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"Scoping of Problem" Document

Project: Reviewing the Capital Adequacy Regulation

Section 1
Project information

PUBLIC-PRIVATE FINANCIAL SECTOR MODERNIZATION MATRIX					
Italian Banking Association CRITERIA	**European Central Bank CRITERIA**				
	Asymmetric information reduction	*Completeness of the market*	*Increased opportunities to engage in financial transactions*	*Reduced transaction costs*	*Increased competition*
Business development					
Industry competitiveness		X			
Industry reputation					

Short description of the context [from project matrix]: 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 methodology used in the current frameworks calculates the (minimum) regulatory capital to cover only for credit risk. Other risk typologies, such as operational risk, have not been addressed yet. Therefore BoA proposes to improve risk management by improving the methodology for calculating risk weighted assets, by improving the existing methodology on credit risk and by including the operational risk.

Stakeholder proposing the project: Bank of Albania

Other Stakeholders involved (sponsors): AAB and Banking community, AMF.

Project objectives:

1. To prepare the necessary regulatory amendments for a sounder prudential risk management through the improvement of credit risk measurement and the introduction of the operational risk measurement.
2. To align better Bank of Albania's capital requirements with Basel II, first pillar, framework.

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3. To define an implementation timeframe for the regulatory amendments.

Description of the project contribution toward financial modernization: The new methodologies for calculation of risk charges will provide tools for a better identification, measurement, monitoring and control of the risks credit and operational. The better adjustment of the capital to risks will promote the banking system stability, will decrease the probability of banks' default and will give thus an enhanced consumer protection.

Project Working Group:

Bank of Albania (PO & PM)

Intesa SanPaolo Bank (DPM)

Intesa SanPaolo Bank (member)

Banka e Pare e Investimeve (member)

Banka ProCredit (member)

Banka Kombetare Greke (member)

Banka Popullore (member)

FSA (member)

The EU Better Regulation Approach	
Steps	**Purpose**
Scoping of problem	
1. Problem identification	To understand if a market/regulatory failure creates the case for regulatory intervention.
2. Definition of policy objectives	To identify the effects of the market /regulatory failure to the regulatory objectives.
3. “Do nothing” option	To identify and state the status quo.
4. Alternative policy options	To identify and state alternative policies (among them the “market solution”).

Section 1:
Scoping the problem

1.1. Problem identification

Background Information

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. More specifically: the numerator of the adequacy ratio, bank’s regulatory capital, is composed of core capital and supplementary capital [1]; the denominator of this ratio consist of the risk-weighted amounts of the balance sheet assets, off balance sheet items representing term financial instruments contracts related to interest and exchange rates and other balance sheet items.

The methodology used in the current framework calculates the (minimum) regulatory capital to cover only for credit risk. Other risk typologies, such as operational risk, have not been addressed yet. Therefore BoA intends to improve risk management in line with Basel II, first pillar of the capital adequacy framework, by enhancing the methodology for calculating risk weighted assets to credit risk and by including the operational risk in calculating the capital requirement.
Basel Committee defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, the risk related, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements, but excludes strategic and reputation risk.

Basel Committee permits banks to choose among broad methodologies for calculating their capital requirements to cover credit and operational risks.

[1] More on the definition and calculation method of the regulatory bank capital is provided on the “Guideline on Regulatory Bank Capital” issued by Bank of Albania. Regulatory bank capital is composed of core capital and supplementary capital.

For calculating credit risk charges banks can 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**[2] **or the 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.

1.1.2 Market Analysis

General market: Banking market
Specific segment: Risk management under prudential framework
Sub segment: Credit market and operational activities

1.1.3 Legal framework

- Law No. 9662 Nr. 9662, dated 18.12.2006, "On Banks of the Republic of Albania".
- Regulation no. 59, dated 05.05.1999 changed, on "Capital Adequacy".
- Guideline No. 57, dated 05.05.1999 changed on "Bank's Regulatory Capital".

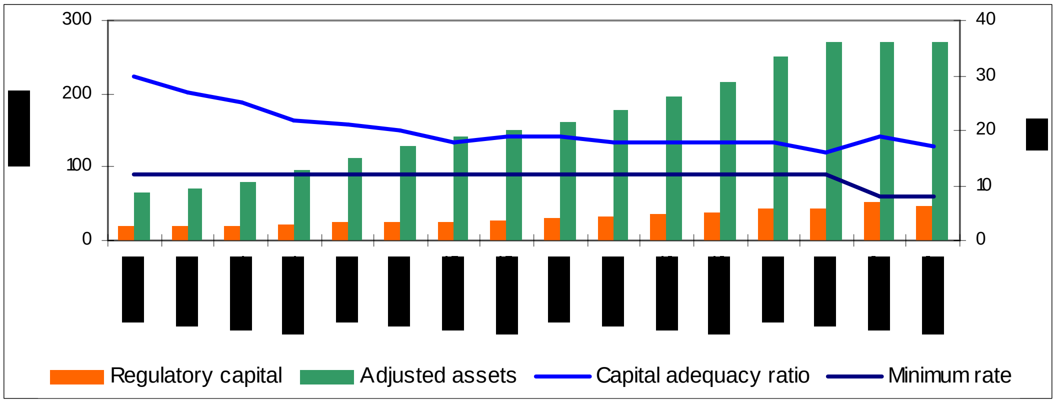
1.1.4 Stakeholders - Institutional framework

- **Bank of Albania**. According to the law "On banks" Bank of Albania shall determine through by-laws the structure, the integral elements and methods for the calculation of banks' regulatory capital (art 59.2). Accordingly, the ratio of regulatory capital adequacy is determined through by-laws of Bank of Albania and since June 2007 this ratio should not be less than 8 %.

