10. **High financial euroization and significant foreign bank presence increase the vulnerability of the financial system to external shocks.** About 59 percent of the banks' loan portfolio is denominated in foreign currency, with about 44 percent of it unhedged, which in combination with large maturity mismatches could create further risks in case of a depreciation of the local currency (Albanian lek). In addition, the largely foreign-owned structure of the banking sector with Austrian, Greek, and Italian banks presents additional risks, as financial difficulties in parent banks could affect the Albanian subsidiaries. Risks may be channeled through contagion or spillover fears (especially from Greece) or defunding pressures in the event that parent banks are unable or unwilling to provide capital support to the local subsidiaries. The 2012 conversion of bank branches to subsidiaries was a timely step to limit deleveraging, as prudential limits on capital adequacy and liquidity were set at the level of the subsidiary rather than the group.

11. **In addition, the strong financial links between banks and government debt holdings can magnify potential vulnerabilities.** A large share of the banks' assets is invested in government securities, which held about 60 percent of Government debt at the end of September 2016. 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 the regular rollover of debt by banks. The risk is heightened by the lack of a secondary market and the recent emergence of investment funds. These investment funds have been successful in attracting new investments (totaling more than €500 million in September 2016) yet face significant liquidity risk and challenges regarding asset valuation. On the Government side, public debt management capacity has also been undermined.

12. **The nonbank sector is small, but important risks continue, as the regulatory and supervisory framework for nonbanks is in the early phase of being strengthened.** Investment funds have grown considerably since 2012 to around EUR 500 million to date. While these funds have helped diversify the ownership of government securities, their emergence has not been matched with a commensurate improvement of the supporting regulatory and supervisory regime. Moreover, given the close links of the investment funds with banks, redemption pressures may spill over to their parent banks. The insurance market also faces significant challenges, as insurance companies have not properly financed their outstanding liabilities for many years. Several policy measures supported under the 2014 Financial Sector Modernization DPL (FSM DPL) strengthened the independence of the nonbank supervisory authority, the AFSA. As the newly established AFSA board is now fully empowered to enhance its institutional and professional capacities, it is expected to better regulate and supervise the markets

under its auspices.³ The BoA and the AFSA, have increased their cooperation, through the FSAG⁴ as well as bilateral protocols, with regard to the systemic risks posed by investment funds activities carried by banks.

13. **The sector of SCAs, representing a small segment of the financial sector, was fragmented until early 2016 and under limited regulation and supervision.** SCAs provide financial services mostly to small farmers and low-income people in the rural areas of the country. Despite rapid growth since their creation, SCAs represent a small proportion of the financial sector (about 0.6 percent of the financial sector's assets). Until early 2016, the sector was fragmented with more than 100 SCAs, which were largely part of two Credit Unions (CUs).⁵ As recognized by the authorities and the CUs, a consolidation of the sector was essential to scale up for future growth. Since SCAs accept deposits, and deposit insurance coverage has been extended to deposits accepted by these institutions, the BoA has worked towards putting in place a stronger regulatory and supervisory framework. In a forward-looking response to the stronger governance and prudential requirements included in the new SCAs Law, each CU consolidated respectively into large SCAs, substantially reducing the number of SCAs in the market from about 108 to about 13 by September 2016.

14. **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. ADIA has made substantial 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 SCAs, facilitate a prompt payout after BoA's intervention, and expand ADIA powers to contribute to a purchase and assumption or bridge bank resolution.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

15. **Strong economic performance during the 2000s resulted in important social gains, but the global financial crisis and subsequent Eurozone crisis interrupted the quest for shared prosperity.** Real GDP growth averaged 6 percent a year between 1998 and 2008, catapulting Albania from the poorest country in Europe to middle-income status in 2008. Growth was accompanied by poverty reduction with poverty rates (measured at US\$5/day) falling from 62.3 percent in 2002 to 45 percent in 2008. Severe poverty (measured at US\$2.5/day) also fell from 12 percent to 6.1 percent. Even after the 2008 global financial crisis, Albania's growth remained relatively robust, averaging 3.2 percent between 2009 and 2011, driven by remittances-fueled consumption. However, growth decelerated in 2012 and 2013, affected by the downturns in neighboring Italy and Greece, leading to an increase in poverty and extreme poverty rates (to 47.5 percent and 6.7 percent in 2012, respectively).

16. **Economic activity has picked up since 2014, driven by strong private investment.** After growing 1.8 percent in 2014 and 2.6 percent in 2015, Albania is expected to grow at 3.2 percent in 2016 as private investment remains strong and consumption continues to pick up supported by growing

³ In 2015, a WB technical assistance program financed by the Swiss SECO was launched to support AFSA in building institutional and professional capacities to regulate and supervise the investment funds sector, and corporate bonds issuances.

⁴ Financial Stability Advisory Group (FSAG) was established in 2006 as a consultative entity to assist in the coordination of policies and ensure the exchange of information among its members, the Ministry of Finance, BoA, AFSA and ADIA.

⁵ The CUs are second-tier federations of SCAs, whose establishment was originally supported by the World Bank, the Foundation of the Irish League of Credit Unions, and other international organizations.

employment. Real GDP is projected to have reached 3.2 percent in 2016. Growth was at 3.1 percent in the third quarter of the year, with the main contribution coming from services, followed by construction and agriculture. The expansion of tourism in the summer season added to the sustained foreign-financed fixed capital formation in large energy-related projects, such as the Trans-Adriatic Pipeline (TAP) and hydropower plant construction in the Devoll river cascade. On the other hand, industry shrank by 2.4 percent as a result of unfavorable commodity markets affecting Albania's extractives. Export of services, together with private investment, and private consumption, drove the expansion of aggregate demand in the third quarter. Positive labor market developments, the easing of credit standards and considerable FDI inflows continue to support the pickup in domestic demand at year-end. General government spending also made a small positive contribution of 0.3 percentage points in the third quarter, after declining for five consecutive quarters, reflecting a softer consolidation stance in the second half of the year. Net exports contributed positively to growth, due to services exports expanding by 25.4 percent. On the other hand, exports of goods continued to shrink while imports increased by 5.6 percent.

17. The economic recovery contributed to slightly better conditions in the labor market. Job creation accelerated by 8.5 percent in the third quarter of 2016. Employment growth may partially reflect increasing formalization of the labor market following the government's actions against informality in late 2015. Employment grew, particularly in market services and manufacturing. Labor force participation which has trended upward since 2014, increased by 2.4 percentage points in the third quarter of 2016. Unemployment stood at 14.7 percent, markedly declining by 2.5 percentage points in comparison to the same quarter in 2015. Despite an increase in employment, real wages appear to have declined since the end of 2013. After freezing nominal public sector wages and pensions since 2013, the government announced an increase in wages and an inflation adjustment for pensions in 2017 with an estimated bill at around 1 percent of GDP.⁶ While being mostly directed to the lower part of the public service salary scale, this change is expected to have a positive effect in alleviating poverty, currently estimated at 45.5 percent (5\$ per day).

18. The economic recovery has been accompanied by the recurrence of external vulnerabilities. Albania has a structural current account deficit, which has been mainly financed by remittances. The current account deficit also fluctuates depending on commodity prices. Imports (particularly of machinery and equipment), which had expanded as investment and economic activity started to pick up in 2014, declined in 2015 due to lower oil prices. Imports have picked up again in 2016 as a result of high investments need in the energy sector. Service exports, led by tourism, more than compensated for the weak results in extractives, leading to a decline in the overall trade deficit in the third quarter of 2016. The current account deficit is projected to expand to 12.1 percent of GDP in 2016 from 10.8 percent in 2015. With about 40 percent of the population living abroad (mainly in Greece and Italy), Albania has traditionally been among the top remittance receiving nations. Current transfers, including remittances declined sharply from 10.8 percent of GDP in 2009 to an estimated 7.2 percent of GDP in 2016. The current account deficit has been largely financed through FDI, which are estimated at 7.4 percent of GDP in 2016. Public external debt has increased since 2009, but remains at a manageable 33.8 percent of GDP in 2016.

⁶ The direct budgetary impact of this increase is estimated at 0.1 percent of GDP.

Table 1. Key Macroeconomic Indicators

	Actual				Est.	Projection		
	2012	2013	2014	2015	2016	2017	2018	2019
Real GDP (% change)	1.4	1	1.8	2.6	3.2	3.5	3.5	3.8
Contributions								
Consumption	0.1	1.4	2.5	-1	0.9	1.1	1.8	1.8
Private Consumption	0.1	1.3	2.2	-0.6	0.9	1	1.7	1.7
Public consumption	0	0.1	0.3	-0.4	0	0.1	0.1	0.1
Gross Fixed investment	-2.8	-0.6	-1.2	2.8	2.8	2.5	2	1.5
Net exports	4.7	-1.6	-2.1	0.8	-0.5	-0.1	-0.3	0.5
Unemployment* rate	13.4	16	17.5	17.1	16			
CPI period average	2	1.9	1.6	1.9	1.3	1.5	2.9	3
Fiscal accounts**	Percent of GDP unless otherwise indicated							
Expenditures	28.2	29.2	32.3	30.9	28.9	28.8	28.5	28.2
Of which arrears clearance			2.4	1.3				
Revenues	24.8	24	26.3	26.3	26.7	27.7	27.5	27.5
General Government Balance	-3.4	-5.2	-6	-4.6	-2.2	-1.1	-1	-0.7
Primary Balance	-0.3	-2	-3.1	-1.9	0.2	1.2	1.1	1.4
PPG (eop)***	62.1	70.4	72.1	73.7	72.7	69.5	66.5	63
Selected monetary indicators	(Annual percentage change unless otherwise indicated)							
Broad money growth	5	2.3	4	4.3	4.1	5.9	6.1	5.9
Credit to non-government	1.4	-1.4	2	-0.8	2.5	4.2	7.5	9.9
Balance of payments	(Percent of GDP unless otherwise indicated)							
Current account balance	-9.8	-10.5	-12.9	-10.8	-12.1	-13.7	-13	-11.8
Imports of G&S	48.7	52.3	47.8	47.2	47.4	44.9	44.4	45.6
Exports of G&S	27.9	29.4	28.9	28.7	28.2	27.1	26.7	27.5
Foreign direct investment (net)	6.5	9.2	8.2	8	7.4	8.3	7.2	5.6
Gross reserves in months of G&S	4.6	4.5	5	6.2	5.7	5.3	4.9	4.5
Other memo items								
Nominal GDP in billions of lek	1,333	1,350	1,400	1,435	1,493	1,579	1,675	1,787
Nominal GDP (in millions US\$)	12776	13231	13709	11141	11547	12061	12663	13538

Source: INSTAT, Albanian Ministry of Finance and Bank of Albania; IMF; and WB Staff estimations and projections.* Unemployment rate is calculated using labor forces survey. **General government (GG) figures, the GG balance is on cash basis. General government debt in 2013, 2014 and 2015 includes arrears. ***Since February 2017, the stock of general government debt includes fully documented unpaid bills owed by local governments, most of which were inherited by the new municipalities after the June 2015 territorial reform. These changes are reflected starting with 2015.

19. **Inflation continues to undershoot the target band due to lower oil and food prices.** In 2016 annual average inflation fell to 1.3 percent with a notable upward drifting towards the second half of the year. Inflation stood at 1.85 percent in the last quarter of the year, as the contribution of food price

inflation returned to normal values contributing to around 80 percent of the total inflation. As the economy continues to grow and utilization of production capacities to recover, underlying long term trends of inflation also grew towards historical averages. Consistent with its price stability objective, the Bank of Albania's policy stance remains accommodative. The policy rate stands at its minimum of 1.25 percent since April 2016. The monetary policy transmission strengthened towards the year end as the average interest rate for loans in domestic currency declined to 7.5 percent, 0.6 percentage points below the levels in 2015. Lower interest rates and eased credit standards stimulated domestic currency lending which grew by 10.4 percent. The real effective exchange rate appreciated by 4.1 percent because of nominal appreciation and the narrower inflation differential with trading partners.

20. **Albania's fiscal position deteriorated after the global financial crisis, but the government has taken important steps to stabilize public finances since 2013.** After clearing a large share of arrears to the private sector in 2014, Albania's fiscal deficit initially widened to 5.2 percent (from 3.5 percent of GDP in 2010). Revenues as a share of GDP declined from 25.9 percent in 2010 to 23.8 percent in 2013 due to fiscal easing and slower economic activity. As revenues fell, so did spending, and in particular capital expenditures, but at a slower pace. In addition to fully clearing accumulated arrears by end of 2015, the government implemented consolidation measures and introduced reforms to alleviate the long-term fiscal burden of pensions and energy subsidies. In 2013 the government also acknowledged arrears initially estimated at 4.8 percent of 2013 GDP. In 2014, the government cleared arrears worth 2.4 percent of GDP in 2014 and an additional 1.3 percent of GDP in 2015.

21. **Recent fiscal results remain on track and support fiscal consolidation.** Fiscal results remained on track supporting macroeconomic stability. Revenues for the first 11 months of 2016 were up by 7.3 percent over the previous year. Tax revenues increased for almost all categories with social security contributions VAT and CIT contributing the most. Nevertheless, VAT, PIT and excises underperformed against the plan, leading to a shortfall of -1.1 percent from tax revenues. Fiscal spending (excluding arrears repayments) increased by 2.8 percent in comparison to the same period in 2015 almost entirely on non-energy subsidies and transfers to local governments. The budget generated important savings from lower interest rates, subsidies to the energy sector and subsidies to the pension scheme, thus benefiting from earlier reforms initiated in 2014, however capital spending remained under-executed (at 97.6 percent of the plan). The central government balance in the first eleven months of the year was in surplus. Preliminary data suggests that due to accelerated spending in December, the 2016 budget reached -2.2 percent of GDP while achieving a small primary surplus of 0.2 percent of GDP, slightly below the programmed level.

