Report No. 42061-AL

Albania Access to Finance for Enterprise Sector

June 29, 2007

Finance and Private Sector Development Department
Europe and Central Asia Region

Document of the World Bank

CURRENCY EQUIVALENTS
(Exchange rate effective June 1, 2007)
Currency Unit: Albanian Lek
US$1 = Lek 92.4

GOVERNMENT FISCAL YEAR
January 1 – December 31

WEIGHTS AND MEASURES
Metric System

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MAIN ABBREVIATIONS AND ACRONYMS

ASC	Albanian Securities Commission
AUSCA	Albanian Union of Savings and Credit Associations
BEEPS	Business Environment and Enterprise Performance Survey
BoA	Bank of Albania
EU	European Union
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GNI	Gross national income
IDP	Institutional Development Program
IFC	International Financial Corporation
IFAD	International Fund for Agricultural Development
IFRS	International financial reporting standards
IMF	International Monetary Fund
INSTAT	National Statistical Institute of Albania
IPRS	Immovable Property Registry System
MAFF	Mountain Areas Finance Fund
MFI	Microfinance institutions
MIS	Management information systems
MSME	Micro, small, and medium enterprise
NBFI	Nonbank financial institutions
OECD	Organization for Economic Co-operation and Development
PCR	Public credit registry
PMU	Project Management Unit
PSHM	Albanian Partner for Microcredit
ROSC	Report on Observance of Standards and Codes
SCA	Savings and credit associations
SME	Small and medium enterprise
TFP	Total factor productivity
UN	United Nations
WDI	World Development Indicators

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Acknowledgments

This report was prepared in close collaboration with the Bank of Albania. The team was composed of Ramin Shojai, Emanuel Salinas Munoz, Mehmet Can Atacik, Peter Kyle, and Ibrahim Hackaj of the World Bank, and Mr. Klodian Shehu from the Bank of Albania.

Lalit Raina (Sector Manager) and Tunc Uyanik (Sector Manager) were the peer reviewers of the report. Fernando Montes-Negret (Sector Director), Gerardo Corrochano (Sector Manager), Camille Lampart Nuamah (Albania Country Manager), Nadir Mohammed (Country Manager) and Hormoz Aghdaey (Lead Financial Sector Specialist) all provided input into the report.

The team would like to thank the Ministry of Finance, the Ministry of Economy, and other Albanian authorities for their input and support in the preparation of this report.

EXECUTIVE SUMMARY

Albania has experienced rapid credit growth in recent years, yet credit to the private sector remains comparatively low at about 18 percent of GDP. While credit has grown at record rates between 2005 (70 percent) and 2006 (50 percent), credit to the private sector in Albania in relation to GDP remains modest compared with other countries in the region. The financial sector in Albania is sizable, with total banking assets accounting for over 40 percent of GDP. However, a significant part of these assets remain invested in treasury bills and other liquid assets, while credit to the private sector stands at a low 18 percent of GDP.

With only about 13 percent of firm financing coming from credit, companies rely heavily on internal financing which severely constrains their ability to finance new investments. Albanian firms rely more on their internal funding for growth and new investments more than any other country in the region and receive 38 percent less in bank credit for their working capital needs than their peers in comparator countries.

Moreover, bank credit appears to be concentrated on the largest corporate borrowers and specific economic sectors, while credit to SMEs and the rural agri-businesses remains limited. A small number of large businesses account for about 74 percent of the credit. SMEs are the smallest category of clients for banks, both in terms of loan volumes and number of clients despite accounting for a large part of the economy. Although allocation of credit largely mirrors the structure of the economy, mainly directed toward services, trade, and to a lesser extent, manufacturing, agriculture with 20 percent of GDP is underserved with only 5 percent of the credit. Given the likely sources of economic growth for Albania over the medium term, tourism and agriculture, increasing access to both small and rural enterprises will be important.

Although micro-credit entities have been expanding credit to underserved segments of the economy, the scope of their operation remains very small and needs to be further developed. Altogether, the aggregate credit portfolio of micro-finance institutions and credit unions in Albania at the end of 2006 was around US$95 million, several times higher than the volume in 2003, but still less than 5 percent of the aggregate loan portfolio of banks. However, with more than 30,000 active clients, MFIs and SCAs service about 20 percent of the overall clientele of the financial system in Albania.

Other types of credit financing, such as leasing and factoring, are at very early stages of development and remain constrained by the credit infrastructure in Albania. On average in the region leasing and trade credit account for about 6 percent of firm financing, whilst in Albania firms receive less than 2 percent of their financing from these sources. The total leasing activity in Albania represents less than 0.05 percent of the banking credit to the private sector, compared with Bosnia and Romania (above around 10 percent in both cases). Factoring is practically non-existent in Albania compared to some other countries in the region.

In addition, bank credit is still dominated by short-term, foreign currency loans while majority of firms have revenues in local currency only, and require longer maturity credit for growth and new investments. More than 70 percent of loans to firms are denominated in foreign currency, and more than 60 percent have a maturity of 12 months or less.

On the other hand, widespread informality fuelled by disincentives in the business environment, limits the effective demand for credit and, thus firms' prospects for investment and growth. Poor business environment has contributed to Albania's higher rate of informality (estimated to be 50 percent of economy), lower total factor productivity, and lower investment levels, trapping significant resources in low-productivity operations with no access to capital. While macroeconomic policies have become increasingly favorable for economic growth, the business environment remains a major challenge. According to the Business Environment and Enterprise Performance Survey 2005 (BEEPS) compared with 2002, the perception of Albanian firms of the business environment in their country is worse than those of their peers' in the region. The World Bank's Doing Business indicators also point out that Albania compares poorly against many of the other countries in the region, ranking Albania at 120 out of 175 countries.

There remains potential for increasing credit to the private sector and allocation to underserved segments. On the supply side, banks report that they expect lending to grow by about 28 percent per year over the next few years. Although much of this lending is expected to be targeted to large firms and consumers, some saturation of these markets coupled with declining government domestic borrowing should create space for lending to SMEs. On the demand size, SME sector has the capacity to absorb much more external financing based on observations of firms with similar characteristics in the region. Albanian firms currently source 50 percent less in external financing than regional comparators.

But weaknesses in the credit infrastructure constrain further expansion in the supply of credit to the private sector, diversification into currently underserved segments, and development of new instruments. Specifically, commercial banks report (i) problems with collateral registration and enforcement, (ii) limited credit information owing to the lack of a well functioning credit registry, and (iii) poor accounting and audit practices which limit verifiable financial information. In addition, borrower awareness and protections remains weak. The most important constraint in lending to large firms is related to problems with the ownership titles of the firms' real estate assets, whereas for lending to SMEs, the most important constraint is informality.

However, the development of credit infrastructure remains an important factor in ensuring that supply can meet demand. In this regard, the authorities should:

- ***Accelerate the establishment of a credit registry*** to facilitate better assessment of borrower credit risks by banks. This registry should initially include positive and negative information on all outstanding information with initial scope of banks at the BoA and later be expanded to a credit bureau to include other financial services.
- ***Identify suitable methods to give banks improved access to company registration and borrowers' tax information*** to compensate for the current weaknesses in financial reporting among small enterprises
- ***Accelerate strengthening of land registration and titling system*** and improve the operations of the IFRS regarding registration and verification of property;

- ***Amend current laws*** (Articles 522, 564, 577, and 573) to introduce deadlines for personal notification to debtor, formalize asset valuation, increase discounts of original collateral, and create a legal framework for auction of foreclosed assets.

To expand credit beyond banking sector, another key area of reform relates to the further development of non-bank credit by strengthening the microfinance and credit associations and encouraging the growth of new instruments. Although the demand for the services of these institutions will remain high in the medium term, future growth of microfinance and credit associations will depend on:

- additional capital and funding
- further investment and technical assistance to reduce cost and improve the SCAs' operational management, and
- institutional setup, that is, whether these institution decide to become commercial entities or stay as nongovernmental organizations (NGOs).

However, without appropriate credit infrastructure to price and distribute risk, government guarantees or subsidies for SME credit will not be effective in supporting growth and productive investment. The Government of Albania is considering the establishment of guarantee funds, or subsidized funds to help give the SME sector better access to credit. However, the experiences of other countries have shown that unless the market and credit infrastructure are in place, pricing of the lending risks within these products remains a challenge and the government's participation creates a moral hazard for both the lender and borrower. In many cases, these funds have ended up largely misallocated.

The development of leasing and factoring will also hinge on adequate credit infrastructure, as well as removing legal ambiguities. For example, Albania needs to clarify the regulatory environment for financial leasing, the fiscal treatment of leasing in Albania in the area of value added tax (VAT) and to allow for recognition of invoices as debt instruments to facilitate their use as full-fledged collateral for working capital loans. In addition, there is a need to enhance public awareness of leasing and factoring as financing options.

Transparency in the pricing of credit will help borrowers better understand and estimate cost of financing. Specifically, there are some concerns that increasing interest rate margins—around 10 percentage points in 2006—may be reflecting not only increasing risk as banks move into new markets, but also higher concentration (and perhaps lower competition in) of the banking sector. An examination of banking information shows however, that even though the larger banks are achieving higher returns, some of this is based on economies of scale and operational efficiency. Nevertheless, the overall cost of credit in Albania is frequently difficult to calculate up front because it entails elements of floating interest rates, exchange rates (for loans denominated in foreign currency), fees, and commissions. The authorities should move to encourage more transparent pricing of credit not only for ease of market analysis for but consumer protection as well.

Any expansion of credit to the private will have to be underpinned by strong regulatory environment, prudential oversight and improved governance. Issues in this area include

continuing anti-money laundering efforts, improving the efficiency the of the judicial system, ensuring that regulatory capacity is sufficient to monitor credit growth and introduction of new financing instruments, and the business environment is conducive for growth. Efforts in these areas will support overall improvements in the business environment, strengthening the competitiveness of both the real and financial sector, and improving the overall risk management, ultimately the development of a sustainable and vibrant private sector.

Policy Recommendations

Improve the Quality, Breadth, and Depth of Financial Intermediation

Area	**Priority**	**Short-Term** (in the upcoming year)	**Medium-Term** (1 to 3 years)	**Long-Term** (in year 3–5)
Credit Information System/Credit Registry to better assess the credit risk of borrowers	High	Establish a credit registry with positive and negative information on all outstanding information with initial scope of banks at the BoA. Ensure the viability of the registry by verifying that it does not contravene existing laws that protect the confidentiality of individuals' and enterprises' financial records.	Expand the credit information bureau to include other financial services, specifically microfinance and credit unions, in the credit registry. Promote credit bureaus. Identify suitable methods to give banks improved access to company registration and borrowers' tax information.	Promote information-based market mechanisms for ongoing evaluation and ratings of companies based on accurate and timely financial results and market developments.
Land registration and titling system in order to eliminate widespread land ownership ambiguities, thus strengthening value of land as collateral	High	Improve the operations of the IPRS regarding registration and verification of property.	Ensure reliability of the property registry for properly registering all properties and addressing land fragmentation. Provide electronic access to prospective creditors and investors.	
Judicial procedures for collateral enforcement, by streamlining performance of court baliffs and auction procedures	High	Amend current laws (Articles 522, 564, 577, and 573) to introduce deadlines for personal notification to debtor, formalize asset valuation, increase discounts of original collateral, and create a legal framework for auction of foreclosed assets.		
Enhance consumer awareness and	Medium	Foster public awareness on terms and conditions of bank lending. Encourage lenders to enhance		Collect information on

protection		transparency on total cost of credit.	standardized credit products (e.g., credit cards, mortgages) offered by different lenders and publish them regularly in comparative terms.

Encourage Growth and Development of Credit Unions and Microfinance Institutions

		Short-Medium Term (0-3 years)	**Long-Term** (in year 3–5)
Credit unions	Medium	Work with donors and IFIs to identify additional sources of funding and technical assistance to strengthen the institutional capacity of Credit Unions with the aim of addressing the financing needs of micro-businesses especially in rural areas. Continue tax exemptions for credit unions for few more years to allow credit unions to provide access to sectors of the economy that remain underserved.	
Microfinance	Medium	Adopt a new legal framework for microfinance. Consider making MAFF (the Mountain Areas Finance Fund) a credit institution instead of a bank and ensure that it operates in a commercial manner with adequate governance and regulatory framework.	

Facilitate the Development of New Instruments

		Short and MediumTerm (0-3 years)	**Long-Term** (in year 3–5)
Further development of leasing	Medium	Reduce the size of capital requirements for leasing companies. Clarify the regulatory environment for financial leasing. Clarify the fiscal treatment of leasing in Albania in the area of value added tax (VAT) (medium priority).	Enhance the public awareness on leasing
Enhanced use of factoring	Medium	Recognize invoices as debt instruments; allow businesses having invoices to use them as full-fledged collateral for working capital loans.	

I. OVERVIEW OF THE MACROECONOMIC ENVIRONMENT

1. **Albania recovered well from the financial collapse of 1997, which was sparked by the collapse of fraudulent pyramid schemes.** Albania has averaged real GDP growth rates of close to 7 percent over the period 1999–2006 (see figure 1), which is among the highest in transitional countries (figure 2). This growth has been driven primarily by post-transition improvements in the allocation of resources from low-productivity sectors, firms, and activities (for example, subsistence agriculture) to high-productivity ones (for example, textiles and footwear).

Figure 1. Cumulative Real GDP Growth, 1996

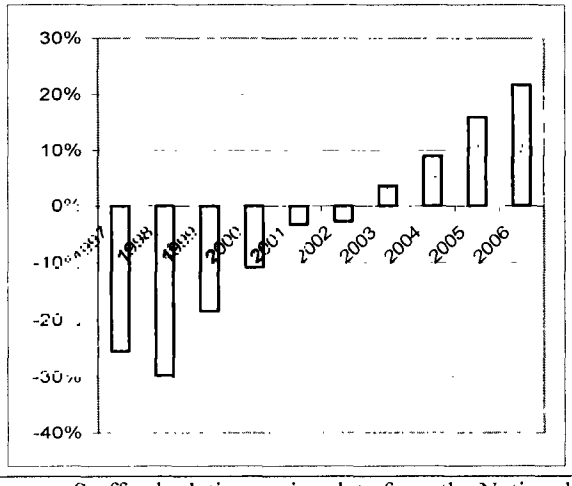
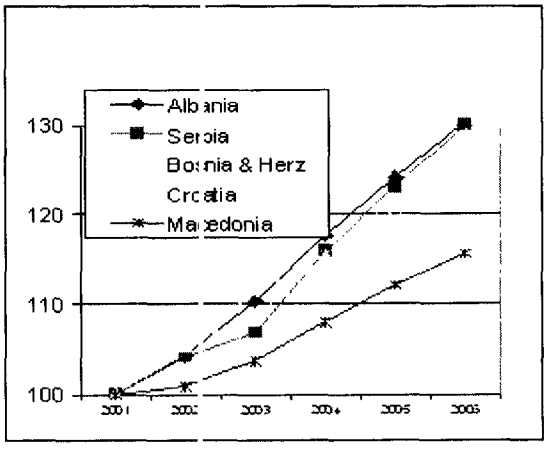


Figure 2. Albanian Growth since 2001 in Comparison to Other Countries

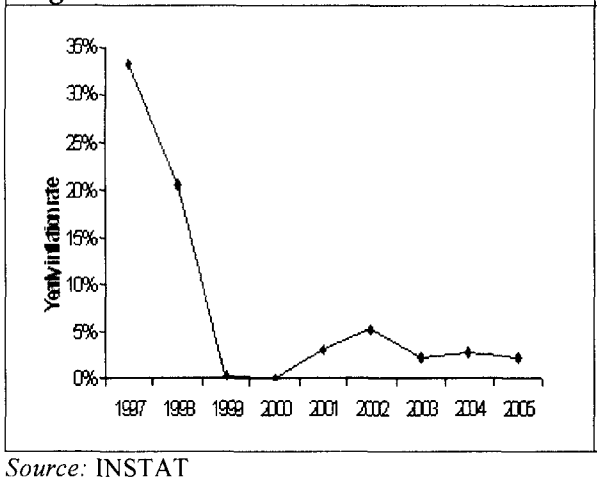


Source: Staff calculations using data from the National Statistical Institute of Albania (INSTAT).

2. **Total factor productivity (TFP) growth has slowed in recent years.** Although increases in TFP have accounted for almost all of the growth in the past decade, according to a recent International Monetary Fund (IMF) report, increases in TFP have stabilized in recent years at a relatively low level, threatening the growth path needed for continued development and poverty reduction.

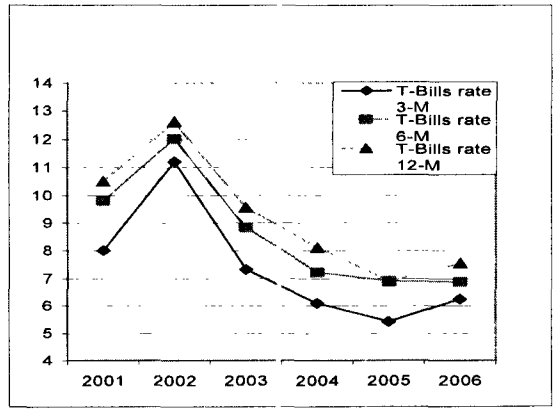
3. **Much of Albania's economic performance has been underpinned by sustained fiscal consolidation and macroeconomic stability.** This includes a reduction of overall fiscal deficit from 13 percent of GDP in 1997 to 3.7 percent in 2005, and a decline in the primary deficit from 8.0 to 0.5 percent of GDP during the same period. Lower public sector borrowing requirements resulting from fiscal consolidation sustained the downward trend in interest rates (figure 3). Inflation, although slightly higher toward the end of 2006 compared to a year earlier, stayed within the Bank of Albania's target range of 2–4 percent (figure 4).

Figure 3. Inflation Rates



Source: INSTAT

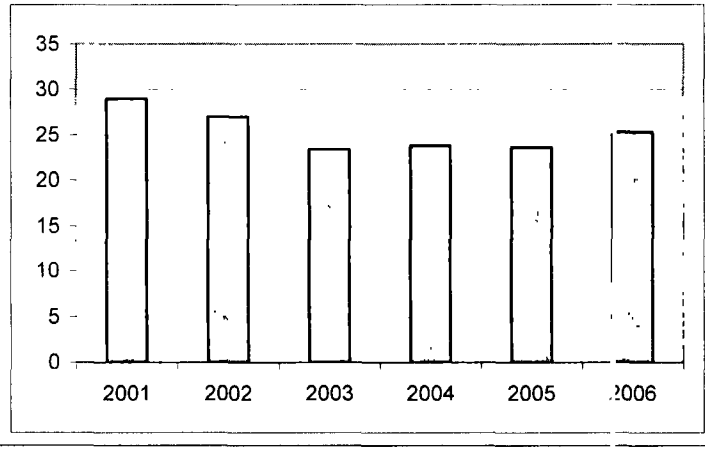
Figure 4. Albanian Treasury Bill Rates (%)



Source: BoA

4. **Despite progress in macroeconomic stability, attracting higher investment has been a challenge, and as a proportion of GDP, the investment level for 2006 was below the 2001 level**. Investment in Albania as a proportion of GDP peaked in 2001 at about 29 percent. However, the ratio continued to decline **to** reach 23.4 percent in 2003 before starting to rise marginally to an estimated level of 25.3 percent[1] in 2006 (figure 5). In addition to continued economic stability and concerted efforts to enhance the investment climate, improvements in the financial sector and increased domestic investment levels are critical for attracting FDI.

Figure 5. Gross Domestic Investment (% GDP)



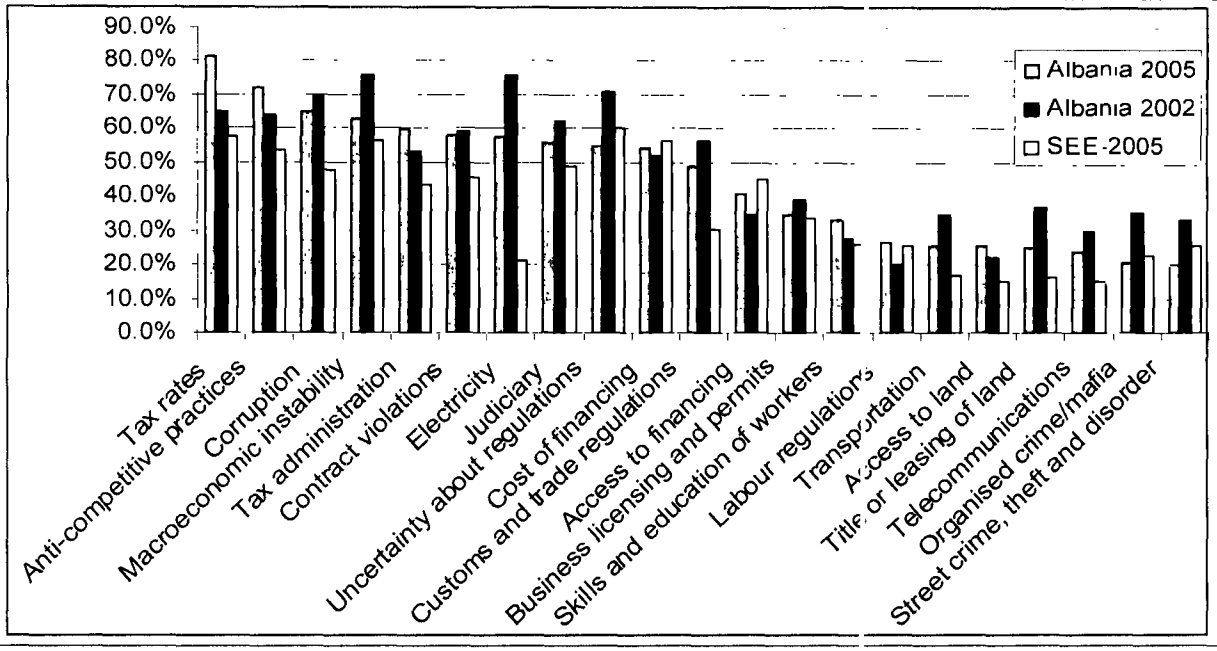
Source: World Development Indicators.

5. **The business environment in Albania remains a major constraint for further investment and growth, and improvements in these areas need to have complementary improvements in the financial sector to realize the potential for growth**. According to the Business Environment and Enterprise Performance Survey 2005 (BEEPS), Albanian firms perceive progress on macroeconomic stability, certainty about regulatory policies, and a decrease

1 World Bank Development Policy Loan Project Appraisal Document, February 2007.

of corruption and organized crime, compared with 2002. However, despite these improvements, compared with the Southeastern Europe averages and the Europe and Central Asia regional averages, Albanian firms rate the local business environment less attractive than their peers in the region in almost all categories (figure 6). The Doing Business indicators also demonstrate that Albania compares poorly against many of the other countries in the region, ranking Albania at 120 out of 175 countries.

Figure 6. Business Perceptions to Improve Private Sector Performance



Source: World Bank, Business Environment and Enterprise Performance Survey (BEEPS)

6. **A poor business environment also contributes to informality, keeping firms beyond the reach of government regulations and limiting their growth and access to finance.** Various studies show that informality costs developing countries 1–2 percentage points in annual GDP growth. This is due to two related effects. First, many firms and workers have no choice but to be informal because of the very high costs involved in becoming formal. As a result, significant resources are trapped in low-productivity operations with no access to capital. Second, the growth of the productive formal firms is significantly slowed because of fiscal and regulatory obligations. These obligations prevent formal firms from out-competing informal firms, despite the fact that they are three times more productive. The informal sector accounts for more than 50 percent of employment and economic activity in Albania.[2]

7. **Most financial intermediation in Albania takes place in the context of Albania's cash-based economy**. The majority of households in Albania are relatively poor and unsophisticated consumers of financial services who prefer to get paid and pay others in cash. Many enterprises have only one employee and operate on a premise of subsistence and survival rather than a growth strategy. The relationship between the Albanian taxpayers and the tax

2 INSTAT Statistical Yearbook 2004.

administrators has always been highly strained. Enterprises recognize in various surveys that they grossly underreport their revenues and profits, and they are not willing to open their financial books to the authorities in an environment where tax collection is highly uneven and does not appear to ensure fair and equal treatment of all taxpayers.

8. **The economy has had a high level of remittance inflows; however, there is little evidence that this has had a positive impact on growth**. Remittances have a significant impact in lowering poverty levels in Albania by financing a significant size of poor and extremely poor families. By some estimates, annual remittances are believed to be over US$1 billion. Almost all of the remittances are used for consumption, and very little of the inflows are used for investment. There is little evidence to show that remittances have had a positive impact on economic development. Furthermore, because they help finance imports, remittances are considered one of the key factors for the high trade-deficit growth because they contribute to finance imports.

9. **Money laundering continues to be an ongoing problem in Albania, requiring additional resources and stronger political will if it is to be combated effectively.** Albania was recognized as noncompliant by MONEYVAL[3]'s July 2006 report on nine of the FATF's recommendations on money laundering and two special recommendations against terrorist financing. In response to this evaluation, Albania began redrafting its AML law.[4] For Albania's financial system to have continued access and transactions with foreign banks, it is essential for Albanian AML activities to be on a par with international norms.

10. **Albanian authorities are aware that future growth will increasingly require higher investment levels underpinned with a robust financial sector that provides for effective and sustainable intermediation.** With the recent slowing of growth in total factor productivity from post-transition reallocation, future growth will have to rely increasingly on governance and institutional reforms to address areas in which Albania lags behind other countries. Authorities are aware that the areas of reform that offer the greatest gains are enterprise restructuring, competition policy, business environment, and intermediation development of the financial sector.

The Objectives and Scope of the Study

11. **The government has identified inadequate financing of small and medium enterprises (SMEs) to be one of the main hindrances to private sector development.** Thus, the GoA is seeking to strengthen further financing of SMEs in the next four years, to increase it by three to four times through the use of additional instruments that support SMEs. The measures

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3 MONEYVAL was established in September 1997 by the Committee of Ministers of the Council of Europe to conduct self and mutual assessment exercises of the anti-money laundering measures in place in Council of Europe countries, which are not members of the Financial Action Task Force (FATF) The effort includes encouraging jurisdictions to improve their anti-money laundering measures in keeping with the FATF Forty Recommendations and to enhance international co-operation. MONEYVAL also engages in a regular typologies exercise focused on the methods and trends of money laundering activity.

4 The original anti–money laundering (AML) law was enacted in 2000 and amended in 2003 to bring it closer to the Financial Action Task Force on Money Laundering (FATF) standards. The law expanded the list of covered businesses and professions, including casinos and notaries.

that are considered by the government are (i) increasing the level of credit and establishing the Albanian credit guarantee fund; (ii) establishing the export guarantee agency; (iii) applying other financial instruments such as factoring, leasing, public-private guarantee schemes, and joint guarantee schemes; and (iv) increasing microcredit funds.

12. **The significant growth in deposits is a major sign that confidence in the banking sector has improved.** The credit has grown also, but it remains shallow at 15 percent of GDP and small compared with the size of deposits. Though the banking system has started to shift an increasing share of the treasury bill assets to lending in pursuit of profitability, the system remains liquid. Therefore, the system has the capacity for further growth, provided the growth in credit is achieved in a sustainable manner. In that context, this study aims to identify the specific constraints and policy recommendations for the development of an efficient and sustainable financial sector as a means to improve access and use of credit for private sector growth. The government of Albania has expressed interest in creating a financial sector that will enhance sustainable access to credit for the private sector. To that purpose, the Bank of Albania has been working in collaboration with the World Bank on this study. Accordingly, following discussions, the BoA agreed with the scope of the study and the specific topics to be covered to ensure its relevance.

13. **The analysis pinpoints the most important constraints to credit from the perspective of lenders**. The study also assesses the prospects for sound credit growth and the requirements for developing different financial mechanisms. In doing so, the analysis builds on previous findings by the Bank and IMF in the context of the Financial Sector Assessment Program. The study also draws on a banking survey (see box 1 below) to capture ( ) the elements behind recent growth (by sector, region, and size); (ii) the current credit practices and the additional costs to lenders and borrowers stemming from deficiencies in credit infrastructure and creditor rights; (iii) the plans of the commercial banks for expanding their credit portfolios in the medium term; and (iv) the credit infrastructure that will be required in order to ensure that such credit growth is sound. This banking survey builds on ongoing World Bank work in Latin America. The report is supported by additional information collected during interviews with representatives from lending institutions and government authorities, including the judiciary, credit registry, property registries, and other institutions supervising and supporting credit.

Box 1. The Structure of the Banking Survey in Albania

For the purpose of this study, the team undertook a survey of banks, including 12 commercial banks that account for more than 80 percent of the banking system's assets. The survey comprised four main sections: current credit allocation, expectations for credit growth, credit processes, and constraints for development of credit activities stemming from credit infrastructure and creditor rights. The survey leveraged the work of a survey recently undertaken by the Financial Sector Development Unit in Latin America.

