

PROJECT

TO THE

ALBANIAN SUPERVISORY AUTHORITY

FOR A

**STRENGTHENING SUPERVISION CAPACITIES OF
THE ALBANIAN FINANCIAL SUPERVISORY AUTHORITY:
FOCUS ON CAPITAL MARKET DEVELOPMENT**

**PROJECT IMPLEMENTATION EXPECTED TO START
WITHIN YEAR 2015**

ABBREVIATIONS AND ACRONYMS

AFSA	Albanian Financial Supervisory Authority
AIFM	Alternative Investment Funds Managers Directive
BoA	Central Bank of Albania
CFCU	Central Finance and Contracting Unit
CIS	Collective Investment Schemes
CPF	Country Partnership Framework
EBRD	European Bank for Reconstruction and Development
EU	European Union
FIRST	Financial Sector Reform and Strengthening Initiative
FSAG	Financial Stability Advisory Group
FSAP	Financial Sector Appraisal Program
FSM DPL	Financial Sector Modernization Development Policy Loan
FSVC	Financial Services Volunteer Corps
IFRS	International Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MIFID	Markets in Financial Instruments Directive
MoF	Ministry of Finance
MTPL	Motor Third Party Liability
NBFIs	Nonbank Financial Institutions
NPLs	Non-Performing Loans
PIT	Project Implementation Team
PSC	Project Steering Committee
SECO	State Secretariat for Economic Affairs (Switzerland)
UCITS	Undertakings for Collective Investment in Transferable

PROJECT DESCRIPTION

The Project *Strengthening Supervision Capacities of the Albanian Financial Supervisory Authority: Focus on Capital Market Development Project*, seeks to support AFSA in strengthening its capacities to supervise the investment funds sector, and the corporate & municipal bonds issuance, and is *expected to be implemented in a period of 36 months*. Implementation will officially start upon signature of the Grant Agreement between Ministry of Finance and the World Bank.

- Albanian Financial Supervisory Authority, is the recipient executing agency, in charge of daily management of project implementation;
- The World Bank initiated the project and supports implementation;
- Swiss State Secretariat for Economic Affairs (SECO), finances the project through a Trust Fund Grant, administered by the World Bank;
- Centre for Financing and Contracting Unit of the Ministry of Finances is in charge of the fiduciary services.

I. STRATEGIC CONTEXT

A. Country Context

Major institutional reforms will be needed to turn AFSA into an effective regulator of the local financial non-bank markets. With new investment fund complexities arising, it is key to improve the organizational structure and capacity of the AFSA. It is necessary that AFSA be supported to enhance its operational and professional capacities, and to upgrade its supervision arrangement of existing and expected capital market activities, i.e. with regard to rapidly evolving investment funds market and expected corporate & municipal bonds public issuances in the near to medium future.

B. Sectorial and Institutional Context

Albanian Financial Supervisory Authority

In 2006 AFSA was established to take over regulatory and supervisory functions from the Insurance Supervisory Authority, the Albanian Securities Commission and the Inspectorate of Supplementary Private Pensions' Institutions. During the years of its operation, the AFSA institutional setup has proven to be ineffective owing to its lack of real independence, severely constrained financial resources, and absence of representation in the law-making process and the acute shortage of qualified personnel.

Major institutional reform was recommended to achieve AFSA's financial and operational independence and enable it to become an effective regulator of the local securities and investment funds market. The package of laws needed amendments included, *inter alia*, (i) abolish the requirements for the AFSA to have its organizational structure approved by the

Parliament (amendments to AFSA Law), and (ii) remove the AFSA from the government employee compensation and benefits structure (amendments to Law on Salaries of Independent Institutions and Civil Servant Law), so to have the ability to attract and retain sufficient experienced technical staff. The legal protection of AFSA's board and staff needed to be strengthened by giving them legal protection for the bona fide discharge of their governmental, regulatory and administrative functions and powers.

The Albanian Parliament approved all the legal changes, paving the way for implementation of actions for strengthening operations and capacities of AFSA. AFSA will proceed with adjusting its structure and remuneration scheme, so to be able to attract professional staff, including young bright candidates, especially to cover areas, such as investment fund supervision that are very insufficiently attended at the moment.

Capital Market Development

From virtually no capital market activities three years ago, Albania has experienced sizable and positive development of specific market segments. This raises prospects for meaningful development of capital market in the future, as well as concerns about the ability of AFSA to regulate and supervise the market. The investment funds sector, emerging in 2012, has grown remarkably fast reaching close to 5% of GDP. Several corporations have issued bonds, albeit through private offers, and market sources indicate for increased interest on public issuance of corporate and municipal bonds. Despite having a basic regulatory framework in place, AFSA lacks adequate staffing and technical capacity to supervise the current market, let alone the prospective wider and more diverse activities.

