



ALBANIAN ASSOCIATION OF BANKS
BANKAT SHKËMBIMTARË TË SHqipëRIE

ALBANIAN ASSOCIATION OF BANKS



Proposed Changes in Collateral Enforcement Rules

Regulatory Impact Assessment

July 11, 2006

DISCLAIMER

The following analysis presents an estimate of the cost savings to the banking system and the possible credit growth impact that would arise from enactment of changes in collateral enforcement procedures as proposed by the Albanian Association of Banks.

This estimate should be refined with a more detailed bank survey of present collateral enforcement procedures.

The analysis does not imply and cannot be deemed to imply a Convergence endorsement of the appropriateness of the regulations that will be enacted as outcome of the public-private dialogue with the Albanian Association of Banks.

- The aim of this document is to make a preliminary assessment of the economic impact on the Albanian banks' financial statements of the outcome of an ongoing public-private dialogue action that started in 2005;
- The public-private dialogue action has the following subject:

Collateral Enforcement

- Public counterpart: Ministry of Justice
- Private counterpart: Albanian Association of Banks

Public-Private Dialogue action description

The AAB has been interacting with the Ministry of Justice in the **drafting process for new collateral enforcement regulations**

with the expected result of:

Improving the regulatory framework of contract enforcement

Yielding a financial benefit to the banking industry of up to about:

Lek 3.1 billion ⁽¹⁾ ⁽²⁾ (Euro 26 million)

Current lending activity

Loans to private sector and individuals

(Bln, Lek)

	2003	2004	2005
Short-term	20.5	18.7	33.3
Medium-term	14.9	24.6	38.9
Long-term	4.6	11.0	29.3
Real estate	7.9	10.6	16.5
Total	47.9	64.9	118.0
<i>Annual growth rate (%)</i>	-	35%	82%

Loan quality

Classification (in % of outstanding loans)

	2003	2004	2005
Standard	92.3%	92.8%	94.1%
Special mention	3.1%	3.2%	3.1%
Sub-standard	1.9%	1.0%	0.8%
Doubtful	0.5%	1.0%	0.5%
Loss	2.1%	2.1%	1.0%

Current collateral enforcement practices in Albania

Foreclosure procedure

Insolvency procedure

Time (years)

1.07 (390 days)

Time (years)

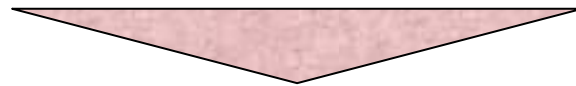
4

Cost (% of debt amount)

29

Cost (% of estate value)

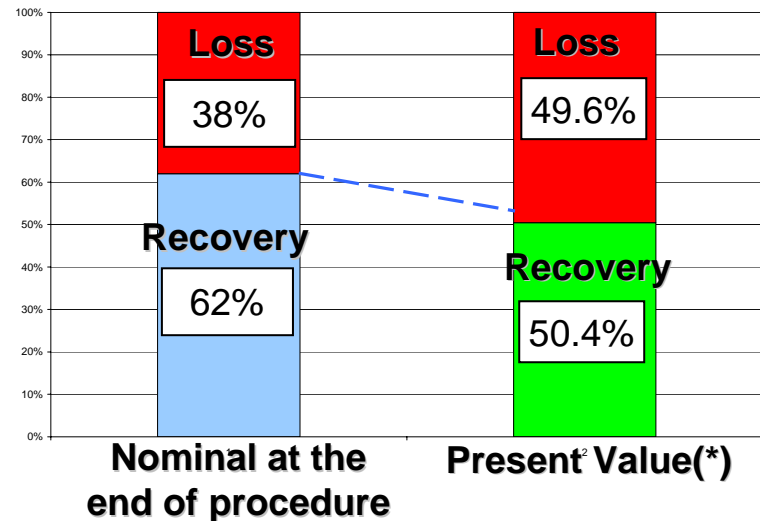
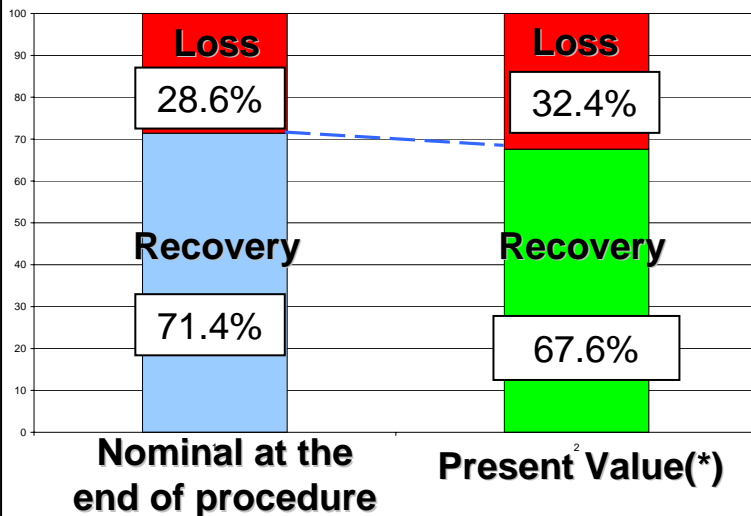
38