14. **The study is structured around five main chapters.** The first chapter provides an overview of the macroeconomic environment, the real sector, and the financial sector. Chapter 2 focuses on demand constraints, analyzing the use of credit by borrowers, the kind of credit used by different groups of borrowers, and the perception of the borrowers on access to credit.

Chapter 3 uses a similar approach to analyze the supply side of credit, looking at the lenders, the types of products offered and those under development, and lenders' perceptions on access to credit and the constraints. Chapter 4 provides an overview of the current credit infrastructure and identifies areas in which further improvements can achieve more effective and sustainable intermediation of credit. Finally, chapter 5 offers key policy recommendations to address the constraints and gaps identified in the analysis.

II. DEMAND CONSTRAINTS ON ACCESS TO FINANCE

15. **Access to credit by SMEs remains very limited and hinders firm-level growth.** Over 90 percent of the businesses in Albania are micro, small, and medium enterprises (MSMEs). Registration of new enterprises has been growing significantly since 1997, driven mainly by microenterprises; however, informality and concentration of firms in urban areas remain problematic. As of 2004, Albania had 147,000 registered firms, but only about 55,000 were active (table 1). About 50 percent of registered firms focus on trade and 25 percent focus on services. Agriculture and industry, which together account for 22 percent and 23 percent of GDP, respectively, account for 1 percent and 11 percent of active firms. These figures indicate that non-registered small farmers and businesses carry out most of the activities in the agriculture and industry sectors. Since 2002, the number of newly registered firms has increased, a good sign that more entrepreneurs are entering the formal economy. Active firms remain concentrated around major urban areas, and in particular around Tirana, which is home to 40 percent of active enterprises. Of the active firms, 75 percent are registered as physical persons and the rest are juridical persons.

Table 1. Active Enterprises, by Economic Activity, Size, and Legal Form, 1995–2004

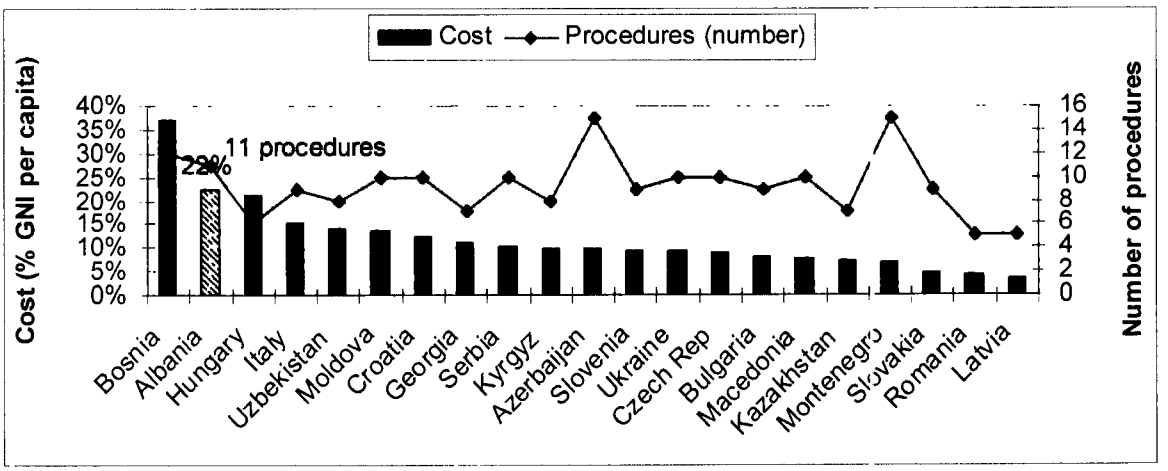
	Year										
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**Total**
Economic activity											
Agriculture	163	17	17	18	19	30	31	38	85	58	**476**
Industry	1,510	432	240	312	323	503	561	641	1,071	717	**6,310**
Construction	800	226	107	187	137	189	157	207	212	317	**2,639**
Transport	1,094	230	88	327	489	770	483	463	835	822	**5,601**
Trade	5,198	1,209	605	1,251	1,856	2,304	2,216	2,512	3,853	5,511	**26,535**
Services	2,832	685	574	595	786	997	1,192	1,406	2,203	2,178	**13,448**
Total	**11,597**	**2,799**	**1,631**	**2,690**	**3,610**	**4,793**	**4,640**	**5,237**	**8,259**	**9,603**	**54,909**
Size class											
Micro	10,246	2,482	1,398	2,446	3,406	4,555	4,423	5,113	8,112	9,512	**51,693**
Small	773	213	132	156	147	177	146	126	121	72	**2,063**
Medium	406	69	72	67	42	45	57	39	25	18	**840**
Large	172	35	29	21	15	16	14	9	1	1	**313**
Total	**11,597**	**2,799**	**1,631**	**2,690**	**3,610**	**4,793**	**4,640**	**5,237**	**8,259**	**9,603**	**54,909**
Legal form											
Physical person	7,498	1,549	784	1,769	2,644	3,593	3,671	4,168	7,255	8,167	**41,098**
Juridical person	4,099	1,250	847	921	966	1,200	969	1,119	1,004	1,436	**13,811**
Total	**11,597**	**2,799**	**1,631**	**2,690**	**3,610**	**4,793**	**4,640**	**5,237**	**8,259**	**9,603**	**54,909**

Source: INSTAT

16. **Bureaucratic and legal hurdles increase the cost and time required to register businesses in Albania, reducing incentives for formality.**[5] The cost of registering a new business in Albania is the second highest in the region, at more than the equivalent of 22 percent of the gross national income (GNI) per capita (see figure 7). At the same time, the process results in significant additional costs in terms of time and documentation required from entrepreneurs, who have to fulfill 11 different procedures to register their business. On average, fulfilling these requirements takes about 39 days, well above the average of 29 days in other countries in the region.

5 These figures are based on the results of the World Bank's Doing Business report for 2006. Estimates are based on assumptions regarding the procedures, time, and cost involved in launching a commercial or industrial firm with up to 50 employees and with start-up capital of 10 times the economy's per capita gross national income (GNI).

Figure 7. Cost and Number of Procedures Required to Formally Register a New Business in Albania



Source: World Bank, Doing Business 2006.

17. **Growth in Albania's enterprise sector has been mainly among micro and small enterprises, yet the number of MSMEs per capita in Albania remains small compared with other countries in the region.** Micro and small enterprises account for about 95 percent and 4.5 percent of all enterprises, respectively (figure 8). Albania has around 840 active medium enterprises and about 300 large companies, with the largest ones working primarily in the energy and telecommunication sectors. Compared with other countries in the region, Albania has the lowest number of formal enterprises per capita, which results from a persistent, and possibly growing, informal economy; comparable economies exhibit a significantly higher number of MSMEs per capita (figure 9). In this context, both the government and private sector can realize significant gains by reducing formality to increase the tax base and improve business access to those services that require formal registration.

Figure 8. Microenterprises as a Percentage of MSMEs, 2004

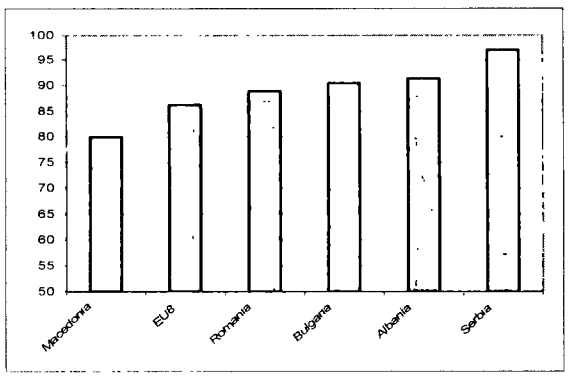
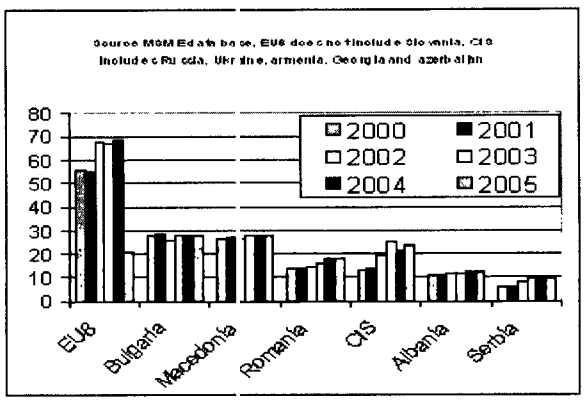


Figure 9[6]. Number of MSMEs, per 1,000 Inhabitants



6 *Source: Micro, Small, and Medium Enterprises: A Collection of Published Data*, by Marta Kozak, International Finance Corporation (IFC), Washington, DC.

Growth of the Real Sector

18. **Even though the rate of growth in the economy has been high, Albania's GDP has been above its pre-crisis level only since 2003 (in real terms- see figure 10).** Overall, there has been a shift in the sectoral composition of the GDP, with a relative increase in the services and construction sectors, and a drastic decline in agriculture, which had real growth of minus 33 percent between 1996 and 2004 (figure 11).

Figure 10. Contribution to GDP, by Sectors

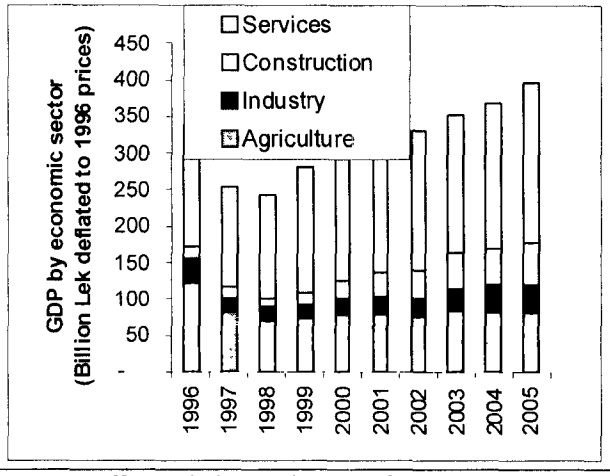
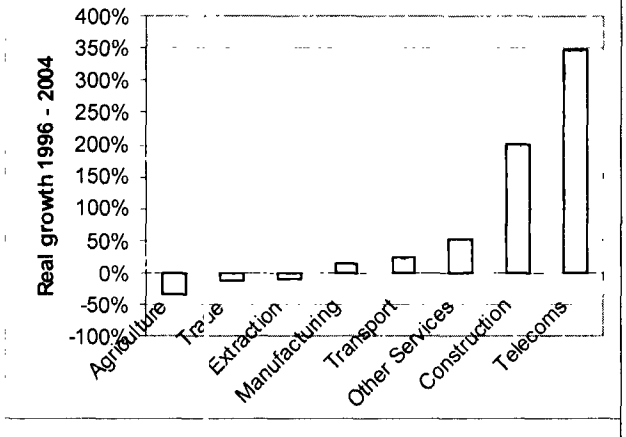


Figure 11. Real Growth, by Sectors



Source: Staff calculations using data from INSTAT

19. **Growth of added value has resulted from construction, trade, telecommunications, and other services.** Construction grew by more than 200 percent (albeit from a low base), and services grew by 20 percent (figure 12). The importance of agriculture in the economy has been steadily decreasing, although its share of employment has remained steady at about 60 percent of the labor force. The contribution of trade has decreased as well. The service sector and construction experienced the largest growth while manufacturing remained stable (figure 13).

Figure 12. Contribution to Total Added Value, by Sector

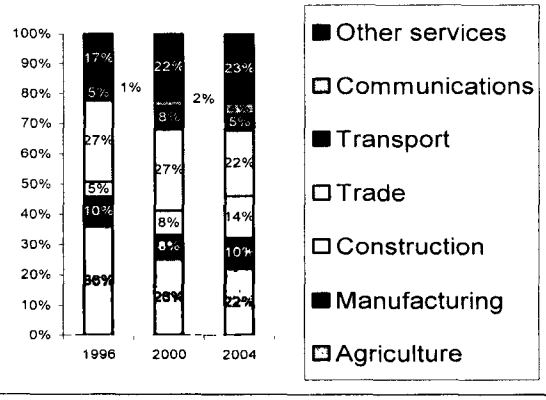
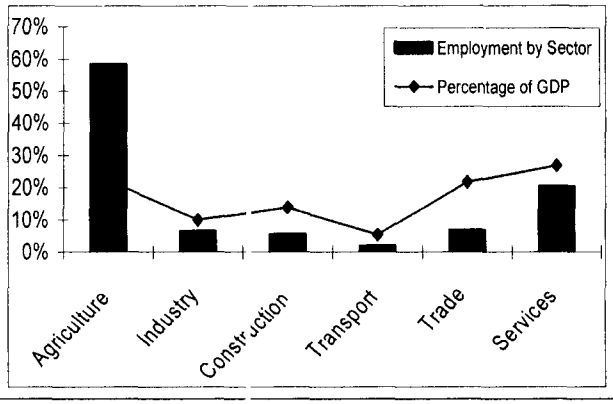


Figure 13. Employment vs. Added Value to GDP, 2005



Source: INSTAT

Demand for Credit by Enterprise Sector

20. **According to BEEPS 2005, Albanian firms on average receive 50 percent less from external financing for working capital and new investment needs than other Southeast Europe countries. More specifically, they rely on their internal funding for growth and new investments more than any other country in the region** and receive 38 percent less in bank credit for their working capital. On average, leasing and trade credit account for about 6 percent of firm financing, whereas in Albania firms receive less than 2 percent of their financing from these sources. Although remittances are notably high, informal financing seems to be considerably less than in peer countries (table 2).

Table 2. Source of Working Capital (WC) and New Investments (NI), % of total

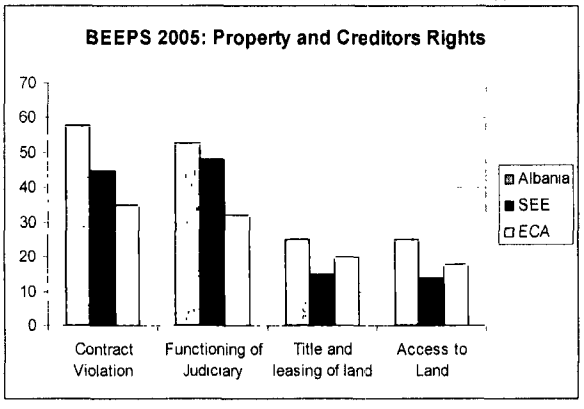
	Albania		BiH		Macedonia		Serbia		Hungary		Croatia		Bulgaria		Regional average	
	WC	NI	WC	NI	WC	NI	WC	NI	WC	NI	WC	NI	WC	NI	WC	NI
Internal funds/ retained earnings	87.2	78.1	61.6	65.0	73.9	66.7	75.7	79.9	57.3	52.5	61.1	55.5	66.0	66.2	69.0	66.3
Equity	0.2	0	2.0	0	1.7	2.3	0.1	0.9	16.6	15.7	3.9	4.1	0.2	0.2	3.5	3.3
Borrowing from banks	**7.9**	**18.2**	**22.6**	**25.6**	**3.9**	**11.5**	**9.8**	**10.8**	**14.0**	**18.5**	**19.1**	**28.0**	**12.6**	**19.3**	12.8	18.8
Loans from family/friend/other	1.7	1.6	2.6	2.1	6.4	7.8	4.2	2.6	2.5	1.3	2.5	1.2	9.9	4.4	4.3	3.0
Trade credit	2.6	0	3.7	1.9	6.4	2.0	5.7	1.4	5.8	1.1	6.4	1.2	5.3	1.5	5.1	1.3
Credit cards	0	1.6	0.3	0.4	0.5	0.2	0.1	0	0.5	0.2	0.8	0.7	0.1	0	0.3	0.4
Leasing	0.1	0	1.5	2.4	0.7	1	1.0	1.7	1.5	7.4	2.7	6.1	1.9	4.8	1.3	3.3
Government	0.1	0.7	1.3	0.3	0	0.4	0.6	0.5	0.5	0.9	1.0	1.7	2.3	1.9	0.8	0.9
Other	0.1	0	4.4	2.3	6.7	8.2	2.9	2.2	1.3	2.4	2.4	1.6	1.7	1.8	2.8	2.6
Number of firms observed	*204*	*174*	*188*	*100*	*196*	*115*	*291*	*215*	*604*	*470*	*224*	*169*	*295*	*232*	286.0	210.7

	Average		**Small (1-19 employees)**		**Medium (20-99 employees)**		**Large (100+ employees)**	
Financing sources	**NI**	**WC**	**NI**	**WC**	**NI**	**WC**	**NI**	**WC**
Internal finance (%)	78.1	87.2	84.19	90.07	73.4	84.25	72.08	85.77
Bank finance (%)	18.2	7.97	11.09	4.08	23.96	11.85	23.75	10.38
Informal finance (%)	1.57	1.67	3.5	1.92	0	1.91	0	0
Leasing arrangement (%)	0	0.15	0	0.31	0	0	0	0
Funds, special development financing, other state services (%)	0.66	0.1	0	0	1.39	0	0.63	0.77
Supplier credit finance (%)	1.55	2.6	1.22	3.31	1.25	1.6	3.54	3.08
Credit cards (%)	0	0.05	0	0	0	0.12	0	0
Equity, sale of stock (%)	0	0.2	0	0.31	0	0.12	0	0
Other financing (%)	0	0.05	0	0	0	0.14	0	0

Source: BEEPS 2005

21. **High collateralization requirements reduce accessibility of credit by smaller prospective borrowers**. In turn, the cost of credit appears to be inflated by deficiencies in basic property and creditors' rights, which remain weak compared to other countries in the region (figure 14). The problems of property registration and contract enforcement are also confirmed by the Doing Business survey (2007), which has dropped Albania's ranking from 74 and 93 to 76 and 99, respectively, from 2006 (Table 3). Furthermore, the same survey ranks Albania at 162 among all 170 economies in terms of protecting investors.

Figure 14. Business Perception of Property and Creditors' Rights



Source: World Bank, BEEPS 2005

Table 3. Doing Business Indicators for Albania

Ease of...	2006 rank	2005 rank	Change in rank
Doing Business	*120*	*115*	*5*
Starting a Business	121	120	-1
Dealing with Licenses	161	160	-1
Employing Workers	113	112	-1
Registering Property	76	74	-2
Getting Credit	48	41	-7
Protecting Investors	162	162	0
Paying Taxes	125	121	-4
Trading Across Borders	101	91	-10
Enforcing Contracts	99	93	-6
Closing a Business	89	83	-6

Source: World Bank, Doing Business

III. SUPPLY CONSTRAINTS IN THE PROVISION OF BANK CREDIT

22. **The financial sector in Albania is dominated by commercial banks and comprises a high number of nonbank financial institutions.** Albania currently has 17 commercial banks, 14 **microfinance** institutions (MFIs), and 118 savings and credit associations (SCAs), which are grouped under the umbrella of two apex institutions. However, in spite of the large number of nonbank financial institutions (NBFIs), the financial sector is dominated by commercial banks, which account for 95 percent of the total credit granted to the private sector.

23. **The Bank of Albania has the legal authority to license and supervise NBFIs in Albania.** The Law **on** the Bank of Albania and the BoA Regulation on the Granting of License to Non-Bank Financial Subjects provide the authority, terms, conditions, and procedures for licensing and regulating NBFIs. So far, such institutions have been limited to credit unions, payment services companies, and foreign exchange bureaus. In addition to these institutions, some nonprofit foundations (BESA Foundation and PSHM) operate in the field of microlending; however, because of the current lack of a legal framework for microfinance activities, these entities do not fall under the BoA's purview.

24. **The Albanian Securities Commission (ASC) has a regulatory and supervisory authority over participants of the capital market**. The ASC itself operates with a mandate provided to it by the Securities Law. It has **issued** a number of rules and regulations for the capital market participants and instruments. Despite a good legal basis and eight years of experience with the ASC and the Tirana Stock Exchange, there are no instruments, players, and activity in the Albanian capital market, with the exception of several T-bill trading licenses issued by the ASC to commercial banks and a few broker-dealers, and occasional trading of the T-bills.

25. **The banking system has grown substantially over the past few years.** As at the October 2006, the total assets of the banking system stood at lek 568 billion (US$6 billion), an increase of almost 50 percent over the size of the system in 2004. Similarly, deposits from the private sector increased by 30 percent, mostly through demand deposits, which accounted for one-third of all deposits, up from one-fifth in 2004.

26. **Growth in the banking system was reflected in increased lending, and in particular in mid- to long-term loans**. Between 2003 and 2006, credit to the private sector increased by 150 percent, even though credit growth slowed in 2005 (25.7 percent). Though growth in short-term credit remained constant, mid- to long-term credit showed growth. Banking system assets increased lek 71 billion during the first three quarters of 2006, or 14 percent more than at year-end 2005, maintaining almost the same growth rate as the previous year. The privatization of the Savings Bank, macroeconomic stability, and low inflation together have contributed to the rapid growth of the banking system.

Table 4. Banking Sector Portfolio (thousands of leks)

	2000	2001	2002	2003	2004	2005	2006
Number of banks (of which, no. that have foreign capital)	13 (12)	13 (12)	13 (12)	15 (13)	16 (14)	17 (14)	17(14)
Total assets of the banking system (year-end)	270,851	318,457	339,333	373,635	426,440	496,561	567,743
Total loans (year-end)	28,213	28,277	38,491	50,824	70,143	127,056	141,484
Total deposits (year-end)	233,087	277,818	289,006	331,426	375,843	432,960	489,693
Total equity	18,254	18,760	21,620	21,985	25,949	26,993	39,883
Credit to GDP ratio (in %)	8.3	4.8	6	7.3	8.9	15	18
Total deposits to GSD ratio (in %)	43.9	47.1	45.8	48	48	52	56

Source: Bank of Albania

The Structure of the Banking System

27. **In spite of significant progress over the past few years, the Albanian banking system is still undergoing a substantial consolidation process.** After a wave of privatization that culminated with the sale of the Savings Bank in 2004, there are currently 17 commercial banks in Albania. The system is relatively concentrated, with the four largest banks accounting for almost 70 percent of the aggregated assets; however, the share of growth contributed by large banks has declined. The downward trend of the large banks' contribution to the growth of the system pointed to a reduction of the overall banking activity concentration.[7] However, further consolidation in the system is expected, with mergers of banks owned by the same financial groups and potential acquisition of the few remaining local banks. Consolidation will likely help the system to enhance efficiency and benefit from economies of scale.

Table 5. Ownership and Market Share of Banks in Albania

Bank	Owner	Country	Market share by							
			Assets		Loans		Deposits		Equity capital	
Raiffeisen Bank	Raiffeisen Bank	Austria	1	35.45%	1	19.05%	1	38.79%	1	24.89%
Italian Albanian Bank	San Paolo IMI	Italy	9	3.59%	11	3.30%	9	3.76%	8	3.93%
National Commercial Bank	Calik Group	Turkey	2	12.97%	4	11.06%	2	14.30%	3	9.99%
Italian Development Bank	F. Mariano + Banca Popolare Pugliese	Italy	16	0,35%	14	0.55%	16	0.19%	17	1.09%
Tirana Bank	Pireaus Group	Greece	4	8.01%	2	13.22%	4	8.16%	5	8.15%
National Bank of Greece (branch)	National Bank of Greece	Greece	10	2.83%	6	6.54%	10	1.91%	7	4.10%
International Commercial Bank	ICB Group	Malaysia	13	0.60%	13	0.64%	13	0.52%	13	2.19%
Alpha Bank (branch)	Alpha Bank	Greece	5	5.92%	5	10.30%	5	5.56%	2	10.15%
American Bank of Albania	Intesa San Paolo	Italy	3	12.88%	3	12.84%	3	10.55%	4	9.66%
Procredit Bank	Procredit Bank	Germany	7	4.52%	7	5.78%	7	4.52%	6	5.04%
First Investment Bank (branch)	First Investment Bank	Bulgaria	15	0.35%	17	0.11%	15	0.20%	15	2.15%

7 Bank of Albania, Economic Bulletin, 2006.

Emporiki Bank	Emporiki Bank	Greece	11	2.02%	9	5.01%	11	1.09%	10	3.50%
Credit Bank of Albania	Al Kharafi Group	Kuwait	17	0.23%	16	0.15%	17	0.08%	16	2.10%
Credins Bank	Albanian shareholders		8	4.42%	8	5.56%	8	4.48%	11	3.43%
Banka Popullore	Societe Generale	France	6	4.60%	10	4.69%	6	4.97%	9	3.68%
Union Bank	Albanian Shareholders	Albania	14	0.52%	15	0.24%	14	0.29%	14	2.19%
United Bank of Albania			12	0.75%	12	0.95%	12	0.63%	12	2.93%

Source: Bank of Albania, Association of Albanian Banks. *Note:* Figures for Credit Bank of Albania are those of third quarter 2006 (unaudited).

28. **A large proportion of the Albanian banking system is under foreign ownership.** Notably, 14 Albanian banks, accounting for 94 percent of the banking system's assets, are owned and managed by foreign financial groups (Table 5). The system has benefited from foreign ownership through the transfer of technology, credit processes, risk management, and governance standards. Moreover, the fact that foreign owners are mostly financial groups based in countries with significant commercial links with Albania may facilitate financing of trade and export activities. However, given the limited credit history and infrastructure in Albania, significant customization of processes and technology will likely be required as banks gain credit experience in this market.

Banking Outreach

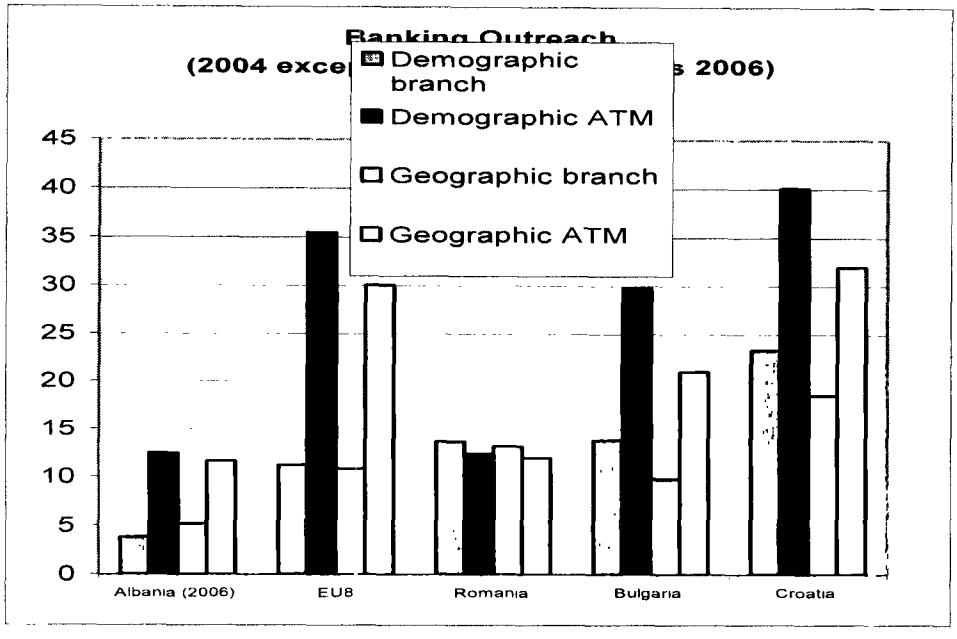
29. **The banking system's network has expanded substantially, but it remains limited in comparative terms.** The system's entry into the market of European banks, which is expected to continue in the near future, has driven competition, and banks have become more aggressive in attracting new borrowers and depositors. Accordingly, 48 new branches and agencies were opened throughout Albania in 2005 alone; 23 of those were opened in Tirana. As of end-2006, the banking system had 150 outlets (including 115 branches, 18 regional offices, and 17 agencies) and 335 automated teller machines (ATMs). This translates into a proportion of one branch for every 26,000 people, one bank unit (branch and agency) for every 12,000 residents, and one ATM for every 8,000 residents. These figures are well below those observed in peer countries in the region (figure 15). Credit and cash card use has also grown 10 times that of 2004, to a total of more than 350,000 cards in 2006 (Table 6).

Table 6. Use of ATM Cash Cards and Credit Cards

	2004	2005	2006
Number of cards in circulation	34,094	225,913	353,465
Cash cards + debit cards	33,288	223,227	343,711
Credit cards + prepaid cards	806	2,686	9,754
Total	34,094	225,913	353,465
Number of point of sale	155	779	1,183
Number of ATM	93	205	335

Source: Bank of Albania

Figure 15. Profile of Banking Outreach



Source: World Bank, *Reaching Out: Access to and Use of Banking Services across Countries*, 2005; and Bank of Albania.