[2] This approach is not considered as another approach *per se* for determining regulatory capital, it rather collects in one place the simplest options for calculating risk-weighted assets.

- **Commercial banks.** The Albanian banking system consists of 16 commercial banks. For 2007 the capital adequacy ratio for the banking system was 17.5%. This ratio has shown a decreasing trend since 2003, reflecting the rapid development of the banking activity.

Table: Regulatory indicators for the banking system, 2004 – 2007



Source: Bank of Albania

1.2. Market/regulatory failure analysis (nature and evidence)

The regulatory framework 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.

1.3. Policy Goal(s) threatened by the failure [e.g. financial stability, market integrity, market confidence, consumer protection, facilitating innovation, enhancing competition]

General Objectives:

- To ensure the banking system stability.

Specific objectives:

- To establish a coherent supervision function of the Supervisory Authority.
- To ensure sound prudential risk management techniques for more adequately preventing financial disruptions and protecting the depositors.
- To improve the comparability and to make a step further in the process of convergence with international capital measurements and standards

Operational:

- To improve the methodology on credit risk charges requirements.
- To introduce the operational risk concept and establish the methodology on operational risk charges for capital requirements.

1.4. “Do nothing” option

1.4.1 Possible medium-term (max 2 years) self – corrective market actions (e.g. mechanisms through which the “Do Nothing” option would address the market/regulatory failure).

In the current status of development of the banking system, the capital requirements in place reflect and cover for the potential and possible risks related to the credit activity. Integration with the global markets and the expected fast developments in the banking activities of the banking will introduce more complex typologies of banking activities and products that will introduce as well more volatility.

In addition, the current regulatory framework on capital adequacy does not reflect the latest international developments in the process of convergence with the international capital standards and measurements.

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.

1.4.2. Impact of the “Do Nothing” option to the various stakeholders
(to be filled only if the “Do Nothing” option could be taken into further consideration)

Impact on regulated firms/ banks:

- Vulnerability to operational risk and to credit risk.
- Risk of undercapitalization.

Impact on consumers:

- More exposure to the risk of bank bankruptcy.

1.5. Alternative policy option(s)

1.5.1. Broad description of the regulatory or self-regulatory action(s) needed to remedy the market or regulatory failure and hence achieve the policy goal(s)

Bank of Albania is seeking to develop the regulatory framework on capital adequacy by improving the credit risk methodology and introducing the operational risk methodology for banks when calculating the capital requirements. These developments are a step further in the process of convergence toward international capital measures and standards, as provided by the Basel Committee on Banking Supervision.

1.5.2. Possible operational regulatory or self-regulatory actions to achieve the policy goal

- to identify the regulations that will be affected.

- to perform a banking survey on the impact of the change in capital requirements.

- to set up the implementation process of the regulatory changes.

1.5.3. General description of various Options

[please give here a general sense of what each option could look like – it will be a guide to understand what Option 1 and Option 2 actually are.]

The Basel Committee permits banks a choice between two broad methodologies for calculating their capital requirements for credit risk, the Standardised Approach or the Internal Ratings-based Approach. Regarding the methodologies on calculating the capital requirements for operational risk, the Committee proposes three methods: (i) the Basic Indicator Approach, (ii) the Standardised Approach and (iii) Advanced Measurement Approaches (AMA). For the operational risk banks are encouraged to move along from the spectrum of available approaches [starting from (i)] as they develop more sophisticated operational risk measurement systems and practices.

1.5.3. Detailed description of Option 1:

For Credit Risk Methodology:

To introduce the Standardised Approach and the Internal Ratings-based Approach.

For Operational Risk Methodology

To introduce the Basic Indicator Approach, the Standardised Approach and Advanced Measurement Approaches (AMA). Banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. For the Standardised Approach and AMA banks have to fulfill some qualifying criteria and the application of these methodologies has to be approved by the Supervisory Authority.

1.5.4. Detailed description of Option 2

For Credit Risk Methodology:

To update the current credit risk methodology with the latest guidelines as provided by the Basel Committee on Banking Supervision in the Simplified Standardised Approach.

For Operational Risk Methodology

To introduce the Basic Indicator Approach.

Summary Problem Scoping			
Auction procedures under foreclosure for immovable collateral			
Market failure			
Asymmetric information	Market power	Positive externalities	Negative externalities
(Existing) Regulatory failure			
Regulation wrongly prescribed for the market	Regulations succeeded in addressing the failure; a different market failure (e.g. side effect)	Regulation made it worse	Regulation so far has failed to work; maybe in due course
x			