Table 2. Operations of the General Government (Percent of GDP)^{1/}

	2012	2013	2014	2015	Est. 2016	2017	Proj 2018	2019
Total revenue and grants	24.8	24	26.3	26.3	26.7	27.7	27.5	27.5
Tax revenue	22.6	21.9	24.1	23.7	24.3	24.9	25.1	25.1
Non-tax revenue	1.8	1.6	1.5	1.8	1.6	1.5	1.5	1.5
Grants	0.4	0.4	0.7	0.8	0.8	0.9	0.9	0.9
Expenditures	28.2	29.2	32.3	30.9	28.9	28.8	28.5	28.2
Current expenditure	23.6	24.3	25.1	24.8	24.7	24.2	24.2	23.5
Personnel cost	5.2	5.2	5.1	5.1	4.5	4.6	4.6	4.4
Goods and services	2.5	2.4	2.2	2.7	2.9	2.8	2.8	2.7
Interest payments	3.1	3.2	2.9	2.7	2.4	2.3	2.1	2.1
Subsidies 2/	0.1	0.1	0.6	0.5	0.2	0.2	0.4	0.5
Social insurance outlays	9	9.5	9.9	9.8	10.1	10.1	10	10
Local government expenditure	2.1	2.2	2.4	2.4	2.9	2.7	2.5	2.5

Social protection transfers	1.5	1.7	1.8	1.4	1.6	1.5	1.4	1.3
Capital expenditure	4.6	4.8	4.3	4.4	3.9	4.5	4.4	4.4
Reserve and contingency funds 3/	0	0	0	0	0.3	0.1	0.2	0.2
Clearance of arrears	0	0	2.4	1.2	-	-	-	-
Others: loans to energy sector	0.1	0	0.4	0.4	0.2	0.1	0	0
Overall Balance	-3.4	-5.2	-6	-4.6	-2.2	-1.1	-1	-0.7
General government financing	3.4	5.2	6	4.6	2.2	1.1	1	0.7
External (net)	1.6	0.8	2.4	4.9	1.1	3.1	0.3	0.8
Domestic (net)	1.8	4.4	3.5	-1.3	1.1	-2	0.7	-0.1
of which privatization	0.1	1.2	0	0.1	0.2	0	0	0

Source: Albanian Ministry of Finance; IMF; WB Staff estimations and projections. Data as of February 2017.

^{1/}On cash basis.

^{2/}Reserve and contingency funds are reported according to their spending category at outturn.

22. **Public debt started to decline.** Public debt increased from 2008 to 2015, where it reached the peak at 73.7% before starting to fall. As of end 2016 it stands at an estimated 72.7 percent of GDP. In 2008, public debt stood at 54.7 percent of GDP, but loose fiscal policy and a depreciation of the Lek caused it to climb to 59.4 percent by 2011. Fiscal pressures rose further during the energy shortage in 2012, when the government supported the power generation company KESH by providing guarantees. Ad hoc increases of pensions and declining revenues added to the fiscal pressures this year. In the run-up to the 2013 elections, Parliament revoked the 60 percent of GDP public debt limit, without proposing any other fiscal or debt anchor. The public debt climbed to 70.4 percent in 2013 driven by both the electoral pressures and the recognition – i.e., inclusion in the stock of public debt – of the government arrears. About 55 percent of Albania's public debt has a floating interest, exposing Albania to interest rate risks. Nevertheless, the Government continues to reduce its reliance on short-term domestic debt and make efforts to develop its domestic debt market. Public debt is estimated at 72.7 percent of GDP in 2016, down from 73.7 percent in 2015, as the government achieved a positive primary balance of 0.2 percent of GDP. The Parliament approved a new organic budget law which mandates an annual decline in the public debt until it reaches 45 percent of GDP. In August 2016, Standard & Poor's confirmed its long-term sovereign credit ratings for the Republic of Albania at 'B+.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

23. **The World Bank projects growth to rise beyond 2017.** In 2017, growth is expected to reach 3.5 percent followed by 3.5 percent and 3.8 percent in 2018-2019 mainly supported by growing domestic demand. Private investment linked to the Trans-Adriatic Pipeline and a hydropower plant in Southern Albania will lead the expansion in domestic demand. Additionally, private consumption is expected to gain strength supported by labor market improvements, increasing its contribution to growth. Government spending will remain limited, following the implementation of fiscal consolidation plans. This baseline scenario assumes a mild increase in international oil and mineral prices, and a gradual recovery in the EU, with some positive implications for Albania's goods' exports. Net external demand is expected to gradually improve.

24. **The medium-term outlook will depend on the pace and depth of additional structural reforms in the energy and financial sector, as well as improvements in the management of public investment (infrastructure).** Subdued government spending, if coupled with efficiency gains and adequate reforms will not have a negative impact on growth. Lower government spending in infrastructure could potentially reduce the direct contribution of government to growth, although returns on this investment are relatively low and there is room for significant efficiency gains. However, other reforms are expected to compensate for this impact. Investment climate bottlenecks, particularly on the design and

enforcement of business regulations appear to be a primary constraint to private sector development, diversification, and higher growth. They discourage investment, limit domestic credit expansion, and create uncertainty and an unlevelled plain field. The government is making progress on this area through the actions supported by the Competitiveness DPL, as well as through a broader agenda including, for example, NPLs clearance strategy, bankruptcy law (supported by this operation), an ambitious justice reform, and improvements in revenues collection and tax administration (supported by the upcoming Fiscal and PFM DPL). These reforms are also expected to support Albania's recovery path.

25. The current account is projected to widen in 2017 and remain large over the medium term due to FDI-related imports, but external financing is sustainable. The current account deficit is expected to increase due to FDI-related imports related to the two large infrastructure projects, and a modest expansion in exports. Remittance flows are expected to remain subdued due to weak economic prospects in the south of Europe. Without the two large projects, however, the current account would have gradually declined after 2018. Strong FDI flows will help compensate for the large deficit. The external debt is expected to gradually decrease after 2017 reaching approximately 39 percent in 2019.

26. Continuing consolidation measures on both the revenue and expenditure side are expected to significantly improve fiscal balances over the medium term. The government foresees further revenue measures in 2017(including one off measures) to support its medium-term fiscal framework, which relies on sustaining current high revenue collections to achieve the fiscal consolidation. The 2017 budget targets a headline deficit of -1.1 percent of GDP and a primary surplus of 1.2 percent, which is an adequate pace of consolidation. The budget proposes tighter control of expenditures and increases revenues through better administration. Tax adjustments include property tax, increased taxes on luxury cars, increasing some of the excises, which together will aim at keeping the revenue to GDP ratio at 27.7 percent in 2017 and 27.5 onwards. On the expenditure side, the government plans an increase in pensions to compensate for inflation and wage bill increase of 0.1 percent of GDP. The expected adjustment in the 2017-2019 period, supported by the IMF program and the Government medium term framework, is consistent with sustaining revenues and with reducing expenditures through efficiency gains, as the ones identified on recent World Bank reports (the latest PFR and SCD). Such adjustments are unlikely to lead to a large adverse impact on growth, although the direct contribution of government consumption to growth will remain subdued in the upcoming year. Part of the saving arises as the result of important structural reforms. Ongoing efforts on the energy sector have led to important efficiency gains and a significant reduction on fiscal subsidies to the sector. Additional gains are expected in the upcoming years. Similar efforts are also starting in the water sector. The pension reform, and limited adjustments to past inflation, help contain the pension bill as share of GDP. Finally, improvements in the eligibility criteria are improving the targeting of social assistance and disability benefits are expected to create additional savings at about 4 percent of GDP between 2017-2019. Sustained fiscal consolidation combined with an increase of GDP growth is expected to bring public debt below 60 percent by 2020.

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

	2014	2015	2016	2017	2018	2019
<i>Financing requirements</i>						
Current Account Deficit	12.5	10.8	12.1	13.7	13.0	11.8
(of which scheduled interest payments)	0.9	1.8	1.8	1.8	1.9	1.9
Debt amortization	5.1	9	5.4	5.4	5.5	5.5
o.w. Government, Government Guaranteed	1.3	4.4	1.5	1.7	2.0	2.0

Financing sources

FDI and portfolio investment (net)	8.4	8.0	7.4	8.3	7.2	5.6
Capital transfers	0.9	1.2	0.8	0.7	0.7	0.6
MLT Disbursements (excl. IMF)	3.6	8.5	1.4	4.1	3.7	2.8
o.w. Government, Government Guaranteed	1.7	1.7	1.7	2.2	2.5	2.5
Short-term (net)	2.5	-1	-1	-0.9	-2.8	-1
Change in net official reserves (increase =-)	-1	-5.9	0.1	0.8	0.8	1
IMF credit	0.5	0.9	1.3	0.6	0	0

Memorandum items

Errors and omissions	2.7	2.6	2.6	2.6	2.6	2.6
External debt and debt service indicators, %						
TDO/XGS	131.2	151.3	157.7	154.2	146.6	134.2
TDO/GDP	37.0	41.0	42.1	42.4	41.5	40.4
TDS/XGS	14.5	26.4	16.5	16.6	16.9	16.6

Source: Bank of Albania; IMF; World Bank staff estimations and projections.

Debt Sustainability Analysis (DSA)

27. This DSA projects the public debt trajectory through 2021 under a baseline scenario with “most likely” assumptions related to arrears clearance, economic growth, public expenditure and revenues, and deficit financing; and then examines the robustness of the projections to changes in the underlying assumptions. The key assumptions underpinning the baseline scenario relate to the clearance of arrears, economic growth, fiscal consolidation, and financing parameters as follows:

- **The clearance of arrears identified in 2013 was complete in 2015.** The total amount of arrears was reflected in the 2013 public debt stock. The clearance schedule consisted of a payment of 33.8 million Lek in 2014, and the balance in 2015. We assume no new arrears will be accumulated at the central level.
- **A gradual pick-up in economic growth.** Growth is expected to recover to 3.5 percent in 2017 and gradually pick up to reach 3.8 percent in 2019 and beyond, fueled by the continued implementation of large infrastructure projects. Gradual recovery in the external environment, sustained FDIs and higher domestic demand will support the gradual increase in growth.
- **Fiscal consolidation.** Public revenues are projected to increase to 27.7 percent of GDP in 2017 and stay at 27.5 percent as a result of measures to expand the tax base and improved collection. Expenditures are expected to decline steadily as result of measures to reduce subsidies in the energy sector, freeze wage increases beyond 2017 and reduce spending on goods and services. The overall balance is projected to reach -0.7 percent in 2019 and onwards.

28. Under the baseline scenario, public debt is projected to gradually decrease below 60 percent of GDP in 2020. Net external government borrowing is estimated to remain at about 0.5 percent of GDP over the medium term.

29. The public debt trajectory is declining, but remains vulnerable to changes in exchange rates, growth, financing terms, and particularly to delays in implementing fiscal consolidation measures. A negative shock that permanently reduces GDP growth by 1.2 percentage points (half a standard

deviation from its 10-year average) throughout the projection period would keep public debt above 64 percent by 2021. An increase in interest rates by 2 percentage point would also lead debt to GDP ratio to around 60.2 percent in 2021. If the Albanian Lek depreciates by 30 percent at one point in time (2017), public debt would peak at 80.4 percent of GDP in 2017 and then decrease to 66.4 percent of GDP in 2021. Finally, if no further consolidation is implemented and the primary balance returns in deficit as in 2015, the public debt would remain above 68 percent by 2021.

Table 4. Scenario analysis – Albania’s Public Debt burden remains sustainable
(percent of GDP)

	2014	2015	2016	2017	2018	2019	2020	2021
Baseline	72.1	73.7	72.7	69.5	66.5	63	59.8	56.7
Higher i-rate	72.1	73.7	72.7	70.9	68.5	65.6	62.8	60.2
Lower Growth	72.1	73.7	72.7	71.1	69.4	67.3	65.6	64.2
30 % Depreciation	72.1	73.7	72.7	80.4	77.2	73.4	69.8	66.4
Combined i-rate/growth	72.1	73.7	72.7	72.2	70.9	69.1	67.4	65.8
PB as in 2015	72.1	73.7	72.7	73	72.1	70.6	69.3	68.1

Source: WB Staff projections

30. **The World Bank Group considers Albania’s macroeconomic policy framework as adequate.** The government is committed to fiscal consolidation, putting public debt on a downward trajectory. On the revenue side, the combination of tax policy and administration measures is expected to generate positive dividends in the medium term. On the expenditures side, the budget foresees a modest decline in social spending as a share of GDP and energy subsidies, as well as controlled increases in operational expenses. The planned pace of fiscal consolidation is supported by structural policies in support of growth, such as additional reforms in the energy and financial sectors as well as improvements in the investment climate. Downside risks are associated with delays in the implementation of these reforms as well as a deterioration in the external environment. Pressures associated with the upcoming elections in June 2017 could undermine reforms, delaying fiscal consolidation. A mitigating factor is that the government has recently approved reforms for strengthening public administration, PFM and the judiciary, limiting the impact of political pressures. Another source of risks is a deterioration of the Euro area economic outlook, including a slower pace of recovery or adverse impacts of Brexit. Albania has a relatively high exposure to neighboring countries, especially Greece and Italy, through remittances, exports and foreign investment. A prudent fiscal policy combined with growth enhancing structural reforms can help mitigate such risks.

2.3 IMF RELATIONS

31. **The IMF approved a three-year Extended Fund Facility (EFF) arrangement for Albania on February 28, 2014 (about Euro 330.9 million) in support of the authorities’ reform program.** Policy priorities focus on pursuing fiscal consolidation, safeguarding financial sector stability, reviving credit growth, and implementing growth-enhancing reforms, including an ambitious electricity sector reform, as well as reforms in the areas of public financial management, tax administration, and expenditure policy.