30. **The ATM network experienced a significant growth during the past three years.** Most banks have established ATMs in Tirana as well as in other main cities. The number of electronic terminals grew from 93 at the end 2004 to 335 as of August 2006, and the number of users increased almost tenfold, from 34,090 to about 295,250.

31. **Most ATMs are used through debit cards, but credit card use is also increasing quickly.** Both Visa and MasterCard are active in Albania, and most banks are members of at least one of them. Although the use of cards is still limited, the growing number of service units accepting electronic payments (up from 155 in December 2004 to 1,183 in 2006) indicates the banks' response to a shift in public demand, which favors the use of cards over the holding of cash.

32. **The number of employees in the banking sector continues to grow fast, and the average number of employees per banking unit has decreased.** In 2005 the number of employees in the sector increased by 24 percent following a 26 percent increase in 2004. By the end of 2005, the Albanian banking system had 3,479 employees compared with 2,816 in 2004. The number of employees per banking unit decreased to 13.9 employees per banking unit in 2005, from 15 in 2004. To some extent this decline reflects the opening of new and smaller branches in more remote areas, and to a smaller extent it reflects the slower pace of developing human capital to match the needs of an increasing number of branches. The significant growth in the number of employees, combined with the increased number of branches, reflects the expansion of the banking system network and the extension of the services offered. Overall, the increased number of banks, branches, and their agencies and the growing number of bank employees have significantly improved coverage of the

population. Thus, the number of inhabitants per bank, banking unit, and bank employee has decreased considerably.

33. **Use of e-banking remains very limited; however, there have been significant improvements in the overall electronic banking infrastructure.** E-banking, which allows customers to execute online transactions, was first offered in 2003 in Albania. Significant improvements have been made in terms of the information technology and communication with commercial banks. After the introduction of the RTGS system for the settlement of gross payments, the payments infrastructure expanded with the Automatic Electronic Clearing House system, which aims at reducing the processing time of small-value payments considerably, thus encouraging the use of banking payments. Banks report that the public's use of e-banking is very limited, although businesses are starting to use these services, primarily for transferring funds and direct payments. Only two banks currently offer e-banking, but other banks have planned to introduce similar services in the near future. The Bank of Albania also has supported e-banking efforts.[8]

34. **Expansion of services to new market segments is fueled by banks' business development drive.** Banks have actively sought to expand operations beyond the segment of large firms to households and, to a lesser extent, to SMEs. According to commercial banks' responses to the bank survey, the segment of large enterprises appears to be close to saturation, with substantial access to bank loans and relatively small intermediation margins. Accordingly, the banks indicated that their decision to expand operations into other market segments largely has been driven by high competition (83 percent) and the need for diversification of their operations (92 percent). (See figures 16 and 17.)

Figure 16. Impact of Competition on Decision to Expand Operations (% of respondents)

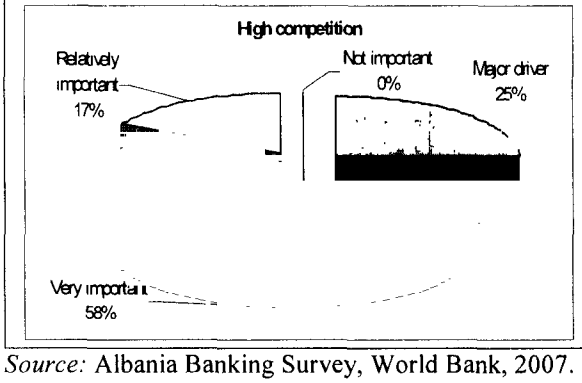
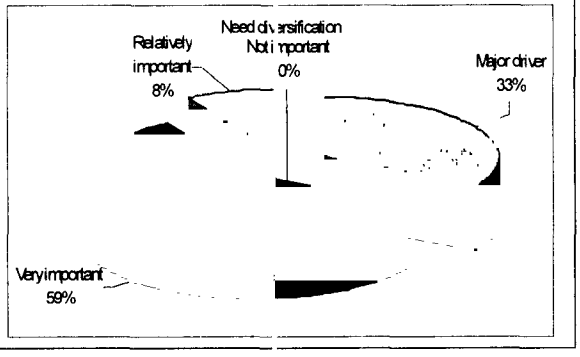


Figure 17. Need for Diversification as a Factor in Decision to Expand Operations (% of respondents)



Source: Albania Banking Survey, World Bank, 2007.

8 The regulation on the Use of Information Technology and Communication of the Entities Licensed by the Bank of Albania was approved by Supervisory Council Decision No. 32, dated May 3, 2006. This regulation not only will assist the provision of a more prudent and complete supervision of the information technology and communication used by banks, but it also is aimed at helping banks in their day-to-day work and in the use of this technology. The regulation is expected to increase the security measures that banks should apply in order to provide the security and the good use of the information, the maintenance of the information, and the continuity of work in cases of extraordinary events.

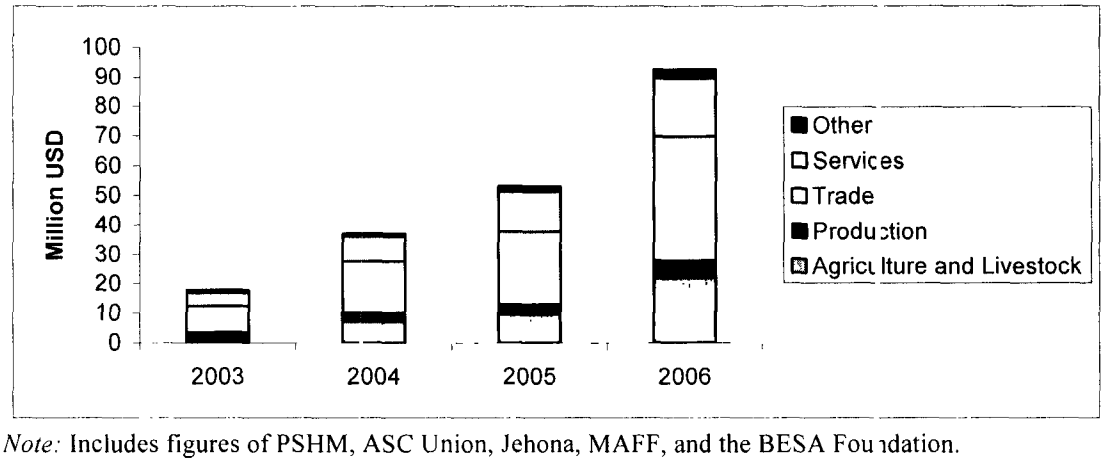
35. **Though competition has increased banks' outreach, further consolidation of the banking system may be required in the medium term to attain operational efficiency.** The number of banks and NBFIs operating in Albania appears to be high, considering the still-limited economic activity in the country and the size of the overall economy. Further consolidation of the banking system (beyond that expected in the short term would help achieve economies of scale and avoid unsound credit practices in the drive to attract clients, especially considering the high credit growth targets at the level of individual bank (see below).

The Structure of the Microcredit Sector

36. **The microcredit sector in Albania comprises microfinance institutions and savings and credit associations.**[9] These entities specifically cover rural and periurban areas that cater to a niche clientele, concentrating their services in locations where commercial banks are mainly absent. MFIs and SCAs have been credited with being successful institutions and are considered to have had significant social and financial impact on the populations they serve. In particular, in the rural areas they are recognized for helping the farmers overcome the emergency phase and for later promoting development, creating some of the first financial structures in villages, and enabling villages to manage credit and other development projects.

37. **Although microcredit entities have had a major role in expanding credit to underserved segments of the economy, the scope of their operation is still very small.** Altogether, the aggregate credit portfolio of MFIs and SCAs in Albania at the end of 2006 was around US$95 million. That is several times higher than the volume in 2003, but it is still less than 5 percent of the aggregate loan portfolio of banks (see figure 18). However, with more than 30,000 active clients, MFIs and SCAs service about 20 percent of the overall clientele of the financial system in Albania.

Figure 18. Aggregate Loan Portfolio of Microcredit Entities

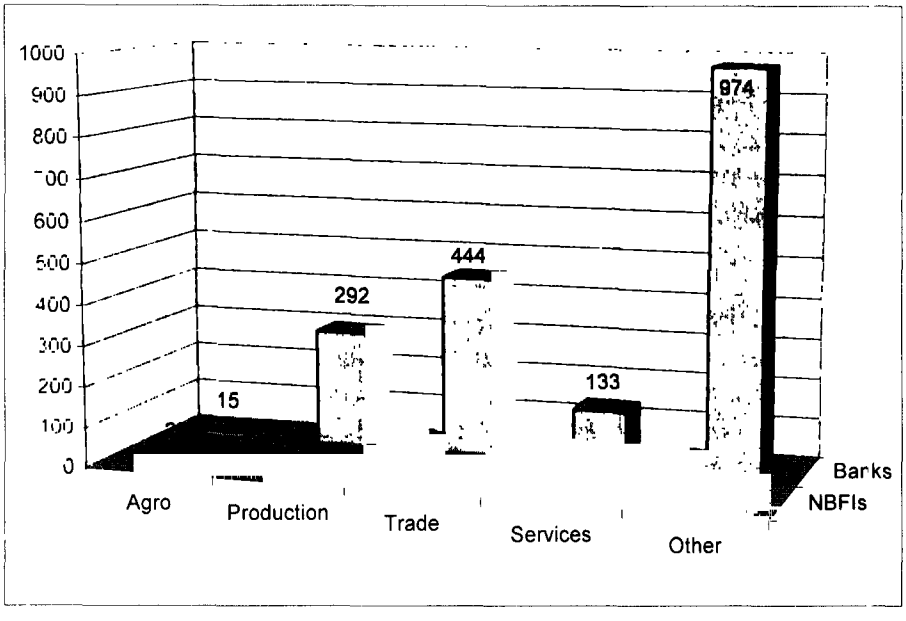


Note: Includes figures of PSHM, ASC Union, Jehona, MAFF, and the BESA Foundation.
Sources: Bank of Albania and PSHM, ASC Union, Jehona, MAFF, and the BESA Foundation.

9 One commercial bank in Albania (ProCredit Bank) is fully focused on microlending activities. Its figures are part of the banking system figures and so are not included in this section.

38. **Microcredit entities have focused on trade, services, and agriculture; however, the limited scope of their operations still leaves a potentially large unmet demand for credit in agriculture.** According to estimates based on data provided by the microcredit entities, at the end of 2006 most of their activities remained concentrated in trade, which accounts for 45 percent of their aggregate loan portfolio, or about US$42 million (Figure 19). Accordingly, agriculture and livestock activities accounted for only one-fourth of the overall credit portfolio of microcredit entities, with about US$22 million in overall volume. This volume of credit is commensurate to that offered by commercial banks and is still well below the potential demand for rural credit, given the importance of agricultural activities in Albania's GDP.

Figure 19. Proportion of Credit from Banks and NBFIs to Different Economic Sectors



Source: Author's calculations based on data from BoA and individual NBFIs.

39. **Fewer people in Albania have access to microcredit than in other countries in the region; however, the industry focuses on the poor to a greater extent.** In 2006, less than 1 percent of the Albanian population in the 15–65 year age range has access to microfinance loans (figure 20). This compares to about 2.5 percent in Central and Eastern Europe in 2004 (figure 21). However, microfinance loans in Albania are relatively small (when measured as a proportion of the GDP per capita) compared with those in other countries in the region. In general terms, this measure usually implies that the outreach of microfinance operations in Albania is deeper, targeting borrowers with lower income.

Figure 20. Regional Comparison of Borrowers in Population 15-65 Age Group

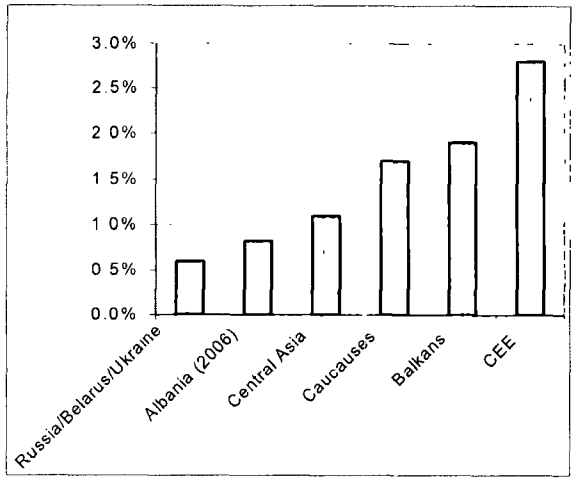
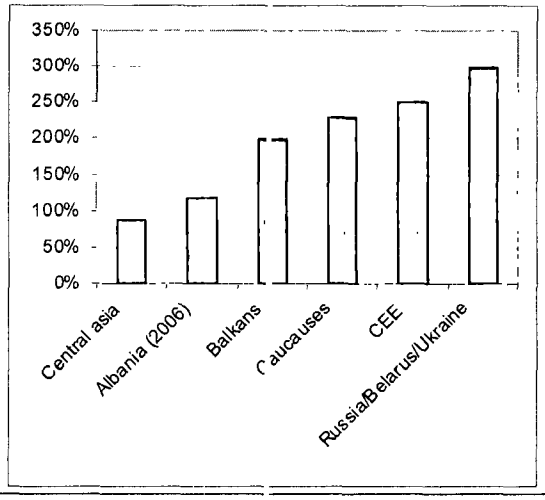


Figure 21. Regional Comparison of Depth of Outreach (loan size to GDP)



Source: European microfinance report, 2004.

Overview of Major Microfinance Institutions

40. **Assets of the microfinance industry are about US$70 million, with three major microfinance institutions accounting for most of the activity**. Microfinance loans are more expensive than banks loans, at 30 percent per year with a maturity of about 24 months. The main microcredit institutions are the BESA Foundation, the Mountain Areas Finance Fund (MAFF), and the Albanian Partner for Microcredit (PSHM). The total value of microcredit organizations is about US$70 million, and they have about 19,000 outstanding loans.

41. **MFIs in Albania offer a range of services, including loans, with significant variations in terms and sizes as well as requirements**. MFIs have grown considerably over the past three years, in part because of consolidation in the microfinance sector and in part as a result of outside investors (Table 7).

Table 7. Loan Portfolios of Major Microfinance Institutions

	Loan portfolio 2006 (US$ million)	Number of outstanding loans	Average loan (US$)
BESA Foundation	29	7,000	4,142
MAFF	14	5,343	2,620
PSHM	14	7,000	2,000

Source: Author's calculations based on data from MAFF, BESA Foundation, and PSHM.

Box 2. The Lack of Legal Framework for Microfinance Activities

No laws currently govern MFI activities in Albania. Accordingly, microcredit institutions are regulated differently depending on their legal status. The Mountain Areas Finance Fund is licensed and supervised by the BoA as a nonbank financial institution based on Article 26 of the Law on Banks (in force since 1998). The Albanian Partner for Microcredit has the status of a joint stock company and is neither licensed nor supervised by the BoA. The BESA Foundation still has the status of a nongovernmental organization[1] and hence is also neither licensed nor supervised.

Some microcredit entities have pondered the possibility of transforming into a bank, which would enable them to raise deposits. However, the transformation can be too onerous in terms of the institutional changes, the investment in required compliance systems, and the minimum capital requirements. In principle, the decision to avoid regulating microfinance activities was considered as a means to foster the development of the sector by easing the regulatory burden. However, it will be necessary to give microfinance entities the means to become formal financial institutions. This transformation is essential to facilitate the MFIs' long-term sustainability by giving them access wider sources of funding while maintaining a level of oversight commensurate with their activities and risks.

Financial authorities should consider legal frameworks adopted by other countries in the region, which aim to balance the need for oversight with potential risks faced by different types of financial institutions. The basic principle of these frameworks is the recognition of three main types of MFIs, categorized according to the level of potential risk for the system and for clients:

- Entities that channel concessional funding from donors to borrowers (the lowest risk)
- Entities that also take loans from other financial institutions (e.g., local banks) and institutional investors
- Entities that are allowed to raise deposits from clients and therefore are regulated and supervised under the same framework of commercial banks

The table below summarizes some of the main features of such a legal framework.

Main Features of Various MFI Types

Type of entity	Legal status	Activities allowed	Minimum capital	Authorization by central bank	Disclosure and regulatory requirements
Microcredit agencies	Not-for-profit entity	- Credit - Leasing	No minimum required	Certificate	Optional external auditing; no prudential regulation
Microcredit companies	Commercial enterprise	- Credit - Leasing - Factoring	Nominal minimum capital (e.g., US$2,500)	Certificate	Optional external auditing; no prudential regulation
Microfinance companies	Commercial joint stock firm	- Credit - Leasing - Factoring - Deposit raising	Minimum capital requirements in line with those for commercial banks	License	Mandatory external auditing; prudential regulation.

1 The BESA Foundation was created in 1999 as a continuation of a government's urban microcredit project under the Albanian Development Fund. At inception, BESA received significant support from the World Bank, the GoA, and the Soros Foundation.

42. **The BESA Foundation is the largest of the three main microfinance entities, and it has experienced significant growth**. The foundation's loans grew from US$14.9 million in 2004 to US$29.4 million in 2006. Its portfolio is 87 percent on trade and services; 80

percent of the borrowers are men and 20 percent are women. An important difference between the BESA Foundation and other microfinance entities is that BESA is fully focused on urban and periurban borrowers, which it services through a network of 17 offices. At the end of 2006, it had 7,000 loans outstanding. Loans usually carry an interest rate of 2 percent per month—that is, 27 percent on an annualized basis—plus an application fee of 1–3 percent. Loans can be as high as US$20,000, but the current average is US$4,600 (up from US$3,700 in 2004). Loans have a maximum maturity of 36 months and are intended to finance investment. Loans are usually collateralized at 150 percent, of which at least 80 percent must be real estate.

43. **The BESA Foundation is currently highly dependent on a limited number of funding sources in concessional conditions.** At the end of 2006, the foundation had funding from the GoA, the Aga Khan Foundation, and the government of Spain. This funding totals about US$18 million and carries interest rates of 3.5–5.5 percent with maturities of 10 and 15 years, respectively. The BESA Foundation has been able to negotiate funding from local banks, which is evidence of confidence on its operations. However, it is clear that this funding would carry much higher costs and stricter conditions.

44. **Mountain Areas Finance Fund (MAFF) is a government-owned financial institution established in 2002 to provide financial services to support economic development and reduce poverty in the mountain areas of the country**. MAFF is licensed by the Albanian National Bank as a nonbanking institution and is an important element of the Albanian financial system; the geographic areas it services are difficult to access but account for 60 percent of the country and 35 percent of the population. To that end, MAFF has developed a substantial network with 19 branches that cover more than 840 villages. MAFF is financially supported mainly by the GoA, but it receives substantial funding from donors, including the International Fund for Agricultural Development (IFAD) and the U.K.'s Department For International Development (DFID).

45. **MAFF's loan portfolio has grown by 35 percent over the past two years; at the end of 2006 it had outstanding loans for lek 1.4 billion (around US$14 million) and more than 5,300 borrowers.** MAFF directors plan to expand its loan portfolio by around 10 percent annually over the next three years. The distribution of MAFF loans in terms of volume is 40 percent in agriculture, 50 percent in trade, and the remaining in services and production. However, in term of numbers of loans, distribution is 6[illegible] percent agriculture, and 28 percent trade. Over 90 percent of loans are for working capital, over 96 percent of loans are in amounts less than lek 1,500, and 70 percent of loans are more than 24 months maturity. MAFF offers three main types of products: group loans (up to lek 150,000, or US$1,400), loans to individuals (up to lek 200,000, or US$1,900), and loans to SMEs (up to lek 20 million, or US$180,000).

46. **Going forward, the expansion of MAFF's operations appears to be largely dependent on availability of funding and development of its institutional capacity.**

MAFF relies heavily on concessional funding from IFAD, OPEC,[10] and the GoA. However, a significant expansion of its operations and its long-term sustainability will largely depend on its ability to secure funding in market conditions, either from financial institutions or from investment funds. In terms of institutional capacity, MAFF has been receiving technical assistance from RIAS (a consultancy arm of Rabobank) on development of new financial products.

47. **The GoA has been evaluating the possibility of transforming MAFF into a full-scale commercial bank**. This move is very ambitious because the GoA considers the privatization of MAFF to be a cooperative, extensive branch expansion (double its current network) that involves developing new savings and loan products. This move would grant MAFF the possibility to expand its funding through low-cost deposits. However, some implications will require careful consideration:

- **Governance.** The proposal for the transformation of MAFF considers that the GoA and IFAD will maintain significant influence in MAFF's strategic direction. This may clash with the principle of a cooperative institution.
- **Regulation of MAFF**. As a general principle, it will be important to ensure that MAFF is subject to the same level of regulation and supervision as that applied to commercial banks. Compliance with banklike regulatory requirements may require significant investment in systems and staff.
- **Social objective**. it will be difficult to match the original social goals of MAFF with the operations of a formal bank. Specifically, prices of MAFF's services would need to be revised to match market-based funding. This could force MAFF to pull away from its current clientele and focus on higher-profitability market segments.

48. **The GoA should evaluate the possibility of transforming MAFF into a credit and savings institution rather than a full-scale bank**. This move would enable MAFF to raise deposits while maintaining a structure that is more akin to its social goals and geographical focus.

49. **The Albanian Partner for Microcredit (PSHM) is a microcredit institution operating as a joint stock company**. PSHM is a member of the Opportunity International network, which includes more than 60 lending institutions in 30 countries around the world. Given the lack of an adequate legal framework, PSHM was created in Albania as a joint stock company. It started activities in 1999 through a grant from U.S. Agency for International Development (USAID), with the objective of providing credit and basic technical assistance to entrepreneurs that could not access credit from traditional lending sources.

10 At the end of 2006 MAFF had a grant and two loans outstanding with IFAD totaling US$7 million and a loan from OPEC for US$800,000. All loans received are highly subsidized, with interest rates of 1 and 4 percent for IFAD and OPEC, respectively. These loans have relatively long maturities of between 4 and 10 years.

50. **PSHM has already reached operational and financial self-sustainability even though it has a relatively small operation, with 10 branches and about 50 employees.** At the end of 2006, PSHM had an outstanding loan portfolio of almost US$30 million and servicing more than 10,000 clients. PSHM provides loans for SMEs and individuals and group credit for clients in rural settings. Its operations cover both urban and rural areas, granting loans to individuals and mutually guaranteed groups. The primary target sectors are trade, manufacturing, transport, agricultural processing, livestock, horticulture, and tourism.

51. **PSHM has one of the most diversified funding bases among microcredit entities in Albania and confirms that microcredit entities can evolve to achieve sustainability of operations in the absence of concessional credit.** PSHM currently has loans from more than 12 different entities, including local commercial banks, donors, and international investment funds. It is important to point out that most of these facilities have been granted at market interest rates.

Overview of Credit Unions

52. **The development of Albanian credit unions compares well with other countries in Europe and with other regions of the world.** However, the average size of loans in Albania is relatively high at US$2,700, versus an average for Europe of US$855. The Bank of Albania has licensed 118 SCAs, which have a total of 21,500 members. These SCAs are grouped under the umbrella of two unions, the Albanian Union of SCA (AUSCA) and Jehona (see Table 8). The loan maturity has been limited by the Bank of Albania to a maximum of five years. As of June 2006, credit unions associated with AUSCA account for over 90 percent of the assets, loans, and capital of all credit unions. In terms of number of members and members' deposits, AUSCA accounts for about 65 percent of the credit unions.

Table 8. Composition of Savings-Credit Associations (millions of leks)

	AUSCA	Jehona	Total
No. of SCAs	95	26	118
No. of SCA members	16,000	7,500	21,500
Total assets			
Unions	1,880.07 (US$17 million)	29.96	1,910.03
SCA network	2,094.10 (25 US$ million)	203.20	2,297.30
Loan portfolio			
Unions	1,455.59	16.52	1,472.11
SCA network	1,999.59	160.62	2,160.21
Members' deposits			
SCA network	327.25	162.22	489.47
Capital			
Unions	623.75	19.17	642.92
SCA network	304.51	23.15	327.66

Source: Bank of Albania

53. **Both unions serve as a managing structure to their SCA network. Their work is based on the decisions of a board of directors, whose members are elected from the boards of individual SCAs.** The internal control function is performed by the supervisory council, whose members are elected with the same procedure as the board of directors. Each SCA is an independent juridical entity with the same managing structure as its umbrella union.

AUSCA and its network have experienced significant growth. Among the reasons for the union's steep growth compared to Jehona's has been their access to external financing, which came from international organizations that deal with microfinance activity. The funds provided to AUSCA are passed on to individual SCAs to provide small loans to SCA members (see Table 9). On the deposit side, depositing activity of individual members of SCAs has been required to support part of these small loans.

Table 9. Overview of Savings-Credit Associations and Their Portfolios (millions of leks)

	2000	2001	2002	2003	2004	2005	2006
Members	506	2,159	5,285	8,161	10,584	12,815	16,260
SCAs	21	59	88	94	90	93	95
Villages	157	173	248	328	361	432	522
SCA network portfolio (US$ million)				9	12	16	25
Union portfolio (US$ million)	3.67	5.06	7.45	9.16	9.30	11.82	17.01
Active clients	4,423	5,277	6,380	7,621	7,157	8,650	10,655
Equity (US$ million)		0.17	0.47	1.08	1.65	2.43	3.07
Savings (US$ million)		0.09	0.12	0.37	1.02	2.03	4.87
Average of the loan	605	698	851	1012	1597	2,725	3,494

Source: AUSCA and Jehona.

54. **Jehona and its network show slightly less steep growth,** with total assets increasing from US$1.5 million in 2004 to US$2.5 million in 2006, and with total loans increasing from US$0.7 million to US$2.0 million. During the same period, the number of active loans increased from 649 to 1,364. Jehona's growth depends entirely on the growth of individual SCAs based on the deposits of their members. These deposits are then used to provide small loans to the individual SCA members. The activity of Jehona is financially supported by the Irish League of Credit Unions to guarantee its existence and to assist in terms of institutional capacity. The average loan term is about one year; (with 87 percent of loans having a maturity of one year.

55. **The regulation of the credit unions (SCAs) within AUSCA and Jehona is based on the Law on Savings and Credit Associations** (Law No. 8782, May 3, 2001). To operate, SCAs are required to obtain a license from the Bank of Albania and they must following the prudential rules put forth by the BoA supervisors and approved by the BoA supervisory board during the period 2002–03. Technical assistance has been provided to the BoA for the preparation of a new set of prudential norms, and an accounting manual has been drafted and is expected to be approved by the board in early 2005. Of course, these institutions are also governed by their own internal regulations.

56. **The credit unions are supervised and evaluated by the BoA once a year; however, the BoA is not yet able to present a complete supervisory report and consolidated statements**. Training and technical assistance have been provided to the BoA supervisors in this area as well. In addition, supervisory committees of the SCAs and their umbrella organizations perform on-site evaluations and internal audits. An external audit is performed once a year. A beneficiary assessment is executed by the World Bank in the case of the AUSCA.

Constraints on Growth of Microfinance and Credit Associations

57. **Both types of institutions—credit unions and the microcredit foundations—have been set up and financed with donor financing, either exclusively or in partnership with the government, but they need to move toward additional means of financing themselves in order to grow**. The AUSCA and the BESA Foundation have been supported by World Bank funds and the Soros Foundation, respectively. MAFF has been mainly financed by IFAD and the Dutch Rabobank; Jehona, by the Irish League of Credit Unions and the Irish government, and the Albanian Partner for Microcredit (PSHM) by USAID. The underlying principle behind the donors' technical and financial support has been to enable the conversion of these institutions into operationally and financially self-sustaining financial intermediaries. At present, most of them have achieved a sustainable level and are now facing the challenge of replacing the reduced donor support as their financing programs near completion. At this point, the future of these institutions depends on several related factors, the source of financing; consolidation or change in their institutional or legal structure, competition from commercial banks, and market demand for their services.

58. **As donor funding declines and donors demand more sustainability, these institutions will need to consider mobilizing additional capital and funding sources**. Most of the institutions are considering several options for securing additional funds. Those options include loans from local banks, loans from other financial institutions (foreign or local), funds from other development institutions or donors, and loans from governments of other countries.

59. **To grow, these institutions may also need to consider consolidation or a change in their institutional or legal structure**. The decision involves whether to operate within the existing structure or merge, convert, or transform into another institution. This decision should be based on a detailed analysis of all the factors that affect the sustainability of the business and that best serve the principal objective of their existence, that is, serving the population in need and helping them prosper. The decision should also take stock of the level of efficiency reached and the impact to date provided by each institution in the areas in which they operate.

