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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

