

Financial RIA Capacity Building Program in Albania

Attn:

- Banka Raiffeisen
- Banka Amerikane e Shqipërisë
- Banka Kombëtare Tregtare
- Banka e Tiranës
- Banka Alpha – Shqipëri
- Banka Popullore
- Banka Credins
- Banka ProCredit
- Banka Emporiki
- Dega e Bankës Kombëtare të Greqisë, Tiranë
- Banka Union
- Banka Italiane e Zhvillimit
- Banka Ndërkombëtare Tregtare
- Banka e Bashkuar e Shqipërisë
- Banka e Parë e Investimeve
- Banka e Kreditit të Shqipërisë

Consultation questionnaire

- Albanian Regulatory Impact Assessment Exercise -

Prepared by

	<i>WG Coordinator</i>					
WG # 1	Bank of Albania	Bank of Albania	Bank of Albania	Bank of Albania	Union Bank	American Bank of Albania
	Mr. Gerond Ziu	Ms. Brisilda Bala	Mr. Ervin Sahatçiu	Mr. Roden Pajaj	Mr. Ilirjan Ligaçaj	Mr. Mehmet Bakalli

Dear Sir,

Bank of Albania together with other entities indicated in the box above are participating in an Impact Assessment (IA) training initiative organized by World Bank administered Convergence Program. The purpose of this initiative is to strengthen our ability to use the disciplines of IA in order to improve the way in which we make policy. IA does this by requiring policy makers to use evidence and economic analysis to justify and explain their proposals. Consultation with stakeholders is a key part of the IA process because it promotes public accountability and provides stakeholders with the opportunity to contribute to the evidence base that should underpin the policy making process. The IA training exercise involves us undertaking a retrospective IA on an existing piece of legislation. In this case we are looking at regulation “**For administration of credit risk**”.

We are writing to you in your capacity as one of the key stakeholders affected by this piece of legislation. We have attached to this letter a questionnaire and we would be most grateful if you could arrange for its completion.

The questionnaire is designed to provide us with evidence relating to:

- a) the nature of the problem that the regulation was seeking to address and
- b) the costs and benefits of the regulation

Once the evidence has been gathered we will complete a final IA report setting out in a clear and transparent fashion what the problem was and why the regulatory response was the best means for addressing the problem. Clearly, since this is a theoretical consultation exercise being undertaken over a shortened period of time, we would not expect you to be able to devote a large amount of resource to this exercise. Nevertheless, we will be following this up with a face-to-face meeting to quality check all stakeholder responses and enhance our understanding of your answers. And, since we do intend to consult with stakeholders in the future, we regard this as a useful exercise for you too, so are looking forward to hearing from you. We very much value your cooperation. If you have any questions regarding this exercise please contact Mr. Gerond Ziu, tel. 250 844, 258 824, ext. 145.

We would appreciate having your written response by February 21st, 2008 in the morning when we invite you to attend the first round of consultation process as per the agenda that you will receive or have already received from FSC .

Then we are also pleased to invite to a more extensive live consultation meeting scheduled in the morning of February 22nd .

Yours sincerely,

NAME: **Gerond Ziu**
Working Group Coordinator

ANNEX A: Impact Assessment questionnaire

Section 1: What is the problem?

In this section we consider what the rationale for a particular regulatory intervention might have been.

The rapid expansion of credit is now a widespread phenomenon through SEE countries. In order to manage the credit expansion, emphasizing intervention to credit in foreign currency for unhedged costumers, we consider that a regulatory intervention is necessary.

We notice that there is asymmetric information inside the institutions themselves and in the relation between the customers and the institutions. Long-term predictions on exchange rates and interest rates have been ignored. There is not a special unit to analyze the macroeconomic developments. Products were designed mostly based on competition pressure. Public has not been able to estimate the characteristics of the products; their choice was mainly based on the installments of the first year. The later developments have shown that many were surprised for the increased indebtedness due to changing interest rates and/or the long maturity. In many cases banks have shown low transparency, taking advantage of customer lack of knowledge.

There has been noticed some regulative requirements that banks have failed to comply with. It mainly refers to transparency issues such presenting the effects of products characteristics in short-term and long term. Recent changes on transparency requirements have started to be applied, but deficiencies in implementation are still present.

Beside that, regulatory requirement do not address detailed requirement regarding the creation of specific structures for product design and monitoring.

Question 1: Do you agree with us that the problem is as described above?

Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible. For example, what evidence do you think would demonstrate or in fact does demonstrate that there was significant regulatory failure?