60. **So far, credit union associations have been very successful as a financial structure in both urban and rural areas and it might be premature to consider at this stage any change in their current legal status or institutional setting**. However, their further consolidation as institutions within the existing structure may be warranted, because they are likely to face higher costs. Increased costs will be related to (i) investments in more sophisticated lending technologies due to increased demand for bigger loans by their

members; (ii) new management information systems (MIS) to manage the financial relations between the umbrella organization and their individual SCAs; (iii) the need to develop and implement innovative approaches (liquidity facility, deposit insurance fund) to increase the umbrella organization's effective lending rate to its SCAs; and (iv) risks associated with dealing with multiple currencies. Hence, credit union associations will need additional technical assistance and financial support for more instruments to develop risk management instruments and improve monitoring and management of these institutions. Microcredit institutions will also be faced with the alternative of either growing within their own structure and hence facing competition from commercial banks or transforming themselves into nonbank financial institutions.

61. **As regards competition from commercial banks, there are two possible scenarios.** One is that the commercial banks start expanding their activity into the areas served by the network of credit unions and microcredit institutions and take away their clients. This is not an immediate threat, as the overall level of credit in the banking system is still low. The banks still have a lot of room to explore in providing lending and other services for big clients in the cities where the risk is lower and the return higher compared with periurban and rural areas. A second scenario is that the credit unions and microcredit institutions themselves try to face commercial bank competition directly by increasing the size of a single loan, focusing on a few big clients, and forgetting the rest.

62. **The future will also depend on economic growth of the areas served by these institutions, as this will alter the market demand for their services both in terms of the size of loans and the variety of services**. In the rural areas, for the medium term, the risk of reduced demand appears moderate. The agricultural sector today is composed of thousands of small family farms that continue to present financial needs that are not met by the formal banking sector services. The inhabitants of the rural areas are practically excluded from the financial market because of their lack of standard collateral and guarantees, distance from the bank branches or agencies, and lack of familiarity with the banking system. Commercial banks also are not interested in providing this type of high-cost service. Despite improvements in the land market legislation, very few transactions relate to the agricultural lands, so a rapid consolidation in the near term is not expected. Poverty is still present in these areas, and the level of income is very low. In conclusion, farmers will still need small loans.

63. **In the urban and periurban areas, the risk of shifting from the services of credit union and microcredit institutions to banking services is more imminent**. However, in the case of urban credit unions such as Jehona, the demand from individuals for unique types of products not offered by the banking system will remain high. For example, schemes include a union of people who share a common **bond** and are interested in the idea of common savings and credit, as might arise from a workplace, association, or area of habitation, This conclusion is reinforced by the fact that the unemployment rate (around 15 percent in 2006) is much higher in periurban areas than in the cities and also much higher in other urban areas compared with Tirana. Also, for most of these people, self-employment by means of a small loan is one of the few means for ensuring their livelihood.

Financial Leasing in Albania

64. **The leasing sector in Albania is still in its early stages, but the potential for development is significant.** The total leasing activity in Albania reached lek 80 million (about US$800,000) in March 2007. This represents less than 0.05 percent of the banking credit to the private sector. In contrast, leasing has been established as an alternative to bank lending for the SMEs and individuals in many developing economies in Eastern Europe, where banks have been eager to establish leasing companies to reach out to the client segments unable to obtain loans (see figure 22). The volume of leasing operations in countries such as Bosnia and Romania (above 3 percent of GDP in both cases) provides some reference in terms of the potential for this sector in Albania. According to a recent study by the International Finance Corporation (IFC), the potential market for financial leasing in Albania is around € 98.4 million in new contracts per year. According to these estimates, the potential for growth is considerable both in leasing of automobiles and of equipment (€37.6 million and 30.8 million in new contracts per year, respectively). Using figures from other countries in the region, the study estimated that in the medium term financial leasing could account for 13 percent to 19 percent of the total investment in the country.

Box 3. Financial Leasing as an Instrument for Financing of Investment

Leasing is a financial instrument that can complement traditional bank activities. Financial leasing is an instrument that is frequently used in many other markets for the acquisition of movable and fixed assets by firms and individuals. In a leasing contract, the lessor (a financial institution) provides the use of an asset to a lessee (client). Through a leasing contract, a financial institution (lessor) grants the use of a determined asset to a client (lessee). In return, the client pays a number of rental fees to the lessor during a period that usually spans several years, depending on the nature of the asset. At the end of the contract, the lessee has the right to acquire the property of the asset through the payment of its residual value (after depreciation), which is usually below the market value of the asset.

The main differences between leasing and financing of assets through traditional bank loans stem from the property of the asset in each case. Throughout the term of a leasing contract, the lessor maintains the property of the underlying asset and recognizes the depreciation accordingly. The lessee recognizes the rental payments as a financial expense that is directly deductible for tax purposes.

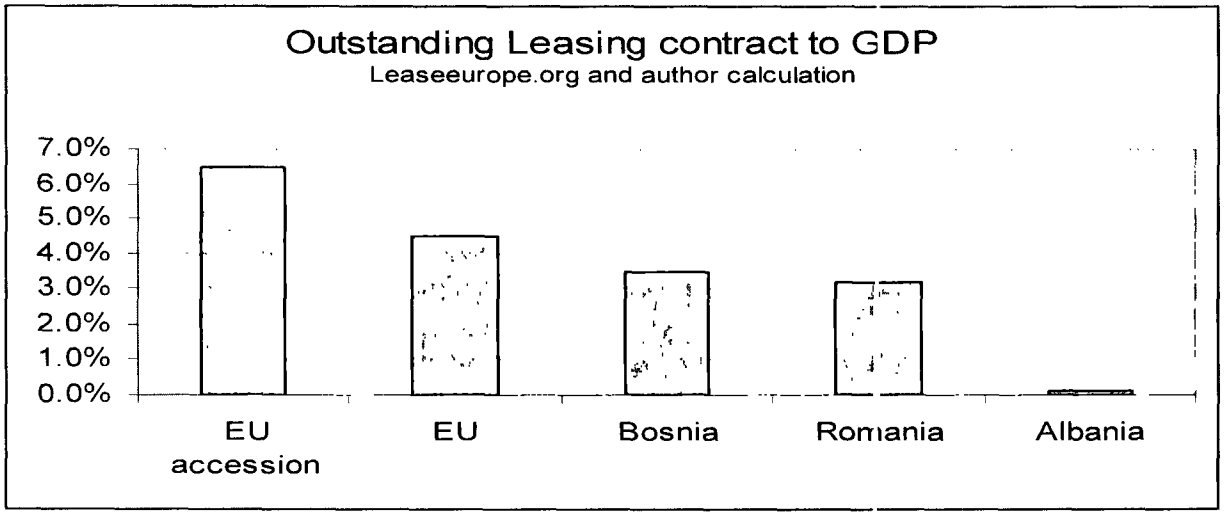
The advantages of leasing for the lessee include obtaining the use of the required assets without the need for a large up-front cash disbursement. Similarly, leasing usually enables clients to better match the cash flows stemming from the productive use of the asset with the rental payments. Moreover, leasing may represent an easier way for firms to obtain financing for investment in developing financial systems, where long-term loans are usually difficult to obtain and require collateral requirements well above the face value of the loan.

Leasing also provides considerable benefits for financial institutions, provided that there is a conducive legal framework. For financial institutions, leasing may be a lower-risk alternative to long-term loans. The spirit of leasing is that, by keeping the property of the asset throughout the term of the contract, the lessor should be able to exercise a rapid foreclosure in case of default, rather than undergoing an extensive legal foreclosure procedure, as would be the case with traditional collateralized loans. This can represent a major difference in countries with a weak track record in contract enforcement. Indeed, a rapid foreclosure process usually translates into lower legal costs and lower overall losses in case of default. In turn, in most cases there is no need for additional collateral besides of the financed asset itself

65. **Financial leasing can address some of the constraints in access to finance by SMEs, including lack of collateral and deficiencies in creditor rights**. Well-functioning

financial leasing programs have several advantages (see box 3). First, Albanian banks report problems in collateral foreclosure procedures. However, asset ownership could render this constraint irrelevant for the leasing companies. Furthermore, leasing would likely improve access to finance possibilities for those companies that have limited collateral to put up to secure a bank loan. However, as in the case of bank loans, financial leasing is also constrained by the same problems of informality.

Figure 22. Leasing in Albania, International Comparison



Source: Staff calculations based on Lease Europe.

66. **Only three financial institutions have started to offer financial leasing in Albania, one bank and two leasing firms.**[11] However, the number of leasing firms will likely increase in the near term because two of the banks surveyed reported plans to enter the market. Anecdotal evidence suggests that leasing might also be done on a limited basis by two commercial firms dealing with automobiles, but this market is small and difficult to quantify because information is not available.

67. **Financial leasing is currently limited mainly to transport equipment.** As opposed to machinery, transport equipment is especially suitable for leasing, since its residual value is relatively easy to appraise and there is a considerable secondary market. Accordingly, the financial leasing activity in Albania is largely limited to this type of asset. As the market develops, leasing firms expect to extend leasing facilities to productive machinery and real estate.

68. **Financial leasing in Albania was formalized with the introduction of a Law on Leasing in May 2005**. The Law represents a major step in favor of the development of the sector, as it reduces uncertainty by providing standard definitions of financial leasing and clarifies the role of the parties involved in these contracts. Similarly, the law defines criteria

11 Raiffeissen Bank, and Tirana Leasing, a subsidiary of Piraeus Bank, and Landeslease, a German equipment supplier.

for firms providing financial leasing services.[12] Furthermore, regulatory and supervisory capacity may need to be strengthened to ensure that potential risks posed by increased use of leasing are monitored adequately and that the instruments are used properly.

69. **All financial leasing firms are licensed and regulated by the Bank of Albania.** A minimum capital requirement is lek 100 million (around US$1 million) for leasing firms that are subsidiaries of commercial banks. This figure is smaller for independent leasing firms (lek 20 million, or US$200,000). In comparison, other countries in the region have lower capital requirements (e.g., €100,000 in Serbia) or none at all. These capital requirements may be a barrier to entry of new participants in the market.

70. **Development of the leasing sector will depend to a great extent on the elimination of uncertainties related to tax treatment of financial leases.** Although the legal framework for leasing was strengthened, the fiscal treatment of leasing remains unclear, especially in relation to the treatment of value added taxes (VAT). A VAT rate of 20 percent is usually applied to imports of equipment and to rental payment on operating leases. However, the application of VAT to financial leasing has yet to be clarified. On one hand, tax regulations predating the leasing law appear to apply VAT to interest on financial leases. On the other hand, financial leasing is defined as a financial service and thereby should be exempt from payment of VAT on interest. Similarly, the procedure for reimbursement of excess VAT tax is not clear. The leasing law does not provide guidance on this, but these issues must be addressed in the short term in order to eliminate uncertainty in the sector.

71. **Lack of awareness by companies and limited incentives for banks to introduce new products also limit the prospects of leasing in Albania.** Besides the problem of unclear fiscal treatment of leasing contracts, other factors appear to constraining the growth of the leasing industry in Albania. The concept of financial leasing is relatively new to Albania, and significant efforts to enhance market awareness will have to be taken. At the same time, Albanian banks lack expertise in these products, and the lack of track record makes complex issues of pricing and foreclosure. Moreover, incentives for banks to develop the required products and expertise are very limited, given the fact that unmet demand for credit allows for rapid expansion of operations in more traditional segments. Finally, according to the study by the IFC, the secondary market for leased assets is underdeveloped, affecting the expected recovery in case of default.

Factoring

72. **Factoring is needed in Albania as a complementary source of financing for working capital purposes**. Factoring is a financial service that aims at providing financing by making liquid any accounts receivable generated through the course of economic

12 The two main types of leasing are financial and operative. All references to leasing in this study are to financial leasing, which is a financial instrument ultimately leading to the acquisition of the underlying asset. By contrast, operational leasing is akin to pure rental of assets. Operative leasing was already present in the market before May 2005, based on commercial law. The Law on Financial Leasing was drafted by a working group that consisted of members of the Albanian Ministry of Economy, Bank of Albania, Ministry of Finance, and Ministry of Justice, with the extensive support of the IFC's Southeast Europe Enterprise Development (SEED) program.

activities. As such, the scope for factoring is linked to the scope of the formal economic activity within the country and the consequent flow of invoices. In this respect, the sustained growth of the private sector since 1998 and the positive economic trends have likely led to an increasing number of commercial operations that require financing for working capital. As Albanian banks have focused on traditional lending based on real estate collateral, there may be a significant unmet need for liquidity, especially among SMEs.

73. **Some banks surveyed for this study have stressed the need for the development of factoring as a way to enable the use of otherwise unproductive assets**. A Law on Factoring passed in 2004 aimed at unleashing the potential for factoring in the country. According to some of the banks surveyed for this study, their potential for credit to enterprises is largely limited by the availability of real estate collateral. However, many of these enterprises have a large stock of accounts receivable that are a normal by-product of their ongoing operations. These assets currently remain largely idle because they are seldom accepted as collateral in credit operations. The use of these assets in the context of factoring operations could help to free up significant resources for enterprises, which would be used for financing of working capital.

74. **Factoring appears to be feasible in Albania**. Many banks surveyed reported undertaking ad hoc transactions whereby accounts receivable of a trusted client were taken as collateral. While this underlines the fact that invoices can carry significant value, it is important to distinguish between factoring and traditional loans collateralized with accounts receivable. According to a recent study by the IFC, factoring, and especially reverse factoring, has a good long-term potential in Albania given the fact that the country's exports are concentrated in the globally most factoring-intense industry, that is, textiles and garments.

75. **Some deficiencies related to the legal framework appear to prevent the development of factoring in Albania**. According to the banks surveyed, the existing Law on Factoring fails to recognize accounts payable as executive titles. Accordingly, in case of default in a factoring operation, financial institutions face the need to prove the existence of a liability, which creates potential for time-consuming and costly legal proceedings. These deficiencies in creditor rights have made various banks wary of offering factoring services; thus, they opt in favor of more traditional credit contracts.

76. **Factoring is especially suitable for Albania's major industries.** Throughout the world, the most factored industry is textiles and apparel.[13] In 2005, these industries accounted for exports totaling €307 million (58 percent of total Albanian exports). Moreover, 82 percent of these exports were made to Italy and Greece, major economic partners of Albania, and countries where factoring is a thriving industry.

77. **Factoring can enhance significantly the financing to the private sector in Albania.** It is difficult to predict the actual demand for a new product such as factoring, as it depends not only on the actual need for this product, but also on other factors, including

13 For example, textiles and apparel account for 75 percent of factoring in the United States.

financial literacy, market awareness, and informality (see below). In a recent study,[14] the IFC assessed the potential for factoring in Albania, taking into account the size of the factoring markets in peer economies in the region and their relative economic development stage (Table 10). According to this assessment, the potential market for factoring in Albania could be as high as US$300 million per year, which is more than one third of the current bank lending to the private sector.

Table 10. Size of the Factoring Industry in Eastern European Economies

Country	Number of factoring companies	Country turnover (US$ millions)
Estonia, Latvia, and Lithuania	15	2,300
Slovenia	4	170
Romania	6	225
Cyprus	3	2,035
Slovakia	6	380

Source: Factors Chain International. 2003 Factoring Statistics.

78. **However, there are significant constraints for the development of this sector.** From the demand side, the potential for factoring is severely limited by the volume of economic activities and the informality in the real sector. Factoring is a financial service that aims at providing financing by making liquid the accounts receivable that are generated through the course of economic activities. As such, the scope for factoring is linked to the scope of the formal economic activity within the country and the consequent flow of invoices. Beyond the natural limitations posed by the size of the economy, anecdotal evidence suggests that the use of invoices has not become a common practice in business transactions in Albania, as most businesses still prefer to deal in cash as a way to minimize tax payments.

79. **From the side of supply, the appetite for development of factoring services may be limited.** Factoring is a financial product distinct from traditional collateralized loans. It requires a more expeditious response to clients and a move from lending based on real estate collateral to a thorough understanding of firms' operations and the industry. At present, given the still large scope for growth through traditional loans, banks have shown little appetite for developing the knowledge and operations required.

80. **Inadequate credit infrastructure or creditor rights also restrict the potential for development of this sector.** Importantly, an invoice is not a recognized debt instrument, as it has not been explicitly recognized by the law. The debtor holding an invoice would need to provide additional evidence (e.g., a written contract or delivery receipt) in a court of law to prove the existence of debt. This legal void precludes businesses' use of invoices as full-fledged collateral for working capital loans. Furthermore, similar legal voids or insufficient provisions exist in the case of quasi-debt instruments, such as preferred debt, convertible debt, subordinated debt, and other forms of equitylike and mezzanine financing. This limits the availability of entry points for private equity or venture capital providers.

14 "Factoring in Albania. Market Assessment," Southeast Europe Enterprise Development, IFC, May 2004.

81. **As in many other countries, factoring is also restricted by the potential for fraud, stemming mainly from counterfeit invoices and failure to transfer payment of invoices to the factor.** In many cases regulators can reduce these risks by seeking confirmation from the buyer of the underlying goods that the invoice is valid and by trying to secure payment directly to the factor. However, this is time consuming and difficult to achieve in many cases. In some countries this has been successfully addressed through the introduction of reverse factoring mechanisms (see box 4). In the case of Albania, these mechanisms may be suitable for factoring of invoices from large buyers such as utilities and the government. These deficiencies have translated into a pervading belief within the banking system that accounts receivable have limited collateral value. The Bank of Albania gives very little credit for collateral constituted on invoices.

Box 4. Reverse Factoring

The development of active factoring industries in many developing countries has been hampered by inadequate legal frameworks that diminish the value of receivables as collateral or make recovery processes lengthy. Similarly, many factoring firms face the risk of fraud through counterfeit receivables.[1] Although these risks can be mitigated (e.g., through higher premiums, recourse to clients, and screening mechanisms), they usually translate into higher prices and restricted access by some prospective clients.

Some measures to mitigate these risks include screening of clients to evaluate their track record and creditworthiness, recourse to clients' assets in case of default, and higher interest and fees or lower advance rate.[15] However, these measures usually translate into increased prices of factoring services, and restricted access to prospective users with a limited track record or relatively low creditworthiness.

The mechanism known as *reverse factoring* is based on discounting of invoices payable by high-quality large buyers to smaller suppliers. As such, this mechanism does not substitute for but can complement an existing factoring industry in a country.

A well-known example of reverse factoring is that implemented by *Nacional Financiera* (Nafin), a Mexican development bank. A major feature of Nafin's program is the development of a system whereby large buyers report the information on their accounts payable. This system is a trustable registry of active invoices, thereby eliminating the risk of fraud. In this system the supplier can discount the invoice through several different financial institutions participating in the program (including banks and factors), which compete on price.

Given that the source of the future payment of the invoice is a high-quality buyer, the credit risk assumed by financial institutions is low, which drives down the interest rates charged on these operations. The collection of receivables is also centralized in the system under Nafin's management, thereby reducing the administrative costs to both suppliers and buyers.

The benefits to suppliers include streamlined financing mechanisms that provide liquidity in an affordable and expeditious way. The reduction in transaction and operational costs for these companies is also significant. In time, it is expected that the track record built through these transactions will enhance the creditworthiness of suppliers, enabling them to access direct credit from the participating financial institutions.

Buyers benefit from the centralized management of their accounts payable to suppliers. Financial institutions benefit by offering a low-risk and low-cost product, which also enables them to access a segment of the market (SMEs) that appears underserved largely due to information asymmetries.

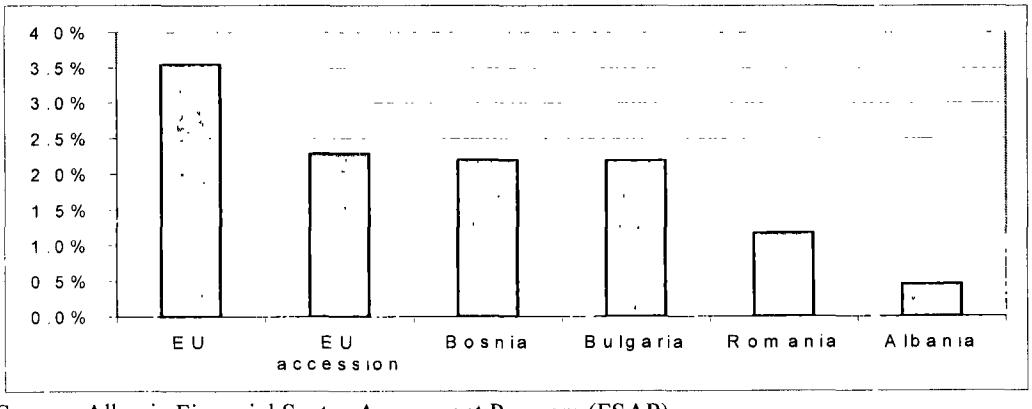
15 In a typical factoring transaction, the factor takes ownership of the entire value of the invoice, but it advances only a fraction of it (typically around 70%) to its client. The difference between the advance and the face value of the invoice is used to pay fees and interests and to create a reserve, which is used to cover any deficiencies in the actual payment of the invoice.

1 See Klapper (2005) for a detailed analysis of reverse factoring.

Insurance Sector

82. The structure for insurance providers remains stable and the market is showing signs of growth, but the sector remains small compared to other countries in the region (see Figure 23). During 2006, 10 insurance companies were operating in the market, out of which seven were in the non–life insurance sector, two were in the life insurance sector, and one was in both the life and non–life insurance sectors. The number of policyholders increased to 507,375, an increase of 9.5 percent as compared to 2005. The increase of the number of policyholders was accompanied by an increase in the premium volume. Gross written insurance premiums recorded an increase of 11.5 percent compared to 2005, accounting for lek 4.5 billion. The market is still mainly oriented toward the non–life insurance sector, which holds 93 percent of the market share, whereas the life insurance sector holds 7 percent.

Figure 23. Insurance Penetration 2005 (premium as % of GDP)



Source: Albania Financial Sector Assessment Program (FSAP).

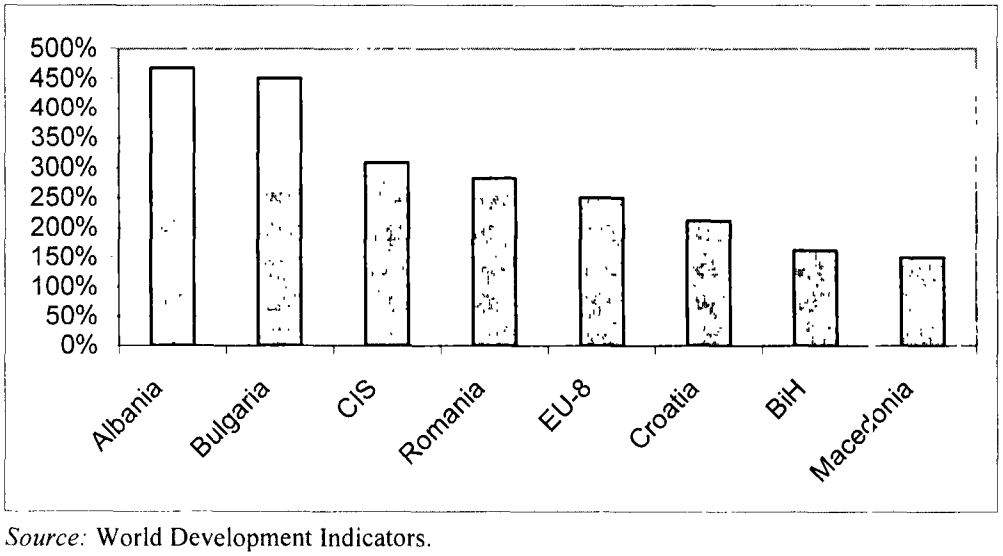
83. **The growth in the insurance sector is increasing opportunities for investment.** Total assets of the insurance **sector** at year-end 2005 counted for lek 11.4 billion, recording an 11.69 percent increase, compared with 2005. This increase is mainly reflected in investments in treasury bills and real estate, 30.89 percent and 23.97 percent, respectively. Bank deposits accounted for lek 3.3 billion, or 28.94 percent of the total market assets, constituting the highest growth. Receivables still remain high, with a value at year-end 2006 of lek 1.2 billion, or 9 percent of the total assets of the insurance sector. The increase of premium tariffs in compulsory insurance for 2006 has made positive changes in the overall market financial situation, improving the cash flow, increasing the investing potential, and improving the quality of assets, especially those backing up insurance liabilities and capital.

IV. CREDIT GROWTH

84. **Credit to the private sector has grown more than in almost any other country in the region between 2001 and 2005 (figure 24)**, from US$248 million in 2000 to US$1.9 billion in October 2006 (around 15 percent of GDP). Credit growth has been particularly fast over the past two years, with a rate of 70 percent in 2005 and over 50 percent in 2006. Part of this growth had to do with the privatization of the Savings Bank, which was prohibited from any lending until it was privatized with the support of the World Bank and IMF.

85. **This rapid growth was highlighted as a potential risk for the financial system by the Financial Sector Assessment Program (FSAP) in 2005.** The Joint World Bank –IMF Financial Sector Assessment Program (FSAP) in 2005 identified that whilst the risks to the banking system at the time were relatively low, credit growth experienced in 2005 (70%) if continued could put a strain on the banking system. The report recommended a number of measures for tightening the prudential and regulatory framework and improving the quality of financial intermediation including the establishment of credit information system and improvements in creditors' rights. Since 2005, the authorities have implemented and are in process of implementing a number of measures including (i) raising reserve requirements on foreign currency deposits, (ii) increasing capital adequacy requirements for high risky investments, (iii) tougher requirements on debt service to disposal income and risk premium for indirect risk on foreign exchange risk, and (iv) enhancing their capacity to work with foreign supervisors. These reforms succeeded in reducing the aggressive credit growth and are expected to bring it to more sustainable levels in 2007. Nevertheless, despite repeated efforts of the authorities and IFIs a number of issues relating to credit information and creditors' rights remain to be implemented to improve access to finance, and in particular remove impediments to credit for underserved segments of the economy.

Figure 24. Real Credit Growth in Private Sector 2001–05, International Comparison



Source: World Development Indicators.

Box 5. FSAP's Main Findings on Potential Risk due to High Credit Growth

Although the risks in Albania are relatively low, accelerating credit growth and competitive pressures arising from the entry of new, larger international banks may put a strain on the banking system, which represents over 90 percent of Albania's financial system. These risks include the following:

Currency mismatch. Albania is a highly dollarized financial system, with leks, euros, and U.S. dollars all having significant shares of assets and liabilities. So the system may be sensitive to shifts in exchange rates and interest rate yield curves for different currencies.

Lack of viable financial information. There is limited viable information available on borrowers, which could hamper the sustainability of credit growth and could lead to increases in nonperforming loans.

Capacity of banks to process loans. Banks are potentially unable to process loans in a timely manner, leading to misestimation of liquidity needs and errors in documentation and recording.

Excessive exposure to real estate. Since a large part of collateral consists of real estate, large increases in property valuation could lead to overextension of credit; thus, efforts to collect price data and gauge the degree of speculative activity are warranted.

Collateral enforcement. Enforcement of collateral remains a major concern should banks seek to obtain the value of collateral in the event of nonperformance of a loan.

86. **Credit to the private sector in Albania in relation to GDP remains modest compared with other countries in the region.** The financial sector in Albania is sizable, with total banking assets accounting for over 40 percent of GDP. However, a significant part of these assets remain invested in treasury bills and other liquid assets, while credit to the private sector stands at a low 18 percent of GDP (see figure 25). Figure 26 shows that while credit to private sector has been growing, claims on the central government remain the main asset base for the banking sector.

