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ALBANIA

FINANCIAL SYSTEM STABILITY ASSESSMENT

March 2014

This Financial System Stability Assessment on Albania was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on February 14, 2014.

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FINANCIAL SYSTEM STABILITY ASSESSMENT

February 14, 2014

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This report is based on the work of the Financial System Assessment Program (FSAP) mission that visited Albania October 28–November 11, 2013. The FSAP findings were discussed with the authorities during the Article IV consultation mission in December 2013.

- The FSAP team was led by S. Erik Oppers (IMF) and Michael Edwards (World Bank), and included Alejandro López-Mejía, Nicolás Arregui, Mario Catalán, Matthew Gaertner, Darryl King, David Parker (all IMF); Eugene Gurenko, Thordur Jonasson, Claire McGuire, Elena Mekhova, Will Price, Olga Akcadag, and Marc Schrijver (all World Bank); and Joel Shapiro and Erik Huitfeldt (external experts). Iacovos Ioannou also contributed to the team's work.

- The mission met with the Governor of the Central Bank of Albania Ardian Fullani; the Minister of Finance Shkelqim Cani; the Minister of Economic Development, Trade and Entrepreneurship Arben Ahmetaj; the Head of the Albanian Financial Regulatory Agency (AFSA) Enkelejda Shehi; the Head of the Albanian Deposit Insurance Agency (ADIA) Tony Gogu; and other senior officials. The mission also met representatives of commercial banks as well as nonbank financial institutions, and savings and credit associations (SCAs).

- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.

- This report was prepared by S. Erik Oppers and Alejandro López Mejía.

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Glossary

ADIA	Albanian Deposit Insurance Agency
AFSA	Albanian Financial Regulatory Authority
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCP	Basel Core Principles
BOA	Central Bank of Albania
CAR	Capital Adequacy Ratio
CP	Crisis Contingency Plans
DIS	Deposit Insurance System
ELA	Emergency Liquidity Assistance
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FSAG	Financial Stability Advisory Group
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IFRS	International Reporting Standards
MOF	Ministry of Finance
MOU	Memorandum of Understanding
MRA	Master Repurchase Agreement
NBFIs	Nonbank Financial Institutions
NPLs	Nonperforming Loans
¶	Paragraph
P&A	Purchase and Assumption
PIE	Public Interest Entities
PML	Probable maximum loss
RRP	Recovery and resolution plans
SCAs	Savings and Credit Associations
SME	Small and Medium Enterprises
SOP	Supervision Operations Policy
SRR	Special Bank Resolution Regime

EXECUTIVE SUMMARY

Although Albania weathered the 2008 global crisis relatively well, the economy is weak, macroeconomic imbalances are large, and the financial sector faces several risks. Policy buffers are depleted and a large share of short-term public debt poses rollover risks. With strong trade and financial links to the euro area, the economy is also vulnerable to external risks.

Several features of the banking sector increase its vulnerability to shocks. Capital-to-asset ratios are sizable but banks hold large amounts of government bonds that expose banks to sizeable losses in case of a sovereign debt re-pricing and balance sheets have deteriorated as a result of a rapid increase of nonperforming loans (NPLs). Sharply declining profitability leaves little room to cope with shocks. The strong financial links between financial institutions and the sovereign pose additional challenges. Large holdings of government securities amidst shallow markets present systemic risk for banks and investment funds, and the government depends on regular rollover of debt by banks. High financial euroization is another source of vulnerability.

Systemic risk in the financial system has increased with the recently established investment funds. While these funds have helped diversify the ownership of government securities, they are inadequately supervised and regulated, invest mostly in longer-dated securities and their clients appear to consider these funds as substitutes for bank accounts. Given the lack of a functioning secondary market for government bonds, the funds face high liquidity risk. Moreover, given the close links with banks, redemption pressures may spill over into deposit runs on banks.

Vulnerabilities in banks are confirmed by stress tests. In extreme macroeconomic scenarios, banks suffer simultaneous losses from credit, market, and sovereign risks, and at least six banks (representing 21 percent of the assets of the banking system) become undercapitalized, although the aggregate capital shortfall is limited. Sensitivity tests also indicate that a lek depreciation would deteriorate the quality of loan portfolios and that credit risk is exacerbated by the high concentration of loan portfolios. Liquidity stress tests confirm that banks are amply liquid, however, and are able to confront large deposit withdrawals—mitigating systemic liquidity risks somewhat. Direct contagion risk through bilateral domestic interbank exposures is also limited.

Mitigating these vulnerabilities is critical. The authorities are encouraged to:

- *Intensify efforts to tackle the rapidly rising NPLs*. The authorities have taken steps to reduce the existing stock of NPLs partly with technical assistance from the World Bank, but efforts need to be stepped up, including by: (i) creating an interagency working group to clarify the tax issues that are preventing banks from writing off loans, propose remedial measures and monitor progress; (ii) issuing guidelines to facilitate NPL sales; (iii) developing measures to achieve stronger financial reporting practices; (iv) expanding the definition of related parties; (v) adopting measures to further strengthen banks' credit policies and underwriting standards; and (vi) initiating an asset quality review.

- *Lessen the systemic risks arising from the large holdings of government securities by banks and investment funds.* Establishing a regulation with minimum liquidity and capital standards for investment funds is an immediate priority, and these funds should be required to have adequate liquidity contingency arrangement with banks. Their assets should also be fully marked to market. In addition, it is important to support the development of the secondary market by rationalizing bond issuances and expanding the range of assets that banks can use to meet the Central Bank of Albania's (BOA) liquidity requirement by including all tradable government securities with longer maturities and, similarly, expanding the range of collateral accepted in BOA operations.

- *Address the risks of the pervasive use of the euro*. While a meaningful decrease in euro use might not be feasible given the strong links to the Euro area, prudential rules should better reflect related vulnerabilities, which focus around credit risk. In particular, to mitigate risks and internalize the costs of euro use, the authorities should increase minimum loan-to-value ratios for loans in foreign currency and implement a higher liquidity requirement on foreign currency deposits relative to that applied to lek deposits.

- *Improve the supervision of non-banks*. The authorities are urged to undertake a major reform of the AFSA to ensure its financial and operational independence and turn it into an effective regulator of the investment and pension funds, and the flagging insurance market.

While the framework for micro- and macroprudential policy has improved significantly since the last FSAP, it needs further refinement. Banking supervision should be strengthened by enhancing risk-based supervision (including by more intrusively assessing credit risk management in banks), expanding consolidated supervision, formalizing cooperation with home supervisors, increasing supervision staff and enhancing their legal protection. The role of the Financial Stability Advisory Group (FSAG) in macroprudential oversight could be enhanced by focusing its mandate and making some operational changes. The BOA has used macroprudential tools to manage the credit cycle, but should remain cognizant that using prudential tools to boost credit has risks to financial stability and that their impact is likely limited due to the difficulty of effectively targeting these measures.

The financial sector safety net and crisis preparedness and management frameworks are generally sound, but could use further strengthening. While the deposit insurance system is largely based on modern principles, amending the Law of the ADIA would help ensure that the agency has greater autonomy in its operations and investments and that its current and former staff has full legal protection. In addition, the bank resolution framework could be strengthened by developing cooperative resolution strategies and agreements among home and host supervisors. Also, the crisis preparedness and management framework could be enhanced by updating detailed contingency plans by all FSAG members, strengthening the existing legal framework to enable extraordinary actions in a crisis**,** and developing a clear communication strategy.

High priority recommendations are shown in Table 1. The status of implementation of recommendations from the 2005 FSAP is given in Appendix I.

Table 1. Albania: FSAP Update—High Priority Recommendations[1]

Recommendations	Term	Institution
Bank Supervision and Regulation and NPL issues		
Encourage prompt clean up of banks' balance sheets (Box 1).	ST/MT	BOA/MOF
Work with banks to improve bottom up stress tests (¶20).	LT	BOA/MOF
Enhance consolidated supervision (¶30, bullet 1).	ST	BOA/AFSA
Formalize cooperation with relevant foreign bank supervisors (¶30, bullet 2).	MT	BOA/MOF
Strengthen risk-based supervision and amend SOP (¶30, bullet 3).	LT	BOA
Improve the effectiveness of the internal audit function in banks (¶30, bullet 4).	LT	BOA
Enhance legal protection for supervisors and fill authorized staff positions in banking supervision (¶30, bullet 5).	ST	BOA
Strengthen supervision of credit policies and underwriting standards (¶30, bullet 6).	ST	BOA
Initiate an asset quality review in banks (¶30, bullet 6).	ST	BOA
Systemic Liquidity and Market Operations		
Expand collateral eligibility in domestic operations to include all Albanian government lek securities (¶9, bullet 2).	MT	BOA
Develop the collateralized money market, including by encouraging use of standard MRA (¶9, bullet 3).	MT	BOA
Differentiate the liquidity requirement on foreign currency deposits from that on lek deposits (¶9, bullet 4).	ST	BOA/AFSA
Government Securities Market		
Separate the BOA allocation from the portion that is offered to the market and reduce the proportion allocated on a non-competitive basis in primary auctions (¶9, bullet 5).	ST	MOF
Assess market readiness for implementation of a primary dealer system (¶9, bullet 5).	MT	MOF
Strengthen the cash forecasting and cash management function within the General Directorate of Treasury (¶9, bullet 6).	MT	GDT
Assure institutional arrangements and staff resources are compatible with the formulation of a Debt Management Strategy and management of public debt (¶9, bullet 6).	ST	MOF
Macroprudential Framework		
Intensify supervision for systemic banks, and if necessary, introduce systemic capital surcharges (¶28).	MT	BOA
Safety Net and Crisis Preparedness and Management		
Bank Resolution: Develop cooperative resolution strategies and agreements among home and host authorities (¶37).	MT	BOA
Deposit Insurance: Determine which SCAs can become ADIA members; amend ADIA law, provide pledged government resources for a deposit insurance fund for SCAs (¶39).	ST	BOA/ADIA /MOF
Crisis Preparedness: Obtain, to the extent possible, support letters from mother banks agreeing to provide liquidity and solvency support to their subsidiaries (¶40, bullet 1).	MT	BOA
Crisis Management: Establish a framework for extraordinary actions in crisis (¶40, bullet 3).	MT	FSAG
Financial Supervisory Authority and Investment Funds		
Amend the regulatory framework for investment funds, including by establishing minimum liquidity and capital standards and a methodology for unit valuation (¶9, bullet 1).	ST	AFSA
Amend AFSA Law to improve operational independence (¶33).	ST	AFSA/MOF

[1] Term refers to the expected time of completion, with short-term (ST) referring to 1 year, medium-term (MT) to 1-3 years, and long-term (LT) to more than 3 years.

BACKGROUND

A. Financial Sector Structure

1. The financial sector in Albania is concentrated and dominated by foreign banks. Banks represent over 90 percent of total financial system assets, equivalent to about 90 percent of GDP in 2012. The largest five banks hold about three-quarters of system assets and deposits (Table 2). Subsidiaries of foreign banks (which include four of the top five banks, including from Austria, Greece, Italy, and Turkey) represent about 90 percent of total banking sector assets (Figure 1).

2. Bank credit is concentrated in the corporate sector, which owes about three-quarters of the value of all loans. Real estate loans account for about 40 percent of total loans, and overdrafts, equipment purchase, and working capital represented about 25 percent, 17 percent, and 13 percent, respectively, at end-September 2013. The share of credit to Small and Medium-sized Enterprises (SMEs) in total loans was 27 percent in September 2013 (down from 37 percent in 2007).

3. The remainder of the financial system is small (6 percent of financial system assets). As of mid-2013, it included 11 insurance companies, 2 investment funds, 124 Savings and Credit Associations (SCAs) in 2 unions, 2 independent SCAs, 3 pension funds, and 21 other non-bank (that is, non-deposit-taking) financial institutions (NBFIs):

- *Insurance companies.* Albania has one of the smallest insurance markets in Europe, with assets of around 1½ percent of total financial system assets. Its development has been hindered by several factors, including lax insurance regulation, low disposable incomes, and a poor record of claims performance

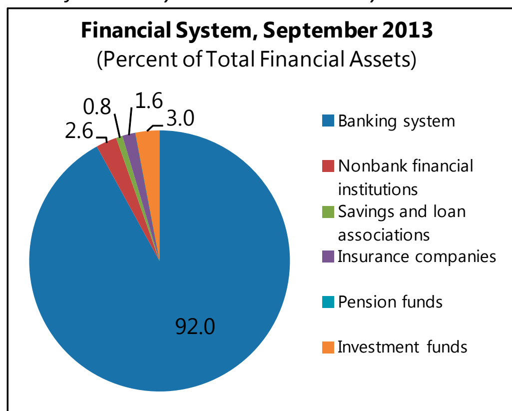
- *Investment funds.* The first fund began operations in 2012 when the Albanian subsidiary of Raiffeisen bank established an investment fund. The timing coincided with the decision of Raiffeisen decision to scale back its participation in the public debt market to limit its exposure to the Albanian sovereign. A second fund was added later. The total net-asset value of the two funds was €316.7 million as of October 2013. There are more than 22,000 investors (mostly individuals).

- *SCAs*. SCAs hold less than 1 percent of financial system assets. There are two unions (with 124 member SCAs) and two independent SCAs. One-third of the unions' assets are invested in bank shares and treasury bills. SCAs lend mostly to members, generally in the agricultural sector.

Figure 1. Financial Sector Overview

The financial sector in Albania is concentrated and dominated by foreign banks.

The financial system is dominated by banks...



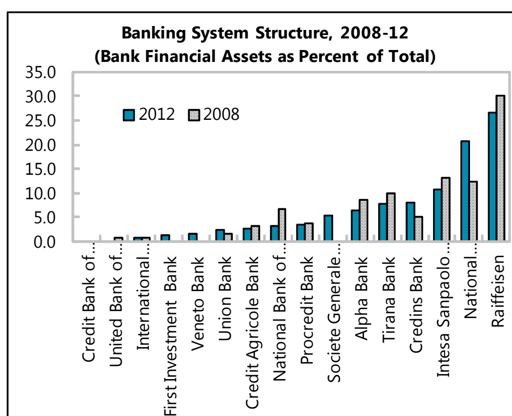
...which have been growing since 2005.

Evolution of the Financial System
(Percent of GDP)

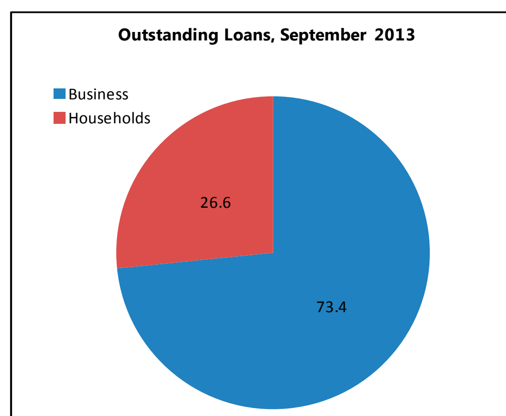
	2005	Sept. 2013
Banking system	75.9	90.8
Nonbank financial institution	1.5	2.5
Savings and loan association:	0.6	0.8
Insurance companies	1.4	1.6
Pension funds	-	-
Investment funds	-	3.0

Source: Bank of Albania

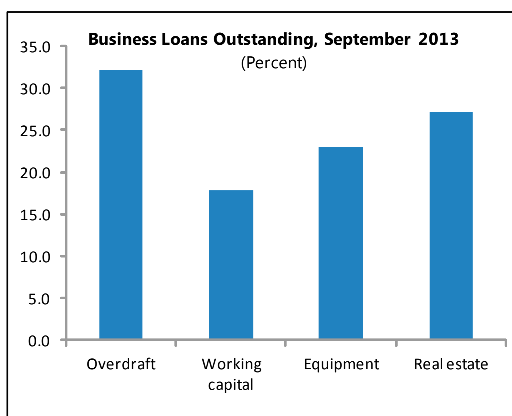
The banking system is primarily foreign owned...



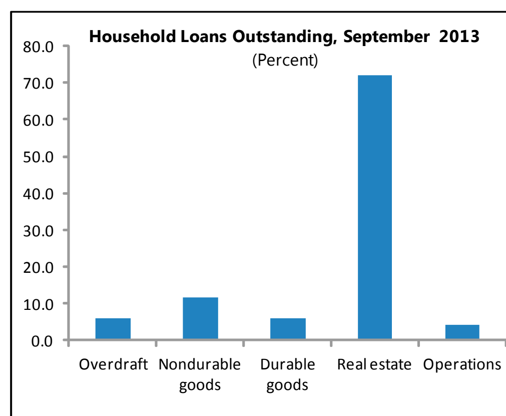
...and credit is concentrated in the corporate sector



While business loans are evenly distributed...



...household loans are skewed towards real estate.



Source: Bank of Albania and IMF staff estimates

- *Pension funds*. The voluntary private pension market ('third pillar') holds less than 0.1 percent of financial system assets and aims at supplementing pensions offered under the government's obligatory scheme.[2] There were only three pension funds operating at end-September 2013, with a net asset value of about US$3.4 million and a total membership of 7,784.

- *Nonbank Financial Institutions (NBFIs)*. These hold 2.6 percent of financial system assets and comprise mainly non-deposit-taking lending institutions and leasing, with a share of 43 percent and 27 percent, respectively. Other institutions undertake money transfers services and factoring.

B. Macroeconomic Performance and Risks

4. Albania weathered the 2008 global financial crisis relatively well, but the economy is weak and macroeconomic imbalances are large. Real GDP growth is estimated at only 0.7 percent in 2013 (Table 3), and is operating well below its potential (the economy fell below potential in 2012 and the output gap is estimated to have increased in 2013). The external current account deficit remains high, mostly reflecting persistent fiscal deficits, Foreign Direct Investment (FDI) related imports and—to some extent—worsening terms of trade. Also, the situation in the euro-zone has weighed on Albania given close export, banking, and migration links. Policy buffers are depleted, with the public debt-to-GDP ratio estimated at 71 percent in 2013 (including government domestic payment arrears and guarantees), with a large share short-term. The economic policies of the new government, for which the authorities are requesting the support of a Fund program, will begin to tackle these vulnerabilities.

5. In addition, the financial sector operates in an uncertain global macroeconomic and financial environment and faces several risks (Appendix II):

- *Surges in global financial market volatility,* associated with the exit from unconventional monetary policies could lead to depreciation pressures and/or increases in domestic interest rates, exposing banks to credit and market risks. While the large current account deficit is mostly financed by foreign direct investment and official loans, funding pressures associated with global market volatility could also complicate the rollover of the outstanding Eurobond.

- *Re-emergence of financial stress in the euro area* could increase deleveraging pressures. Subsidiaries of affected banks could be forced to cut back lending. If liquidity pressures emerge, the capacity of the BOA to act as a lender of last resort in foreign currency is limited.

- *A deterioration in domestic market sentiment* could trigger significant stress given the strong financial linkages between the sovereign, the banking sector, and the emerging investment fund sector (¶8). If existing macroeconomic imbalances and fiscal pressures are not addressed with determination, the sovereign could lose market access, leading to a sharp depreciation of the

[2] The public pension scheme ('first pillar') is a mandatory pay-as- you-go system with universal coverage.

lek, threatening the solvency of banks. Alternatively, liquidity pressures in investment funds could lead to a run from government bonds, also undermining the government's financing needs. Resulting higher interest rates would impart substantial mark-to-market losses on banks given their large holdings of government bonds. Government payment arrears could also increase further, leading to additional increases in NPLs for borrowers with exposure to the government.

- *A protracted period of slower growth in advanced and emerging economies*. The economy could remain weak as a result of weak growth in European trading partners (through declines in trade and remittances) or weak implementation of domestic reforms. NPLs could increase further, requiring additional provisioning and adversely affecting bank profitability. If this threatens Albanian banks' capitalization and foreign parents cannot (or will not) provide additional capital, banks may be forced to deleverage, hurting the economic recovery.

SOUNDNESS OF THE BANKING SECTOR

A. Vulnerabilities

6. Several features of the banking sector increase its vulnerability to shocks (Figure 2 and Table 4):

- *Low bank profitability and rapidly rising NPLs*. The NPL ratio has increased from 3.4 percent at end-2007 to more than 24 percent in September 2013 (or 9.1 percent net of provisions) (Figure 3). This reflects economic weakness and government arrears (recently estimated at more than 5 percent of GDP),[3] but also the consequences of a lending boom prior to the global financial crisis, when deficiencies in supervision allowed underwriting standards to weaken. The credit cycle has now moved into a downturn and repair stage (Figure 4). While these risks are mitigated somewhat by solvency ratios that are above international norms, and domestic provisioning rules are stringent, net NPLs still amount to 55 percent of bank capital.[4] In addition, bank profitability has declined sharply and turned negative in September 2013 (-1.7 percent), eroding buffers that had previously supported loan provisioning.

- *High financial euroization.* Although net open positions in the euro are small, risks include: (i) half of loans in foreign currency are to unhedged borrowers; (ii) there are large maturity mismatches; and (iii) credit risk for euro loans may be underpriced, as indirect exchange rate risk may be difficult to measure. In addition, a sudden stop in FDI would directly affect systemic liquidity in Euros and the BOA has a limited capacity to act as a lender of last resort in foreign currency.

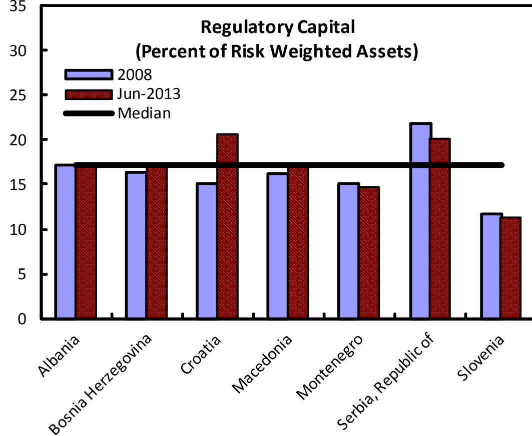
[3] The BOA has estimated that government arrears may have contributed 5-6 percentage points to the NPL ratio.

[4] While most lending is secured by collateral, the BOA does not allow this value to be subtracted from loan-loss provisions for prudential purposes. Total provisions represented 62.3 percent of NPLs at end-September 2013.

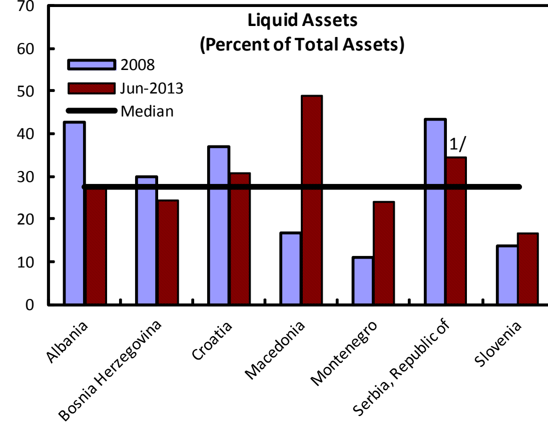
Figure 2. Banking Sector Indicators

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

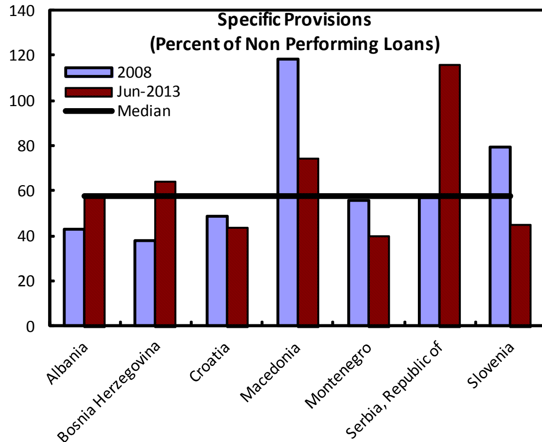
The banking system remains well capitalized...



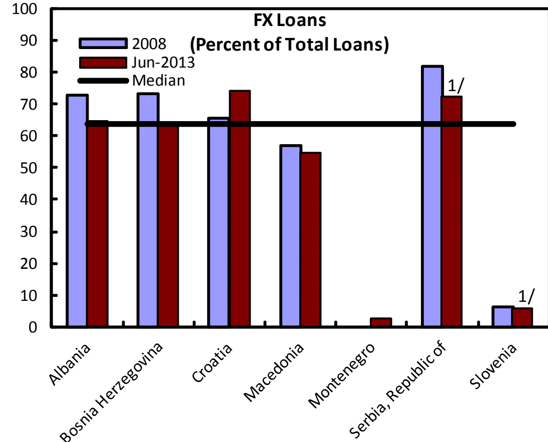
...liquid...



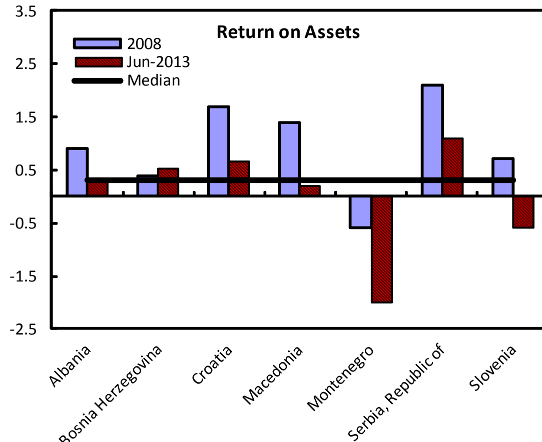
...and provisioning appears to be adequate.



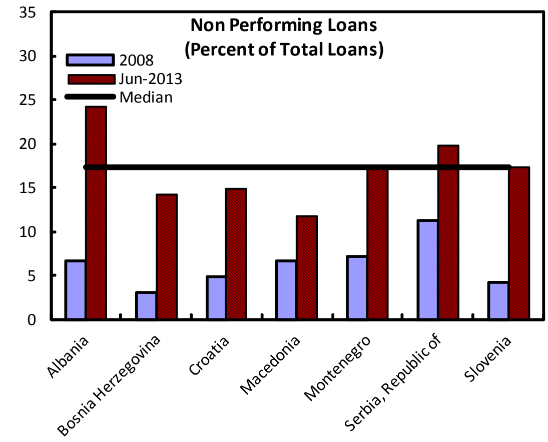
However, financial euroization is high [2]...



...profitability is low...