32. **An IMF mission visiting Albania in January 2017 reached staff level agreement with Albania’s authorities on the policies needed to complete the ninth and tenth reviews, the last ones of the country’s EFF.** The team also discussed policy priorities under Post-Program Monitoring. The mission assessed that the economic program remains on track and has achieved its core objectives of

correcting large macroeconomic imbalances and boosting economic growth. Most quantitative targets were met. Despite some delays, there is overall good progress in implementing structural reforms. The Executive Board of the IMF is expected to discuss the ninth and tenth reviews in February 2017. Approval of the review would enable the disbursement of SDR 57.28 million (about €72.44 million).

3. THE GOVERNMENT'S PROGRAM

33. **The National Strategy for Development and Integration (NSDI) 2015–2020 was approved in May 2016.** The NSDI rests on four pillars: (a) ensuring fiscal and macroeconomic and financial stability, (b) enhancing competitiveness, (c) making public services transparent and accountable, and (d) promoting efficient use of natural resources. Improving governance and the rule of law constitute its foundation. This operation supports the first pillar, which focuses on the importance of macroeconomic and financial stability.

34. **In 2014, the BoA adopted a series of additional supervisory and regulatory measures in the financial sector, supported by the 2014 FSM DPL.** These measures aimed to: (a) increase effectiveness of banking supervision, (b) provide for banks to adopt recovery plans to demonstrate their ability to operate during periods of stress, (c) introduce the obligatory write-off of stale-dated NPLs following a fixed period, classified in the 'loss category',⁷ (d) strengthen credit underwriting practices and NPL recovery and resolution for large borrowers, and (e) resolve key NPL tax ambiguities to enable banks to write off NPLs in protracted litigation.

35. **Additionally, the authorities have been working on strengthening the deposit insurance regime and improving the legal and regulatory framework for the nonbank financial sector.** The ADIA Law was amended in 2012 and 2014 to: (a) extend coverage to SCAs, (b) facilitate a prompt payout after the BoA's intervention, (c) expand ADIA powers to contribute to a purchase and assumption or bridge bank resolution, and (d) better align its operations to Core Principles for Effective Deposit Insurance Systems. Supported by the 2014 FSM DPL, a series of legal amendments were adopted in 2014 to ensure the financial and operational independence of the AFSA (a new Insurance Law, amendments to the AFSA Law, Law on Salaries of Independent Institutions, and the Civil Service Law). Following the legal amendments, four members of the new AFSA board were appointed during 2015, with the fifth and last member of the board appointed in January 2016, further enhancing AFSA's governance and decision making.

36. **The authorities are continuing reforms to support the sound development of the financial sector, complementing and building on the reforms supported by the 2014 FSM DPL and the current proposed operation.** Key reforms are continuing in the following areas: (a) NPL management and resolution, (b) insurance market development, (c) pension reform, (d) public debt management and government bond market development, (e) investment funds' supervision, (f) regulation and supervision of SCAs, and (g) corporate financial reporting. The Financial Sector Reform and Strengthening Initiative has been supporting the insurance market development, voluntary pensions reform, and the improvement of public debt management and development of the government securities market.

37. **On NPLs resolution, the authorities recognize the complexities and the need to adopt meaningful measures that would contribute to the reduction of NPLs.** In August 2015, the prime

⁷ This measure resulted in ALL 26.6 billion in NPL write-downs for 2015 (as of December 2015), equivalent to 20 percent of all NPLs in the system.

minister and the BoA governor endorsed a comprehensive twelve-point NPL Action Plan to reduce the stock and flow of NPLs (see Box 1). The BoA has progressed in detailing the status and outlook of the 35 large syndicated exposures responsible for more than half of the NPLs in the country. The 'London approach'⁸ will be followed, under BoA's leadership, to resolve these cases, aiming at voluntary and concerted restructuring of viable exposures and sending the other cases for insolvency proceedings.

Box 1. The Government's NPL Action Plan

The NPL's reduction Action Plan approved by the authorities includes measures that tackle both the stock and the flow of NPLs in the future. Eight out of twelve measures are to be implemented by the BoA, with the rest to be implemented by the MoJ.

Actions

1. * Drafting the new Bankruptcy Law that aims, among others, to regulate bankrupt company restructuring, and better protect creditors' rights.
2. * Amending the Code of Civil Procedure to improve collateral execution process, including change to enable introduction of success fees for private bailiffs.
3. Amending the Law 'on registration of the immovable properties' to enable the registration of properties under construction that can be placed and clearly identified as collateral.
4. Amending the law 'on securing charges' aiming to correct issues with definition and use of intangible assets (including financial assets) as lending collateral.
5. Extending the deadline for relaxation of prudential measures undertaken by the BoA in 2013 to stimulate lending by banks.
6. Changing the terminology in the BoA's Credit Regulation with regard to NPLs write-offs, to make it clear that the obligations of the debtor are not extinguished after the classification of the loan as off-balance sheet item.
7. Amending the accounting depreciation term limit imposed by the BoA for the real estate collateral held by banks.
8. Addressing the issue of 35 large defaulting groups that are responsible for more than 50 percent of NPLs. The BoA will draft a detailed action plan to tackle the large borrowers.
9. Relaxing the BoA's licensing and supervision requirements for subjects that buy and manage NPLs.
10. Upgrading the Credit Register operated by the BoA. In the short term, the register needs to include information on borrowers' legal cases and restructurings, and in the long term, the register will incorporate a credit scoring system.
11. Introducing mandatory requirement (entering in force from January 2018) for banks to grant loans based only on fiscal declarations.
12. Under the BoA's endorsement, commercial banks are to adopt a framework agreement that enables voluntary out-of-court debt restructuring.

* These measures are prior actions of this proposed Financial Sector DPL

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

38. **The proposed Financial Sector DPL program supports the Government's pillar 1 of growth through fiscal and macroeconomic and financial stability, as outlined in the NSDI for 2015 – 2020.** The NSDI emphasizes the importance of the macroeconomic stability in ensuring the predictability of the economic environment and, as a result, enabling long-term capital allocation. The objectives outlined in these pillars are supported by the proposed operation, which promotes a sound and stable financial sector that will create an enabling environment for banks and nonbanks to expand credit to the private

⁸ The 'London approach' is based on a collective process for voluntary workouts to restructure debts of corporates in distress, while maximizing their value as going concerns.

sector, which in turn will invest in the economy, and to protect depositor and investor savings.

39. **The proposed operation has incorporated lessons from the World Bank's development policy financing retrospective reviews, responses to financial crises, the Implementation Completion and Results Report (ICR) of the 2014 Albania Financial Sector Modernization DPL, and other DPLs in Albania.** The following lessons are underscored:

- **Focus on sustainable results.** In responding to an uneven and uncertain external environment, it is crucial that the operation focuses on selected key areas for sustainable outcomes. The proposed operation incorporates this lesson by focusing on the main challenges recognized by the Government and the BoA: addressing key regulatory and supervisory gaps for the bank and nonbank sectors, and reducing the level of NPLs. Results in these areas would enable the financial sector to be more resilient and able to cope with future shocks.
- **Relevant analytical work in supporting policy dialogue with the client.** This operation builds on the findings of the Financial Sector Assessment Program (FSAP) carried out jointly with the IMF in 2013. The FSAP recommendations provide the analytical foundation for the reforms supported by the 2014 FSM DPL and this proposed operation. In addition, further analytical work has been conducted with regard to SCAs', audit, and investment funds.
- **Congruence between the policy reforms supported and the results framework.** The team, in cooperation with the authorities, has identified results indicators that can demonstrate that the development objectives have been satisfactorily achieved. For instance, one of the major expected results of this DPL is the reduction of the NPLs' ratio to 17 percent or less of total loans. This would be the most visible and impactful result of the reforms supported under Pillar 1 of this DPL: adopting policy measures to reduce NPLs and enhance the financial safety net.
- **Collaboration with the IMF.** The World Bank and IMF have coordinated their involvement in Albania with regard to the macro fiscal framework reforms, including the financial sector-related policy actions. Several measures supported by the 2014 FSM DPL and the proposed operation, such as those related to NPLs' reduction and strengthening of the Nonbank Financial Institutions' (NBFIs') supervision (originating from the joint FSAP), have also been included under the IMF's structural benchmarks. The IMF has also reviewed drafts of legal acts, including the new Bankruptcy Law and the new Bank Resolution Law. Both the World Bank and IMF have supported the NPL Action Plan prepared by the authorities.
- **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, MoJ, and other key stakeholders.

4.2 PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

40. **This proposed operation aims to strengthen the resiliency of the banking sector and the regulation and supervision of nonbank financial institutions.** The proposed reforms are built around three pillars: (a) adopting policy measures to reduce NPLs and financial safety net, (b) strengthening regulation, supervision, and resolution regime of banks and SCAs, and (c) strengthening the regulation and supervision of investment funds.

41. **This operation builds on the achievements of the 2014 FSM DPL with additional reforms to strengthen the resiliency of the financial sector.** Table 1 illustrates the prior actions supported by the 2014 FSM DPL and by the proposed DPL.

Table 5. Prior Actions Supported by the 2014 FSM DPL and the Proposed FS DPL

2014 FSM DPL	Proposed FS DPL
Regulation and supervision of the banking sector and safety net	
The BoA's Supervisory Council adopts a new comprehensive risk-based supervisory manual and a new supervisory operational policy to increase effectiveness of banking supervision.	The BoA completes evaluation of systemic banks' recovery plans for 2015, to enable effective crisis preparedness and management.
The BoA's Supervisory Council issues new instruction for designated systemic banks to adopt recovery plans to demonstrate their ability to operate during periods of stress.	
Amendments to the law on deposit insurance are accepted by the cabinet of ministers and submitted to the parliament, to better align the legislation and operations of ADIA with the core principles for effective deposit insurance systems.	
	Parliament approves the strengthening of the commercial banks' resolution framework in line with the EU Banks' Recovery and Resolution Directive, by enacting the Law On Bank Resolution (Law No. 133/2016).
	Parliament approves the extension of coverage to legal entities by enacting amendments to the Law on Deposit Insurance Law (Law No. 39/2016).
NPLs reducing measures	
A 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.	Parliament approves the strengthening of the insolvency regime by enacting the Law on Bankruptcy (Law No. 110/2016).
The BoA's Supervisory Council adopts amended regulation on 'Credit Risk Administration' for the obligatory write-off of stale-dated NPLs following a fixed period, classified in the 'loss category'.	Parliament approves the introduction of new private bailiff reforms to expedite collateral executions, by enacting amendments to the Civil Procedure Code and the Private Bailiffs Law (Law No. 109/2016).
The BoA issues three sets of guidelines on (a) loan restructuring for businesses, (b) loan restructuring for individuals, and (c) real estate appraisal, based on international good practice.	Parliament approves improvements to the audit quality of PIEs approximating it with the EU acquis communautaire, by enacting amendments to the Law On Statutory Audit, (Law No. 47/2016).
The BoA's 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.	
The MoJ and MoF to issue new instructions to provide market-based incentives for private bailiffs' compensation.	
Regulation and supervision of Nonbank Financial Institutions (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 the AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law.	Parliament approves the strengthening of SCAs' regulation and supervision by enacting the Savings and Credit Associations Law (Law No. 52/2016).
	The BoA adopts new licensing, reporting, and risk management regulations for SCAs, in support of

	enhanced regulation and supervision of the sector, by adopting Board Decisions No. 104, No. 105, and No. 106.
	Parliament approves the strengthening of the AFSA's enforcement powers by enacting amendments to the Collective Investment Undertakings Law (Law No. 36/2016).
The AFSA adopts market stabilization measures to issue (a) a regulation on minimum Motor Third Party Liability reserving standards and (b) a time-bound plan to replenish funding of the Compensation Fund.	The AFSA adopts new regulations on liquidity management and mark-to-market valuations to lower the risks for investment funds' unit holders, by adopting Board Decisions No. 45 and 46.

Pillar I. Reducing NPLs and enhancing the financial safety net

Prior Action #1: Parliament approves the strengthening of the insolvency regime by enacting the Law on Bankruptcy (Law No. 110/2016).

42. **Although Albania has a reasonably modern insolvency framework on paper, it has been scarcely used as a means to resolve NPLs.** Insolvency administrators and commercial judges are unprepared to hear complex restructuring cases and whenever the insolvency law is used, the process is slow and cumbersome. An efficient insolvency system would help improve access to credit by establishing predictable mechanisms for resolving distress to provide credible deterrents for recalcitrant borrowers. In addition, an efficient exit system is fundamental for encouraging growth because it frees up capital to move on to more productive activities.

43. **Given the weaknesses in the insolvency system, a comprehensive insolvency reform program was launched, and a new bankruptcy law was approved in 2016.** The MoJ launched the insolvency reform program in September 2014 with support from the World Bank Group. The newly approved bankruptcy law in October 2016 outlines the following improvements : (a) strengthens creditors' rights, including to ensure further creditor participation in the process and an adequate regime of priorities, (b) contemplates an expedited reorganization mechanism that allows court confirmation of workouts ('pre-packaged plans' or 'pre-packs'), (c) allows for post-filing financing, (d) improves the reorganization process, and (e) simplifies and strengthens the system of avoidance actions against fraudulent transactions.

