Albania
Regulatory Impact Analysis on the draft law on Corporate and Municipal Bonds

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1 Introduction

The project aims at assessing the impact of the provisions to be introduced by the draft law on Corporate and Municipal Bonds on the Albanian securities market, at identifying and assessing the problems arising out of the new legislation, with reference to the local government, and at proposing recommendations on how the new legal framework can be improved and implemented in the best and most effective and efficient way possible.

It takes place in the framework of the activities carried out by the EBRD to assist the Albanian Securities Commission (now Financial Supervisory Authority) of the Republic of Albania in drafting new legislation providing corporations and municipalities with alternative means of raising debt capital and finance their investments.

The OECD reference checklist for regulatory decision-making (and subsequent adaptations to transitional countries by the SIGMA EU/OECD program) was adopted in assessing the draft law on Corporate and Municipal Bonds. Two municipalities: Fier and Kruja and three banks operating in Albania were selected and interviewed for understanding problems raised by the draft law.

Paragraph two of the report gives account of the methodological choices. Paragraphs three and four analyse the Albanian context, either with reference to the situation of local governments and local public finance or with reference to the existing and more recent legislative provisions. In paragraph five, the two municipal case studies are described including information drawn from documental sources and interviews to the mayors and technical staff. In paragraph six, the results of the Regulatory Impact Analysis of the draft law are highlighted, including those coming out of the interviews to the banks, and changes suggested.

2 Methodology

This paragraph is dedicated to some methodological choices made in assessing the draft law. Two methods of analysis were used: the Regulatory Impact Analysis and the case-study analysis.

The information sources for suggesting changes and improvements to the draft law were drawn from:

- a comparison with the existing Albanian regulations on the matter;
- a comparison with regulation in force in EU countries and subsequent experience gathered in its implementation in the past years;
- an assessment of the impact that the draft law would have on the Albanian municipalities (considering the specific characteristics of the Albanian local finance and analysing the point of view of municipalities and banks).
2.1 The Regulatory Impact Analysis method

Several methods exist to ensure that regulations operate efficiently to boost economic growth, social welfare and environmental standards and to avoid the risk of introducing sub-optimal laws and regulations. This can mean that legal norms:

- cannot be implemented because institutional capacities are not up to the task, or sufficient budget funds are not available;
- impose unnecessary costs on society or the economy leading to loss of competitiveness;
- are not judicable because of the quality of legal drafting or the capacity of the justice system;
- open up opportunities for abuse and corruption;
- introduce bias in favour of certain actors;
- or simply do not achieve their goals.

Impact assessment is designed to improve the quality of information available to decision-makers and the Regulatory Impact Analysis (hereinafter called RIA) is one of the most adopted ways of assessing the positive and negative effects of a regulation. It is evidence-based, drawing on consultation with affected groups and assessing economic, social and environmental impacts.

RIA is an assessment of the likely effects of a proposed new regulation or regulatory change. It involves a detailed analysis to ascertain whether or not the new regulation would have the desired impact. It helps to identify the side effects and any hidden costs associated with regulation. RIA clarifies the desired outcomes of the proposed regulatory change. It also provides for consultation with stakeholders to ensure that their views and interests are understood during the regulatory process. OECD Member countries have found that the quality of their legislation can be greatly enhanced if certain issues are specifically addressed.

Common post-drafting policy assessments in developed countries are based on the OECD Reference Checklist For Regulatory Decision-Making, issued on March 1995 by the OECD Council. This checklist has also been adapted to central and eastern European countries by the SIGMA program.

Based on the aforementioned recommendations on the questions to be asked when regulatory action is under consideration as well as on the experience developed in other countries, the following regulatory checklist has been defined for assessing the impact of the draft law on Corporate and Municipal Bonds.

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3 It includes the following items: A. policy checks; B. law drafting organisation; C. drafting primary legislation; D. drafting secondary legislation; E. specific verifications of draft legislation; F. publication of legislation. Cf. SIGMA (1997), Checklist on Law Drafting and Regulatory Management in Central and Eastern Europe, Sigma Paper No. 15.
Box 1: Regulatory checklist adopted for the draft law on Corporate and Municipal Bonds

1. **Terminology**: Is the law object correctly defined? Is the regulation clear, consistent, comprehensible, and accessible to users? Is it drafted in such a way as to be easy to understand and work with; to be clear in the way its contents are set out; to avoid unnecessarily legalistic terms; and to be written in language of standard usage by the public affected by the legislation?

2. **Rationale for intervention**: Is government action justified? Is regulation the best form of government action? Is there a legal basis for regulation? What is the appropriate level of government for this action? Do the benefits of regulation justify the costs?

3. **Compliance with the existing law and legal system**: Does the text of the draft comply with the requirements of the Constitution? Is the new legislation required or can the matter be dealt with under existing law or by other means not requiring legislation? Is the text of the draft consistent with existing law, legal structures and procedures? Is it consistent with EU law?

4. **Participation and stakeholder involvement**: Have all interested parties had the opportunity to present their views? Have formal arrangements been made to afford opportunities to the general public to comment upon legislative proposals or draft legislation, in particular stipulating how the attention of the public is to be drawn to legislative proposals and how their responses are to be sought, made and considered?

5. **Impact checks**: What is the costs and economic impact of the draft law? What counterproductive effects or unintended and inappropriate consequences may it lead to? What are the expected benefits of the new legislation, in particular the shortcomings of the existing law and how the new scheme will help to improve the situation? Could the draft law lead to opportunities for corrupt practices in local administrations?

6. **Implementability**: Are the human, institutional and financial resources that will be needed to give effect to the draft law in place?

7. **Secondary legislation**: Does the draft law identify the secondary legislation that has to be prepared for the purpose of implementing it?

The checklist is designed to provide a practical tool for all those in charge of setting up or revising the drafting process. It therefore covers not only questions concerning the regulation itself, but also organisational and staffing issues.

The answers to all the questions in the regulatory checklist, no matter how and when they are obtained, are important for the work of the law drafter.

Question two of the checklist has been addressed and dealt with in previous EBRD work such as, for instance, the “Advisory Support to the Albanian Financial Authority on drafting the new law on bonds (Action Plan - Phase I, December 12th, 2006)”.

4 It can be consulted on the EBRD website at: [http://www.ebrd.com/country/sector/law/capital/project/bonds.pdf](http://www.ebrd.com/country/sector/law/capital/project/bonds.pdf)
2.2 The case-study analysis

Some of the information necessary for conducting the RIA was gathered through a case-study analysis performed in selected municipalities and banks and aimed at understanding the impact of the draft law on Corporate and Municipal Bonds on the Albanian market and on local governments.

The case study research was based on the triangulation strategy, which consists in integrating document analysis, participant observation and semi-structured interviews, in order to obtain a more comprehensive understanding of the potential use and attractiveness of municipal bonds as alternative means of raising debt capital and of financing territorial development.

The interviews were semi-structured and were conducted in October 2008.

Regarding municipalities, both opened and semi-structured interviews were conducted to the major and staff of the Fier and Kruja municipalities.5

Regarding banks, a semi-structured questionnaire was sent via email to all the banks operating in Albania:6

- Banka Alpha
- Intesa Sanpaolo Bank Albania
- United Bank of Albania
- CredinsBank
- Italian Development Bank
- Emporiki Bank
- National Commercial Bank
- National Bank of Greece
- International Commercial Bank
- Credit Bank of Albania
- Popular Bank
- First Investment Bank
- ProCredit Bank
- Union Bank
- Raiffeisen Bank
- Tirana Bank

Three replies to the questionnaire were received by the date of completion of this report, which were used in an anonymous way. The banks pertain to G1 and G3.7

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5 Interviews to municipalities were based on questionnaire 1 available in Appendix 1.
6 Interviews to banks were based on questionnaire 2 available in Appendix 1.
7 The G3 (private banks) includes the largest banks, while G1 (state-owned banks) and G2 (joint-venture banks) gather respectively the small and medium-sized banks.
3 The policy context

3.1 Local finance in Albania

Albania has undertaken major reforms in its system of local government finance since 2000. What had been a system in which local functions were ambiguous and financing was largely provided through tightly controlled earmarked grants is now one in which functions are relatively clear and local governments have more autonomy over the allocation of funds.

Local governments derive their revenues from a variety of sources.

Roughly half of local government revenues come in the form of conditional (earmarked) grants. Discretionary revenues increased dramatically between 2000 and 2006, partly due to growth in unconditional transfers but also due to changes in legislation, which have increased the taxing powers of local governments. Forty-three percent of discretionary revenues are derived from locally administered taxes and fees.

Figure 1: Trends in level and composition of revenues


9 Albanian local governments provide economic services: principally the maintenance of streets and rural roads and various urban “housekeeping” functions.
The other principal source of local discretionary revenues is unconditional transfers. The core criteria for distributing the grant (total population, urban population, and land area) are reasonably transparent and equitable. The total amount to be allocated to the unconditional grant is largely based on the previous year’s allocation, adjusted on the margin to reflect the central government’s overall budget constraints and the strength of competing claims.

Table 1: Sources of local government discretionary revenues (2007)

<table>
<thead>
<tr>
<th>Source</th>
<th>Revenues (LK mn)</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Taxes, Fees</td>
<td>8,956</td>
<td>43%</td>
</tr>
<tr>
<td>small business tax</td>
<td>2,185</td>
<td>11%</td>
</tr>
<tr>
<td>construction fee</td>
<td>1,872</td>
<td>9%</td>
</tr>
<tr>
<td>cleaning fee</td>
<td>1,022</td>
<td>5%</td>
</tr>
<tr>
<td>property (building) tax</td>
<td>938</td>
<td>5%</td>
</tr>
<tr>
<td>ag. land tax</td>
<td>387</td>
<td>2%</td>
</tr>
<tr>
<td>other fees</td>
<td>2,551</td>
<td>12%</td>
</tr>
<tr>
<td>Unconditional transfers</td>
<td>9,893</td>
<td>48%</td>
</tr>
<tr>
<td>Shared Taxes</td>
<td>1,075</td>
<td>5%</td>
</tr>
<tr>
<td>vehicle</td>
<td>581</td>
<td>3%</td>
</tr>
<tr>
<td>property sales</td>
<td>495</td>
<td>2%</td>
</tr>
<tr>
<td>Non-tax Revenue</td>
<td>725</td>
<td>4%</td>
</tr>
<tr>
<td><strong>Total discretionary revenues</strong></td>
<td><strong>20,650</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>


The principal shortcoming of the current transfer system is its unpredictability.

The main weakness in the Albanian structure of local finance, however, is not the system for financing recurrent expenditures but rather the system for allocating funding for capital works. Municipal capital investments are financed from a variety of sources. Donors finance municipal projects, either directly in individual jurisdictions, or through intermediaries such as the Albania Development Fund. The central government provides counterpart funding for these projects and funds other projects directly from the budget.

Until 2006, central government funding for small scale local investments—in schools, health facilities, water supply, and roads—were allocated by sectoral ministries in the form of conditional grants.

Since 2006, the central government has been experimenting with a system of competitive grants to finance small scale local investments. As of 2007, the competitive grants system therefore governs local capital investments in four sectors: (1) local roads and other municipal infrastructure, (2) water supply, (3) education, and (4) health. Separate grant programs exist for each sector. While the current evaluation process is successful in winnowing technically sound projects out of hundreds of applications,
each program has certain weaknesses. In the case of the municipal infrastructure grant, the problem is a tendency to approve more projects than can be fully funded in the current year. As a result, projects are only partially funded. This results in costly delays and interruptions.