Figure 25. Credit to Private Sector, international comparison (% of GDP)

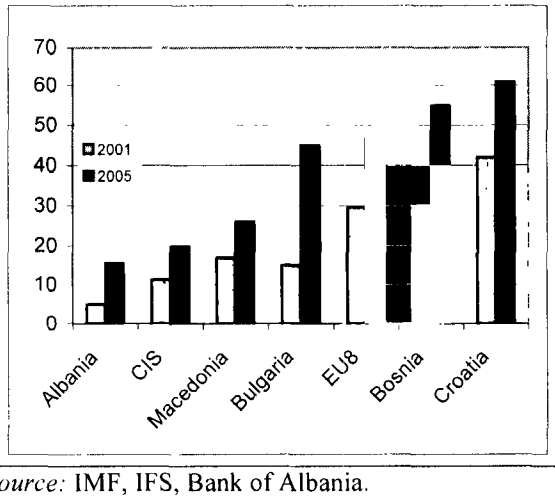
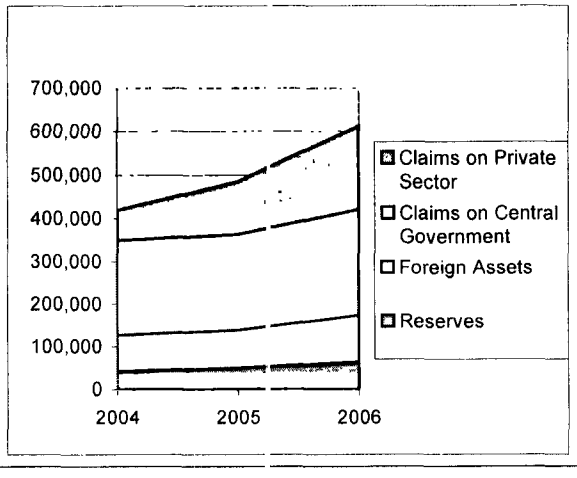


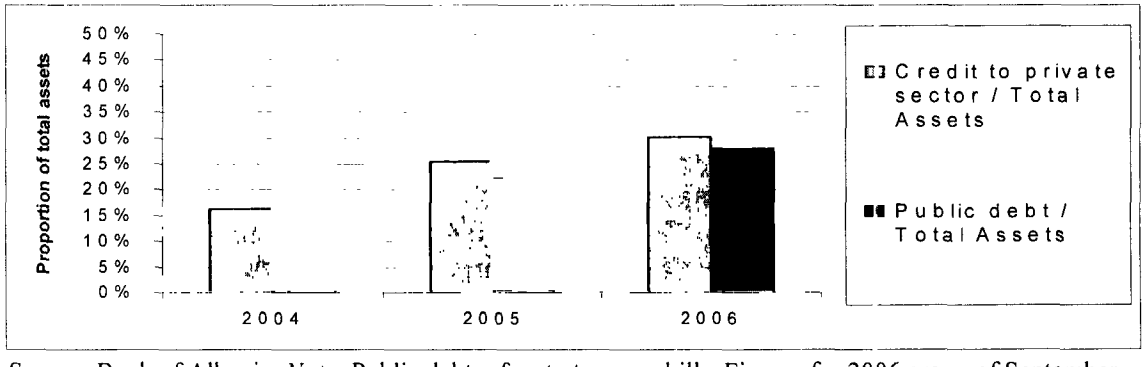
Figure 26. Growth of Albanian Banks Balance Sheet



Source: IMF, IFS, Bank of Albania.

87. **Significant progress has been made in expanding banks' activities into credit, although the Albanian banking system remains highly liquid**. Up until 2003, banks limited their activities to capturing deposits and channeling those funds to government debt. A relatively high spread provided significant profitability to banks at a very low risk. However, consistently decreasing interest rates have reduced margins, generating incentives for banks to enhance their credit activities. Consistently, the proportion of the banking system's assets invested in government bonds declined from 46 percent in 2004 to 28 percent in 2006, while credit to the private sector increased from 16 percent of total assets to 30 percent during the same period. However, the level of investment on public debt remains relatively high compared with the regional average. Similarly, although the proportion of credit over deposits almost doubled (from 19 to 35 percent) during this period, it remains relatively low. This high level of liquidity in the banking system underpins the rapid credit growth observed and banks' high expectations for further growth (see figure 27).

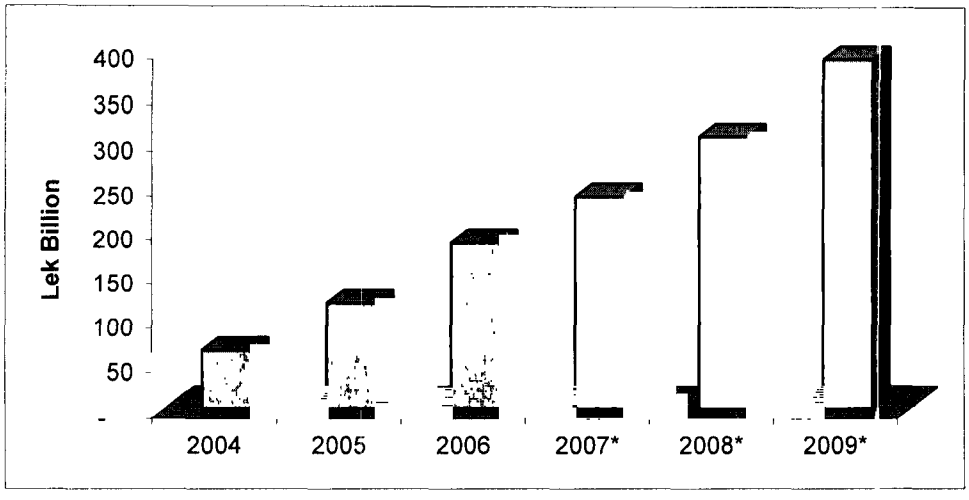
Figure 27. Credit and Government Debt as a Proportion of Total Assets of the Banking System



Source: Bank of Albania. *Note:* Public debt refers to treasury bills. Figures for 2006 are as of September.

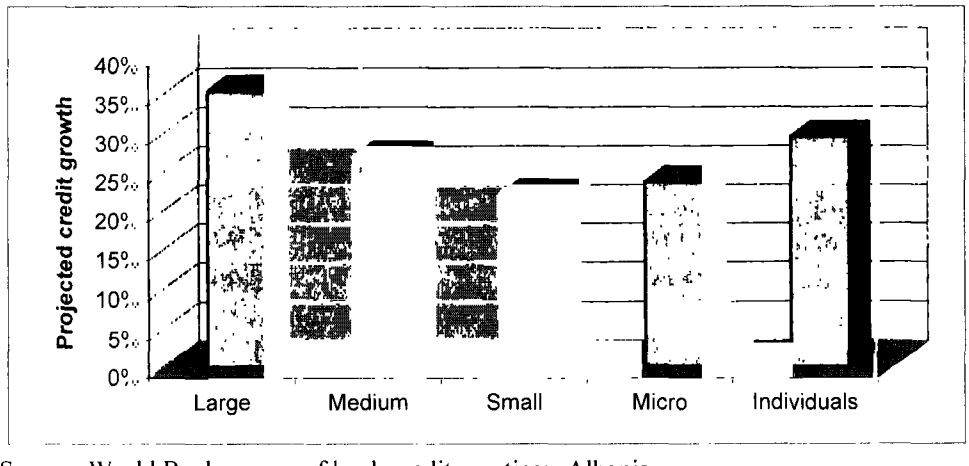
88. **Further credit growth is expected, especially in corporate and consumer credit.** Banks participating in the survey have high expectations for their business prospects, with projected nominal growth rates averaging 28 percent per year over the next three years (see figure 28). According to banks' expectations, credit growth will be largely driven by lending to large enterprises and, to a lesser extent, by credit to individuals, which are expected to experience yearly growth rates of 35 percent and 30 percent, respectively, during this period (see figure 29). On the other hand, credit to small enterprises is expected to grow at a much slower pace during this period.

Figure 28. Prospects for Credit Growth



Source: World Bank survey of bank credit practices, Albania.
Note: Figures for 2006 are as of September. Figures for 2007–09 are projected.
Estimates are based on projections for growth reported by eight out of the 12 commercial banks surveyed. Respondent banks account for 52 percent of the banking system's loan portfolio. The estimated growth in the credit portfolio of the total banking system represents an extrapolation of the average growth projections reported by respondent banks, weighted by each bank's market share.

Figure 29. Expected Yearly Growth Rates during the Period 2007–09



Source: World Bank survey of bank credit practices, Albania.
Note: Estimates are derived from forecasts for overall credit growth reported by eight of the 12

Box 6. Credit Growth as a Source of Concern.

Rapid credit growth has been a source of concern for both authorities and external observers. According to the FSAP in 2005, while the trend in credit growth is a positive one, the pace of growth warrants attention from authorities. In a situation in which banks' available lending resources grow faster than the amount of profitable lending propositions in the economy, the intensifying competition among banks could lead to riskier lending and an increase in nonperforming loans in the future. Authorities have reacted to this by establishing new prudential measures requiring additional capital requirements to banks that exhibit rapid growth. According to these measures, banks that exhibit growth above certain thresholds (30% growth of loan portfolio, 7% growth of total assets or nonperforming loans above 7%) must create provisions for considering a weight of 150 percent for all assets above the threshold.

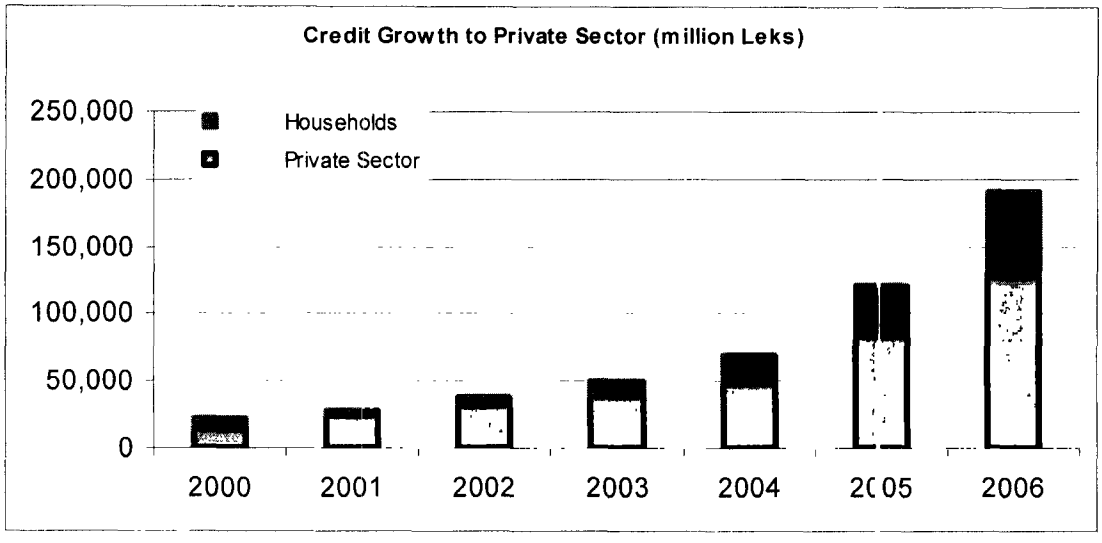
At present, the quality of the loan portfolio of Albanian banks appears to be good compared with that of other countries in the region. Nonperforming loans[16] in Albania accounted for 3.2 percent of total loans at the end of the third quarter of 2006. This compares favorably to the levels observed in other countries in the region. This outlook is further supported by a relatively high capital adequacy ratio of 18.3 percent. However, the rapid credit growth might be hiding a potential deterioration in the banks' loan portfolio. Trouble loans have been growing at a much higher pace than performing loans, as evidenced in the figure below. At the same time, although coverage, including loan loss provision, appears to be relatively high, at a level of 2.9 times, it is significantly below the level observed in previous years. Moreover, the experience in other countries in the region shows that the situation of the banking system can change drastically in a short period of time after a banking crisis. Beyond that, the sound expansion of banks' activities must be based on enhanced credit infrastructure within the system and risk management capabilities within banks. Credit to individuals (both consumer and housing) and SMEs are largely untested markets. As banks enter these higher risk segments they will be pressed to develop adequate products and risk management processes. Furthermore, this underlines the need for development of the credit infrastructure necessary to ensure that the basis of banks' incursion into these untested markets is sound.

The Characteristics of Credit Granted

89. Rapid expansion in credit does not necessarily imply availability of adequate financing products for firms and affordability of credit. It is important to note that the rapid credit growth has been fueled, to a great extent, by consumer and mortgage credit to households (see figure 30).

16 For the purpose of this note nonperforming loans have been calculated as the sum of "substandard," "doubtful," and "loss" loans, as defined in the regulation of the Bank of Albania.

Figure 30. Credit Growth in the Private Sector, 2000–06



Source: Bank of Albania.

90. Bank credit in Albania largely mirrors the contribution of each economic sector to the country's GDP. Banks have concentrated their lending activities in services, trade, and to a lesser extent, manufacturing, which are the sectors with the largest contribution to GDP. At the same time, banks have supported the development of construction in the country, a sector that has been growing very rapidly and that currently accounts for almost 20 percent of the aggregate loan portfolio of the banking sector.

91. However, banks have refrained from lending to agricultural and rural activities. Although agriculture still accounts for more than 20 percent of the country's GDP, banks allocate less than 5 percent of their loans to this sector (see figure 31 and 32). This situation is due to several factors, including the perception of higher risk of the sector (as compared with other economic activities), the lack of formal information on prospective borrowers, and, most importantly, deficiencies related to the use of land as collateral. Indeed, most banks surveyed reportedly avoid taking rural land or properties as collateral on loans because their expectation of recovery in case of borrowers' default is very low. This expectation is largely based on problems related to clarification of land ownership and the current fragmentation of property, which reduce the certainty of liens on properties and can significantly complicate the legal foreclosure. At the same time, the secondary market for rural property appears to be extremely limited, which makes it difficult to estimate the value of property and to sell foreclosed properties.

Figure 31. Allocation of Bank Credit and Contribution of Each Economic Sector to GDP

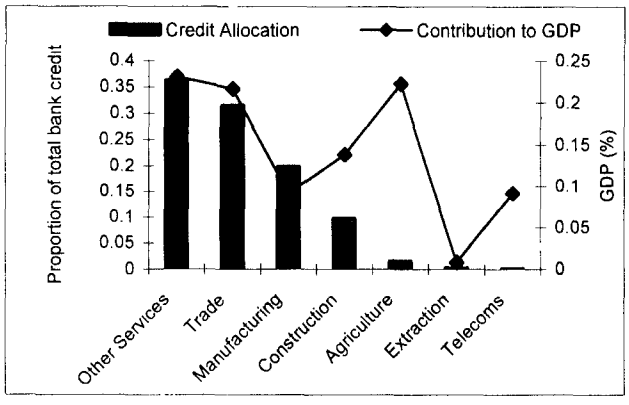
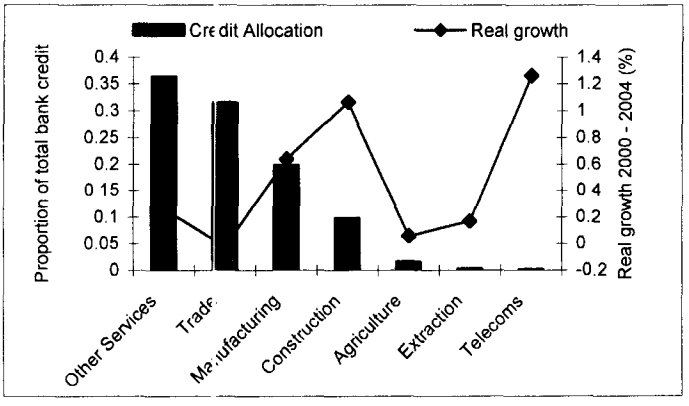


Figure 32. Allocation of Bank Credit and Real Growth in Each Economic Sector



Source: Staff's calculations based on data from Bank of Albania and INSTAT.

92. **At the same time, the conditions of credit to enterprises may not correspond to the characteristics of local firms or their financial needs, exposing the private sector to a set of risks, in particular, currency risk.** For example, though the growth of loans in lek has increased substantially in the past few years,[17] more than 70 percent of loans granted to firms are still denominated in foreign currency, and the majority of firms in the country have revenues in local currency only. However, lek-denominated loans continue to rise faster than credits in foreign currency, and at end-September 2006 had increased by 96 percent year on year. Lek loans are growing as banks offer new products, such as overdrafts to clients who have a salary account with them. Nevertheless, local-currency loans accounted for only 29.8 percent of outstanding credits at end-September, up from 23.7 percent at the same point in 2005.[18]

93. **Credit in foreign currency exposes borrowers to exchange risk and can translate into a significant deterioration of banks' loan portfolio in an adverse economic scenario.** Borrowers in Albania have been keen on credit in foreign currency, attracted by lower interest rates, even though most of them only have income in lek (see figure 33 and 34). It is important to question whether borrowers have the financial knowledge necessary to understand properly the type of risk that they are incurring in these operations. Though Albania has experienced a positive macroeconomic scenario with a stable exchange rate, changes in this scenario could translate directly into a reduced repayment capacity for borrowers, with a consequent deterioration in the overall portfolio of banks. Authorities should consider the establishment of prudential measures or the enhancement of information to borrowers.

17 Credit in lek counted for 28.5% at the end of November 2006. It grew during the entire year 2006 and at a faster pace than that of credit in foreign currency. Credit in lek has grown by 83% since November 2005. Credit in foreign currency has grown about 45% since a year ago[[when is that?]], and about 38% during 2006.
18 EIU,
http://www.eiu.com/index.asp?layout=displayIssueArticle&issue_id=891932674&article_id=1881932773.

Figure 33. Distribution of Loans

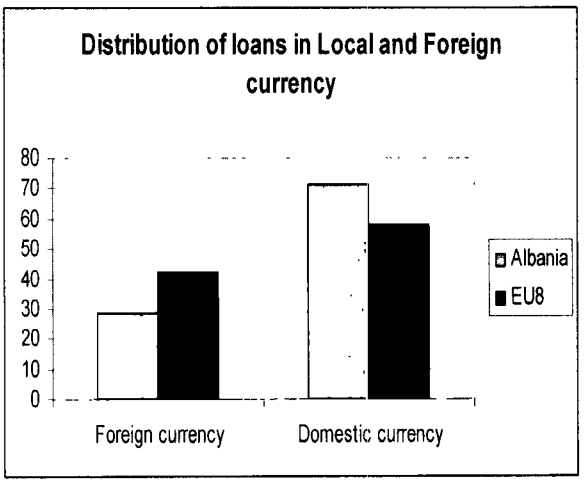
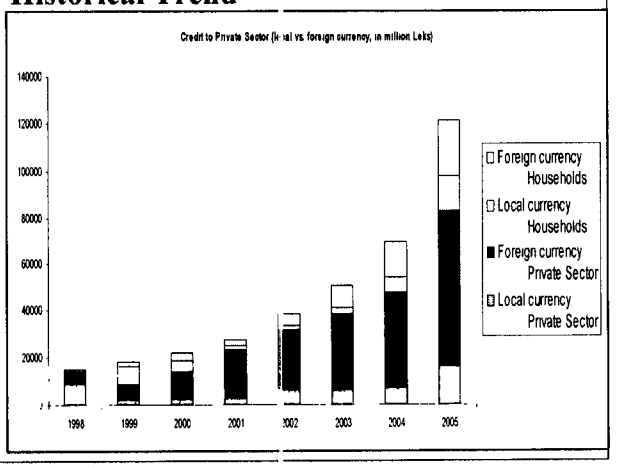


Figure 34. Distribution of Loans – Historical Trend



Source: Author's calculations based on data from Bank of Albania.

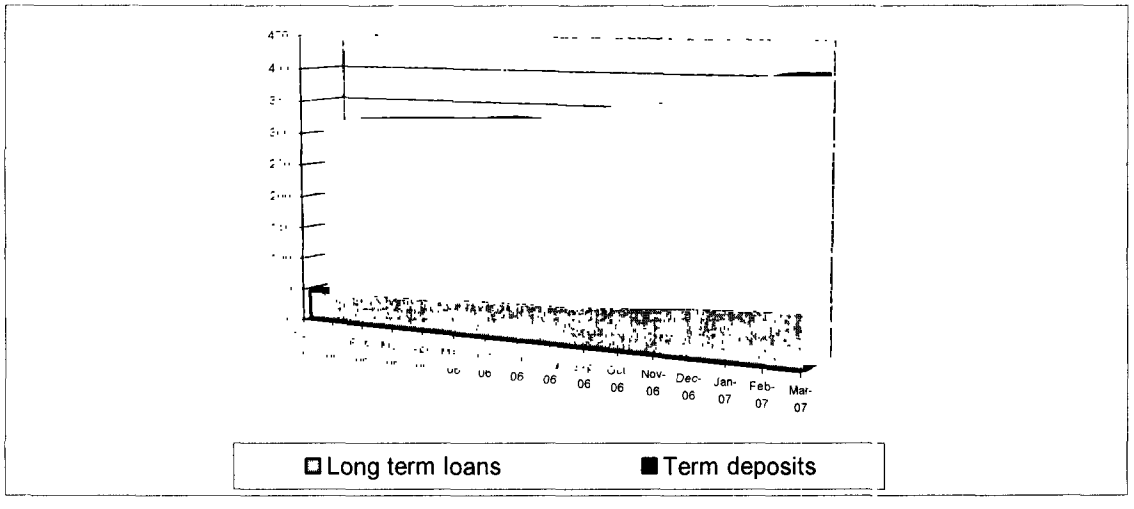
94. **More than 60 percent of total loans granted are for short or medium terms only, which reduces the risk for lenders but is inadequate for financing investments.** Although the share of long-term lending by banks has increased from 20 percent to 38 percent of total loan portfolios, banks appear to prefer to lend short and medium term (accounting for 28 percent and 33 percent of total portfolio, respectively). In the case of MFIs and credit unions, most of the loans have a term of less than two years. This is the result of poor and inadequate information about their borrowers and the fact that most of their deposits are demand deposits from households. Research shows that long-term finance tends to be associated with higher productivity. An active stock market and an ability to enter into long-term contracts also allow firms to grow at faster rates than they could attain by relying on internal sources of funds and short-term credit alone, which are currently lacking in Albania. Several other factors determine the optimal mix of long- and short-term debt. These include the firm's credit rating, its portfolio of growth opportunities, the profitability of the project, the ability to fund the project through retained earnings, the liquidation value of the assets, the perceived accuracy of financial information, the firm's size and age, and the level of banking competition. Firms in developing countries may have less long-term debt than firms in developed countries simply because they have different characteristics (in terms of size, type of assets, projects, etc.) than because of deficiencies in credit markets.[19]

95. **The balance sheet of banks appears to signal potential for further expansion of long-term credit**. As of May 2007 the volume of long-term credit outstanding accounted for only one-fifth of the term deposits raised by banks. Moreover, term deposits have grown substantially since mid-2006 (see figure 35). Although the available information's level of detail is insufficient to assess more exactly the maturity mismatch between loans and deposits, the high and increasing balance of term deposits appears to indicate that the level of long-term financing provided by banks is not limited by availability of term funding. This was confirmed by banks surveyed for this study, which consistently responded that the main constraint for long-term credit is their current inability to assess the creditworthiness of

19 Caprio and Demirguc-Kunt (1998). The Role of Long-term Finance: Theory and Evidence, World Bank.[[need authors' initials; check spelling]]

prospective borrowers due to both exogenous factors (including deficiencies in credit infrastructure and firms informality) and endogenous shortcomings related to their nascent credit risk management capabilities and systems.

Figure 35. Volume of Long-Term Loans and Term Deposits (billion leks)



Source: Authors calculations based on data from **the** BoA.

96. **Moreover, bank credit appears to be concentrated on the largest corporate borrowers and specific economic sectors, while credit to SMEs remains limited (see figure 36 and 37)**. According to the banking sector survey conducted for this study, SMEs are the smallest category of clients for banks, both in terms of loan volumes and number of clients. Large businesses have the largest share of loans, at about 74 percent, with a highly concentrated small number of borrowers.

Figure 36. Distribution of Loan Portfolios

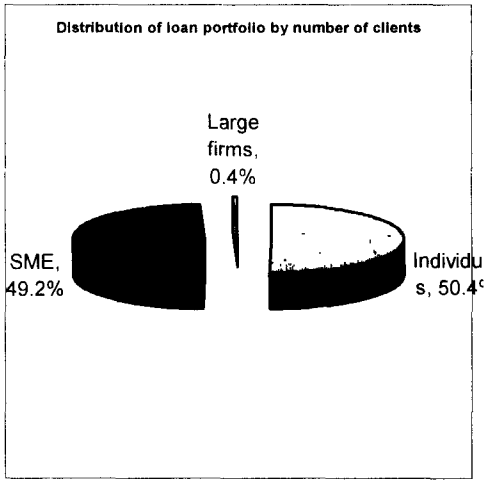
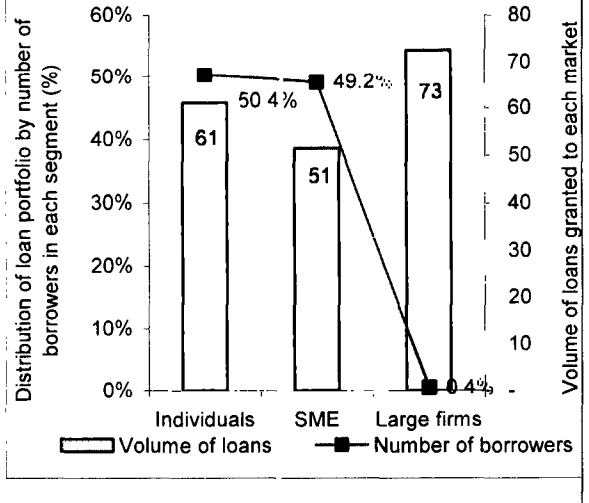


Figure 37. Distribution of Loan Portfolio by Size of Borrower

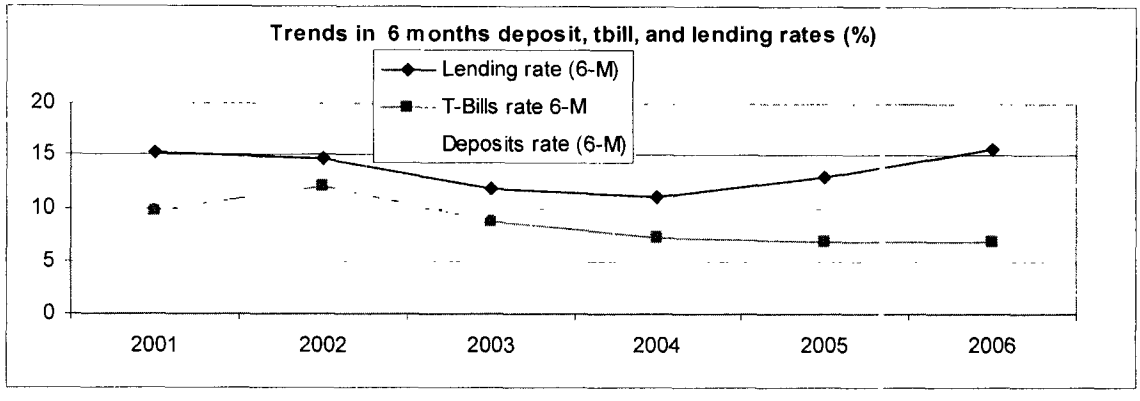


Source: Author's calculations based on data from Bank of Albania.

Cost of Credit

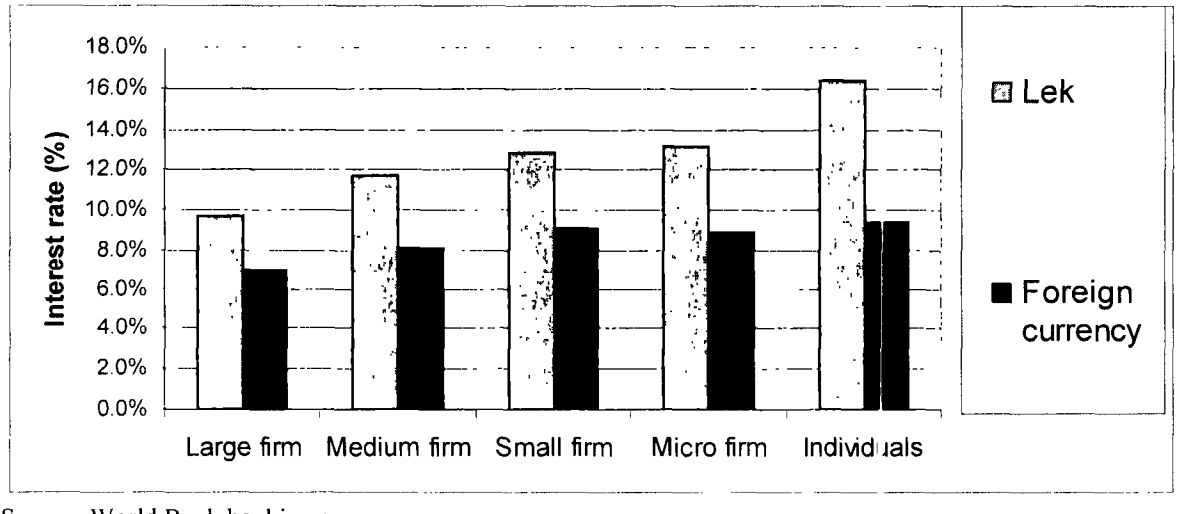
97. **Even though the cost of financing for banks has been decreasing constantly since 2002, the cost of financing for borrowers has increased substantially (see figure 38 and 39).** In 2006, the spread between passive and active interest rates at banks was more than 10 percentage points, and this spread has increased constantly over the past few years. This adjustment in pricing at a systemic level may reflect the change in composition of the loan portfolio of banks due to the rapidly expanding consumer credit, which usually carries higher spreads than loans to enterprises.

Figure 38. Trends in Active and Passive Interest Rates in Albania



Source: Bank of Albania.

