How to Regulate Bank Lending Risks to Un-Hedged Borrowers in Albania

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Summary Of Exercise

January 31-February 1	Convergence's RIA Program & Launch of RIA exercise
Early February	Preliminary Issue Analysis
February 21	Market Consultations
March	Analysis Completed
April	Public Presentation of Results

Exercise Topics

- Regulation “On Credit Risk Administration”
- Regulation for transparency and information publication

Working Group Composition

for Credit Risk Administration

WG # 1	*WG Coordinator* Bank of Albania **Gerond Ziu**	Bank of Albania **Brisilda Bala**	Bank of Albania **Ervin Sahatçiu**	Bank of Albania **Roden Pajaj**	Union Bank **Ilirjan Ligaçaj**

Facilitator

Mr. Luigi Passamonti
Head of Convergence Program

Co-facilitator

Mr. Riccardo Brogi
Senior Regulatory Economist
Convergence Program

Impact Assessment Proccess

9. Policy Recommendation
8. Overall Feedback and Responses
7. Questions Asked
6. Feedback Goals
5. Stakeholders Consulted
4. Proposed Regulatory Action
3. Statutory Goals at Risk
2. Problem Identification
1. Regulatory Context

Main Findings Overview

9. Policy Recommendation	**Final Step**
8. Overall Feedback and Responses	A detailed description is presented in a longer form of presentation
7. Questions Asked	Questions were provided based on arguments raised and supposed effects
6. Feedback Goals	Regulatory changes more relevant in terms of costs and benefits.
5. Stakeholders Consulted	**1.** Banks operating in the banking system **2.** Non-bank institutions
4. Proposed Regulatory Action	**1.** Do nothing Option **3.** Quantitative Option **2.** Qualitative Option
3. Statutory Goals at Risk	**1.** Capacity to absorb shocks **2.** Fair business conduct rules **3.** Costumer awareness
2. Problem Identification	**1.** Market Failure **2.** Regulatory Failure
1. Regulatory Context	**"On credit risk administration"**

1. Regulatory Context

Regulation “ On Credit Risk Administration”.

- It is aimed at improving requirements for reducing credit risk exposures, especially to foreign currency loans issued to unhedged customers.

- Other regulations or guidelines might be identified for further improvement in respect to the identified issue.

2. Problem Identification

Credit expansion has raised concerns over specific risks issue. Our focus is especially on foreign currency loans provided to unhedged customers. At the end of 2007, credit to unhedged customers over total portfolio is at 44.5%. The risks of foreign exchange rate fluctuation especially of American currency the last years is a matter of unease which needs intervention.

The problem addresses the following:

- ***Market Failure***

1. Asymmetric Information
2. Negative External Factors

- ***Regulatory Failure***

In the past we have had weaknesses in regulatory enforcement regarding transparency issues; as well as the absence of regulatory requirements regarding the creation of specific structures for product design and monitoring.

3. Statutory Goals

Statutory Goals at risk:

Capacity to absorb shocks
(loan portfolio quality)

Fair business conduct rules

Customer awareness

4. Proposed Regulatory Actions

1. <u>“Do nothing” option</u>

1st – major banks established risk management deps. But the time required to secure its proper functioning and final results can extend beyond the necessity to mitigate the already evidenced risks.

2nd – the market is left like it is and hence it is unlikely to enhance towards better standards. Some banks will react passively, just designing product features based on markets not being able to create the internal necessary environment for smoothing the effects.

3rd – industry and banks themselves will find difficult to address this goal which can be regarded as “public good”

4. Proposed Regulatory Actions

2. <u>Qualitative Options</u>

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.

3. <u>Quantitative Options</u>

Limit growth of loans to unhedged customers

- make each loan more expensive

(e.g. provisions, risk weighting)

- quantitative restrictions (e.g. install./income ratio)

- make loans beyond a threshold less feasible (e.g. % of reg. cap.)

5. Stakeholders Consulted

- Banks operating in the Banking Sector

- Non-bank financial Institutions

6. Feedback Goals

Understanding how the proposed regulatory changes would impact the firms operating in the Albanian banking sector.
What is their overall opinion on the raised issue and what are their proposed actions.

- Which are the costs related to possible regulatory changes and what is their impact on the firms activity and to the customers?

- What regulatory choices are more relevant in terms of costs and benefits?

7. Questions Asked

- Do you agree with us that the problem is as described?
- Do you agree with our analysis if no intervention would have taken place?
- Do you agree with the possible policy solutions?
- Do you agree with the listed costs and benefits for each option? Please provide an estimate of the costs and benefits (qualitative and quantitative).

8. Overall feedback and responses

Problem identification

Stakeholders

Stakeholders generally agree on the fact that there is a need for a regulatory improvement mainly due to the low level of transparency. Some banks instead believe that the problem sounds more dramatic than it actually is.

Small firms generally don't agree on the use of quantitative options which may affect more small firms and may reduce the credit growing.

WG

Market risk is significant because not addressing the internal risk management properly might cause high exposures to possible shocks from international or national developments. This would raise concern for future developments. There is also a regulatory failure to address.