Table 2: Budget Allocations for Competitive Grants (lekë mn)


<table>
<thead>
<tr>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>1,600</td>
</tr>
<tr>
<td>Health</td>
<td>800</td>
</tr>
<tr>
<td>Water Supply</td>
<td>1,000</td>
</tr>
<tr>
<td>General Municipal Infrastructure</td>
<td>1,900</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>7,307</td>
</tr>
</tbody>
</table>

In the very long term, the central government could decrease the allocation of funds for local capital investment and partly share this function with the private capital market. Local governments could identify their own investment priorities and seek funding from private financial investors. Some move in this direction is reflected in the central government’s decision to remove the prohibition on local government borrowing and substitute limited borrowing powers.

The new local government borrowing law imposes some quantitative controls on the volume of local borrowing. However, in the absence of central government guarantees, the private financial sector is likely to limit its exposure to long term local government debt.

However, in the short term, the issue is considered as highly controversial. It is not clear that the financial sector is prepared to play a major role in local infrastructure financing any time soon. Although the Albanian banking system has made remarkable progress since the 1997 crisis, lending to municipalities for infrastructure projects presents particular risks as their physical assets make poor collateral and lenders may also be justifiably distrustful of making loans that extend beyond the tenure of the existing mayor and council, fearing that winning candidates would renege on the obligations incurred by their predecessors.

In principle, local governments could provide some reassurance to lenders by pledging revenues. The borrowing law gives local governments the authority to pledge specific revenues for debt service and to authorize the Treasury to pay debt service directly to creditors by deducting it from unconditional transfers. This is usually practiced in EU

10 See paragraph 4.
12 State owned banks have been gradually privatized and there has been an increase in the number of private banks (from four in 1997 to 17 in 2006). As a result of enhanced confidence in the domestic banking system, the ratio of banking assets to GDP has increased to 70%.
countries – for instance, in Italy – but carries some risks. With debt service guaranteed by a Treasury intercept, lenders may be lax in assessing the debt servicing capacity of local government and may extend more credit than local governments are able to repay.

3.2 **The bond loan financial strategy**

The mid and long-term borrowing by local governments, here considered in the technical form of bond loans, is motivated by the need to find funds additional to those coming from traditional financial sources (transfers from other levels of government, donations, operational and general surplus) to cover the acquisition and long-term investment realization costs.

The criteria for selecting a financial instrument include the following:

- The identification of the project to be financed
- An assessment of the indebtedness capacity
- A comparative analysis of the financial instruments available.

The first stage concerns the prioritization between the different investments included in the mid or long-term development plan. Secondly, the indebtedness capacity should be assessed: this proves particularly difficult in the longer term as it depends on interest rates and on operational revenues, which could be both variable.

Only at this point, the comparison between the different financial instruments available can be made weighing up own revenues, operational surpluses, revenues generated from asset sales, building permits, etc., transfers from the State or international / foreign donors, municipal bonds or bank loans, etc. In particular, the comparison between banking loans and municipal bonds considers the procedure easiness and timing and the costs. However, in the longer term, the interest rate is the parameter making the difference between the two.

Usually municipal bonds come in two varieties: general obligation bonds and revenue bonds. The former, issued to raise immediate capital to cover expenses, are supported by the taxing power of the issuer. Revenue bonds, which are issued to fund infrastructure projects, are supported by the income generated by those projects.

The Law nr. 9869, date 4/02/2008, article 4, paragraph 2, bullet ii) identifies the possibility to issue a debt to refinance an already-incurred loan, provided that the new debt has a longer maturity than the debt being refinanced. In that case, furthermore, the debt shall be subject to the approval of the Ministry of Finance (article 7, paragraph 6).

Loans, no matter the type or the duration, are characterized for being “charged funding”, implying, beyond collateral costs, the obligation to pay down the fund and to pay interests according to a fixed or variable rate.

The bearing by the local government of the costs following a medium long term loan is justified because, without these financial resources, it would not be possible to enhance the social and economic development through public investments.
In practice, a significant increase of the long term local public investments (local government fixed assets) is indissolubly related to the availability of non current revenues, different from those necessary for ensuring the normal functioning of the administration and the current delivery of local public services.

It should be noticed that only increasing the volume of long term public investments, especially the infrastructural ones, it is possible to enhance the quantity-quality levels of the services provided to the local communities.

On the other hand, capital expenditures financed through bond loans not only imply burdens connected to the debt service, but also contribute to increase the current expenditure.

In other terms, the subsequent management and maintenance of the long term public investment, however it is funded, has operational costs and implies current expenditures.

This means that the local government should attentively verify not only its capacity to pay the debt service for all the duration of the loan (that cannot exceed the useful life of the investment being financed), but also its capacity to manage and maintain the investment with its current revenues.

For instance, it could be financially sustainable for a local government to build a street or a public park through the issuance of bonds, because the future revenues will be sufficient to pay the debt service; however, before issuing the loan, a financial plan should be defined that verifies the availability of sufficient resources for the realization of the investment, its maintenance and management in the following years, avoiding further borrowing.

Other types of investment may generate revenues such as, for instance, sport facilities. In these cases, the investment financial plan should consider beyond the expenditure flows for the repayment of the bond loan (capital and interest) and the current expenditure for managing the investment, the positive financial resources that the investment may generate.

The qualitative-quantitative correlation between bond loans and long-term investments does not only depend on the lack of financial resources in absence of loans, but is essential for ensuring the sustainability of the financial equilibrium of local governments.

In other words, it is not acceptable that the resources obtained through a bond loan be used for covering current expenditure, as correctly regulated by the Albanian law. When the result of the current operation (current revenues > current expenditure + capital instalment of the long-term bond loan) or of the general operation (total revenues > total expenditures) is positive, it can contribute to the funding of the investment.

The article 4 of the law nr. 9869/2008, correctly states that the long-term debt can be issued by a local government to finance capital investments that serve as an essential local government function.
However, connecting the term capital investments, here interpreted as the accounting concept of tangible fixed assets, to an essential function of the local government may raise some interpretative problems.

While the functions performed by a local government are listed by the law (chapter IV of the law on local government n. 8652/2000), the adjective essential may suggest that some functions are more essential than others.

This may lead to a subjective assessment by the Council as well as of the Ministry of Finance that approves the decision of the local government to issue a long-term loan.

On another note, neither the draft law, nor the law on local borrowing specify if the local government can issue a bond loan to fund one or more than one fixed material asset.

Although the amount of the loan cannot exceed the amount of the investment to be realized, it could make sense to collect financial resources for funding a plurality of investments to be realized contemporaneously by the same local government. In that case, a single investment plan and a single resolution shall be approved by the local council. The whole amount obtained through the bond loan could be fragmented in more than one investment without violating the provision that establishes the duration of the bond loan lower than the useful life of the investment. That requirement will, in fact, be extended to all the investments included in the plan.

4 The regulatory framework on municipal bonds in Albania

According to the point n. 3 of the RIA checklist described in paragraph 2, one of the most critical aspects of new laws conditioning the quality of regulation is their compatibility and consistency with existing regulation.

To this end, this paragraph describes the most relevant existing regulations and compares them with provisions included in the draft law. Conclusions of this analysis and suggestions on how to improve the draft law are offered in paragraph 6.

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**Box 2: Municipal bonds – Legislative framework in Albania**

- Nr. 8652, 31.07.2000 “Per organizimin dhe funksionimin e qeverise vendore” – Law “On the Organisation and Functioning of Local Governments”
- Ligji Nr. 9869, 04.02.2008 “Per huamarrjen e qeverise vendore” – Law “On Local Government Borrowing”
- Ligji Nr. 9936, 26.06.2008 “Per menaxhimin e sistemit buxhetor ne Republiken e Shqiperise” – Law “On the Administration of the Budgetary System”
The draft law is part of a comprehensive reform which is being recently undertaken by the Albanian authorities: a new Law on Securities, a new Law on Local Government Borrowing and a new Law on the public budget system were enacted in 2008.

Beyond these recent regulations, the Law “On the Organisation and Functioning of Local Governments” enacted in 2000 is relevant for the bond loans issued by Albanian local governments and therefore in assessing the draft law “On corporate and local government bonds” (version August 21st, 2008).

The Law on Organisation and Functioning of Local Government (Organic Law, passed with 3/5 of the Parliament votes) n. 8652/2000 regulates the organisation and functioning of Local Government Units in the Republic of Albania, and also sets forth their functions, powers, rights and duties.

Article 6, paragraph 2, identifies the representative body of communes and municipalities in the Council.

Chapter V, article 15 on Local government finance states, as one of the fundamental principles of local government finance, that the national fiscal policy shall guarantee the fiscal self-sufficiency of local governments through diversified sources of revenue.

Article 19, paragraph 6, bullet c) states that one of the purposes of the local government budget is to provide information enabling the residents of the local jurisdiction to understand and participate in decisions regarding the exclusive, shared and delegated functions of the local government.

Finally, articles 21 and 22 are dedicated, respectively, to internal and external financial controls. Internal financial controls are performed by a Finance Commission appointed by the local council, which has full access to all accounting documents, including the tax rolls, and controls the revenues and expenditures made by the executive body, in compliance with the budget adopted by the local council. External finance controls are performed by the High State Control, based on the principle of legality of use of financial resources.

The Law n. 9572/2006 on the Financial Supervisory Authority (Autoriteti i Mbikëqyrjes Financiare or AMF) gives the AMF the authority to prepare the secondary legislation (articles 13 and 14). In our view, the AMF could provide some secondary regulation also for implementing the draft law on municipal bonds.

The Law on Local Government Borrowing (9869/2008) is one of the most relevant regulations with reference to municipal bond loans.

The law has several valuable features. First it defines debt broadly, to include any monetary obligation or liability created by a financing agreement, the issuance of securities, or a guarantee to third parties. As such it closes several loopholes which have been a source of problems in neighbouring countries.

Article 3 provides two definitions: those of long-term debt, which is payable over a period of one year or more, and short-term debt, which is payable within a period of less than one year.
In article 4, the purpose of the debt is specified distinguishing between short-term debts, issued to address temporarily finance cash flow budget deficits and long-term debt, issued to finance capital investments or to refinance outstanding long-term indebtedness issued pursuant to finance capital investments.

According to article 6, a local government may incur short-term debt only following a negative reply by the Ministry of Finance to finance the temporary budget deficit through interest free or soft loan from the state budget.

Chapter II, article 6, attributes the authority to issue a short-term debt to the local council. Article 7 attributes the authority to issue long-term debt, again, to the Council of the local government. The decision, it is specified, should be approved by a majority of the members of such Council at a meeting of the Council that is open to the public. Also article 30 states that the Mayor and any other local government official are authorized to take any actions necessary for, or incidental to, the issuance of debt.

In article 7, paragraph 2, the elements of the Resolution of the Council authorizing the debt are listed, including: the principal amount of the Debt; the interest rate; the form of the Debt; the maturity and repayment terms; the purpose for which the Debt is being issued; the source of security for the payment of the Debt, including a description of any pledged revenues; evidence of compliance with the debt limitation contained in Chapter 4; the “Useful Life” of the facilities being financed from the proceeds of the debt.