Figure 39. Interest Rates of Different Types of Lenders

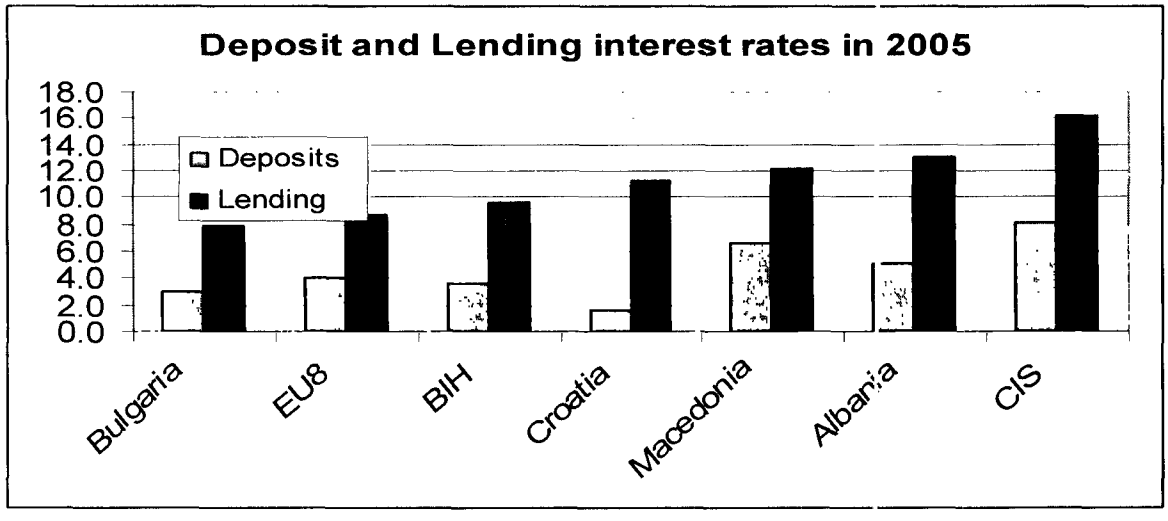


Source: World Bank banking survey.

98. **The interest margins in Albania are at the highest end of the spectrum when compared with those observed in other Eastern European countries (see figure 40).** In theory, the spread should comprise a liquidity risk premium "rewarding" banks for transforming more liquid assets (deposits) into less liquid assets (loans), and information premium for banks' comparative advantage in selecting and monitoring project borrowers, and a premium for controlling and managing risk. In reality, it is a very complicated task to

assess whether these premiums are too high or too low for efficient intermediation. Based on a highly simplified model[20] it seems that the spread in Albania could be between 3 to 3.5 percent versus the existing average spread of about 10 percent in Albania. The large spreads has resulted in commercial banks in Albania achieving high profitability figures. (see Box 7)

Figure 40. Comparative Active and Passive Interest Rates in the Region, 2005



Source: World Development Indicators.

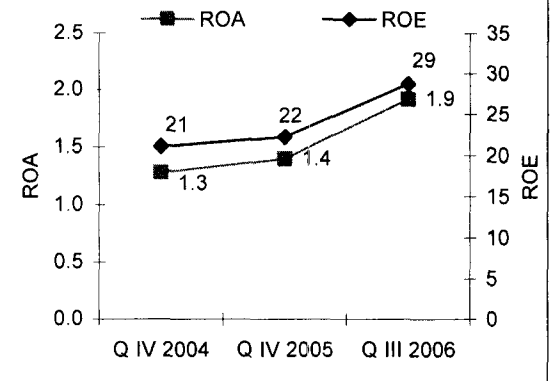
99. **Part of the reason behind such the high interest spreads in Albania compared to regional countries could be the relative level of development of the financial system and credit infrastructure in each country.** Higher interest rate spreads may be a consequence of the shorter track record and lower level of development of the Albanian banking system compared with regional peers. In other words, lending activities could be considered more difficult, costly, and risky in Albania, thus carrying a higher premium for lenders. In turn, rising interest rate spreads have translated into high and increasing profitability in the Albanian banking system.

20 *Source: Are Bank Interest Rate spread too high? World Bank Viewpoint 1996, by Fernando Montes-Negret and Luca papi.*

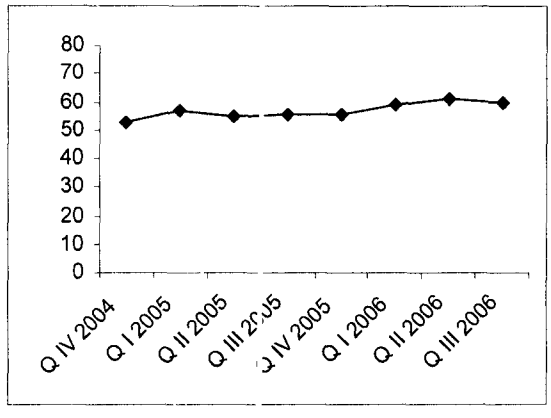
Box 7. The High Profitability of Albanian Banks

The growing interest rate spreads have translated into substantial increases in the profitability of banks. The return on assets (ROA) of the aggregate banking system increased by more than half in the past two years. The increase in the profitability measured as a percentage of banks' equity is similar. However, the increased return on equity (ROE) appears to be driven more by the higher interest margins than by enhancements in banks' operations, as the efficiency of banks has increased only slightly over the same period.

ROA and ROE of the Banking System



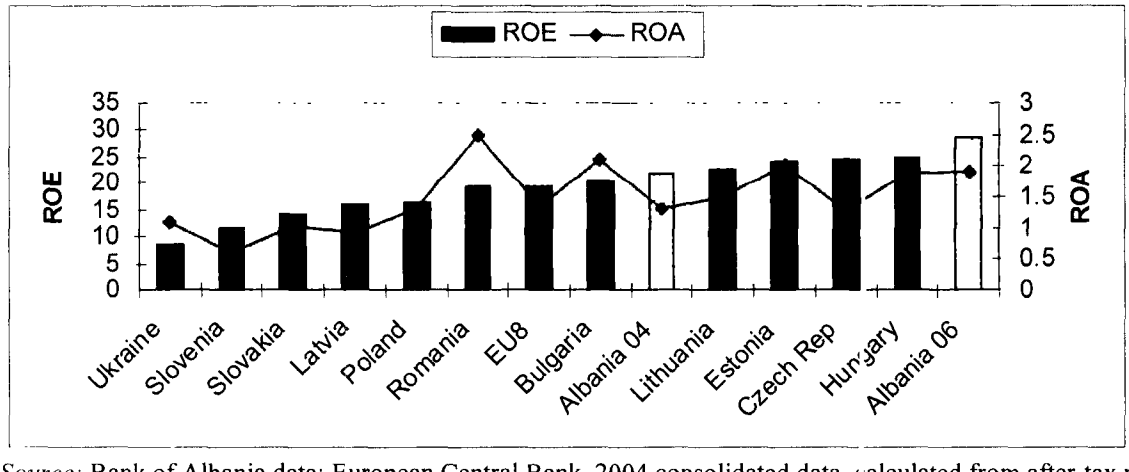
Efficiency Ratio of the Banking System



Source: Staff's calculations based on data from Bank of Albania.

The current level of profitability of Albanian banks is very high compared with that of other banking systems in the region. In 2004 the profitability of Albanian banks stood near the average in the region. However, the pace of growth in profitability of Albanian banks is hardly matched by that of more mature markets.

Profitability of Banking Sectors in Countries in the Region



Source: Bank of Albania data; European Central Bank, 2004 consolidated data, calculated from after-tax profit.

100. **The high interest rate spreads in the Albanian banking system may also reflect the dynamics of competition in the financial sector.** Even though Albania has a relatively large number of commercial banks, the general perception among practitioners if that the market still has not reached saturation, with the exception of the segment of credit to large firms. With demand for credit outpacing supply, lenders have had significant flexibility to

determine the conditions of credit granted. In fact, anecdotal evidence shows that similar credit products can coexist and thrive in the market with widely diverging cost. (see box 7).

Box 8. Competition in the Albanian Banking Sector

Using publicly available information, the study compared the balance sheets of the four largest banks in Albania. The largest four banks account for 70% of assets, 56% of loans and 70 percent of deposits. Whilst their return on asset is not much different with industry average, their average return on equity of about 38% is much higher than the industry average of 29%.

In fact, the higher average rate of ROE for largest banks is mainly due to Bank A which achieved a very high ROE of about 55 percent. Bank A has highest share of banking assets (35%) and deposits (39%), and whilst it has the largest share of loans it only accounts for 19% of outstanding loans.

Bank A's higher return on equity could be mainly as the result of number of factors including:

(i) low administrative expenses compared to their income, (29% versus 35% for its peer group)

(ii) less capital requirement. Whilst Bank A has satisfactory capital adequacy ratio (17 percent versus average of 16% for its peers), it requires less total capital (4.9 percent compared to peer average of 7.2 percent) since their investments in treasury bill will require less capital.

In this context, the study did not identify any evidence of anti competitive behavior by the largest bank.

	ROE	ROA	Share of Assets	Share of Loans	Share of deposit	interest income/ Total income	Non interest income/ total income	Interest expense/ Total income	Other expense/ Total income	Total income/ Total Asset	Loans/ Assets	Tbills/ Assets
Bank A	55.0%	2.0%	35.0%	19.0%	39.0%	91.7%	8.3%	35.6%	29.6%	6.6%	17.3%	60.5%
Bank B	30.0%	1.6%	12.9%	12.8%	10.5%	87.4%	12.6%	36.1%	38.0%	5.7%	31.4%	39.4%
Bank C	38.4%	1.7%	12.9%	11.0%	14.3%	93.5%	6.5%	40.4%	30.6%	6.0%	26.7%	28.1%
Bank D	28.5%	1.7%	8.0%	13.2%	8.1%	93.2%	6.8%	34.0%	40.8%	6.7%	51.7%	16.5%
Average	38.0%	1.8%	17.2%	14.0%	18.0%	91.4%	8.6%	36.5%	34.7%	6.2%	31.8%	36.1%

Consumer Protection Considerations

101. **Unwarranted variations in the cost of credit across lenders also suggest the need to implement consumer protection measures.** The overall cost of credit in Albania is frequently difficult to **calculate** up front as it entails elements of floating interest rates, exchange rates (for loans denominated in foreign currency), and fees and commissions (see Table 11 for an example of the characteristics of some mortgage loans offered).

Table 11. Comparative Conditions of Some Mortgage Loans Offered in Albania

	Bank 1	Bank 2	Bank 3	Bank 4
Max loan amount	NA	NA	€30,000	€35,000
Loan to value (%)	100	80	80	80
Interest rates	NA	5.7% fixed for 3 years, thereafter Euribor + 5 %	1st year 9.75%, thereafter T-bill + 3.5%; 1st year 7.5%, thereafter Euribor + 4.5%	5.75% first year, thereafter Euribor + 3.7
Maximum term	25 years	15 years	20 years	15 years

Source: World Bank banking survey.

102. **Regulation aimed at disclosure of the total annual cost of credit has been postponed.** Although this regulation was issued in 2006, the Bank of Albania has delayed its application because it believed that compliance would be too onerous for banks at this stage. Instead, banks are required to disclose all the terms and conditions of the credit offered. Though this disclosure is necessary, it is important to reevaluate the application of this regulation given that the average borrowers' level of financial literacy may still be too limited for them to adequately evaluate their financing options. Many lenders currently present information on the amount of monthly installments on credit This information allows borrowers to determine the affordability of credit given their sources of income, but it may also undermine the transparency in the real cost of credit.

103. **Other consumer protection measures should be considered.** In other countries with developing financial systems, financial authorities have taken an active position in enhancing transparency in credit markets. For example, some authorities collect information on standardized credit products offered by different lenders (e.g., credit cards and mortgages) and regularly publish comparative figures in a simple form. This information can help unsophisticated borrowers understand their financing options.

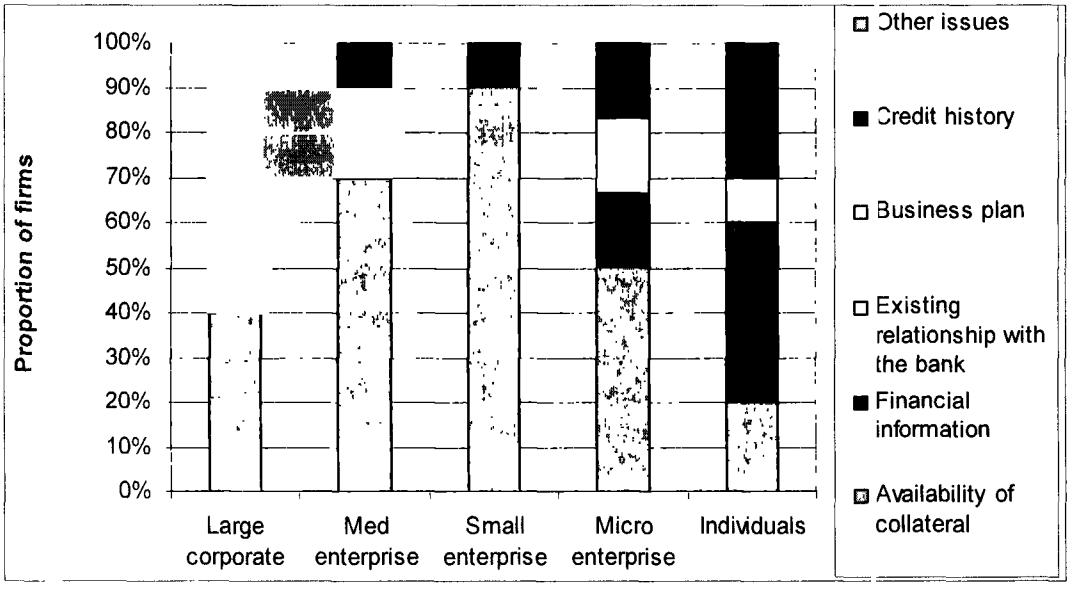
The Basis for Banks' Credit Decisions

104. **The factors determining banks' credit decisions vary according to the type of client (figure 41). The majority of banks surveyed base their credit decisions for large firms on financial information and credit history.** This basis reflects the fact that banks consider financial figures from large enterprises to be sufficiently representative of the real situation of firms, and the track record of these firms can be easily observed. However, as banks move down market, financial information on firms becomes scarce and unreliable, and records of the firms' payment behavior are more difficult to obtain. Accordingly, banks' credit decisions are highly dependent on the availability of collateral for SMEs, with up to 90 percent of banks surveyed considering the collateral as the main decision element in credit to small enterprises.

105. **Credit to individuals and microenterprises depends on the existing relationship of the client with the bank as well as credit history.** In the absence of a credit bureau,

many banks have developed informal mechanisms to acquire information on smaller borrowers, including consultation with other lenders. In credit to individuals, many banks base credit decisions on verification of borrowers' income, mainly through employment records, and verification with employers. Similarly, an existing relationship with clients through noncredit products (e.g., deposit accounts) is also used in some cases as a mechanism to identify and screen potential clients.

Figure 41. Proportion of Banks That Consider Each Factor as the Most Important Element in a Credit Decision



Source: Albania Banking Survey, World Bank, 2007.
Note: For individuals, financial information refers to employment and income records.

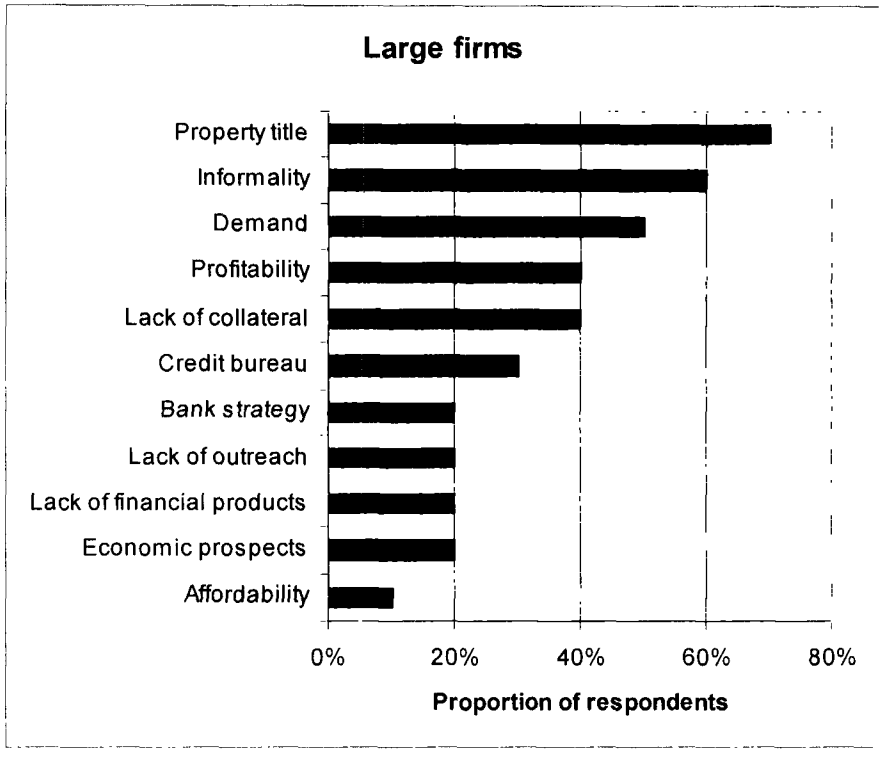
Main Constraints for Sound Credit Growth

106. **According to the banks surveyed, the most significant constraints to healthy growth of credit in Albania are related to credit infrastructure.** Banks participating in the survey were asked to identify the major constraints for credit growth, including factors related to the economic environment, business prospects, the bank's business strategy, availability of collateral, and credit infrastructure. Moreover, taking into account the differences in the characteristics of different types of borrowers, banks identified these constraints for large firms, SMEs, and individuals. Although the ranking of constraining factors varies across market segments, the most important constraints are related to deficiencies in credit infrastructure, rather than to the characteristics of firms.

107. **According to the survey, the most important constraint in credit to large firms are the problems with ownership titles of the firms' real estate assets (see figure 42).** Although firms have substantial assets to pledge as collateral, in many cases irregularities with their property title affect the eligibility of those assets as collateral. The process to solve these irregularities is reportedly lengthy, cumbersome, and uncertain. The second most important constraint appears to be informality, which is considered to be the lack of

reliability of the firms' financial statements. The third and fourth factors reflect the high competition observed in this market segment. As credit supply has increased in this segment, the credit margins have decreased, affecting the profitability for banks.

Figure 42. Major Constraints in Credit to Large Firms



Source: Albania banking survey, World Bank, 2007.

108. **The most important constraints in credit to SMEs and micro enterprises are informality and credit infrastructure (see figure 43).** Banks surveyed have reportedly experienced significant difficulties in assessing the creditworthiness of SME clients because of low reliability of their financial statements—usually related to underreporting of revenues—or even the absence of financial statements altogether. Transactions among Albanian SMEs appear to be mainly cash based, usually lacking supporting documentation. This, together with the lack of a credit bureau, restricts the possibility for lenders to make credit decisions based on analysis of firms' creditworthiness, and thus makes credit highly reliant on availability of collateral. However, deficiencies related to the property title significantly reduce the availability of qualifying collateral.

Figure 43. Obstacles to Extending Credit to SMEs

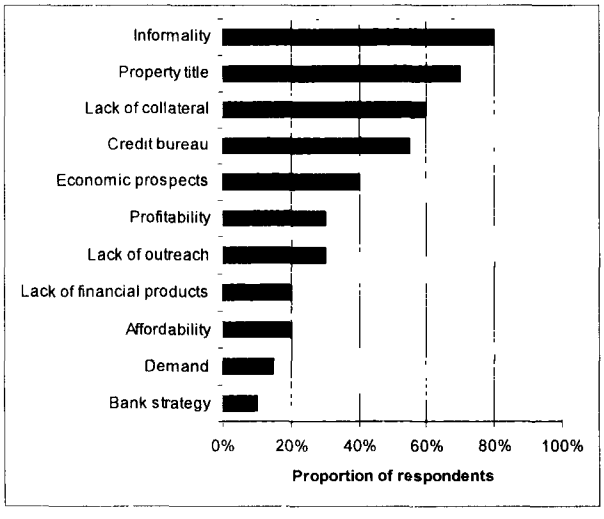
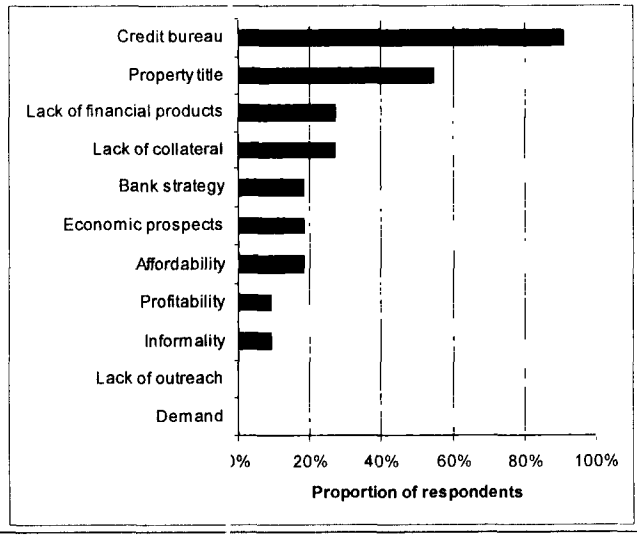


Figure 44. Obstacles to Extending Credit to Individuals



Source: Albania banking survey, World Bank, 2007.

109. **Credit to individuals is restricted mainly by the lack of a credit bureau (see figure 44).** Credit history of individuals is nonexistent in Albania. Moreover, banks do not have the possibility of assessing the level of indebtedness of individuals from credit granted by other banks. Many banks have tried to reduce this risk through an informal exchange of information, which has proved to be a costly, time-consuming, and unreliable mechanism.

V. CREDIT INFRASTRUCTURE

110. **Albanian banks surveyed for this study invest considerable resources to obtain more information on prospective borrowers**. Banks customarily investigate the financial situation of borrowers, verifying their accounting records and conducting ad hoc background checks. Many banks surveyed undertake significant efforts to restate the financial information of borrowers based on on-site checks of their economic activity. However, these efforts are costly and economically justifiable only for larger loans. Thus, the unavailability of low-cost, reliable information restricts the ability and willingness of lenders to expand credit operations to SMEs. Many banks have developed informal mechanisms for acquiring prospective borrowers' information. Some of the banks surveyed reportedly exchange information on clients with other financial institutions, but this is done on an ad hoc basis and depends on the willingness of other parties. Moreover, the information collected in this way is not verifiable and anecdotal and therefore can be highly unreliable [21] Many banks surveyed have also sought to pass on the cost of collecting information to prospective borrowers by requesting them to obtain "certificates of no liabilities" from other lenders. This is costly and time-consuming and has discouraged many prospective borrowers.

111. **Credit information systems are essential elements of the financial infrastructure that facilitate access to finance**. Credit bureaus or credit registries (see below for a discussion on features of **these** entities) usually underpin the lending activity of financial institutions by helping to address the problems of "asymmetric information"—that is, a prospective borrower knows the likelihood of repaying his liabilities much better than the lender does. In turn, the quality of the credit portfolio of financial institutions depends directly on their ability to accurately assess the creditworthiness of borrowers. Credit information systems allow lenders to better assess credit risks and make informed credit decisions based on the past behavior of borrowers, which has proved an extremely good predictor of future credit behavior. This information has a direct impact on profitability and long-term sustainability of financial institutions' operations.

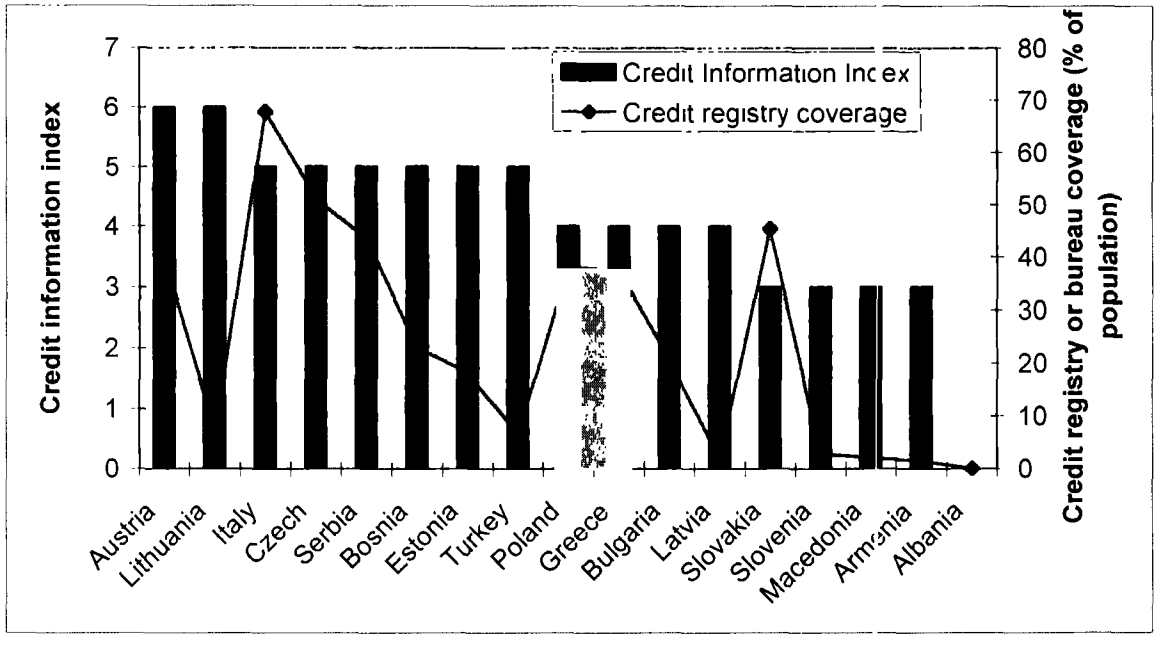
112. **In Albania, the existence of a registry of credit history is essential in order to build a credit culture.** As mentioned in previous sections, credit has just started to become available to the population in Albania over the past couple of years. In this context, the existence of mechanisms to record and disseminate credit history of borrowers may be an essential tool for building a credit culture. Indeed, the prospect of being black-listed may help to enhance borrowers' willingness to repay their debts.

113. **The Bank of Albania is taking the lead on setting up a long-needed credit registry**. The FSAP report in 2005 outlined the need for a well-functioning credit registry or bureau that would provide financial intermediaries access to historical information on borrowers. In the past there have been multiple attempts by the banks, represented by the Bankers Association, and the BoA to set up such an entity, but the initiatives have not

21 Banks do not have an incentive to disclose information on good borrowers to competing financial institutions. Conversely, they have incentives to overstate the creditworthiness of bad clients in order to rid of them.

materialized. Many of these initiatives failed to gain agreement on practicalities regarding the setup and operation of a credit registry or bureau. Accordingly, Albania has lagged well behind other countries in the region in terms of availability of credit information (see figure 45).

Figure 45. Credit Information Index and Level of Coverage of Credit Registries in the Region



Source: World Bank, Doing Business.

114. **Since March 2006 the BoA, with support from the IMF, has been working on the design and implementation of a credit registry**. The basic framework for the setup of the registry is expected to be operative by year-end 2007 and would include the mandatory participation of all commercial banks. Anecdotal information suggests that the project is on track to meet expected milestones on time. Banks surveyed for this study have praised the efforts of the BoA and are unanimously committed to providing information to the credit registry, because they have recognized the need for a repository of information on borrowers.

115. **The development of the information repository is being managed by a working group of the BoA with the assistance of an international consultant**. One of the initial tasks of the working group was to design the basic features of based on considerations related to the repository's scope, location, and institutional framework. For this purpose, the working group has assessed the needs of the BoA in light of the experience in other countries, the basic operation standards needed, basic information available from banks, and the options for the technical platform.

116. **The BoA working group identified five major elements to take into account in developing the repository and have obtained recommendations from the international consultant on each of them.** The ultimate design of the credit registry is in line with these

recommendations (see Table 12). Some of the implications of these recommendations are discussed below.

Table 12. Main Issues in the Design of the Credit Registry and Recommendations from Consultant

Consideration	Recommendation from consultant
The convenience and practicalities of the establishment of a credit bureau versus a credit registry	For the needs of the BoA, a credit registry would be more appropriate than a credit bureau.
The physical location and institutional framework for the registry	Inception of the registry as a unit of the BoA.
The type of financial institutions providing information to the credit registry	The registry would limit its initial scope to banks and branches of international banks.
The scope of the information collected by the registry (i.e., positive, negative, or both)	The registry should include both positive and negative information.
The practicalities of including information on disbursed credits versus credits granted after the establishment of the registry	The registry should include information on all credits outstanding and subsequent credits.