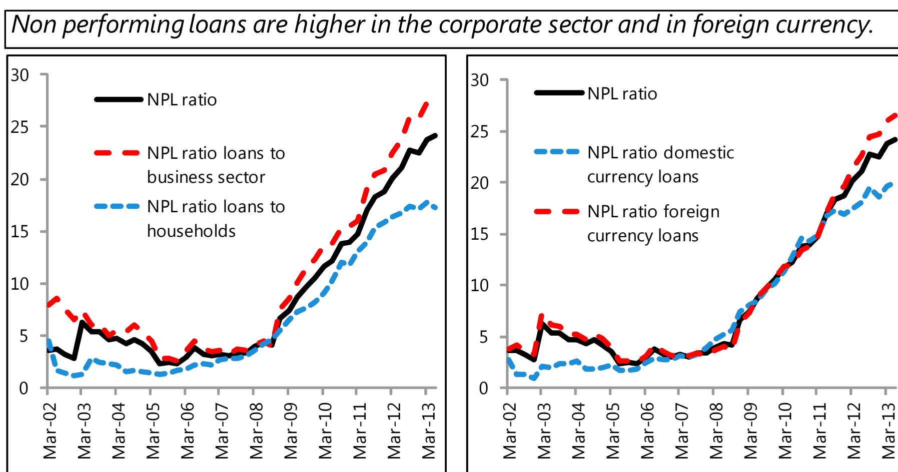
...and non-performing loans are the highest in the region.



Source: IMF staff reports and FSI database.
1/ Data refers to December 2012.
2/ The Euro is the domestic currency in Montenegro and Slovenia.

Figure 3. Developments in Nonperforming Loans

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



Source: Albanian authorities and IMF staff calculations.

- *Strong systemic links between investment funds, banks, and the sovereign.* One-third of bank assets consist of government securities, and these holdings represent two-thirds of total government debt.[5] This financial interdependence represents systemic risks for banks, which are vulnerable to changes in the value of longer-term debt securities, and for the government, which depends on regular rollover of debt by banks. In addition, investment funds, which hold mostly illiquid government bonds, present a systemic liquidity risk that affects banks (¶8).

- *A significant foreign bank presence.* Financial difficulties in parent cou*ntries can affect Albanian institutio*ns 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, deleveraging pressures may nevertheless continue (Figure 5).[6]

B. Systemic Liquidity and Market Operations

7. Monetary policy is governed by an inflation-targeting framework. The BOA uses a mid-corridor approach to implement monetary policy, and holds weekly repo operations for which treasury bills and bonds with remaining maturity of one year or less are eligible. The exchange system was significantly liberalized in 2009. The BOA has a clearly articulated intervention policy and has not transacted to affect the exchange rate since 2009. The BOA requires the Government to meet its own foreign currency requirements and coordinates closely to prevent market instability. Banks are generally liquid and must hold liquid assets (which exclude some Government securities),

---

[5] Albania government debt in Lek and foreign currency has a risk weight of zero and 100 percent, respectively.

[6] This measure benefited financial stability by establishing prudential limits on capital adequacy and liquidity at the level of the subsidiary. Deleveraging can nevertheless continue through shrinking loan books and balance sheets.

covering 15 percent of short-term liabilities in each currency with an aggregate requirement of 20 percent (Figure 6).[7]

8. Potential systemic liquidity risks arise from illiquid markets, high levels of euroization, the operations of investment funds and public debt management. Specific risks are:

- *Investment funds*. These funds have helped diversify the ownership of government securities, thus lessening the risk associated with the bank-sovereign links. However, systemic risk in the financial system may have increased partly because these funds are inadequately supervised and regulated. The funds invest mostly in longer-dated securities and their clients appear to consider the funds as substitutes for bank accounts. Accordingly, and given the lack of a secondary market, the funds face high liquidity risk. Moreover, their close links with banks means that redemption pressures could spill over into deposit runs on banks. These risks are exacerbated by a lack of clarity on the funds' liquidity policy and the methodology for establishing unit values.[8]

- *Illiquid lek money markets.* Banks face liquidity management constraints because of shallow and illiquid lek markets. Activity is concentrated in the interbank overnight and 7-day segments for unsecured funds. The volume of transactions on a collateralized basis is small largely because of: (i) the lack of a standard framework for conducting repo transactions (encompassing the use of Master Repurchase Agreements (MRA)); and; (ii) risks in the payments and securities settlement process (there is no simultaneous delivery of securities and payment).

- *Euroization.* Banks manage their short-term foreign currency liquidity primarily through their parents and correspondent banks as the BOA does not offer foreign currency standing facilities. The BOA has announced an Emergency Liquidity Assistance (ELA) facility which is (conditionally) available on similar terms in lek and foreign currency (¶35). However, the BOA has limited ability to provide foreign currency.

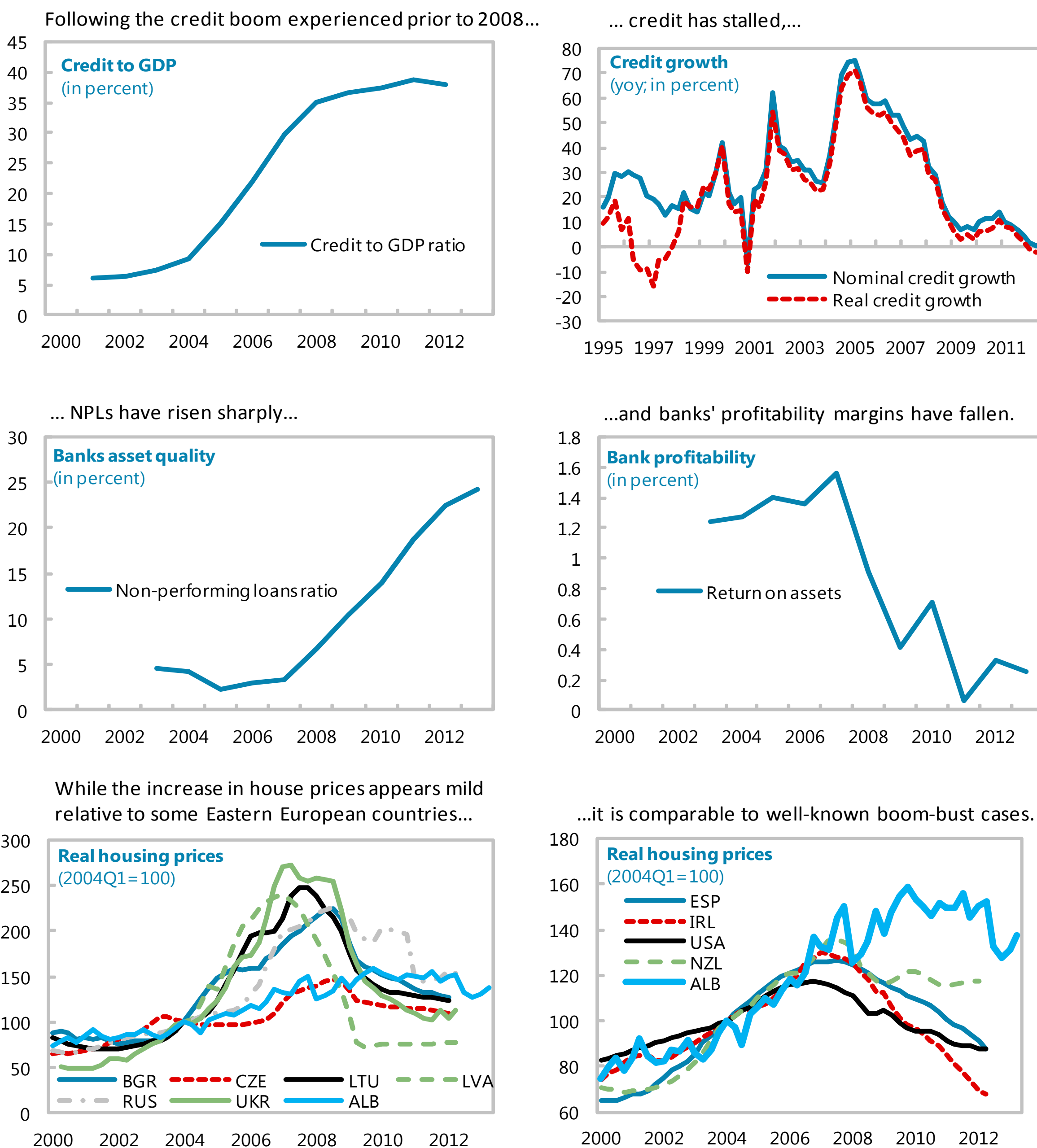
- *Public debt management challenges and imperfect markets for government securities.* Volatile treasury balances and antiquated management systems pose significant challenges to public debt management. Price signals in the primary market are undermined by the significant participation of the BOA and retail investors on a non-competitive basis whose bids are filled first—and often leaving few competitive bids upon which the price is set. There is almost no activity in the secondary market primarily because of a narrow investor base and an abundance of liquidity, thus undermining incentives for active management. Consequently, participants cannot use government securities to manage their liquidity positions. In addition, the relatively high public debt management capacity is now being threatened by widespread reduction of staff in the public sector.

[7] The requirement was recently lowered from 20 percent per currency and 25 percent overall to stimulate credit.

[8] Around half of the major Lek fund is currently valued on a hold-to-maturity basis. This could result in redemption pressures when interest rates rise and unit holders recognize that the fall in the unit price is less than the fall in the value of the underlying assets of the fund.

Figure 4. The Credit Cycle

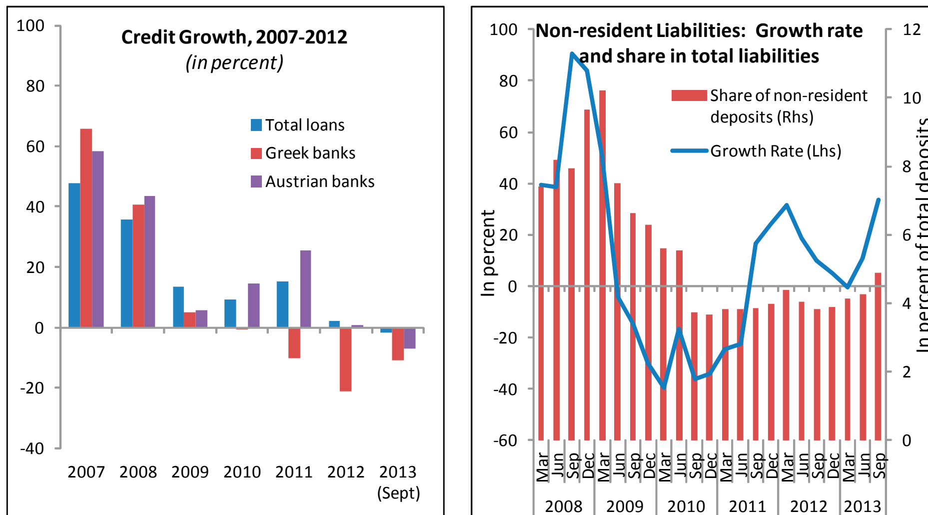
The credit cycle in Albania has entered a *downturn and repair* stage, and real estate prices have increased significantly.



Source: BoA, OECD, WEO database and IMF staff calculations.

Figure 5. Deleveraging Pressures in Foreign-Owned Banks

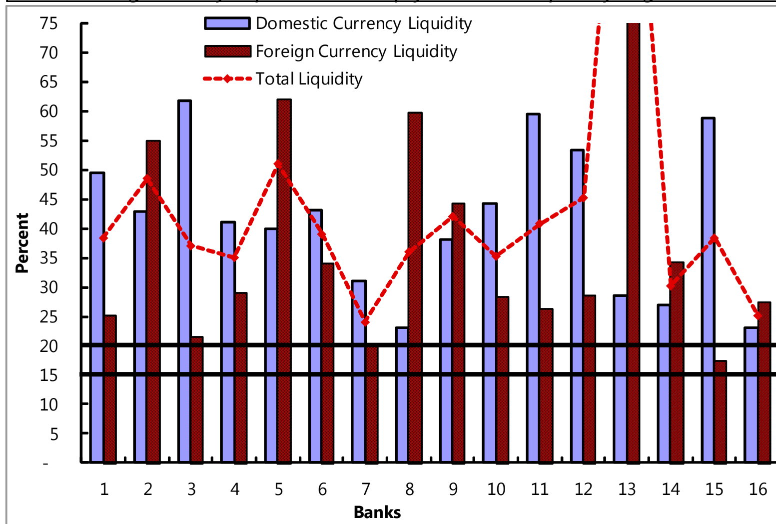
Key subsidiaries of foreign banks have cut lending since 2010 and, while a relatively small source of funding, banks' liabilities to non-residents fell at the height of the crisis.



Source: Albanian authorities and IMF staff calculations.

Figure 6. Compliance with Liquidity Regulations by Banks, end-August 2013

Banks are generally liquid and comply with the liquidity regulations.



Source: Bank of Albania

9. Several measures can be adopted to mitigate these risks. These include:

- *Strengthening the regulatory framework for investment funds.* The regulatory framework for investment funds should be amended to: (i) require that the calculation of the unit value represent the proportionate share of the aggregate market value of the underlying assets of the fund;[9] (ii) introduce capital adequacy requirements aligned with relevant E.U. regulations; (iii) introduce liquidity requirements consistent with recent E.U. regulatory developments and the current level of development of the Albanian market; and (iv) ensure that investment funds have adequate liquidity contingency arrangements in place with banks.[10] In addition, investment funds should be required to prominently disclose to their clients that investment fund units are not insured by the ADIA.

- *Enhancing the operational framework for monetary policy.* Expanding collateral eligibility to include all tradable Albanian government treasury securities (using an appropriate schedule of haircuts based on the maturity of these securities and consistent with the BOA's risk tolerance) would provide the BOA with greater flexibility to influence liquidity conditions. It could also serve to discourage the use of the euro if it expands lek liquidity. In addition, the liquidity requirement should be used primarily to manage prudential risks (rather than for macroeconomic management).

- *Developing the collateralized money market.* The operational framework for repo transactions could be strengthened further by market-wide adoption of a standard MRA. The BOA should limit its own liquidity-injecting operations to deal only with banks that have executed the MRA with the BOA, while encouraging all banks also to execute the document bilaterally. The expected implementation by mid-2014 of a central securities depository interfaced with the real-time payments system will help eliminate settlement risks on securities transactions. Furthermore, the BOA is considering a market structure—the *Interbank Collateralized Market Platform*—that mitigates concerns about counterparty risk by pooling collateral so that lenders are not exposed to a single borrower. This initiative is encouraged, but the BOA should ensure that it does not bear financial risks arising from transactions between private counterparties.

- *Internalizing the higher liquidity cost of using foreign currency*. In order for the BOA to serve as a lender of last resort in foreign currency, it has to hold foreign reserves, which is costly. To internalize these costs to banks, the foreign currency liquidity requirement should be set higher

[9] Mark-to-market valuations are challenging where secondary markets are not active. Therefore, to determine valuations, estimates of the yield will need to be derived from most recent auction outcomes. Also, an independent body should publish rates for all government securities on a regular basis.

[10] Providing a liquidity backstop through banks will limit the liquidity risk for investment funds and possible spillover of redemption pressures to banks in a system where the BOA cannot directly provide liquidity to these funds. With investment funds unlevered and the risks for banks mitigated through full collateralization with conservative haircuts, the associated financial stability risks of these arrangements are limited.

than that for lek. To avoid increasing the aggregate liquidity requirement, this could be achieved by a reduction in the lek requirement and an increase in the foreign currency requirement.[11]

- *Enhancing the markets for government securities.* The transmission of price signals in the primary market would be improved by: (i) separating the BOA allocation from the portion to be raised from the market; and (ii) reducing significantly the amount allocated on a non-competitive basis to retail investors. Moreover, retail investors should gradually be restricted from placing direct bids and, ultimately, all retail participation should be facilitated through intermediaries selected through a competitive process, with such intermediaries effectively supervised (which requires a strengthening of AFSA, ¶32-33). Secondary market development would be supported by (i) rationalizing the bond issuance program (focusing on key maturities on the yield curve) and (ii) expanding the range of assets eligible for satisfying the BOA's liquidity requirement and for collateral in BOA operations to include all tradable government securities (as the authorities are considering in the context of adopting the Basle III liquidity coverage ratio). A primary dealer arrangement should be considered as market developments warrant over the medium term.

- *Strengthening public debt management.* To that end, it is important to enhance cash forecasting and cash management (including by establishing higher minimum cash buffers in the Treasury account), upgrade management systems and ensure that staff reductions in the public sector do not undermine the capacity for debt management within the General Directorate of Treasury.

C. Resilience of Banks: Stress Tests

10. Given these vulnerabilities, the mission conducted stress tests to assess the resilience of the banking system to specific solvency, liquidity, and contagion risks (Appendix III).

Solvency Risk

11. Even in the benign baseline projections, some banks suffer a deterioration in their capital positions. This is a result of previously nonperforming loans deteriorating further in quality (requiring further provisions). Especially in banks that have seen recent declines in profitability, these provisions cannot be fully paid out of profits, leading to a deterioration of capital.

[11] The broadening of the lek asset eligibility (recommended below) will effectively lower the liquidity requirement; this could be taken into account in setting the new differentiated lek and foreign currency requirements.

12. Stress tests suggest that banks are vulnerable to *extreme* but *plausible* adverse macroeconomic scenarios. Two adverse scenarios are characterized by a cumulative decline of GDP of two standard deviations (12.3 percentage points) relative to the baseline over two years: (i) a U-shaped recession characterized by negative growth of 3.9 percent and 3.2 percent in 2014 and 2015, respectively; and (ii) a V-shaped severe recession, with a decline in GDP of 6.9 percentage points in 2014 followed by no growth in 2015.[12] The results indicate that (Figure 7):

The stress tests are based on extreme but plausible adverse scenarios

	Est. 2013	Projections 2014	2015
Real GDP growth			
Baseline	1.7	2.3	3.0
Adverse (U)	1.7	-3.9	-3.2
Adverse (V)	1.7	-6.9	0.0
Exchange rate (lek per euro), y-o-y change			
Baseline	1.4	2.0	1.6
Adverse (U)	1.4	20.0	15.0
Adverse (V)	1.4	30.0	5.0
Nominal interest rate (12 month T-bill)			
Baseline	5.8	6.1	7.3
Adverse (U)	5.8	14.1	12.3
Adverse (V)	5.8	15.1	9.3
GDP deflator, y-o-y change			
Baseline	2.5	2.7	3.1
Adverse (U)	2.5	1.7	1.4
Adverse (V)	2.5	0.8	2.5

Source: IMF Staff estimates
Note: scenarios are based on estimates and projections from the third quarter of 2013.

- *While several banks would become undercapitalized, the recapitalization need is not large*. In the U-shaped scenario, 6 banks with 21 percent of banking system's assets become undercapitalized, and in the more severe V-shaped scenario, 10 banks (with 78 percent of banking assets) face capital shortfalls. The overall estimated shortfall (relative to a 12 percent capital adequacy threshold for all banks) is small in both cases: 0.5 percentage points and 1.5 percentage points of 2013 GDP for the U-shaped and V-shaped recessions, respectively.[13]

- *Credit risk is a main vulnerability.* For loans in foreign currency, a depreciation and a decline in growth lead to a sharp increase in NPLs; for loans in domestic currency the main effect comes from lower growth (and to a lesser extent from higher domestic interest rates) (Figure 8).[14] Bank loan loss provisions rise with higher NPL ratios, with negative effects on profitability.[15]

[12] These scenarios reflect downside external risks and a domestic credit supply shock. Although the scenarios could be considered extreme given that Albania has recorded only positive growth rates during the last 15 years, the magnitude is standard for FSAP stress tests. The stress tests did not quantify the second-round effects of how adverse developments in the banking system would impact the macroeconomic situation. However, international experience indicates that if banks are under stress (for example because of undercapitalization) private credit could slow further, dampening economic growth, and weakening fiscal revenues.

[13] There is a significant dispersion in banks' performance in the adverse scenarios and several banks maintain CARs over 20 percent. This is explained by the significant variation in asset portfolios and relative exposures to credit, market, and sovereign risks across banks.

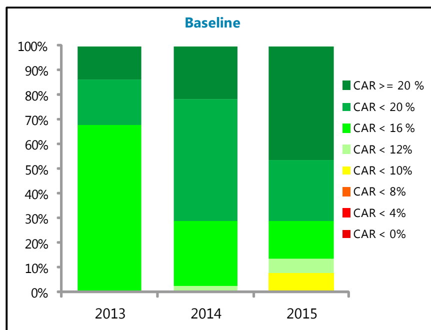
[14] NPLs decline in 2015 in the V-shaped scenario because the decline in GDP is arrested, the exchange rate depreciation is limited, and interest rates decline. These developments lead to an improvement of loan quality compared to 2014.

[15] However, direct market gains associated with positive net foreign exchange positions partially safeguard banks against the (indirect) credit losses induced by lek-depreciation.

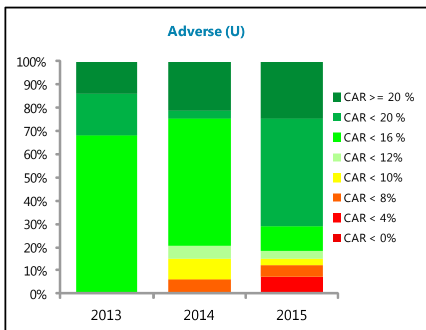
Figure 7. Results of the Stress Tests: Distribution of Banking Assets by Bank Capitalization
(in percent of total banking system assets)

The financial system is stable, but banks are vulnerable to shocks.

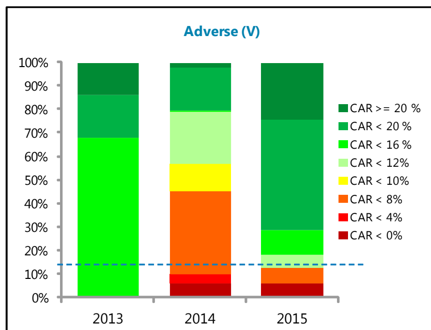
While in the baseline scenario most banks are well capitalized…



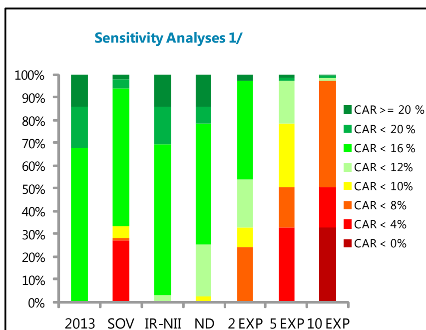
…in the U-shaped scenario, several banks became undercapitalized.



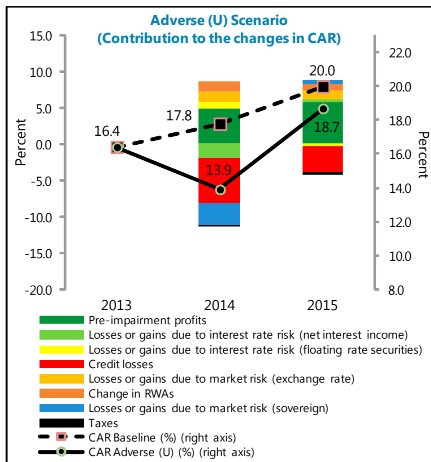
…and the same happens under the V-shaped scenario.



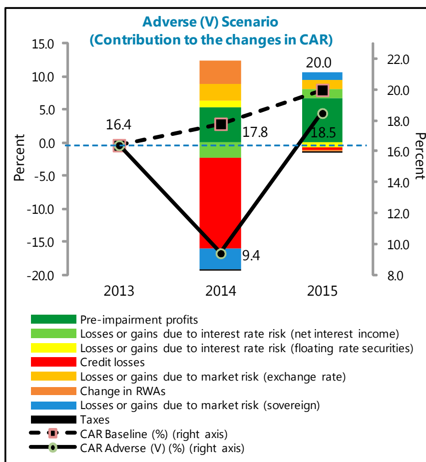
These results are confirmed by sensitivity tests.



Credit risk is a main vulnerability in the U-shaped scenario…



…and in the V-shaped scenario.

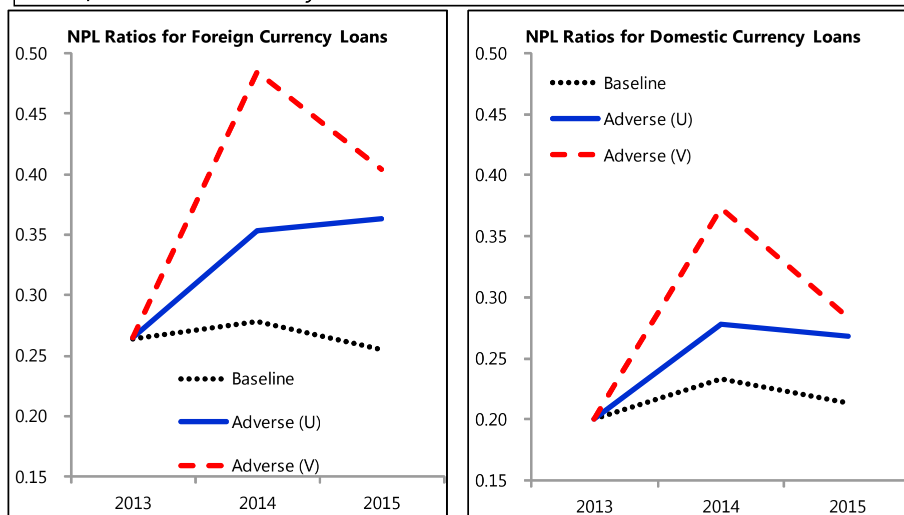


1/ Note: SOV = increase in sovereign bond yields (20 percent haircut); IR-NII = increase in interest rates (500 bps), effect on net interest income; ND = nominal depreciation (30 percent), effect on NPL ratios; 2 EXP = failure of largest 2 exposures; 5 EXP = failure of largest 5 exposures; 10 EXP = failure of largest 10 exposures.

Source: IMF staff estimates

Figure 8. Nonperforming Loans Under Extreme Adverse Scenarios

Under the adverse scenarios, NPL ratios for foreign currency loans increase more than for domestic currency loans.