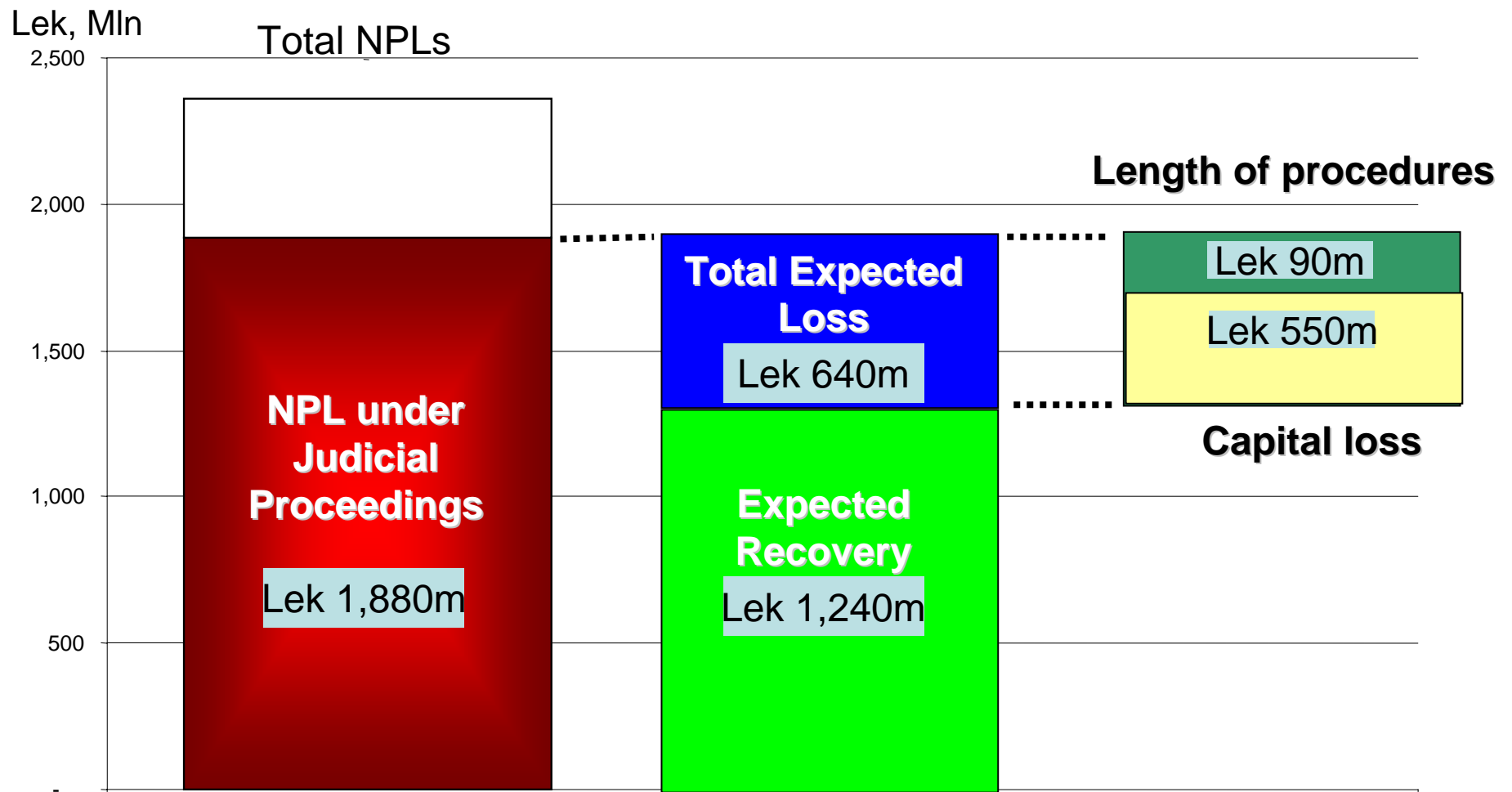
Estimates of recovery rate for loans via the two procedures