The law provides an appropriate level of Ministry of Finance oversight. The law provides that local governments must inform the Ministry of Finance of the issuance of any debt within ten days of doing so. The Ministry of Finance’s responsibility, once it receives this information, is limited to the validation of the local government’s compliance with procedural requirements and debt limitations. Failure by the Ministry of Finance to respond within 20 days of notification constitutes approval. This somewhat detached approach to regulation is desirable as it limits the scope for political interference in what should be the competence of local government: the actual choice of the project to be built.

The law provides for closer scrutiny in three cases: debt issued to refinance existing debt, debt issued by a local government that has defaulted within the previous five years, and debt issued in international markets. In these cases, positive approval must be issued by Ministry of Finance (article 66). The higher level of scrutiny in these three cases is justified.

Article 8 recalls the law on securities as applicable to the issuance of Local Government Securities.

Article 10 regulates the use of the revenues derived from the loan issuance, which could be used only for the purposes authorized in the Resolution of the Council for the issuance of debt. Changes to the purpose of the issuance of the debt subsequent to its issuance should follow a precise procedure: the Council shall amend the Resolution with the same procedures that were required for the initial Resolution and obtain the consent of the Lender to such changes.

Finally, the law establishes, in Chapter 4, some quantitative restrictions on short and long-term debts, respectively in articles 17 and 18.
With respect to short-term debt, it limits the stock of debt at any one time to ten percent of revenues from local taxes, fees and shared taxes in the previous year. By excluding unconditional transfers from this calculation, the ceiling is quite restrictive and rightly so.

Box 3

\[ \text{STD}_{t} = 10\% \text{ of TOR}_{t-1} \]

**Legend:**
- STD → Short-Term Debt
- TOR → Total operational revenues = local taxes/fees + shared taxes/fees
- \( t \) → issuance year
- \( t-1 \) → previous fiscal year

Regarding long-term debt, first, the debt service is restricted to 20% of revenues. The second limits the ratio of the stock of debt to revenues to 1.3:1. These restrictions are complementary. The first limits the proportion of total resources that can be used for debt service, but may be distorted by temporary reductions in debt service arising from grace periods and variable interest rates. These are captured in the debt stock: revenue ratio. “Revenues”, in the case of long-term debt, is defined as local taxes and fees, unconditional transfers and shared taxes – a somewhat more liberal definition than applies to short term debt.

The third quantitative ceiling requires an operating surplus coverage ratio (the ratio of operating surpluses to debt service) of at least 1.4:1. For purposes of this calculation, the operating surplus is defined as the difference between: (1) revenues from local taxes and fees, shared taxes and unconditional transfers and (2) unconditional operating expenditures\(^\text{13}\). This is a useful supplementary restriction on local borrowing. The operating surplus indicates the level of a local government’s discretionary resources – i.e., revenues not pledged to wages, pension contributions, recurrent services and other non-interest recurrent obligations – that would be available to service debt in the event of an unexpected drop in revenues or increase in other recurrent expenditures. The specific ratio adopted by the government is fairly liberal. In effect, the 1.4:1 ratio requires a local government to have financial cushion equal to 40% of its debt service obligations. Under these circumstances, a highly leveraged local government could find itself unable to service its debt if it experienced, for example, a relatively minor drop in revenues.

\(^{13}\) Operating expenditures exclude interest payments. The term “unconditional” excludes spending on functions financed through earmarked grants and from competitive grants.
Box 4

(1) \( \text{OS}_{t-1} : \text{debt service} \geq 1.4 : 1 \)
(2) \( \text{debt stock} : \text{TOR} \leq 1.3 : 1 \)
(3) \( \text{debt service LTD} \leq 20\% \) of average \( \text{TOR}_{t-1 \text{--} t-3} \)

Legenda:
LTD → Long-Term Debt
OS → operational surplus = total operational revenues – non conditional operational expenditures
TOR → total operational revenues = unconditional transfer + shared taxes + local taxes/fees
own sources + shared taxes + unconditional transfers
\( t \) → issuance year
\( t-1 \text{--} t-3 \) → previous three fiscal years

Box 5: Example

A local government with revenues of 100 million lekë and current expenditures of 75 million lekë would have an operating surplus of 25 million lekë, permitting debt service of 18 million lekë.

A ten percent drop in revenues would reduce the operating surplus to 15 million lekë, which would be insufficient to cover existing debt service, even if all non-recurrent expenditures other than principal repayments were eliminated.

Source: WB (2008)

The law also provides for measures to be taken if debt, once contracted, is not serviced. Article 23 of the law specifies a series of actions to be taken in the event of fiscal distress. This is defined as a situation in which: (1) the level of accounts payable (including debt service) over 90 days in arrears exceeds 30 percent of the local government budget for that quarter or (2) any short term loans remain outstanding after November 30th of the current budget year. Under either of these conditions, a local government is forbidden to take any decision that “could result in an increase in financial liabilities”, introduce any new public services, or borrow without the approval of the Ministry of Finance. The local government must also prepare a financial rehabilitation plan and submit regular reports on its implementation to the Ministry of Finance. The distress status ends only after the local government has run a budget surplus (or at least avoided a deficit) for two years in a row and the Ministry of Finance finds that the local government has “taken actions sufficient to eliminate the original source of problem”. The law also makes a provision for a more severe financial condition, termed insolvency.

But there is negative side to such provisions. They can open the door to politically-motivated central government involvement, e.g., in deciding whether a particular local government decision “could result in an increase in financial liabilities” or whether a local government has “taken actions sufficient to eliminate the original source of problem”.
The **Law on securities** (9879/2008)\(^{14}\) regulates the different financial instruments, the ways and conditions for their issuing, etc. It is applicable to bonds issued by local governments (articles 3 and 5).

Article 16 defines obligations as long-term loans, while article 22 defines State debts as loans having a duration longer than one year. Short-term securities are regulated by article 36; the informative prospect is not required but the issuer must communicate to the AMF, within seven days, information on: the loan, its underwriting and payment; the issuer; the persons responsible.

The deliberation of the issuance of the loan includes, according to article 17, the following elements\(^{15}\):

1. The name and headquarters of the issuer.
2. The principal amount of the debt;
3. The nominal value of the debt.
4. The guarantees for the payment of the debt.
5. The form of issuance and underwriting of the debt.
6. The purpose for which the debt is being issued;
7. The form of the debt and the rights of bondholders.
8. The maturity and repayment terms.
9. The interest rate and the calculation criteria.
10. The value of the joint stock and the percentage of the bond loan.
11. The source of the revenues that will be used to repay the debt.
12. Structure and number of obligations.
13. The conversion rights the bond into other kind of securities.
14. The priority of repayment in case of bankruptcy of the issuer.

Articles 28 and 29 as well as 33 and 34 regulate the informative prospect requested for the public offer of the securities. The mandatory elements are listed in article 29. In particular, information on the financial situation of the issuer for the past three years (and especially the last three months) is required (bullet ç). Furthermore, the name and report of the expert accountant which has certified the financial reports should be provided.

Article 34 limits the requirement to provide the information on assets, financial situation, etc. to only one year, in case of private offer.

Article 33 regulates modifications to the informative prospect; the approval of the AMF is required and the silent-is-consent clause is applied.

Articles 103 and 104 regulate the guarantees provided for the payment of the interests and of the loan.

The **Law on the administration of the budgetary system** (9936/2008) regulates the budget cycle.

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\(^{14}\) Although article 41 (*Neni 41: Përjashtimet nga zbatimi i dispozitave të këtij kreu*) states that articles 27-40 do not apply to bonds issued by the State or the Bank of Albania.

\(^{15}\) Some of these elements are also stated in article 24, including bullets 2, 3, 5, 6, 8 and 9 of article 17.
Article 3, paragraph 20, defines loans and identifies borrowing purpose in investments, temporary lack of liquidity and fiscal deficit. Long-term loans are defined, in paragraph 21, as those having a duration equal or more than one year.

Paragraphs 35 and 36 regulate internal audit activities.

Article 8, on local financial management, states that local governments earn an interest rate by depositing temporary free funds in the public treasury.

According to article 23, in the mid-term macroeconomic assessment report prepared by the Ministry of Finance (which covers the two years preceding the current fiscal year and the three following years), a detailed information on the debt stock of the local governments is provided.

In the following table, the aforementioned laws are compared to the provisions contained in the draft law on municipal bonds. Suggestions on how to improve the letter of law are provided in the following section 6.4.
<table>
<thead>
<tr>
<th>Relevant regulations</th>
<th>Definition and types of bond loans</th>
<th>Decision / deliberation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Draft law on corporate and municipal bonds (21.08.2008)</td>
<td>Definition of bond as a long term security (article 2, paragraph 2, bullet c) and of long-term bonds (bullet gj) as bonds with a maturity &gt; 12 months. Article 64 identifies the two types of loan. Article 66 refers to an outstanding Bond loan: a more restricted type of debt as compared to the one regulated by article 7, paragraph 6 of the law n. 9869/2008.</td>
<td>According to article 65, the decision to issue a Bond loan is taken from the management bodies of the local governments, according to the provisions of Law on Local Government Borrowing. Also, article 69 refers to the management body of the issuer (which, for local governments, means the executive body not the council). The representative body of communes and municipalities shall be the Council (article 6, paragraph 2).</td>
</tr>
<tr>
<td>Law on local government (8652/2000)</td>
<td>Definition of long-term loans in article 3, paragraph 7 (≥ 1 year).</td>
<td>Article 6, paragraph 1; article 7 and article 30 attribute the authority to issue a short-term debt to the local Council.</td>
</tr>
<tr>
<td>Law on financial monitoring (9572/2006)</td>
<td>Definition of obligations as long-term loans in article 16. State obligations have a duration &gt; one year, according to article 22.</td>
<td>Article 29, paragraph DH. The local Council according to article 57.</td>
</tr>
<tr>
<td>Law on local government borrowing (9869/2008)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Law on securities (9879/2008)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Law on the public budgeting system (9936/2008)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Mandatory elements**

  The contents of the certificate of bonds (article 4) include:
  a. the name of the issuer;
  b. the place and time of the Bonds’ issuance;
  c. the nominal value of each Bond;
  ç. the total nominal value of the Bond loan;
  d. the name of the bondholder if the Bond is registered;
  dh. the place, time and manner of redemption;
  e. the signature of the legal representatives of the issuer;
  ğ. the data which is required for the determination of the rights of the bondholders-creditors and in particular the securities of the loan, the conversion right or the right to participate in the gains of the issuer;
  f. the series number of the Bond;
  g. any interest units, if the Bond is interest-baring;
  gj. any rights of the issuer for early
<table>
<thead>
<tr>
<th>Issues in bond loans</th>
<th>Relevant regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Draft law on corporate and municipal bonds (21.08.2008)</td>
<td>termination (redemption) of the Bond.</td>
</tr>
<tr>
<td>Law on local government (8652/2000)</td>
<td></td>
</tr>
<tr>
<td>Law on financial monitoring (9572/2006)</td>
<td></td>
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<tr>
<td>Law on local government borrowing (9869/2008)</td>
<td></td>
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<tr>
<td>Law on securities (9879/2008)</td>
<td></td>
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<tr>
<td>Law on the public budgeting system (9936/2008)</td>
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</tr>
</tbody>
</table>

**Role of the MoF**

- The Minister of Finance can decide to assign to a chartered accountant or state auditor a general or specific audit of a local government which has issued an outstanding Bond loan (article 66, paragraph 3).
- By a decision of the Minister of Finance it is possible to establish specific obligations of the local governments which have issued an outstanding Bond loan (article 66, paragraph 4).
- Debt issued to refinance other Debt, or issued in the international market, or issued by Local government that has been in financial distress during the past five years, shall be subject to the approval of the Ministry of Finance (article 7, paragraph 6).
- Local governments must inform the Ministry of Finance of the issuance of any debt within ten days of doing so. The Ministry of Finance’s responsibility is limited to the validation of the local government’s compliance with procedural requirements and debt limitations. Failure by the Ministry of Finance to respond within 20 days of notification constitutes approval.
- The law also provides for measures to be taken if debt, once contracted, is not serviced (article 23): a local government is forbidden to take any decision that “could result in an increase in financial liabilities”, introduce any new public services, or borrow without the approval of the MoF. The local government must also prepare a financial rehabilitation plan and submit regular reports on its implementation to the MoF.