Source: IMF staff estimates

- *Banks are highly exposed to domestic sovereign risk.* Bank losses from sovereign debt re-pricing (market risk) would be sizable and pose systemic risks. In the adverse macroeconomic scenarios, the duration-adjusted haircuts applied to all the government securities held in the trading and banking books—excluding Treasury bills and floating rate instruments—cause losses equivalent to 8 percent of the initial valuations, with significant impact on bank capitalization.[16]

13. Sensitivity tests largely confirm these results. The tests suggest that 6 of the 16 banks, representing 25 percent of the system's assets, would be undercapitalized after a 30 percent depreciation of the lek. The sensitivity tests also show that credit risk is exacerbated by the high concentration of loan portfolios, with strong effects from default of banks' largest borrowers.

Liquidity Risk

14. Liquidity stress tests reveal that banks could handle large deposit withdrawals.[17] The results of the tests in domestic currency revealed that, with the exception of a small institution, all banks could confront persistent and sizable withdrawals of funding without ELA from the BOA.[18] The

[16] The losses are calculated based on the value of the stressed portfolio. The losses are equivalent to 4.3 percent when compared to the overall securities portfolio (including Treasury bills and floating rate instruments).

[17] Cash flow-based liquidity stress tests assessed resilience to strong shocks characterized by run-off rates on funding sources calibrated by type, with haircuts on assets. The tests were currency-specific, but a supplementary test also combined cash flows in all foreign currencies. The structure of contractual maturities and run-off rates resulted in deposit withdrawals equivalent to 18 percent of the initial stock within the first six months.

[18] A complication arises due to the limited secondary market for sovereign securities. The tests allowed banks to obtain liquidity from the standard BOA lending facility by using their sovereign securities as collateral (with prevailing

(continued)

tests in foreign currency also revealed that in case of stress, only one small bank would need BOA support at a one week horizon; two banks (accounting for less than 5 percent of the system's assets) would need BOA support at a two-month horizon.

Contagion Risk

15. Direct contagion risk through bilateral domestic interbank exposures is limited. As domestic banks are highly liquid, their reliance on interbank transactions is small. Indeed, for every bank in the system, the sum of all its domestic interbank exposures is smaller than its regulatory capital. Hence, no single failure of domestic banks would trigger knock-on failures in the rest of the system. As of June 2013, however, a failure of domestic banks could result in undercapitalization of other domestic banks because 5 of the 16 banks had total domestic interbank exposures that were larger than their excess of capital over the required minimum (assumed at 12 percent for all banks). Bilateral exposures to foreign banks tend to be larger and highly concentrated and failure of the largest foreign counterpart would cause undercapitalization in 9 banks.

Policy recommendations

16. Specific vulnerabilities in banks should be addressed. The BOA is encouraged to engage each bank with their individual stress test results and require them to adopt mitigation measures, improve risk management in the areas that show specific vulnerability, monitor progress and adopt enforcement measures if necessary. This is especially important for banks that are most affected in the stress test scenarios, which tend to be those that suffer from weak underlying profitability and have high initial NPL ratios, a large share of loans in foreign currency, and a large share of longer-dated fixed-coupon government bonds. For banks that become undercapitalized in the baseline scenario, the authorities could require capital injections to cover the shortfall (estimated at about 0.1 percent of GDP). For those banks that are initially well capitalized but become undercapitalized in the adverse scenarios, the authorities could consider requiring a strengthening of their capital buffers to cover the shortfalls (estimated at about 1.5 percent of GDP, ¶12).

17. Risk to banks of lending in foreign currency should be mitigated through appropriate pricing mechanisms. Risk to borrowers without foreign-currency income can be internalized by requiring more conservative loan-to-value and debt-to-income ratios. In addition, banks could also be required to hold additional capital for exposures arising from foreign currency lending to such unhedged borrowers.[19] Robust consumer education and protection to make borrowers fully aware of the associated risks is also important.

18. The rising trend of NPLs has to be tackled decisively. Addressing remaining weakness in bank supervision will help ensure the good quality of new loans (¶30). Also, while the authorities are

haircuts). It was assumed that ELA would not be necessary until they run out of eligible collateral to access the standard facility.

[19] Calibration of additional capital requirements should be based on an analysis of the historical performance of NPL ratios and loan loss provisioning rates of foreign currency loans compared to those of domestic currency loans.

taking steps to deal with the stock of bad loans, partly with technical assistance by the World Bank, additional measures are needed to encourage the cleanup of banks' balance sheets, including by clarifying tax rules that are preventing banks from writing off loans, adopting measures to facilitate NPL sales, and accelerating insolvency reforms (see Box 1).

19. Developments in real estate deserve close monitoring. While there has been some downward movement in house prices (for example in the real-estate index for Tirana), the increase experienced during the last decade shows similarities with well-known boom-bust cases (see Figure 4).[20] Careful monitoring of developments in real estate will therefore be key, especially given that banks' exposures to the sector are significant (residential mortgages and construction loans account for 30 percent of portfolios). As collateral execution begins to pick up, a large amount of properties could come into the market, putting pressure on prices.

20. The BOA should encourage further refinement of banks' stress testing methodologies. The results from the tests conducted by banks show significant differences with the tests conducted by the BOA and IMF staff. Although the bottom-up stress testing methodology developed by the BOA is robust, it presumes that banks use sound models to project credit and profit losses under adverse scenarios. However, banks appear to use mainly expert judgment to undertake stress tests and often appear to fail to incorporate the shocks embedded in the macroeconomic scenarios.

FINANCIAL OVERSIGHT

21. BOA plays a central role in the oversight of the financial system. By law the BOA responsibilities include formulating and implementing monetary and exchange rate policy, managing international reserves, promoting a smooth operation of the payments system, and supervising the banking system, SCAs, and NBFIs. The Albanian Financial Regulatory Authority (AFSA) supervises insurance companies, pension and investments funds. A high-level Financial Stability Advisory Group (FSAG) became operational in 2012 and meets on a quarterly basis to monitor developments and risks to the financial system.

A. Macroprudential Oversight

Institutional setup

22. A macroprudential mandate for the BOA is found in existing legislation. The BOA Law mandates the BOA to secure the stability of the banking sector and report on a semi-annual basis to Parliament on risks to the financial system and propose ways to manage them. In addition, the Banking Law of 2011 mandates the BOA to take action to mitigate systemic risk.

[20] The empirical literature does not find significant differences in the boom and bust patterns (duration and magnitude) of real estate prices between advanced and emerging economies. However, country mortgage market characteristics appear to matter in terms of the economic consequences of a house bust. Relevant variables to characterize the mortgage market (e.g., loan to value ratios) are not available in Albania.

Box 1. Tackling Nonperforming Loans in Albania

The authorities are drawing from international best practice to support the mitigation of NPLs. Weaknesses in judicial enforcement and land registration, and a small secondary real estate market have made it difficult to execute collateral. Key changes to the Civil Procedure Code that became effective in October 2013 will help shorten and simplify collateral enforcement procedures. In addition, the authorities should:

- *Enhance supervision regarding NPL management by:* (i) amending the regulation on credit risk management to provide detailed requirements on minimum supervisory expectations for NPLs management; (ii) expanding governance requirements for credit risk and NPL management (e.g. banks could separate the credit risk underwriting and review functions, adopt early warning systems for credit risks, regularly monitor loan loss provisions, set and monitor collection goals and develop key performance indicators) ; and (iii) presenting granular prudential standards on NPL management and resolution.

- *Provide forward guidance on the use of sanctioning powers.* A clear regulatory framework would help minimize NPL misclassification errors and ensure a clear understanding of the criteria used to determine supervisory action. Establishing the criteria that the BOA uses when granting approvals to hold property provided as collateral could help prevent accumulation of property on banks' balance sheets.

The authorities are encouraged to adopt additional measures to clean up bank's balance sheets, including: (i) creating an interagency working group to clarify tax issues (and propose measures, if necessary) that are preventing banks to write-off loans (the BOA estimates that the NPL ratio could decline by 5–6 percentage points if the tax treatment of write-offs is resolved); (ii) issuing guidelines to facilitate NPL sales; and (iii) strengthening insolvency reforms, including ensuring that private bailiffs are paid on a negotiated or "success fee" basis. In addition, some articles of the Civil Code should be modified to further: (i) regulate courts' discretion to postpone payments owed to the creditor; and (ii) clarify priority ranking for mortgage claims.

In the medium term, the BOA can foster a robust and transparent accounting and auditing environment. The BOA could: (i) encourage stronger financial reporting practices by larger corporate borrowers; (ii) introduce more punitive risk weights for unaudited accounts submitted during the underwriting process; and (iii) adopt a prudential regulation requiring banks to consider only borrowers' official tax statements when underwriting loans.

23. The macroprudential role of the BOA is complemented by the inter-agency FSAG. The FSAG was established in 2006 as a consultative entity to assist in the coordination of policies and exchange of information regarding financial development, crisis prevention, and crisis management. Its meetings are attended by the Minister of Finance (chair), the BOA Governor, and the AFSA and ADIA Directors.

24. The role of the FSAG can be enhanced further by focusing its mandate and meeting more frequently. The FSAG should focus on systemically important financial institutions and risks, with its financial development mandate assigned to another body. The FSAG should meet on a quarterly basis, as mandated, and the BOA should assess regularly whether more frequent meetings are necessary given financial developments. It is also recommended that technical staff meet monthly. Meeting agendas and minutes are key to keep track and follow-up on important issues.

Systemic risk monitoring

25. The BOA has made significant progress developing tools to monitor the time and cross-sectional dimensions of systemic risk. The lack of market data is a challenge and the authorities should obtain other data for systemic risk monitoring, including a representative real-estate price, information on the loan-to-value ratios and debt-to-income ratios used by banks and data on bank and non-bank interlinkages.

Macroprudential tools

26. The BOA has used macroprudential tools to safeguard financial stability. In 2007 higher risk weights and stricter loan-to-value and debt-to-income ratios were placed on banks surpassing twin limits on the rate of credit growth and NPL levels. A second set of macroprudential policies was put in place in late 2011 to limit contagion risks and international spillovers: (i) foreign bank branches were converted into subsidiaries; (ii) liquidity regulations were tightened;[21] and (iii) the regulation on related-party exposure was enhanced.

27. The authorities should use caution when using prudential measures to attempt to stimulate credit, as the BOA did 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.[22] The use of prudential tools to boost credit carries potential risks to financial stability (which should be monitored) and their impact is likely to be limited due to the difficulty of effectively targeting

[21] The required ratio of liquid assets to short term liabilities was raised from 20 percent to 25 percent (with 30 percent for certain banks) and separate limits of 20 percent for local and foreign currencies (25 percent for certain banks) were introduced. The definition of liquid assets was also tightened, with haircuts applied to eligible assets based on their credit rating.

[22] The last two measures are in place only for 2013 and 2014. In the computation of the capital adequacy ratio, banks expanding credit between 4 percent and 10 percent deduct the new lending from risk weighted assets. The separate liquidity requirements for local and foreign currencies were lowered from 20 percent to 15 percent.

measures (see the IMF's Global Financial Stability Report of October 2013). In general, prudential measures should not be a substitute for more fundamental (and perhaps difficult) economic and financial reforms.

28. The macroprudential toolkit could be strengthened further. In the time dimension, the toolkit can be expanded to include instruments addressing the procyclicality of credit in preparation for Albania's next financial cycle (like countercyclical capital buffers).[23] In the cross-sectional dimension, special attention should be given to systemically important banks. As a first line of defense, microprudential supervisors should approach these institutions with intensified supervision and with special attention to asset classification and provisioning practices. Authorities could also consider systemic capital surcharges, but should weigh in the risk of potentially intensifying deleveraging pressures of foreign-owned subsidiaries.

B. Microprudential Oversight

Banks

29. The quality of banking supervision has improved significantly since the 2005 FSAP and the regulatory and supervisory framework has moved toward alignment with EU standards. The BOA has incorporated many guidelines from the Basel Accords into its regulatory framework, which has served to strengthen the banking supervisory regime. Progress in implementing the recommendations from the 2005 FSAP includes increased risk weights for unhedged loans denominated in foreign currency to 150 percent and a limit of such loans to 400 percent of capital. The framework for licensing activities, including evaluating the application for a *de novo* bank, has been strengthened. BOA has established criteria for corporate governance and issued standards for bank management, the internal audit function and several prudential standards.

30. Addressing remaining weaknesses in banking supervision is key to underpin improvements in the health of the banking sector.

- *Enhance consolidated supervision.* This is important given the emergence of investment funds. Authorities should: (i) ensure a more systematic information protocol between the BOA and AFSA; (ii) undertake joint on-site examinations of the new funds and their affiliated banks; and (iii) require investment funds to have contingency liquidity arrangements with banks (¶9).

- *Formalize cooperation with relevant foreign supervisors.* Cross-border supervision is generally effective, but Memoranda of Understanding (MOUs) are not in place with all relevant home supervisors (including Austria, the home country of the largest bank in Albania). With 93 percent

[23] The countercyclical capital buffer aims at making banks more resilient and may diminish banks' willingness to lend excessively during a boom. As the buffer is built above the minimum capital requirement, the decision to release it in times of stress could lower the tension between macroprudential and microprudential policy objectives. In order to avoid restricting credit further in the downturn, the buffer should not be implemented until the credit cycle reaches the expansion phase.

of the banking sector owned by foreign banks, home country supervisors rely principally on the BOA to perform on-site examinations. The lack of MOUs with some foreign bank supervisors appears not to have been an impediment to the BOA to supervise banks effectively.[24] Still, the BOA is encouraged to seek ways to facilitate a more formal exchange of supervisory information.

- *Strengthen risk-based supervision*. Full implementation of Basel II (using the standard approach) is expected by end-2015. The BOA has developed a road map (with assistance from the IMF) and a new capital adequacy regulation and guidelines for Pillar 1 and Pillar 2 capital requirements (with the assistance of Bank of Italy). The Pillar 2 framework will help enhance the evaluation of risk management practices in banks, but its implementation will be challenging. The regulations on credit risk and problem loan management as well as the Supervision Operations Policy (SOP) will need to be revised to adapt processes to a risk-based approach. The expected implementation of the liquidity component of Basel III is welcomed.

- *Improve the effectiveness of the internal audit functions in banks*. This is key, since the expected move towards risk-based supervision will require supervisors to rely more on the work of internal auditors to reduce the scope of examinations so as to focus on areas of highest risks. Among others, audit plans and procedures will need to become more risk-focused and internal auditors will need to be trained in risk-based auditing.

- *Strengthen the legal protection available to supervisors and expand the banking supervision staff.* While the legal protection to supervisors has been enhanced since the 2005 FSAP, further improvements regarding indemnification from the costs of litigation are necessary. This would have a positive impact on the willingness and ability to carry out intensive supervision. Existing vacancies should be filled promptly to support the risk based approach with expertise in risk management evaluation, Basel II, and other disciplines.

- *Challenge banks more intensively on the quality of their credit policies and underwriting standards*. Beyond taking measures to reduce the existing stock of NPLs (Box 1), supervisors need to evaluate current underwriting standards used by banks more intensively to support the quality of new loans. To help banks in this area, the BOA should foster stronger financial reporting practices by large corporate borrowers. Other measures that could guard against deteriorating performance of future loan vintages are adding risk-based aspects to the regulation on provisioning (paying particular attention to related parties), expanding the definition of related parties, and strengthening the regulation governing the management of loans that are in various stages of non-performance. The mission could not rule out the risk of misclassification of problem loans in banks. To gauge the overall accuracy of asset quality rating in banks, the BOA is also encouraged to undertake an asset quality review.

[24] For example, BOA has frequent contact with such authorities on supervisory matters. Moreover, although prohibited from participating in the supervisory colleges, it nonetheless receives elements of the supervisory package and risk assessment, including quarterly updates on supervisory matters.

31. BOA's enforcement tools have been broadly effective to resolve shortcomings in prudential limits, but their use should be expanded to cover risk management concerns. While the application of corrective measures to address inadequate capital or poor liquidity is appropriate, these may not address fundamental risk management problems in the bank. Correcting underlying safety and soundness problems is equally important and BOA should consider imposing formal enforcement action, including a *warning* or *order*, against banks that do not resolve these problems.

The Albanian Financial Services Authority

32. The effectiveness of the AFSA is severely hindered by a weak regulatory framework. The institutional setup of its insurance, pension, and investment fund supervision and regulation is ineffective due to its lack of independence, severely constrained financial resources, absence of representation in the law-making process and the acute shortage of qualified personnel.

- *Insurance*. The supervisory powers of AFSA are severely constrained by a rules-based insurance law that prevents AFSA from quickly issuing by-laws to address evolving needs in the sector and from adopting a risk-based approach to prioritizing on-site inspections. The authority of AFSA to regulate the market is further undermined by the ability of insurance companies to suspend AFSA's rulings by filing an appeal in court.

- *Investment funds*. The regulatory framework for investment funds is weak, lacking appropriate liquidity and capital requirements, as well as a clear methodology for determining unit values (¶9).

33. Major institutional reform to turn AFSA into an effective regulator is a priority. AFSA needs the ability to attract and retain sufficient experienced technical staff. To that end, the AFSA Law must be amended, including by abolishing the requirement for Parliament to approve AFSA's organizational structure and removing the AFSA from the government employee compensation and benefits structure. The legal protection of AFSA's Board and staff must also be strengthened, as current shortcomings potentially hamper their willingness and ability to carry out effective supervision. Recognizing these challenges, the AFSA has recently put forward key amendments to the AFSA law and a new draft Insurance Law that addresses most shortcomings mentioned above.

Anti-Money Laundering and Combating the Financing of Terrorism

34. Albania has enhanced its framework for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) and is encouraged to address remaining deficiencies. At the time of Albania's last assessment in 2011, the AML/CFT framework had significant shortcomings. Since then, the authorities have made steady progress concerning preventive measures (e.g., beneficial ownership and existing clients) and criminalization of terrorist financing. Further remedial action, such as strengthening the analytical function of the Financial Intelligence Unit, is currently underway. In October 2013, the Parliament adopted a law on measures against terrorist financing, which will be reviewed by the Financial Action Task Force International Cooperation Review Group. Further progress is required to strengthen AML/CFT supervision of the insurance and securities

sectors and tackle more effectively illicit cross-border transportation of currency. Lacking a recent assessment, the authorities are encouraged to establish an assessment timetable and request an assessment from a competent authority (MONEYVAL) within 18 months of the FSAP mission.

FINANCIAL SECTOR SAFETY NET AND CRISIS PREPAREDNESS AND MANAGEMENT

A. Emergency Liquidity Assistance

35. The institutional framework for the provision of Emergency Liquidity Assistance (ELA) is generally strong, but the capacity to provide assistance in foreign currencies is limited by the BOA's reserves. Only solvent but temporarily illiquid banks can apply for the loans, which must be fully collateralized. The framework could be strengthened by: (i) increasing supervisory reach and intrusion on banks in receipt of ELA to prevent asset stripping (particularly where foreign currency loans are involved to circumvent up-streaming to parent banks); (ii) considering mechanisms (in conjunction with home country central banks) to provide parent institutions with incentives to supply funding; (iii) establishing a contingency plan to be used in the event the BOA's foreign currency resources are insufficient to meet ELA demands;[25] (iv) establishing internal guidelines for reporting the use of ELA (making sure such reporting does not unduly affect market sentiment);[26] and (v) conducting simulations of stressed scenarios to fully test operational procedures.

B. Bank Resolution Framework

36. The bank resolution framework is generally effective. The BOA is the resolution authority and has comprehensive enforcement powers. If enforcement measures were insufficient to restore soundness, the BOA can appoint a Conservator, and, *in extremis*, revoke a bank's license.[27] A Special Bank Resolution Regime (SRR) is in place, which provides that BOA's decision to revoke a bank's license cannot be reversed by any court. This framework, combined with intense advance preparation by BOA and ADIA enables prompt repayment of, or access to, insured depositors' funds through a Purchase and Assumption (P&A) transaction.[28] The BOA requires systemic banks and four medium-sized banks to prepare Recovery and resolution plans (RRP).

[25] Liquidity stress tests show that at the moment, banks are very liquid in foreign exchange and the potential use of ELA in foreign exchange is small (¶14). A contingency plan would nevertheless be useful.

[26] Regardless of the communication framework established for ELA, the approach must be coordinated among the BOA, the Government and the institution requesting ELA to ensure that a consistent message is provided.

[27] These powers are broadly consistent with the Financial Stability Board's Key Attributes for Effective Resolution http://www.financialstabilityboard.org/publications/r_111104cc.htm.

[28] The banking law provides two tiered depositor preference, thus overcoming the "no creditor worse off" obstacle to a P&A transaction.

37. There is scope for strengthening the framework. In particular, the BOA could: (i) supplement the MOUs that have been signed with home supervisors of European banking groups with cooperative resolution strategies among home and host authorities; (ii) consider the P&A transaction as the preferred resolution tool for non-systemic banks and together with the ADIA conduct periodic bilateral bank resolution simulations; (iii) maintain lists of strong banks that could be potential acquirers and of possible Conservators for possible future assignments on short notice; and (iv) require all banks to prepare comprehensive financial contingency plans based on proportionality (i.e., with complexity of the plan based on the size of the bank).

C. Deposit Insurance

38. Albania's deposit insurance system is largely based on modern principles. The system provides coverage for deposits of individuals up to 2.5 million lek (approximately US$25,000), which covers 95 percent of depositors, and about 58 percent of all system deposits.[29] The mandate of the deposit insurer as a paybox is appropriate for the development of the financial sector. The use of a flat rate deposit insurance premium of 0.5 percent of insured deposits as opposed to risk-based premia is prudent given ADIA's relatively recent establishment. The fund has assets equal to about 3.7 percent of insured deposits—sufficient to cover net insured deposits of the smallest 8 of the 16 banks insured by the scheme. Once the fund reached 5 percent of insured deposits, it may reduce the premiums it collects.[30] However, coverage for small enterprises (currently absent) could usefully be aligned with the E.U. draft Directive on deposit insurance regarding scope of coverage.

39. The ADIA is encouraged to become fully compliant with the Core Principles. To that end, the ADIA needs to enter into information sharing arrangements with relevant regional deposit insurance agencies and enhance cooperation and information sharing with the BOA. The ADIA law has to be amended to help ensure that the agency has greater autonomy in its operations and investments and that its current and former staff have full legal protection. While the ADIA has developed procedures for admitting qualified SCAs to the deposit insurance scheme (in line with the 2005 FSAP recommendations), it is important that the initial capital of 50 million lek be funded, as the government already agreed to provide this funding in the 2012 amendments to ADIA's law.

D. Crisis Preparedness and Management

40. The crisis preparedness and management framework is generally sound, but there is scope to strengthen it further. The establishment of the FSAG as a coordinating crisis prevention and management group strengthened the framework (¶23). Also, the BOA has generally effective contingency plans (CP) and is authorized to create a bridge bank, a tool preferable to outright nationalization or recapitalization with taxpayer funds. It is important to continue enhancing this framework by:

[29] While high by international standards, this level of coverage should not be lowered.

[30] It is recommended that premiums are not reduced until the initial funding is repaid to the government.

- *Obtaining, to the extent possible, support letters from mother banks agreeing to provide liquidity and solvency support as necessary,* especially with those in jurisdictions with whom the BOA has not signed MOUs of cooperation and information sharing.

- *Enhancing the role of the FSAG further* by focusing its mandate and making some operational changes (¶24). All FSAG members should be encouraged to conduct periodic individual and joint crisis simulations and develop/update their own CPs—and these CPs should be rolled up into a national CP coordinated by the FSAG.

- *Establishing, ex ante, a framework to enable extraordinary actions in a crisis***.** The framework could include measures related to liquidity or solvency support, asset purchases, loans or guarantees to ailing systemic banks, and allowing the government to guarantee uninsured depositors and other creditors.[31]

- *Creating a resolution fund, paid for by assessments on systemic banks*, to help defray future bank resolution expenses.[32]

- *Amending the Banking Law to limit the use of the bridge bank tool to resolving systemic situations.* Moreover, the MOF must be prepared to own and operate bridge banks.

- *Strengthening the communication strategy to ensure public confidence*. The authorities are encouraged to agree on draft press releases that clearly communicate the underlying problems of the crisis and how the measures taken address these weaknesses and strengthen the stability of the financial system.

41. Because public resources are used in crisis situations, the MOF is encouraged to take the lead in crisis management. Any solvency assistance from the government should carry strict conditions and caution must be used when exercising such powers. In particular, the preferred solution is that parent banks ensure adequate liquidity and capital; if this support is unavailable the authorities should use appropriate measures to ensure that public funds are not up-streamed to the benefit of the parent and detriment of Albania's taxpayers.[33]

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[31] Ex ante passing a law carries the risk that such powers may be used inappropriately (such as providing financial support). Having a draft law on the shelf to be passed only when a crisis occurs may be preferable. The suggested measures to be contained in this law are consistent with the Financial Stability Board's Key Attributes for Effective Resolution http://www.financialstabilityboard.org/publications/r_111104cc.htm.

[32] A resolution fund is comprised of periodic premiums from banks (similar to ADIA assessments) and follows the bank resolution tenet that the banking industry should bear some of the cost of bank failures. Although the resolution fund should be separate from the ADIA fund, economies of scale may be realized by permitting ADIA to manage the fund.

[33] During the problem bank resolution process, BOA should monitor closely, and block if necessary, large transactions of insiders, related parties, and intra-group companies.

