SPI Albania Project on
"Reviewing the Capital Adequacy Regulation"

Minutes
of the meeting with the PWG member from RZBAL and PMT

Purpose of the Meeting:

To follow-up with the 2nd PWG meeting task of SPI Secretariat and PMT to discuss on the RZBAL experience in implementing Basel II recommendations on credit and operational risk.

Participants:

Ms. Miranda Ramaj, Deputy Director, Supervisory Department, Bank of Albania and Project Manager - PM
Ms. Ermira Curri, Chief of Regulation, Interpretation and Standards, Supervisory Department, Bank of Albania and PWG member.
Mr. Gerond Ziu, Chief of Inspection Office, Supervisory Department, Bank of Albania.
Mr. Eris Sharxhi, Chief of Offsite Analysis Office, Supervisory Department, Bank of Albania.
Ms. Majlinda Gjata, Head of Risk Management Division, RZBAL, PWG member
Ms. Endrita Xhaferaj, SPI Albania Director of Financial Modernization Program & Analytics

Venue:

March 9, 2008 – Raiffeisen Bank, Albania.

The Project Manager and her Bank of Albania's team working on Basel II implementation, together with SPI Secretariat, met with the Head of Risk Management Division at Raiffeisen Bank Albania (RZBAL). The objective of the meeting was to discuss the experience of RZBAL in the implementation of Basel II, with a particular focus on the Standardized Approach on credit risk.

Ms. Gjata explained that in order to comply with Raiffeisen International Group standards, the RZBAL needed to replace the current system with a solution that complied with the requirements for the Standardized Approach and/or the Internal Rating Based Foundation Approach (IRB) according to Basel II recommendations.

As she explained it, implementing Basel II requirements is both a business and an IT issue, and it involves a major change in the bank's software at considerable costs. The software side required implementation of a "Rating Database" that covers country and bank ratings, as well as the ratings of financial customers.

Since 2005 Raiffeisen has started collecting data according to the needs of credit risk measurement for both the Standardized and the Internal Rating Based Approach. Data should be collected for enough time to create relevant time series on the basis of which to decide about scoring.

1. Credit Risk

RZBAL is implementing the Standardized Approach for Credit Risk, and aims at implementing the Internal Rating Based Foundation Approach in the near future.

The concept papers have been delivered from Raiffeisen International (Vienna), with detailed information and guidelines.

1.1. Asset segmentation and risk weighted assets calculation

First, guidelines were given for the asset class segmentation in order to be able to calculate Risk Weighted Assets (RWA).

According to the Standardized Approach the following exposures have been determined:

(a) claims or contingent claims on central governments or central banks;
(b) claims or contingent claims on regional governments or local authorities;
(c) claims or contingent claims on administrative bodies and non-commercial undertakings;
(d) claims or contingent claims on multilateral development banks;
(e) claims or contingent claims on international organizations;
(f) claims or contingent claims on institutions;
(g) claims or contingent claims on corporate;
(h) retail claims or contingent retail claims;
(i) claims or contingent claims secured on real estate property;
(j) past due items;
(k) items belonging to regulatory high-risk categories;
(l) claims in the form of covered bonds;
(m) securitization positions;
(n) short-term claims on institutions and corporate;
(o) claims in the form of collective investment undertakings ('CIU'); or
(p) other items.

Different concept papers have been delivered for the classification of customers in retail and non retail, retail leasing, and other types of assets. In addition, different concept papers have been delivered on the RWA calculation for different type of asset class segment.

Ms. Gjata explained as an example the case of RETAIL. Under the standardized approach, RBAL Group has identified retail asset class (01- private individual and 20 - micro) under two broad categories:

- **Exposures secured on real estate** that includes exposures secured by residential mortgage, exposures secured by commercial mortgage and any other exposure which is secured by real estate, as separate sub-portfolios; and
- **All other retail exposures** including all retail products that are not mortgages.

Using the risk weights (RW) and the exposure amounts, risk-weighted assets are calculated for each exposure as:

RWAi = RW(i) x Exposure amount(i)

Total risk-weighted assets (for the retail portfolio) are then calculated as:

Total RWA = ΣRW(i) x Exposure amount(i)

where the RWA represents the overall risk-weighted assets of the retail portfolio.

1.2. Credit Risk Mitigation

In compliance with RI indications and Basel II Directive provisions, in order to determine if the collaterals can be recognized for credit protection, the following steps must be realized:

1. Fulfillment of operational and risk management requirements: Preparation and implementation of risk management processes to control the risks it is exposed to in the collateralized transaction;

2. Checking of the collateral eligibility;

3. Checking the legal certainty of the collaterals;

4. Additional requirements depending on the approach chosen;

5. Identification of "maturity and currency mismatch" ("Maturity mismatch" means that the residual maturity of the protected exposure concerned is longer than the residual maturity of the credit protection involved, and "Currency mismatch" means that the credit protection is labeled in a currency different from the currency of the exposure);

6. Determination of the Credit Risk Mitigation effects.

2. Operational Risk.

Raiffeisen Bank Albania is actually calculating required capital for operational risk using the Basic Indicator Approach, thus multiplying by 12.5% the annual gross positive income.

By year 2015 they are expected to be in full compliance with the Advanced Measurement Approach (AMA). For this purpose, the risk department has started collecting and preparing the Loss Incidents database and develop their own risk model with 25 Scenario Analysis.

The meeting members agreed that the gross income, taken into consideration in the basic indicator approach, might be not very relevant to calculate the operational risk. AMA might be more appropriate but more difficult to apply in big banks as it requires many efforts to collect data.

Ms. Gjata expressed the opinion that the level of 12% of the capital adequacy ratio in Albania (instead of 8% in other countries) might be covering already the need for additional capital reserve for operational risk.

3. Conclusions

The participants at the meeting acknowledged the very interesting and valuable experience of RZBAL on implementing Basel II recommendations. It gave some good indications on how to move toward the Standardized Approach in calculating capital requirements for credit risk by segmenting assets classes. It is also provided guidance on how to determine and recognize collaterals for credit protection.

The implementation process for the Standardized Approach in RZBAL started by the end of year 2005 and was completed by the end of year 2008, while the work continues for the implementation of the Internal Rating Based Foundation Approach. This provides an indication on the time span needed to fully implement different approaches to risk management.

The team from Bank of Albania took note on the RZBAL's experience and steps followed, as guidance in its way towards the implementation of Basel II in Albania. However, BoA is also taking in consideration the need to make the implementation strategy acceptable and adaptable for all commercial banks in Albania, which have different data entry systems, and different levels of risk management.