Investment Funds Sector

The investment funds sector in Albania has gone through a dramatic structural change in less than three years. Investment funds had no presence in Albania before December 2011 when Raiffeisen Invest was provided a license to start its first investment fund, the Raiffeisen Prestige Fund, which invests exclusively on government treasury bills and bonds. A second fund, Raiffeisen Invest Euro fund was subsequently added. In about three years, these two funds have now grown to an impressive total net-asset value of EUR 470 million at the end of March 2015, with close to 33,000 investors (overwhelmingly individuals). In GDP terms, investment funds in Albania amount to 4.6% of GDP, as of the end of 2014. While the funds size has grown sharply, AFSA has not been able to commensurately improve its supervisory or regulatory capacities.

While recently established investment funds helped to diversify holdings of government securities in the financial system, their fast growth gives rise to potential systemic risk in the country. As the investment funds are in an early stage of development, it is essential to put in place a framework that helps ensure that key risks are understood (by fund management and by its customers) and contained, while also striking an appropriate balance between the need to foster market development and ensure financial stability.

The investment fund sector is regulated by a comprehensive legal framework, adequate to the current level of market development, notwithstanding the noted gaps on liquidity

policy, and unit valuations. The investment fund sector is regulated by Law “On collective investment undertakings”, but other laws such as the Law “On Financial Supervisory Authority” and Law “On Securities” are relevant for the regulation of the investment fund sector. There are in addition about ten different sets of regulations issued by AFSA of relevance to the regulation of the sector (which can be found at AFSA webpage: <http://amf.gov.al/ligje.asp>). Despite the above, the proposed project will assist AFSA in upgrading the legal framework. As investment funds extend beyond government securities into riskier instruments there is a need to (i) enhance and detail the regulations of investment funds to address market needs, and also update the compliance with amended/new EU related directives; (ii) solve any related deficiencies/incompatibilities of the investment funds legislation with the general securities market legislation.

There is an acute need for the AFSA to upgrade its supervision of Investment Funds Management companies and Investment Funds. For all practical purposes, this represents a new mandate for the AFSA with its limited supervisory resources. The investment funds industry, considering their current size and concentration in Albanian government securities, poses serious systemic risks and might become a burden for financial system and the country if it is not properly supervised. The legal and supervisory framework and requirements for consumer disclosure, funds units/shares distribution, custody, investment advising, etc., should be strengthened in compliance with IOSCO principles and with EU directives, especially the EU UCITS, MIFID, and AIFM directives. This would help to contain the risks and ensure a sound future development. As the ability of AFSA board to adopt its own structure and establish attractive remuneration is made effective, new, dedicated investment fund management staff are necessary to be hired and trained, and arrangements made in by-laws or internal guidelines for off-site and on-site supervision. The key goal of this proposed support is to assist AFSA in developing its institutional and professional capacities to supervise and regulate the investment funds sector.

Corporate and Municipal Bonds Issuance

Considering the rapid development of investment fund sector since 2012, AFSA expects other capital market activities to emerge in the near to medium-term, especially as it regards the issuance of corporate and municipal bonds. The regulatory framework on corporate and municipal bonds issuance and trade includes the Securities Law, the Corporate and Municipal Bonds Law and respective bylaws. The Bonds Law has been in place since 2009 and in broad accord with (then) best practice. Despite this, a few areas in the legislation base need to be improved in short term to facilitate eventual bond issuances.

As the EU directives and international standards related to capital market have evolved substantially in the past five years, there is a need to review the current bonds related legal framework and lay the ground for substantial changes to this framework in the future, in line with expected market developments.

This proposed project will assist AFSA to upgrade its capacity to properly respond to forthcoming bonds issuance applications. In the short term, there is a need to focus on the building capacities at AFSA to duly assess the merits of a bond issuance application (especially

on public issuances), prepare a guideline for application approval by AFSA, and amend the legal framework to fix perceived gaps that hinder a smooth process of bonds issuance.

II. PROJECT DEVELOPMENT OBJECTIVES

The development objective of the project is to support AFSA in strengthening its capacities to supervise the Investment Funds sector, and the Corporate & Municipal Bonds issuance. SECO funding is expected to cover two specific areas:

Area 1: Develop capacities of AFSA to supervise and regulate Investment Funds sector;

Area 2: Develop capacities of AFSA to prepare for corporate bonds & municipal bonds issuance;

Project Beneficiaries

The Albanian Financial Supervisory Authority is the direct beneficiary of this project, while the Government, as well the Bank of Albania have a clear stake in the sound development of the non-bank financial markets.