“Do nothing option”

If no intervention or further intervention will be taken loans in foreign currency will keep in growing pace, raising concern for future developments being exposed to possible shocks from international or national developments. Bigger banks will try to establish risk management and economic analysis units, which development is not that clear. Minor banks will behave mainly based on competitive pressure.

Question 2: Do you agree with us about the analysis above? Please provide your opinion.

Section 2: What are the possible policy solutions?

Taking into consideration the problem occurred due to market/regulatory failure and the possible solutions, we suggest these regulatory change options:

1. *“Do nothing option”*

2. *“Qualitative option”*

- 2.1 Assigning of regulatory restriction for the establishment of a special unit for risk management and economic analysis. Size of unit should match the bank’s size and type of activity.
- 2.2 Imposing restricting rules for Board of Directors in order to secure an improved process of credit risk management and mitigation.
- 2.3 Defining of specific requirements for foreign currency loans such as ratio of installment on income or collateral value restrictions.
- 2.4 Setting of transparency prerequisites for minimum information provided to the customers

3. *“Quantitative option”*

- 3.1 Identification of quantitative constraints such as provision rate increase or exposure to bank’s capital. This includes application of 5 % increase of provision rate for loans in foreign currency granted to unhedged customers and defining a limit rate of 400% between the portfolio at risk of unhedged customers to the regulatory capital amount. The portfolio at risk sum beyond this rate should considered as a deductive element in regulatory capital requirements.

Section 3: Cost-Benefit Analysis

I- Analysis of impacts (Users)

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
<p>1. Costs to consumers</p>	<p>In our point of view, if firms pass on higher costs there would be a risk of increasing of charges for the clients.</p> <p>Question a): Do you agree with the analysis above? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	<p>Question b): If you agree with a), please estimate the extend to which the costs to consumers would be reflected (qualitative and quantitative)</p>
<p>2. Benefits</p>	<p>We believe that possible intervention options will lead to higher protection and transparency.</p>	<p>Question b): If you agree with question a), please estimate the benefits for consumers (qualitative and quantitative)</p>

II - Analysis of impacts (Regulator and Regulated firms)¹

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
3. Direct costs	Costs are relatively low because there are no needs for new structures.	
4. Benefits	Higher stability in the banking system, higher financial stability and higher confidence in the financial market.	
5. Compliance costs	<p>Question a) – Do you agree with the cost categories we have identified below?</p> <p>Please also state other kinds of costs, which you think will arise to regulated firms due to the new regulatory requirements.</p> <p><u>“Qualitative option”</u></p> <p><i>Improvement of the regulatory framework and assigning of regulatory restriction for the establishment of a special unit for risk management and economic analysis. Restricting rules for Board of Directors in order to secure an improved process of credit risk management and mitigation and setting of transparency prerequisites for minimum information provided to the customers.</i></p> <p>1. Costs for analyzing the necessities of introducing the new regulatory requirements (staff-time, one-off cost)</p> <p>2. Costs for setting up a new unit for risk management and economic analysis:</p> <p>a) hiring staff with appropriate experience and knowledge (one-off cost for the hiring process)</p> <p>b) the firm has to provide training for the employees on the new rules</p> <p>c) cost for buying and/or introducing a new electronic system and/or other office equipment</p>	<p>Question b) – With regard to Question a), please provide an estimate of the costs previously qualified:</p> <p><i>(Please enter cost items, currency and time horizon and other required figures)</i></p> <p>1) first full year 2) over 5- year horizon</p>

¹ The table above is drawn from the UK Financial Services Authority

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	<p>3. Operational costs for the risk management department: a) salaries for staff (ongoing costs) b) necessary IT hardware and software, office equipment and office materials maintenance (ongoing costs)</p> <p>4. Operational cost for management and Board of Directors: - One-off costs for structure improvement as per the new unit establishment - one-off cost for policy and procedure writing - costs for annual review of the procedures (ongoing cost)</p> <p>5. Costs for complying transparency requirements: Costs for publications. (on-going costs)</p> <p><u>“Quantitative option”</u> <i>Increment of provisions by 5% for new credit in foreign currency extended to unhedged clients) and setting an exposure limit of 400 per cent of regulatory capital for credit extended in foreign currency. Every exposure over this limit will be discounted from the regulatory capital.</i></p> <p>1. Costs for prior internal analyses as per impact on expenses and future plans. (staff-time, one-off cost)</p> <p>2. Higher provisions leading to a reduced net result which on the other hand leads to lower regulatory capital and lower CAR ratio.</p> <p>3. Investment reductions in the case of overleaping the limit of 400 percent of regulatory capital for credit extended in foreign currency.</p> <p>4. Lower regulatory capital and lower CAR in case of exceeding the 400 %exposure.</p>	