Foreclosure procedure

Insolvency procedure



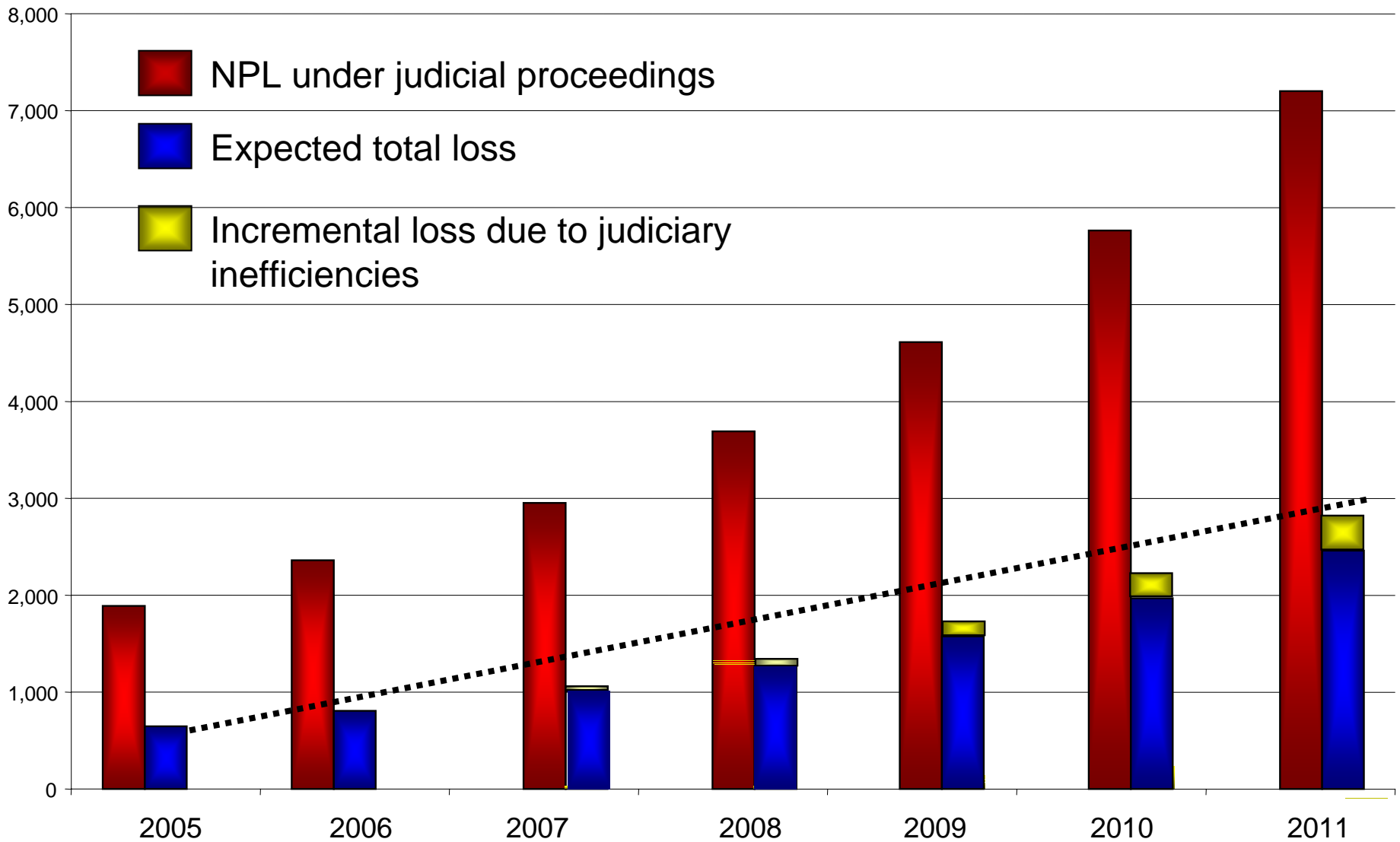
NPLs under judicial proceedings: estimated value impairment (2005)



- **The Albanian banking industry is experiencing a high rate of growth in its lending activities to households, SMEs and corporates (approx. 34% over 80% in 2004 and 2005 respectively) .**
- **Why a more efficient enforcement framework? (*)**
 - Easier contract enforcement is associated with higher bank lending;
 - Bottlenecks in bankruptcy (i.e. lenders' inefficiencies in selling defaulted properties) reduce the amount that claimants can recover.
- **As of today, the total outstanding amount of banking loans does not seem to generate too many judicial disputes**

This implies that when a higher amount (in number of filings and in amount of credit granted) of disputes reaches the Courts, the current judicial set up will be put under stress. Thus, the data in the previous slide may underestimate the real cost.
- **Lack of an adequate and efficient procedure for collateral enforcement can become a risk to the current expansion phase of credit lending in Albania**

The potential medium-term risk



(1) Assumption of a worsening of the overall recovery rate as follows: 2% in 2007, 3% in 2008, 5% in 2009, 7% in 2010, 9% in 2011.

Key problem areas in current collateral enforcement practices

The current dialogue is seeking to improve contract enforcement by focusing on the following specific issues:

- Execution against debtor of unknown residence;
- Opening auction price based on Official Cadastre valuation of collateral;
- Auction procedures inadequate to protect creditor's interests.

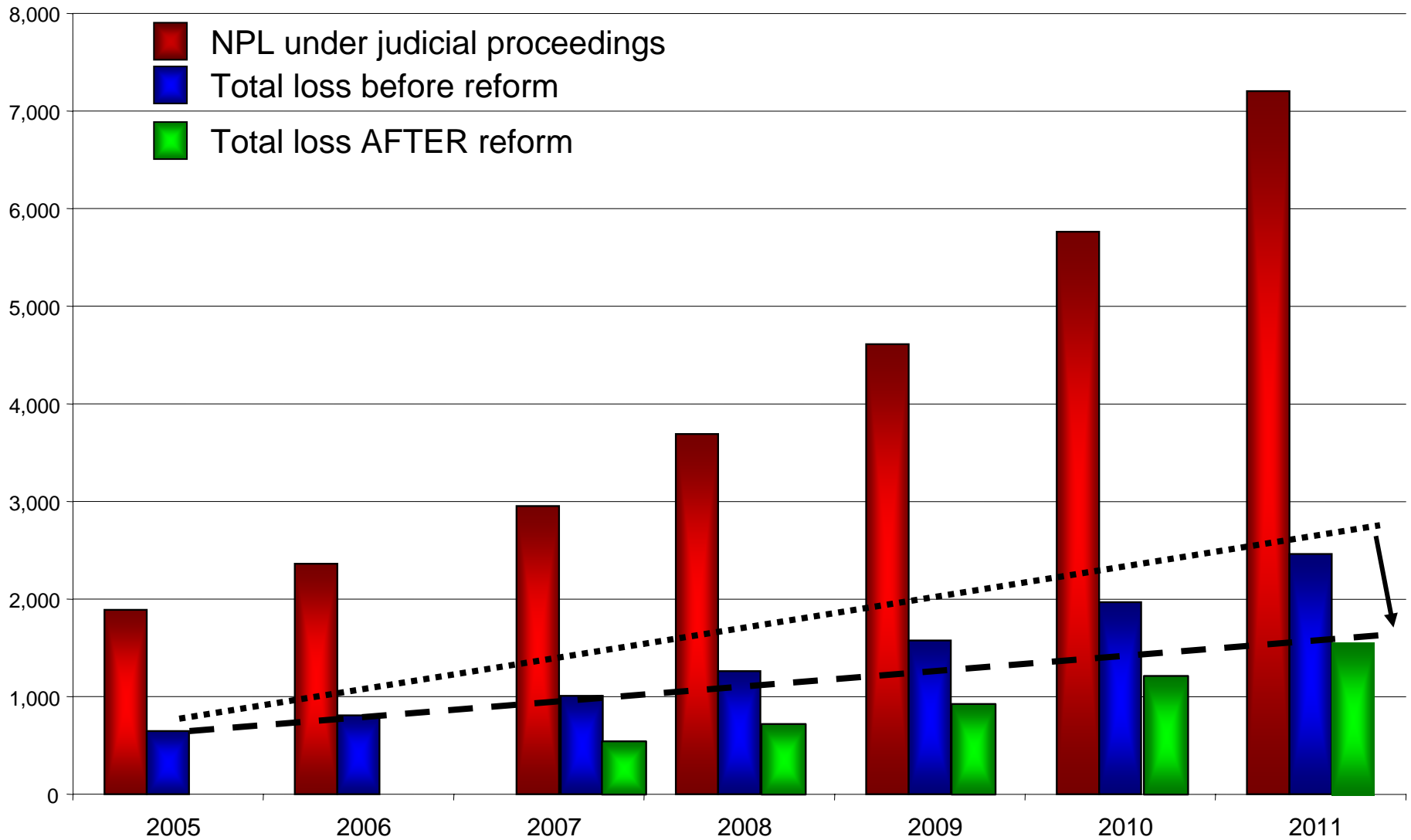
Summary Of Impact of Main Proposed Changes