**Constraints, limits and requirements**

- **Quantitative limits / ceilings**
  - Short-Term Debt shall not at any one time exceed more than 10% of total actual revenues of the local government of the previous fiscal year (article 17). The ratio of operational surplus of the previous fiscal year to the amount of debt service due in any year on all long term debt shall be at least 1.4:1. The ratio of debt stock to total operational revenues shall not be higher than 1.3:1. The amount of debt service due in any year on all long-term debt shall not exceed 20% of the average total actual revenues of the local government of the previous three fiscal years (article 18).
  - The same limitations as law 9869/2008 (article 57): the 1.4:1 and 1.3:1 ratios. Furthermore, total public debt < 60% GDP.
<table>
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<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Procedural limits</td>
<td></td>
<td></td>
<td></td>
<td>A local government may incur short-term debt only following a negative reply by the Ministry of Finance to finance the temporary budget deficit through interest free or soft loan from the state budget (article 6, paragraph 2).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competent bodies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial audit requirements</td>
<td>A Local government which has issued a Bond loan is mandatorily audited each fiscal year by a chartered accountant. The report of the chartered accountant for every fiscal year must be conducted by the 30th of April at the latest, covering the preceding fiscal year and is made available to any Bondholder at the expense and responsibility of the issuer (article 66).</td>
<td>Articles 21 and 22 on internal financial audit (finance commission and certified accountant) and on external audit (SAI and central government), respectively.</td>
<td>Chapter VIII on internal (article 66-68) and external (article 70) audit (not directly referred to borrowing)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes to the (bond) loan program</td>
<td>Changes of the Bond loan program must be approved by the group of Bondholders (article 15).</td>
<td>In the event a Council desires to change the purpose of the issuance of the Debt subsequent to its issuance, the Council shall amend the Resolution to provide for the amended purpose with the same procedures that were required for the initial Resolution and obtain the consent of the Lender to such changes (article 10, paragraph 1).</td>
<td>Changes to the prospect including the aim of the bond ex article 19) are regulated by article 33; the approval of the AMF is required and the silent-is-consent clause is applied.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guarantees</td>
<td>The principal, interests and expenses of the Bond loan can be secured by any kind of security or guarantee, provided by the issuer or a third party as detailed in the Bond loan program (article 38).</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Articles 103-104</td>
</tr>
<tr>
<td>Use of funds</td>
<td>In each case of a Bond loan issue it is mandatory to organise the Bondholders into a group (article 16).</td>
<td>The purpose of the local government budget is to provide information which will enable the residents of the local jurisdiction to understand and participate in decisions regarding the exclusive, shared and delegated functions (article 19, paragraph 6, bullet c).</td>
<td></td>
<td></td>
<td></td>
<td>Article 8 &amp; 60</td>
</tr>
<tr>
<td>Information to and relations with bondholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Prospect’s contents listed in articles 28-29</td>
</tr>
</tbody>
</table>
5 The point of view of municipalities

5.1 Fier municipality

Fier distances 100 kilometres from Tirana and has 82,000 inhabitants. Worthy of note projects of the municipality are an information system, a regulatory plan (PRr), a capital investments plan (PIK) and a participatory budget project (BP).

Fier is the third region in Albania for amount of cash and revenues in circulation.

Municipal assets include:

- Streets (primary 8,000 ml lekë; secondary 21,440 ml lekë; tertiary 58,960 ml lekë).
- 10,857 motor vehicles
- One general hospital, 8 ambulances, 1 public pharmacy, 3 paediatric clinics, 2 maternity clinics, 18 general practitioners centres, each healthcare unit covers 10,000 inhabitants, one civil hospital and one paediatric hospital.
- A municipal theatre having 450 posts.
- A public library with 26,000 books.
- A historical museum.

The last budget for 2008 has been approved by the municipal Council on January 31st, 2008.

Table 4: Fier: budget for fiscal year 2008 (000/Lekë)

<table>
<thead>
<tr>
<th>Total revenues</th>
<th>684 230</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local revenues</td>
<td>433 525</td>
</tr>
<tr>
<td>Unconditional grants</td>
<td>172 188</td>
</tr>
<tr>
<td>Conditional grants</td>
<td>3 300</td>
</tr>
<tr>
<td>Past revenues</td>
<td>61 224</td>
</tr>
<tr>
<td>Past grants</td>
<td>13 993</td>
</tr>
<tr>
<td><strong>Total expenditure</strong></td>
<td><strong>684 230</strong></td>
</tr>
</tbody>
</table>


An increase of 25% of local revenues is forecasted for 2008. This will not come from greater fiscal burden on citizens and businesses but will derive from the improvement of the local tax management system; from the fiscal incentives to promote new businesses; and from a better identification of the tax base.
Table 5: Fier: local revenues

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local taxes</td>
<td>274,435</td>
<td>250,463</td>
<td>248,087</td>
<td>308,380</td>
</tr>
<tr>
<td>Local fees</td>
<td>68,134</td>
<td>62,962</td>
<td>64,408</td>
<td>74,145</td>
</tr>
<tr>
<td>Other revenues</td>
<td>28,563</td>
<td>45,658</td>
<td>26,101</td>
<td>41,000</td>
</tr>
<tr>
<td>Total (000/Lekë)</td>
<td>371,132</td>
<td>359,083</td>
<td>338,596</td>
<td>423,525</td>
</tr>
</tbody>
</table>


Expenditures for fiscal year 2008 are composed as follows:

Table 6: Fier: local expenditure

<table>
<thead>
<tr>
<th></th>
<th>000/Lekë</th>
<th>&amp;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>182,810</td>
<td>27%</td>
</tr>
<tr>
<td>Insurance</td>
<td>38,333</td>
<td>6%</td>
</tr>
<tr>
<td>Operational expenditure</td>
<td>225,519</td>
<td>33%</td>
</tr>
<tr>
<td>Investments</td>
<td>227,568</td>
<td>34%</td>
</tr>
<tr>
<td>Total</td>
<td>674,230</td>
<td>100%</td>
</tr>
</tbody>
</table>


Operational expenditure has increased in the past years as a result of a growth of the surfaces subject to cleaning, lighting, green maintenance; the raise of the fuel prices; inflation; an increase of the number of municipal assets.

The expenditure will be allocated for 20% to the general administration; 22% to arts & sports; 24% to local public services and 34% to capital investments.

Capital investments present this trend during 2004-2008:

Figure 2: Fier: capital investments 2004-2008


The trend of the two sources of funds covering investments has been as follows:
Figure 3: Fier: investments’ funding


Regarding investments to be carried out in fiscal year 2008, a plan of investments has been approved, which considers financial sources: local revenues (209,102,000 lekë) and transfers for the State budget (13,166,000 lekë). Priority areas for investments have been identified through a participatory planning process.

The mayor, Baftjar Zeqaj, and the head of the Department of Finance, Antoneta Dhima, were interviewed in October 9th, 2008, according to the questionnaire provided in the appendix 1 of this document.

The interviewees have not participated, either as Fier municipality or through the Albanian Association of Municipalities, in the drafting of the two laws (on borrowing and on municipal bonds). However, some training has been done on the application of the former.

The municipality of Fier is interested in borrowing and on issuing a bond loan. This is particularly true for: the building of a multi-sports stadium and of a bus-terminal station. A general territorial and economic development strategy has been approved.

The municipality has never borrowed from banks.

The local accounting system is a pure “cash system”\(^{16}\).

Both internal and external audit activities are in place.

The forecasted revenues (especially local taxes and fees) are increasing, which would enable the municipality of Fier to fulfill to limitations on borrowing.

However, either technical assistance or training of staff is considered as essential to perform all the stages of the bond issuance process (including the preparation of the mandatory documentation).

The interviewees reported that citizens may not be interested in buying municipal bonds, mainly because a bond market does not exist.

\(^{16}\) According to the Decisions of the Council of Ministers nr. 248 of 10.04.1998 “Per miratimin e planit kontabel publik per organet e pushtetit lokal, institucionet shteterore, qendrore dhe lokale si dhe te njesive qe varen prej tij”, nr. 25, of 20.01.2003 “Per disa shtesa e ndryshime ne VKM nr. 248”.

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5.2 Kruja municipality

Kruja is a tourist city close to Tirana and has approximately 16,000 inhabitants.

The mayor of the municipality of Kruja, Lulzim Guni, was interviewed in October 10th, 2008, according to the semi-structured questionnaire provided in the appendix 1 of this document.

It should be noticed that, although required, neither documentation nor data were provided and the municipality, differently from the previous one, doesn’t have an official website.

The mayor reported a satisfactory situation of revenues – especially after the issuance of a building permit, which has brought to the local budget 1 million of $.

The satisfactory levels of local revenues have permitted to fund several investments such as the central square (380 mil. Lekë – 6 months), the public lightning system, etc.

The cultural building (more than 2 bill. lekë) was funded from the State budget.

Other projects, such as the road going to the castle, has been financed with European Union funding (1,000,350 €).

A sports stadium has been built totally financed with private funds (contributions from businessmen, who have invested in the Kruja municipality).

A significant investment was projected: a 27.5 kilometres highway from Tirana to Kruja, which would enhance territorial development by boosting new productive activities.

The need to intervene only gradually in infrastructure enhancement was considered coherent with the availability of local financial resources.

However, a major problem was reported that can be reasonably addressed through (bond) loans. The mayor reported several and continuous delays in the transfer of funds from the central government or the line ministries (for funding specific capital investments in their area of competence). This implied a longer duration of investments not motivated by technical reasons (for instance, 4 to 5 years for a 30 kilometres road that would take only few months to be completed). These delays hinder territorial economic development.
6 Results of the Regulatory Impact Analysis of the draft law on Corporate and Municipal Bonds

6.1 Introduction

According to the Terms of Reference of this project as well as to the RIA checklist presented in paragraph 2, the object of the analysis has been the assessment of: the terminology of the draft law, the rationale for a central regulation, the compliance and consistency with the existing regulatory framework (a detailed comparison with the existing relevant regulations has been carried out, which is described in paragraph 4), the inclusiveness of the drafting process, the impact on local governments and Albanian market (this aspects have been highlighted mainly through interviews to selected Albanian municipalities and banks) and its implementability and need of secondary legislation.

The next sections describe in detail the results of this assessment and give suggestions aimed at improving the letter of law and at facilitating its implementation.

6.2 Terminology

The field of application of the law is precisely defined and limited to bond loans issued by joint-stock companies having their registered seat in the Republic of Albania and local governments.

