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

20 March 2014

Dear Dr. Kim:

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

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

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

Although the Albanian financial system withstood the shocks of 2008 global crisis relatively well, it continues to operate in highly uncertain macroeconomic environment, which triggers increased vulnerabilities in the system. Prior to the global financial crisis, credit growth in Albania was excessive, but it has moved into a downturn and repair stage, as suggested by the slowdown in credit and moderation in house prices, the sharp increase in non-performing loans and the reduction in banks profitability margins. While the Bank of Albania (BoA) has been vigilant in mitigating the risks –through instituting capital adequacy and solvency ratios that are above international norms, and putting in place stringent provisioning rules-- the financial sector remains vulnerable to several risks. Stress tests show that some banks still remain vulnerable to shocks. The decline in profitability, growing non-performing loans (NPLs), substantial level of euroization, continued deleveraging of foreign bank subsidiaries from Austria, Greece, Italy and Turkey and significant investments in government bonds in the absence of active secondary market are the main challenges that banking system faces. Given strong trade and financial links with euro area, the financial system and real sector in general are increasingly vulnerable to external shocks as well.
Albania's high public debt poses additional significant challenges for the financial sector's sustainability. Albania's public debt has increased from about 55 percent of GDP in 2008 to about 70.5 percent in 2013 emanating largely from poor tax revenue performance, slower economic growth and continued infrastructure spending, resulting in a large stock of unpaid arrears. Large holdings of government securities present potential systemic risks for banks, making them vulnerable to changes in interest rates and the value of debt securities. At the same time, the government depends on regular rollover of debt by banks. The risk is heightened by the lack of a well-functioning secondary market and the emergence of investment funds, which face significant liquidity risk and challenges regarding asset valuation.

Government's Program

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

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

- We are committed to putting our public finances on a sustainable path and lowering public debt over the medium-term. We have begun the process of fiscal consolidation with 2014 budget, with the goal to achieve a reduction in public debt in 2015. By 2016, we aim to bring public debt down to 69 percent of GDP. We remain cautious about the uncertainties ahead, particularly the risks related with the economic developments in the Eurozone, and we stand ready to make the adjustments necessary to ensure that fiscal consolidation is preserved. We will work closely with our international partners, including the World Bank and the IMF to strengthen medium-term fiscal framework and public financial management.

- We are committed to taking a proactive role in reforming the business climate to support robust and sustainable growth. In addition to resolving the problem of arrears, which is critical for reducing the elevated level of NPL and consequently restoring the health of both financial and real private sector, we plan to ensure that business complaints are addressed. Strengthening the revenue administration; fighting the informal economy to reduce the competitiveness distortions; reducing redundant regulatory and procedural hurdles faced by the business community are some of the key measures in this regard.

- Albania’s long-term goal is to join the European Union. As outlined in the European Commission’s 2013 Progress Report for Albania, we have adopted key judicial, public administration and parliamentary reform measures that would allow us to make progress toward EU accession. We have also made strides in the fight against corruption and
organized crime. We intend to further strengthen the independence and efficiency of the justice system, the fight against corruption and organized crime, and reforms in public administration.

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

Reforms Supported by the Financial Sector Development Policy Loan

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

(i) Expediting the resolution of Non-Performing Loans

The level of NPLs in the banking system has increased significantly in the aftermath of the financial crisis. Although the financial sector remained largely stable during the global crises, the highly elevated level of NPLs introduces significant risks to the stability of the sector as well as to its effective and efficient operation. NPLs have increased from 3.4 percent at end-2007 to more than 24 percent in September 2013. The rapid increase of NPLs likely involves a combination of factors, including the economic slowdown, government payment arrears and weak credit underwriting standards during the credit boom before the financial crisis. Also, loss loans are not being cleared from banks’ books due to prolonged major difficulties in the execution of collateral for loans in default (e.g., loans in execution at end-2013 represent around 17 percent of all loans, or more than 2/3 of banks’ total NPLs). Thus, accelerating collateral execution process represents a very critical issue, exasperated by the lack of clarity in the tax treatment of loan write-offs.
Credit to the real economy has stalled. Comparatively strict provisioning requirements and a comfortable capital adequacy ratio have helped to contain the NPLs' negative shocks to the system thus far. However, the large increase in NPLs and deterioration in the economic outlook have caused banks to take a much more conservative approach to lending and contributed to a sharp slowdown in credit growth in the last four years. Annual credit growth turned negative in September 2013 for the first time in the last decade, declining by 3 percent (year-on-year). Although the accumulation of domestic deposits in the banking system has been steady during the last years, the banks continue to pose tight credit supply conditions toward the domestic real sector. Furthermore, the banks have significantly increased investing of domestic savings in foreign assets.