<u>Main Remedy</u> ⁽¹⁾	<u>Estimated savings for the banking system (Lek mln)</u> ⁽²⁾
● Reducing uncertainty of debtors' domicile	400
● Opening auction price based on collateral market value	900
● Auction procedures redesigned to protect creditor's interest	1,800
TOTAL:	<u>3,100</u>

(1) More details about envisaged policy measures can be found in the methodological section (slides 17-24)

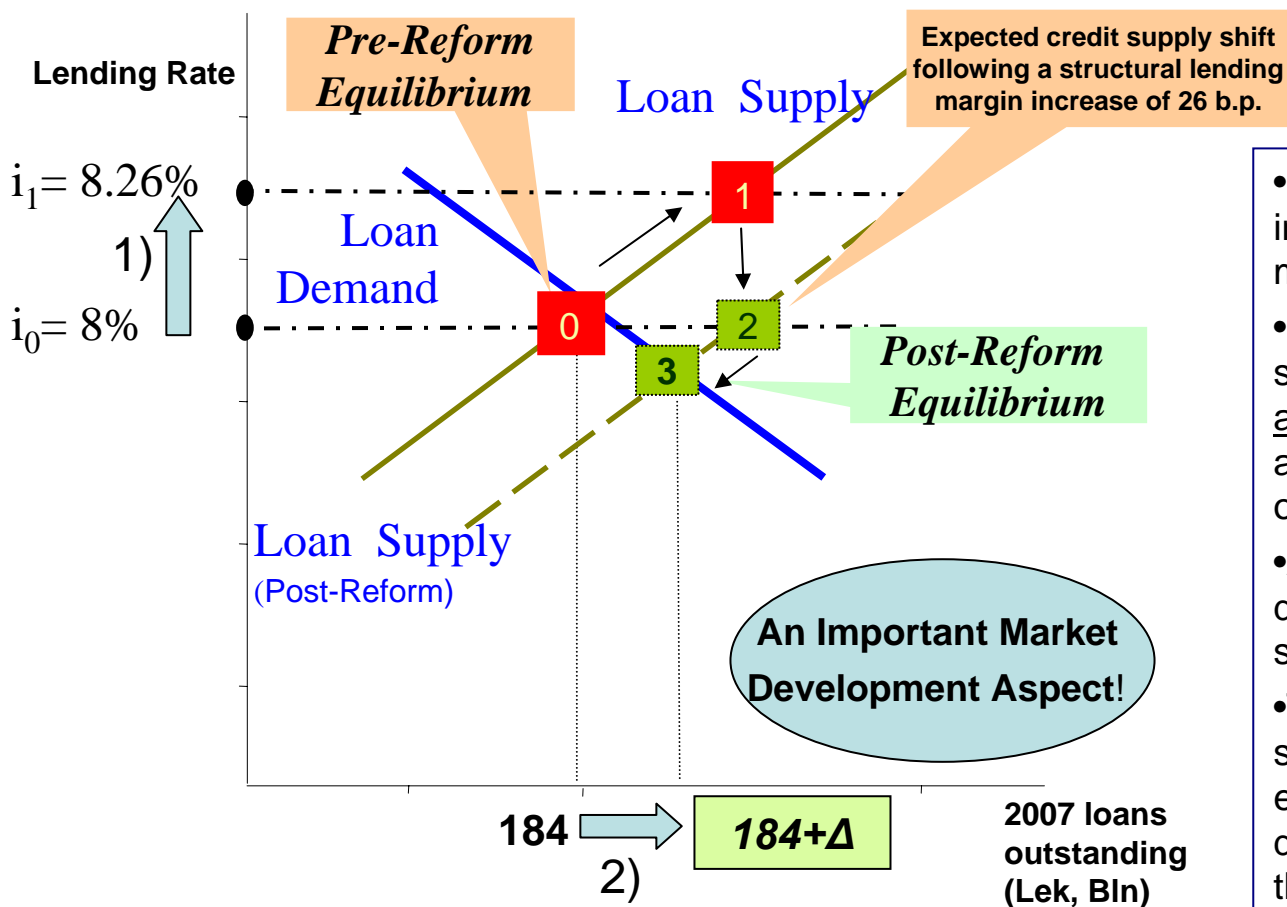
(2) Sum of PV over 5 years

Impact on recovery loss: baseline vs post-reform



1/: Amounts are expressed in PV

How Does Lower Credit Risk Impact New Lending Volume?