8. Overall feedback and responses

CBA (Indirect Costs/Quantitative option)

Stakeholders

Quantity of products offered –Quantity will be reduced because loans in foreign currency will be more expensive
Quality – As a matter of principle, regulatory change can improve the decision-making process at banking organizations and the entire process will lead to an improved selection process of the products.
Variety – the changes may affect the variety of products
Efficiency of competition – Small operators will suffer more than big ones from this regulatory extra burden.

WG

Quantity of products offered - WG believes that an increase of 5% of provisions will reduce the initiative of banks to offer loans in foreign currency
Quality – The entire process will lead to an improved selection process of the products.
Variety – As long as quality is enhanced, the variety will be manageable according to institutional capacities.
Efficiency of competition – it is possible that costs associated with the possible regulatory changes are more difficult to bear for small intermediaries. Meanwhile, these ones will enhance competition in the hedged costumers' market segment.

8. Overall feedback and responses

CBA (Costs/Qualitative option)

Stakeholders

Generally participants didn't have a good reaction to the establishment of a special unit. This was mainly due to the costs which they pretend to affect more small banks than higher ones.

Some banks supplied us with figures but they weren't based on careful calculations, they were generally empirical figures.

WG

- One-off cost for the hiring process, training, buying and/or introducing a new electronic system and/or other office equipment
- Operational costs: salaries for staff (on-going costs), IT hardware and software, office equipment and office materials maintenance (on-going costs)
- Operational cost for management and Board of Directors: One-off cost for structure improvement as per the new unit establishment, one-off cost for policy and procedure writing, costs for annual review of the procedures (on-going cost)
- Costs for complying transparency requirements: costs for publications (on-going costs)

8. Overall feedback and responses

CBA (Benefits/Qualitative option)

Stakeholders	Banks believe that higher transparency requirements will lead to fair market rules. This as a result will benefit banks, costumers and the whole banking system.
WG	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. We believe that possible intervention options will lead to higher protection and transparency. Higher stability in the banking system, higher financial stability and higher confidence in the financial market.

9. Policy Recommendations

- WG suggests that both qualitative and quantitative options should be included in the regulatory change.
- It is essential for banks to have a unit / function for risk management and economic analysis. We agree with the small banks which concern about the costs related to the implementation of this unit, but its size should match the bank's size and type of activity.
- Banks do all agree with the fact that more transparency requirements are needed.
- 5% of increased provisions for each category for new loans to unhedged costumers will increase the interest rate for this type of loans at least of 4% (if all costs are passed to costumers). This raises the comparability of loans in foreign currency and local currency.
- Some of the banks are near the limit of 400% of regulatory capital (loans in foreign currency to unhedged costumers/regulatory capital). This limit will discourage banks to raise the amount of loans in foreign currency to unhedged costumers or will encourage them to raise the capital. In both cases the systems' stability benefits.

9. Policy Recommendations (optionalities)

There are alternatives between options and for different market participants under consideration.

Banks - for new loans to unhedged customers, application of:

- 5% rate of provision increase for each category **OR**
- 150% to 200% risk weight.

Branches of foreign banks - application of:

- An obligatory deposit held at Bank of Albania, calculated as a percentage of the new portfolio to unhedged customers **OR**
- A limit exposure toward entire portfolio of loans to unhedged customers.

LESSONS LEARNED

9. Policy Recommendations
(optionalities)

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INTRODUCTION

What is Regulatory Impact Assessment - RIA?

RIA is a policy tool designed:

1. to identify and quantify where possible, the impact of new regulations;
2. to be used also in the review of existing regulations;
3. to clarify the relevant factors for decision-making through comprehensiveness and awareness;
4. to encourage policy-makers to make balanced decisions when considering regulatory action that deals with the possible solutions to a problem, aiming the financial stability goal .

RIA ADVANTAGES

- Effectiveness - efficient regulation that address market failures
- Transparency - setting out ex-ante the reasons for policy decision, addressing the identified and quantified problem, anticipating costs and benefits.
- Accountability - improving the regulatory body reliability
- Consistency - compatibility with laws/regulations/standards
- Calibrating expectation - ex-ante effects calculations
- Communication - increasing understanding
- Experience sharing - building-in comprehensive consultation process

RIA Challenges of Implementation

- **Institutional capacity.**

  Necessity for staff with the requisite training, overall resources.

- **Participatory level.**

  A coherent, evidence based and market actors participatory and consideration is needed.

What does RIA really improve?

RIA directly improves three stages:

- facilitates consultative, evidence-based, rational policy development;
- provides a framework against which the policy development process can be judged; and
- provides a benchmark against which policies can be monitored and evaluated.

At last, but not least, RIA establishes ways of doing things.

Conclusions

- Although in our practice, many of the steps in the RIA process are already undertaken when a regulation is being prepared.

- Introduction of a formalized system of RIA will increase the consistency with the steps undertaken and will assist in the application of best practice during the regulation designing process.

THANK YOU