APENDIX

SPI Albania Project: The Impact on the Banking Regulations of IFRS Implementation

Group I – High priority regulations

1. Regulation on Credit Risk Administration

2. Regulation "On the amount and fill in the "initial minimal capital" on allowed activities for banks and foreign branches"

3. Regulation on Foreign Open Position

4. Regulation on Interest rate risk administration

5. Bank Accounting Manual

1. Regulation on Credit Risk Administration

- Substantial differences in loan provisioning policy

Under the current framework, loans are classified in 5 categories – standard loans, special attention loan, substandard loans, doubtful loans and lost loans (art.7). Among many characteristics, the days past due serve as the pivotal characteristic that rules the classification of the loan during its maturation process. To cover for potential losses from default, the bank has to create allowances, provisions, weighting periodically its expenses, respectively to the category the provisions are 1%, 5%, 20%, 50% and 100% (art.15).

Under IFRS, in accordance with IAS 39 the loan portfolio should be registered at amortized cost and subject to impairment measurement if there is an objective evidence of impairment as result of events that occurred after initial recognition of the asset and that loss event (or events) has an impact on the estimated future cash flows of the loan portfolio (financial asset) that can be reliably estimated.

The bank first has to assess whether exist objective evidence of impairment on individual or collective financial assets[1].

- If for an individually assessed asset is determined that no objective evidence of impairment exists the asset is included in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

[1] The assessment is done individually or collectively based on their significance.

- If for an individually assessed asset is determined that an impairment loss is or continues to be recognized the asset is not included in a collective assessment of impairment.

To make sound assessments on objective evidence of impairment of given financial assets requires experience in credit judgment, sound estimate techniques and comprehensive information data set systems with historical information on financial assets and groups.

- Different treatment of the calculated interest on problematic loans

Under the current framework, the calculated interests of the substandard, doubtful and loss loans are not recorded on books, in order not to burden the financial statements with interests that have a low possibility of recovery (art.13).

Under IFRS, in accordance with IAS 39 – AG 39, when an financial asset is removed as result of a lost from devaluation, the revenues from the interests are recognized, using the interest rate that is used to discount future cash flows of the monetary assets in order to measure the devaluation lost.

2. Regulation "On the amount and fill in the "initial minimal capital" on allowed activities for banks and foreign branches"

Under the current framework, if the minimal paid in capital is in foreign currency, the bank has to revaluate the capital with the current / spot exchange rate, creating a "revaluation difference" (art.4.2.1)

Under IFRS, in accordance with IASXX, capital is considered as "non-monetary" item and consequently is recorded in books with historical value. The capital is converted with the exchange rate in the date of transaction, eliminating the need to record revaluation differences.

The selected approach to convert the capital, in addition to the minimal paid in capital, affects the regulatory capital and consequently the capital adequacy ratio.

The profits calculated according to IFRS differs from the amount of profits calculated according BoA's requirements (general IFRS earning > statutory earnings). The discrepancy will be reflected in the "dividend policy".

- According to IFRS's calculations the bank might have a substantial level of profit to distribute dividends and to preserve a satisfactory level of the capital requirements; but
- According to statutory accounting calculations the bank might not have enough profits as to distribute and to preserve capital requirements.
- The extreme case: According to IFRS standards the bank is in profits and according to BoA standards the bank is in loss

3. Regulation on Foreign Open Position

Under the current framework, banks have the power to interpret regarding the out-of-balance-sheet items expressed in foreign currencies. It has to be specified which items has to be included in the process of valuating the foreign open position and it has to be specified as well the methodology (statutory or IFRS) to be used to calculate the underlying items.

4. Regulation on Interest rate risk administration

The same rationale as for the regulation on Foreign open position lies behind the regulation on Interest rate risk, regulation on Market risk and directive on Risks for foreign exchange.

The European experience with Interest rate risk management

The new international standards, as they apply to overall interest rate risk management in the banking sector, and IAS 393 in particular, initially gave rise to fears that sweeping changes would be required in the implementation procedures for asset-liability management (ALM) if no alterations were made to adjust the new principles to the context of macro-hedge accounting. Then, the application of IAS 37 on Provisions, Contingent Liabilities and Contingent Assets led to the calculation of a provision to cover the risk of the exercise of options embedded in home savings schemes.

Adoption of IAS 39 with the transitional carve-out solution.

The discussions preceding the European Commission's adoption of IAS 39 on 19 November 2004 focused on ALM. The most difficult aspects were the following ones:
– The impossibility of hedging a net position or dynamic management of hedged items and hedging instruments;
– The risk of instruments being disqualified from hedge accounting in the event of a shortfall in the hedge or the associated underlyings;
– Recognition of sight deposits, when the IASB deems that the fair value is equal to the nominal value, whereas, with regard to balance sheet management, such deposits obey runoff rules that ought to reflect their statistical stability.

IAS 39 was finally adopted on 19 November 2004, after major adjustments. The European Commission adopted only part of IAS 39 after carving out some of its provisions.
The carve-out concerns the following macro-hedge accounting principles:
– Looser requirements for hedge effectiveness to avoid disqualification in the event of a shortfall in the hedge or the underlyings;
– Lifting the ban on including sight deposits in hedged items.

This means that the version that was ultimately approved by the European Commission has had, in practice, only a limited impact on overall interest rate risk management.