Its clarity could be enhanced by introducing a second article, following article 1 on scope, briefly describing the purpose of the law. Moreover, article 1, bullet (1)b could enlist the organizational units that are considered local governments for the effects of the law: for instance, could associations of municipalities issue bonds?

Almost all articles regarding local government loans are written in language of standard usage by the public affected by the legislation.

Both the Albanian and the English versions of the draft law were analysed. Quite often the Albanian text was far more comprehensible than the English one.

6.3 Rationale for intervention

Municipal bonds are considered an important financial lever for enhancing social and economical development, as the realization of investments cannot be carried out relying only on the traditional financing forms (for instance, current revenues are insufficient and pose problems of inter-generational inequity).

Furthermore, the possibility for local governments to issue bond loans could positively contribute to the start-up of the stock-exchange market (or, at least, of the secondary market) activities and could provide investment opportunities for pension funds or remittances.
While there are significant benefits from municipal bond loans, government action (through new legislation and implementation provisions) in this field is essential as the 1996-97 deep economic and social crisis has demonstrated.

The wide appeal of Albania’s financial pyramid schemes can be attributed to several factors, including Albanians’ unfamiliarity with financial markets; the deficiencies of the country’s formal financial system, which encouraged the development of an informal market and, within this market, of the pyramid schemes; and failures of governance (Jarvis, 1999).

6.4 Compliance with the existing law and legal system

As already mentioned, an analysis of the existing regulations on local governments (organization and functioning, budgeting and borrowing) was carried out in paragraph 4 and these laws were compared to the provisions contained in the draft law on municipal bonds.

Generally speaking, the draft law complies with the requirements of the existing regulations, including the Albanian Constitution. Few inconsistencies were identified and, in this section, the articles of the third part of the DL are analysed in detail, suggesting improvements.

With reference to the content analysis of the PART III of the draft law, two kinds of changes are suggested:

a) Inconsistencies between the provisions included in the draft law (hereinafter DL);

b) Inconsistencies between the provisions contained in the draft law and the regulation provided by the Law on Local Government Borrowing (hereinafter LLGB).

**Article 64 - Short-term and Long-term bond loans**

**Paragraph 1**

“Local Governments may issue Short-term and Long-term debt in the form of Bond loans according to the provisions of the Law on Local Government Borrowing.”

The first aspect to be dealt with concerns the possibility for local governments, considered by Comma 1, to issue short-term bonds.

Article 2, paragraph 2, bullet b) of the DL defines bonds as “a long term debt security binding the issuer to pay the holder, on a determined date, the nominal value and the interest, in one or more instalments”.

Bullet gj) of the same paragraph and article defines a long-term bond as “a bond with a maturity of longer than twelve months”.

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These definitions, though commonly used, are characterized by several inconsistencies, considering that municipal short-term bonds are unlikely to be issued.

Two aspects should be analyzed and addressed:

c) The DL relates the term bond exclusively to a long term perspective; this implies, generally speaking, that local governments cannot issue “short-term bonds”;

d) The DL defines as a long-term obligation, one having a maturity longer than twelve months; this implies that a one-year loan should be included among the long-term loans.

As already mentioned, the possibility of local governments to issue short-term bonds is explicitly regulated by article 64, paragraph 1 of the DL. However, PART I of the DL (articles 1 to 46) states some general provisions to be applied either to the joint-stock companies having their registered seat in the Republic of Albania or to Local governments. Therefore, only the following two alternatives are feasible:

**First option**

The hypothesis that local governments can issue short-term bonds, provided by article 64, paragraph 1 of the DL, is removed. In this way, general provisions for local governments and joint-stock companies are aligned. The coherency with the regulation provided by the LLGB needs to be checked (see following). According to this option, the title of the article 64 would be reworded, substituting the current “Short-term and Long-term Bond loans” with the following title: “Long-term Bond loans”. Paragraph 1 of this article would state as follows: “Local Governments may issue Long-term debt in the form of Bond loans according to the provisions of the Law on Local Government Borrowing”.

**Second option**

Article 2, paragraph 2, bullet b) of the DL is changed, specifying that the term “bond” may stand for “a long or a short-term debt security binding the issuer to pay the holder, on a determined date, the nominal value and the interest, in one or more instalments” and a definition of short-term bonds is added in paragraph 2.

No matter the option chosen. In any case, it is imperative to modify the definition of “long-term bonds”.

In order to make the text of the DL consistent to the text of the LLGB, the former needs to be adapted to the latter.

In consideration of the above, the Article 3, paragraphs 5 and 6 of the LLGB define, respectively, the long-term debt as a “debt which is payable over a period of one year
or more” and the short-term debt as a “debt, which is payable within a period of less than one year”.

The inconsistency between the two is self-evident. Although only for a day difference, the same bond, having a twelve-month maturity, is contemporaneously a long-term loan for the effects of the LLGB and a short-term loan (bond) according to the DL definition.

It is not a simple terminological issue.

The accounting procedures, the currency in which the bond is issued, the different constrains, the authorizations needed, the destination of the funds, the guarantees provided (all the technical forms in which these are required, including municipal bonds), all these aspects are regulated differently by the LLGB, according to the nature of the loan (short versus long term).

For instance, borrowing short-term loans from third parties is only a “residual” alternative for local governments. Article 6, paragraph 2 of the LLGB states that “a local government may incur short-term debt only following a negative reply by the Ministry of Finance to finance the temporary budget deficit through interest free or soft loan from the state budget. The Ministry of Finance responds within ten days from every receipt of request for short-term financing. The Ministry of Finance shall be deemed to have denied the request if it has not responded within ten days and the Local Government may apply for short-term debt from other sources”.

It is questionable, therefore, if the first option put forward – i.e. to eliminate the possibility of issuing short-term bonds by the local governments (DL (article 64, paragraph 1) – is a feasible option from a technical and juridical point of view.

In our opinion, it is a technically feasible option and even desirable considering the limits that the LLGB poses to local governments for accessing this kind of loan.

Beyond the residual nature of this kind of borrowing from private entities, our position is also motivated by the following considerations:

a) Short-term borrowing is permitted to Albanian local governments (similarly to other countries) only for ensuring cash flexibility during the financial year (article 4, paragraph 1 of the LLGB).

b) The amount of the loan should be reimbursed within the last day of November and it is not possible to renew it or to extend the due date (article 5, paragraph 3 of the LLGB).

Taking into consideration the collateral costs that a bond implies, the institutional framework of the Albanian financial and capital market, and considering the need that cash flexibility loans be promptly provided, we believe that the issuance of bonds to finance cash flexibility is so reasonably unlikely to be removed from the DL.

17 Long-term loans are defined as having a duration $\geq$ one year also by the law on local government borrowing (n. 9869/2008; article 3, paragraph 7) and the law on the public budgeting system (n. 9936/2008; article 3, paragraph 21).
**Article 64 - Short-term and Long-term bond loans**

**Paragraph 2**

“The Bonds issued by Local Governments contain the elements described in the Law on Local Government Borrowing.”

From the interpretation of this paragraph and considering the definition of bonds given in article 2, paragraph 2, bullet b) of the DL, the term bonds would be substituted here with the term “certificate of bonds”.

In any case, it is not clear the reason for recalling the LLGB.

Comparing article 8, paragraph 3 of the LLGB with article 4, paragraph 1 of the DL, it is clear that the latter is much more complete and detailed than the former.

It would be more correct to depart from the general principle (applicable to both the local governments and the joint stock companies) stated in article 4, paragraph 1 of the DL.

<table>
<thead>
<tr>
<th>DL - article 4 (Bonds in paper form), paragraph 1</th>
<th>LLGB - article 8 (Local Government Securities), paragraph 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>The content of the certificate of Bonds in paper form must contain the following elements: a. the name of the issuer; b. the place and time of the Bonds’ issuance; c. the nominal value of each Bond; ç. the total nominal value of the Bond loan; d. the name of the bondholder if the Bond is registered; dh. the place, time and manner of redemption; e. the signature of the legal representatives of the issuer; è. the data which is required for the determination of the rights of the bondholders-creditors and in particular the securities of the loan, the conversion right or the right to participate in the gains of the issuer; f. the series number of the Bond; g. any interest units, if the Bond is interest-bearing; gj. any rights of the issuer for early termination (redemption) of the Bond;</td>
<td>Local Government Securities issued in certificated, or physical form are obligations of the Local Government, and are identified by their series of issuance, distinctive serial number, face amount, and may be in either registered or bearer form ...</td>
</tr>
</tbody>
</table>

Article 65 - Competency for the issuance of a Bond loan

“The decision to issue a Bond loan is taken from the management bodies of the Local Governments, according to the provisions of Law on Local Government Borrowing.”

It is stated that the above provision is coherent with the LLGB. However, Chapter II of the LLGB regulates in a different way the local government bodies which are responsible for deciding on the matter.

In particular, article 7 of the LLGB (Authority to issue long-term debt), paragraph 1 clearly states that “a Local Government may incur long term debt pursuant to a resolution duly adopted by the Council of the local government and approved by a majority of the members of such Council at a meeting of the Council that is open to the public”.

According to the Albanian legislation, it is the local Council and not the local government management body which has the responsibility to incur a long-term debt (including the issuance of a long-term bond).

Even considering the possibility of the DL to issue a short-term bond, the competent body would still be the local Council.

Article 6, paragraph 1 of the LLGB states that “a Local Government may incur short-term debt pursuant to the decision of the local council on the budget of the actual fiscal year. Within short-term debt limitations defined in this law, the Council defines the actual limit, within which the Mayor of the Local Government is authorized to issue short-term debt case by case”.

Therefore, it is suggested to specify that the competent decision-making subject is the Local Council (better specifying the Albanian version of the DL, which refers to competent decision-making bodies, and modifying the English version).

Article 66 - Obligations of the issuer

Paragraph 1

“A Local Government which has issued a Bond loan is mandatorily audited each fiscal year by a chartered accountant”.

a) It is essential that the local government that intends to issue municipal bonds present accounts, which have been audited and certified; in other terms, it is not sufficient to present the certified accounts to lenders only after the bond has been issued. It is of utmost importance that the local government financial reports be certified also before the borrowing takes place. It would be desirable that the local government present certified accounts of at least two or three years before the local council approves the bond issuance. If such a time frame is considered too long, the financial reports of the fiscal year preceding the one in which the issuance occurs, should, at least, be certified.
b) The object of the audit is not the local government but its financial reports; the reference audit principles are not specified.

c) It is not sufficient to have a professional accountant, member of a Register of Accounting Auditors, auditing the financial reports. Considering the relevance of such financial operations for a rising capital market as the Albanian one is, it is crucial that the audit be performed by an outstanding audit firm. We are conscious that this may lead to increased issuance costs; nonetheless, it is, in our opinion, incautious to assign such a responsibility to a single professional.

In the explanatory report (pg. 20), it is better specified that the chartered accountant is, either a bank or a state auditor. **While the latter state auditor may provide some guarantee, the same does not apply for the chartered accountant.**

d) For bond lending issued in a foreign currency (article 5, paragraph 2 of the LLGB) it would be appropriate to get a credit rating. However, it is not necessary to have a legal prescription as there will be the market to impose this requirement.

**Article 66 - Obligations of the issuer**

**Paragraph 2**

“The report of the chartered accountant for every fiscal year must be conducted by the 30th of April at the latest, covering the preceding fiscal year and is made available to any Bondholder at the expense and responsibility of the issuer”.