Table 2. Albania. Structure of the Banking System

	Bank	Year established	Total Assets (bn lek)	Total Assets (percent of total)	Ownership structure (percent): Domestic: Private non-financial	Domestic: Public	Domestic: Other financial institutions	Foreign	Current Ownership	Nationality
1	RAIFFEISEN BANK	1992	301	25.0				100	Raiffeisen SEE Region Holding	Austria
2	NATIONAL COMMERCIAL BANK (BANKA KOMBETARE TREGTARE)	1992	258	21.4				100	Çalik Finansal Hizmetler A.S.	Turkey
3	INTESA SANPAOLO BANK ALBANIA	1998	132	11.0				100	Intesa SanPaolo S.p.A.	Italy
4	CREDINS BANK	2003	101	8.4	72		5	0	Individuals, Balkan Financial Sector Equity Holding B.V.	Albania, Netherlands
5	TIRANA BANK	1996	89	7.4				100	Pireaues Bank	Greece
6	ALPHA BANK ALBANIA	1998	71	5.9				100	Alpha Bank A.E.	Greece
7	SOCIETE GENERALE BANK ALBANIA	2004	64	5.3	11			89	Societe Generale France, Individuals	France, Albania
8	NBG BANK ALBANIA	1996	40	3.3				100	National Bank of Greece S.A.	Greece
9	PROCREDIT BANK	1999	39	3.2				100	Procredit Holding AG	Germany
10	CREDIT AGRICOLE BANK ALBANIA	1999	32	2.6				100	IUB Holding	France
11	UNION BANK	2006	29	2.4	4		83	13	Unioni Financiar Tirane	Albania
12	VENETO BANK	1994	19	1.6				100	Veneto Banca Holding S.p.A.	Italy
13	FIRST INVESTMENT BANK ALBANIA	1999	14	1.1				100	First Investment Bank AD	Bulgaria
14	INTERNATIONAL COMMERCIAL BANI	1997	8	0.7				100	ICB Financial Group Holding AG	Malaysia (registered in Switzerland)
15	UNITED BANK OF ALBANIA	1994	6	0.5				100	Islamic Development Bank	Saudi Arabia
16	CREDIT BANK OF ALBANIA	2002	2	0.1				100	Individuals	Kuwait

Source: Bank of Albania

Table 3. Albania. Selected Economic Indicators, 2009–2019

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Est.	Projections					
Real sector					(Growth rate in percent)						
Real GDP	3.3	3.8	3.1	1.3	0.7	2.1	3.3	4.2	4.5	4.5	4.7
Consumer Price Index (avg.)	2.3	3.5	3.4	2.0	1.9	2.7	2.8	3.0	3.0	3.0	3.0
Consumer Price Index (eop)	3.7	3.4	1.7	2.4	1.9	2.6	3.0	3.0	3.0	3.0	3.0
GDP deflator	2.0	2.6	3.5	2.1	1.7	2.3	2.5	2.7	2.8	2.8	2.8
Saving-investment balance					(Percent of GDP)						
Foreign savings	14.1	10.0	9.6	9.3	9.0	10.3	12.4	14.8	13.0	9.9	8.2
National savings	16.2	16.9	16.2	15.0	15.2	15.0	13.4	13.0	15.7	17.1	18.8
Public	1.0	1.2	1.6	0.9	-1.0	0.2	0.8	1.9	2.9	3.7	4.3
Private	15.2	15.6	14.6	14.1	16.2	14.8	12.7	11.1	12.8	13.4	14.6
Investment	30.3	26.9	25.8	24.3	24.2	25.3	25.8	27.8	28.7	27.0	27.0
Public	10.1	6.8	6.2	5.2	6.2	5.2	5.2	5.2	5.2	5.2	5.2
Private	20.2	20.1	19.6	19.1	18.0	20.1	20.6	22.6	23.5	21.8	21.8
Fiscal sector					(Percent of GDP)						
Revenues and grants	26.0	26.1	25.8	24.9	24.0	25.4	25.3	25.2	25.2	25.2	25.2
Tax revenue	23.6	23.6	23.7	22.7	21.6	23.3	23.3	23.3	23.3	23.3	23.3
Expenditures	33.5	29.9	29.3	28.4	30.1	32.1	31.3	31.1	29.9	29.7	29.5
of which: Clearance of unpaid bills						2.5	1.3	1.1			
Primary	30.3	26.5	26.1	25.2	26.9	28.9	27.1	26.9	25.8	25.8	25.8
Interest	3.2	3.4	3.2	3.1	3.2	3.2	4.1	4.2	4.1	3.9	3.7
Unidentified measures (cumulative)						0.0	1.2	2.4	3.3	4.0	4.3
Overall balance	-7.4	-3.8	-3.6	-3.5	-6.2	-6.7	-4.8	-3.4	-1.3	-0.5	0.0
Primary balance	-4.3	-0.4	-0.4	-0.3	-2.9	-3.4	-0.7	0.8	2.8	3.4	3.7
Net domestic financing	3.3	1.4	1.9	2.3	5.4	3.0	1.6	1.5	2.3	2.1	1.3
of which: Privatization receipts	2.4	0.4	0.0	0.1	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Foreign financing	3.7	2.1	1.6	1.2	1.0	1.2	1.1	-0.3	-1.0	-1.6	-1.3
Public Debt	59.5	58.5	60.3	62.4	70.5	71.7	71.2	68.8	65.4	61.4	57.1
Domestic	36.1	33.3	34.2	35.5	43.7	42.3	40.3	38.1	37.8	37.4	36.1
of which: Unpaid bills and arrears					5.3	2.6	1.2	0.0			
External (including publicly guaranteed)	23.3	25.2	26.0	27.0	26.8	29.3	30.9	30.7	27.6	24.1	21.1
Monetary indicators					(Growth rate in percent)						
Broad money growth	6.8	12.5	9.1	5.0	2.9	4.6	5.9	6.8	7.1	7.0	7.7
Private credit growth	10.3	10.1	10.4	1.4	-3.0	2.6	4.9	6.2	6.4	6.5	6.7
Velocity	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Interest rate (3-mth T-bills, end-period)	6.3	5.3	5.3	5.0	3.3	…	…	…	…	…	…
BoA repo rate (in percent)	5.3	5.0	4.8	4.0	3.0	…	…	…	…	…	…
External sector					(Percent of GDP, unless otherwise indicated)						
Trade balance (goods and services)	-24.7	-20.9	-23.1	-19.0	-17.1	-17.0	-18.4	-20.8	-18.9	-15.8	-13.7
Current account balance (including official transfers)	-14.1	-10.0	-9.6	-9.3	-9.0	-10.3	-12.4	-14.8	-13.0	-9.9	-8.2
Current account balance (excluding official transfers)	-14.7	-12.0	-12.5	-11.0	-10.4	-11.3	-13.2	-15.5	-13.7	-10.5	-8.8
Official transfers	0.7	2.1	2.9	1.7	1.4	1.0	0.9	0.8	0.7	0.7	0.6
Gross international reserves (in billions of Euros)	1.6	1.9	1.9	2.0	2.0	2.1	2.1	2.2	2.2	2.3	2.5
(In months of imports of goods and services)	4.1	4.4	4.5	4.8	4.8	4.5	4.1	4.0	4.1	4.0	4.0
(Relative to external debt service)	2.4	3.4	8.4	7.9	5.8	4.7	2.6	3.9	3.7	3.4	3.8
(In percent of broad money)	26.0	27.0	24.9	24.6	24.6	24.2	23.5	22.6	21.7	20.8	21.3
Change in real exchange rate (eop, in percent)	-7.8	-2.5	-0.5	-1.1	…	…	…	…	…	…	…
Memorandum items											
Nominal GDP (in billions of lek)	1148.1	1222.5	1282.3	1326.5	1357.9	1418.0	1501.6	1607.4	1726.0	1853.5	1994.4
Output gap (percent, - = gap)	1.8	1.8	1.7	0.5	-1.5	-2.2	-2.1	-1.4	-0.8	-0.4	0.1

Sources: Albanian authorities; and IMF staff estimates and projections.

	1148	1222	1282	1330	1362	1422	1506	1612	1731	1859	2000

Table 4. Albania. Financial Soundness Indicators, December 2007–September 2013

		Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Sep-13
I	Capital-based							
(i)	Regulatory capital as a percent of risk-weighted assets	17.1	17.2	16.2	15.4	15.6	16.2	17.8
(ii)	Regulatory Tier 1 capital as a percent of risk-weighted assets	16.0	16.3	15.3	14.5	14.3	14.6	14.8
(iii)	Capital as a percent of total assets							
	Regulatory Tier 1 capital as a percent of total assets	5.8	6.7	8.7	8.6	8.1	7.9	7.7
	Regulatory capital as a percent of total assets	6.2	7.0	9.2	9.1	8.8	8.8	9.2
	Shareholders' equity as a percent of total assets	7.6	8.6	9.6	9.4	8.7	8.6	8.3
(iv)	Nonperforming loans net of provisions as a percent of capital							
	Nonperforming loans net of provisions as a percent of regulatory Tier 1 capital	12.0	27.2	29.9	38.1	56.6	61.8	54.7
	Nonperforming loans net of provisions as a percent of regulatory capital	11.2	25.7	28.2	35.9	52.0	55.6	45.4
	Nonperforming loans net of provisions as a percent of shareholders' equity	9.1	21.1	27.1	34.8	52.6	56.9	50.7
(v)	Return on equity (ROE) (annual basis) 1/	20.7	11.4	4.6	7.6	0.8	3.8	-1.7
(vi)	Net open position in foreign exchange as a percent of capital							
	Net open position in foreign exchange as a percent of regulatory Tier 1 capital	1.8	4.5	4.1	5.3	4.3	4.1	5.2
	Net open position in foreign exchange as a percent of regulatory capital	1.7	4.3	3.9	5.0	3.9	3.7	4.3
	Net open position in foreign exchange as a percent of shareholders' equity	1.4	3.5	3.7	4.9	4.0	3.8	5.2
II	Asset-based							
(vii)	Liquid assets as a percent of total assets (Liquid-asset ratio) 2/	49.8	42.8	27.6	25.9	26.5	29.4	29.2
(viii)	Liquid assets as a percent of short-term liabilities 2/	55.6	104.7	32.6	30.6	33.1	34.9	36.5
(ix)	Return on assets (ROA) (net income to average total assets) (annual basis)	1.6	0.9	0.4	0.7	0.1	0.3	-0.1
(x)	Nonperforming loans (gross) as a percent of total loans	3.4	6.6	10.5	14.0	18.8	22.5	24.2
III	Income and expense-based							
(xi)	Interest margin to gross income	92.7	106.5	119.6	118.9	147.7	130.4	148.3
(xii)	Noninterest expenses to gross income 3/	58.5	69.6	83.0	75.5	91.3	85.0	98.3
IV	Memorandum items							
	Other (noncore) indicators:							
	Customer deposits as a percent of total (non-interbank) loans	215.5	162.6	154.3	166.4	163.2	171.6	180.9
	Foreign currency-denominated loans to total loans	72.5	72.6	70.2	69.8	67.9	64.5	63.7
	Foreign currency-denominated liabilities as a percent of total liabilities	46.9	48.5	48.9	51.0	51.9	52.6	52.9
	Other indicators:							
	Risk weighted assets as a percent of total assets	36.4	40.8	56.7	59.2	56.5	54.2	52.0
	Total loans as a percent of total assets	39.4	47.6	50.8	49.6	50.5	48.6	46.0
	Total loans as a percent of shareholders' equity	516.4	555.1	530.2	527.0	581.9	567.4	555.0

Source: Data provided by Bank of Albania.

1/ The decline in ROE in the third quarter of 2013 is due to stepped-up provisioning rates against loan losses and, to a lesser extent, to non-recurrent losses.

2/ Definition of liquid assets and short term liabilities were changed in October 2009.

3/ Noninterest expenses defined as expenses other than those from core banking activity.

Appendix I. Key Recommendations of 2005 FSAP

Area/Issue	Recommendations	Time Frame	Status/Comments
Strengthen Financial Markets (Banking and Non-Banking) Supervision	• Pursue efforts to increase the awareness of consumers and other bank borrowers of the risks inherent in foreign currency borrowing, by encouraging or requiring banks to discuss exchange rate risks explicitly with borrowers before contracts are signed.	Short-term	The regulation addressing consumer protection was strengthened to clarify the terms and conditions under which a client is entering a contract with a bank for a loan or deposit. The regulation requires banks to provide certain types of information on the borrowing relationship (e.g. a bank must: provide a warning to clients advising of the dangers in borrowing in foreign currency; and advise the borrower of the effective interest rate of a loan).
	• Discuss with banks means of assessing the risks arising from foreign currency denominated loans and adjust existing loan classification schemes or provisioning if warranted.	Short-term	BOA's regulation governing credit risk administration now addresses unhedged foreign currency credit exposure held by banks. BOA established a limit for banks by prohibiting a bank from having such an exposure in aggregate exceeding 400 percent of its regulatory capital. Exposures exceeding the limit are deducted from regulatory capital. Moreover, the risk weight for these exposures was set at 150 percent.
	• Undertake review of bank exit/receivership provisions and contingency planning arrangements, using "emergency bank failure scenarios" to assure readiness for such eventualities.	Short-term	The Law on Banks (Chapter VII) establishes the power of BOA to place a bank in conservatorship or liquidation. The law provides for the appointment of a conservator in appropriate circumstances. In 2010 BOA adopted an operating manual containing processes and procedures that would be employed in the resolution of a bank. The U.S. Federal Deposit Insurance Corporation assisted in the development of the manual, which can be used under both conservatorship and liquidation scenarios. Recently, some amendments to the Law on Banks were adopted to grant the BOA more powers to administer systemic risk situations. The amendments enable BOA to provide remedies for the resolution of a problem bank more effectively, and include the power to pursue a purchase and assumption strategy to facilitate the takeover of the weaker bank by a stronger institution, establish a bridge bank to remove problem assets from a weak institution, and convert foreign bank branches to subsidiaries to preserve liquidity in the banking system.
	• Include senior qualified and experienced finance professionals in the leadership of the Insurance	Short-term	The ability of the AFSA to effectively supervise the insurance sector has been weakened

Area/Issue	Recommendations	Time Frame	Status/Comments
	Supervisory Authority (ISA) both at the supervisory board level and management with adequate remuneration. • Issue and enforce insurance sector prudential regulations in line with international standards. • Begin integration of insurance, securities, and pension fund regulatory bodies into an integrated nonbanking regulator; consider feasibility of integrating banking supervision at a later stage.	Medium-term Medium-term	by its inability to retain staff due to restrictions on remuneration. AFSA has been losing professional staff due the restrictions on remuneration levels. With the recent market growth and increasing presence of foreign insurance companies, this is harming the quality of supervision. . To retain highly qualified staff and to ensure AFSA's financial and operational independence, the World Bank has recommended to adopt a new insurance law and to amend the AFSA law, the law on Salaries of Independent Institutions, and the law on Civil Servants. Although over the last few years the AFSA has been receiving assistance from the World Bank and FIRST little progress has been made towards improving the quality of insurance supervision. The integration of non-bank regulatory entities into the AFSA is complete, but not fully effective.
Improve Institutional Capacity for Public Debt Management	• Improve institutional capacity for public debt management by clearly articulating the objectives, strategies, and decision-making process for public debt management.	Short-term	According to the Debt Management Performance Assessment (June 2011), of more than 50 countries assessed by the World Bank, Albania is one of the few which has sound debt management practices across a large number of areas. The medium-term debt management strategy is based on debt management objectives, covers interest rate, refinancing and foreign currency risks, includes a description of measures aimed at supporting domestic debt market development, and has realistic target levels for indicators of interest rate, refinancing and foreign currency risks. The strategy is prepared by the principal debt management entity, the views of BOA on the proposal are obtained, and the proposal is approved by the Council of Ministers. The strategy is updated annually and is publicly available. Areas for improvements are external borrowing (by moving to a more systematic planning and assessment of potential borrowings and creditors) and some parts of the operational risk management framework. The latest Eurobond issue highlighted that the decision-making process for external market borrowing is rather cumbersome. Additionally, there is no systematic tracking of foreign holding of the government securities issued in the domestic market.
Encourage	• Encourage bottom up consolidation or pooling of	Medium-term	The World Bank prepared a report on Microfinance Institutions and Credit Unions in Albania - Regulatory, Supervisory and Market Development Issues, in June 2008. The

Area/Issue	Recommendations	Time Frame	Status/Comments
Growth and Development of Credit Unions	resources of credit and savings unions. • Harmonize and enhance regulation governing various credit unions and consider introduction of a separate deposit insurance scheme for these institutions.	 Medium-term	report provided a set of recommendations on the legal and supervisory aspects. Several of the recommendations of this report were addressed and microfinance institutions have developed, and the SCA Union is in the process of collaboration with one of the banks to transfer in the bank all its financial transactions. There is no initiative for a larger consolidated merged cooperative union. ADIA and BOA are in the process of developing a plan for the integration of the SCAs into the deposit insurance scheme. ADIA's law was amended in 2012 to allow for such integration but the government contribution to begin a separate fund administered by ADIA as set forth in the amended law has not been made.
Improve Quality, Breadth and Depth of Financial Intermediation	• Facilitate the creation of a well-functioning credit bureau under the leadership of BOA. • Offer the Albanian Securities Exchange (ASE) to the private financial sector for a nominal amount to own and operate; failing that, close down the idle ASE. • Ensure effective implementation of proper accounting • Improve land registration titling and judicial procedures for collateral enforcement.	Short-term Short-term Medium-term Medium-term	Completed. Not implemented. Albanian Stock Exchange still exists, though it is not operational. Overall, financial reporting legislation in Albania has improved and has a high degree of alignment with the EU acquis communautaire. The legislation contains differentiated financial reporting requirements, including requirements to apply International Financial reporting Standards (IFRS) for Public Interest Entities (PIEs), and National Accounting Standards for other entities. Improvements on land registration and titling are ongoing. Still a problematic issue and a big reform agenda lie ahead. The World Bank supports country authorities with the Land Administration and Management Project which began in 2007 and will end in June, 2014. The project supports the completion of the systematic registration of 400,000 properties in 140 priority urban cadastral zones, and the development of the centralized IT system to manage property registration information. The IT system has been rolled out to 5 large offices and another 5 offices are planned prior to the end of the project. In the future the government should develop a plan to complete the IT system roll out to all 35 offices, the completion of First Registration in the remaining zones (approximately 100 cadastral zones) and data quality improvement of the paper based registration data for

Area/Issue	Recommendations	Time Frame	Status/Comments
			approximately 2,000 zones (over 2 million properties) that need to be digitized and uploaded into the new IT system. On judicial procedures, changes in the Civil Procedural Code were approved by Parliament in April 2013 and are targeted to: (a) reduce the scope for suspension of collateral execution (art. 206, 202-203, and 517); (b) modernize the real estate appraisal and auction procedures (art. 577);(c) remove the right to long-term suspension when the executive title is featured in a bank's loan contract (art. 609); (d) the exclusion of the suspension procedure in case of actions against court appointed bailiffs (art. 611); (e) curbed court discretion to suspend execution procedure (art. 615); and (f) limit the abrogation of suspension of execution (art. 616). This crucial set of changes became effective on October 1, 2013 and going forward are widely expected to positively impact the collateral execution process for creditors.
Improve the AML/CFT Enforcement Framework	• Proceed with the plans to revise the AML law in line with the FATF Recommendations 2003. • Increase the capacity of the financial intelligence unit (FIU) to deal with money laundering.	Short-term Medium-term	Completed. The authorities have revised the AML law. Its compliance with the FATF standard will be established in the context of the next AML/CFT assessment. Staff has been increased, data management has been improved and the reporting of suspicious transactions has become more focused. The analytical function of the FIU has been strengthened, but staffing for on-site and off-site inspections remains inadequate.

Appendix II. Risk Assessment Matrix

<table>
<tr><th rowspan="2">Nature/Source of Main Threats</th><th colspan="2">Overall Level of Concern</th></tr>
<tr><th>Likelihood of Severe Realization of Threat in the Next 1–3 Years
(high, medium or low)</th><th>Expected Impact on Financial Stability if Threat is Realized
(high, medium or low)</th></tr>
<tr><td>1. Surges in global financial market volatility, associated with the exit from unconventional monetary policies.</td><td>Staff assessment: High
• Financial market volatility could lead to spikes in interest rates, especially in emerging markets.
• The Bank of Albania would face the dilemma of allowing the lek to depreciate or to raise interest rates to counteract depreciation pressures.
Mitigating factors:
• The BOA may have some room for intervention, since international reserves are at relatively comfortable levels.</td><td>Staff assessment: Medium
• NPLs would likely rise further both in the case of increases in interest rates and in the case of lek depreciation, since both would weaken the repayment capacity of borrowers (many of which have unhedged loans in foreign currency).
• Financial market turmoil would also complicate rollover of the Albanian sovereign Eurobond in 2015.
• Difficulties in rolling over the Eurobond could spill over to the domestic government bond market. Bond price declines would expose banks to losses on bonds held in the trading book.
Mitigating factors:
• Banks have relatively healthy levels of capitalization.</td></tr>
<tr><td>2. A re-emergence of financial stress in the euro area, and/or exit of a foreign bank from the market.</td><td>Staff assessment: Medium
• Stress in European parent banks could reduce their ability to re-capitalize Albanian subsidiaries.
• Such deleveraging pressures could lead to an exit of foreign banks.
Mitigating factors:
• Level of capital appears adequate, banks are largely funded by domestic deposits and do not depend on parent funding.</td><td>Staff assessment: High
• A loss of depositor confidence or a large withdrawal of parent funding could lead to significant stress.
• The capacity of the BOA to act as lender of last resort in foreign currency is limited.
• If parent banks are unable to capitalize subsidiaries, banks may be forced to cut back lending.</td></tr>
<tr><td>3. A deterioration in domestic market sentiment, leading to reduced access of the sovereign.</td><td>Staff assessment: Medium
• Failure to address macroeconomic imbalances could lead the sovereign to lose market access, leading to a depreciation of the</td><td>Staff assessment: High
• Given the strong linkages between banks and the sovereign, banks are vulnerable to changes in the value of longer-term debt securities, and the</td></tr>
</table>

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years *(high, medium or low)*	**Expected Impact on Financial Stability if Threat is Realized** *(high, medium or low)*
	lek, a spike in interest rates, and weakening the solvency of banks. • Redemption pressures in investment funds could lead to a run from government bonds. • Pressures in the domestic bond market could complicate rollover of the Eurobond in 2015. • A deterioration in the fiscal outlook would increase risk premia and interest rate increases. • Most public debt is short term and debt roll-over difficulties could arise, raising risk premia. ***Mitigating factors:*** • The new government is committed to fiscal sustainability.	government is vulnerable to the regular rollover of debt by banks. • Government payment arrears could increase further and lead to further increases in NPLs.
4. A protracted period of slower growth in advanced and emerging economies.	***Staff assessment: Medium-High*** • Weak growth in European trading partners could further slow the Albanian economy through declines in trade and remittances. • In the absence of fiscal policy buffers, monetary policy may be eased further and lead to a depreciation of the lek. ***Mitigating factors:*** • The share of exports in GDP remains low.	***Staff assessment: Medium*** • Slower growth and attempts to stimulate credit could increase NPLs further. • A depreciation of the lek could threaten the solvency of banks, as many borrowers have unhedged loans in foreign currency. ***Mitigating factors:*** • Banks have relatively healthy levels of capitalization. • Stimulus measures could have a positive impact on output in the short term, improving prospects for banks.

Appendix III. Stress Test Methodology

A. Macroeconomic Scenarios for the Stress Tests

42. The baseline macroeconomic scenario is based on the projections of IMF staff as of early November, 2013. It envisages that growth will remain weak in 2013, followed by a gradual recovery in 2014–15. The weak performance in 2013 is attributed to lackluster credit growth and declines in remittances, foreign direct investment, and export demand. The recovery in 2014 and 2015 is driven by improvements in foreign demand and the trade balance, increased remittances and FDI inflows, and higher credit growth.

43. The *extreme* but *plausible* adverse macroeconomic scenarios reflect downside external risks and a domestic credit supply shock. Two adverse scenarios run through the BOA's macroeconomic model (and BOA judgment) result in a cumulative decline of GDP equivalent to 2 standard deviations (12.3 percentage points, calculated based on data covering 1995–2012) relative to the baseline over two years. The two adverse scenarios are: (i) a U-shaped scenario with negative growth of 3.9 and 3.2 percentage points in 2014 and 2015, respectively; and (ii) a V-shaped scenario with a large decline in GDP of 6.9 percentage points in the first year and no growth in the second year. External shocks are assumed to be more protracted in the U-shaped scenario. The V-shaped scenario is dominated by a large shock to domestic credit growth in 2014 that triggers a deeper decline in GDP.

External and domestic shocks in the U- and V-shaped adverse scenarios

Deviations from baseline, in percent 1/

		External shocks			Domestic shocks
Scenario	Year	Remittances	Foreign demand	Private investment	Credit
U-shaped	2014	-37.5	-3.5	-3.1	-15.0
	2015	-16.2	-2.8	-3.1	-15.0
V-shaped	2014	-37.5	-3.5	-5.2	-25.0
	2015	0.0	0.0	-6.5	-15.0

1/ Remittances and foreign demand, and the shocks applied to them, are measured in foreign currency units (euros). The declines in real private investment result from shocks to foreign direct investment; a 15 percent pass-through from foreign direct investment to domestic private investment is assumed.

44. More specifically, the adverse scenarios are driven by the following shocks:

- *Remittances*. Shocks to remittances are triggered by reduced employment opportunities in the two main host countries of Albanian emigrants (Italy and Greece). These shocks are transmitted to disposable income and consumption (with a long-run coefficient of 0.88). The decline in consumption affects aggregate demand and output, generating second round negative effects.
- *Foreign direct investment and foreign demand*. Shocks to foreign direct investment reduce gross capital formation with a 15 percent pass-through. These shocks, in turn, negatively affect aggregate demand and

output growth. Also, a deterioration in economic activity in the main trading partners leads to lower demand for Albanian exports.

- *Credit growth*. Deleveraging and risk pull back from foreign banks causes a sharp decline in credit growth, with a direct impact on consumption and private investment. It is estimated that a 1 percent slowdown in credit growth leads to declines in consumption and private investment equivalent to 0.06 and 0.14 percent, respectively.
- *Lek depreciation and interest rates*. The external and domestic shocks trigger a sharp depreciation of the lek (about 35 percent over 2014–15). Lek depreciation pressures and expectations of U.S. Federal Reserve tapering force Albania to also raise interest rates to prevent inflationary pressures. In the adverse event, interest rates in Albania increase to 14 percent to 15 percent, slowing down credit growth, private investment, and GDP growth.

