PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

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Operation Name	Financial Sector Modernization DPL
Region	EUROPE AND CENTRAL ASIA
Country	Albania
Sector	Banking (100%)
Operation ID	P146280
Lending Instrument	Development Policy Lending
Borrower(s)	MINISTRY OF FINANCE
Implementing Agency	Bank of Albania (BoA), Albanian Financial Supervisory Agency (AFSA), Ministry of Finance (MoF), Ministry of Justice (MoJ), Albanian Deposit Insurance Agency (ADIA)
Date PID Prepared	March 24, 2014
Estimated Date of Appraisal	March 18, 2014
Estimated Date of Board Approval	May 15, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

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

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

3. **Domestic and external vulnerabilities are high and continue to pose risks to macroeconomic stability.** Public debt and fiscal financing needs are among the highest in the region. Heavy trade, financial and remittance dependence on Italy and Greece remain important potential sources of vulnerability. The country's limited export base and vulnerability to shocks

pose additional external risks. Insufficient fiscal consolidation efforts or slow progress on structural reforms could undermine investor confidence and increase rollover risks for government debt.

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

5. **The decline in bank profitability and the high NPL rates are key risks to the banking sector, and undermine credit growth.** Bank profitability has declined sharply with the return on equity falling from over 20 percent in 2007 to below 6.4 percent in 2013. NPLs have increased from 3 percent at end-2007 to more than 23 percent at end-2013, and provisions covered 65 percent of NPLs at end-2013. Due the large stock of NPLs in the banking system, credit growth turned negative at end-November 2013, declining by 2.4 percent (year-on-year). The largely foreign-owned structure of the banking sector with Austrian, Greek, Italian, and Turkish banks presents additional risks. Financial difficulties in parent banks can affect the Albanian subsidiaries through direct contagion due to spill over fears. The strong financial links between banks and the government further increase the vulnerabilities, as a large share of bank assets is invested in government securities.

6. **The non-bank sector is small but new risks have emerged, coupled with a regulatory and supervisory framework that can be significantly strengthened.** Investment funds have grown considerably since 2012, but while these funds have helped diversify the ownership of government securities, their emergence has not been matched with an adequate regulatory and supervisory regime. Moreover, given the close links of the investment funds with banks, redemption pressures may spill over onto banks. The insurance market also faces significant challenges as insurance companies are not financing outstanding liabilities in full. The underwriting performance of non-life insurance sector has been negative in recent years with a major deterioration in 2013. Due to the need of major institutional reform to achieve financial and operational independence of the nonbank regulator, the regulation and supervision of the sector has lagged behind.

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

II. Operation Objectives

8. **The Policy Development objective** is to strengthen the financial sector regulatory and

supervisory regime and mitigate key vulnerabilities of the bank and non-bank financial sectors. The DPL is structured around three pillars: (i) strengthening regulation and supervision of the banking sector and financial safety net; (ii) expediting resolution of non-performing loans (NPLs); and (iii) strengthening regulation and supervision of Non-bank Financial Institutions (NBFIs).

9. **Expected results:** for Pillar I activities – Strengthening regulation and supervision of the banking sector and financial safety net. By end-March 2015, expected result is that BoA will have conducted inspections of 5 of 16 banks in accordance with the new Risk Based Supervisory Manual, including at least two systemic banks. Also, that all banks determined as systemically important will submit enhanced Recovery Plans to BoA, in line with the new BoA Instruction that formalizes content which is to be included in banks' Recovery Plans. And the ADIA will complete assessment of compliance of eligible SCAs to enter the deposit insurance scheme by end-2015 and ADIA will have approved its own budget without BoA ratification.

10. For Pillar II activities - Expediting resolution of NPLs. By end-March 2015, the ratio of NPLs/total loans would decline to 20% or less, with the write-off of at least 20 billion of NPLs.