The same observations proposed above, on the opportunity of having an outstanding audit firm certifying the local government financial reports, apply.

**Article 66 - Obligations of the issuer**

**Paragraph 3**

“The Minister of Finance can decide to assign to a chartered accountant or state auditor a general or specific audit of a Local Government which has issued an outstanding Bond loan”.

a) This paragraph is very generic. While it may make sense to reserve a special prerogative to the Minister of Finance for some typologies of loans, in line with the need of maintaining fiscal discipline, these must be: (1) precisely defined in order to avoid politically-motivated central government involvement and (2) include all the types of debt that can reasonably put at risk the fiscal discipline.

b) Regarding the first aspect, a highly discretionally power is attributed to the Minister of Finance considering the vagueness of the expression “outstanding bond loan” (i.e., how long should the loan remain undischarged to be considered outstanding?). A more precise definition of outstanding debt is provided in Article 23 of the LLGB, which should, in our view, be recalled.
Furthermore, the LLGB establishes precise quantitative as well as qualitative and procedural limitations (cf. Chapter 4 of the LLGB), stating that a bond loan can be issued only when the local government fulfills specific requirements that ensure the capacity of the local government to pay the loan service.

c) Regarding the second aspect, the LLGB identifies three types of “critical debts” (article 7, paragraph 6):
   - Debt issued to refinance other Debt;
   - Debt issued in the international market;
   - Debt issued by Local government that has been in financial distress during the past five years.

These could add up to the provision contained in article 66 of the DL (currently limited to the more restricted outstanding bond loan).

d) The object of this additional audit is not clear, also considering that the two adjectives “general” and “specific” referred to the “audit of a local government” do not have a precise technical meaning.

e) There is a potential contradiction with the paragraph 1. If, in any case, the local government is to go through an audit, the provision of paragraph 3 makes questionable the autonomous capacity of the local government to select the auditor. Again, if this activity is carried out by an outstanding audit firm or a State Auditor, instead of a chartered accountant, a greater guarantee of professionalism would make redundant the prescription contained in paragraph 3.

### Article 66 - Obligations of the issuer

**Paragraph 4**

“By a decision of the Minister of Finance it is possible to establish specific obligations of the Local Governments which have issued an outstanding Bond loan.”

a) As already observed for paragraph 3, also paragraph 4 recognizes a highly discretionally power to the Minister of Finance.

b) The expression “specific obligations” is generic. The LLGB provides for measures to be taken if debt, once contracted, is not serviced. Article 23 of the LLGB specifies a series of actions to be taken in the event of fiscal distress as well as in case of a more severe financial condition, termed insolvency. Therefore, we disagree to give the Minister of Finance the discretionally power to impose additional generic obligations in case of “outstanding bond loans”.

Articles 67 and 68 do not present particular weaknesses.
**Article 69 - Rights of the Bondholders’ agent**

**Paragraph 1**

“The Bondholders’ agent has the right to participate in the meeting of the management body of the issuer, without any voting rights, when the agenda addresses subjects which concern the interests of the group of Bondholders. In such cases the management body, at its own initiative, shall notify the Bondholders’ agent of the agenda and invite him to the meeting.”

a) As already mentioned elsewhere, it is necessary to substitute the expression “management body of the issuer” with Council; being the Local Council, according to the LLGB, the body competent of any decision related to the bond loan.

b) Being a political and representative body it is superfluous to specify that the bondholders’ agent has no voting rights.

**Article 69 - Rights of the Bondholders’ agent**

**Paragraph 2**

“The Bondholders’ agent may request the provision of information which is useful for the actual evaluation of the subjects of paragraph (1) in the same terms and conditions which apply for the members of the management body of the Local Government.”

As mentioned before, the expression “management body of the issuer” should be replaced by Local Council, which is, according to the LLGB, the body competent of any decision related to the bond loan.

**Article 46 - Tax exemptions**

The issuance of the Bond loan as of the present law, the granting of any security in favour of Bondholders, all agreements provided for by this law, as well as any relevant or side agreements or acts and the registration of these to the public books, wherever necessary, the issuance of temporary and permanent titles of Bonds, the distribution and circulation of these, the payment of the principal from Bonds and business claims covering these and, in general, the exercise of rights deriving from Bonds which are issued in accordance with the present law and from business claims covering these, as well as any transfer of Bonds in or outside any securities market and the creation of property liens on these, are exempted from any direct or indirect tax including the tax of overvalue, charge, giving back or not, stamp duty, contribution, commission, right or other charge in favour of the Republic of Albania or third parties.

Article 46 provides tax exemption for the bond loans regulated by the draft law, which includes both municipal and corporate bond loans. Compared to the experience of other countries, this article could be improved by limiting tax exemption to public-interest investments and activities (in other countries, corporate bonds are fully taxable and municipal bonds pay a commensurately lower rate than other bonds as a result of their tax-free status). An alternative option could be to consider the limitation of tax-exemption only at a later stage, considering the need to promote the financial activity in this area.
6.5 Participation and stakeholder involvement

Most of the interested parties have had the opportunity to present their views. Efforts have been made to involve municipalities (either single municipalities – in particular, Fier, Kruja and Lezha – or the Association of Albanian Municipalities) and banks (including the Albanian Association of Banks). In particular, an opened interview was realized with Raiffeisen Bank and the questionnaire (see appendix 8.2) was send to all the banks operating in Albania.

6.6 Potential impact

The economic impact assessment of the draft law has proven particularly difficult as local governments in Albania hold no past experience with bonds and loans. Thus, the assessment of the comparative advantage of bonds with respect to loans required some simplificatory assumptions.

Two main considerations are made in the following sections, respectively, on the impact on the Albanian market (which depends on the appetite of banks and on the attitude of municipalities) and on the comparison of the competitive advantage of bonds towards loans.

6.6.1 The attractiveness of municipal bonds to banks

As already highlighted in paragraph 5, during the interviews to mayors and municipal staff, the impression we had was that of a weakened cultural aversion to indebtedness, no longer viewed as a sign of financial instability or a risky form of financing. The attractiveness of bonds (and borrowing more in general) was greater in municipalities having large investments in their urban and development plans (such as, for instance, the Kruja-Tirana highway).

The attractiveness of municipal borrowing is quite different for the banks. Two out of the three banks replying to the questionnaire declared being not interested in lending to municipalities but, nonetheless, interested in underwriting municipal bonds, mainly due to a perception of greater convenience in terms of risk and returns (tax-exemption). The municipal bonds are perceived as less risky because potentially more marketable.

The limits to local borrowing (Law 9869/2008) are not able to overcome the reluctance of banks towards mid-long term lending to municipalities, which is mainly dependent on the high risk of long-term investments in Albanian Lek.

The largest bank among the respondents was declared interested in lending to Albanian municipalities on the middle-longer term as this strategy was viewed as an opportunity to enlarge the activity of their Treasury/Investment Banking division by introducing new business and service. It was also perceived as a way to contribute to further developing of the capital market in Albania and to add new financing/lending opportunities for municipalities. Nonetheless, the respondent highlighted that actual municipal lending is very short term, with variable interest rate.
It was also declared interested to act as underwriter, sponsor or investor in a municipal bond issuance mainly because it already owns the expertise to act as underwriter and has all needed capacity to sponsor or even invest the municipality bond issuance.

The smallest bank among the respondents was declared absolutely not interested in financing municipal fixed-interest rate multi-year investments. Mainly this was due to the unavailability of Lek instruments for interest-rate risk hedging.

Official statistics (mainly Bank of Albania) show low levels of credit to government, mainly concentrated in foreign currency and having a short-term duration (figures 4-8). This is partly a generalized trend. More than 60% of total loans granted are for short or medium terms only, which reduces the risk for banks but is inadequate for financing investments. 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. However, 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. 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. The main constraint for long-term credit is the inability of banks to assess the creditworthiness of investment projects (World Bank, 2007).

**Figure 4:** Bank lending to the domestic economy, 1998-2002

![Figure 4: Bank lending to the domestic economy, 1998-2002](source: Ceca et al, 2008 on Bank of Albania data.)
**Figure 5:** Credit to Economy by Subjects (Albanian Lek, September 2008)

<table>
<thead>
<tr>
<th></th>
<th>Short-term loans</th>
<th>Mid-term loans</th>
<th>Long-term loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government loans AAL - Sept. 08</td>
<td>1092244</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>AAL (all other loans) - Sept. 08</td>
<td>24780476</td>
<td>30403567</td>
<td>42106347</td>
</tr>
</tbody>
</table>

*Source*: Albanian Association of Banks / Shoqata Shqiptare e Bankave

**Figure 6:** Credit to Economy by Subjects (Albanian Lek, January 2008)

<table>
<thead>
<tr>
<th></th>
<th>Short-term loans</th>
<th>Mid-term loans</th>
<th>Long-term loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government loans AAL - Jan. 08</td>
<td>30</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>AAL (all other loans) - Jan. 08</td>
<td>19141221</td>
<td>28162568</td>
<td>32813966</td>
</tr>
</tbody>
</table>

*Source*: Albanian Association of Banks / Shoqata Shqiptare e Bankave

**Figure 7:** Credit to Economy by Subjects (foreign currency, September 2008)

<table>
<thead>
<tr>
<th></th>
<th>Short-term loans</th>
<th>Mid-term loans</th>
<th>Long-term loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government loans Foreign Currency - Sept. 08</td>
<td>5757557</td>
<td>408837</td>
<td>0</td>
</tr>
<tr>
<td>Foreign Currency (all other loans) - Sept. 08</td>
<td>85097846</td>
<td>50297759</td>
<td>129797730</td>
</tr>
</tbody>
</table>

*Source*: Albanian Association of Banks / Shoqata Shqiptare e Bankave
This paragraph aims at verifying whether the bond issuance could be a competitive alternative to banking loans, by considering the respective costs. To this aim, both municipalities (see paragraph 5) and banks were interviewed.

First of all, it should be noticed that the actual cost of financial resources collection through banking loans and bonds is determined on a case by case basis and cannot be exactly quantified \textit{a priori}. Loan interest rates, for instance, depend on the quantitative limits on indebtedness imposed by the law and on the conditions of the financial markets, as well as on the relative contractual power of the bank and of the issuer.

Secondly, the comparative analysis here presented is strongly influenced either by the current situation of high instability of financial markets or by the degree of maturity of the Albanian financial market. In particular, the following elements should be considered:

- Albanian municipalities have not a rich experience of bank borrowing and have never issued bond loans. Therefore, the assessment of the credit risk of municipalities is a new activity for Albanian financial operators. As the cost of the banking loan or of the bond is strictly dependent on risk levels, the quantification of the costs is highly approximate.

- The current situation of the financial market determines a significant risk for the long-term investments in Lek. This is a general category of risk that exists regardless of the specific bank - local government relationship. However, this adds up to the normal credit risk of municipalities and gives birth to difficulties in terms of price assessment from the bank side and spurs a situation in which municipal lending is very short term, with variable interest rate.
In Albania, financial instruments (such as the interest rate swap) that can be used by financial institutions to manage their fixed or floating assets and liabilities in Albanian Lek are not yet developed.

Therefore, from a methodological point of view, the cost assessment of bonds and loans required some simplificatory assumptions. In particular, the calculation of costs is based on the following assumptions:

- It is based on estimated costs and not effective costs. As already noted, real costs will depend on the actual dynamics of financial markets, which could not be predetermined.