B. Stress Test Matrix for the Banking Sector

Domain		Assumptions	
		Bottom-Up by Banks	Top-Down by Authorities and FSAP Team
BANKING SECTOR: SOLVENCY RISK			
1.Institutional Perimeter	Institutions included	• The following banks: Raiffeisen Bank, National Commercial Bank, Intesa Sanpaolo Bank, Credins Bank and Tirana Bank.	• The following banks: Raiffeisen Bank; United Bank of Albania; Veneto Banka; National Commercial Bank; Tirana Bank; National Bank of Greece; International Commercial Bank; Alpha Bank – Albania; Intesa Sanpaolo Bank Albania; Procredit Bank; Credit Agricole–Albania; Credit Bank of Albania; Credins Bank; Société Générale Albania; Union Bank; First Investment Bank.
	Market share	• 74 percent of total sector assets.	• 100 percent of total sector assets.
	Data and baseline date	• Latest data: August 2013. • Own data. • Scope of consolidation: Consolidated banking group. • Coverage of sovereign exposures: Trading and banking books including own sovereign, valuated at MTM at starting point.	• Latest data: August 2013. • Supervisory and publicly available data (balance sheet and income statements). • Scope of consolidation: Perimeter of individual bank. Coverage of sovereign exposures: Trading and banking books including own sovereign, valuated at MTM at starting point.
2. Channels of Risk Propagation	Methodology	• Banks' own models.	• Authorities' macroeconomic models and satellite models developed by the Authorities jointly with the FSAP team. • Balance-sheet approach based on a dynamic extension of Cihak (2007) and developed by the FSAP team.
	Satellite Models for Macro-Financial linkages	• Banks' own models.	• Satellite model of credit risk developed jointly by the Authorities and the FSAP team. • Profits model developed by the Authorities with guidance by the

Domain		Assumptions	
		Bottom-Up by Banks	Top-Down by Authorities and FSAP Team
			FSAP team, based on changes in market prices (interest rates, exchange rates, sovereign yields). • Methodology to calculate losses from bonds and money market instruments (sovereign and other issuers). Haircuts are calculated based on a modified duration approach and historical distributions of changes in yield. • Net fee income and commission income, and operating expenses, projected based on nominal GDP growth under general static balance sheet assumptions.
	Stress test horizon	• 2013–15	• 2013–15
3. Tail shocks	Scenario analysis	• Macroeconomic scenario analysis: the authorities provide the scenarios to individual banks.	• Macroeconomic scenario analysis: agreed with authorities. • Baseline scenario based on latest IMF staff projections. • The adverse scenario will be based on a cumulative decline of GDP of 2 standard deviations over two years and will incorporate *external shocks* (remittances, foreign direct investment, foreign demand, and interest rates) and a *domestic shock* to credit supply.
	Sensitivity analysis	n.a.	• Sensitivity analysis: agreed with authorities. It evaluates *domestic* shocks: direct effects of interest rate shocks; interest rate shock on credit quality; direct and indirect effects of exchange rate shocks; a decline in the prices of sovereign securities; an external credit-rating downgrade; and failure of the largest 2, 5, and 10 corporate exposures.
4.Risks and Buffers	Risks/factors assessed (How each element is derived, assumptions.)	• Market and sovereign losses: direct effects of interest rate shocks; direct effects of exchange rate shocks; shocks to sovereign yields. • Credit risk: indirect effects of	• Credit losses. • Losses from bonds and money market instruments (sovereign and other issuers) in the banking and trading books. • Funding costs. Market risk, including foreign exchange risk.

Domain		Assumptions	
		Bottom-Up by Banks	Top-Down by Authorities and FSAP Team
		interest rate shocks; indirect effects of exchange rate shocks; failure of large exposures.	
	Behavioral adjustments	• Static balance sheet assumption.	• Balance sheet grows with nominal GDP. • No dividends are paid out by banks that remain adequately capitalized.
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	• Point in time risk parameters for credit risk parameters or proxies.	• Point in time risk parameters for credit risk parameters or proxies.
	Regulatory/Accounting and Market-Based Standards	• Total Capital and Tier 1 Capital. • Standard approach.	• Total Capital and Tier 1 Capital. • Standard approach.
6. Reporting Format for Results	Output presentation	• Capital shortfall system wide. • Dispersion of capital ratios: min., avg., max.; percentage of assets that fail. • For each hurdle rate (or range), share in whole system by asset.	• Capital shortfall system wide. • Dispersion of capital ratios: min., avg., max.; percentage of assets that fail. • For each hurdle rate (or range), share in whole system by asset.
BANKING SECTOR: LIQUIDITY RISK			
1. Institutional Perimeter	Institutions included	n.a.	• The following banks: Raiffeisen Bank; United Bank of Albania; Veneto Banka; National Commercial Bank; Tirana Bank; National Bank of Greece; International Commercial Bank; Alpha Bank – Albania; Intesa Sanpaolo Bank Albania; Procredit Bank; Credit Agricole–Albania; Credit Bank of Albania; Credins Bank; Société Générale Albania;

Domain		Assumptions	
		Bottom-Up by Banks	Top-Down by Authorities and FSAP Team
			Union Bank; First Investment Bank.
	Market share	n.a.	• 100 percent of total sector assets.
	Data and baseline date	n.a.	• Latest data: June 2013. • Source: supervisory data. • Scope of consolidation: perimeter of individual bank.
2. Channels of Risk Propagation	Methodology	n.a.	• Cash flow-based liquidity stress test using maturity buckets by bank and currency (lek, euro, U.S. dollar); additional tests combining cash-flows in "all foreign currencies" "—including those denominated in British pounds, Canadian dollars, etc. • Reverse liquidity test by bank and currency. • Test will be top-down with detailed guidance by the FSAP team.
3.Risks and Buffers	Risks	n.a.	• Funding liquidity. • Market liquidity.
	Buffers	n.a.	• Counterbalancing capacity. • Central bank facilities.
4. Tail shocks	Size of the shock	n.a.	• Run-off rates calculated following historical events and LCR rates. • Bank run and dry up of wholesale funding markets, taking into account haircuts to liquid assets.

Domain		Assumptions	
		Bottom-Up by Banks	Top-Down by Authorities and FSAP Team
5. Regulatory and Market-Based Standards and Parameters	Regulatory standards	n.a.	• Liquidity gap, survival period. • Consistent with Basel III draft standards (LCR and NSFR).
6. Reporting Format for Results	Output presentation	n.a.	• Liquidity gap by bank and by currency, aggregated. • Survival period in days by bank, number of banks that still can meet their obligations.
BANKING SECTOR: CONTAGION RISK			
1.Institutional Perimeter	Institutions included	n.a.	• The following banks: Raiffeisen Bank; United Bank of Albania; Veneto Banka; National Commercial Bank; Tirana Bank; National Bank of Greece; International Commercial Bank; Alpha Bank – Albania; Intesa Sanpaolo Bank Albania; Procredit Bank; Credit Agricole–Albania; Credit Bank of Albania; Credins Bank; Société Générale Albania; Union Bank; First Investment Bank. • Cross-border: based on available interbank data vis-à-vis foreign institutions.
	Market share	n.a.	• 100 percent of total sector assets.
	Data and baseline date	n.a.	• Latest data: June 2013. • Source: supervisory. • Scope of consolidation: individual banking institutions.

Domain		Assumptions	
		Bottom-Up by Banks	**Top-Down by Authorities and FSAP Team**
2. Channels of Risk Propagation	Methodology	n.a.	• Network interbank model by Espinosa-Vega and Sole (2010).
3. Tail shocks	Size of the shock	n.a.	• Pure contagion: default of institutions. • Pure contagion combined with fire sales stemming from funding shock.
4. Reporting Format for Results	Output presentation	n.a.	• Number of undercapitalized and failed institutions, and their share of assets in the system.

Appendix IV. Report on the Observance of Standards and Codes: Basel Core Principles—Summary Assessment

A. Overview of the Institutional Setting and Market Structure

45. Financial intermediation in Albania is dominated by banks. Banks represented about 94 percent of total financial system assets, equivalent to 88 percent of GDP in 2012 (up from 76 percent of GDP in 2005). The banking system is concentrated and foreign ownership dominates, with the preponderance of foreign institutions headquartered in EU countries. Out of 16 operating banks, the largest five hold about three-quarters of system assets and deposits. Bank credit is concentrated in the corporate sector (representing 74 percent of loans in 2012) and in few economic sectors, with 45 percent channeled to the trade sector, 22 percent to construction, and 20 percent to industry. Subsidiaries of foreign banks represent about 93 percent of total banking sector assets. Bank credit is funded largely by local deposits (the loan-to-deposit ratio was 58 percent in 2012).

46. A range of laws govern the activities of the banking system. Central to the supervision of the banking system is the Law on Banks (2006, as amended) and the Central Bank Act (1997), supplemented by a series of regulations addressing specific banking activities and risks. Banks are subject to an array of other laws governing their activities, including the Civil Code and legislation addressing accounting and market disclosure, AML/CFT, and competition.

47. The BOA is the sole supervisor of the domestic banking system, saving and loans associations, and certain other NBFIs. The BOA intends to implement Basel II by 2015 and complement the current focus on compliance with a forward-looking risk-based approach to supervision. It cooperates with a number of home supervisors of European banking groups that operate in Albania.

48. There are credit quality concerns in the Albanian banking system. NPLs are high and have exhibited a rising trend over the past several years. NPLs net of provisions as a percentage of regulatory capital was 56 percent in June 2013. The increase in NPLs is partly due to the economic slowdown, but is being exacerbated by unpaid VAT refunds and government payment arrears. Bank efforts to resolve problem loans have been hindered by lengthy loan recovery procedures and adverse treatment of write-offs.

49. The BOA has a relatively high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCP). The preponderance of Principles are rated Largely Compliant, notwithstanding the challenging environment and vulnerabilities to which the banking system has been exposed in the aftermath of the financial crisis. The BOA continues on a course to align its supervisory practices with EU standards.

B. Preconditions for Effective Supervision

50. *Macro-economic environment.* Albania's institutional framework supporting the conduct of macro-economic policy is led by the BOA and the MOF. Albania avoided a serious economic slowdown resulting from the financial crisis. However, economic imbalances have become large. Real GDP growth is low and the external current account deficit remains high, largely reflecting persistent fiscal deficits and worsening terms of trade. Albania's high exposure to the euro zone poses potentially high risks to the economy, as it has large trade, labor market and banking system links with the euro zone. Economic weaknesses and elevated macroeconomic imbalances have resulted in high levels of public debt, in part because of the accumulation of unpaid government bills and arrears and poor tax revenue performance. With public debt estimated at about 71 percent of GDP in 2013, the budget has high financing needs, including because of the short maturity structure of domestic debt.

51. *Financial stability framework.* The current framework assigns responsibilities in the area of financial stability to several entities (BOA, AFSA, ADIA and MOF), although in practice BOA, being the prudential regulator for the banking system, plays a leading role. To further strengthen the different structures of the financial stability framework, the four regulators with financial stability responsibilities became signatories to a Memorandum of Understanding in 2012 that created a high level financial stability committee, named FSAG.

52. *Public Infrastructure.* Albania is seeking membership in the EU, and with this goal in mind, reforms to existing legislative codes to bring them in line with EU standards are in process in many areas. Currently, Albania's legal system governing corporate activities is not well developed. The authorities now largely recognize the need to accelerate the adoption of legal and prudential means to reduce the stock and flow of NPLs, and have begun to seek external inputs to improve its capacities and supporting framework.

53. *Crisis management recovery and resolution.* The legal framework provides the BOA, the AFSA and the ADIA with a range of tools or responsibilities relative to intervention in the event a crisis situation arises. The banking law specifies going concern resolution powers for capital and liquidity inadequacies, and in cases of declared insolvency.

54. *Systemic protection (safety net).* 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, but only about 58 percent of all system deposits. The mandate of the deposit insurer as a paybox is appropriate for the development and size of the financial sector. Equally the use of a flat rate deposit insurance premium of 0.5 percent of insured deposits as opposed to risk-based premia is prudent given ADIA's relatively recent establishment. However, the absence of coverage for small enterprises is a material weakness in the safety net for depositors, as it contravenes a primary objective of deposit insurance—to protect small, financially unsophisticated depositors—as well as European Union guidance on coverage.

55. *Market discipline.* In the medium term, a robust and transparent accounting and auditing environment should be actively encouraged by the BOA so as to enhance the overall quality of financial reporting in Albania. Many borrowers have several sets of financial statements (statutory accounts, management accounts, fiscal accounts). In addition, many customers of banks in Albania do not have audited financial statements. This means that banks' credit underwriting staffs are obliged to frequently rely on unaudited statutory and/or management accounts. The BOA should encourage stronger reporting practices by larger corporate borrowers.

C. Main Findings

Objectives, powers, independence, accountability and cooperation (CPs 1–3)

56. There is a generally comprehensive set of laws and regulations governing the supervision of the banking industry. BOA is autonomous both from a *de jure* and *de facto* perspective. While the legal framework provides some protection to bank supervisors against damages resulting from the discharge of their responsibilities, it is inadequate as it does not provide protection against the costs of defending acts of commission or commission of their duties in good faith unless the supervisor is exonerated in a court of law. Banking supervision would likely be adequately staffed if the existing vacancies were filled, all of which have been authorized. A fully staffed unit is necessary in light of several supervisory initiatives, including implementation of risk-based supervision and Basel II.

57. BOA is empowered to engage in cooperative efforts with both foreign and domestic supervisory authorities. Toward that end it has entered into cooperative arrangements with other financial sector supervisors in Albania and many foreign supervisors whose institutions have operations in Albania. These arrangements have proven to be effective, and have enabled BOA to exchange supervisory-related information with other supervisors. Nevertheless, BOA needs to explore ways that it can enhance its cooperative arrangements with the supervisor of the institution possessing the largest market share in Albania.

Ownership, licensing, and structure (CPs 4–7)

58. The legal framework is clear relative to the types of banking and non-banking activities in which banks may engage. At present, licensing applications are limited principally to increases in capital and approval of members of the Steering Council. Nevertheless, the legal framework, policies and processes are in place to evaluate new banking licenses and changes in control, although they have not been tested.

59. The transfer of ownership is well defined in the law and there explicit definitions for controlling interests. However, the requirements for an acquisition representing either a presumption of control or a controlling interest could be enhanced to differentiate them from the requirements for lower levels of ownership interests. The definition of an indirect ownership in a

bank needs to be strengthened, and BOA needs to formally require the reporting of such interests through its regulatory reporting process.

60. **The investment by banks in NBFIs and non-financial institutions is governed by a satisfactory set of laws.** These feature situations in which prior approval and notification only are required.

Methods of ongoing banking supervision (CPs 8–10)

61. **The supervisory approach tends to be compliance-based and should move more towards risk-based supervision.** Nevertheless, BOA did adopt different elements of risk-based supervision and prepared the next step of moving towards a more risk based approach. A new supervisory methodology aligned with Basel 2 is set up and planned to be implemented mid-2014 together with a new supervisory cycle that has yet to be developed.

62. **The BOA has an appropriate mix of on-site and off-site supervision to evaluate the condition of the banks.** It uses some progressive approaches in addressing the root cause outside the perimeter of the supervisor. But, there are some weaknesses that need attention. First, the business model analysis of a bank needs to deepen. Second, although the portfolio managers are qualified to assess the financial condition of a borrower and are willing to intervene if necessary, there is limited expertise on the specific businesses of the borrower to really challenge the payment capacity of a borrower. Part of this is because there is a lack of industry to benchmark. Third, it takes sometimes between one and four months to issue an examination report. This frustrates prompt formal action if needed. This turnaround should be improved. Risk-based supervision will help in this direction.

63. **There is an extensive array of reporting requirements for banks that provides a wide range of data and risk management information, principally on a consolidated basis, but solo data is collected as needed.** Appropriately, the information is used in the supervision process to evaluate risk and for other objectives. Some of the information must be collated manually at present and this inhibits the amount of data that can be analyzed efficiently. An automated platform is being introduced late in 2013 that should address the problem and facilitate higher quality analytical work.

Corrective and sanctioning powers of supervisor (CP 11)

64. **Corrective measures imposed on banks are mostly based on prudential standards rather than focused on addressing risk management issues.** While risk management issues have been addressed principally through the examination process, and have been generally successful, there are cases where such issues have lingered. In such cases, the employment of other components of the supervisory toolkit—principally formal enforcement actions—should be applied. The use of such corrective measures to address prudential issues is very important, but applying such measures when underlying risk management issues have not been resolved informally for a protracted period of time also is warranted.

Consolidated and cross-border banking supervision (CPs 12–13)

65. BOA has developed an overall satisfactory program of consolidated supervision. Supervisors are aware of the organizational structure of banking groups, have identified areas of risk, and maintain contract with other foreign bank supervisors and domestic authorities. The program can nevertheless be strengthened by enhancing cooperative efforts with AFSA, the supervisor of investment funds, so that risk management issues can be appropriately identifies and supervised. One such fund is associated with the largest banking group in Albania.

66. Cross-border banking supervision is implemented through participation in supervisory colleges and bilateral relationships with foreign bank supervisors. BOA engages in host-home country relationships commensurate with the size and complexity of the operations of foreign banks operating in Albania, and the one Albanian bank operating abroad. Formal written agreements governing cooperation and information exchange are in effect between BOA and the preponderance of authorities who supervise banks with a presence in Albania. There is no agreement with the authority supervising the bank with the largest market share in Albania, but the communications channels are nonetheless generally effective in communicating important information.

Corporate Governance (CP 14)

67. Supervisors determine adequately that banks have robust corporate governance policies and processes. Though, BOA can deepen their understanding of the board dynamics and balance of power within a bank, and challenge explicitly the risk appetite of banks.

Prudential requirements, regulatory framework (CPs 15–25)

68. While banks are expected to have appropriate risk management policies and processes, organizational structures and measures for measuring and controlling risks, collectively the analysis of risk management is not as robust as it could be. The supervisors determine that a bank has policies and procedures in place, and determine compliance with the policies. The quality of risk management is a more ephemeral evaluation to capture and their view on this facet of risk management analysis is less clear. Furthermore, the implementation of Basel 2 requires that all examination officers have a good understanding of how to evaluate risk management in practice. However, it is observed that the quality of operations depends on a relatively small group of staff. Therefore, BOA needs to invest in the skills of the examining officers to deepen the evaluation of risk management practices in banks.

69. BOA has according to Basel 1 adequate capital requirements (quantity) and definition of capital components (quality). However, currently BOA does not charge capital for operational risk, interest rate risk in banking book and concentration risk. This will be fixed when BOA implements Basel 2. Nevertheless, because BOA requires a higher capital than prescribed according to Basel 1 (more than 12 percent), there is a cushion for some of these risks.

70. BOA can enhance its scrutiny of credit underwriting policy. Although laws, regulations and the supervisor require banks to have adequate credit risk management that covers the full credit lifecycle, bankers should get more (and regularly) challenges on their credit underwriting policies. Despite the fact that corporate borrowers have weak financial reporting practices (unaudited financial statements) and there is a lack of industry data to benchmark against.

71. BOA has put an increasing amount of effort into solving the root cause of the multi-dimensional NPL problem outside the regulatory perimeter, but should address the problem of misclassification and take the next step in strengthening problem loan management. It is noticed that in a substantial part of the executed examinations the supervisor required several banks to reclassify part of the reviewed loans because of observed misclassifications. Although BOA has devoted significant efforts to solve this problem, misclassification still exists and needs to be adequately addressed. In addition, although there are general provisions in the regulation on credit risk that provide a legal base to set requirements for problem loan management, there are no specific requirements in the regulation on the management of problem loans especially relative to policies and procedures for pre work out, work out, restructuring, collection, recovery and resolution of these assets. It would benefit the banking sector if BOA gives guidance on this topic via regulation.

72. Albanian banks have a substantial concentration risk of Albanian government paper. One systemic bank even has a concentration of Albanian government bonds held-for-trading. This portfolio is valued at fair value and therefore all its gains go directly into the P&L. There has not been a proportional capital charge if the profit turns into losses. Although Basel 2, pillar 2 would address this issue from capital perspective, BOA should address this problem through FSAG.

73. BOA has all the law and regulation in place that addresses abuse and conflict of interest because of related parties, but didn't capture the informal way of doing business in Albania. Different sources state that relatedness is more important than financial condition in doing business in Albania. This means that not all kind of relatedness is captured by the definition on related parties. For instance, situations where loan officers grant loans based on relatedness instead of financial conditions are not captured by this definition. BOA should therefore review their definition of related parties.

74. Country risk and transfer risk are not explicitly addressed in law and regulation. Although BOA does address country risk issues on an ad hoc base mostly in times of crisis, it needs to develop regulation to address country risk on a regular base.

75. The BOA implemented market risk regulation for interest rate risk and FX risk in the trading book (based on Basel 1) as well as for interest rate risk in the banking book (based on Basel 2). Although duration is a good instrument to measure interest rate risks, BOA needs to assess what the uncertainty is regarding other sources of interest rate risk and if the management information system is capable of capturing these sources.

76. The liquidity regulation stems from 2009 and has been a good starting point for managing liquidity risk. However it is time to align the current liquidity regulation with the new Basel 3 requirements, in particular with regard to liquidity coverage ratio (LCR). The greatest liquidity risk is the market risk of government paper, because the liquidity buffer mainly exists of government paper in a very superficial market dominated by one systemic relevant bank. Although, it can also uses the paper for a repo agreement.

77. BOA has implemented the qualitative side of operational risk of Basel 2, except the self- assessment and the capital requirement. The capital requirements for Basel 2 will be implemented together with the total implementation of pillar 2 during 2014. Banks shall have to choose between the basic indicator approach and the standard approach. The banks are expected to be fully compliant by the end of 2014. It is noted that banks have a growing, though not yet material, position in property as a result of foreclosures. Banks are allowed to take this property on their book. Because managing property is not the core business of a bank, it has operational risks which should be reflected going forward on the implementation in 2014 of Basel 2.

Internal control, internal and external audit, financial reporting, market disclosure and transparency (CPs 26–28)

78. There is a reasonably comprehensive set of rules and regulations governing the mandate and quality of the internal audit function and the requirements for a robust internal control system. In connection with the plan to adopt a risk-based supervision program, the authorities will need to require enhancements to internal audit functions in banks, particularly in risk-based audit planning, and ensuring that audit process and procedures are in accordance with international best practice.

79. External auditors are held to high professional and ethical standards in law and practice by BOA, whose requirements are complemented by a self-regulating organization. BOA is empowered to approve the external auditing firm that is retained by a bank, and requires rotation of audit firms periodically.

80. Disclosure requirements are strict, and follow international standards. The banking system prepares its accounting records and reports financial information in accordance with IFRS. Regulatory returns are filed at present in accordance with NAS, but conversion to IFRS for supervisory reporting is being undertaken concurrently with introduction of the fully automated reporting platform.

Abuse of financial services (CP 29)

81. The law governing the requirements for banks and other financial institutions is reasonably comprehensive for combating AML/CFT. BOA has a dedicated staff exercising supervisory responsibilities over AML/CFT activities. BOA and the FIU have coordinated their efforts through joint examinations, training and in other ways.

D. Authorities' Response

82. The Bank of Albania deeply appreciates the fruitful and diligent work carried out through the assessment of the Albanian financial sector by the FSAP Assessment Team.

83. The assessment shed light on the current level of compliance with best international practices, while identifying a number of areas for improvement, several of which are currently subject to ongoing efforts to improve. In this context, we would like to highlight several remaining issues.

84. With regard to core principle 18, it is our belief that the position and all the measures already taken by the Bank of Albania go beyond the objectives of the CP. This is reflected also in your recommendations, which provide additional assurance to properly address the resolution of problem assets, and in particular, provisions and reserves. The Bank of Albania believes the assessment did not fully consider the extremely severe market developments that coincided with the assessment's review period.

85. Moreover, the rating of core principle 19 on government bonds reflect the their liquidity, although many of these bonds are eligible for Bank of Albania operations. We would like to emphasize the fact that this represents a complex matter, going beyond the reach of bank supervision. Nonetheless, Bank of Albania is aware and is already planning the actions to be taken in this respect, also in line with the recommendations of the report.

86. Last, but not least, concerning the issue of related party's transactions, core principal 23. We accept as true that higher consideration has to be paid to the fact that the definition in the law is fairly broad and encompasses all relationships that could be considered during the credit risk evaluation of a connected group of borrowers. Additionally, the Bank of Albania aims to promote sound credit underwriting criteria based on adequate borrower's financial information and is committed to strengthen the legal requirements and enforcement regarding relatedness issues.

87. Finally, it should be noted that, the Bank of Albania remains fully committed to implement all these recommendations, and to use the assessment as a guideline for the action plan to advance the level of supervisory standards towards the best practices, considering that this is also the best contribution to its mandate of guaranteeing the banking and financial stability.

Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Comments
1. Responsibilities, objectives and powers	There is a comprehensive set of laws and directives governing the supervision of the banking industry. The legal framework provides sufficient supervisory tools to require banking corporations to comply with laws and directives, and there are adequate provisions in the law to facilitate consolidated and cross-border supervision. However, certain provision of the law could be amended to strengthen the legal framework still further.
2. Independence, accountability, resourcing and legal protection for supervisors	BOA has a great deal of de jure and de facto independence, and accountability mechanisms are in place. The salary scale for supervisory staff raises concerns long-term about the ability of BOA to attract and retain skilled staff. The protections in the law to indemnify bank supervisors against litigation in the proper conduct and execution of their responsibilities as bank supervisors has been improved significantly, but further improvements are needed regarding the indemnification of supervisors in the event of litigation.
3. Cooperation and collaboration	A satisfactory framework for cooperation on supervisory issues and the exchange of information exists between BOA and other financial regulators, both domestic and foreign. However, such arrangements with two important foreign supervisors have not been concluded, although BOA has initiated efforts in the past to do so.
4. Permissible activities	The legal framework is clear relative to the types of banking activities in which banking institutions may engage. However, BOA would have to interpret the meaning of banking activities very broadly in order to enable banks to engage in new products as they are introduced in the market. An amendment to the LOB providing BOA with the flexibility to authorize new products is a better alternative.
5. Licensing criteria	While licensing activities are limited, the infrastructure is in place in terms of the legal framework, policies and processes to evaluate such applications.
6. Transfer of significant ownership	The transfer of ownership is well defined in the law, and there are explicit definitions for qualifying holders and controlling interests. Some improvements in the law are nevertheless warranted. A strengthening of the definition of indirect holdings is needed, and the report providing the ownership structure of the bank does not include indirect holdings. At the higher ownership thresholds, the approval process should include more stringent hurdles inasmuch as ownership transfers at this level may represent a presumption of control or acquisition of the bank.
7. Major acquisitions	The law governing the acquisition of non-bank companies and other investments provides reasonably restrictive limits on such investments. Regulation and the supervisor consider risks to the institution and the ability to practice consolidated supervision.
8. Supervisory approach	The supervisory approach tends to be compliance-based in a rule-based environment and should move more towards risk-based supervision. Nevertheless, BOA did adopt different elements of risk-based supervision and prepared the next step of moving towards a more risk based approach. A new supervisory methodology aligned with Basel 2 is set up and planned to be implemented mid-2014 together with a new supervisory cycle that has yet to be developed. In addition, the current supervisory cycles doesn't take (prior to assessment) the systemic relevance into account. This should be remedied through adopting risk based supervision. Lastly, the crisis management framework should be strengthened (see main text ¶40).
9. Supervisory techniques and tools	BOA has an appropriate mix of on-site and off-site supervision to evaluate the condition of the banks. It uses some progressive approaches in addressing the root cause outside

	the perimeter of the supervisor (see Principle 18). Still, there are weaknesses that need attention. First, BOA does not record a comprehensive and actual risk profile of a bank (quantitative or qualitative). Second, the alignment between on-site and off-site supervision is frustrated by the dual CA(M)ELS methodology. Although the on-site and off-site evaluations come together in the Supervision Strategy that is required to be updated every three months. Third, early indicator signals can take a year before they will be followed up, although the informality of the organization could find its way. This seems to be related to the fixed inspection cycle. Fourth, the business model analysis of a bank needs to deepen to answer the question: how does this bank earn money, now and in the future, and what are the risks involved: This analysis will help making supervision more forward looking. Fifth, although the portfolio managers are qualified to assess the financial condition of a borrower and are willing to intervene if necessary, there is limited expertise on the specific businesses of the borrower to really challenge the payment capacity of a borrower. Part of this is because there is a lack of industry to benchmark the assessment. Sixth, it takes sometimes between one and four months to issue an examination report. This frustrates prompt formal action if needed. This turnaround should be improved. Risk-based supervision will help in this direction.
10. Supervisory reporting	There is an extensive array of reporting requirements for banks that provides a wide range of data and risk management information, principally on a consolidated basis, but solo data is collected as needed. Appropriately, the information is used in the supervision process to evaluate risk and for other objectives. Some of the information must be collated manually at present and this inhibits the amount of data that can be analyzed efficiently. An automated platform is being introduced late in 2013 that should address the problem and facilitate higher quality analytical work.
11. Corrective and sanctioning powers of supervisors	Corrective measures imposed on banks are mostly based on prudential standards rather than focused on addressing risk management issues. The former is very important, but applying such measures when underlying risk management issues have not been resolved informally for a protracted period of time is warranted.
12. Consolidated supervision	BOA has developed an overall satisfactory program of consolidated supervision. Nonetheless, there is an important gap in the supervision of investment fund activities relative to the evaluation of its risk management practices and a resolution of this problem will necessitate cooperative efforts with the fund's primary supervisor, especially since the fund has grown rapidly.
13. Home-host relationships	BOA engages in host-home country relationships commensurate with the size and complexity of the operations of foreign banks operating in Albania, and the one Albanian bank operating abroad. Formal written agreements governing cooperation and information exchange are in effect between BOA and the preponderance of authorities who supervise banks with a presence in Albania. There is no agreement with the authority supervising the bank with the largest market share in Albania, but the communications channels are nonetheless generally effective in communicating important information.
14. Corporate governance	Supervisors assess if banks have the required strategy, policies, and procedures in place as is stipulated by law and regulation, although BSD can be more intrusive by challenging the risk appetite for all risk categories of banks and their alignment with policy and procedures. Nevertheless on-site supervision observes the dynamics in the

	board room by means of reviewing board minutes and internal reports. This is clearly a good instrument to assess the balance of power within a bank.
15. Risk management process	While banks are expected to have appropriate risk management policies and processes, organizational structures and measures for measuring and controlling risks, collectively the analysis of risk management is not as robust as it could be. The supervisors determine that a bank has policies and procedures in place, and determine compliance with the policies. The quality of risk management is a more ephemeral evaluation to capture and their view on this facet of risk management analysis is less clear. Furthermore, the implementation of Basel 2 requires that all examination officers have a good understanding of how to evaluate risk management in practice. However, it is observed that the quality of operations depends on a relatively small group of staff.
16. Capital adequacy	BOA has according to Basel 1 adequate capital requirements (quantity) and definition of capital components (quality). However there are a few weaknesses and uncertainties. First, the NPL figure, although provisioned for, could deteriorate further the coming period and would therefore need more provisioning. Second, the "NPL reduction strategy" organized by BOA to inventory the quality of the loan portfolio together with third party and to incentivize restructuring, could also lead to more provisioning, although the long-term effect of successful restructuring (and collection) could lead to release of provisional exposures. Third, new loans could also become bad, because of the insufficient quality of underwriting policy and procedures within banks. Fourth, the latter uncertainty could be enlarged by the fact that BOA incentivized growth through relaxing asset risk weightings on new lending in 2013 and 2014. This could attract banks with bad underwriting policies and procedures to accept high risky loans. Five, the NPL could also be inaccurate, because of the set-up of regulations on provisioning being based on reality and therefore does not incentivize prudent conduct, but compliance oriented conduct. Though the fixed system seems to overstate the needed provisions. Six, there is a growing amount of property (as a result of foreclosure) on the balance sheet. Although not material yet, it could lead to a market risk (impairment of value) and operational risk (lack of expertise how to manage property). Currently, BOA does not charge capital for operational risk, interest rate risk in banking book and concentration risk, which would be charged under pillar 1 and 2 of Basel 2. All of the above mentioned risks could be a reason for an extra capital charge; as well as a capital charge for systemic relevance for some of the banks. However, because BOA requires a higher capital than prescribed according to Basel 1 (more than 12%), there is a cushion for some of these risks. With regard to the quality capital levels it is noted that banks are free to payout dividend. This means that actual capital position can sharply change after year end, because of dividend payment. Although BSD anticipated this by setting a higher capital requirement threshold. This can become a risk in times of crisis, when the shareholder is more inclined to pressure the Steering Council (see definition in principle 14 corporate governance, EC 1) for dividend payout, which relates directly to strength of the corporate governance. Next, the quality of capital did decrease the last two years because of the introduction of subordinated debt and hybrid capital instruments used by a few banks. Lastly, the quality of capital is defined within so called "obligatory guidelines". Although BOA states that these guidelines are binding, it is the assessor not clear what the legal status of these guidelines is in times of stress.
17. Credit risk	Laws, regulations and the supervisor through examination reports, meetings, et cetera, require banks to have adequate credit risk management. The full credit lifecycle is covered. Nevertheless, the supervisor can enhance its scrutiny of credit underwriting policy, procedures and criteria, especially with regard to the approval of (new, renewed,

	or restructuring) loans and their financial analysis and valuation of collateral. Although the supervisor does determine if the policy and procedures are compliant with the rules and regulations, including the prescribed classification and provisioning rules, and credit underwriting standards. Bankers should get more (and regularly) challenges on their own credit underwriting policies and procedures (including risk appetite and risk profile) through loan reviews. Connected to this issue are three preconditions not being fulfilled that weaken the ability of the supervisor to do a profound analysis of the credit underwriting policy and challenge the banker: 1) non-audited financial information; 2) lack of industry data; 3) a fixed system of provisioning which provokes compliance-based supervision.
18. Problem assets, provisions, and reserves	**In general** Although BOA has put an increasing amount of effort into solving the root cause of the multi-dimensional NPL problem outside the regulatory perimeter, also addresses the issue of problem loan management to the bankers (by means of examination report and meetings). BOA should address the problem of misclassification adequately and take the next step in strengthening problem loan management. **Identification of problem loans** An adequate identification of loans depends on a clear definition on past due and forbearance measures. Although BOA has defined past due for related parties in the regulation, the classification of a borrower, as part of a related group is as high as the classification of the customer with the lowest rating. In addition, a customer could go into a higher classification if, based upon a documented analysis that the reclassification is justified. However, this leaves much room for interpretation between supervisor and bank. This could contribute to misclassifications by bankers. It is noticed that in a substantial part of the executed examinations the supervisor required several banks to reclassify part of the reviewed loans because of observed misclassifications. Although BOA has devoted significant effort to solve this problem, misclassification still exists. Hence, BOA should not only require banks to correct misclassification after an examination, but should try to address the root cause of the problem so that corrections are not necessary. **Management of problem loans** Although there are general provisions in the regulation on credit risk (see principle 20), that provide a legal base to set requirements for problem loan management, there are no specific requirements in the regulation on the management of problem loans especially relative to policies and procedures for pre work out, work out, restructuring, collection, recovery and resolution of these assets. It would benefit the banking sector if BSD gives guidance on this topic via regulation. Nevertheless, BSD did a lot of other activities to resolve the problem loans. It issued in November 2013 a guideline on restructuring loans (corporate and retail) to give banks guiding principles on how to restructure loans (for and works on several areas to open the strategy of collection (see preconditions). It also hired a private party to help assessing the quality of category 2 – 4 loans and build up the restructure repertoire for banks (going to health or going to collection). And it set up a paragraph in the regulation on credit risk (LOB 17) to incentivize restructuring for category special mention borrowers. In an environment with negative economic conditions and with a tendency for forbearance, this could stimulate the banks that have poor risk management to indeed restructure a loan with no future and wouldn't therefore recognize the problem. On the other hand it is also a measure that could stimulate restructuring in a positive way.

	Review See principle 17 credit risk and the remarks on credit underwriting. Same findings are applicable on loan review. **Provisioning** The regulation requires banks to provision according to a fixed percentage. Category standard, special mention, sub-standard, doubtful and loss are required to provision respectively 1%, 5%, 20%, 50%, or 100%. This methodology is established in 1997. Since then, no changes were made. Because of changes in the economic environment since 1997, it would be recommended to calibrate the provision methodology against the current economic situation and international standards as well as best practices in the financial sector in Albania. Further, a fixed system of provisioning could veil the clear responsibility of a bank to act according to prudent standards. Therefore, this fixed system could be contributing to the problem of misclassifications. Although this is difficult to assess. BSD could consider (in long term) implementing provisioning standards based on an incurred an expected loss model (like IFRS). But because this model is based on reliable measurements of experienced bankers, BOA first need to set some preconditions under which stronger financial reporting practices by customers of banks and build-up industry data (see further principle 17 on credit risk). **Write-offs** In principle banks are required to be compliant with local accounting standards based on IFRS 1998 (see Bank Accounting Manual). In addition, in the regulation on credit risk there is one article on write-off (ROC article 17) that state that a write-off should be assessed on an ongoing basis, not less than once in 6 months, and decided by the Steering Council. According to local accounting standards, banks are required to write-off their non-performing loans when "the lack of economic benefit is considered other than temporary" (see Bank accounting manual, part 2.1, section 5). Nevertheless there is a substantial amount of NPLs not been written-off in the prudential report (6%-point of 24% NPL according to BOA estimation), while some banks that also have to file a financial statement based on current IFRS standards of the parent company did account a write-off. This indicates that there is enough evidence to indeed write-off bad loans. The reason why this hasn't been practiced is because of the tax issue. The tax authorities do not recognize write-off as tax deductible. Therefore banks are reluctant to write-off. Recently the Ministry of Finance aligned the definition in the tax regulation and is in the process of implementing this practice. Nevertheless, according to local accounting standards, banks could have written-off NPL's regardless of the issue with the tax authorities. Sound accounting practice would account the write-off, not (yet) taken into account by the tax authorities as a deferred tax asset. The supervisor could address this issue with the banks and the external auditor. The current IFRS standards state that you write-off in case there is "no reasonable expectations of recovery". Though, BOA states that write-off under the current tax regulation would have an enormous negative impact on the profitability of banks.
19. Concentration risk and large exposure limits	The supervisor determines that banks have policies and processes in place to identify and monitor concentration risk, but this is limited and not systematically guided by law and regulation. The law and regulation on concentration risk is stipulated in three different sections under which the LOB article 63 and 64, regulation on credit risk article 6 and 9, and the regulation on large exposure. For large exposures, BOA does have the necessary requirements, including limits for individual customers, groups of connected customers and aggregated large exposures. One systemic bank has an enormous concentration of government bonds held-for-trading. This portfolio is valued at fair value and therefore all its gains and losses go

	directly into the P&L. There has not been a proportional capital charge against this, because it is government paper. Although there are no breaches of market risk regulation, there is a material concentration risk, which should have been addressed. In the last period the portfolio gained a profit, but that can change someday. Therefore a capital charge should be applicable because of the concentration risk. Pillar 2 would have had measures to address this problem.
20. Transactions with related parties	BOA has all the law and regulation in place that addresses abuse and conflict of interest because of related parties and assesses during on-site examination if the banks are compliant with these. However, different sources state that relatedness is more important than financial condition in doing business in Albania. This means that not all kind of relatedness is captured by the definition on related parties. For instance, situations where loan officers grant loans based on relatedness instead of financial conditions are not captured by this definition.
21. Country and transfer risks	While BOA does address country risk issues on an ad hoc basis mostly in times of crisis, neither country risk and transfer risk are explicitly addressed in law and regulation. Nevertheless foreign parents of Albania subsidiaries do require their subsidiary to identify, measure, and control country and transfer risk.
22. Market risk	Although BOA implemented a market risk regulation (quantitative and qualitative) based on Basel 1 for both interest rate risk and FX risk in the trading book, there is clearly a high concentration risk in Albanian government paper in local currency within systemic relevant banks. These positions are both in the trading book and the available for sale portfolio. The trading book is valued at fair value, where the change of value directly goes into the profit/loss. This is both for local accounting standard and for IFRS. The available for sale is within local accounting standards valued at acquisition costs and impaired when there is a loss. So there is a hidden reserve if the value of the government paper is higher than the acquired costs. There are no limits with regard to banks' buying government debt. But, there are, though limited, capital requirements for these positions based on Basel 1 (on average 2.5% of the position). BOA also requires extra capital for these systemic banks because of these positions. Nevertheless, the concentration is very high and BOA should consider intervening and mitigate this concentration risk in a prudent way (see principle 19 Concentration risk).
23. Interest rate risk in the banking book	BOA couldn't make explicit that they challenge the interest rate risk appetite of a bank. Because duration is a good instrument to measure interest rate risks, BSD needs to assess what the uncertainty is regarding other sources of interest rate risk and if the management information system is capable of capturing these sources. For instance, BOA could require banks to stress the interest rate position by rotation of the yield or other scenarios. Although BOA asks banks to do stress test that take different sources into account, it also requires banks to measure interest rate risk via the methodology prescribed in the obligatory guideline.
24. Liquidity risk	The liquidity regulation stems from 2009 and has been a good starting point for managing liquidity risk. However it is time to align the current liquidity regulation with the new Basel 3 requirements, in particular with regard to liquidity coverage ratio (LCR). The greatest liquidity risk is the market risk of government paper, because the liquidity buffer mainly is government paper in a very superficial market dominated by one systemic relevant bank (although it can be used in a repo agreement). This means that in case of a bank run, a bank needs to sell its government paper, there could be no buyers for it (see crisis management framework; and systemic liquidity risk). In addition, with regard to held to maturity for government paper up to one month, there could also be a loss hidden because of the mismatch between daily liquidity management and

	(local) accounting standards. Further, there are some banks that are more sensitive than others for reputational risk. The deposit holder covers 83% of the funding of the banking systems of which 30% is up to 1 month. BOA took some additional measures to mitigate for the weaknesses and risks of this "rough" ratio from 2009. First, since the crisis in 2008 BOA receives liquidity information on a daily and weekly basis. These are useful early indicators, but do not improve the liquidity position. Second, supervisors assess the liquidity management framework, including the contingency plan. This is an important instrument to challenge the liquidity risk management. Third, there is ELA which is an instrument in times of stress. Important is also a robust safety net for the deposit holders (see precondition) that prevent people from a bank run and a clear crisis management framework.
25. Operational risk	BOA has implemented the qualitative side of operational risk of Basel 2, except the self-assessment and the capital requirement. The capital requirements for Basel 2 will be implemented together with the total implementation of pillar 2 during 2014. Banks only can choose between the basic indicator approach and the standard approach. The banks are expected to be fully compliant by the end of 2014. Currently banks report the prescribed key operational risk indicators (including indicators on IT risk) quarterly and their operational risk losses by business lines and type of events yearly (including losses related to IT risk). Bank use low thresholds with regard to the amount they report. No material losses were reported by the banks. In the current supervisory CAMELS methodology operational and IT risk are together with governance part of Management (M). This is resolved in the new Supervisory Manual (yet to be implemented). Operational risk will be a separate risk category together with reputational risk. These are two off-site activities: 1) quarterly the key operational risk indicator will be recorded in a database by the off-site officers (and annually the operational risk losses per business line). Anything unusual will be (informally) reported to portfolio manager. There are no formal reporting lines on a quarterly basis; 2) annually around August the off-site officers will analyze both the quarterly and annually reports and report it formally to the portfolio manager. For the on-site examination, the timing depends on the inspection cycle. Operational risk is part of the full scope examination. On-site the examiners assess if the policies and procedures are compliant with the regulation on operational risk. They assess the nature of the reported losses and reconcile the reported losses with the general ledger. It is noted that banks have a growing, though not yet material, position in property as a result of foreclosures. Banks are allowed to take this property on their book (LOB article 70, paragraph 5.1). Because managing property is not the core business of a bank, it has operational risks which should be reflected going forward on the implementation in 2014 of Basel 2.
26. Internal control and audit	There is a reasonably comprehensive set of rules and regulations governing the mandate and quality of the internal audit function and the requirements for a robust internal control system. In connection with the plan to adopt a risk-based supervision program, the authorities will need to scrutinize closely the overall effectiveness of the internal audit function.
27. Financial reporting and external audit	Meetings with external auditors are held infrequently to discuss accounting and financial issues, and other areas of general interest. More frequent meetings could be beneficial to all parties.
28. Disclosure and transparency	Disclosure requirements are in accordance with IFRS, and external auditors are employed to ensure that disclosure rules are adhered to. Accounting standards require IFRS for published financial reports and NAS for supervisory purposes. The authorities are planning to transition the banking system solely to IFRS standards by 2015 if the

	transition goes smoothly. There is a reasonably complete regulation governing market disclosure, but it may need some modifications to the regulation after Pillar 1 and 2 requirements are finalized in connection with implementation of Basel II.
29. Abuse of financial services	The law governing the requirements for banks and other financial institutions is reasonably comprehensive for combating AML/CFT. BOA and the FIU have coordinated their efforts through joint examination, training and in other ways. The data provided to the FIU through suspicious activity reports could be employed effectively for analysis in BOA's AL/CFT supervision program.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Principle 1	The legal framework provides BOA with sufficient authority to supervise the banking system, but amendments to the LOB or regulations would strengthen it further. Principles 2, 4 and 6 contain recommendations for strengthening the legal framework.
Principle 2	With the impending adoption of risk-based supervision and Basel II among other important supervisory initiatives, consideration should be given to increasing the staff size to capacity, as specialized skills in risk management evaluation and Basel II will be needed. Article 132 of the LOB provides that no liability shall attach to BOA staff in the execution of their duties and responsibilities in good faith, which represents a significant improvement in protecting staff from litigation. However, the indemnification clause of the law specifies that indemnification shall occur only when there is no conviction in a court of law. The effect is that a defendant will have to incur the costs of litigation prior to the verdict being rendered. Article 132 should be amended further to provide full indemnification benefits such that the employee would not be forced to pay costs from personal resources prior to the verdict.
Principle 3	Look for ways to deepen the relationship with the Austrian supervisory authority so as to preserve the flow of information received at present for the institution with the largest market share in Albania.
Principle 4	Amend Article 54 of the LOB to enable BOA to have the flexibility to approve a new business activity without amending the LOB each time a new product is developed and introduced into the market. The LOB explicitly lists all permitted business activities, and an amendment would be required to expand or change the list.
Principle 5	BOA evaluates the capacity of a home country supervisor in the event a foreign bank applies for a bank license in Albania. In the event an Albanian bank wishes to apply for a presence in a foreign country, the authorities should evaluate the supervisory capacity of the host country supervisor.
Principle 6	Consider requiring more stringent approval requirements for qualifying holders acquiring a 33% or 50% stake in a bank. At these thresholds of ownership, there can be a presumption of control or acquisition of the bank. Among other requirements, risk management, internal control and corporate governance plans should be required, as the new owners may have a different view of risk and the bank's prospective risk profile than the previous holders. A stronger definition of indirect holding should be contained in the LOB, and the report submitted to the BOA annually listing owners of the bank should be amended to include indirect holdings and a description of the type of such ownership, especially if through a medium of a nominee, trustee or shell holding company. Amend the LOB to require a bank to notify the BOA of material adverse information about a qualifying holder.
Principle 7	Expand the criteria for approval of an investment in a commercial company in accordance with Regulation 42 to include the requirement to conduct a credit evaluation of the prospective investment

Principle 8	Implement a supervisory approach that is risk-based and forward looking. Adapt an inspection cycle reflecting a risk-based approach. Differentiate prior to assessment the inspection cycle of the systemically relevant banks from non-systemically relevant banks, focusing more resources on systemic institutions. Do self-assessment on crisis management. Strengthen the framework for early intervention and the crisis management framework. Execute periodic crisis simulations.
Principle 9	Start implementing the new supervisory methodology and integrate on- and off-site information to develop a real-time comprehensive risk profile of an institution, including financial information and early warning indicators (for instance operational risk). Deepen the business model analysis. Revise the process for preparing and distributing the examination report so that it is shortened.
Principle 10	Monitor the progress of the banks relative to their conversion to IFRS for regulatory returns to ensure there are no material problems. While no such problems are anticipated because banks file in accordance with IFRS for published financial statements, due diligence is warranted.
Principle 11	Consider using formal corrective measures for safety and soundness issues where the informal supervisory strategy has not resolved supervisory issues in a timely manner. Such measures are not only for application against prudential standards, and will attack underlying risk management issues that can result in an inadequate prudential standard.
Principle 12	There is a gap in the supervision of the financial group with the largest market share in Albania. Consider pursuing more intensely a coordinated supervisory approach on risk management issues with the primary supervisory of the NBFI in question.
Principle 13	Seek ways to further strengthen communication with foreign bank supervisors. This is particularly important for jurisdictions where communication is not governed by a cooperation and exchange of information agreement. The conservatorship and liquidation manual should be expanded to incorporate a plan for the resolution of cross-border banking operations.
Principle 14	Enable the supervisors (on-site, off-site) to be more intrusive towards their evaluation of risk appetite versus banks' incentive system, to benchmark against the control environment. Enhance assessments of balance of power by means of, for example, stakeholder analysis, and assessment of the leadership profile of administrators attending credit risk committees. Evaluate "the tone at the top".
Principle 15	Move the banking system in the direction of comprehensive risk management. Invest in the skills of the examining officers to deepen the evaluation of risk management practices in banks. Have comprehensive policy meetings on board level on the alignment between risk appetite, risk tolerance, true risk profile, risk culture, bank strategy and capital allocation.
Principle 16	Conclude assessment of recovery and resolution plans of banks, especially of those banks indentified as systemically important. Provide written guidance to banks. Make regulation on regulatory bank capital (instead obligatory guidelines).
Principle 17	Determine deeply the adequacy of underwriting processes, including loan review; Build up industry data for most important sectors to underpin financial analysis for supervisors; Encourage stronger financial reporting practices by larger corporate

	borrowers.
Principle 18	Address the size and nature of the problem of misclassification. Evaluate the fixed system of provisioning. Formulate requirements for problem loan management which would address the collection, restructuring, recovery and resolution of loans. Evaluate write-off practice together with stakeholders and experts. Keep addressing NPL problem to different stakeholders;
Principle 19	Address concentration risk of government paper in the banking system through the FSAG. Consider how to deal with the concentration of market risk because of portfolios of government paper held-for-trading now before introduction of Basel 2, pillar 2. Develop a separate regulation on concentration risk.
Principle 20	Consider expanding the definition on related parties in a manner that it can capture situations of loan officers granting loans based on relatedness instead of financial conditions. Consider assessing the extent to which loans are granted based on relatedness instead of financial conditions.
Principle 21	Develop a regulation on country risk.
Principle 22	See 19 for concentration government paper in the trading book.
Principle 23	Identify and evaluate the sources of interest rate risk in the event the Basel II proxy applies to individual banks. This should be developed in connection with introduction of the SREP in 2014.
Principle 24	Move towards Basel III regarding liquidity risk management. Refine the liquidity ratio (liquid assets, short term deposits), expand monitoring tools, and assess the sources of liquidity risk, moving beyond the prudential standard. Consider implementing ILAAP.
Principle 25	Consider expanding your outreach to service providers of outsourced activities (including outside Albania) by requiring banks to include in their outsourcing contracts that BOA has the right to audit the service provider.
Principle 26	Encourage banks through the supervisory process to focus on further enhancements in the effectiveness of the internal audit function. This is an important component of risk-based supervision that would enable the supervisors to focus supervisory resources on high risk areas of the bank.
Principle 27	More frequent *ad hoc* meetings with external auditors are recommended. These meetings provided a forum to exchange views and information in a dynamic setting on accounting, auditing and financial issues relevant to all parties.
Principle 28	Some modifications to the market disclosure regulation (regulation 60) may be needed after conversion to Basel II. The supervisor should review the regulation relative to the Pillar 2 requirements once the risk management framework under Pillar 2 is developed.
Principle 29	Explore ways to obtain either summary or institution-specific information on the contents of suspicious activity reports submitted to the FIU. The information should be useful in identifying trends or issues in a particular institution, and help focus supervisory resources on high risk areas. Toward that end, an MOU with the FIU would facilitate the exchange of such information.

Appendix V. Report on the Observance of Standards and Codes: Core Principles for Effective Deposit Insurance Systems—Summary Assessment

A. Background

88. An assessment of compliance with the Core Principles for Effective Deposit Insurance Systems (Core Principles) was conducted as a part of the Financial Sector Assessment Program (FSAP) performed by the International Monetary Fund and the World Bank at the request of the Albanian government. The assessment was conducted during a mission to Albania from October 28 to November 11, 2013.