44. **The World Bank is providing implementation support to the authorities with regard to the insolvency framework and out of court workouts.** The technical assistance is focused on drafting the implementing bylaws of the new bankruptcy law, in accordance with the recent EU proposals on improving the in-court insolvency proceedings and out of court workouts, as well as capacity building activities for insolvency administrators. In parallel, technical assistance will be provided to BoA (through FINSAC) to support resolving cases of high NPLs. In the meantime, BoA has undertaken several measures to encourage NPLs sales, and de-incentivize banks to hold repossessed real estate collateral, in order to expedite the reduction in NPLs.

Prior Action #2: Parliament approves the introduction of new private bailiff reforms to expedite collateral executions, by enacting amendments to the Civil Procedure Code (Law No. 114/2016) and the Private Bailiffs Law (Law No. 109/2016).

45. **Important impediments for collateral execution and NPL resolution remained because of poorly regulated private bailiffs.** The regulatory framework for private bailiffs did not properly align bailiffs' incentives toward a successful collateral execution process, as their fees were fixed and fully paid in advance. Instruction 1164 (issued jointly by the MoF and the MoJ in March 2014) was not able to successfully address this issue. As a result, private bailiffs de facto continued to be paid in full by creditors at the beginning of the collateral execution process, irrespective of their success.

46. **Thus, two laws have been amended in accordance with international good practices with regard to the operations of private bailiffs.** In October/November 2016, the Civil Procedure Code was amended as well as the Private Bailiffs Law, indicating that the MoF and the MoJ have the authority to regulate not only the 'fees' of the private bailiffs but also the 'type of compensation', including the 'success fee' for the private bailiffs. An amended joint ministerial instruction should be issued to align bailiffs' fees with the success in their recovery. The Bank team will collaborate closely with the authorities to support the preparation of the joint ministerial instruction.

47. **Results.** By March 2018, the ratio of NPLs to total loans declines to 16 percent or less of total loans.

Prior Action #3: Parliament approves improvements to the audit quality of Public Interest Entities (PIEs) approximating it with the EU *acquis communautaire*, by enacting amendments to the Law On Statutory Audit (Law No. 47/2016).

48. **PIEs in Albania are critical for the economy and adequate quality audits contribute to financial stability.** Most PIEs in Albania are financial sector entities, such as banks, insurance companies, and investment funds. Improvement in the audit quality will assist banks in assessing in the future large non-financial sector PIEs, which account for a large share of the NPLs stock.

49. **The integrity of financial reporting in the financial sector required a well-functioning audit oversight system to ensure adequate quality assurance of external audits.** Although the audit oversight and quality assurance system had been established, it needed further development to establish a financially viable and sustainable institutional framework. The audit oversight system did not have the ability to enforce audit standards and ensure audit quality. Therefore, financial sector regulators and other market participants could not fully benefit from the audit oversight. An adequate institutional setup and funding sources for the public oversight system, combined with high-quality direct inspections by the POB, will contribute to improved audit quality and enhanced reliability of financial statements.

50. **The improvement of the audit oversight system required amendments to the Law on Audit.** The 2009 Law on Audit⁹ established a foundation for an audit oversight system, through creation of the POB. However, due to resource and capacity constraints, the POB was not able to fulfil its oversight and quality assurance duties to effectively influence the quality of audits. The POB had no legal status and it did not have executive staff or a reliable funding source. In addition, the independence of the board members needed to be enhanced, as well as representation of the financial sector regulators in the board. The need for a more independent and well-functioning POB is a requirement of the EU Statutory Audit Directive (as amended in 2014) and the new Regulation on PIEs audits, which Albania has

⁹ Law 'On Statutory Audit, Organising of Certified Auditor and Certified Accountant Professions', No. 10091, dated 5 March 2009

committed to transpose. The amendments to the Law on Audit corrected the above-mentioned deficiencies.

51. **The ongoing Enhancing Quality of Financial Reporting (EQFinRep) Project will offer assistance to the institutions responsible for monitoring and enforcement financial reporting of PIEs.** The project (funded by Swiss SECO) envisages assistance to the POB, as well as BoA, and AFSA for improving monitoring and enforcement activities. This will include capacity building through training and developing tools and methodologies for the oversight of PIE auditors, collaboration between POB, BoA and AFSA on audit oversight, as well as enforcement of financial reporting of entities supervised by BoA and AFSA.

52. **Results.** By March 2018, a functional, and funded POB is established, with adequate staffing and funding as required by the EU Statutory Audit directive, and with the capacity to improve the audit quality of PIEs.

Prior Action #4: Parliament approves the extension of deposit insurance coverage to legal entities by enacting amendments to the Law on Deposit Insurance Law (Law No. 39/2016).

53. **Albania's deposit insurance system is largely based on modern principles, and recent reforms have strengthened the legal framework.** However, deposit insurance coverage for legal entities was lacking. The absence of coverage for small enterprises was a material weakness in the safety net for depositors, as it contravened a primary objective of deposit insurance—to protect small, financially unsophisticated depositors—and EU guidance on coverage. Approved amendments to the Deposit Insurance Law have now addressed this weakness.

54. **Results.** By March 2018, 100 percent of eligible legal entities' deposits are insured up to the limit of 2,500,000 lek.

Pillar II. Strengthening regulation, supervision, and resolution regime of banks, and Savings and Credit Associations (SCAs)

Prior Action #5: Parliament approves the strengthening of the commercial banks' resolution framework in line with the EU Banks' Recovery and Resolution Directive, by enacting the Law On Bank Resolution.

55. **The legal framework for resolving distressed banks had significant gaps that have been addressed through the adoption of the bank resolution law, supported by this operation.** The legal system for resolving distressed banks was based on 'early intervention' through conservatorship and an administrative-based banking liquidation system. The BoA had developed a comprehensive internal bank conservatorship and liquidation manual to support decision making. However, important gaps remained in the legal framework. Thus, this operation supported the preparation of a Bank Resolution Law in accordance with international good practice. The law is based on the EU Banks' Recovery and Resolution Directive, with divergence in certain areas, as deemed appropriate. The law provides for an industry- financed resolution fund to reduce the need for public support. The law ensures among others: (a) a proper institutional setup and functional separation of powers between supervision and resolution ('resolution authority'), (b) early and decisive intervention by the authorities, by identifying adequate triggers for early intervention, the application of resolution tools, and liquidation, (c) banks taking appropriate actions by themselves when conditions deteriorate (for example, using recovery plans), (d) banks are resolvable and ex ante resolution plans are prepared, (e) continuity of critical functions for

banks of 'public interest', and (f) banks can either be restored or exit the market, as a principle, without the use of public money.

56. **Following the adoption of the bank resolution law, technical assistance will be provided in key areas to ensure the operationalization of the new resolution framework.** Support by FINSAC will be provided for: (a) the establishment of the resolution unit including on staffing, internal organization and development of internal procedures and manuals, (b) the drafting of key by- laws, especially on recovery plans and bail-in/minimum requirement for own funds and eligible liabilities (MREL), (c) identification of possible additional reporting needs, making sure the agencies have all the information in place to set MREL and assess possible effects of the application of bail-in, and (d) drawing up of resolution plans.

57. **Results.** By March 2018, a dedicated resolution unit is established in BoA.

Prior Action #6: The BoA completes evaluation of systemic banks' recovery plans for the year of 2015 to enable effective crisis preparedness and management.

58. **In 2014, the BoA developed mandatory guidelines requiring banks to adopt recovery plans and submit them during 2015 to the BoA for assessment.** As highlighted by international standards developed in the wake of the financial crisis, the adoption of recovery and resolution plans is one of the essential instruments for effective crisis preparedness and management. Recovery plans increase the resilience of the banking system and allow the BoA to better use and target its supervisory resources and powers. For the first time, the BoA assessed the recovery plans of the seven designated 'systemically important banks'¹⁰ at end-2015. In assessing these plans, the BoA issued a regulation and developed an internal methodology for assessing and verifying the adequacy of qualitative and quantitative recovery indicators, the impact of the proposed recovery actions on banks' capital, liquidity, leverage, and other financial indicators, and the range of financial stress scenarios used in the plans.

59. **The BoA assessed the plans against both a BoA regulation on recovery plans (BoA Decision No. 11) and the internal methodology, which follows more recent EU standards.** The plans initially lacked the relevant information needed for the assessment of the respective recovery plans. Therefore, the BoA instructed the banks to enhance future plans to enable a comprehensive assessment. After the enactment of the Bank Resolution Law, the BoA will issue a new regulation on recovery planning, aligned with the European Banking Authority's technical standards. Assessment of the recovery plans by BoA will be done annually. FINSAC will provide technical assistance to BoA to draft the new regulation for "Guidelines on Recovery and Resolution Plans".

60. **Results.** By March 2018, systemic banks submit annual recovery plans in accordance with the new enhanced regulation for "Guidelines on Recovery and Resolution Plans" issued by the BoA.

Prior Action #7: Parliament approves the strengthening of SCAs' regulation and supervision by enacting the Savings and Credit Associations Law (Law No. 52/2016).

61. **The existing legal, regulatory, and supervisory framework for SCAs had some weaknesses with regard to governance and risk management, corrective measures, and resolution powers.** In addition, the framework did not provide incentives for the consolidation of a highly fragmented sector. It also did not recognize the crucial role of the CUs in supporting the administration and management of the small SCAs, which did not have the professional capacity to comply with applicable financial sector regulations

¹⁰ As defined according to criteria adopted by BoA.

and standards. The approval of a new SCA legislation and supporting regulations, coupled with a more robust supervision framework, address these issues. The new comprehensive framework has guided the sector toward consolidation, with fewer and stronger entities that are adequately supervised and will be able to diversify and expand their services to underserved regions.

62. **The new approved legislation for the SCAs provides incentives for the voluntary consolidation of the SCA sector, establishing an adequate supervisory framework and enhancing the governance of the sector.** To support the consolidation of the sector through mergers, the new law laid the ground for higher minimum requirements for the number of members and capital, and more stringent prudential benchmarks in line with international standards.

Prior Action #8: The BoA adopts new licensing, reporting, and risk management regulations for SCAs in support of stronger regulation and supervision of the sector, by adopting Board Decisions No. 104, No. 105, and No. 106.

63. **The new SCA legislation has been complemented with secondary regulation that cover the following areas, including:** (a) new licensing provisions, (b) an enhanced supervision and reporting framework based on a risk-based approach, including a stronger and more systematic oversight to foster the financial soundness of the SCAs, (c) strengthened governance provisions in terms of internal statutes, governing bodies to enhance the sustainability of the system, and (d) adequate provisions for the BoA to address weak or nonviable SCAs.

64. **Results.** By March 2018, the sector of SCAs has consolidated from 108 to less than 20 SCAs, and half of the SCAs have been subject to BoA's on-site inspections based on the new regulatory framework.

Pillar III. Strengthening regulation and supervision of investment funds

Prior Action #9: Parliament approves the strengthening of the AFSA's enforcement powers by enacting amendments to the Collective Investment Undertakings Law (Law No. 36/2016).

65. **The fast growing investment funds industry, which has added to the systemic vulnerabilities of the financial sector, has obliged the AFSA to improve its risk management enforcement powers to undertake quick remedial measures.**¹¹ The legal basis for investment fund enforcement powers needed to be upgraded to equip the AFSA with the necessary authority to intervene under special circumstances.

66. **The approved legal amendments have enabled the AFSA to: (a) issue a regulation that defines minimal requirements for risk management systems at investment funds management companies and (b) suspend the redemption of funds' units' if warranted by specific market circumstances.** In principle, in periods of loss of confidence in the financial industry, the financial system could suffer from an acute lack of liquidity. The investment funds management companies need to put in place adequate risk identification and mitigation systems to be prepared with stressed situations. In the likely case that the investment funds management company is forced to sell government securities in an illiquid market,

¹¹ Following recommendations from the FSAP, and supported by the 2014 FSM DPL, a set of amendments to three separate laws were approved by parliament in 2014, which substantially increased the independence of the AFSA. Following these amendments, the AFSA has changed its structure to adapt to the need for stronger supervision of investment funds and has started recruiting additional supervision staff. Furthermore, AFSA has launched a three-year technical assistance (TA) program funded by the Swiss State Secretariat for Economic Affairs (SECO) to train its staff and overhaul the investment funds supervision framework.

it would not receive realistic prices, which is not in the interest of investors¹². The Collective Investment Undertakings Law was amended in 2016 to empower the AFSA to require and enforce adequate risk management arrangements and allow suspension of units' redemption by companies.

Prior Action #10: The AFSA adopts new regulations on liquidity management and market (?)to-market valuations to lower the risks for investment funds' unit holders, by adopting Board Decisions No. 45 and 46.

67. **While the investment funds helped diversify holdings of government securities in the financial system, their fast growth magnified risks.** The diversification of government debt ownership lessens the risks from the financial interdependence arising from banks' large holdings of government securities. However, the investment funds also magnify the risks, as lack of an established secondary market for government securities represents a key liquidity risk to the investment funds. Moreover, the AFSA's regulatory framework did not require the investment funds to hold liquidity buffers to meet the demands for the redemption of units. These risks were exacerbated by the lack of clarity on the liquidity requirements and the methodology for establishing the value of the investment fund units, which does not provide for fair pricing of units, therefore penalizing existing and prospective investors in case of interest rate fluctuations, and as result harming the credibility of the funds.

68. **The proposed operation has supported the AFSA's adoption in 2015 of two new regulations for investment funds.** These have: (a) introduced liquidity requirements to ensure that investment funds have suitable liquidity risk management policies and adequate contingency liquidity arrangements in place to deal with stressful situations, and (b) required that the calculation of the unit value represents the proportionate share of the aggregate market value of the underlying assets of the fund. In support of these risk-lowering measures, the AFSA has already upgraded capital adequacy and the consumer disclosure requirements for investment funds management companies.

69. **Results.** By March 2018, in excess of 10 percent of assets of investment funds are in liquid form, and all licensed asset management companies and the respective authorized investment funds have been subject to on-site inspection by the AFSA.