Level Results Indicators

The proposed development objective is expected to achieve the following results:

Result 1: AFSA is equipped with a comprehensive supervision methodology and practices for investment funds as well as related operational manuals and tools.

Result 2: AFSA is better able to support development of the corporate & municipal bonds market through improved regulatory framework.

Result 3: Professional and human resources of AFSA to supervise capital market activities are strengthened through on-site and off-site capacity building activities.

III. PROJECT DESCRIPTION

A. Project Components

The assistance envisioned under this proposal aims to support AFSA in strengthening its capacities to supervise the Investment Funds sector, and the Corporate & Municipal Bonds issuance. This project will cover two specific components:

- ***Component 1: Develop capacities of AFSA to supervise and regulate Investment Funds sector.*** Under this area the following Technical Assistance will be delivered:

- a. Sub-component 1: Perform an assessment of the supervisory needs of AFSA with regard to the rapidly developing Investment Funds sector, in terms of:
- i. Current local legal framework (law & bylaws), and existing supervision arrangements;
 - ii. Current and expecting EU regulatory and supervisory development, as well as applicable IOSCO principles
 - iii. Current and expected local industry development
 - iv. Current and prospective staffing functions and requirements (quantity & quality)
 - v. Overall fitting of investment fund supervision with the other supervisory directions of AFSA (ie, insurance, private pensions, other capital market activities)

The proposed activities will include: (i) Assess the development path of the investment funds market and prepare a policy paper with regard to licensing of investment funds and market development; (ii) Assessment of current organizational arrangements and identification of shortages and proposal for changes; (iii) Assessment of current staffing and training needs and preparation of a Staffing Development Strategy and a Training Program.

- b. Sub-component 2: This sub-component will assist AFSA to (i) develop the investment funds sector supervision methodology, manuals and tools; (i) prepare the necessary legal acts and amendments related to the upgraded supervision methodology; (iii) upgrade its ability for crisis scenarios management.

The following key outputs are expected with regard to the supervision of the investment funds:

- i. Detailed analysis of the legal base as per compatibility with current and expecting EU regulatory and supervisory development, as well as applicable IOSCO principles;
- ii. Revised investment funds legislation framework;
- iii. Proposal of the on and off-site supervision methodology for investment funds sector that takes into consideration the current and expected medium term market development
- iv. Development of off-site documents and tools, including:
 1. Market participants licensing regulation and toolkit
 2. Investment Funds Prospectus evaluation toolkit
 3. Reporting templates for market participants
 4. Off-site analysis manual
- v. Development of the draft of on-site inspection manual for investment funds sector

The activities foreseen under this sub-component include: (i) Detailed Legal and Supervisory Framework Review; (ii) Preparation of the supervision methodology and early warning system; (iii) Preparation of the new drafts/amendments to the related legal acts and regulations; (iv) preparation of evaluation toolkit for investment funds prospectuses; (v) Support strengthening the implementation of inter-agency coordinated crisis management protocols and capacities to manage crisis situations.

- c. *Sub-component 3: Develop Professional and Human Resources capacities of AFSA.* Based on the identified needs and on the supervision approach for investment funds, this component will provide support along three lines:
- i. On-job training – a resident advisor will be established at AFSA to provide on-job regulatory and supervisory training and guidance to AFSA for a one year period, subject to possible extension. This experienced advisor will work hand by hand with the AFSA management staff, in implementing and making functional outputs of sub-components 1 and 2, as well as advise on policy and supervisory decisions and actions of AFSA. The resident advisor will also assist AFSA to establish a mechanism for maintaining the sustainability of the training program in the future. This will include among others preparation of toolkits to be used in the future.
 - ii. Gaining expertise and experience through: (i) trainings hosted at/by (a) supervisory agency(ies) selected among European countries with relevant and positive history and capacities. Such exchange might also be extended into field/practical case support by the foreign supervisory agency through short time assignments of its experts, and possibly, organizing secondment opportunities for AFSA staff and (ii) tailor made training workshops delivered to AFSA on specialized issued. Short term expert consultants will be hired to deliver such trainings.
 - iii. Fund AFSA staff submitting exams and acquiring recognized investment knowledge certificates. Supporting AFSA staff to acquire professional certificates will help to motivate them (both new and existing staff) and to also to acknowledge their learning progress:
 1. For more junior staff, “lighter” programs might be considered, such as the Claritas Investment Certificate of CFA Institute (www.cfainstitute.org/claritas)
 2. For staff of more advanced knowledge and experience funding of CFA Certification Program attendance might be considered (www.cfainstitute.org/cfaprogram).

Both CFA designation and Claritas certificate are awarded by CFA Institute, world’s most prestigious investment management organization, upon absorption of a comprehensive body of knowledge. Candidates submit rigorous exams to test their knowledge.