B. Methodology Used for the Assessment

89. The evaluation of the compliance with the Core Principles for Effective Deposit Insurance Systems was conducted on Albania's deposit insurer, the Albanian Deposit Insurance Agency (ADIA) utilizing the Methodology for Compliance Assessment adopted in December 2010 by the Bank for International Settlements and the International Association of Deposit Insurers. The Assessment addresses ADIA's compliance with the Core Principles with respect to its operations as an insurer of deposits in 16 banks. ADIA was also recently given responsibility for developing rules for insuring the deposits in 126 savings and credit cooperative associations (SCAs). In accordance with the Methodology, the Assessment is designed to assess to the extent possible whether the criteria are fulfilled in practice and not just in theory (Methodology at 2).

90. The assessment was based on a review of relevant laws, regulations and regulatory and supervisory practices related to the banking sector and the operations of ADIA. Multiple meetings were held with various employees of the Bank of Albania (BOA), Ministry of Finance (MOF), the Banker's Association, the two Savings and Credit Associations, and ADIA. ADIA completed a self-assessment in preparation for the FSAP.

91. There have not been any failures of an insured institution since ADIA's establishment in 2002. As a result the Assessment looked at the relevant provisions of the amended legal framework without consideration of how the laws had been applied in practice or interpreted by the courts.

C. Institutional And Macroprudential Setting And Market Structure Overview

Supervisory Environment

92. The financial system is concentrated. In Albania, banks dominate the financial system, accounting for 94 percent of financial system activity, equivalent to 88 percent of GDP in 2012 (up from 76 percent in 2005). Subsidiaries of foreign banks represent about 93 percent of total banking assets. Bank credit is funded largely by local deposits.

93. BOA supervises the domestic banking system, saving and credit cooperatives, and other nonbank financial institutions, and the Albanian Financial Regulatory Authority (AFSA) supervises insurance companies, pensions and investments funds. The BOA intends to implement Basel II by 2015 and complement the current focus on compliance with a forward-looking risk-based approach to supervision. It cooperates with a number of home supervisors of European banking groups that operate in Albania.[34] A high level financial stability advisory group (FSAG) chaired by MOF was formed in 2006 and became fully operational in 2012. It meets on a quarterly basis to monitor developments and risks to the financial system. ADIA is administered by a Board of Directors appointed by BOA and is managed by an executive, the General Manager.

Overview Of The Financial System

94. The largest banks dominate the financial system. The top banks comprised almost three-quarters of total financial assets as of year-end 2012. As a result of legal changes in 2012, all foreign banks operate as subsidiaries. There are 15 foreign-owned bank subsidiaries of major international banks, including banks from neighboring countries (Greece, Italy, Turkey and the largest bank, Raiffeisen, from Austria). Greek banks account for one-fifth of Albania's banking system. The NBFI sector constitutes a small but growing share of the total financial system, with about 6.4 percent of financial system assets.

95. Albania's banking CAR and liquidity ratios are high, offset by significant NPLs. As of March 2013, the banking system's capital adequacy ratio (CAR) was 16.8 percent. Overall the banking sector is characterized by moderate liquidity risk and adequate capitalization. However, (NPLs) reached 24 percent of gross loans, the highest in the region. Credit risk thus represents the biggest challenge in the operation of the financial sector.

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[34] The BOA has signed Memoranda of Understanding with supervisory authorities in Bulgaria, Germany, Greece, Italy, Kosovo, Macedonia, Montenegro, and Turkey and the regional supervisory authority.

96. The remainder of the financial system is small (6.4 percent of financial system assets). As of mid-2013, it included 11 insurance companies, 1 investment fund, 126 savings and credit associations largely in two unions, 6 pension funds, and 21 other non-bank (that is, non-deposit-taking) financial institutions.

D. General Preconditions For And Effective Deposit Insurance System

97. The preconditions for an effective deposit insurance system (a stable macroeconomic environment, sound governance of agencies comprising the safety net, strong prudential regulation and supervision, a well-developed legal framework and a sound accounting and disclosure regime) are largely in place.

98. BOA has the authority to enter into arrangements with domestic and foreign supervisory authorities to coordinate financial stability measures if relevant. BOA has entered into a number of agreements with foreign supervisory authorities and participates in some of the Supervisory Colleges for its largest banks.

E. Main Findings

99. The deposit insurance framework in Albania, managed by ADIA, broadly conforms to best international practice. ADIA was established in 2002 pursuant to Law No. 8873, as amended in 2009 and 2012. ADIA administers a Deposit Insurance System (DIS) which covers deposits in 16 banks. It will also take on the responsibility for insuring deposits in SCAs in the future as provided under the 2012 amendments to its governing law. ADIA does not have a statutory target ratio per se, but under Article 24 of its law it has the authority to reduce annual insurance premiums if its assets exceed 5% of the average of total insured deposits. It is projected that as of December 31, 2013, ADIA's fund will be at approximately 3.68 percent of insured deposits.

100. ADIA is funded by annual premiums collected from member institutions. The rate is 0.5 percent of the average amount of insured deposits held by the banks at the close of business of the last calendar quarter of the preceding year. Premiums are paid on a quarterly basis; there is no risk based element to the premiums. ADIA also has the authority to collect advance premiums and, with the approval of BOA, special contributions where needed to replenish its fund.

101. ADIA is managing an investment portfolio that has reached almost 20 billion ALL or approximately 1.4 percent of GDP at end-September 2013. Potential payouts from the fund to insured depositors would be in ALL, but insured deposits are denominated both in ALL and foreign currencies (largely Euro). Investment policies of ADIA are based on its law and an internally approved policy appropriately focused on safety and liquidity over return. Current investments are focused on safe investments in Treasury bills up to twelve months.

102. As the portfolio grows and more information becomes available on its liability structure it would be prudent for ADIA to adopt principles of asset-liability management. This would entail taking into account the currency risk related to foreign denominated deposits and an

appropriate investment horizon. ADIA's share of the twelve month Treasury bill portfolio is growing and is now close to 10 percent of outstanding Treasury bills which makes it increasingly difficult for ADIA to roll over its portfolio.

103. Deposit insurance is compulsory for all banks. ADIA protects only natural persons, up to the maximum of 2.5 million ALL (about US$25,000) per depositor. Foreign denominated deposits are insured to the same amount, but are paid in ALL, with the exchange rate set under Article 4 of ADIA's law as that in effect on the date of intervention. ADIA is legally mandated to reimburse depositors within three months of the intervention by BOA in an insured bank, with the ability to ask that this time be extended for no more than six additional months. ADIA insures approximately 95 percent of individual depositors and 58 percent of deposits in the banking system.

104. ADIA is in broad compliance with the Core Principles (one Principle is Not Applicable). ADIA has a number of strengths, including its ability to attract qualified staff, its efforts to build a computerized data collection system and its cordial working relationship with BOA as an entity within the central bank. However, there are several areas for improvement, including its public awareness program particularly as it relates to investment products offered by one of its member institutions, its governance framework which requires ratification of many of its actions by BOA, the absence of full implementation of the information sharing agreement between BOA and ADIA (including the lack of access to supervisory information about member institutions that could impact ADIA's preparedness for a payout), its overly restrictive legal requirements for approved investments and the limitations on legal protection for its current and former employees as well as those acting at its direction.

105. Table 1 offers a principle-by-principle summary of the assessment results, while recommendations to improve compliance with the CPs are summarized in Table 2.

Table 1. Summary Compliance with the Core Principles

Core Principle	Comments
1. Public Policy Objectives	ADIA's law does not include its PPOs. ADIA does not have a process for regularly reviewing whether its operations do meet its PPOs.
2. Mitigating Moral Hazard	There is limited deposit insurance coverage for deposits held by natural persons (currently the approximate equivalent of $25,000 per person per institution). Foreign denominated accounts are insured at the same level. ADIA charges flat rate premiums to its member banks which is appropriate at this stage of its development.
3. Mandate	ADIA has a paybox mandate to act as an insurer of deposits. This mandate is clearly specified in ADIA's governing statute in Article 6.
4. Powers	ADIA has powers consistent with its paybox mandate, including the power to get information from member banks, to reimburse insured deposits, to enter into contracts without regard to public contracting laws when making insured deposit payments, to decide on the admission and exclusion of banks in the deposit insurance system, to share information with other members of the safety net and to engage in contingency planning. However, many of its actions need to be ratified by the BOA, including its internal operating budget, and it does not have the direct power to compel member institutions to meet their obligations to pay premiums and provide information on deposit accounts.
5. Governance	ADIA is a public legal entity supervised by BOA. There are five members of ADIA's board appointed for staggered five year terms. A Chief Executive Officer is selected by BOA and appointed by the Board of Directors. Members of the Board are appointed by BOA, with two members selected by BOA, two members selected by MOF and one member selected by the Professional Union of Public Accountants. Board members cannot be employed by an insured entity, must meet certain other qualifications, and can only be dismissed for specified cause under Article 13 of ADIA's law. All employees are subject to the conflict of interest provisions of Article 17 of ADIA's statute.
6. Relationships with other safety-net participants	There is a MOU in place between ADIA and BOA that dates from 2002. However, the materials identified in the MOU have not as a matter of practice been shared with ADIA. There is a MOU in place among MOF, BOA, AFSA and ADIA regarding the operation of the FSAG and the exchange of information connected with that operation.
7. Cross-border Issues	ADIA has the legal authority under Article 9 of its law to enter into agreements with foreign deposit insurers for the sharing of relevant information. However, no such agreements have been made to date. ADIA is only responsible for the payment of insured deposits within Albania.
8. Compulsory Membership	All banks licensed by BOA are members of the DIS. ADIA's law provides (in accordance with its amendment in 2012) for the entry of SCAs into the

Core Principle	Comments
	deposit insurance scheme. However, all necessary applications have not been completed by the SCAs. In addition to the requirement that SCAs complete an application to join the deposit insurance scheme, the Government of Albania agreed in the 2012 amendments to ADIA's law to provide initial funding for such purposes to ADIA in the amount of 50 million ALL. To date that funding has not been provided.
9. Coverage	ADIA insures deposits of natural persons in both local and foreign currencies up to 2.5 million ALL per person per institution. Current coverage levels cover 95% of individual depositors, 69% of all individual deposits and approximately 58% of all bank deposits. There is no established process for review of coverage rules and limits. The 2012 amendments to ADIA's law clarified that set-off of insured deposits would only occur against past due loans.
10. Transitioning from a Blanket Guarantee	Not applicable.
11. Funding	ADIA manages an *ex ante* fund. There was an initial contribution to the Fund by the government which forms part of the capital of ADIA. Once the fund reaches 5 percent of insured deposits ADIA may reduce the level of premiums it collects. By year end 2013 it will be at approximately 3.68 percent of insured deposits. Back-up funding for an insured deposit payout is provided in accordance with Article 20/1 of the ADIA law and pursuant to a tri-partite agreement with MOF, BOA and ADIA signed in March 2012.
12. Public Awareness	ADIA has prepared a pamphlet that describes what is and is not covered by deposit insurance and this pamphlet is provided at events ADIA attends. The account forms prepared by member institutions for new accounts contain information about deposit insurance. There are signs about ADIA coverage on bank premises. ADIA also has information about coverage on its website and has provided information on deposit insurance to BOA to include in its education outreach on financial literacy. ADIA has not measured the level of awareness of deposit insurance generally although there are plans to develop a survey (there is such an instrument in draft). ADIA has recently reorganized to have a dedicated public awareness group.
13. Legal Protection	Only ADIA employees have legal protection under Article 16/1 of its law. There is no legal protection for former employees or for those acting at ADIA's direction. In addition employees are required to pay for the costs of their legal defense and seek reimbursement from ADIA if they are found not responsible.
14. Dealing with Parties at Fault in a Failure	There are processes in place for dealing with parties at fault in a bank failure, including through the public prosecutor and BOA. ADIA is not involved in the process.
15. Early Detection and	ADIA does not receive information from BOA about banks that are part of the

Core Principle	Comments
Timely Intervention and Resolution	Early Warning System and thus is not part of the early detection framework. BOA does have the power to use a variety of resolution tools, and ADIA under Article 7 of its law can contribute to a P&A or bridge bank, up to the amount of insured deposits.
16. Effective Resolution Processes	ADIA is involved in the resolution process once the BOA determines to place a bank into liquidation (this is defined as an "intervention" under ADIA's law). Its role is limited to either completing an insured deposit payout or contributing funds in that amount to a P&A or bridge bank transaction. There is no formal process for ADIA to participate in the decision as to the use of its funds in resolution.
17. Reimbursing Depositors	ADIA is in the process of developing an automated system for the payment of insured deposits with the cooperation of its member banks. The system would allow it to perform a payout in less than the current time it is provided in its law (three months). Once its automated system is operational ADIA intends to conduct a simulation exercise to test its readiness for a payout. ADIA's law was amended in 2012 to eliminate set-off for other than overdue loans, thereby simplifying calculations for a payout. There is no authority to make advance or interim payments to depositors in case of delay.
18. Recoveries	ADIA is subrogated to the claims of depositors it pays under its insurance obligation. Adequate judicial processes exist to allow for asset recovery although the process of realizing on collateral can be slow.

Table 2. Recommendations to Improve Compliance with the Core Principles

Core Principle	Recommended Action
1. Public Policy Objectives	Amend ADIA's governing statute to specifically state its public policy objectives. Develop a process for measuring whether ADSIA meets those objectives.
4. Powers	ADIA should be able to have greater autonomy from BOA in its daily operations and should have fewer of its actions subject to ratification by BOA. ADIA's exemption from public procurement rules should be extended to include work done in preparation for an insured deposit payment and the transfer of funds.
6. Relationships with other Safety Net Participants	The MOU between ADIA and BOA on information sharing should be fully implemented.
7. Cross-border Issues	ADIA should enter into agreements with relevant deposit insurance authorities to facilitate resolution planning and ensure an effective communication strategy if parent banks should face stress in their operations.
8. Compulsory Membership	ADIA and BOA should work together to complete the process of having all eligible SCAs join the deposit insurance system; the government must comply with its obligation to provide the funding for the DIS to allow the SCAs to be covered by ADIA.
9. Coverage	ADIA should review its list of exclusions from coverage and should study the appropriate level of insurance coverage for the SCAs and the possibility of extending deposit insurance coverage to enterprises.
11. Funding	Allow greater diversification and longer maturities in ADIA's investment portfolio; prepare an Investment Policy that reflects the risk ADIA has with regard to the presence of insured foreign deposits; adopt principles of asset-liability management and internal controls on investment operations and make clear that back-up funding is available to ADIA to support its contributions to a bridge bank or P&A resolution.

12. Public Awareness	Fully implement a Public Awareness Plan including making clear to investors in products sold by banks the uninsured nature of those products.
13. Legal Protection	Provide legal protection to former employees and those working at ADIA's direction and provide rules for ex ante payment of defense costs.
15. Early Detection and Timely Resolution	Fully implement the MOU with BOA to allow access to information on member banks, including information in BOA's examination reports and EWS.
16. Effective Resolution Processes	Develop a formal process for ADIA's involvement in the decision to use its funds in support of bridge bank or P&A resolution decisions.
17. Reimbursing Depositors	Provide ADIA the authority to make advance or interim payments to insured depositors.
19. Recoveries	Treat ADIA's expenses in preparing for the use of its funds in resolution as an administrative expense under Article 121 of the LOB.

Appendix VI. Report on the Observance of Standards and Codes: Insurance Core Principles—Summary Assessment

A. Introduction

106. This assessment of Albania's compliance with the International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP) was carried out as part of the 2013 Financial Sector Assessment Program (FSAP). Although this is the second FSAP for Albania, this is the first external assessment of Albania's compliance with the ICPs.

107. The Albanian Financial Supervisory Authority (AFSA) has all the responsibility for insurance regulation and supervision in Albania.

B. Information and Methodology Used for the Assessment

108. This assessment is based upon information made available to the assessor in preparation for and during the November 2013 FSAP mission. The AFSA contributed its self-assessment and a detailed update thereof at the individual criterion level. Further sectoral information (including responses to a questionnaire sent out in advance) was provided before and during the mission. Comprehensive documentation, including all relevant laws, by-laws and regulations were (i) available on the AFSA's web-site or (ii) provided to the assessor by the AFSA's management.

109. The assessment has also been informed by discussions with the AFSA and insurance market participants. The assessor met with management and staff from the AFSA, and insurance companies in Tirana. The assessor is grateful for the full cooperation extended by all and, in particular, for the excellent support provided by the AFSA.

110. The assessment employs the 2011 version of the IAIS Insurance Core Principles and Methodology revised in October 2012. It takes into account IAIS standards and guidelines.

C. Institutional and Market Structure Overview

111. The insurance sector in Albania remains small and underdeveloped with gross written premium of about 0.66 percent of GDP. With insurance consumption of €20 per capita, Albania lags behind all countries of Southeastern and Central Europe. Over the last three years, the market experienced little growth in real terms mainly due to weak economic growth, lack of public awareness, low insurance 9.5 fierce price competition among 11 insurers who shared the market of only €64 million in gross premium written (GPW).

112. By the end of 2012, there were 11 companies in insurance market, out of which eight non-life insurers, two life insurers and one composite company (INSIG). Insurance Law specifically requires the separation of life from and non-life insurance, however the state-owned

INSIG is allowed to perform both types of activities under the same entity until it is finally privatized. In 2012, five subsidiaries of Austrian insurance groups accounted for 63.4% percent of non-life premiums and 51.2 percent of life insurance premiums respectively. Licensed entities also include seven insurance brokerage companies, 17 independent claims adjusting firms and 279 individual licensed agents and 15 authorized actuaries.

113. Despite a very low market penetration rate, the real growth of insurance premiums from 2009 to 2012 was only 3 percent, falling even below the cumulative GDP growth (7.5 percent) over the same period. As a result, insurance penetration measured as a ratio of gross written premiums to GDP dropped from 0.69 percent to 0.66 percent from 2009 to 2012. The development of the sector has been hindered by the lax insurance regulation, low disposable incomes, poor industry record of claims performance, the lack of trust in insurance among the public.

Figure 1: Insurance Penetration

Insurance Penetration	2008	2009	2010	2011	2012
Gross Premiums Written/GDP	0.65	0.69	0.67	0.62	**0.66**
Insurance Market Assets /GDP	1.42	1.42	1.45	1.45	**1.51**

Source: Albanian Financial Regulatory Authority.

114. In 2012, the share of life and non-life insurance in total premium was 10 and 90 percent, respectively, with motor third-party liability insurance (MTPL) insurance constituting the largest share of the total non-life premium - 56.9 percent. About 63.7 percent of premiums came from motor lines of business (both MTPL and casco), 7.7 percent from personal accident and health, 21.2 percent from property, 4.4 percent from general liability and the rest from MAT[35] and financial insurance.

115. About 59 percent of life insurance premiums came from credit life insurance. Commercial banks require their clients to buy credit life insurance sufficient to cover the unpaid loan balance. However, in 2012, the total life insurance premiums dropped by 17.3 percent compared to 2011 due to the slowdown of lending by the banks and a 25 percent decline in credit life premiums. Although life insurers have introduced long term life insurance products with saving elements, the difficult economic conditions and the lack of insurance tradition do not bode well for a quick growth of life insurance in Albania. The insurance revenues from such products were only 14.6 percent of a rather small life insurance portfolio which totals EUR 6.3mm. The development of life insurance

[35] Marine, Aviation, and Transport.

would require the adjustment of current regulation with regards to the (i) calculation of mathematical reserves for long term products (no requirements for interests used in calculations) and (ii) relevant investment criteria.

116. As shown in Table 1 below, the underwriting performance of non-life insurance sector was not good in the last five last years, despite the fact that the market claims ratio was only 45 percent. While theoretically plausible, such a low claims ratio is more likely to indicate a poor claims performance by most insurers and a low level of consumer protection. As shown in the same table, around 70 percent of premiums went to cover insurers' operational expenses, which are well above the levels observed in other insurance markets of the region.

Table 1: Key Performance Indicators of Non-Life Insurance Market

Ratio	2008	2009	2010	2011	2012
Premium retention ratio (NPW/GPW)	79.5%	82.2%	84.4%	81.6%	76.9%
Claims ratio	25.7%	36.2%	32.9%	43.0%	34.5%
Expense ratio	69.0%	73.3%	64.5%	72.7%	65.1%
Combined ratio	94.7%	109.6%	97.4%	115.7%	99.6%
Operational ratio (1-profit ratio)	84.2%	91.7%	84.8%	107.0%	92.0%
Receivables ratio 1 (receivables/total assets)	9.4%	10.7%	9.1%	8.6%	9.6%
Receivables ratio 2 (receivables/equity)	17.6%	21.7%	16.8%	17.3%	20.4%
Liquidity ratio (cash and short-term investment/total assets)	50.2%	52.6%	56.8%	49.9%	46.9%
Market solvency margin ratio (surplus capital/required solvency I ca	316.0%	374.4%	439.6%	333.3%	346.0%
Premium leverage ratio (NPW/surplus capital)	71.2%	84.8%	75.2%	73.5%	76.6%
Non-life technical reserves ratio (technical reserves/NPW)	72.5%	77.0%	77.8%	96.3%	98.7%

Source: Albanian Financial Regulatory Authority.

117. The current law defines capital and solvency criteria based on the Solvency I regime. The market solvency ratio (measured as a ratio of surplus capital with EU Solvency I margin) above 300 percent (Table 1) indicates a highly solvent market. However, if the assessment of premiums and solvency were to be carried out on (i) properly priced policies; and (ii) adequate technical provisions for all insurers, the ratio would be much lower for the market and may result below the accepted threshold for some insurers.

118. As shown in Table 1, the non-life insurance market net retention ratio measured as ratio of net written premiums with gross written premiums is in the range of 80 percent. The reinsurance regulation defines minimum requirements on (i) the amount of reinsurance required based on a maximum 'per risk' net retention; and (ii) quality of reinsurers (and admittance of reinsurance assets) based on their credit ratings. There are no detailed procedures or criteria in place to address capital requirements in case of risk accumulation from multiple insurance contracts

covering catastrophe risks (risk of earthquake) and PML[36]-based assessment in general. The AFSA requires cedants to be transparent in their reinsurance arrangements and management of the associated risks. However AFSA's capacity to assess the adequacy of reinsurance arrangements is limited.

119. The AFSA has established investment regulations which address (i) capital investment and (ii) investment of assets covering technical provisions. The regulation (i) defines investment categories for assets covering technical and mathematical provisions; and (ii) sets limitations for specific types of investments. However, specific investment guidelines for life insurance (assets covering mathematical provisions) are not in place.

120. The primary legislation empowers the AFSA to conduct the supervision of insurance activities carried out by legal entities or individuals in Albania. Specifically, the legislation defines the AFSA as the sole authority responsible for conducting insurance supervision in Albania. The governance structure is defined in the AFSA Act and further elaborated in the AFSA's internal by-laws. The highest decision-making body is the AFSA Board, consisting of seven individuals, appointed by the Parliament.

121. The AFSA has set comprehensive requirements for the submission of regular, systematic and comprehensive financial and statistical information, actuarial reports, solvency position reports and other information from all insurers through the EBRD financed electronic reporting platform. The AFSA may require additional information and paperwork which should be timely submitted by the insurer to ensure proper supervisory review and analysis. However, such additional requirements are not risk-driven and not based on the nature, scale and complexity of issues and identified gaps which need to be filled in.

122. Each insurer operating in the market, despite its financial or underwriting performance, is subject to the same on-site supervision regime (usually one to two inspections per year). This approach is far from a risk-based model of supervision which would require allocation of most supervisory resources to problematic companies rather than regular annual visits to all market players.

123. There is no sufficient capacity in the AFSA to perform adequate and timely assessment of (i) insurers' liabilities (especially technical provisions); and (ii) perform ongoing checks of their assets, based the comprehensive information reported through the electronic platform and on-going communication with insurers.

124. The underwriting performance of non-life insurance sector has been negative in four out of six last recent years with a major deterioration in the first half of 2013. Due to severe price competition, there was a significant deterioration in technical results in first half of 2013 – an

[36] Probable maximum loss (PML) is an estimate of the largest loss that a risk is likely to suffer from a single insured event after the available risk mitigation measures have been put in place.

underwriting loss of about AL 644 million, or about 26 percent of the net earned premiums for the period.

125. More than 70 percent of premiums cover insurers' operational expenses, which are well above the levels observed in all other insurance markets of the region. Eight out of nine non-life insurers recorded combined ratios above 100 percent during the first six months of 2013, despite the fact that the market claims ratio was only 50 percent. While theoretically plausible, such a low claims ratio over last few years is more likely to indicate a poor claims performance by most insurers and a rather low level of consumer protection. The underwriting losses can largely be attributed to the unusually high level of expenses incurred by insurers owing to low premiums and high commissions applied in a fierce and unfair competition in the MTPL insurance market.

126. Unchecked by regulatory constraints on minimum technical provisions, insurance companies have been aggressively competing on price of most common insurance products without regard to their solvency or profitability. Although the market as a whole appeared to be highly solvent in 2012, this may not be the case for all insurers, and particularly those which have made MTPL their main line of business. In 2012, the ratio of IBNR claims reserves relative to MTPL premiums varied greatly from company to company, despite the fact that all companies were writing virtually identical homogenous MTPL business. Due to the inadequate reserving, the industry is likely to suffer from the ongoing reputational risk of poor claims performance which may hamper its further growth and development at least in the near future.

127. The growing number of uninsured claims may severely impact insurers' credibility, solvency and the financial stability of the market. The industry Compensation Fund, which guarantees payments to consumers injured by uninsured drivers, is currently ALL 890 million (EUR 6.5 million) short of funding its technical provisions – the liability to be yet covered by individual insurers. In June 2013, the unfunded market liability arising from uninsured claims was about 60 percent of the total MTPL claims reserve for the entire market. If properly accounted for in the financial statement of insurers, these uninsured claims obligations would have a highly adverse impact on the solvency position of several insurers.

128. Albania is highly vulnerable to natural disasters and climate change. Yet, there is a significant earthquake risk accumulation in insurers' balance-sheets, a major part of which comes from insurance of properties used as loan collateral by local banks. Through this insurance coverage, a typical earthquake portfolio of a small size insurer with minimum capital (EUR 3million) gets exposed to a risk accumulation of about EUR 380 million of earthquake risk mainly in Tirana. Such risk accumulations require proper risk management to ensure that claims are paid in full and insurer remains solvent after the earthquake, which currently is often not the case.