- It considers only the main component of cost: the interest rate and not other additional cost elements that may apply such as issuance expenses, early debt retirement premium, risk rating costs, disclosure costs, etc. However those costs are considered by the literature as less relevant for determining the comparative advantage of a financial instrument as opposed to another, particularly for bond loans and especially in the longer term. Given the novelty of these financial instruments, it should also be noticed that it was not possible to gain reliable information in loco on these cost dimensions.

- The analysis was limited to the comparison between variable-interest rate loans and bonds. Because of the high risk of long-term investments in Lek and of the lack of instruments for compensating this risk, at the moment a (even potential) supply of long-term loans in Lek does not exist (and so does a price).

- The esteemed interest rate (for bank loans and municipal bonds) is based on the information directly provided by three banks which have replied to the questionnaire (Tables 7 and 8).

That being stated, the costs of loans and bonds were calculated adopting the following formulas:

\[
(1) \quad C_{BL} = r_{ref} + s_{bl}
\]

where

- \(C_{BL}\) = the cost of municipal bank loan
- \(r_{ref}\) = reference rate (T-Bills 12M)
- \(s_{bl}\) = the spread applied by the bank for loan

\[
(2) \quad C_{MB} = r_{ref} + s_{mb}
\]

where

- \(C_{MB}\) = the cost of municipal bond loan
- \(r_{ref}\) = reference rate (T-Bills 12M)
- \(s_{mb}\) = the spread applied by the bank for bond
The following table gives account of the data employed in the calculation.

### Table 7: Bank loan - variable interest rate

<table>
<thead>
<tr>
<th>Reference rate</th>
<th>5 years</th>
<th>10 years</th>
<th>15 years</th>
<th>20 years</th>
<th>25 years</th>
<th>30 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRIBOR 12M</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
</tr>
<tr>
<td>Spread</td>
<td>4.00%</td>
<td>4.40%</td>
<td>4.80%</td>
<td>5.20%</td>
<td>5.60%</td>
<td>6.00%</td>
</tr>
<tr>
<td>cost of bank loan ( (C_{BL}) )</td>
<td>interest rate</td>
<td>12.47%</td>
<td>12.87%</td>
<td>13.27%</td>
<td>13.67%</td>
<td>14.07%</td>
</tr>
</tbody>
</table>

### Table 8: Bond loan - variable interest rate

<table>
<thead>
<tr>
<th>Reference rate</th>
<th>5 years</th>
<th>10 years</th>
<th>15 years</th>
<th>20 years</th>
<th>25 years</th>
<th>30 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRIBOR 12M</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
<td>8.47%</td>
</tr>
<tr>
<td>Spread</td>
<td>1.50%</td>
<td>1.75%</td>
<td>2.00%</td>
<td>2.25%</td>
<td>2.50%</td>
<td>3.00%</td>
</tr>
<tr>
<td>cost of municipal bond loan ( (C_{MB}) )</td>
<td>interest rate</td>
<td>9.97%</td>
<td>10.22%</td>
<td>10.47%</td>
<td>10.72%</td>
<td>10.97%</td>
</tr>
</tbody>
</table>

Figures 9 and 10 illustrate the results of the comparative analysis.

**Figure 9: Comparison of municipal bonds and banking loans (variable rate)**
Figure 10: Differential interest rate for municipal bonds and bank loans

Summing up, the comparative analysis highlights that, under the aforementioned conditions, bonds could be less costly than loans especially in the mid-longer term.

The same relative advantage of bonds will persist also in the case of a fixed-interest rate, when the market conditions (greater control of the risks of long-term investments in Lek) will be in place and allow for this kind of borrowing.

Other things being equal (market trends, municipalities’ risk levels, etc.), the reasons that make bonds more advantageous than loans include the following:

- A potential wider marketability.
- Tax advantages.

Nevertheless, the analysis has highlighted that several conditions should be in place in order for these potential benefits to become real:

1. The reference rate to be considered: some banks have suggested the TRIBOR 12M, while others consider this parameter as inadequate and suggest to use the T-Bills 12M or, in prospect, the T-bond prices\(^{18}\).

\(^{18}\) In any case, the adoption of one parameter instead of another does not impact on the advantage of bonds as compared to loans, since the relative convenience is determined by the difference in terms of the spread rate among the two. It is also worth considering that, at the moment, the TRIBOR 12M and the T-Bills 12M have a similar rate (8.48% the former and 8.14% the latter). Finally, regarding the T-bond, nowadays, it is not possible to use it as a reference rate as neither a market nor a price do yet exist.
2. The development of an interbank market and of instruments such as the swap rate for banking loans in Albanian Lek: in absence of such conditions, it would be difficult to have widespread banking loans and bonds that rely on a fixed-interest rate. In turn, this will penalize local governments which will not have the possibility to access fixed-rate loans and will determine their overexposure to variable-interest rates.

3. Some of the respondents have suggested that, regardless of any evolving interbank practices regarding the Repo (Repurchase Agreement) collateralization of such bonds, it would help if the central bank would make these bonds eligible for central bank financing.

6.7 Implementability: demand and supply side

In the short term, the major constraints to the issuance of municipal bonds include, on the one hand, the absence of past experience of both municipalities and banks and, on the other hand, a general distrust of banks towards lending to municipalities (and to long-term lending more in general).

The implementability of the draft law could, therefore, be enhanced by making municipal bonds more attractive to potential investors as well as more easy-to-use for local governments.

Regarding the demand side, banking credit will increase by an average of 28% annually in the next years (World Bank, 2007). Therefore, municipal bonds may benefit from this general trend, mainly by informing banks on the comparative advantage of municipal bonds (the possibility to have tax-free income).

Other positive drivers could be:

- the possibility for municipal bonds to be considered by the pension funds and
- the possibility to benefit from remittances, which constitute the largest influx of funds into the Albanian economy, outdistancing foreign direct investments and exports.

An additional possible way of enhancing the capacity of Albanian local governments to issue mid and long-term bonds may be the introduction of convertible bonds that can be exchanged for shares of local utilities, transformed or to be transformed in joint stock companies.

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19 However, these funds flow substantially outside formal channels and, for the most part, help meet the most pressing needs of Albanian emigrants’ families and relatives. But, in fact, they do not currently play a significant role in furthering economic expansion and financial investment in Albania, partly because Albanian financial institutions lack the customized and remittances-oriented financial products and services that would encourage formal inflows. Cf. Meka E., Bendo L., Frashëri A., (2007), Remittances and financial products in Albania. Reality and the future. A Survey Analysis, International Organization for Migration, Tirana.
Furthermore, the possibility of the central government providing collateral guarantee to municipal bonds and / or contributing to cover part of the interest payments could help to make this financial instrument of common use.

Regarding the supply side, training to municipalities and technical assistance in preparing the necessary documentation may be beneficial.

6.8 Secondary legislation

The draft law should identify the secondary legislation that has to be prepared for the purpose of implementing it.

First of all, it should be said that the implementation of the draft law would greatly benefit from the existence of the secondary legislation for the Law Nr. 9869/2008 “On Local Government Borrowing”, which is a very recent one. The secondary legislation regulating the activities of the Tirana stock-exchange will also impact on the success of the bond market, either municipal or corporate-driven ²⁰.

Possible issues to be dealt by secondary legislation to the draft law include the following.

The possibility to issue bonds in foreign currency should be considered and subsequent regulations should mandatorily require contracting a currency swap, which ads up to the costs of the bond operation.

Furthermore, limits to the spread could be imposed as it already happens in other countries (for instance in Italy).

Finally, standard formats and guidelines for preparing the council resolution, the investment plan, the amortization schedule, etc. could be provided.

6.9 Implementability and technical assistance

The effectiveness of the draft law will depend mainly on the role of three actors:

- The local governments;
- The banks and other financial institutions;
- The Albanian Financial Supervisory Authority (AMF).

Local governments need to enhance their financial management capacities and organizational structures. Training on financial management should be provided to municipalities and it should be aimed not only at developing know-how on the functioning of particular financial instruments (such as loans, bonds, project finance and public-private partnerships, etc.) but mainly at enhancing the financial management

capacities of local civil servants (strategic planning and project management, investment evaluation, accounting, etc.). In particular, local governments need to become familiar with capital budgeting (i.e. investment appraisal) in order to be able to determine whether long-term investments are worth pursuing.

Central units, as for instance the Albanian Association of Municipalities, could provide advice on institutional issues such as the legal framework for budgeting or the organisational structure of the finance function, or advice on specific technical issues such as expenditure and revenue projections and analysis, budget formulation and budget execution, internal control, accounting and reporting, and audit, as well as factors that make for success and failure in carrying out these tasks.

More generally, well-functioning budget institutions and systems are vital for making informed policy decisions – and for the ability to implement these policies – regardless of the sources of financing.

Regarding the organizational structures responsible for financial management, several alternative configurations are feasible, also according to the dimension of the specific local government:

- The creation of an ad hoc finance department: this option can be chosen by large cities, such as Tirana, Durres or Elbasan. These can also provide technical assistance to other, smaller, local governments.
- The enlargement of the tasks carried out by an already existent economic department, usually responsible for the managerial accounting and control tasks. This option is advisable in the early stages of the finance function.
- The creation of an organizational unit placed in staff to the top management level (director general), acting as an interface with advisors in case of bond issuing and handling the rating process.
- The creation of an interdepartmental task-force, including employees from the economic department, the infrastructure department, the legal affairs, etc.
- The contracting in of the specific financial project (bond issuing, project finance, leasing, etc.) to another local government (a larger municipality or the region / province).
- The creation of an inter-institutional network in which the different partner local governments get specialized in one task of the bond issuing process.

Another option could be possible, i.e. the contracting out of the bond issuing project to a private firm (consultancy firm or audit firm). However, it is considered as a very risky option at this stage considering the information and capabilities necessary for the local government to control and manage the outsourcing relationship.

It would also be very important to create a knowledge and empirical base drawing from the first Albanian experiences as well as from the more advanced international ones. This relevant role of knowledge management could be played by the Albanian Association of Municipalities and the Albanian Association of Communes, assisted by an academic partner.
Regarding the **banks**, their knowledge of the specificities of local governments should be improved and their need to understand the several benefits of such a market segment. The Albanian Association of Banks could be involved in the subsequent efforts implementing the law.

Banks, with the support of the AMF and of the Bank of Albania should work together to develop Lek instruments for interest-rate risk hedging, which would make possible to have bonds in fixed rates for multi-year investments.

Finally, the role of the **Albanian Financial Supervisory Authority** (AMF) is a complex and challenging one. Both banks and local governments, involved in a municipal bonds operation, are institutions under the jurisdiction of the Authority, as is the Tirana Stock Exchange.

The AMF key functions include the regulation and supervision of the insurance market, securities market, supplementary pensions market, etc. Its fundamental mission is to protect the consumers’ and investors’ interests, closely linked with the safety of the supervised operators, by ensuring adherence to all legal provisions.

Among its strategic objectives there is the enforcement of the law and the enhancement of sustainability, transparency and reliability of financial markets.

Therefore, with reference to the local government bond financing, the AMF should:

- Enforce the draft law (in its final version to be approved by the Albanian Parliament): in particular, it should implement provisions included in Chapter II: “Account providers”. First of all, this means that the AMF will need to establish the criteria and a formal procedure for licensing account providers (article 11 of the draft law). Secondly, the AMF will have to identify the minimum information that the account provider will have to give to bondholders in case of over the counter bonds. Finally, the AMF should monitor the activity of the account provider and impose any sanctions in case of break of law (article 13).