- Reduced recovery costs results in an increased net lending margin
- Its first-round effect on the supply of credit can be approximated by the impact of an increase in the lending rate on quantities offered (1)
- As the lending rate increase is deemed structural, the credit supply curve shifts to the right (2)
- The actual increase in the supply of credit (and the new equilibrium lending rate) will depend on the actual slope of the credit demand curve (3)

Key parameters and assumptions:

- 1) Impact of improved recovery procedures on effective lending margin: **26 basis points** (in 2007)^(*)
- 2) Quantity effect depends on elasticity of loan supply and demand curves, to be determined through further research

(*) Corresponds to projected savings of Lek 475 Mln on estimated 2007 loans of Lek 184 Bln

Conclusions

- Proposed package of measures to improve collateral enforcement procedures is likely to have a significant financial impact on Albania's financial institutions;
- It will also have an important economic impact because of a structural reduction in credit risk with quantity and price benefits to existing and potential borrowers;
- Timing of these measure is highly opportune
 - Before credit stock (and NPLs) grow

Methodology Section

Assumptions and analytics to estimate the impact
of the three proposed changes

List of Assumptions (1)

		Time Span				
		2007	2008	2009	2010	2011
A	Estimated annual lending growth rate (%)	25%				
B	Outstanding loans to private sector and individuals (Lek, Bln)	184	230	288	360	450
C	Doubtful and loss (D&L) loans (%)	2%				
D	Estimated share of D&L loans that go to judicial procedures with collateral enforcement (%)	80%				
E	Estimated amount of D&L loans that go to judicial procedures with collateral enforcement (Lek, Bln)	2.9	3.7	4.6	5.8	7.2

List of Assumptions (2)

		Time Span				
		2007	2008	2009	2010	2011
F	Estimated composition of Judicial procedures loans go through					
	Foreclosure procedures (%)	90%	90%	85%	85%	80%
	Insolvency procedures (%)	10%	10%	15%	15%	20%

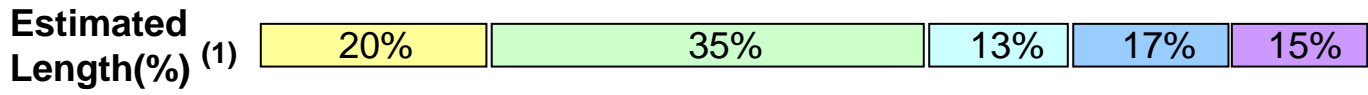
- These assumptions need to be validated through surveys and additional analytical work
- They are a useful starting point for sensitivity and scenario analysis

Collateral enforcement workflow

Main phases of collateral enforcement procedures

- Start of the legal process
- Presentation of all documents, appointment of an expert
- Scheduling and execution of first auction
- Scheduling and execution of subsequent auctions
- Closing of the procedure and distribution of revenues

The present length of a judicial procedure can be estimated as follows:



Corresponding Number of Days for:

Foreclosure	78	137	51	66	59
Insolvency	292	511	190	248	219

Total length (days)	Nominal value recovered
390	71%
1,460	62%

(1) Need for bank survey

A) Reducing uncertainty of debtor's domicile

Regulatory baseline:

Borrowers may submit to the bank an unknown and unconfirmed address.

AAB proposal:

To make it compulsory to nominate a legal representative of the debtor within a specified deadline from filing.

Phase of the procedure affected by the proposal



Economic driver affected by the proposal:

Reduction of process duration and increase in amounts recovered

Estimate of loans affected by the proposal :

20%

Assumption:

Timeframe for identifying “uncertain” borrowers” reduced from 4 to 1.5 times that required for fully identifies borrowers;

10% of defaulted loans would currently be written off due to inability to serve notices. These loans would be recovered at the average rate of 71% under the new proposals

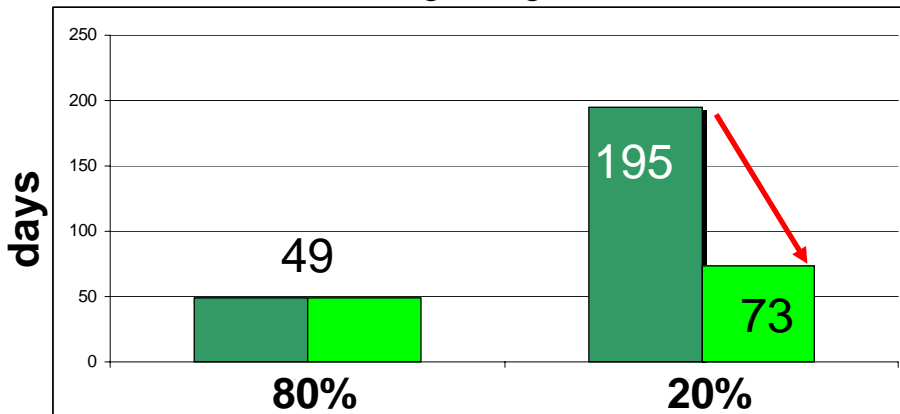
NPV Benefit (Lek, Mln) ⁽¹⁾:

400

A) Reducing uncertainty of debtor's domicile (2)

Foreclosure procedures (I stage)

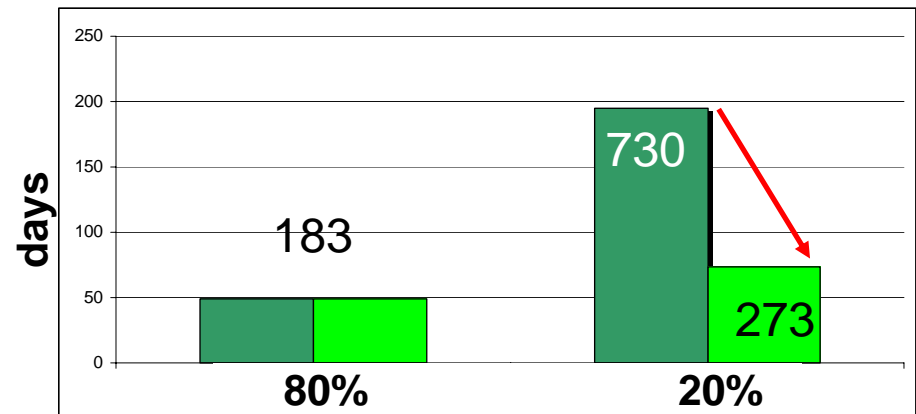
Present average length: 78 days



Future average length: 53 days

Insolvency procedures (I stage)

Present average length: 292 days



Future average length: 200 days

A) Reducing uncertainty of debtor's domicile(3): RIA spreadsheet

		2007	2008	2009	2010	2011		
Benefit I	Bad loans (Mln, Lek)	a)	2,950.29	3,687.86	4,609.82	5,762.28	7,202.85	
	Part of debt interested by this regulatory change (%)	b)	20%	20%	20%	20%	20%	
	Composition of Judicial procedures	c)						
	Foreclosure procedures	c-1)	90.0%	90.0%	85.0%	85.0%	80.0%	
	Insolvency procedures	c-2)	10.0%	10.0%	15.0%	15.0%	20.0%	
			100.0%	100.0%	100.0%	100.0%	100.0%	
	Sub-part of debt that benefits from reduction of length (%)	d)	80%	80%	80%	80%	80%	
	Estimated reduction of length in the first stage - Foreclosure (days)	e)	122	122	122	122	122	
	Estimated reduction of length in the first stage - Insolvency (days)	f)	456	456	456	456	456	
	Estimated lending rate (%)	g)	8%	8%	8%	8%	8%	
	Amount of debt entitled for the benefit I (Lek, Mln)	h)						
	Foreclosure procedure	h-1)=a*c-	424.84	531.05	626.94	783.67	921.96	
	Insolvency procedure	h-2)=a*c-	47.20	59.01	110.64	138.29	230.49	
			472.0	590.1	737.6	922.0	1152.5	
	Annual benefit from reduction of length	i)						
Foreclosure (Lek, Mln)	i-1)	11.06	13.82	16.32	20.40	24.00	85.60	
Insolvency (Lek, Mln)	i-2)	4.77	5.96	11.17	13.97	23.28	59.14	
		15.83	19.78	27.49	34.36	47.27	144.74	
PV		15.03	17.84	23.55	27.95	36.52	120.88	

A) Reducing uncertainty of debtor's domicile(4): RIA spreadsheet

Benefit II	Nominal value recovered otherwise completely written off - Foreclosure (%)	j-1)	71.4%	71.4%	71.4%	71.4%	71.4%	
	Nominal value recovered otherwise completely written off - Insolvency (%)	j-2)	62%	62%	62%	62%	62%	
	Sub-part of debt that benefits from credit recovery (%)	k)	10%	10%	10%	10%	10%	
	Amount of debt entitled for the benefit II (Lek, Mln)	l)						
	Foreclosure procedure	l-1)	53.11	66.38	78.37	97.96	115.25	
Insolvency procedure	l-2)	5.90	7.38	13.83	17.29	28.81		
Credit recovered - nominal value (Lek, Mln)		m)						
	Foreclosure procedure	m-1)	37.92	47.40	55.95	69.94	82.29	293.50
	Insolvency procedure	m-2)	3.66	4.57	8.57	10.72	17.86	45.39
			41.58	51.97	64.53	80.66	100.15	338.88
	PV		39.48	46.87	55.27	65.61	77.36	284.58
Benefit I+Benefit II - Grand Total (Lek, Mln)			57.40	71.75	92.02	115.02	147.42	483.62
	PV		54.51	64.71	78.81	93.56	113.87	405.47

B) Opening auction price based on market value (1)

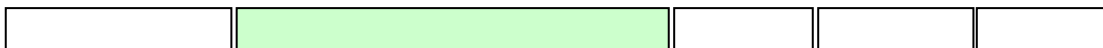
Regulatory baseline:

According to current regulation, the value is based on the Official Cadastre, which is often lower than market value

AAB proposal:

The auction must have a base price based on the market value of the collateral given by an independent panel.