Source: Bank of Albania.

Credit Bureau versus Credit Registry

117. **A public credit registry (PCR) may be an effective way to fill the gap for information on borrowers**. Given the relatively short free-market tradition, the involvement of authorities in Albania is perceived as an essential element for the establishment of a viable private credit information **industry** in the country.[22] However, a PCR is not a perfect substitute for a credit bureau, and its limitations must be understood and evaluated. The limitations of a PCR with respect to a credit bureau are significant and reflect the sources of information, the availability of value-added services, and in some cases, the reliability and timeliness of data collected. Setting up a PCR will be a significant step toward the consolidating the credit infrastructure in Albania; however, it is important to first take into account the characteristics of a credit registry compared with a full-scale credit bureau (see box 9).

118. **The exclusion of NBFIs from the credit registry may have a significant impact on the representativeness of the information collected.** In an initial phase the credit registry in Albania will include only the participation of commercial banks as sources of information on borrowers. Notably, microfinance institutions, savings and credit associations, and other NBFIs (e.g., leasing **companies**) will not be included in the initial registry. According to information from the working group, this decision represents a compromise in order to set up the basis for the credit information system in the country,

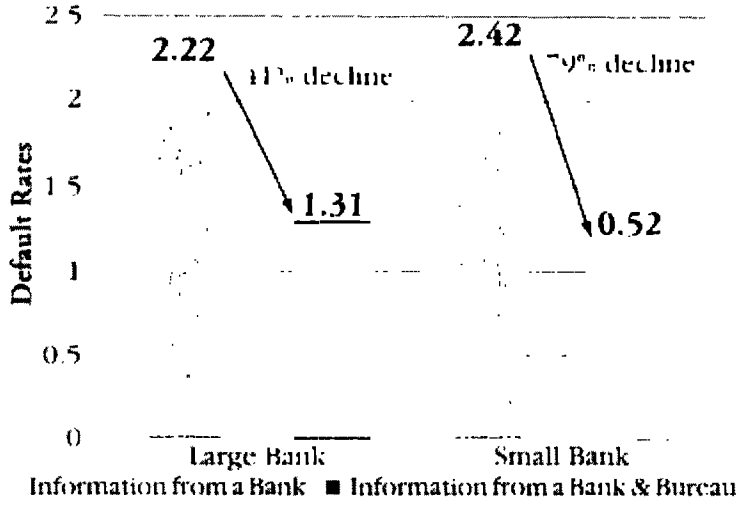
22 Governments in many countries have played a critical role in creating transparency in credit markets through an appropriate legal and regulatory framework for private credit information systems. For example, recently several countries, including Kazakhstan, Mexico, the Russian Federation, and Singapore, issued laws and regulations encouraging financial institutions to share information through private credit bureaus.

which can be expanded in the future. The current exclusion of NBFIs translates into three main considerations:

- **Credit risk.** Nonbank lenders account for more than 20 percent of all borrowers in the financial system. This severely limits the pervasiveness of the PCR as a source of information on borrowers' credit history. In practice, this decision implies that banks will not be able to screen out nonperforming borrowers of MFIs and SCAs, which will be detrimental to the quality of their loan portfolio.
- **Access to finance.** Preventing the participation of nonbank financial institutions may limit the prospects for competition in the system. Indeed, bona fide NBFI borrowers may be locked into the microfinance sector because they will find it difficult to prove their good track record to commercial banks.
- **Information sharing with NBFIs.** It will be important to determine whether nonparticipating NBFIs will be able to access information from the credit registry and the conditions for that access. In principle, having access to information from banks without contributing their own information may create an unfair advantage for NBFIs. On the other hand, preventing NBFIs' access to the information on the credit registry would go against the basic principle of facilitating transparency in the system and helping financial institutions to better assess their risks.

Going forward, it will be important to define a realistic time frame for the inclusion of NBFIs and to start work on achieving this goal. Because the institutional capacity and information technology systems of NBFIs are more limited than those of banks, ensuring the future participation of NBFIs in the credit registry will likely require a longer lead time. The importance of integrating NBFIs as sources of information for the credit registry stems not only from increased coverage of information but also from tangible benefits for large lenders. A recent study in Argentina found that large and small lenders experience significant reductions in their default rates through **exchange** of information on borrowers (see figure 46). Although the results may vary across countries, anecdotal and empirical evidence suggests that the benefits of exchanging information across financial institutions of all sizes can help to reduce credit risk.

Figure 46. Effect on Default Rates of Increasing Sources of Information



Source: "Credit Bureau Knowledge Guide," IFC, 2006.

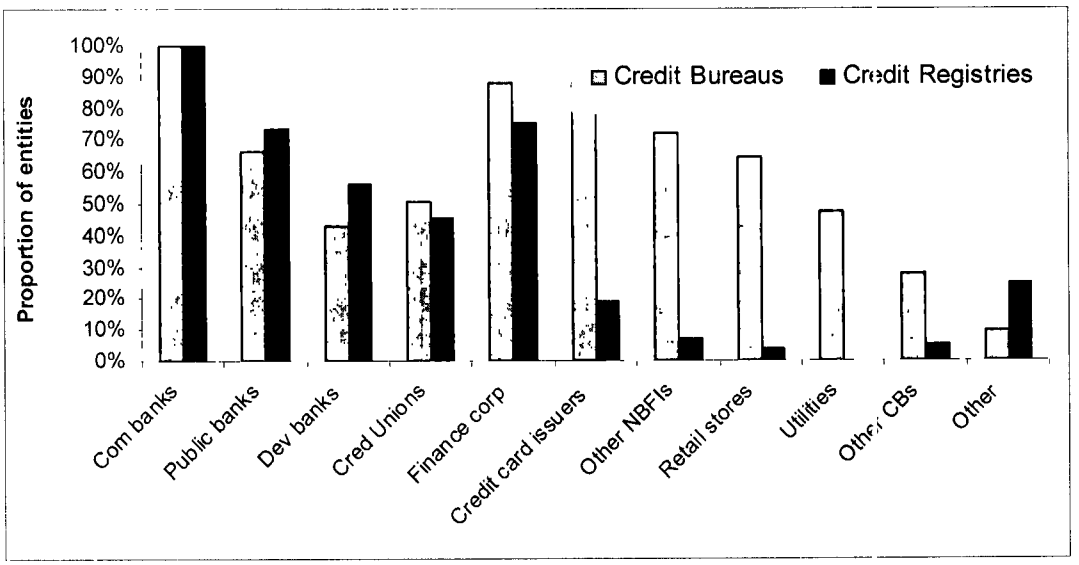
119. **The inclusion of positive as well as negative information in the registry will be a major element in fostering transparency in the system.** Negative information (also known as *black lists*) refers to defaults and usually includes the outstanding amount and date of default. When the defaulted debt is repaid, the information on delinquency is deleted from the database. This type of database does not allow the identification of borrowers that have accumulated debt from various different sources, who are highly risky even if they have not defaulted. In contrast, positive and negative information (also known as *full-file* information) includes all open and closed credit accounts, including the amount approved and the history of repayment. If a client has defaulted and subsequently paid off the loan, the information is maintained for a period of time. According to a survey by the World Bank, 68 percent of all credit bureaus include both positive and negative information, which significantly enhances the possibilities for lenders to accurately assess the creditworthiness of a borrower. Figure 47shows a diagram with the depth and breadth of information potentially included in a credit bureau or registry and the effect that it has on the sufficiency of these records for credit risk assessment.

Box 9. Public Credit Registry versus Credit Bureau: Some Practical Considerations

A public credit registry is a database that is usually managed by the central bank or the bank supervisor that collects information on the creditworthiness of individuals or businesses attempting to borrow from supervised financial institutions. The primary reason for establishing a PCR is to support banking supervision functions and monitor systemic risks; thus, participation is usually mandatory for supervised financial institutions. In addition, many PCRs provide credit reports to lenders as part of their operations. According to a 2004 World Bank survey, 57 PCRs were operating globally, many of which were set up following financial crises in the 1990s.

Credit bureaus are usually private enterprises that collect information from lenders and other public sources on borrowers' (individuals and enterprises) credit history. The objective of credit bureaus is to collect as much data as possible to provide lenders with information, not only on credit history but also on other characteristics of borrowers. This information usually includes credit repayment records, court judgments, bankruptcies, payment of utilities, and most important, information from NBFIs (see figure).

Sources of Information for Private Credit Bureaus and Credit Registries



The level of coverage of PCRs is usually lower than that of credit bureaus, which act on the information they receive regarding retail borrowers. Given their supervisory objective—most PCRs are set up with the primary purpose of supervising banks—they usually only include loans above a certain minimum amount. In a recent World Bank survey, about 60 percent of PCRs had loan cutoffs that were at least twice the average GNI per capita, thus excluding most retail and small business loans. Accordingly, the average coverage ratio of PCRs in developing countries was at 3.6 percent of the active population, whereas private credit bureau coverage was at 16 percent.

Other features also differentiate PCRs from credit bureaus. PCRs usually provide their credit reports at low or no cost to the lenders. This nonprofit basis of operation often translates into the PCRs' lack of the necessary motivation and funds to invest in data quality assurance systems. Conversely, private credit bureaus have higher incentive for reliability and timeliness, which usually translates into higher levels of service and investment in developing value added services, such as credit scoring and portfolio monitoring. According to the 2004 Doing Business Database, of the 57 PCRs surveyed by the World Bank, only four had a subscription fee.

Source: "Credit Bureau Knowledge Guide," IFC, 2006.

Figure 47. Effect of Types and Sources of Information on Predictive Power

Types of Information / Sources of Information	"Positive & Negative"	"Negative Only"
Full information shared by banks retailers NBFIs)		Lower Predictiveness (e.g Australia)
"Fragmented" (e.g. information shared among banks only or retail only)	Lower Predictiveness (e g Mexico)	Lower Predictiveness (e g Morocco)

Source: "Credit Bureau Knowledge Guide," IFC, 2006.

The Legal Framework of the Credit Registry

120. **The legal framework for the operation of the credit registry is based on the new Law on Banks.** Article 127 of the law provides the legal basis for the creation of the registry and defines the entities subject to the obligation to report information to the registry. The BoA credit working group is currently developing by-laws to regulate the operations of the registry, together with technical issues related to the types of information to be reported, reporting regularity, and reporting media.

121. **Ensuring an adequate legal framework for the operation of the credit registry is essential for its operations.** In particular, it will be important to ensure that the operations of the registry do not contravene existing laws protecting the confidentiality of individuals' and enterprises' financial records. The working group has worked extensively on the definition of a "clause of consent" whereby borrowers allow lenders to share their information with the credit registry.

122. **Ensuring that the information on existing loans can effectively be transmitted to the credit registry is paramount in order to ensure that valuable current information is not lost**. According to informal discussions with representatives of the working group, a legal due diligence has been undertaken to ensure that banks will be able to effectively transfer information on existing loans to the credit registry, even when they have not stated their individual consent to that. This is an important factor in the inception of the registry because it ensures that information on existing clients is duly transferred to the registry and constitutes a basis for its operations. In the absence of this provision, banks would only be able to report information on credits granted after the inception of the registry (whose credit contract would include the clause of consent). This would represent a **major** loss of credit knowledge and a significant delay for the registry.

123. **The working group is currently defining the institutional framework for the credit registry, along with considerations on its economic sustainability**. The working group, with the advice of the consultant, have determined that the credit registry will operate based on a technological platform outsourced from international vendors. In the following

months they will design the relevant unit within the organizational structure of the BoA that will be in charge of managing the credit registry. This also includes considerations on the tariff structure that the authorized users of the registry will have to pay.

124. **Banks surveyed for this study have expressed their full support of the BoA's initiative, but they voiced some concerns regarding the fees.** Continuous communication with banks has ensured banks' awareness of this project and, in most cases, prompted internal actions aimed at ensuring compliance with the requirements for participation, usually related to the type of information collected. However, banks surveyed reported an absence of information on the fees that the use of the registry will entail for them. Most of the representatives of banks surveyed considered that fees will be a major element in their decision to use the credit registry, especially for smaller loans.

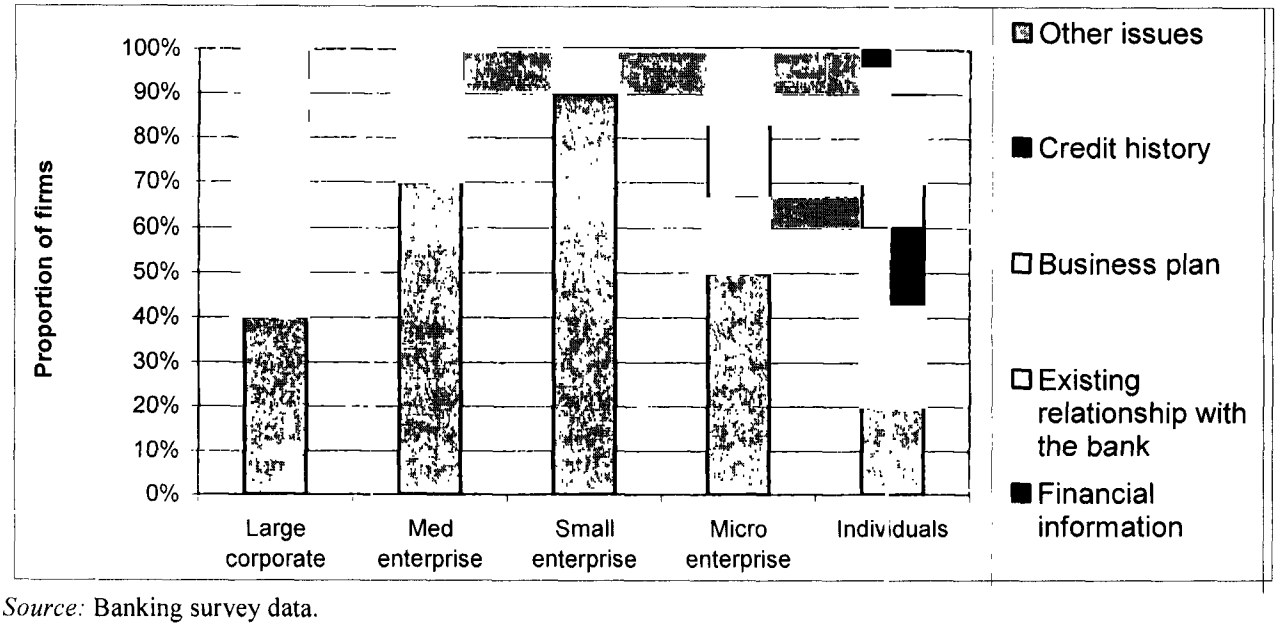
Real Estate Collateral—A Major Element of Access to Finance in Albania

125. **In the absence of reliable sources of information on potential and existing borrowers, financial institutions rely heavily on the availability of collateral for their credit decisions**. As discussed in **previous** sections, 9 out of 10 banks surveyed for this study considered availability of qualifying collateral as the most important element in a credit decision in lending to small enterprises, and 7 out of 10 considered collateral for medium-size firms also. Moreover, many banks surveyed considered that in more than 15 percent of cases, lending to otherwise creditworthy potential clients cannot materialize as a result of problems with the formalization of the property title.[23] Accordingly, most banks surveyed considered that collateral-related problems (lack of collateral or difficulties with property title) were the most important constraints in sustainable expansion of credit to enterprises.

126. **Besides being a major element of credit decisions for banks, real estate collateralization of loans also plays a major role for regulatory purposes, since it significantly reduces the level of provisioning that banks need to do to extend credit to enterprises.** At the same time, deficiencies with property titles are a natural constraint to banks that offer mortgage loans to individuals. However, major deficiencies occur with real estate property titles in Albania, which in turn translate into reduced access to credit for many enterprises (see figure 48).

23 This figure corresponds to clients that have undergone screening and credit analysis and for whom deficiencies in their property title become evident at the final stages of credit formalization. Banks surveyed considered that the proportion of firms facing credit constraints owing to deficient property titles may be significantly higher, but most of these are screened out at initial stages of the application process or fail to apply for loans altogether.

Figure 48. Proportion of Banks That Consider Each Factor as the Most Important Element in a Credit Decision



Source: Banking survey data.
Note: For individuals, financial *information* refers to employment and income records.

Box 10. The Movable Property Register—So far a lost opportunity for use of movable assets as collateral

The Law on Securing Charges foresees the use of non–real estate assets as collateral on a credit operation, including intangible property or rights as well as "serial numbered goods" such as agricultural machinery, aircraft, aircraft engines, automobiles, boats, construction machines, motorcycles, motor vehicles, trailers, and trolleys. To execute the law, the government created a central registry for securing charges on these assets, initially as a department of the Ministry of Finance but with the objective of becoming a fully self-financing operation.

The registry records some 5,000 entries each year. At its inception, the registry was intended to be fully computerized, and access is available to the public through the Internet. Unfortunately, the movable property registry does not play a significant role in facilitating access to finance in Albania, even though the majority of the banks surveyed for this study thought that it could have a major impact. At present, almost 50 percent of the banks surveyed do not commonly use the registry as part of their credit operations. According to these banks, the shortcomings of this registry stem both from operational issues and from the institutional setting.

About the operations of the registry. The experience of banks surveyed varies widely. Though some banks reported obtaining relatively fast response from the registry, others reported severe delays in its standard operations. According to the latter group, these delays are often due to lack of resources, including staff and even office materials. (One of the banks surveyed reported having to provide office supplies as the registry had run out of paper to print official documents.) In theory the registry is fully automated, but three banks suggested that the actual records are kept and managed in physical registry books.

About the institutional setting. The registry is not linked to any other relevant institution dealing with movable property, which makes it obsolete and reduces its effectiveness. For example, the registry does not exchange information with the authorities in charge of licensing of vehicles. Accordingly, a car that has been pledged as collateral can easily be sold without notice to the registry or the lender.

About the regulatory framework. Movable property has very limited value as collateral for loans, thereby reducing the incentives for banks to accept this type of assets as a guarantee.

Registration of liens on movable assets is intended to enhance the position of secured lenders in case of borrowers' default or bankruptcy. However, in practice most banks surveyed have failed to exercise this right through the courts.

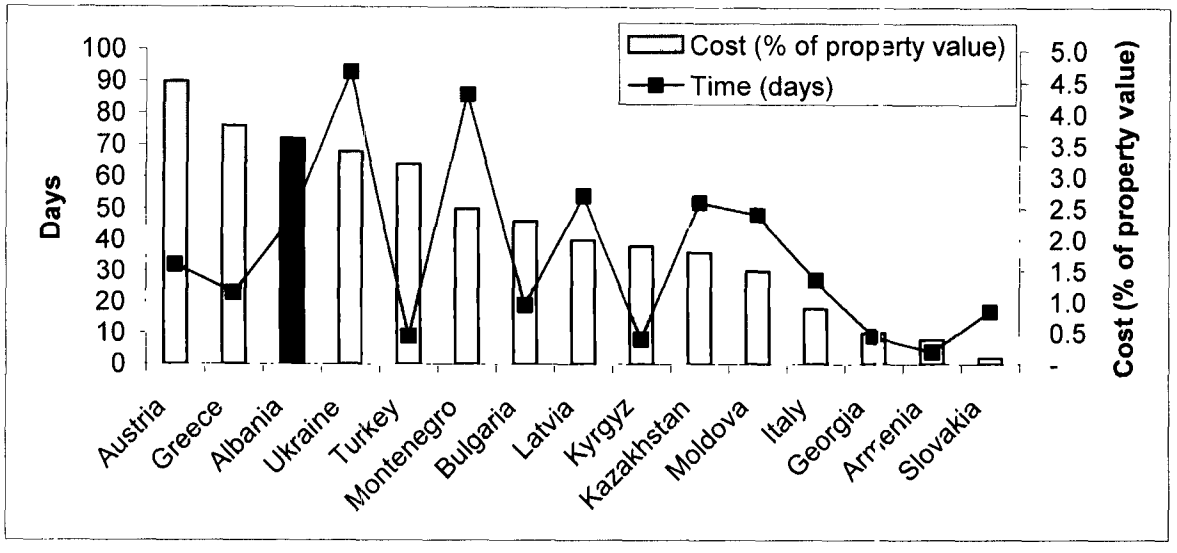
127. **The success of the incipient housing finance market in Albania also depends on the possibility of effectively using collateral.** Five out of 10 banks surveyed for this study offer mortgage **loans**, and two other banks are planning to offer these services in the near future. For these banks, the most important constraint for the development of housing finance is related to the possibility of using existing real estate as collateral and effectively executing those pledges in case of default by borrowers.

128. **However, severe shortcomings prevent the efficient use of real estate collateral.** Informal estimations from surveyed banks suggest that more than 15 percent of credit applications ultimately are rejected because of problems with the formalization or verification of property titles of real estate collateral. Moreover, the proportion of potential creditworthy clients affected by this may be much higher. Indeed, prospective clients with unregistered property usually fail to apply for a loan or are screened out before a credit analysis is done. These cases are difficult to quantify, because records are not maintained. However, informal estimates are well above the 15 percent mentioned above.

129. **These deficiencies appear to be due to either the operation of the Immovable Property Registry System (IPRS) (see Box 10) or broader problems related to the status of formalization of land property rights.** This study focuses on problems related to the operation of IPRS and other institutions and the formalization of property rights and inscription of mortgages. These deficiencies are separate from wider constraints on land use that stem from historical deficiencies of land reform, privatization, and restitution to previous owners. Those issues are discussed as background in box 11 and annex 1 because they severely hinder economic and property market development, deter foreign investment, undermine the confidence of the public, and create bottlenecks in courts. However, this study will not present recommendations on these deficiencies because they are the focus of other ongoing efforts by the World Bank and the IFC.

130. **Significant costs implied in the formalization of property rights appear to be a major constraint for the development of a reliable property registry**. There are considerable formal and informal costs implied in the formalization of real estate property rights. First, the official cost of registering real estate property in Albania is about 3.6 percent of the value of the property. This is well above the average of other emerging economies in the region (see figure 49). Complementary notary fees are excessive and variable, burdens that are compounded by the cost of survey preparation and documentation required from users. The IPRS's poor quality of service creates business opportunities for informal brokers that expedite the registration processes for a fee.

Figure 49. Time Required and Cost of Registering Property



Source: World Bank, Doing Business 2006

131. **The IPRS was created in 1993 in accordance with the typical model of a European registry system.** The IPRS is a governmental unit subordinated to the Ministry of Justice, with 36 district offices and a central office in Tirana. It is the primary source of data on legal ownership and commercial transactions involving real estate.[24] A property owner who wants to enter a transaction should first go to the IPRS to obtain the certificate of ownership. The certificate is presented to the notary or mediator and to the other party as substantiation of the owner's status. Subsequently, the new agreement must be brought to the IPRS for registration.

132. **Anecdotal evidence indicates that the IPRS is not efficient even though there have been important efforts to enhance its operations.** The FSAP report outlined severe issues related to the efficiency of **the** IPRS. The registry was found to be prone to losing files, common petty corruption, and bureaucratic and unpredictable filing processes. At the time of the report, the expectation was that significant improvements would be achieved in the short term after the registry was moved to a modern building; more windows were made available for registration, the register was slowly being computerized, and efforts were being made to reduce the opportunities for corruption. However, the bank survey undertaken by this study shows that in 2007 many of the deficiencies identified are still present.

133. **There appears to be considerable room for improvement of the operations of the IPRS regarding registration and verification of property**. Anecdotal evidence suggests that prospective borrowers spend considerable time obtaining a property title, which significantly delays the overall credit process. Some banks reported unsubstantiated comments from clients, suggesting **the** use of informal payments to expedite this process. Though all banks surveyed confirmed that they do not incur any type of such informal

24 The IPRS uses a system of registry volumes and pages (called kartelas) to record the description of each property (size, boundaries, and location) and its title information (ownership, subordinate rights, and restrictions).

payments, most of them have had to develop informal relationships with the registry in order to expedite the process of verifying the property titles and liens. According to banks surveyed, this verification of the property title usually takes between one week and one month. More than 50 percent of banks surveyed have dedicated personnel to undertake these activities, which increases their operational cost and thus the cost of credit.

Box 11. The Current Status of Land Tenure

Several important efforts have been undertaken in Albania to regularize the status of real estate in order to assign property rights and enable commercial transactions involving these properties to take place.[25] However, a large proportion of the rural properties in the country are usually not usable for collateral purposes. Of the about 4.5 million land parcels and separately owned immovable property units, 73 percent are rural properties, and 26 percent are state-owned. Illegal properties constitute a large share of real estate units. An estimated 90,000 properties have arisen from informal subdivision of land and unauthorized building. Such properties are concentrated in informal urban districts on the periphery of cities, tourist areas on the seacoast, service buildings on highways, and houses on agricultural fields outside the village centers. The properties account for roughly 10 percent of the total urban units in the country. Moreover, twice as many unauthorized properties as new legal urban dwelling units were constructed between 1991 and 2004. This situation results in major limitations in terms of facilitating access to finance, as most banks in Albania usually do not admit rural properties as collateral on loans.

The land reform started with the granting of title documents of ownership to private owners, citizens, and juridical persons. Subsequently, the law required registration of these properties in order to fix their status in civil law and make the properties eligible for future transactions. The resulting information is aimed at providing the baseline legal situation on the date of first registration.[26] also Subsequent transactions would be recorded in individual files, or kartela, thus creating the "chain of title." Accordingly, it was expected that the kartela of each property would provide an accurate and guaranteed certification about the status of the property and its ownership. However, registration of properties is essential for their use in commercial transactions, since only registered properties can be given significance and protected by the courts. Failure to register a transaction renders it null, with no legal protection.

However, first registration of properties is far from finalized, especially with regard to urban properties. According to a study by the World Bank, in 2005 only about 58 percent of properties were either registered or in the process of being registered, while more than 1.7 million properties were still pending registration. Notably, most of these properties were in rural areas, where first registration had covered more than 80 percent of units. As opposed to this, only 18 percent of urban units were either registered or in the process of being registered at the time, with a backlog of around 750,000 urban properties. First registration is slow as it requires development of accurate maps and surveys. Significant efforts have been undertaken to complete the first registration process, with a focus on priority areas, but they are not complete and many have yielded faulty or incomplete records.[27]

[25] This section draws on the report "Status of Land Reform and Real Property Markets in Albania," by William Valletta, Ejup Hamza, Mirvjena Laha, Kathrine Kelm, Nadir Mohammed, and Julian Lampietti (World Bank, 2006).

[26] This "first registration" process consists of researching the ownership history of properties using different archives, field surveys, and physical mapping. This registration usually cross-references archive documents recording ownership and subordinate rights with documents held by citizens and juridical persons.

[27] Efforts undertaken by a PMU[[spell out]] of the Ministry of Agriculture between 1994 and 2001 completed the first registration of 2 million rural properties and 168,000 apartment units. However, the latter were done without mapping of the urban zones. Efforts undertaken in partnership with USAID and EU ended in 2001, after audits revealed significant problems in its organizational and financial structure and a high level of errors in the registry data. A subsequent first registration process was undertaken in 2002–04 with a focus on 62 rural "economic priority" zones (with tourism or industrial potential), 16 urban zones and 58 rural zones. In 2005, work continued with a focus on four zones in the Korce District and selected priority economic zones.

Land fragmentation hinders the application of civil law, the functioning of markets, and the practical use of land and property. Housing privatization and restitution fragmented urban land in parcels limited to 300 square meters, while the land surrounding houses or buildings is kept in state ownership. Similarly, in many cases of restitution, a house or building and its underlying land are separated from the surrounding land, which is transferred to the former owner. In practice, the result is a very cumbersome situation in which each owner must reach agreement with neighboring owners to undertake basic decisions regarding the use or commercial transfer of property. Almost any investment in development or redevelopment requires a consolidation of land, and the state or municipal government almost always becomes a partner because of its bits of land. Besides the complexity for individual owners, this setting places a heavy burden on the Albanian system, which must handle and formalize a very large number of small agreements.

There has been an expectation that the number of civil law and market transactions would grow as land parcels and immovable objects are transferred and registered, but this has not been the case. Statistics seem to show that the majority of transactions do not make use of civil law and market mechanisms; rather, customary, informal, and nontransparent relationships are predominant. While the requests for certificates has increased to over 130,000 per year in 2005 (up from 80,000 in 2000), this accounts for only about 4 percent of the 3 million units in the IPRS registry. Moreover, updated input on registered properties is extremely low, showing that few people are bringing to the registry any new documents recording purchase or sale, inheritance, lease, or mortgage. This is a significant problem because the guarantee of legal rights in the registry rests on the unbroken chain of transfers.

Source: "Status of Land Reform and Real Property Markets in Albania," World Bank, 2006.