11. For Pillar III – Strengthening regulation and supervision of NBFIs: By end- March 2015, AFSA's Board adopts its own organizational structure and market based salary scale independently from Parliament. By end March-2015, funding of the MTPL Compensation Fund is restored in the amount of Lek 430 Million to enable payment of pending insurance claims.

12. **The proposed Financial Sector Modernization DPL supports a set of 10 prior actions to help Albania implement key financial sector reforms:**

13. **Prior Action #1: BoA Supervisory Council adopts a new comprehensive Risk Based Supervisory Manual and a new Supervisory Operational Policy to increase effectiveness of banking supervision.** The adoption of a risk-based supervisory framework will result in more efficient utilization of supervisory resources, and hence will increase the quality of banking supervision and contribute to the stability of the financial system.

14. **Prior Action #2: BoA Supervisory Council issues new Instruction for designated systemic banks to adopt Recovery Plans to demonstrate their ability to operate during periods of stress.** The formal adoption of a new mandatory Instruction for the preparation of bank specific recovery plans would increase the resiliency of the banking system and allow BoA to better utilize its supervisory resources and resolution powers.

15. **Prior Action # 3: Amendments to the Law on Deposit Insurance are accepted by Cabinet of Ministers and submitted to Parliament, to better align the legislation and operations of ADIA with the Core Principles for Effective Deposit Insurance Systems.** To fulfill international best practice, ADIA should be provided greater autonomy in its operations in accordance with Core Principle 5 (Governance).

16. **Prior Action # 4: Cabinet of Ministers submits draft amendments of tax law No. 8438 to Parliament to resolve key NPL tax ambiguities to enable banks to write-off NPLs in protracted litigation.** The five prior actions (Nos. 4 – 8) are to cumulatively contribute to the reduction of the NPL stock**.** The expected result is that by end-March 2015, the ratio of

NPLs/total loans declines to 20% or less.

17. **Prior Action # 5: BoA Supervisory Council adopts amended regulation on "Credit Risk Administration" for the obligatory write-off of stale-dated NPLs following a fixed period of time classified in the "loss category."** To facilitate the write-off of stale-dated NPLs, the BoA will introduce changes to the regulation "On Credit Risk Administration" to define a maximum period of holding loss loans in the balance sheet on the bank.

Prior Action # 6: BOA issues three sets of guidelines on: (i) loan restructuring for businesses; (ii) loan restructuring for individuals; and (iii) real estate appraisal, based on international good practice. The goal is to allow cooperative borrowers facing financial difficulties the opportunity to fulfill their contractual obligations so their businesses can continue and minimize the execution of collateral.

18. **Prior Action #7: BoA Supervisory Council adopts a new regulation on "Risk Administration for Banks' Large Exposures" to strengthen credit underwriting practices and NPL recovery and resolution for large borrowers.** It is expected that banks will significantly improve their underwriting standards.

19. **Prior Action #8: MoJ and MoF to issue new instructions to provide market based incentives for private bailiffs' compensation.** This will result in increased competition and improved incentives to promptly execute on collateral, a necessary prerequisite to the reduction of NPLs.

20. **Prior Action #9: To ensure the financial and operational independence of the AFSA, the Cabinet of Ministers accepts and submits to Parliament: a new Insurance bill, and amendments to AFSA Law, Law on Salaries of Independent Institutions, and the Civil Servant Law.** The AFSA Law is to be amended, *inter alia*, to: (i) abolish the requirements for the AFSA to have its organizational structure approved by the Parliament, and (ii) remove the AFSA from the civil servants' compensation and benefits structure, so it has the ability to attract and retain sufficient experienced technical staff.

21. **Prior Action #10: The AFSA adopts market stabilization measures to issue: (i) a regulation on minimum MTPL reserving standards; and (ii) a time-bound plan to replenish funding of the Compensation Fund.** AFSA has agreed to undertake immediate MTPL market stabilization measures by establishing through regulation minimum reserving standards to ensure a level playing field, adequate claims paying capacity and the overall solvency of the market.