The training program should strike the right balance between technical vs. process issues. Sub-component 3 will also touch on tangible objectives related to the EU legislation reference, such as meeting EU UCITS standards and aligning regulation with EU’s MiFID and AIFM directives, etc.

While the implementation of sub-component 1 will precede the other components, sub-components 2 & 3 are expected to start simultaneously, with the third component extending well past closure of sub-component 2.

- ***Component 2: Develop capacities of AFSA to prepare for corporate bonds & municipal bonds issuance.***

Sub-component 1: Perform a review of current corporate & municipal bonds regulatory and supervision framework and recommend changes in two levels:

- Quick fixes in AFSA bylaws that would enable it to adequately and properly handle applications for bonds private or public offers in the near to medium future;
- Long term changes to the legal, regulatory and supervisory framework to bring it in line with the evolved local and EU legislation, and international standards. Implementation of long term changes would be tackled at a later stage and it will not be part of this SECO funding application.

Specifically, this sub-component is expected to include the following activities: (i) Assess the current situation in Albanian market for bonds and evaluate the potential for its development; (ii) Review the existing issuance application process for bonds and propose the necessary improvements to the current related regulations and procedures. (iii) Perform a comprehensive gap analysis of the current legal framework for bonds with EU legislation and international standards, and propose a mid-term road map aiming at narrowing the gaps identified; (iv) Support development of a bond law and related by-laws as necessary.

- Sub-component 2:* provide capacity building to AFSA to increase knowledge on debt instruments and markets.
 - Activities would include specific tailored training sessions to AFSA staff on topics such as debt instruments, risk factors, issuance, trading, development of proper prospectuses, valuation methodologies for this market, pricing (e.g., premium or discount against par and how to assess), cash flow based pricing, etc., as well as approach from supervisor's perspective.
 - Additional training activities will be needed to handle in practice bond offers applications at AFSA. The resident advisor (selected under sub-component 3, of component 1) will allocate part of its time to train AFSA staff on this topic. The cooperation with the selected supervisory agency (ies) will include as needed exchange of experience on handling bond issuance applications.

This component is strongly linked with the capacity building activities envisaged under the Investment Funds support (sub-component 3, component 1) due to the wide overlapping of bodies of knowledge. AFSA staff receiving training on general capital market issues, and also participating in certification examinations, will also as a by-product increase their knowledge on debt instruments and markets.

IV. PROCUREMENT AND FINANCIAL MANAGEMENT

Economic and Financial Analyses

This project originates from the need to support gaps identified through FSAP which was carried in autumn 2013. The need to strengthen the independence and capacities of AFSA, and reduce the risks of the investment funds sector was among the findings of FSAP. The main benefits for Albania of this project will be: (i) a stronger and more competent Financial Supervisory Authority; (ii) enhanced stability of the financial sector; (iii) a better and more stimulating environment for government and private sector debt demand (domestic and foreign); (iv) increased compatibility of the Albanian financial sector legislation framework with the EU directives.

Technical

The rationale for the selected project design is based on the idea of supporting AFSA to enhance its capacities to supervise the capital market activities, especially the investment funds and the bonds issuance. The project will focus on: (i) assessing in detail the capacities of AFSA to supervise the investment fund sector; (ii) upgrade the investment funds legal and supervision framework; (iii) improve as necessary the AFSA regulatory base and processes related to corporate and municipal bonds issuance; (iii) support enhancement of the professional and institutional capacities of AFSA as related to above mentioned capital market activities.

The activities selected jointly with the AFSA, are indicated as the key building blocks for a healthy capital markets supervision regime and as the main priorities that will reduce financial sector risks and enable a healthy development of capital market activities.

Procurement

Fiduciary aspects of the trust fund management, including procurement and financial management, will be handled by the Central Finance and Contracting Unit (CFCU) at the MoF, primarily responsible for implementation of the EU IPA funds. CFCU has experience in managing fiduciary aspects of the World Bank's existing Integrated Planning System Multi-Donor Trust Fund, and the closed Corporate Financial Reporting Enhancement Project (CFREP) among others. This well established unit has an adequate financial management and procurement capacity to manage an additional donor trust fund. The fiduciary arrangements will be further assessed and confirmed during the project appraisal.

Procurement for the project will be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" published May 2004 and revised in October 2006 (Procurement Guidelines); and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" published May 2004 and revised in October 2006 (Consultant Guidelines) and the provisions stipulated in the Grant Agreement. The overall risk for the project after mitigation is rated "substantial". Annex 8 provides details on the risks associated with procurement, the mitigation measures, the initial procurement plan and the relevant procurement arrangements for the project.