SPI Project on Reviewing the Capital Adequacy Regulation

Project Objective

Within the policy goal of improving the capital adequacy to the credit risk and to the operational risk according to Basel II, First pillar, the project objective is to prepare the necessary regulatory amendments and to define an implementation timeframe

Project Management Team

Project Owner (PO): Indrit Banka, Supervision Director, BoA
Project Manager (PM): Miranda Ramaj, Supervision Deputy Director, BoA
Deputy Project Manger (DPM): Adela Xhemali, VP, Head of Finance Department, Intesa San Paolo Bank

Minutes

First meeting
December 5, 2008—AAB premises

Attendees: Miranda Ramaj, BoA (PM)
Ermira Curri, BoA (DPM)
Admir Ramadani, FIB (member)
Entela Gjyzari, BP (member)
Rezarta Kocollari, NBG (alternate member)
Elona Bollano, SPI Albania, Director of Analysis and Policy
Anuela Ristani, SPI Albania, Director of Operations

AGENDA

I. Welcome Note and Introduction of Participants

II. Presentation of SPI Albania

III. Project Terms of Reference presentation (Discussion and approval)

IV. Presentation of the Draft Note on International Experience (Discussion and approval)

V. Presentation of the Scoping of the Problem Document (Discussion and approval)

VI. Presentation of the Cost-Benefit Analysis (Discussion and approval)

VII. Conclusions and Distribution of Tasks

VIII. Closing Remarks

I. Welcome Note and Introduction of the Participants

PM and SPI Secretariat welcomed all the PWG members and introduced the PMT, and the SPI Albania Secretariat. All members introduced themselves and the institutions they were representing. The PM and the PWG members suggested that the PWG should include all 16 banks' representatives due to the importance of the objective for this project and since the entire process of Basel II implementation will require constant consultations all the banks. SPI Secretariat will ask for AAB assistance in communicating to all the banks in order for them to appoint their respective representatives as PWG members. SPI Secretariat will follow up accordingly in order for the PWG composition to be completed before the second PWG meeting.

II. Presentation of SPI Albania

In order for the PWG members to have a better understanding on the SPI work process and, the SPI Secretariat held a short presentation focusing on the SPI Albania Project management and Methodologies.

The SPI Secretariat presented to the PWG the organizational and Project Management structures that lead all the SPI project initiatives from the conception of the project proposal until the enactment procedures for each project outcome. The partnership is lead by a high level public private Committee with representatives from BoA (First Deputy Governor), AAB (Chairman) and the Head of Convergence Program (World Bank) as well as 3 Permanent Observers (MoF, AMF and Market Surveillance

Department-MoE). SPI Secretariat orchestrates different working groups for each SPI Project.

SPI Secretariat presented the role and responsibilities of the PMT and PWG members as well as the role of the Secretariat throughout the entire project process from the initial initiative to enactment monitoring.

SPI Secretariat presented the methodology followed for every SPI Albania project. After the Terms of Reference are endorsed by the SPI Committee and reviewed / approved by the PMT, the PWG first target is identifying the problem and its causes (a market or a regulatory failure) in order to understand if it creates the case for a regulatory intervention or for self-regulatory actions. PWG defines the policy objectives to be achieved with this project and considers if 'do nothing option' could be a solution and its costs. PWG identifies then the possible regulatory/self-regulatory policy options that could be envisaged for solving the problem.

Once the Scoping of the Problem is concluded as described above, the PWG is focused on the Analysis of the impact that is: to identify and state the costs borne and benefits yielded by consumers, and by the regulator and regulated firms and to collect market structure data to perform a quantitative cost and benefit analysis. While SPI Albania has performed three different bank questionnaires, the first complete regulatory impact assessment was conducted for the Civil Procedure Code changes, where the impact of the suggested changes was measured in number of days and costs reduced for the foreclosure procedures.

With the conclusion of the analytical work, the policy document is drafted and consultations are run with various stakeholders. The actual work of the PWG is concluded with the SPI Committee approval of the final PWG recommendation. However the PWG members, representing the professional experts for each respective project, will stand ready to participate in further consultations with the regulators or other authorities during the enactment process.

III. Project Terms of Reference presentation (Discussion and approval)

SPI Secretariat presented the Project Terms of Reference as the outlining document that will guide the PWG through all the project steps.

BoA is seeking to improve and to expand the coverage of the regulation on capital adequacy in order to capture a wider range of risks faced by the banks. The current regulation on Capital Adequacy establishes the regulatory capital to risk weighted assets and off-balance sheet items ratio, and sets the minimum required limit for this ratio.

The methodology used in the current framework calculates the (minimum) regulatory capital to cover only for credit risk. BoA intends to improve risk management in line with Basel II, by enhancing the methodology for calculating risk weighted assets to credit risk and by including the operational risk in calculating the capital requirement.

In this way in the banking regulations will be introduced the first pillar on minimum capital requirements of Basel II.