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	<p><i>General statement:</i></p> <ul style="list-style-type: none"> - <i>The costs described above depend on the nature, scale and complexity of the business of the intermediaries.</i> 	
<p>6. Benefits</p>	<p>Question a) – Do you agree with the benefit categories we have identified below?</p> <p>1. In our point of view, there will be major benefits as better internal organization can lead to a decrease of operational and market risks associating with activities of the intermediaries. Applying these rules can lead to greater confidence in the market. Banks are better protected from possible collapses due to the incapacity of debtors to repay their loans. <i>(in case of implementing the qualitative option)</i></p> <p>2. Reduced risk exposure to unhedged customers due to restrictive quantitative requirements.<i>(in case of implementing the quantitative option)</i></p>	<p>Question b) – With regard to Question a), please provide an estimate of the benefits previously qualified: <i>(Please enter cost items, currency and time horizon and other required figures)</i></p> <p>1. first full year 2. over 5- year horizon</p>

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
<p>7. Indirect costs</p> <p>7.1 Quality of the products offered</p>	<p>In case of implementing the “qualitative option”, we believe that the entire process will lead to an improved selection process of the products. Products’ features will be better designed, and/or existing products’ features will improve.</p> <p>Question: Do you agree that the proposed regulatory changes will enable you to offer a higher quality of products? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	
<p>7.2 Quantity of products offered</p>	<p>Quantity will depend on firms’ internal decision. We believe that the prior analyses might lead to the identification of improper products, but overall quantity will not be affected.</p> <p>Question: Do you agree that the proposed regulatory changes will affect the quantity of products offered? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	
<p>7.3 Variety of products offered</p>	<p>As long as quality is enhanced, the variety will be manageable according to institutional capacities.</p> <p>Question: Do you agree that the proposed regulatory changes will affect the variety of products offered? <i>Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
7.4 Efficiency of competition	<p>It is possible that costs associated with the possible regulatory changes are more difficult to bear for small intermediaries. However, requirements for better risk management, transparency and other quantitative regulatory requirements would on the other hand lead to a greater competition among intermediaries and will enhance competition in the hedged costumers' market segment.</p> <p>Questions:</p> <p>a) Do you think small firms are more affected by the implementation and ongoing costs of the proposed options than larger firms?</p> <p>b) How do you think competition will be affected by the new rules?</p> <p><i>Please explain your answers, including evidence (or suggesting the type of evidence that would be relevant) where at all possible</i></p>	

ANNEX B: Some assessment criteria for costs and benefits

Costs may be assessed using such distinctions as:

- **Fixed costs** are costs which do not vary with output. In the long run, all costs can be considered variable;
- **Variable costs** are costs which vary directly with the output. Variable costs are associated with productive work, and naturally rise and fall with business activity.

- **Set-up (or one-off) costs** are costs which are incurred at the beginning of a project only;
- **On-going costs** are costs which are incurred again and again during a project or an investment. Usually set-up costs are very large in comparison to ongoing costs each time the latter occur.

Benefits may be assessed using one of the following techniques:

- **Comparison to a relevant historical case:** In many cases, an incident or series of incidents over time will be part of the reason to regulate. In order to make an estimate of the expected benefits, the losses in a number of historical cases can be used as an indicator for how much of the loss could have been prevented through the proposed regulation;
- **Evaluation by a proxy:** This approach uses observable variables which are linked to the unobservable variable - e.g. when there exists a known correlation structure - or focuses on simulations of the unobservable variable;
- **Use of a break-even approach:** The third possible approach is what can be called the break-even approach. This approach consists of calculating the amount of benefit needed - for example a reduction in loss needed - to cover the costs incurred, which are quantifiable. With this approach, the loss prevention is separated into the risk of loss and the extent of loss which allows one to capture the impact on the market. The potential loss for each market participant and the risk that a market participant will actually suffer loss are then estimated. It will then be possible to determine by how much the loss, risk of loss or a combination of these elements needs to be reduced in order to cover the costs of regulations and supervision. For this break-even assumption, one can examine whether this would be a realistic expectation. The impact of incidents can often be estimated with the help of event studies. The significance of the impact of incidents can be calculated and an estimate of the extent can be given. In the break-even approach, one can calculate by how much the risk of an incident must be reduced in order to cover the costs.

Source: CESR-CEBS-CEIOPS, Impact Assessment Guidelines, January 2008.