70. **The World 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 6 lays out the analytical activities and their linkages to prior actions supported by this operation.

Table 6. DPL Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar I. Reducing NPLs and enhancing the financial safety net	
Parliament approves the strengthening of the insolvency regime by enacting the Law on Bankruptcy (Law No. 110/2016).	FSAP 2013, GFMDR ongoing TA on Insolvency and Debt Resolution
Parliament approves the introduction of new private bailiff reforms to expedite collateral executions, by enacting amendments to the Civil Procedure Code (Law	FSAP 2013, World Bank TA on supporting the MoJ and MoF to draft new Instruction on Private Bailiffs Fees

¹² Suspending redemptions is a temporary decision taken only in extraordinary circumstances and until the market liquidity is restored.

No. 114/2016) and the Private Bailiffs Law (Law No. 109/2016).	
Parliament approves improvements to the audit quality of PIEs approximating it with the EU acquis communautaire, by enacting amendments to the Law On Statutory Audit (Law No. 47/2016).	FSAP 2013, Corporate Financial reporting Enhancement Project, and Enhancing Quality of Financial Reporting project TA projects on improving the Audit Public Oversight System and wider enhancing the corporate financial reporting under the REPARIS Program.
Parliament approves the extension of coverage to legal entities by enacting amendments to the Law on Deposit Insurance Law (Law No. 39/2016).	FSAP 2013
Pillar II. Strengthening regulation, supervision, and resolution regime of banks, Savings and Credit Associations (SCAs)	
Parliament approves the strengthening of the commercial banks' resolution framework in line with the EU Banks' Recovery and Resolution Directive, by enacting the Law On Bank Resolution.	FinSAC TA
The BoA completes evaluation of systemic banks' recovery plans for 2015 to enable effective crisis preparedness and management.	FinSAC TA
Parliament approves the strengthening of SCAs' regulation and supervision by enacting the Savings and Credit Associations Law (Law No. 52/2016).	FSAP 2013, Aide Memoire on SCA sector of July 2014 and subsequent recommendations to the SCA Law
The BoA adopts new licensing, reporting, and risk management regulations for SCAs in support of a stronger regulation and supervision of the sector, by adopting Board Decisions No. 104, No. 105, and No. 106.	FSAP 2013, Aide Memoire on SCA sector of July 2014 and comments and recommendations to the SCA Law
Pillar III. Strengthening regulation and supervision of investment funds	
Parliament approves the strengthening of the AFSA's enforcement powers by enacting amendments to the Collective Investment Undertakings Law (Law No. 36/2016).	FSAP 2013, World Bank TA to the AFSA to support preparation of the draft regulation on liquidity requirements
The AFSA adopts new regulations on liquidity management and mark-to-market valuations to lower the risks for investment funds' unit holders, by adopting Board Decisions No. 45 and 46.	FSAP 2013, World Bank, and IMF TA to the AFSA to support preparation of the draft regulation on liquidity requirements. Ongoing WB TA support to strengthen regulation and supervision of investment funds.

Note: FinSAC = Financial Sector Advisory Centre.

4.3 LINK TO CPF, OTHER BANK OPERATIONS, AND THE WORLD BANK GROUP STRATEGY

71. **This operation directly contributes to the CPF 2015-2019 Focus Area 1 objective to improve financial stability.** The CPF focuses on three broad focus areas: (a) restoring macroeconomic balances, (b) creating conditions for accelerated private sector growth, and (c) strengthening public sector management and service delivery. The first focus area includes three CPF objectives that aim to support Albania's efforts to improve fiscal sustainability, strengthen public investment management, and improve financial stability. The high level of NPLs is both a potential source of macroeconomic instability and a key impediment to improving access to financing and promoting financial stability. The recently adopted reforms for improving the insolvency regime and collateral execution processes are expected to further reduce NPLs. Overall, strengthening the independence and capacities of financial regulators is

the sine qua non for the maintenance of financial stability and further development of financial sector intermediation. It also creates the preconditions for financial inclusion in areas with a low financial penetration, such as rural areas, paving the way for welfare gains among the bottom 40 percent.

72. The World Bank has been providing substantial support to Albania in recent years, through several development policy operations. In addition to the 2014 FSM DPL, the World Bank's Board of Executive Directors approved a Public Finance and Growth DPL and a Public Finance PBG to improve Albania's public finances and sustain poverty-reducing growth. The Public Finance DPL and the PBG focus on addressing inadequacies in public finance management that have resulted in the accumulation of general government arrears, improving Albania's fiscal outlook through revenue-enhancing measures and pension and energy sector reforms. The World Bank's Board of Executive Directors also approved in January 2017 a Competitiveness DPL that supports the Government's strategy to enhance Albania's competitiveness to achieve higher and more inclusive growth. The development objective of this operation is to enhance Albania's competitiveness through improving the investment regime, facilitating trade, and making it easier to do business.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

73. 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. The IMF's EFF program 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 growth path. The World Bank and IMF have coordinated the provision of technical assistance to the AFSA on tackling regulatory gaps related to investment funds, with the World Bank taking a lead on liquidity requirements for investment funds, and the IMF on the valuation model for fund's units.

74. The World Bank has also consulted other donors on financial sector-related reforms, including the European Commission (EC), the Swiss State Secretariat for Economic Affairs (SECO), and other bilateral donors. It has consulted the EC on financial sector-related reforms, so that the proposed measures are in line with Albania's commitments toward the EU. SECO has financed, through a World Bank administered trust fund, support for the financial reporting reform, and has provided funds for technical assistance to the AFSA to strengthen its capacities to regulate and supervise investment funds. In addition, the World Bank has consulted with the United States Agency for International Development, which is implementing a Country Financial Sector Development Program and has been providing technical assistance to the BoA, ADIA, and the AFSA.

75. The World Bank and the financial sector authorities have consulted with a range of stakeholders on the specific measures supported by this DPL. In particular, the World Bank has held a series of workshops to consult with the banking industry on issues related to NPL resolution, to foster collaboration between the banking sector and bailiffs, to advance awareness about the inclusion of SCAs in the deposit insurance scheme and the need for the sector's consolidation, by meeting with SCAs, farmers, small businesses, and NGOs. A wide range of public workshops were also held with law practitioners, judges, businesses associations, consultants and advisors, financial sector entities, and advocacy NGOs to consult on the insolvency law. With regard to the investment funds sector, the AFSA has maintained regular consultations with the industry, considering the systemic vulnerabilities emanating from the sector. The World Bank has also periodically engaged with the Parliamentary committees to raise awareness about the reforms and respond to technical questions.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

76. **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 euro area 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 microenterprises alike.

77. **Financial sector reforms supported by this operation would mitigate the effects 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 a decrease in NPLs 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.

78. **Reforms to the regulatory and supervisory framework for SCAs are expected to increase the safety and efficiency of the SCAs serving small farmers and microenterprises.**¹³ Despite the small size (only 0.6 percent of financial sector assets), the SCAs play a particularly important role for financing agriculture and the underserved segments of the population. In spite of agriculture's importance for employment and GDP, lending by banks is extremely shallow. Agriculture is a vital sector of Albania's economy. It provides employment for almost 50 per cent of the population in rural areas and accounts for around 20 per cent of the country's GDP. However, the sector remains underserved by financial institutions, with loans to agribusiness accounting for only 2 per cent of total lending to the economy. Reforms proposed by this operation will contribute to improving the performance of SCAs, outreach, and the living situation of the disadvantaged constituencies that depend on them. The consolidation of the SCAs will not result in reduced access to finance, as the smaller institutions have been merged in to larger entities, with stronger performance and outreach. In addition, bringing eligible SCAs into the deposit insurance scheme provides an important measure of protection for small depositors and the poor in rural areas.

79. **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. However, limited available data suggests that women are less included in the financial system than men, with a lower share having an account, savings, or a loan in a financial institution (2011). Therefore, reforms to strengthen and further develop the financial system may contribute to including underrepresented groups, such as women, in the financial sector.

5.2 ENVIRONMENTAL ASPECTS

80. **The proposed DPL measures are not expected to have any impact on the environment, water resources, habitat, or other natural resources.** The policy measures focus on legal, regulatory, and supervisory reforms to strengthen the financial sector, with no impact on the environment. The legal and regulatory changes implemented in the context of this DPL do not modify the existing

¹³ SCAs focus approximately 80 percent of their assets in rural areas.

environmental regulatory framework in any way or facilitate the circumvention of any environmental regulations.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

81. **Albania has participated in a number of detailed reviews of its Public Financial Management (PFM).** These include two Public Expenditure and Financial Accountability (PEFA) assessments (2006 and 2011); a Public Expenditure Review (2006); a Public Finance Review (2013); annual EU-SIGMA reviews, and other 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. The last PEFA assessment for Albania from 2011 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. Lagging areas, as identified in the 2011 PEFA assessment include (a) multiyear perspective in fiscal planning and policy formulation, (b) public investment management, (c) internal audit, (d) implementation of the integrated planning system (Financial management Integrated System), (e) the implementation of expenditure commitment controls, and (f) scope and nature of the external audit function.

82. **The Medium Term Budget Plan and the Annual Budget Law are the two main documents presented for parliamentary review and approval.** These documents are part of Albania's IPS which tries to ensure that the core policy and financial processes of the Government function in an integrated manner. Still, the process of 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 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.

83. **Albania has made important progress in developing the national treasury system, yet challenges remain.** A Treasury Single Account has been introduced and all central Government revenues and expenditures are recorded in 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 widely disseminated. The state treasury is also a direct participant in the automated inter-banking system of the BoA. Reconciliations between the central bank and the treasury are performed on a daily basis. The 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 on a daily basis as these accounts are managed by regional treasury offices. Monthly and annual budget execution reports are available to the public—these reports can be found on the MoF's website. All contracts are required to be registered with the treasury within three days of signing. In an attempt to strengthen cash management and planning, the treasury system can register multiyear contracts; however, the outer year commitments are not currently disaggregated, thereby distorting the actual level of commitments and obligations and affecting effective medium-term budget and financial planning. Revenue receipts (tax and customs collections) are collected outside the Treasury Single Account and are reported daily to the treasury on a

net basis (taxes levied less refunds).

84. **The MoF discloses the Annual State Budget Law along with monthly and quarterly execution reports, which are prepared on a cash basis.** The MoF prepares and publishes a monthly Consolidated Fiscal Indicators report and a quarterly Fiscal Statistics of Government report. The Government prepares a set of consolidated¹⁴ Government Finance Statistics-based financial statements that are not fully compliant with the International Public Sector Accounting Standards for cash-based reporting systems. The data for such reports are drawn from the treasury system when the final accounts are closed and audited. The Government is committed to implementing financial reporting based on the International Public Sector Accounting Standards over the next five years.

85. **The external audit remains an area for improvement toward establishing a well-functioning public financial accountability and assurance mechanism for the legislature and the public.** The independence, mandate, and organization of the Supreme Audit Institution of Albania (High State Control) are established and protected by the Constitution and by primary legislation.¹⁵ While the High State Control carries out the full range of audits as defined in the current International Standards of Supreme Audit Institutions, regularity audits do not yet result in professional audit opinions. Financial audits are not yet widely used. The practical application of the International Standards of Supreme Audit Institutions is limited because of lack of professional training. The approach of auditing focuses more on identifying errors and noncompliance with regulations rather than identifying opportunities to improve systems or address potential improvements in the efficiency and effectiveness of public service delivery.

86. **The public procurement system rests on a sound legal framework, which is comprehensive and based on transparency, open competition, fairness, equal treatment and non-discrimination.** The Public Procurement Law applies to all public procurement financed by the government budget, with the exception of certain categories which are commonly excluded from procurement legislation in most countries. The overall institutional set up on public procurement is well organized, and the PPL defines in a comprehensive manner the roles and responsibilities of entities involved in procurement both at central and at contracting authority level. Equally important, accountability and enforcement of the regulatory framework is expected to be ensured through a robust complaints review mechanism, audit and other controls mechanisms that are in place in Albania.

87. **Based on the IMF country report dated September 2016, BoA is making substantial progress in implementing the safeguards recommendations and rebuilding BoA's credibility, following the events in 2014**¹⁶. BoA has strengthened its safeguards framework in a number of areas: Inspector General has been appointed and internal audit function has resumed normal operations; a fully operation audit committee has been established; periodic follow up on the implementation of internal and external auditor recommendations was set up; and the financial statements in accordance with IFRS have been prepared for the first time for the year 2015. In particular, the authorities are in the process of amending the BoA Law, in order to align it with the European System of Central Bank statute¹⁷, strengthen the central bank institutional and operational independence, and improve its governance and operations. Of note, the BoA has received unqualified (or clean) audit opinions from two external auditors (Grant Thornton, Albania, and KPMG, Albania) for the past five years (2011–2015).

¹⁴ Including central Government, social security fund, and local government.

¹⁵ Law No. 154/27 on the State Supreme Audit Institution, November 27, 2014.

¹⁶ . In August 2014, the BoA governor was removed by the Albanian Parliament after a BoA employee confessed to the theft of ALL 700 million (or 0.05 percent of GDP) of bank notes withdrawn from circulation.

¹⁷ Recommendations have been provided by the Bank of Italy and IMF TA (IMF Staff report, September 2016)

88. **The fiduciary risk for this operation is assessed as moderate.** Although the fiduciary risk related with the use of the loan proceeds is primarily driven by the current PFM environment in Albania, the shortcomings in this area do not indicate major fiduciary risk given the nature and content of the program. The clean audit opinions of the Bank of Albania and the combination of the prior actions of Albania Public Finance DPF series and the medium-term PFM reform program support this assessment.