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

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

- Removing ambiguities on tax treatment of NPL write-offs, by introducing legal changes and ensuring a better understanding and appropriate execution by tax inspectors. The respective amendments of tax law No. 8438 will be shortly submitted for approval to Parliament. Such legal changes, will allow BoA to swiftly introduce changes in the regulatory supervisory framework addressing the obligatory write-off of stale dated NPL following a fixed period of time classified in the “loss” category.

- BoA has issued new guidelines related with loans restructuring for businesses and individuals, as well as for real estate appraisals. These will serve as best practice to banks in this regard.

- With continuing assistance of the World Bank (FinSAC), the BoA is designing a comprehensive NPL resolution platform. The main focus of this initiative is to develop the appropriate tools to facilitate, on one hand, the effective enforcement of creditors’ rights and on the other hand, to return the operationally viable borrowers to sustainable debt servicing capabilities and enhance new borrowing via appropriate financial and corporate restructuring activities. Therefore, the addressing of impaired loans that could return to sustainable performance status through restructuring actions is expected to
further improve the NPL ratio.

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

- These measures, along with a broader cooperation with the World Bank in this regard, are expected to contribute to the lowering of the NPL ratio below 20%, by the end-of March 2015.

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

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

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

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

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

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

- The BoA will advance toward risk-based supervision, by adopting a Risk-based Supervision Framework which already includes a new Risk Based Supervisory Manual and a new Supervisory Operational Policy, to be both implemented in banks’ on-site inspections during 2014. The above two documents were approved by BoA Supervisory Council and by the First Deputy Governor, respectively on 26.03.2014 decision No. 9 and date 27.03.2014, decision No. 590. By end-March 2015, inspections of 5 banks would have been conducted in accordance with this new Risk-based Supervision Framework.

- The BoA issued a mandatory Guideline on Recovery Plans, on 26 February 2014, requiring systemic banks to adopt recovery plans and demonstrate their ability to operate during period of stress. By end-March 2015, banks of systemic importance will have submitted enhanced Recovery Plans to BoA, in line with the this Guideline.

- The BoA, with decisions no.12 and 13 of its Supervisory Council meeting of February 26, 2014 has adopted collateral standards for all its monetary operations (including repurchase and reverse repurchase agreements) and has expanded collateral eligibility to all negotiable securities issued by the government of Albania.

- The Memorandum of Understanding covering operations of the inter-agency Financial Sector Advisory Group (FSAG) has been amended in the FSAG meeting of March 10, 2014 to: (i) require technical-level meetings every month (in addition to the existing three-monthly high-level meetings); and (ii) exclude financial development from the mandate of the FSAG.
We will amend the Law “On deposit insurance” to better align the legislation and operations of Albanian Deposits Insurance Agency (ADIA) with the Core Principles for Effective Deposit Insurance Systems. Such amendments will be approved soon by Parliament, which will allow the ADIA to complete by end-March 2015 its assessment of eligible Saving and Credit Associations (SCAs) in line its legal and technical requirements. This will ensure that compliant SCAs enter the deposit insurance scheme by end-2015. Furthermore, by end-December 2014, the ADIA independence will have enhanced by having the authority to approve its own budget, without BoA ratification.

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

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

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

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

- The AFSA will improve the regulatory framework on insurance companies and investment funds, to deal with rising risks on their activity by end-June 2014. In particular, the regulatory framework for investment funds on asset valuation, liquidity requirement, and capital adequacy requirement will be enhanced.

- To ensure the financial and operational independence of the AFSA, the Council of Ministers will submit to Parliament by end-March 2014: a new Insurance Law, and amendments to AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law. By end-March 2015, AFSA independence will have enhanced as measured by the adoption of its own organizational structure, allowing it to regulate and supervise more effectively the insurance sector.

- The AFSA will adopt by end-March 2014 market stabilization measures to issue: (i) a regulation on minimum MTPL reserving standards; and (ii) a time-bound plan to restore funding of the Compensation Fund.
Finally, the Government of Albania notes that a number of proposed actions entail submission of
draft laws and amendments to Parliament for enactment. The Government of Albania provides
its utmost high assurances to the World Bank that it will use its best efforts to secure timely
enactment of these laws and amendments in question.

Shëqëqim Cani

Minister of Finance

Ardian Fullani

Governor, Bank of Albania