Phase(s) of the procedure affected by the proposal



Economic driver affected by the proposal: Higher loan recovery through collateral liquidation

Estimate of loans affected by the proposal : **70%**

Assumption: *Increase in proceeds from collateral liquidation of 10%*

NPV Benefit (Lek, Mln) ⁽¹⁾: **900**

B) Opening auction price based on market value (2)

RIA Spreadsheet

		2007	2008	2009	2010	2011	
Bad loans (Mln, Lek)	a)	2,950.29	3,687.86	4,609.82	5,762.28	7,202.85	
Part of debt interested by this regulatory change (%)	b)	70%	70%	70%	70%	70%	
Composition of Judicial procedures	c)						
Foreclosure procedures	c-1)	90.0%	90.0%	85.0%	85.0%	80.0%	
Insolvency procedures	c-2)	10.0%	10.0%	15.0%	15.0%	20.0%	
		100.0%	100.0%	100.0%	100.0%	100.0%	
Amount interested by this regulatory change	d)						
Foreclosure procedures	d-1)=a*b*c-1	1,858.68	2,323.35	2,742.85	3,428.56	4,033.60	
Insolvency procedures	d-2)=a*b*c-2	206.52	258.15	484.03	605.04	1,008.40	
Higher collateral realisation value (%)	e)			10%			
Recovery rate at the end of procedure (%)	f)						
Foreclosure	f-1)			71.4%			
Insolvency	f-2)			62.0%			
Incremental value of the collateral due to a market-based estimate* (%)	g)						
*Assumption: the incremental value completely transferred to the repayment of loan							
Foreclosure procedures (%)	g-1)=e*f-1			7.14%			
Insolvency procedures (%)	g-2)=e*f-2			6.20%			
Amount of incremental credit recovered due to the higher value of the collateral (Lek, Mln)	h)						
Foreclosure procedures - nominal value	h-1)	132.71	165.89	195.84	244.80	288.00	1,027.23
Insolvency procedures - nominal value	h-2)	12.80	16.01	30.01	37.51	62.52	158.85
		145.51	181.89	225.85	282.31	350.52	1,186.09
PV		128.55	152.60	179.94	213.61	251.87	926.57

C) Auction procedures redesigned (1)

Regulatory baseline:

in case the immovable property is not sold in the second auction, the CPC forces the bank either to take possession of the property or to lose collateral title.

AAB proposal:

Allow the creditor to choose the timing for the second auction so as to maximize the sale proceeds, allow more flexibility in setting price range for second auction

Phase(s) of the procedure affected by the proposal

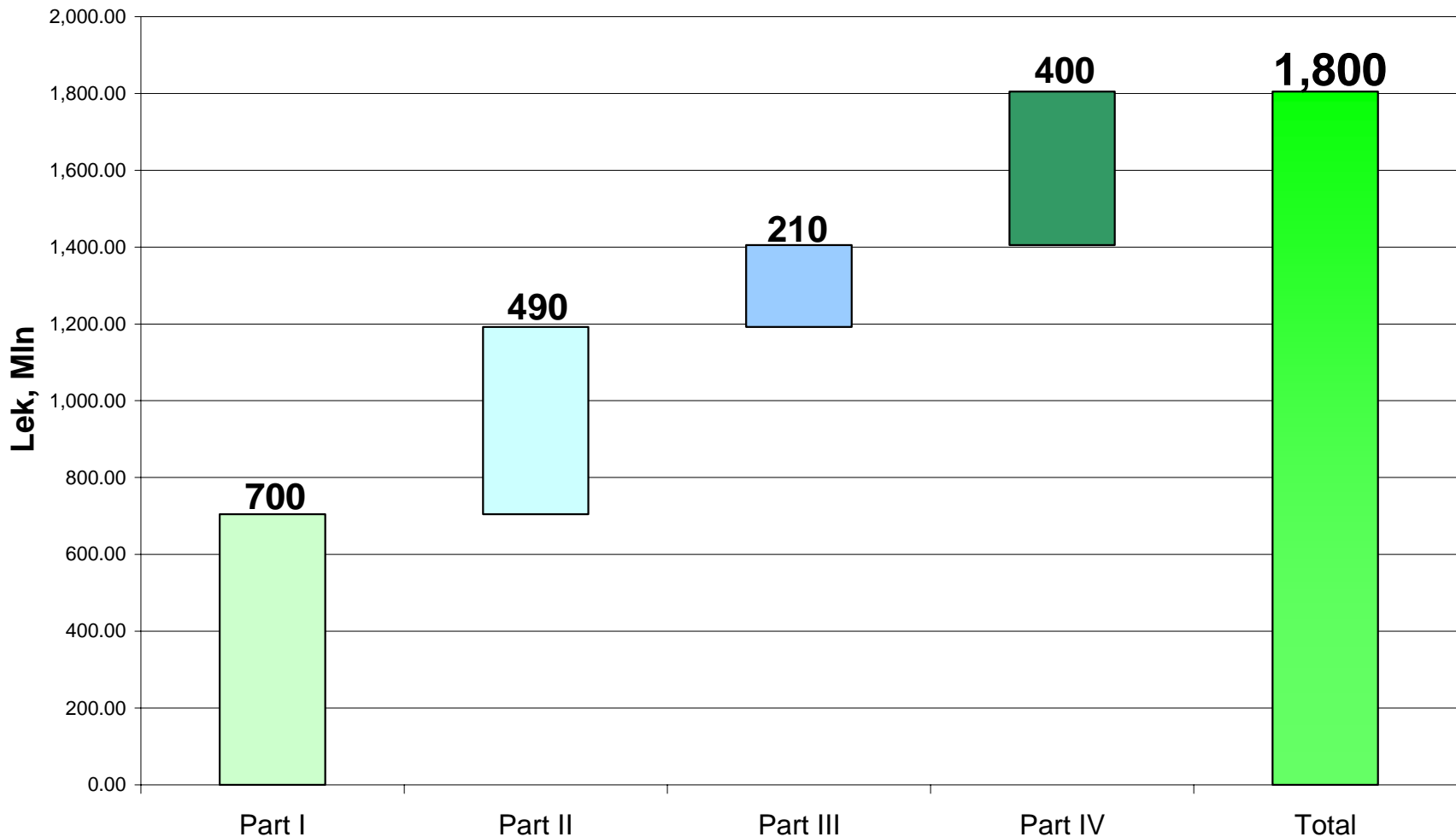


Economic driver affected by the proposal: Recovered amounts from sale of collateral, opportunity costs from locked-up capital, and transaction costs on avoidable property transactions