134. **The reliability of property titles is still limited, creating risks and costs for users and financial institutions**. Of banks surveyed, 30 percent reported negative experiences related to the reliability of the property title. These cases refer mainly to the possibility that previous owners may have a claim on the property pledged, even when the current owner has a property title. To reduce this risk, banks must spend considerable time reviewing the history of ownership of the property. This process is costly but is considered a necessary complement to the work of the property registry.

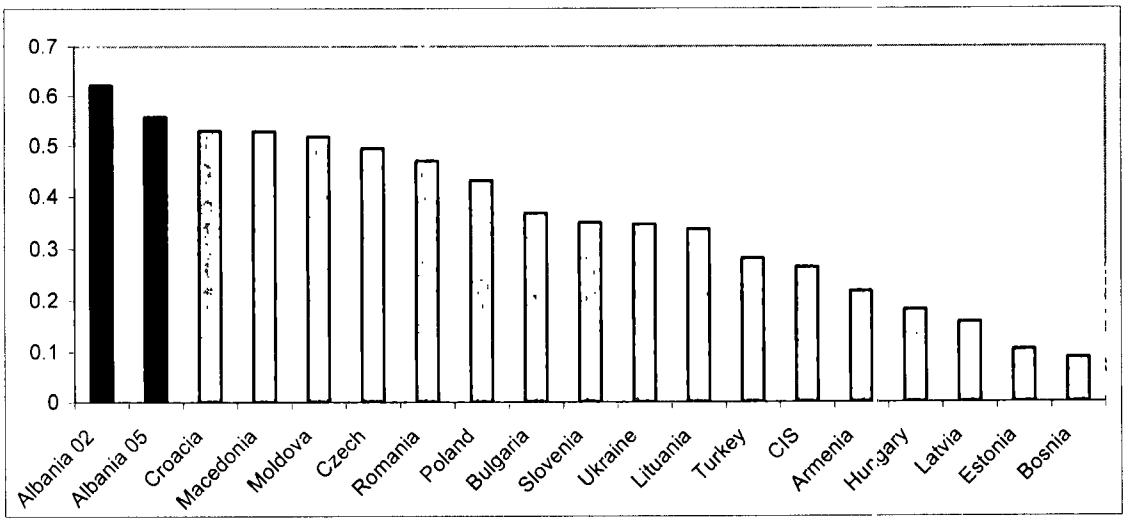
Creditor Rights

135. **A well-functioning judicial and legal framework is an essential element of the overall credit infrastructure and the basis for creditor rights.** While infrastructure supporting well-functioning credit information helps reduce the risk of borrowers' default, a reliable legal system and judiciary are necessary for lenders to enforce contracts and foreclose collateral on loans. By contrast, inefficient legal processes, slow court proceedings, and unpredictable court rulings increase the risk for lenders and make the foreclosure processes time-consuming and expensive. Similarly, inadequate creditor rights can diminish the incentives for borrowers to meet their financial obligations. In turn, these factors usually translate into market inefficiencies, with a lower number of credit operations taking place and higher cost of financing for borrowers.

136. **The perception of the reliability of the judiciary in Albania has improved slightly over past years, but it is still the lowest in the region.** According to BEEPS, in 2005, 56 percent of companies surveyed in Albania did not have confidence that the legal system would uphold contracts and property rights in legal disputes. Similarly, 55 percent of these firms considered that the reliability of the judiciary is a significant problem for doing business in the country. Though this proportion is lower than that reported in 2002 (62 percent), the reliability of Albanian judiciary, as assessed by firms surveyed, still ranks at the

bottom of the region (see figure 50). This translates into a very low use of courts to settle disputes, as only 16 percent of surveyed firms used courts to settle overdue accounts, compared with an average of 40 percent in Southeastern Europe.

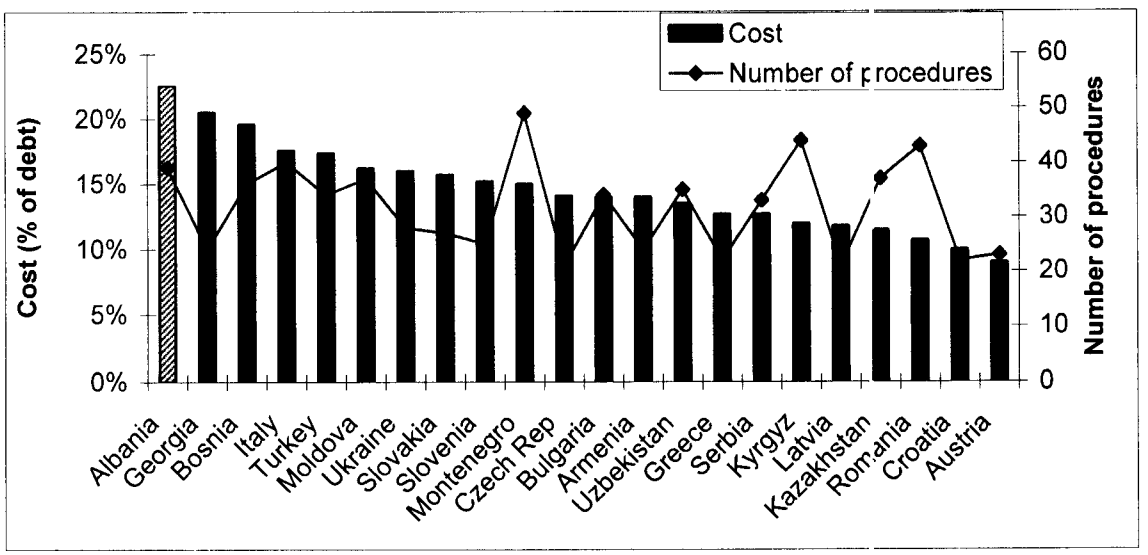
Figure 50. Proportion of Firms That Consider the Reliability of the Judiciary a Problem for Doing Business



Source: World Bank, BEEPS 2002 and 2005.

137. **The cost of enforcing contracts in Albania is the highest in the region**. According to the Doing Business indicators, collecting debts through legal proceedings costs more than 20 percent of the amount of the claims and takes, on average, more than a year. This cost is the highest in the region (see figure 51) and is based on information provided by commercial firms surveyed.

Figure 51. Enforcing Contracts in Albania—Cost and Number of Procedures Required



Source: World Bank, Doing Business Indicators, 2006.

Table 13. Enforcing Contracts in Albania—Time and Cost

Nature of Procedure (2005)	Indicator
Total time (days)	390
Filing period (days)	30
Judgment period (days)	180
Enforcement period (days)	180
Cost (% of debt)	22.6
Attorney cost (% of debt)	21.6
Court cost (% of debt)	1.0

Source: World Bank, Doing Business 2006.

138. **Albanian lenders' reliance on collateral for credit decisions emphasizes the need for adequate procedures for contract enforcement.** As mentioned before, lenders have relied heavily on collateral for their credit decisions given the absence of information on borrowers. Real estate collateral usually plays a major role in reducing the expected losses of banks in credit operations, but this benefit may be limited in the case of Albania, given the deficiencies in the legal procedures. Accordingly, it is imperative that lenders have a clear view of the actual cost and timing implied in execution of collateral, to fully understand the actual risk they will incur in their credit operations.

139. **The experience of formal lenders with foreclosure of assets is very limited.** Banks surveyed for this study reported very limited experience with legal enforcement of collateral. Though banks customarily initiate legal proceedings against defaulting borrowers, proceedings are frequently used as a pressure instrument in order to reach out-of-court settlement of debts with nonperforming debtors. Accordingly, very few of these cases are followed through to the end of the process, and the experience of banks surveyed is limited to less than 10 finalized cases each on average, even though many more cases have been brought to court.[28] This experience is extremely limited and does not allow banks to make sufficient estimations in terms of the actual risk of their credit operations

140. **The experience of the banks is not sufficient to determine the actual protection granted by collateral.** The scarce experience of banks in foreclosing on nonperforming loans is time-consuming, usually taking much more than one year to complete. Moreover, there are perceptions that total foreclosure and repossession of living quarters is not permitted in order to prevent homelessness, although no specific legal basis for this policy has been found. At the same time, the expenses incurred by banks throughout the process are significant, although no studies have quantified these costs. In summary, the actual recovery, after costs, that banks may be able to attain on collateralized loans may well be below the expectations and happen several months after default.

141. **Moreover, as the current credit portfolio of Albania's banks matures, the backlog of cases of collateral enforcement may be above the institutional capacity of courts.** Banks interviewed for this study expressed a positive view of the process and timing

28 For example, a bank interviewed for this study reported that they have brought to court more than 100 cases over the past three years. Out of these, two cases have been followed through to the whole legal process, which took around three years to complete. Two other cases were considered unviable and were written off. The rest of the cases remain to be solved.

required for obtaining a court decision on foreclosure of collateral; on average, banks reportedly obtain this decision two to three months after the start of the proceedings. This perception largely appears to be based on the introduction of the preferential status of bank loans, which has been recently challenged in Constitutional Court (see box 12). However, it is important to note that the number of cases brought to court is still relatively limited. As the portfolio of financial institutions matures, the volume of cases brought to court will likely increase significantly, challenging the institutional capacity of courts and potentially leading to longer waits for court decisions.

Box 12. Enforcing Bank Loan Contracts through Court

The process to obtain a court decision on a nonperforming loan is expeditious, but may be adversely affected by potential changes to the Civil Code. Commercial credit contracts disputed in court must go through a legal due diligence to prove the existence of the liability. According to practitioners, this is a time-consuming and cumbersome process. As opposed to this, the Code of Civil Procedures (Article 505b) grants banks' credit contracts the preferential status of "executive title," thereby eliminating the need for the above-mentioned due diligence. Notably, this provision does not apply to credit contracts of NBFIs, which are subject to the same rules as commercial transactions.

This measure has proved instrumental in expediting the overall contract enforcement process. However, in early 2007 a district court challenged the constitutionality of this provision, questioning the validity of such preferential treatment. The case is currently under review by the Constitutional Court.

A ruling against this provision could have significant negative effects on creditor rights and further complicate the contract enforcement procedures for banks. The institutional capacity of courts (staff, training, and systems) must be substantially enhanced before a decision is made to eliminate this provision. If this provision is maintained, it should be extended to credit operations of NBFIs as well as banks.

142. **The operations of bailiffs appear to be a major source of unwarranted inefficiencies in foreclosure of collateral.** According to practitioners and banks surveyed for this study, though the procedure to obtain a court ruling on foreclosure of collateral is quite expeditious, the enforcement of this ruling by bailiffs is usually subject to major delays. Efforts have been made to improve the performance of bailiffs, but the institution remains the focus of major criticism from practitioners.

143. **The bailiffs have a monopoly over the enforcement process, which results in major delays and increased costs.** The bailiff system is the institution that is in charge of carrying out foreclosure and sale of assets. Banks surveyed for this study have reported negative experiences in dealing with bailiffs, including arbitrary decisions, inconsistency in bailiffs' processes, and undue extension of lead times for enforcement of court decisions. Moreover, the intervention of bailiffs has a major negative effect on the overall costs of contract enforcement, given that the fee for use of their services amounts to a high 7 percent of the value of the property, payable up front. A new law regulating the bailiff profession was introduced in 2001, after which the services of a number of bailiffs were terminated for poor performance.

144. **Besides the issues related to enforcement of collateral, there are major deficiencies in the legal framework governing these activities.** The execution of real estate collateral is regulated by Law "Code of Civil Procedures of the Republic of Albania" (No. 8116 of 29.03.1996, amended). Many elements of the law generate opportunities for delay in

the due process, caused by vagueness in the law and room for interpretation, as described in Table 14

Table 14. Summary and Critique of Laws Governing Collateral

Prescription of current law	Problem	Suggested solution[29]
Article 522, "Execution versus a debtor whose residence/location is not known"		
The law requires personal notification to the debtor about the legal proceeding. In cases where the debtor is not found, the bailiff is required to appoint a representative, but no deadline is considered for such appointment.	The law results in unjustified delay in the process.	Introduction of a concrete deadline no longer than 30 days for the appointment of the representative of the debtor.
Article 564, "The evaluation/assessment of the seized-off asset"		
Foreclosed assets must be valuated by either: a. the bailiff, based on information available in the Immovable Property Registry (IPR), or b. external experts. The valuation based on information in the IPR is frequently based on outdated information and is usually nonrepresentative of the real value of the property. The debtor has the right to appeal the valuation and request a second one under different criteria.	Debtors usually contend the valuation done by the bailiff and require a second valuation by experts, with consequent delays and additional costs.	Valuation of assets should be done directly by authorized or approved experts, reducing the possibility for controversial valuations by bailiff.
Article 577, "Repetition of the auction"		
In the cases where the foreclosed asset is not sold in a first auction, the law requires that a second auction take place no sooner than three months afterwards.	The three-month period is considered to be an unwarranted constraint.	The timing restriction should be considerably reduced or eliminated to enhance the possibilities for creditors to maximize the recovery on sale of property.
The minimum price of the asset in a second auction is set at a 20% discount from the original valuation price.	According to practitioners, this discount is frequently insufficient to ensure that there will be interest from potential bidders.	The BoA suggested allowing for a discount of up to 30 percent of the initial valuation in order to enhance potential for sale.[30]
After a failed second auction, the creditor must take property of the asset at auction valuation price.	Restitution of differential to borrower can be onerous, as the	The restitution of positive differentials to borrowers should be based on the actual amount realized

Any positive differential between the valuation price and the liability claimed must be paid back to the borrower. Alternatively, the creditor can choose to share the ownership of the asset with the borrower. If the creditor refuses to take ownership of the asset in lieu of liability, the pledge on the asset is lifted in favor of the debtor.	bank will likely have to further invest in selling the asset, and the sale price may be well below the discounted valuation. Joint ownership subjects the creditor to the willingness of the debtor to sell the asset in order to realize its value.	on the sale of the assets, rather than on the valuation.[31] In cases where the sale of the asset is not sufficient to cover the amount of the debt, it is important to consider whether the remaining debt should be written off or further pursued by the creditor.
Article 573, "Award of the winner of the auction"		
The civil code establishes that the auction of assets shall be taken in accordance to a specific law that has not been approved by the Parliament.	The legal framework for auctions of foreclosed assets is not defined.	A special law with regard to the detailed procedures for the conduct of the auction should be approved. This may enhance transparency and consistency of the procedure in which the bailiff executes collateral.

Source: Proposal for modifications of the Code of Civil Procedures. Working document of the Bank of Albania.

Law on Insolvency

145. **Albania enacted a new Law on Insolvency in 2002, replacing the cumbersome Law on Bankruptcy Procedures of 1995.**[32] The new law is deemed to be in conformity with the legal system of Albania and well in line with international best practices and in harmony with the EU legislation. While the new law included significant improvements at all stages of the insolvency procedures, an assessment by the European Bank for Reconstruction and Development in 2003 found some deficiencies, including the following:

- The absence of appropriate qualifications for potential insolvency administrators
- Lack of obligations of debtors to provide relevant information
- Exclusion of cases where the assets of the insolvent entity are insufficient to meet the costs of the insolvency process
- Absence of a provision enabling a creditor to establish the inability of a debtor to pay a mature debt

[29] Although these suggestions are formulated as practical ways to address the deficiencies in the law, their impact on other laws must be assessed before they are implemented. Some relevant laws to take into account are Law No. 7843 of 13.07.1994, on the registration of immovable properties, and Law No.8730 of 18.01.2001, on the organization and operation of the Judicial Bailiff's Office.

[30] The Bank of Albania suggests that the minimum value of the collateral must be at least equal to the amount of the defaulted debt. The rationale is that the sale of the collateral would necessarily extinguish the debt. However, this could have a negative effect when the debt is higher than the appraised value of the collateral, effectively preventing the sale of the collateral through auction.

[31] The Bank of Albania suggests that any differential after extinguishing the debt should be kept by the creditor. This principle may not be fair in the cases where the collateral is significantly more valuable than the debt and could reduce significantly the willingness of borrowers to pledge collateral for smaller loans.

32 This section draws on the findings of the FSAP (2005). For additional information on international best practices see World Bank Principles for Effective Insolvency and Creditor Rights Systems, World Bank (2005).

- Absence of a clear statement concerning the control and management of a debtor who seeks to propose a plan of reorganization
- Absence of adequate provisions concerning the financing of a debtor during the early stages of a possible reorganization

146. **The existence of an adequate bankruptcy framework is an essential element of creditor rights, and there have been important efforts to enhance its application in Albania**. The World Bank formulated an Institutional Development Program (IDP) for insolvency and secured financing enforcement that contributed to efforts to develop an adequate legal framework for insolvency as a necessary basis for sound financial intermediation. These efforts have been substantially backed by the Ministry of Finance and the Ministry of Justice[33] and include the preparation of an insolvency manual, training materials for judicial seminars on the insolvency law, and training for judges on liquidation and reorganization.

147. **Even though the Law on Insolvency has been in force for five years, it has seldom been used.** Indeed, none of the banks surveyed for this study has experience with bankruptcy, usually favoring out-of-court arrangements with nonperforming debtors. At the same time, banks expect that the legal cost of a **bankruptcy** process would be so high that it would be nonviable from an economic perspective in most of the cases, given the relatively small size of average loans. Going forward it will be important to closely monitor any bankruptcy cases in order to ascertain strengths and weaknesses of the legal procedures, institutional framework, and roles of the different parties involved.

Accounting and Auditing

148. **Availability and reliability of financial information is very limited in Albania.** According to the Auditing and Accounting ROSC conducted by the World Bank in June 2006, the legal framework on financial reporting in Albania is characterized by a lack of cohesiveness. The ROSC found a lack of agreement in the understanding of requirements for reporting and very limited availability of published financial information.

149. **A new accounting law aims to address many of the shortcomings in auditing and financial reporting.** Previous accounting regulations and laws do not cover issues such as consolidated financial statements, leasing, construction contracts, and impairment of assets. The new accounting law addresses these issues by requiring the use of IFRS by public interest entities and simplified reporting requirements for SMEs. The requirement to use local accounting standards is expected to take place in January 2008, after the IFRS has been translated into Albanian and the National Accounting Standards are finalized.

150. **Improvements in legislation must be accompanied by improvements in the capacity of industry, audit professions, and enforcement agencies.** According to the Auditing and Accounting ROSC, there is an overwhelming need for training across all areas of the economy with respect to accounting, auditing, and financial reporting. The existing monitoring and enforcement mechanisms are not effective in inducing compliance with

33 The IDP was approved on April 2002 by the Ministry of Finance and the Ministry of Justice; it sets out a program for improving enforcement of insolvency and secured financing legislation.

current auditing and accounting standards; they will need to be reinforced once new legislation is in effect and the National Accounting Standards are established.

VI. PROPOSED ACTION PLAN

151. This study has looked at the issue of access to credit mainly from the point of view of prospective creditors (banks and microfinance institutions). Assessing a demand and supply assessment would require a detailed assessment of enterprise needs and matching of this demand with the potential supply of credit. To better understand the needs of the enterprise sector, including their financial needs, the World Bank is about to undertake an investment climate assessment that includes a large survey of enterprises. However, this study performs a brief assessment of demand and supply of credit using the BEEPS and a banking survey. The BEEPS shows that in 2005, Albanian firms received 50 percent less external financing than their counterparts in other countries in the region. If we assume that Albanian firms have similar financing demands, external financing could grow by about 25 percent (20 percent real) annually until 2009.

152. Regarding the supply side, the banking survey suggests that banking credit will increase by an average of 28 percent annually, with credit to large enterprises expected to grow about 35 percent and credit for SMEs to remain below 20 percent. This suggests that the proposed supply of credit over the next few years will match the potential demand. However, for this growth in credit to materialize sustainably, a number of preconditions should be set.

153. **Development of the financial sector and access to credit cannot be achieved without the development of the overall business climate**. Therefore, in parallel to efforts to develop the various subsectors, this study recommends that the government carry out a number of structural reforms related to anti-corruption efforts, public sector reform, auditing and accounting, and judicial reform. Furthermore, efforts to improve corporate governance remain a prerequisite to financial sector development.

154. **The areas of reform that offer the greatest gains to ensure access to credit and eventual economic and financial sector development are related to improving the quality, breadth and depth of financial intermediation and fostering the further development of creation of nonbank Credit institutions.** The GoA is considering the establishment of guaranteed funds, or subsidized funds, to facilitate better access to credit for the SME sector. Although access to credit for SMEs and rural and agriculture sectors remains small, the experiences of other countries have shown that unless the market and credit infrastructure are in place, any measures to introduce credit enhancement products, such as creation of guaranteed funds and development banks, will not have a viable impact on the development of credit in Albania. This study believes the reform with most optimum impact on sustainable credit growth should be focused on (i) improving the quality, breadth, and depth of financial intermediation, (ii) growth and development of credit unions and microfinance institutions, and (iii) Facilitate the Development of new instruments. The authorities should also focus on implementing reforms to become compliant with FATF recommendation.

Improve quality, Breadth and Depth of Financial Intermediation

155. **According to the study survey, the most significant constraints for healthy credit growth in Albania are related to credit infrastructure**. Although the ranking of constraining factors varies across market segments, the most important constraints are related to deficiencies in credit infrastructure, rather than to constraints directly related to the characteristics of firms.

156. **The highest priorities should be given to the establishment and effective operation of a credit registry, which can be extended to nonbank financial credit organizations such as microfinance and credit associations.** Going forward, the authorities should work to facilitate the development of private credit bureaus, which have a larger data coverage.

157. **Severe shortcomings continue to prevent the efficient use of real estate collateral.** Significant costs implied in the formalization of property rights appear to be a major constraint for the development of a reliable property registry. Considerable formal and informal costs are implied in the formalization of real estate property rights. These deficiencies appear to be due to the operation of the Immovable Property Registry System (IPRS) and broader problems related to the formalization of land property rights. Furthermore, the operations of bailiffs appear to be a major source of unwarranted inefficiencies in foreclosure of collateral, and the administrative process for foreclosure of assets is still very time-consuming.

Table 15. Targets for Improving quality, Breadth and Depth of Financial Intermediation.

	Priority	Short Term	Medium Term	Long-Term
Credit Information System/Credit Registry to better assess the credit risk of borrowers	High	Establish a credit registry with positive and negative information on all outstanding information with initial scope of banks at the BoA. Ensure the viability of the registry by verifying that it does not contravene existing laws that protect the confidentiality of individuals' and enterprises' financial records.	Expand credit information bureau to include other financial services; specifically include microfinance and credit unions in a credit registry. Promote Credit Bureaus Identify suitable methods to allow Banks improved access to company registration and borrower tax information	Promote information-based market mechanisms for ongoing evaluation and rating of companies based on accurate and timely financial results and market developments.

Land registration and titling system in order to eliminate widespread land ownership ambiguities, thus strengthening value of land as collateral	High	Improve the operations of the IPRS regarding registration and verification of property.	Ensure the reliability of property registry all properties by properly registering all properties and addressing land fragmentations. Provide electronic access to prospective creditors and investors.	
Judicial procedures for collateral enforcement, by streamlining performance of court baliffs and auction procedures	High	Make changes to current laws articles 522, 564, 577, and 573 to introduce deadlines for personal notification to debtor, formalize asset valuation, increase discounts of original collateral, and create a legal framework for auction of foreclosed assets		

Facilitate the Growth and development of credit unions and microfinance institutions

158. **Microcredit and credit union institutions have been exceptionally important sources of finance for microenterprises and rural sectors that are currently not adequately serviced by the banking system.** Without these institutions the micro and small enterprises, as well as inhabitants of rural areas, are practically excluded from the financial market because of the absence of standard collateral and guarantees, distance from the bank branches or agencies, and a lack of familiarity with the banking system. Commercial banks also lack interest in providing this type of high-cost service. Furthermore, poverty is still present in these areas, and the level of income is very low. In conclusion, small and microenterprises and farmers will still need small loans.

159. **At present Albania has no law governing the activities of microfinance entities.** Accordingly, microcredit institutions are regulated differently, depending on their legal status. MAFF is licensed and supervised by the BoA as a nonbank financial institution based on Article 26 of the 1998 Law on Banks. **However**, going forward it will be necessary for microfinance entities to be given the means to transform into formal financial institutions. This transformation is essential to facilitate the long-term sustainability of these entities by enabling them to access wider sources of funding while maintaining a level of oversight commensurate with their activities and risks.

160. **Financial authorities should consider legal frameworks adopted by other countries in the region that aim at balancing the need for oversight with the potential risks of different types of financial institutions.** The basic principle of these frameworks is

the recognition of three main types of microfinance institutions, which are categorized according to the level of potential risk for the system and for clients:

- Entities that channel concessional funding from donors to borrowers (lowest risk)
- Entities that also take loans from other financial institutions, such as local banks and institutional investors
- Entities that are allowed to raise deposits from clients, which are regulated and supervised under the same framework as commercial banks

161. **The GoA is evaluating the possibility of transforming MAFF into a full-scale commercial bank.** This move is very ambitious as it considers the privatization of MAFF as a cooperative, extensive branch expansion (double its current network). It also considers the development of new savings and loan products. The GoA should evaluate the possibility of transforming MAFF into a credit and savings institution rather than a full-scale bank. This move would enable MAFF to raise deposits while maintaining a structure that is more akin to its social goals and geographical focus.

162. **As donor funding declines and donors demand more sustainability, institutions will need to consider mobilizing additional capital and funding sources.** Most of the institutions are approaching several options for securing additional funds, which include loans from local banks, loans from other financial institutions (foreign or local), funds from other development institutions or donors, and loans from governments of other countries.

Table 16. Targets for further development of Microfinance and Credit Associations

	Priority	**Short-Term and Medium Term**	**Long-Term**
Microfinance	Medium	Adopt a new legal framework for microfinance Consider making MAFF a credit institution instead of a bank and ensure that they operate in a commercial manner with adequate governance and regulatory framework	
Credit Unions	Medium	Work with donors and IFIs to identify additional sources of funding and technical assistance to credit unions aimed at agriculture, rural, and microbusinesses (high priority)	

Facilitate the Development of new instruments

Leasing

163. **Given that leasing can potentially become an important area of growth in the financial sector in Albania**, any residual tax discrimination against leasing activity for industrial and agricultural machinery and business equipment (e.g., computers) should be eliminated to increase diversification of leasing applications. Development of the leasing sector will depend to a great extent on the elimination of uncertainties related to tax treatment of financial leases. Whereas the legal framework for leasing was strengthened, the fiscal treatment of leasing remains unclear, especially in relation to the treatment of VAT. Furthermore, lack of awareness by companies and limited incentives for banks to introduce new products also limit the prospects for leasing in Albania.

164. The minimum capital requirement for leasing firms that are subsidiaries of commercial banks is lek 100 million (about US$1 million). This figure is smaller for independent leasing firms (lek 20 million, or US$200,000). In comparison, other countries in the region have lower capital requirements (e.g., €100,000 in Serbia) or none at all.

Factoring

165. **Factoring market development should be promoted as a basis for easing SME liquidity challenges.** This can be done by (i) encouraging better information systems to allow domestic ratings based on payment performance to help with market development and the pricing of factoring packages, (ii) encouraging the banks to effectively implement the planned credit information system for voluntary information exchange, and (iii) promoting additions to the credit information system from nonbank participants.

166. **Inadequate credit infrastructure and creditor rights restrict the potential for development of this sector**. An important factor is that an invoice is not a recognized debt instrument, because it has not been explicitly recognized by the law. The debtor holding an invoice would need to provide additional evidence (e.g., written contract, delivery receipt) in a court of law to prove the existence of debt. This legal void precludes the use of invoices by businesses as full-fledged collateral for working capital loans.

167. **Authorities may consider new instruments such as reverse factoring to reduce the risk of fraud and foster improved intercompany credit**. Suppliers can benefit from streamlined financing mechanisms that provide liquidity in an affordable and expeditious way. The reduction in transaction and operational costs for these companies is also significant. In time, it is expected that the track record built through these transactions will enhance the creditworthiness of suppliers, enabling them to access direct credit from the participating financial institutions. Buyers benefit from a centralized management of their accounts payable to suppliers. Financial institutions benefit from operating a low-risk and low-cost product, which also enables them to access a segment of the market (such as SMEs) that appears underserved, largely due to information asymmetries.

Table 17. Facilitate the Development of New Instruments

	Priority	Short-Term and Medium Term	Long-Term
Leasing	Low-Medium	Reduce the size of capital requirement for leasing companies. (medium) Equalize tax incentives for borrowings regarding deductibility as are available to companies borrowing from banks. (medium) Adopt provisions to permit leasing companies to provision for losses. Allow amortization of VAT. Permit leasing companies to hold reserves. (medium)	Facilitate better awareness of companies about leasing products. (Low)
Factoring	Low-Medium	Recognize invoice as debt instrument, allow businesses with invoices to use them as full-fledged collateral for working capital loans. (medium)	Consider the development of *reverse factoring* mechanism. (low)