89. **Loan proceeds will be disbursed in one single tranche to the existing treasury account in the BoA and will form part of Albania's official foreign exchange reserves.** The proposed loan will follow the World Bank's procedures for development policy lending. Disbursement will be made upon declaration of loan effectiveness and submission of a withdrawal application to the World Bank. 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 (treasury single 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 request the Government to provide confirmation to the World 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.

5.4 MONITORING, EVALUATION, AND ACCOUNTABILITY

90. **The World 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, MoJ, ADIA, and the 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).

91. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

92. **The overall risk to the operation is Moderate.**

Table 2. Summary Risk Ratings

Risk Categories	Rating (H, S, M, or L)*
1. Political and governance	Substantial
2. Macroeconomic	Moderate
3. Sector strategies and policies	Moderate
4. Technical design of project or program	Moderate
5. Institutional capacity for implementation and sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and social	Low
8. Stakeholders	Low
9. Other	n.a.
Overall	Moderate

Note: *H = High; S = Substantial; M = Moderate; L = Low.

93. **Political and governance risks are substantial.** In general, sustained efforts are required to tackle governance issues in the country, such as a weak rule of law and corruption. A mitigating factor is that the Government has accelerated structural reforms related to strengthening public administration and the judiciary. Substantial political consensus has been built to pass financial sector legislation in parliament, albeit at a slow pace. Related financial sector legislative reforms supported under the 2014 FSM DPL were all passed by parliament, demonstrating a strong political commitment with regard to the financial sector agenda. The political risks are also partially mitigated by broad and inclusive consultations with the relevant ministries and regulators.

94. **Macroeconomic risks are moderate and stem mainly from a deterioration of the euro area economic outlook.** A slower than projected recovery in the euro area could lead to lower growth in Albania, which would adversely affect the banking sector. Given their substantial holdings of government bonds, banks would incur substantial losses if interest rates rise. NPLs could either increase further or decline more slowly, because of a lower than expected economic growth, requiring additional provisioning and adversely affecting bank profitability. Albania has a relatively high exposure to neighboring countries, especially Greece and Italy, through remittances, exports, and foreign investment. A prudent fiscal consolidation path combined with growth-enhancing structural reforms, in particular, related to the business climate and significant financial support from the World Bank, the IMF, and the EU are likely to mitigate macroeconomic risks.

95. **The sector risks are moderate.** The prolonged financial and economic crisis in Greece, and more recently the banking sector crisis in Italy keep the deleveraging pressures and may still cause the exit of one or more foreign banks. These risks are partially mitigated by the banks' high liquidity and capital ratios.

96. **The fiduciary risk is moderate.** Although the fiduciary risk related with the use of the loan proceeds is primarily driven by the current PFM environment in Albania, the shortcomings in this area do not indicate major fiduciary risk given the nature and content of the program. The clean audit opinions of the Bank of Albania, and the combination of the prior actions of Albania Public Finance DPF series and the medium-term PFM reform program, support this assessment.

ANNEX 1: POLICY AND RESULTS MATRIX

	Prior Actions	Results Indicators
Pillar I. Reducing NPLs and enhancing the financial safety net		
1	Parliament approves the strengthening of the insolvency regime by enacting the Law on Bankruptcy (Law No. 110/2016).	By March 2018, the ratio of NPLs to total loans declines to 16 percent or less of total loans. Baseline as of June 2016: NPLs ratio is 20 percent.
2	Parliament approves the introduction of new private bailiff reforms to expedite collateral executions, by enacting amendments to the Civil Procedure Code (Law No. 114/2016) and the Private Bailiffs Law (Law No. 109/2016).	
3	Parliament approves improvements to the audit quality of Public Interest Entities approximating it with the EU <i>acquis communautaire</i> , by enacting amendments to the Law On Statutory Audit, (Law No. 47/2016).	By March 2018, A functional, and funded POB is established, with adequate staffing and funding as required by the EU Statutory Audit directive, and with the capacity to improve the audit quality of PIEs. Baseline as of end-Dec 2015: The POB is underfunded and unable to fulfill its audit oversight mandate.
4	Parliament approves the extension of deposit insurance coverage to legal entities by enacting amendments to the Law on Deposit Insurance Law (Law No. 39/2016).	By March 2018, 100 percent of eligible legal entities' deposits are insured up to the limit of 2,500,000 lek. Baseline as of end-2015: 0 percent.
Pillar II. Strengthening regulation, supervision, and resolution regime of banks, Savings and Credit Associations (SCAs)		
5	Parliament approves the strengthening of the commercial banks' resolution framework in line with the EU Banks' Recovery and Resolution Directive, by enacting the Law On Bank Resolution (Law No. 133/2016).	By March 2018, a dedicated resolution unit is established in BoA. Baseline as of end-2015: Lack of an adequate bank resolution framework and a designated resolution authority.
6	The BoA completes evaluation of systemic banks' recovery plans for the year of 2015 to enable effective crisis preparedness and management.	By March 2018, systemic banks submit annual recovery plans in accordance with the new enhanced regulation for "Guidelines on Recovery and Resolution Plans" issued by BoA. Baseline as of end-2015: Prior systemic bank recovery plans not in accordance with European Bank Authority technical standards and guidelines.
7	Parliament approves the strengthening of SCAs' regulation and supervision by enacting the Savings and Credit Associations Law (Law No. 52/2016).	By March 2018, the sector of SCAs has consolidated from 108 to less than 20 SCAs, and half of the SCAs have been subject to BoA's on-site inspections based on the new regulatory framework. Baseline as of end-2015: A fragmented sector of 108 SCAs, which were not adequately regulated and supervised.
8	The BoA adopts new licensing, reporting, and risk management regulations for SCAs, in support of enhanced regulation and supervision of the sector, by adopting Board Decisions No. 104, No. 105, and No. 106.	

Pillar III. Strengthening regulation and supervision of investment funds		
9	Parliament approves the strengthening of the AFSA's enforcement powers by enacting amendments to the Collective Investment Undertakings Law (Law No. 36/2016).	By March 2018 In excess of 10 percent of assets of investment funds are in liquid form, and all licensed asset management companies and the respective authorized investment funds have been subject to on-site inspection. Baseline as of March 2015: About 5 percent of assets are liquid at end-March 2015.
10	The AFSA adopts new regulations on liquidity management and mark-to-market valuations to lower the risks for investment funds' unit holders, by adopting Board Decisions No. 45 and 46.	

ANNEX 2: LETTER OF DEVELOPMENT POLICY



REPUBLIKA E SHQIPËRISË

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14.12.16.

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

December 9, 2016

REF: Letter of Development Policy
Albania: Financial Sector 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

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.

The banking system remains stable, well capitalized and liquid. The system-wide capital adequacy ratio is around 16 percent and the liquidity ratio is around 33 percent, well above statutory requirements. Although the Albanian banking system is dominated by foreign banks (with a market share of 86 percent), it is mostly funded by domestic deposits, mitigating the effects of deleveraging compared to regional peers. The level of bank intermediation remains low, with private sector credit at around 35 percent of GDP, compared to 45 percent of GDP in the Western Balkans region. Profitability has been low, but has been recovering since the crisis. Key vulnerabilities stem from high euroization, large exposure to illiquid central government securities, and persistently high NPLs.

Credit growth to the private sector is subdued, as banks remain risk-averse given the significant NPL overhang. While demand for credit is weak, difficulties with contract enforcement and collateral execution in the court system also deter new lending. NPLs have declined substantially

from their peak of 25 percent in September 2014 but still remain high at 18 percent of all loans in December 2015. Provisions cover 71 percent of gross NPLs.

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.

We are fully committed to go through several deep reforms during the medium term 2017 - 2020 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 since 2014, with the goal to achieve a reduction in public. By 2020, we aim to bring public debt down to 60 percent of GDP from about 71 percent in 2013. In 2016 we are targeting a positive primary surplus and remain fully confident to achieve that by the end of the year. That makes only the second time Albania has had a positive primary surplus while the overall balance targeted at 2.4 percent of GDP for this year makes it the lowest deficit level Albania has recorded in the post-communist period. 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. Earlier this year we presented several key legal improvements in the medium-term fiscal framework and public financial management including debt reduction fiscal rule, which were closely consulted with our international partners, including the World Bank and the IMF to strengthen.
- *We are committed to taking a proactive role in reforming the business climate to support robust and sustainable growth.* As we have now resolved the problem of arrears, we plan to ensure that other 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 2015 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 and the constitutional amendments approved unanimously by the Parliament in July of this year is a fundamental step in this direction. We plan to progress quickly with other laws necessary for a successful implementation of justice reform which than will open the door for negotiations with EU to advance in the integration process.
- *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 are implementing a comprehensive strategy to further to reduce NPLs. The plan integrates and sequences reforms in the areas of supervision, regulatory enforcement, debt restructuring, and insolvency. We have already submitted legal changes to Parliament to better protect financial collateral and to strengthen property rights over real estate,

amended regulations to facilitate write-offs and collateral management, and formulated an action plan for handling the 35 largest holders of NPLs (that account for around 50 percent of the NPLs). Additional measures supported by this DPL have been recently approved, such as the bankruptcy law, as well as amendments to the Civil Procedure Code and the Private Bailiff's Law, in order to increase the efficiency of the NPLs resolution process.

- *Bank of Albania has made significant strides in improving its supervisory vigilance.* Although Greek banks account for around 13 percent of total assets, the banking system weathered the financial turmoil in Greece last summer with minimal spillovers. The authorities adopted the Basel II framework in 2015 strengthening the banks' risk management practices. With about 70 percent of assets concentrated in the four largest banks, the authorities have been monitoring closely systemic institutions. The crisis management framework has been improved, including by preparing a new draft bank resolution law. The BoA also joined the European Banking Authority College in 2015, which will enable better coordination with foreign supervisors. The level of unhedged foreign currency lending remains high. However, it is being closely monitored and tackled by the BoA through the support of IMF. Share of local currency loans has increased in the few recent years.
- *Nonbank supervision has been strengthened.* The non-banking sector in Albania is relatively small at around 10 percent of GDP, but has seen rapid growth over the past few years. 5 Investment funds in particular have expanded rapidly, currently accounting for about half of this sector. The low interest rate environment is leading to increased appetite for savings instruments in the non-banking sector. In June 2015, we approved new regulations on liquidity requirements and asset valuation for investment funds. All vacancies on the executive board of the Albanian Financial Supervisory Authority (AFSA) have now been filled, after some delays.

Reforms Supported by the Financial Sector Development Policy Loan

The 2014 Financial Sector Modernization Development Policy Loan (FSM DPL) from the World Bank supported a set of 10 prior actions to help Albania implement key financial sector reforms. This Financial Sector DPL will support our efforts to further strengthen the resiliency of the financial sector in the following three areas: (i) adopting policy measures to reduce Non Performing Loans (NPLs) and enhance the financial safety net; (ii) strengthening regulation, supervision and resolution regime of banks, and Savings and Credit Associations (SCAs); and (iii) strengthening the regulation and supervision of investment funds.

(i) Reducing NPLs and enhancing the financial safety net

Further policy measures are needed in order to reduce NPLs. The NPL ratio reached 24.9 percent at end-September 2014, before declining to 18.2 percent at end-December 2015, and then increasing slightly to 19.5% in May 2016. Despite the decline, the NPL level remains high on the back of sluggish economic growth due to internal/external factors and further legal measures are needed to better tackle the reduction of NPLs. We formed an inter-agency working group, which together with the banking industry, worked on an NPL reduction strategy. As result, a NPLs reduction Action Plan was drafted, that was endorsed by the Prime Minister and the BoA Governor in August 2015. We remain committed to encourage the resolution of 35 large NPLs, by supporting implementation plan prepared by BoA, which aims to stimulate voluntary out of the court restructuring.

More specifically, the Government and other relevant institutions are implementing the following key measures with the support of this DPL:

- *The Parliament approved a new Bankruptcy Law to strengthen the insolvency regime.* Although Albania has a reasonably modern insolvency framework on paper, it has been scarcely used as a means to resolve NPLs. Albania's main bankruptcy law was outdated. Insolvency administrators and commercial judges are unprepared to hear complex restructuring cases and whenever the insolvency law is used, the process is quite slow and cumbersome. An efficient insolvency system helps improve access to credit by establishing predictable mechanisms for resolving distress. In addition, an efficient exit system is significant for growth, since it serves to free up both entrepreneurs and capital to move on to more productive activities. The reformed insolvency framework: (i) strengthens creditors' rights, including to ensure further creditor participation in the process and an adequate regime of priorities; (ii) contemplates an expedited reorganization mechanism that allows court confirmation of workouts ("pre-packaged plans" or "pre-packs"); (iii) allows for post-filing financing; (iv) improves the reorganization process and (v) simplifies and strengthens the system of avoidance actions against fraudulent transactions.. A number of regulations should be issued afterwards in order to implement the law, especially with regards to insolvency administrators.
- *The Parliament approved amendments to the Civil Procedure Code and the Private Bailiffs Law introducing new private bailiff reforms to expedite collateral executions.* Important impediments for collateral execution and NPL resolution remained as a result of poorly regulated private bailiffs. Several meetings between the Bailiffs' Chamber and the AAB have taken place to discuss some of the issues highlighted below, which have been identified as problematic. Several laws and regulations have been amended in accordance with international good practices with regards to the operations and practices of private bailiffs, and supported by this DPL. The Civil Procedure Code was amended as well as Law No. 10031 (Private Bailiffs Law), indicating that the MoF and the MoJ have the authority to regulate not only the 'fees' of the private bailiffs but also the 'type of compensation', including the 'success fee' for the private bailiffs. Finally, an amended Instruction should be issued to align bailiffs' fees with the success in their recovery, and since both banks and bailiffs demanded more clarity and consistency in the private bailiff regulation. We expect that by March 2018, the ratio of NPLs to total loans declines significantly.
- *The improvement of the audit oversight system has required amendments to the Law on Audit.* The 2009 Law on Audit established a foundation for an audit oversight system, through creation of a Public Oversight Board (POB). However, due to resources and capacity constraints, the POB was not able to fulfil its oversight and quality assurance duties to effectively influence the quality of audits. The POB had no legal status and no executive staff or reliable funding source. In addition, the independence of the board members needed to be enhanced, as well as representation of the financial sector regulators in the board. The need for a more independent and well-functioning POB is a requirement of the EU Statutory Audit Directive (as amended in 2014) and the new Regulation on PIE audits, which Albania has committed to transpose. The approved amendments to the Law on Audit have corrected the above mentioned deficiencies, the most critical of which are: (i) the establishment of a POB executive legal entity (possibly under the existing umbrella of National Accounting Council), and (ii) a system of adequate funding to enable hiring qualified inspectors for audit quality. We expect that by March 2018, a functional, and funded POB, independent from the audit profession is established, with the capacity to improve audit quality of PIEs.