Insurance Supervision Challenges

129. The IAIS assessment conducted as part of this FSAP found that Albania's legal and regulatory framework for the insurance industry is only partially compliant with most IAIS requirements. Despite the establishment of the AFSA in 2006 and enactment of supporting

insurance laws and regulations, the supervision of the Albanian insurance market has been light. As a result, local insurance companies have been engaged in a never ending price war for its most common products, which overtime has led to decreased volume of premium written, considerably increased risk exposure and negative profitability. On the consumer side, the deteriorating health of insurers manifests itself in the reduced average amount of payment per claim and the increased waiting time to receive indemnification payments.

130. The institutional setup of insurance supervision and supporting legislation has proven to be largely ineffective due to the lack of real independence, severely constrained financial resources, absent representation in the law-making process and the acute shortage of qualified personnel. Despite receiving significant supervisory fee income from the industry, the AFSA has been prevented by the Law on Public Administration and the Civil Servants Law from bringing the level of compensation for technical staff of the agency closer to that offered in the private insurance market or hiring more employees. As a result of strict limitations imposed by the government's salary scale and hiring practices, AFSA suffers from a very high turnover of personnel[37], which invariably leads to the shortage of technical expertise (e.g., actuarial skills, qualified on-site insurance inspectors) and seriously impacts the quality of insurance oversight.

131. Despite its nominal independence as laid out in the AFSA Law, its supervisory powers have been severely constrained by the rigid rule-based Insurance Law, which prevents the agency from issuing insurance by-laws to address the constantly evolving needs of insurance supervision. The new draft Insurance Law prepared as early as 2011 is yet to be cleared by Government for consideration by the Parliament.

132. Despite the scarcity of experienced technical personnel in its on-site supervision unit (only two inspectors with 6 years of experience supervise three markets), AFSA does not prioritize its on-site inspections based on the risk profile and past record of regulatory compliance of insurance companies. Instead, every company is inspected at least once a year – the practice which further detracts from the already fragile quality of insurance supervision.

133. The AFSA does not have either the legal mandate or the sufficient technical capacity to control the adequacy and effectiveness of insurers' corporate governance. Due to the lack of a risk based supervisory regime, insurers are not required to adopt appropriate policies and procedures with regards to (i) maintaining effective operations in compliance with their strategy and guidelines; (ii) introducing sound risk management practices and fair treatment of consumers; (iii) introducing adequate management information systems to ensure timely monitoring of risk exposures and the performance of Senior Management.

[37] The average tenure of staff in on and off-site supervision unit of FSA is only 1.7 years.

134. Due to its high-quality web-based market data collection system, the AFSA has been able to largely observe all IAIS ICPs dealing with information disclosure, data sharing and transparency. The agency has also been by and large transparent in its supervision process and accountable to the public.

135. The existing legal framework for insurance supervision has been eroded over time by enactment of conflicting with other laws and regulations. Albania's rule-based insurance laws are now out of date and do not comply with the risk-based insurance supervisory requirements underpinning IAIS ICPs as the pending legislative amendments proposed by the AFSA to the current insurance (and related) legislation have not been enacted. Although a Risk-Focused Manual was prepared with Bank's assistance, there is no legal ground to enable its implementation.

136. AFSA's authority to regulate the market is further undermined by the ability of insurance companies to easily suspend its rulings in court by means of filing an appeal.

137. Although Albania adopted the relevant AML/CFT regulatory framework for the financial sector, the insurance sector specific AML laws and regulations have not been enacted. Thus the AFSA currently neither has a legal mandate nor a specially designated unit (with qualified staff) to supervise the AML related aspects of insurance market operations. A similar problem exists with detecting, monitoring and supervision of fraud in the insurance sector, as the AFSA does not have the legal authority for discharging this mandate. As a result, the assessment found the AFSA to be only partially compliant with these ICPs.

138. The broad series of weaknesses in insurance supervision identified during the FSAP assessment act as a drag on growth of the insurance industry in Albania. In the absence of decisive concerted government and legislative actions, the financial fundamentals of insurance industry in Albania are likely to deteriorate to a point, where non-payment of claims will become a common practice, while the solvency of most companies in the market will become a major suspect. With the growing competitive pressures in the market, unchecked by vigorously enforced regulatory requirements on technical provisions, the already unsatisfactory rate of return on capital invested in insurance companies, is likely to drop even further, thus making the industry unattractive to investors representing large international insurance groups.

139. Major institutional reform will be needed to achieve AFSA's financial and operational independence and turn it into an effective regulator of the local insurance market. Due to its lack of authority and the financial flexibility to use its resources at its disposal to retain qualified technical staff, the AFSA's ability to carry out effective supervision has been limited.

D. Observance of IAIS Insurance Core Principles

140. The detailed IAIS ICP assessment conducted as part of this FSAP concluded that Albania's legal and regulatory framework for the insurance industry is only partially compliant with most IAIS requirements. Assessor's comments on the observance of each ICP are provided in Table 1 below:

Table 1: Summary of Observance of the Insurance Core Principles—ROSCs

Insurance Core Principle (ICP)	Comment
ICP1 **Objectives, Powers and Responsibilities of the Supervisor**	The legislation clearly defines supervisory objectives. However, the AFSA's responsibilities, powers and effectiveness to discharge insurance regulatory and supervisory functions are only partially satisfactory due to its: a) inability to timely intervene in main legislation and b) insufficient institutional capacity due to several restrictions (e.g. inability to restructure the organization and financial limitations). The AFSA cannot directly initiate changes in main legislation. Although the AFSA is fully financed by the market, its organizational structure (number and positions) and the remuneration are decided by the Parliament.
ICP2 **Supervisor**	Out of five main criteria listed in this ICP, only the protection of information can be considered as largely met. The AFSA's independence, accountability and professionalism are hindered by the lack of (i) flexibility to amend the legislation, (ii) authority to take timely action, and (iii) adequate institutional capacity to oversee the market. The regulator will have to wait for years until the legislation is amended properly, while it cannot guarantee the stability of the institution and retain qualified technical experts due to the organizational and financial limitations imposed by the current legal framework. But even then, the ultimate outcome is not guaranteed due to AFSA's inability to influence the legislative process. The AFSA's officials are not immune from legal action that might be brought in by disgruntled insurers.
ICP3 **Information Exchange and Confidentiality Requirements**	Law and regulations enable cross sharing of information with other regulators. However the requirements of ICP3 are not specifically addressed by the law. MOU's with other supervisors comply with the IAIS terms which take into account the ICP requirements.
ICP4 **Licensing**	The law and regulations set out detailed licensing criteria in line with the requirements for this ICP. The AFSA is the responsible authority for licensing all insurance operators. ▪ The legislation clearly defines requirements and procedures with regards to licensing of insurance activity and provides a level playing field for every applicant. ▪ Licensing requirements and procedures are clear, objective and public, and are consistently applied. ▪ The law clearly defines capital and solvency criteria based on the Solvency I regime. ▪ Minimum fit-and-proper criteria apply to the proposed Board Members and senior management;

	▪ Shareholders must provide information with regard to the source of the establishment capital; ▪ Approval from home supervisor is required in case of subsidiaries of foreign companies. However, the technical capacity of the regulator to check full compliance of documentation submitted by license applicants is limited.
ICP5 **Suitability of Persons**	The legislation sets general suitability criteria for insurance companies' shareholders, supervisory board and senior management. Changes in shareholders and managing bodies of an insurance company should be approved by the AFSA. Yet, the legislation has to be further detailed in respect to requirements related to criminal records of shareholders. The AFSA can exchange information with the home supervisors of foreign insurers operating in Albania (through local subsidiaries) to confirm the suitability of Board members, senior management, key persons in control functions and significant owners of an insurer.
ICP6 **Changes in Control and Portfolio Transfers**	Supervisory approval is required to acquire significant ownership (10% or more) or an interest in an insurer. All changes in ownership require the AFSA's consent through the submission and acceptance of the new Charter. When foreign investors are involved, supervisors from country of origin must provide their consent. Portfolio transfer requires AFSA's approval. However, the legislation does not specifically require a favorable opinion on the transaction from a qualified actuary and there is not enough capacity at the AFSA to assess the adequacy of reserves and assets that accompany the transferred portfolio.
ICP7 **Corporate Governance**	There is no requirement that the Board must be composed of people with adequate level of knowledge, skills and expertise commensurate with the governance structure and the nature, scale and complexity of the insurer's business. There are no clear requirements on a) the risk management function and b) specific procedures that have to be set by insurers for their day-to-day operations with regards to monitoring and performance of risk exposures, treatment of consumers, performance of senior management, proper communication with stakeholders, and the regulator. There are no requirements to insurers to adopted appropriate policies and procedures with regards to (i) maintaining effective operations in compliance with their strategy and guidelines, (ii) introducing sound risk management practices and fair treatment of consumers, (iii) introducing adequate management information systems to ensure timely monitoring of risk exposures and the performance of Senior Management. The AFSA does not have either the legal mandate or the sufficient

	technical capacity to control the adequacy and effectiveness of insurers' corporate governance.
ICP8 **Risk Management and Internal Controls**	The law and regulations specify criteria on capital/solvency, technical reserves, investments, reinsurance, etc. Companies report them on a quarterly basis (annually for life). The current law specifically requires internal audit and actuarial functions (although independence is an issue). The current criteria are not risk-based and do not support the effective risk management function necessary to identify, assess, monitor, manage and report on key risks in a timely fashion. The current law does not address the issue of risk accumulation due to catastrophe risk insurance.
ICP9 **Supervisory Review and Reporting**	The ability of AFSA to supervise the market is severely constrained by the lack of qualified personnel. Despite the scarcity of technical resources, their allocation is not determined by the nature, scale and specific risks of each insurer. ▪ The on-site inspections are not properly guided by prior off-site risk examinations, which ideally should define the scope and areas for field inspections in problematic areas and companies. ▪ Given the AFSA's limited capacity (only two qualified insurance inspectors and limited actuarial capacity), the current approach severely impacts the quality of on-site insurance supervision. ▪ There is not sufficient capacity within the AFSA to perform adequate and timely assessment of (i) insurers' liabilities (especially technical provisions) and (ii) ongoing checks of their assets, based the comprehensive information reported through the electronic platform and on-going communication with insurers. There is a high quality reporting and data collection system, which is in line with the international standards.
ICP10 **Preventive and Corrective Measures**	Although the law describes preventive and corrective measures commensurate with the severity of the insurer’s problems, it does not provide the AFSA with ability for timely interventions, particularly in cases dealing with insolvency. The AFSA can take administrative measures to prevent the violations of the law. However the rule-based supervisory regime makes it difficult to timely trigger the corrective regulatory action when the evidence of violation is not entirely clear. In addition, there is limited capacity to understand the extent of problem when it comes to capital adequacy related matters.

ICP11 **Enforcement**	The enforcement of AFSA decisions is undermined by the ability of insurers to challenge AFSA's rulings in court, which can suspend such decisions for an indefinite period of time, even prior to hearing the case. On average, it takes 3-6 months to address severe cases of insolvency and even then, it is not guaranteed that the solvency will be fully restored. The courts may suspend AFSA's decisions for an indefinite time (sometimes for years) which can result in insolvency situations causing a major adverse impact on consumers and insurance companies.
ICP12 **Winding-up and Exit from the Market**	Procedures for winding up and exit from the market are clearly defined in the law and provide for adequate protection of policyholders in the case of an exit. The legislation provides for the determination of the point at which it is no longer permissible for an insurer to continue its business. However, the immediate enforcement with regards to writing new business or asset infringement may be obstructed by the suspension of AFSA decision by the courts, if the later misinterpret the provisions of the Civil Procedure Code. Nevertheless, in the absence of insolvencies in the history of the Albanian market, the possibility of such a suspension of an AFSA decision to infringe assets of an insolvent insurer remains theoretical, as the courts will find it very difficult to misinterpret the provisions of the Civil Procedure Code for insolvencies related to the financial sector due to their major adverse public impact.
ICP13 **Reinsurance and Other Forms of Risk Transfer**	The current regulation determines a set of rules on a 'per risk net retention' basis and prescribes the minimum credit quality of participating reinsurers. However, it does not address the issue of risk accumulation from multiple insurance contracts covering catastrophe risks (risk of earthquake) and PML-based assessment in general. The AFSA does not have sufficient reinsurance expertise to assess the insurers' compliance with the reinsurance regulation.
ICP14 **Valuation**	AFSA carries out insurance supervision under a rule-based approach. Therefore the calculation of the Solvency margin (EU S1) and valuation of assets and liabilities are not compliant with the risk-based approach. Valuation of technical provisions (regulatory and practical) does not properly address the time value of money. There are no statutory prescribed discount rates for the calculation of mathematical life reserves. In addition, the valuation of claims provisions is not grounded in appropriate actuarial assessment of historic claims development patterns. • Based on the current law, the technical provisions are certified by actuaries authorized by the AFSA, however, in practice the actuaries obey to management decisions with regards to the amounts of reserves. • Although the regulation requires independent review of technical reserves from external auditors, however their job is not as easy under the lack necessary detailed data required for

	a proper assessment of reserves. Economic valuation is not observed in the absence of the RBS approach.
ICP15 **Investment**	The AFSA has established investment regulations which address (i) capital investment and (ii) investment of assets covering technical provisions. The regulation (i) defines investment categories for assets covering technical and mathematical provisions and (ii) sets limitations for specific types of investments. However, specific investment guidelines for life insurance (assets covering mathematical provisions) are not in place. Specifically, the ALM regulations should be developed to provide for interest, currency and duration matching.
ICP16 **Enterprise Risk Management for Solvency Purposes**	The requirements of ICP 16 cannot be met in Albania until it adopts a comprehensive risk-based supervisory approach. In the absence of the risk-based supervisory regime, enterprise risk management cannot be implemented. There are no requirements for risk measurement or explanations on internal measurement approaches and key assumptions made by companies to assess their risks. The law does not require companies to have their risk management policies clearly articulated.
ICP17 **Capital Adequacy**	Although the current regulation has established capital adequacy requirements for solvency purposes, the current solvency regime (S1) does not provide for capital adequacy requirements for solvency purposes to enable (i) proper (risk sensitive) solvency assessment and (ii) timely supervisory intervention. The total balance-sheet approach is not required by the current regulatory regime. The concept of 'Prescribed Capital Requirement (PCR),' which requires a specified level of safety over a defined time horizon, is not observed in the current regulation.
ICP18 **Intermediaries**	There are regulations in place for licensing intermediaries which include fit-and-proper criteria (professional and integrity requirements) and financial requirements. However, there are no training materials for insurance and reinsurance brokers to be used in the preparation for the licensing exams. The Act on Insurance and the respective by-law clearly spell out disclosure requirements which include: explanations and advice on policy terms and conditions, contract time periods, limitations or exclusions, insurance premium, and relations with the insurer. The AFSA requires an insurance intermediary who handles client money to have sufficient safeguards in place to protect these funds.

	On-site inspections of intermediaries are rare and poorly structured (no inspection manuals).
ICP19 **Conduct of Business**	The current regulation sets general business conduct requirements such as product transparency (information on rights, obligations and financial aspects of insurance contracts). While life insurance is still in its nascence, additional regulations are required for disclosure and transparency when selling life insurance products such as unit link insurance where the client shares investment risk with insurer, or long-term products with the guaranteed savings part. The AFSA has developed a) claims settlement guidelines and regulations and b) complaints procedures. However, the practical enforcement of such regulations is yet to be improved through introduction of additional market stabilization and consumer protection measures to ensure proper and timely payment of insurance claims.
ICP20 **Public Disclosure**	The AFSA collects ample information on the insurance market and on the ongoing basis discloses it to the public. Annual financial statements are made available to the public directly by insurance companies. However, as per ICP requirements, more detailed financial information on insurers should be disclosed to the public.
ICP21 **Countering Fraud in Insurance**	There is no specific regulation or provision in the existing insurance law related to combating insurance fraud. There is no fraud database. The regulator has limited capacity to deter, prevent, detect, report and remedy fraud.
ICP22 **Anti-Money Laundering and Combating the Financing of Terrorism**	There is no specific regulation or provision in the existing insurance law regarding anti money laundering. There is no designated unit in the AFSA to address the Anti-Money Laundering (AML) issues. Although three AFSA employees received some basic training on the subject, still there are no on-site inspection manuals or guidelines that could be used by the AFSA in conducting market supervision. The AFSA received the mandate to address the AML issues only recently.
ICP23 **Group wide Supervision**	The current law does not address the issue of group-wide supervision. The cooperation has been recently established (MOUs signed) in recent years with home group supervisors (Austria) or host regulators for subsidiaries of Albanian companies (Macedonia, Kosovo).
ICP24 **Macroprudential Surveillance and Insurance Supervision**	Although the current regulation does not address potential systemic risks such as potential liabilities arising from improper catastrophe insurance underwriting and risk management, aviation risks, or underestimation of life insurance reserves, which may lead to potential financial stability risk, a strategy has already been developed by the AFSA to deal with these risks.

ICP25 **Supervisory Cooperation and Coordination**	The current regulation does not address group-wide supervision. However, effective cooperation has been established with supervisors of other countries. To that effect, MOUs have been signed and the AFSA has been invited to become part of supervisory colleges.
ICP26 **Cross-border Cooperation and Coordination on Crisis Management**	Although cross border cooperation exists, in practice the AFSA does not have the mandate to look into contingency plans and operational risk management of insurers under the current law due to the lack of the RBS. The AFSA's limited capacity (due to inability to effectively organize its activities and hire experienced professionals) prevents it from conducting proper and timely assessment of insurers commensurate with the nature and complexity of risks.

E. Recommendations

141. The following detailed technical recommendations were provided by the FSAP mission after a thorough assessment of (i) insurance market fundamentals; and (ii) challenges of current insurance supervision in Albania.

142. Reform the current institutional and legal set-up of the insurance supervisory authority by: (a) empowering it to sponsor and present to the Parliament new insurance laws, by-laws and amendment to the existing laws, if required; (b) make the AFSA exempt from the Law on Public Administration, which renders the agency an extension of the government, thereby thwarting its ability to fulfill its mandate; (c) pass the amendments to the AFSA law which would empower the agency to offer competitive compensation terms to its technical staff and thus enable it to attract experienced and qualified insurance professionals from the market; (d) change the agency's horizontal administrative structure by creating technical positions responsible only for insurance supervision; (e) enable the AFSA to retain independent insurance consultants from the industry to urgently address its acute need for highly qualified experienced actuaries and IT specialists.

143. Enact the pending drafts of insurance legislation such as the draft Insurance Law and the draft MTPL insurance law, which will enable AFSA to bring its regulatory practices and regulatory framework closer in line with the IAIS requirements and introduce risk based by-laws and regulations to address current challenges:

- Introduce the risk based "early warning" claims performance and solvency requirements which would require companies to (a) timely meet insurance liabilities arising from insurance contracts and (b) maintain a capital buffer over and above the minimum solvency requirement.

- Adopt appropriate requirements with regards to (i) corporate governance and sound risk management practices and (ii) adequate management information systems to ensure timely monitoring of insurer's risk exposures as well as the performance of its senior management.

- Develop an internal insurers' risk rating system for the purposes of efficiently allocating scarce supervisory resources to the most problematic companies and areas of operations.

- Develop detailed inspection manuals for thematic regulatory inspections to provide for targeted and quick supervisory action.

- Prepare and enact relevant and regulations on life insurance which are currently not in place with outsourced technical assistance from highly qualified life insurance experts, and introduce a nation-wide earthquake insurance program for homeowners compliant with catastrophe risk management requirements.

144. Prepare and enact relevant regulations on management of earthquake risk which are not current in place and introduce a nation-wide earthquake insurance program for homeowners. Please refer to Annex 1 (attached and integral part of this document) for additional information on the impact of earthquakes on consumers, financial sector and country's economy.

145. Undertake immediate MTPL market stabilization measures by establishing minimum reserving standards based on market-wide claims performance and ensure proper funding of reserves. These special stabilization measures designed to immediately address the poor claims payment performance by most insurers, should be phased out over time in response to visible improvements in the market fundamentals. All necessary amendments to the MTPL law should be done in consultation with the insurance market.

146. Carry out a market-wide study of companies' MTPL reserving practices with the view to understanding the industry historic claims development patterns and drafting a by-law on the minimum regulatory requirement to technical provisions (IBNR) for the MTPL line of business. The reserving requirements and the underlying actuarial methodology (a) shall support the implementation of sound claims performance by all insurers in the market and (b) should be supported by a detailed reserving supervision manual and relevant automated IT supervisory tools.

147. To guarantee proper level of provisions, the AFSA should immediately restore the funding of the Compensation Fund which until now has not been funded by member insurance companies. The insurance companies should be required to immediately finance the outstanding liabilities of the Fund and ensure proper and timely payment of claims arising from uninsured vehicles, as required by the law.

148. To address the social and fiscal impact of natural disasters, mitigate the impact of MTPL stabilization measures on insurers, and support the growth of insurance market, we recommend (a) establishment of a national compulsory earthquake insurance program, (b) introduction of liability insurance requirements for various professional services and (c) waging VAT requirement for at least non-compulsory insurance products. Despite being heavily exposed to earthquakes, the earthquake insurance for homeowners is almost non-existing, thus leaving homeowners and the government financially vulnerable to natural disasters.

149. Introduce a legal mandate for the AFSA to obtain the financial and human resources that may be required to supervise compliance of the insurance market with the AML and CFT regulations.

F. AFSA Response to the Assessment Recommendations

150. The assessment on the IAIS ICP observance and FSAP recommendations were discussed with the AFSA in detail. The AFSA confirmed its agreement with the detailed assessment on the observance of each ICP and recommendations provided by the FSAP team. A summary of AFSA's main comments to the FSAP documents is provided below along with the respective clarifications from the assessor.

151. The AFSA agreed with the FSAP recommendation to introduce emergency market stabilization measures in MTPL insurance through minimum reserving requirements along with a vigorous enforcement mechanism and asked for specific details with regards to implementation timelines, minimum reserving amounts, funding requirements. Due to the limited scope of the FSAP, the provided recommendation cannot be detailed further without undertaking an additional technical analysis of the requirements to the amount of such minimum reserves and the modalities of their minimum funding requirements. The requested detailed technical requirements will be developed with the World Bank support during the preparation of the upcoming DPL program over the next few months.

152. The AFSA commented that in a liberalized MTPL insurance market, it has no legal power to supervise the pricing practices by the MTPL insurers and may not be able to control prices (whether low or high). From the FSAP assessment, the current real (discounted) prices for MTPL insurance coverage in Albania are about 25 percent of those in the neighboring countries, which shows that the main problem of the market is the claims payment performance and the overall market capital adequacy. Hence, it is expected that the proposed market stabilization measures will put the minimum "floor" for the future MTPL rates due to the minimum reserve funding requirements. This does not mean however that all companies will start charging the same rate for the MTPL coverage.

153. The AFSA agreed with the recommendation to restore the Compensation Fund by requiring insurance companies to finance the outstanding liabilities of the Fund. Due to a potential liquidity pressure on insurers from the proposed MTPL stabilization measures, the AFSA suggested to have a transitional period of three years during which the insurance market would (i) pay all compensation fund claims; and (ii) establish a mechanism for consistent funding of liabilities on an ongoing basis. The FSAP recommends that the suggestion for a transitional period until the consolidation of a fully financed Compensation Fund, should be detailed and specified by the AFSA in an action plan to ensure (i) full and timely payments of all current liabilities of the Compensation Fund; and (ii) sustainable financing of the Fund in the future. Other countries have implemented additional legal requirements to ensure a minimum level of financing for such funds regardless of their current liabilities. Such international practice may be considered when amending the MTPL law. The potential increase in insured claims reserves of several insurers should reflect the liabilities arising from the underlying business. Hence the assessment of insurers' liabilities arising from insured claims should remain fully independent from the assessment of uninsured claims liabilities (e.g. those of the Guarantee Fund).

154. The AFSA highlighted the fact that fines imposed on the uninsured motorists are not used to finance the Compensation Fund, although the MTPL Law mentions them as a source of financing. The FSAP identified that the Law simply mentions that the Compensation Fund can be financed through fines imposed on uninsured drivers, without detailing the level of financing. It is important that the Law is amended to specify the share of fines to be allocated to the Compensation Fund. In addition, a close cooperation should be established with the government agencies to reduce the level of uninsured drivers in the country.

155. Enactment of a risk based supervisory approach providing for risk ratings, early warning solvency requirements and a clear on-site inspection mandate was seen by the AFSA as a long process. The FSAP mission clarified that the recommendation referred to paving the way for a gradual introduction of the risk based supervision through the enactment of necessary legal framework. Such a process has already started with the preparation of the new draft Insurance Law by the AFSA. The full-scale implementation of the risk based supervisory approach will certainly be a longer-term process which may require technical assistance to AFSA from the Bank or other professional organizations.

156. The AFSA concurred with the proposed development alternatives of the nascent insurance market through (a) establishment a national compulsory earthquake insurance program, (b) introduction of liability insurance requirements for various professional services and (c) waving the VAT requirement for at least non-compulsory insurance products. However, such initiatives would require government's commitment to develop and enact respective laws and support their implementation. The role of government in the establishment of the national earthquake insurance program was clearly stated in the FSPAP Aide Memoire provided to the government and discussed at length with the MOF which expressed support for this measure. The implementation of market development measures in general will also require government support and extensive technical assistance.

157. The recommendation for a more transparent consultation with insurance market on enactment of insurance laws and regulations was deemed by the AFSA as observed. The current level of cooperation with the market was acknowledged by the FSAP Mission. However it was further recommended to enhance the process of consultations with the market by providing insurers with: (a) timely information about the forthcoming legislative initiatives; and (b) sufficient time to provide their input on new laws and regulations. Insurers' inputs to the law making process have to be acknowledged and accounted for through transparent and timely comments by AFSA on their submissions. In addition, the FSAP Mission recommended to AFSA to issue a regulation that would clearly spell out the procedure for market consultations for all future AFSA's legislative initiatives.

158. The AFSA highlighted the fact that only life insurance companies and reinsurance companies are subject to Law no. 9917, date 19.05.2008 "On Anti money Laundering and Counter Terrorism Financing. In general, it is assumed that the AML and CFT risks are higher for life insurers and reinsurance companies compared to other insurance market players. However, the FSAP recommended that the scope is expanded to give the AFSA a legal mandate for monitoring all insurance activities for the risk of money-laundering and terrorism financing.