III. Rationale for Bank Involvement

22. **The Albanian financial sector authorities have undertaken significant reforms in recent years to address vulnerabilities in the financial sector.** Amendments to the Banking Law in 2011 provided the BoA with more options for bank resolution, through the establishment of bridge bank and purchase and assumption transactions, and allowed for the transformation of branches of foreign-owned banks into subsidiaries. The BoA also enhanced its monitoring and analytical tools for assessing financial stability and widened the list of collateral for Emergency

Liquidity Assistance. Additionally, key amendments to the Civil Procedure Code were adopted in 2013 to shorten and simplify collateral enforcement procedures. In addition, ADIA law was amended in 2012 to address a key set of reforms to extend coverage to Savings and Credit Associations (SCAs), facilitate a prompt pay-out after BoA intervention, and expand ADIA powers to contribute to a purchase and assumption or bridge bank resolution.

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

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

IV. Tentative financing

Source:		($m.)
Borrower		0
International Bank for Reconstruction and Development		100
Borrower/Recipient		0
IBRD, Others (specify)		0
	Total	100

V. Tranches *(if applicable)*

	($m.)
First Tranche	100
Total	100

VI. Institutional and Implementation Arrangements

25. **The Bank will continue to work closely with the MoF, BoA and other key stakeholders to monitor and assess reform progress and impacts during the course of this financial sector operation.** Monitoring and evaluation will be supported by the BoA, MoF, the MoJ, the ADIA and AFSA, as well as the Prime Minister's office through legislative and economic data provided by the authorities and verified in official disclosures, directives and

regulations. Baseline and updated data are provided by the respective agencies and tracked according to the indicators and outcome measures shown in the monitoring and results framework of the policy matrix.

VII. Risks and Risk Mitigation

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

27. **An exit from unconventional monetary policy in the United States could trigger a pullback in global risk appetite.** This risk is mitigated by the planned FIRST Initiative TA in support of public debt management and the BoA's strengthening of its systemic liquidity and market operation mechanisms. Another risk is a weak economy, rising interest rates or further deterioration in the domestic fiscal outlook would adversely impact the banking sector. This risk is partly mitigated by high solvency ratios and stringent provisioning rules. Another key source of risk which could undermine the results from this operation is the re-emergence of financial stress in the Eurozone. It could increase deleveraging pressures, and/or result in the exit of a foreign bank from the market. This set of largely exogenous risks can be mitigated by enhancing the market for government securities.

28. **Finally, the viability of the Financial Sector Modernization DPL program may be undermined if there is insufficient political consensus to pass in Parliament the underlying five law amendments and the Insurance Bill featured in the Prior Actions, or more broadly implement the financial sector related reforms, which depend upon the continued collaboration amongst the authorities (MoF, BoA, FSA, ADIA, and MoJ).** The authorities have embarked on a challenging reform agenda of fiscal consolidation and financial sector reforms, some of which may prove politically difficult to implement. This risk is partially mitigated by broad and inclusive consultations with the relevant Ministries and regulators. A Ministerial Committee has been formed to coordinate the implementation of prior actions. There is broad support for strengthening the banking sector, reducing NPLs, and improving the regulation and supervision of the insurance sector and investment funds. The implementation of the reform program supported under this operation will be closely monitored through ongoing policy dialogue and planned financial sector focused technical assistance building on key FSAP findings and recommendations.

VIII. Poverty and Social Impacts and Environment Aspects

29. **The reforms supported by this operation contribute to poverty reduction and shared prosperity, through mitigating financial sector vulnerabilities which, if realized would undermine broad-based growth.** As evidenced by the recent Eurozone financial crisis, a malfunctioning financial sector can be detrimental to economic growth and can undermine achievements in shared prosperity. A sound and stable financial sector intermediating funds to the economy is essential for sustained economic growth, which in the long term contributes to poverty reduction and shared prosperity. Moreover, effective financial sector reforms increase

the availability of credit and extend the reach of savings, payment and insurance services to the poor, rural dwellers and micro-enterprises alike.

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

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

IX. Contact points:

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