- *The Parliament approved amendments to the Deposit Insurance Law to extend coverage to legal entities.* 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 SCAs with an initial government contribution of Lek 50 million for a separately administered deposit insurance fund; (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. Additional amendments aimed to enhance, inter alia: (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 SCAs. Despite improvements, coverage for legal entities was lacking. The absence of coverage for small enterprises was a material weakness in the safety net for depositors, as it contravened a primary objective of deposit insurance—to protect small, financially unsophisticated depositors—as well as European Union guidance on coverage. We expect that by March 2018, 100 percent of eligible legal entities' deposits are insured up to the limit of 2,500,000 lek.

(ii) *Strengthening regulation, supervision and resolution regime of banks, Savings and Credit Associations (SCAs)*

Policy reforms in this pillar aim to strengthen the resolution regime for banks, and the legal, regulatory and supervisory framework of SCAs. There is a need for the establishment of a new resolution framework for banks, for which normal insolvency (liquidation) is not an option because of financial stability reasons and the provision of critical functions. A designated resolution authority needs to have resolution tools and powers so that they may take steps to preserve the critical functions of a bank in resolution and impose losses on the existing holders of its liabilities. Post-resolution steps are also important – including the restructuring of firms and providing compensation to creditors where they have been treated worse in resolution than they would have been had the firm been put into insolvency. Considering the actual stage of the development of the SCAs sector and issues identified by the Authorities, the SCAs supervisory and regulatory framework has been strengthened and the sector has consolidated.

More specifically, the Government and Bank of Albania are implementing the following key measures with the support of this operation:

- *Parliament will approve a Bank Resolution Law.* Albania's banking supervision system is largely based on modern principles, and recent reforms have strengthened the legal framework, but significant gaps remain in the resolution framework. The legal system for resolving distressed banks is based on "early intervention" via conservatorship and an administrative based banking liquidation system. Moreover, the BoA has developed a comprehensive internal bank conservatorship and liquidation manual to support decision making. However, important gaps remain in the legal framework. Under conservatorship, BoA can only override shareholder rights to transfer to a bridge bank, but not with a view to execute a P&A (they are only "frozen"). Hence, BoA can only "order" shareholders to sell all or part of a bank's assets, but bank shareholders are still bound by company law -- and thus may not respond to BoA "orders".

- Furthermore, the parameters triggering BoA intervention are not aligned with international standards. There is no clarity in the legal framework with regards to the resolution authority, or on the issue of financing “resolution” apart from possible ADIA support. In view of a potential conflict of interests within the supervisory authority deciding on the application of resolution tools, the creation of a separate “resolution authority” seems adequate. In addition to gaps in the legal framework, several internal procedures are also lacking, such as the ex-ante preparation of a P&A in order to ensure the franchise value is kept, and lack of a P&A draft template, or an internal toolkit for the assessment of the least cost tests. In addition, bank specific assessments (resolution plans) should be prepared ex-ante in order to ensure that banks can be resolved either via liquidation or the application of resolution tools (i.e. a P&A or a bridge bank).
- *Given the limitations of the current legal framework on bank resolution, a new bank resolution law in accord with international good practice would be a significant step forward.* Such a law would ensure, inter alia: (i) a proper institutional set up and functional separation of powers between supervision and resolution (“resolution authority”); (ii) early and decisive intervention by the authorities, by identifying adequate triggers for early intervention, the application of resolution tools and liquidation; (iii) banks taking appropriate actions themselves when conditions deteriorate (utilizing recovery plans for example); (iv) banks are resolvable and ex-ante resolution plans are prepared; (v) continuity of critical functions for banks of “public interest;” and (vi) banks can either be restored or exit the market, as a principle, without the use of public money. We expect that by March 2018 a dedicated resolution unit is established in BoA.
- *BoA has completed the annual evaluation of systemic banks’ Recovery Plans for 2015.* The BoA developed mandatory guidelines in 2014 requiring banks to adopt annual recovery plans and submit them during 2015 to BoA for assessment. As highlighted by international standards adopted in the wake of the financial crisis, the adoption of Recovery and Resolution Plans (RRPs) is one of the essential instruments for effective crisis preparedness and management. The BoA assessed, for the first time, the recovery plans of the 7 designated “systemically important banks” at end-2015. In assessing these plans, the BoA developed an internal methodology for assessing and verifying the adequacy of qualitative and quantitative recovery indicators, the impact of the proposed recovery action on banks’ capital, liquidity, leverage, and other financial indicators, and the range of financial stress scenarios used in the plans. After the enactment of the Bank Resolution Law, the BoA will issue new enhanced regulation for “Guidelines on Recovery and Resolution Plans”, aligned with the EBA’s technical standards and guidelines. We expect that by March 2018, systemic banks submit annual recovery plans in accordance with the enhanced regulation for “Guidelines on Recovery and Resolution Plans”, issued by BoA.
- *The Parliament has approved a new SCAs Law.* The legal, regulatory and supervisory framework did not provide adequate rules for governance and risk management, while its provisions regarding supervision, corrective measures and resolution did not assign adequate powers to the authorities. In addition, the framework did not provide incentives for the consolidation of a highly fragmented sector and it did not recognize the crucial role the Credit Unions in supporting the administration and management of the small SCAs, which did not have the professional capacity to comply with applicable financial sector regulations and standards. The approval of a new SCA legislation and supporting regulations, coupled with a more robust supervision framework, have addressed these

issues. The new framework has guided the sector towards consolidation, with fewer and stronger entities that are adequately supervised and able to diversify and expand their services to underserved regions.

- *The new legislation for the SCAs has provided incentives for the consolidation of the SCA sector, established an adequate supervisory framework, and enhanced the governance of the sector.*
- *The Bank of Albania Supervisory Council adopted new licensing, reporting, and supervision regulations for SCAs in support of a stronger regulation, supervision and consolidation of the sector, including in the following areas: (i) new licensing provisions; (ii) an enhanced supervision and reporting framework based on a risk-based approach including a stronger and more systematic oversight to foster the financial soundness of the SCAs; (iii) strengthened governance provisions in terms of internal statutes, governing bodies to enhance the sustainability of the system; and (iv) adequate provisions for BoA to address weak or non-viable SCAs. We expect that by March 2018, the sector of SCAs has consolidated to less than 20, and half of the SCAs have been subject to BoA's on-site inspections based on the new regulatory framework.*

(iii) Strengthening regulation and supervision of investment funds

The Government and other relevant institutions are implementing the following key measures with the support of this DPL:

- *The Parliament approved amendments to the Collective Investment Undertakings Law in order to strengthen AFSA's enforcement powers.* The fast growing investment funds industry, which has added to the systemic vulnerabilities of the financial sector, obliges the AFSA to improve its risk management enforcement powers to undertake quick remedial measures. Following recommendations from the FSAP, and supported by the 2014 FSM DPL, a set of amendments to three separate laws were approved by Parliament in 2014, which substantially increased the independence of AFSA. In the interim, the legal base for investment funds enforcement powers needed to be upgraded to equip the AFSA with the necessary authority to intervene as may be necessary. The legal amendments have enabled the AFSA to: (i) issue a regulation that defines minimal requirements for risk management systems at IFs management companies; and (ii) suspend the funds' units redemption if warranted by specific market circumstances. In principle, in periods of loss of confidence in the financial industry, the financial system could suffer from an acute lack of liquidity. The investment funds management companies need to raise adequate risk identification and mitigation systems in order to be prepared with stressed situations. In the possible case that the investment fund management company is forced to sell government securities in an illiquid market, it will not receive realistic prices, which is not in the interest of investors. Suspending redemptions is a temporary decision taken only in extraordinary circumstances and until the market liquidity is restored. The Collective Investment Undertakings Law has been amended to empower AFSA to require and enforce adequate risk management arrangements and allow suspension of units redemption by companies, as approved or forced by AFSA.
- *AFSA has adopted new regulations on liquidity management and mark-to-market valuations.* While the investment funds helped to diversify holdings of government securities in the financial system, their fast growth gives rise to higher risks. The diversification of government debt ownership lessens the risks from the financial

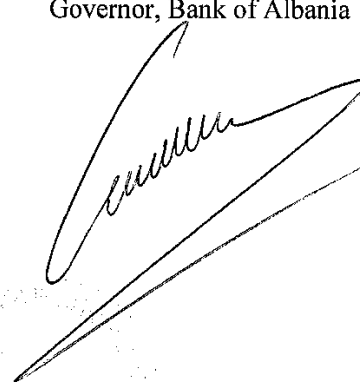
interdependence arising from banks' large holdings of government securities. However, the investment funds also magnify the risks, as lack of an established secondary market for government securities represents a key liquidity risk to the investment funds. Moreover, the AFSA's regulatory framework did not require the investment funds to hold liquidity buffers to meet the demands for the redemption of units. These risks were exacerbated by the lack of clarity on the liquidity requirements and the methodology for establishing the value of the investment fund units. The proposed operation supported AFSA's adoption of two new regulations for investment funds, which have: (i) introduced liquidity requirements to ensure that investment funds have suitable liquidity risk management policies, as well as adequate contingency liquidity arrangements in place to deal with stressful situations; (ii) required that the calculation of the unit value represents the proportionate share of the aggregate market value of the underlying assets of the fund. In support of these risk lowering measures, AFSA has already upgraded capital adequacy and the consumer disclosure requirements for investment funds management companies. We expect that by March 2018, in excess of 10 percent of assets of investment funds are in liquid form, and all licensed asset management companies and the respective authorized investment funds have been subject to on-site inspection.

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 all these legal reforms.

Arben Ahmetaj
Minister of Finance



Gent Sejko
Governor, Bank of Albania



ANNEX 3: FUND RELATIONS ANNEX

Press Release: IMF Executive Board Completes Eighth Review under Albania's Extended Fund Facility and Approves €35.9 Million Disbursement

August 31, 2016

The Executive Board of the International Monetary Fund (IMF) today completed the eighth review of Albania's economic performance under the Extended Fund Facility (EFF). The completion of the review enables an immediate disbursement of SDR 28.65 million (about €35.9 million), bringing total disbursements under the arrangement to SDR 238.14 million (about €298.3 million). The decision¹ was taken without a formal meeting.

All end-April 2016 performance criteria were met with comfortable margins, and good progress has been made on the structural reform agenda. The economic recovery is strengthening, supported by large energy-related investments and a gradual recovery in domestic demand. The current account deficit is widening due to import-intensive foreign direct investment (FDI). Inflation is recovering from very low levels, although underlying inflationary pressures remain weak. Despite substantial monetary easing, credit growth remains sluggish, constrained by the still sizable overhang of nonperforming loans (NPLs) on bank balance sheets.

The authorities' policy mix should continue to focus on fiscal adjustment, while supporting growth through monetary easing. A strategy based on broadening the tax base, improving tax compliance and administration, and implementing structural reforms will help lower debt levels while allowing space for more productive public spending. Fiscal structural reforms to enable a valuation-based property tax and strengthen public financial management are also crucial for entrenching the consolidation gains. The central bank's monetary easing using conventional policy tools is appropriate given signs of a nascent demand recovery. Addressing the high stock of NPLs remains key for reviving credit and supporting growth.

The Executive Board approved a 36-month arrangement under the EFF for Albania on February 28, 2014 (see Press Release No. 14/81) in an amount equivalent to SDR 295.42 million (about €370.0 million, or 212.1 percent of the country's current quota in the Fund).