Basel Committee for calculating credit risk charges permits banks to choose between two broad methodologies. One alternative is to measure credit risk in a standardized manner using the Standardized Approach. The other alternative, the Internal Ratings-based Approach, allows banks to use their internal rating systems for credit risk management. This approach is subject to the explicit approval of the bank's supervisor.

For calculating operational risk charges the Committee provides three methods: (i) the Basic Indicator Approach; (ii) the Standardized Approach; and (iii) Advanced Measurement Approaches (AMA).

Given the current status of developments of the banking industry and the internal capacities, BoA has considered that the **Simplified Standardized Approach** as the most appropriate method for calculating credit risk charges. In line with the simplified standardized approach Basel Committee suggests the **Basic Indicator Approach** for operational risk.
Committee encourages banks to move along from the spectrum of available approaches [starting from (i)] as they develop more sophisticated operational risk measurement systems and practices. The other more sophisticated approaches require long time series and experience in operational risk identification and management

Therefore, the project objective is to prepare the necessary regulatory amendments and to define an implementation timeframe.
The objective of the project will be achieved by undertaking the following actions:

1. The identification the legal framework that regulates the capital requirements for banks
2. The acquisition of a clear understanding on the provisions of Basel II and EU respective directives and international experience on capital adequacy framework, focused on credit and operational risk;
3. Based on the gained expertise, to formulation of the proposal for amendments in the existing legal framework and/or for issuing new regulations and guidelines in order to have a comprehensive regulatory framework;
4. The assessment of the possible impact of the new methodologies on credit and operational risk and run consultations on the regulatory design and impact;
5. The identification of the implementation plan.

IV. Presentation of the Draft Note on International Experience

Basel Committee on Banking Supervision has the mandate to establish the framework on capital adequacy for credit institutions. The revised framework on Capital Accord Basel II is a comprehensive and extensive framework that describes exhaustive measures and minimum standards for capital adequacy. While in Europe, in 2006 the European Commission issued two directives on capital requirements for credit institutions. The European Directives reflect Basel II and are mandatory for the EU member countries.
Basel II lays in a three pillar structure:

- The **First Pillar** on the minimum capital requirements provides the methodologies to calculate the minimum capital requirements for credit risk, operation risk and market risk;

- The **Second Pillar** on supervisory review process provides the key principles of supervisory review, risk management guidance and supervisory transparency and accountability;

- The **Third Pillar** encourages market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

Further the methods on credit and operational risk were discussed in principle base. Related to the Simplified and Standardized Approach, for credit risk BoA intends to apply the sections General rules for risk weights and the selected Credit risk mitigation techniques.

Regarding the transposition of the Capital Requirements Directive, EU member states have followed different patterns in revising their regulatory framework. In some countries, like Romania, the supervisory authorities for banking and for securities have amended the entire legal framework (banking law, regulations, and orders), in cascade, in order to reflect the capital adequacy principles and requirements.

Another group of countries have included all the changes brought by the new directive on capital adequacy in one single document. Poland and the Czech Republic for example, have issued a single document on the capital requirements against particular risks and the detailed principles to be applied in determining those requirements, in a very comprehensive resolution on capital.

V. Presentation of the Scoping of the Problem Document (Discussion and approval)

This document analyzes the market, the participants and the regulatory framework that governs this market. In the analysis is identified that the regulatory framework on capital requirements has not been updated to the new realities and complexity of the banking activities and the capital requirements are not covering currently all the types of risks. According to our assessment this situation, in the near future, will lead in a regulatory failure, as the regulation would be wrongly prescribed for the market. There is no evidence for this regulatory failure in terms of banking bankruptcies, but the central bank should act in a visionary and prudent manner and prevent the occurrence of these situations in the future. This regulatory failure threats Bank of Albania's objective to ensure the banking stability.

To respond to these developments banks might introduce voluntarily operational risk charges or even use more sophisticated methods to account for credit risk. Given that a large share of banks operating in Albania are part of international groups, some banks (or the respective parent) might have already introduced operational risk when defining the strategy or are planning to introduce it in the near future. Anyhow the intervention from the central supervisory authority is essential in order to establish and apply a uniform methodology that would correctly reflect the prudential concerns on credit and operational risk.

The capital adequacy framework might be revised in a comprehensive manner (Option 1) by transposing the two methodologies in credit risk and the three methodologies in operational risk or (Option 2) in a more tailored manner by improving the credit risk methodology and, as suggest by the Committee, introduce in the first stage the Basic Indicator Approach for operational risk and in a latter stage complete the operational risk requirements by introducing the two other approaches.

VI. Presentation of the Cost-Benefit Analysis (Discussion and approval)

With regards to the Cost and Benefits to stakeholders the PWG generally agreed that there will be some costs related to the initial implementation of the revised framework, but in the long run the benefits, in monetary and non-monetary terms, will exceed by far the identified costs.

VII. Conclusions and distribution of tasks

- SPI Secretariat will send the meeting minutes and the revised drafts of the documents for final approval to the PWG
- SPI will invite, through AAB, all the banks to participate through their respective representatives in the PWG.

VII. Closing Remarks

The second PWG meeting is preliminarily scheduled to take place in January 2009.