Estimate of loans affected by the proposal : **30%**

NPV Benefit (Lek, Mln) ⁽¹⁾: **1,800**

C) Auction procedures redesigned (2)



Part I: Loss from difference between awarding price and outstanding loan

Part II: Opportunity cost on capital “locked up” in real estate assets

Part III: Brokerage and other transaction costs to eventually liquidate the asset

Part IV: Loss on eventual sale of collateral at a lower price

C) Auction procedures redesigned (3)

RIA Spreadsheet - Loss from difference between awarding price and outstanding loan

		2007	2008	2009	2010	2011	
Bad loans (Mln, Lek)	a)	2,950.29	3,687.86	4,609.82	5,762.28	7,202.85	
Part of debt interested by this regulatory change (%)	b)	30%	30%	30%	30%	30%	
Composition of Judicial procedures	c)						
Foreclosure procedures	c-1)	90.0%	90.0%	85.0%	85.0%	80.0%	
Insolvency procedures	c-2)	10.0%	10.0%	15.0%	15.0%	20.0%	
		100.0%	100.0%	100.0%	100.0%	100.0%	
Amount interested by this regulatory change (Lek, Mln)	d)						
Foreclosure procedures	d-1)	796.58	995.72	1,175.51	1,469.38	1,728.68	
Insolvency procedures	d-2)	88.51	110.64	207.44	259.30	432.17	
Part I							
Weighted awarding price							
Foreclosure	e)						
	e-1)						
			71.4				
		Current regulation	30.0%	84	<u>0.50</u>	42.0	
			70.0%	84		84.0	
	e-2)						
			75.2				
		Better regulation	30.0%	84	<u>0.65</u>	54.6	
			70.0%	84		84.0	
Higher collateral realisation value (%)	f)=(e-2)-(e-1)						12.6%
Insolvency	g)						
	g-1)						
			62.0				
		Current regulation	30.0%	72.94	<u>0.50</u>	36.5	
			70.0%	72.94		72.9	
	g-2)						
			65.3				
		Better regulation	30.0%	72.94	<u>0.65</u>	47.4	
			70.0%	72.94		72.9	
Higher collateral realisation value (%)	h)=(g-2)-(g-1)						10.9%
Higher collateral realisation (Lek, Mln)	j						
Foreclosure - nominal value	j-1)=a*b*c-1*f	100.4	125.5	148.1	185.1	217.8	776.9
Insolvency - nominal value	j-2)=a*b*c-2*h	9.7	12.1	22.7	28.4	47.3	120.1
		110.1	137.6	170.8	213.5	265.1	897.0
PV		97.73	116.01	136.80	162.39	191.47	704.39

C) Auction procedures redesigned (4)

RIA Spreadsheet - Opportunity cost on capital "locked up" in real estate assets

<u>Part II</u>							
Oppcortunity cost	k)						8%
Timespan	l)						1
Magnitute of the opportunity cost (Lek, Mln)	$m)=[(a*b)*(1+k)]-(a*b)$	70.81	88.51	110.64	138.29	172.87	581.1
PV		67.24	79.82	94.76	112.48	133.53	487.84

C) Auction procedures redesigned (5)

RIA Spreadsheet - Brokerage and other transaction costs to eventually liquidate the asset

<u>Part III</u>							
Intermediation commission (%)	n)						5%
Intermediation commission (Lek, Mln)	o)						
Foreclosure	$o-1)=a \cdot b \cdot c-$ $1 \cdot n \cdot n$	28.44	35.55	41.97	52.46	61.71	220.1
Insolvency	$o-2)=a \cdot b \cdot c-$ $2 \cdot g \cdot n$	2.74	3.43	6.43	8.04	13.40	34.0
		31.18	38.98	48.40	60.50	75.11	254.2
PV		29.61	35.15	41.45	49.20	58.02	213.44

C) Auction procedures redesigned (6)

RIA Spreadsheet - Loss on eventual sale of collateral at a lower price

Part IV							
Lower re-selling price (%)	p)			10%			
Loss due to unfavourable re-selling - foreclosure (mln, Lek)	$q)=a*b*c-1*e*p$	56.88	71.09	83.93	104.91	123.43	440.24
Loss due to unfavourable re-selling - insolvency (mln, Lek)	$r)=a*b*c-2*g*p$	5.49	6.86	12.86	16.08	26.79	68.08
		62.36	77.95	96.79	120.99	150.22	508.32
	PV	55.38	65.74	77.52	92.02	108.50	399.16

This a Convergence Analysis

“Convergence”⁽¹⁾ is a financial sector development program for South-East Europe focused on:

- Undertaking, as an “honest broker”, analytical tasks of micro-institutional issues as a basis for identifying solutions tailored to country circumstances
- Taking EU integration as a strategic perspective
- Building awareness of market participants, involving them in the search of market-building solutions, and fostering their dialogue with authorities
- Using the experience of regional former policy makers and local experts whenever possible
- Working in partnership with other institutions

Contact: Convergence@worldbank.org

(1) “Convergence” is sponsored by the World Bank with the support of a grant from Italy’s Ministry of Economy