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

	Prior Actions	Significant Positive or Negative Environment Effects (yes/no/to be determined)	Significant Poverty, Social, or Distributional Effects Positive or Negative (yes/no/to be determined)
	Pillar I. Reducing NPLs and enhancing the financial safety net		
1	Parliament approves the strengthening of the insolvency by enacting the Law on Bankruptcy (Law No. 110/2016).	No	Yes. Reduced likelihood of a financial sector crisis, which can be costly to depositors and affect the poor disproportionately, leading to an increase in poverty.
2	Parliament approves the introduction of new private bailiff reforms to expedite collateral executions, by enacting amendments to the Civil Procedure Code (Law No. 114/2016) and the Private Bailiffs Law (Law No. 109/2016).	No	
3	Parliament approves improvements to the audit quality of PIEs approximating it with the EU acquis communautaire, by enacting amendments to the Law On Statutory Audit, (Law No. 47/2016).	No	
4	Parliament approves the extension of coverage to legal entities by enacting amendments to the Law on Deposit Insurance Law (Law No. 39/2016).	No	Yes. Micro and small businesses will benefit.
	Pillar II. Strengthening regulation, supervision, and resolution regime of banks, Savings and Credit Associations (SCAs)		
5	Parliament approves the strengthening of the commercial banks' resolution framework in line with the Banks' Recovery and Resolution EU Directive, by enacting the Law On Bank Resolution (Law No. 133/2016).	No	Yes. Better risk mitigation and handling of bank failures by the BoA, which benefits deposit holders. The new bankruptcy law emphasizes less use of public money.
6	The BoA completes evaluation of systemic banks' recovery plans for 2015 to enable effective crisis preparedness and management.	No	
7	Parliament approves the strengthening of SCAs' regulation and supervision by enacting the Savings and Credit Associations Law (Law No. 52/2016).	No	Yes. Reforms to the regulatory and supervisory framework for SCAs are expected to increase the safety and efficiency of the SCAs serving small farmers and microenterprises.
8	The BoA adopts new licensing, reporting, and risk management regulations for SCAs in support of a stronger regulation and supervision of the sector, by adopting Board Decisions No. 104, No. 105, and No. 106.	No	
	Pillar III. Strengthening regulation and supervision of investment funds		
9	Parliament approves the strengthening of the AFSA's enforcement powers by enacting amendments to the Collective Investment Undertakings Law (Law No. 36/2016).	No	Yes. Better protection for the holders of investment funds units. The investment funds sector numbers about 33,000 individual investors.
10	The AFSA adopts new regulations on liquidity management and mark-to-market valuations to lower the risks for investment funds' unit holders, by adopting Board Decisions No. 45 and 46.	No	

ANNEX 5: FINANCIAL SECTOR OVERVIEW

1. **The financial sector in Albania is dominated by banks.** Banks represent about 90 percent of total financial system assets, equivalent to 91.3 percent of GDP in December 2015 (up from 75.9 percent of GDP in 2005, largely reflecting the strong credit growth before the global financial crisis) (figure 5.1).

Figure 5.1. Financial Sector Overview



Source: BoA and Albanian Association of Banks

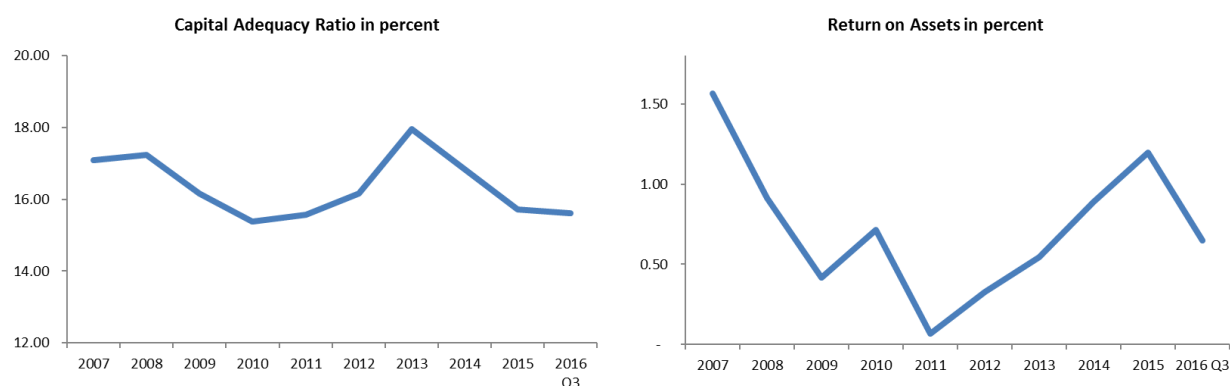
2. **Out of sixteen banks operating in Albania, two banks are dominating the market with a cumulative 46.3 percent market share.** Historically, the subsidiary of Austrian Raiffeisen bank used to be the market leader with more than 30 percent market share, though recent deleveraging pressures have significantly changed that trend, enabling local and non-European subsidiaries to expand their market penetration. Nevertheless, of the five largest banks, which collectively hold about three-quarters of total assets, four are foreign banks with Austrian, Turkish, Italian, and Greek ownership. There are six midsize players in the market, while the five smallest totaled less than 5 percent of total assets. In sum, foreign banks represent about 86 percent of total banking sector assets.

3. **Banking services are fairly modern and skewed toward urban areas.** In recent years, there has been a significant increase in bank branches 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.** The corporate sector held about 69 percent of the value of loans as of June 2016. At end-June 2016, 50.6 percent of loans were real estate collateralized or around 67 percent of loans to households, and around 44.7 percent of loans to businesses. The businesses 'overdraft' has the major share in the total loan portfolio (about 25 percent); followed by 'investment for real estate' to businesses (about 20 percent); loans for 'investment in real estate' to households (about 22 percent); and loans for 'investment to purchase equipment' to businesses (17 percent).

5. **Several features of the banking sector increase its vulnerability to shocks.** High NPLs and weak loan demand are the main risks that the banking system faces. The quality of the loan portfolio deteriorated markedly since the onset of the financial crisis. NPLs reached their peak in end-September 2014, at 24.9 percent. Since then NPLs have been on a decreasing path. As of December 2015, the NPLs fell to 18.2 percent before slightly increasing to 20 percent in June 2016. As of end-September 2016, the NPLs ratio reached 21.3 percent. Foreign currency loans have performed worse than local currency loans, with NPL ratios of 20.2 percent and 15 percent, respectively. The system remains well capitalized, with capital adequacy ratios well above the regulatory minimum of 12 percent, and is profitable despite low credit growth (figure 5.2).

Figure 5.2. Capital Adequacy and Profitability



Source: BoA

6. **A sizeable reduction of NPL ratio in 2015 was caused by NPL write-offs.** In total, ALL 26.65 billion of NPLs were written off by the banks in 2015 (figure 5.3). ALL 21.4 billion was written off because of enforcement of Article 17 of 'Credit Risk Administration' Regulation, an amendment introduced in 2014 by the BoA as a measure under the 2014 FSM DPL. Article 17 requires banks to write off NPLs that have been in the 'lost' category for more than three years and further ALL 5.25 billion was voluntarily written off by banks. Lost loans category increased considerably during 2012–2014, while the overall level of NPLs remained stagnant during the same period. NPLs started to fall after the peak in September 2014, following most notably heightened write-offs. Credit growth has been low in the recent few years, but it has shown signs of recovery in 2016.

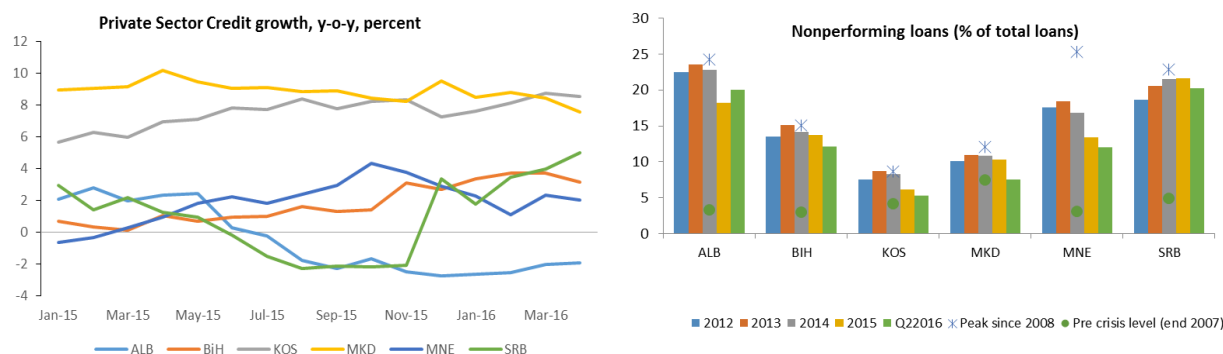


Figure 5.3. Developments in NPLs

Source: BoA

7. **Despite recent improvements, Albania does not rank well compared to other countries with regard to NPLs and credit growth.** Credit growth has somehow picked up since the second half of 2014 and 2015, but it has been affected by the enhanced write-offs, especially during 2015, which recorded a negative growth of 1.54 percent. Albania has the second highest NPL ratio in the region, after Serbia, well above the rest of the countries.

Figure 5.4. Regional Trends in NPLs and Credit Growth



Source: IMF International Financial Statistics and WB staff calculations

Source: National Central Banks

8. **The authorities should continue implementation of the NPL Action Plan.** The plan, which was endorsed by the prime minister and the BoA governor in August 2015, is essential to improve the collateral execution regime and resolution of NPLs belonging to 35 largest corporate groups (responsible for more than half of all NPLs). The BoA has progressed in detailing the status and outlook of the 35 large syndicated exposures responsible for more than half of the NPLs in the country. The 'London approach' will be used as basis for the approach to be followed to resolve these cases, aiming for voluntary and concerted restructuring of viable exposures and sending the other cases for insolvency proceedings. Further substantial reduction of the NPL is essential to lower risk premiums and restore lending activity to levels adequate to support the economy.

9. **High financial euroization contributes to the vulnerabilities in the financial system.** The euro is used pervasively in the financial system. As of Q3 2016, 59.4 percent of loans 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 about 43 percent and 63 percent, respectively. Although net open positions in the euro are small, risks include the following: (a) close to half of loans in foreign currency are unhedged, (b) there are large maturity mismatches, and (c) 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.

10. **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.

11. **Vulnerabilities exist to external shock as well mainly because of 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.
12. **The BoA is given a macroprudential 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 macroprudential policies was put in place in late 2011 to limit contagion risks and international spillovers: (a) foreign bank branches were converted into subsidiaries, (b) liquidity regulations were tightened, and (c) the regulation on related party exposure was enhanced.
13. **The Greek economic and financial crisis poses significant risks to Albania because of the extended economic and financial links between the countries.** The capital controls effected in Greece in late June 2015 caused deposit withdrawals for a short period from the three Greek-owned banks in the country (holding around 13 percent of banking sector total assets), as the concerns of the large Albanian emigrant community in Greece were transmitted to relatives in Albania. These banks remain liquid and capitalized, supported also by improvements in the financial situation of the parent banks in Greece.
14. **As credit growth has failed to pick up significantly, the BoA has extended the relaxed prudential requirements for banks (introduced in 2013) and lowered the base interest rate to stimulate credit growth.** In 2013, 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 because of 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. As inflation has remained below the 3 percent target, the BoA has lowered the lek base interest rate numerous times during 2014–2016, to a historic low of 1.25 percent.
15. **The macroprudential 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 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 head. Building on the statutory duties of each authority, a Memorandum of Understanding signed in 2012 elaborates on the role of each institution in crisis management and enhances cooperation among its members toward three objectives: financial development, crisis prevention, and crisis management. The involvement of ADIA in the FSAG was also initiated through this Memorandum of Understanding.
16. **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. In 2014, the ADIA Law changed to admit qualified SCAs to the deposit insurance scheme, expectedly within 2016. In 2015, the Government provided the initial capital of ALL 75 million for the SCAs deposit insurance fund.

17. **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.** The 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. The BoA has established criteria for corporate governance and issued standards for bank management, the internal audit function, and several prudential standards. In 2015, the BoA introduced a risk-based approach to supervising the banking sector, and systemic banks were required to submit recovery plans. Consolidated supervision should be enhanced in light of the establishment of the new investments funds, including by closer information sharing and cooperation with the AFSA.

Nonbank financial sector

18. **The nonbank financial sector in Albania is relatively small, constituting 10 percent of financial system assets.** As of September 2016, it included 11 insurance companies, 3 investment funds, 13 SCAs (resulting from consolidation of about 100 SCAs in early 2016), 3 pension funds, and 28 other nonbank (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 ALL 14.09 billion (€102 million) of both life and non-life insurance in 2015. 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. Local insurance companies frequently engage in a Motor Third Party Liability price war, which leads to volatility of premiums written, considerably increased risk exposure, an inadequate level of reserves, and weak underwriting performance.
- (b) **Investment funds.** Before 2012, investment funds had no presence in Albania 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 because 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 slightly more than €500 million (as of end-September 2016). They have about 31,000 investors (largely individuals). In June 2016, AFSA authorized a third investment fund managed by Credins Invest.
- (c) **Savings and credit cooperatives.** In June 2016, the assets of SCAs accounted for about 0.6 percent of financial system assets. The sector counts about 13 SCAs. The two unions (in aggregate more than 100 member SCAs) consolidated their respective networks in two large SCAs in early 2016. The sector also includes a few other smaller 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 the BoA.

- (d) **Pension funds.** The voluntary private pension market ('third pillar') holds about 0.1 percent of financial system assets and aims at supplementing pensions offered under the Government's obligatory scheme.¹⁸ There were three pension funds operating at end-September 2016, with a net asset value of about US\$9.4 million, or 29 percent higher than it was at the end of 2015, and a total membership of 15,957, or 27 percent higher as compared to the end of 2015.
- (e) **Other NBFIs.** These hold 2.6 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 transfer services and factoring. Such NBFIs are funded primarily through borrowing (about 60 percent) and their capital (about 35 percent). They are supervised by the BoA.

AFSA

19. **Insurance market, investment funds, and pension funds are regulated and supervised the AFSA.** The AFSA is an integrated supervisory authority established in 2006 through merging of three separate supervisory authorities. It is a public institution which is funded by the industry and is accountable to the parliament. The AFSA has not been receiving any state budget financing since 2010. However, the autonomy in setting its budget and its internal organizational arrangements were considerably restricted till 2014 when the parliament approved three legal amendments giving powers to the AFSA to set its own structure and remuneration scheme. The AFSA has been benefiting from two separate TA programs to improve regulations and supervision for insurance and pension markets. By the end of 2015, a third program was launched to upgrade the AFSA capacities to regulate and supervise investment funds, and corporate bonds issuances.

¹⁸ 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, an independent public entity under the supervision of the Ministry of Labor and Social Affairs.