- Enhance the functioning of financial markets (i.e. sustainability, transparency and reliability): this is a particularly relevant task if the previous financial crisis in Albania is considered. On the one hand, the confidence of both local governments and banks in bond issuing as an alternative way of funding investments needs to be enhanced. On the other hand, the reliability of the instrument should be enforced, mainly by assisting these two actors (local governments and banks) in managing this financial instrument.

A valuable approach would be for the AMF to enter into cooperation and information exchange memorandums with authorities and research centres, both in Albania and abroad. One key actor with whom to engage in collaborative activities is the Committee of European Securities Regulators (following figure), established in 2001 to improve co-ordination among securities regulators, act as an advisory group to assist the EU Commission and work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.
Finally, the organizational structure of the AMF could be, in perspective, revised in order to better reflect its new responsibilities. For instance, in the following figures, the organizational structure of a similar authority of a European country is illustrated and compared to the current structure of the AMF.

Source: http://www.cesr-eu.org/
Figure 12: AMF organizational chart

Source: Annual Report 2007

Figure 13: Organizational structure of a financial monitoring authority of an EU country

Source: http://www.consob.it/main/consob/Chi_e/organizzazione/organigramma.html
In its early stages, the implementability of the project could be enhanced, beside the capacities of the different actors, by developing an inter-institutional task-force including representatives from banks, local governments, the AMF, the Ministry of Finance and the Bank of Albania, as well as from foreign universities and international research centres, providing advice and technical assistance (especially relevant for small municipalities), gathering, analysing and diffusing the knowledge base and general principles of good practice, etc.

7 Concluding remarks and policy recommendations

The general legislative framework analysed in this report and, more in particular, the draft law on Corporate and Municipal Bonds, can open new opportunities to Albanian local governments.

Allowing local governments to collect additional financial resources by issuing long-term bond loans is a necessary prerequisite for achieving a sustainable social and economical development in the country, for enhancing the quality and the quantity of the services delivered to the citizens, for attracting new businesses and investments, for increasing the current revenues of the administrations by enlarging the local tax base.

The realization of investments, especially the infrastructural ones, could not be satisfactory performed by relying only on the traditional financing forms.

Current revenues (or more exactly, current operational surpluses) are insufficient for funding investments, not only from a quantitative point of view, but also considering an argument of inter-generational equity. The benefits of investments are spread over a future period and it is unfair to ask the initial generation to sustain the whole cost.

Counting on central government’s grants is important, but it may as well limit the decision-making autonomy of local governments and may move to the “periphery” liquidity tensions experimented by the central government. This slows down the transfer of resources and translates into delays in the realization of the investments.

Similar considerations can be made on the funding obtained from international donors.

During the interviews to local governments, the impression we had was that of a weakened cultural aversion to indebtedness (debt is lesser viewed as a sign of financial instability, a risky form of financing, which places an unfair burden on future generations).

The possibility for local governments to issue bond loans, considering the stringent conditions posed by the Albanian legislator as well as the recommendations offered in this report, could positively contribute to the start-up of the stock-exchange market (or, at least, of the secondary market) activities.
In Albania, as it already happens in other countries (for example, in Italy), where the issuance of bond-loans by local governments is a common practice, the banks may underwrite the transaction and subsequently resale the bonds to its clients.

The middle and long-term borrowing should, therefore, be considered as a highly relevant opportunity for the local governments; in the absence of loans there are no investments; without investments it is not possible to achieve a sustainable social and economical development.

Nonetheless, as already noticed, gaining access to borrowing, and to the bond market in particular, requires the accomplishment of several conditions, which the legislator can only in part regulate.

Indeed, complying with the qualitative, quantitative and procedural requirements posed by the law represents a necessary, but insufficient condition, for an effective financial planning of the investments.

It is of outmost importance that the local administrations have adequate managerial and political capacities in place for correctly programming the investments and their funding.

In particular:

a) The investments should address the real needs of development of the governed territories. This requires the capacity to carry on a detailed and rigorous cost-benefit analysis of the investment, not only singularly considered by also in the framework of a long-term socio-economical territorial development plan.

b) The aforementioned plans could (and sometimes should) span the geographical boundaries of the single local government, which may hinder social and economic development. The possibility to issue bond loans may also be an opportunity of inter-municipal cooperation in the framework of integrated public policies (for instance, transportation and mobility, environment protections, etc.). This is especially true for small municipalities that do not have the necessary administrative and financial capacities to issue bonds on their own.

c) The expected costs of an investment are not limited to the debt service and the collateral costs, but should include (net of any earnings produced by the investment) other financial burdens that the investment may generate during its useful life, mainly for its management and maintenance.

d) Such further burdens constitute current expenditure and require the availability of similar future revenues to keep the current account in equilibrium in the following years (golden rule).

e) The transparency of the accounting information regarding the borrowing operations should be maximised. It is, therefore, essential to distinguish between the current and the capital part of the budget, in order to have a clear correlation of revenues to expenditures in both parts of the budget.

f) It is also useful to make use of an accrual accounting system, in order to precisely determine the investment’s amortisation.
g) The issuance of a bond loan allows to the local administration to immediately have at its disposal the total amount of the loan and, therefore, to extremely accelerate the completion of the investments.

h) A collaborative relationship between local governments and banks is of outmost importance. In the absence of a well-developed stock exchange market, their role is decisive either when the financial plans are defined or when the bonds are underwritten. It is necessary to understand if the way banks collect financial resources allows them (and to what extent) to invest these in the middle and longer term.

A possible way of enhancing the capacity of Albanian local governments to issue mid and long-term bonds may be the introduction of convertible bonds that can be exchanged for shares of local utilities, transformed or to be transformed in joint stock companies.

It is not an immediately applicable option considering the current configuration of local public services, but, nonetheless, of extremely interest. In fact, adopting a public-private partnership perspective, this option allows to attract relevant private (also international) investments, without necessarily loosing the control of the companies delivering local public services and reducing the bond issuance cost.

As a matter of fact, and if the legislative provisions allow for it, an investor interested in entering the local public services (utilities) market may underwrite a convertible bond loan, even accepting a lower interest rate as compared to the one offered by the market, until the bond is converted into stocks.
Appendix 1: The questionnaires used for the interviews

8.1 Questionnaire directed to municipalities

1) A e njihni ligjin Nr. 9869 te 4/2/2008 “Për huamarrjen e qeverisë vendore”? A ju kanë konsultuar në hartimin e tij? A e njihni projektiligion mbi obligacioneve e shoqërive anonime dhe qeverisë vendore (versioni i 20 Gushtit 2008)?

2) A jeni të interesuar në huamarrjen nga bankat? A jeni të interesuar të nxirrni tituj/letra? Për çfarë projektesh? Çfarë vantazhesh mendoni që mund të keni nga kjo mënyrë financimi?

3) A keni aprovuara një plan të zhvillimit ekonomik në bashkinë tuaj? Çfarë fondesh përdorni / do përdorni për investimet? Cilat nga këto fonde mund të zëvendësojë huamarrja?

4) Ç’raport kenë me bankat? A keni konsulente financiarë që ju ndihmojnë?

5) Çfare sistemi kontabël keni? Çfare principe kontabël adoptoni?

6) A i jeni ndërvënë auditimit? Te brendshë apo te jashtëm?

7) Ligji imponon disa kushte për të marrë hua (për shëmbull, neni 18: raporti i tepricës operative të vitit fiskal paraardhës me shërbimin e borxhit vjetor duhet të jetë jo më pak se 1,4:1 dhe raporti i stokut të borxhit ndaj të ardhurave operative duhet të jetë jo më shumë se 1,3:1). A i perplotësoni keto kushte? Cilat kufizime keni më të veshtira ti respektoni dhe pse?

8) Dokumentat e nevojshme që duhet te paraqiten për të kerkuar hua mund ti pergatitni vetë apo keni nevojë për ndihmë? Çfare tip ndihme (asistencë teknike, trainim, etj.)?

9) Sa është dimensioni mesatar i një investimenti?

10) Qytetarët tuaj mund të jenë të interesuar të blejnë tituj / letra të bashkisë?
8.2 Questionnaire directed to banks

This questionnaire is aimed at:

− assessing the appetite for banks to intervene in the procedure as underwriter, sponsor or investor
− assessing the costs for the municipalities issuing bonds
− comparing the relative convenience of the two alternatives: municipal bonds and bank loans.

1. Would your Bank be interested to lend to Albanian municipalities on the middle-longer term?
   
   **Yes □**  **No □**
   
   Why?
   _______________________________________________________________
   _______________________________________________________________
   _______________________________________________________________
   _______________________________________________________________

2. Would your Bank be interested to act as underwriter, sponsor or investor in a municipal bond issuance?

   **Yes □**  **No □**
   
   Why?
   _______________________________________________________________
   _______________________________________________________________
   _______________________________________________________________
   _______________________________________________________________

3. Regarding **bank loans** to an Albanian municipality, please quantify the following parameters (*by filling the yellow parts in the following Table I)*:
   a) Reference rate (as for example EURIRS) in case of a **fixed** interest rate
   b) Spread applied in case of a **fixed** interest rate
   c) Reference rate (as for example EURIBOR) in case of a **variable** interest rate
   d) Spread applied in case of a **variable** interest rate
   e) Other costs and / or commissions applied
Table 1

Reference rate (as for example EURIRS) = ?

<table>
<thead>
<tr>
<th>Bank loan - fixed interest rate</th>
<th>duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal amount (Lek)</td>
<td>5 years</td>
</tr>
</tbody>
</table>

Other costs

Reference rate (as for example EURIBOR) = ?

<table>
<thead>
<tr>
<th>Bank loan - variable interest rate</th>
<th>duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal amount (Lek)</td>
<td>5 years</td>
</tr>
</tbody>
</table>

Other costs

4. Regarding municipal bond loans, please quantify the following parameters (by filling the yellow parts in the following Table 2):
   a) Reference rate (as for example EURIRS) in case of a fixed interest rate
   b) Spread applied in case of a fixed interest rate
   c) Reference rate (as for example EURIBOR) in case of a variable interest rate
   d) Spread applied in case of a variable interest rate
   e) Bond issuing expense
   f) Other costs related to the issuance operation (advisory, technical assistance, etc.)

Table 2

Reference rate (as for example EURIRS) = ?

<table>
<thead>
<tr>
<th>Bond loan - fixed interest rate</th>
<th>duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal amount (Lek)</td>
<td>5 years</td>
</tr>
</tbody>
</table>

Bond issuing expense

Other costs related to the issuance operation (advisory, etc.)
Reference rate (as for example EURIBOR) = ?

**Bond loan - variable interest rate**

<table>
<thead>
<tr>
<th>Nominal amount (Lek)</th>
<th>5 years</th>
<th>10 years</th>
<th>15 years</th>
<th>20 years</th>
<th>25 years</th>
<th>30 years</th>
</tr>
</thead>
</table>

*Bond issuing expense*

*Other costs related to the issuance operation (advisory, etc.)*
9 References


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Meneguzzo M., (2003), Manuale di finanza innovativa per le amministrazioni pubbliche, Dipartimento della Funzione pubblica, Rubbettino editore.


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Council of Ministers
Department of Public Administration
Government Department of Information
Institute of Statistics
Ministry of Finance
Parliament
State Audit Institution