



TERMS OF REFERENCE

Project: Reviewing the Capital Adequacy Regulation

Project Owner:	Mr. Indrit Bank, Bank of Albania, Supervision Department.
Project Manager:	Mrs. Miranda Ramaj, Bank of Albania, Supervision Department.
Deputy Project Managers:	Mrs. Adela Xhemali, Intesa SanPaolo Bank
Technical Anchor (TAN):	One or two peer reviewers from Central Banks in the region.
Project Working Group:	BoA – Supervision Department, Legal Department, Banks, AMF.

I - Background - Identification of the problem

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 capital¹; 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.

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.

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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 reputational risk.

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

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 Approach² 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.

I.2 Legal Framework.

The legal framework built up by BoA on capital requirements for banks consists of laws, regulations and guidelines. In order to implement the new methodologies on credit risk and operational risk a thorough investigation of the current framework is necessary.

The preliminary legal framework.

Existing framework	Actions to be followed: Review / Amendment / Issue
Law No. 9662 Nr. 9662, dated	Review: Chapter V “Risk Management”, art. 58

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.

18.12.2006 “On Banks of the Republic of Albania”.	“Regulations for risk management”.
Regulation on Capital Adequacy approved and amended by BoA’s Supervisory Council.	a) Amend: The methodology for Credit risk charges calculation. Proposed methodology: Simplified Standardized Approach. b) Issue: The methodology for Operational risk calculation. Proposed methodology: Basic Indicator Approach.
Guideline on Regulatory Bank Capital approved and amended by BoA’s Supervisory Council.	Amend: Chapter I “General”, art. 3, “Purpose”
	Issue a guideline on Credit Risk Management
	Issue a guideline on Operational Risk Management
	Comply with Basel Committee guidance on Sound Practices for the Management and Supervision of Operational Risk
Other	

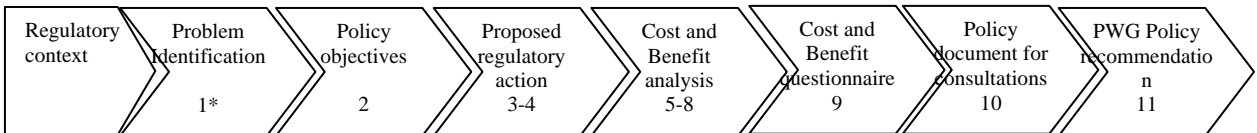
II - Project Objective – Definition of policy goals

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.

III – Intended Strategy – Description of the BR 9 steps

===== *Scoping of Problem* ===== || ===== *Analysis* ===== || = *Policy*
= || = *Conclusion* =

Of Impact Consultation



* See attachment

The project management group (Project Owner, Project Manager, Deputy Project Manager, supported by the SPI Secretariat) will act based on the mandate received from the SPI Committee to review the Capital Adequacy regulation, to modify the methodology on credit risk and to introduce operational risk in calculating capital requirements.

The project working group (PWG), with the support of SPI Albania Secretariat, will work to revise the existing Capital Adequacy and bring it in line with the developments in banking system and with Basel II requirement on capital adequacy.

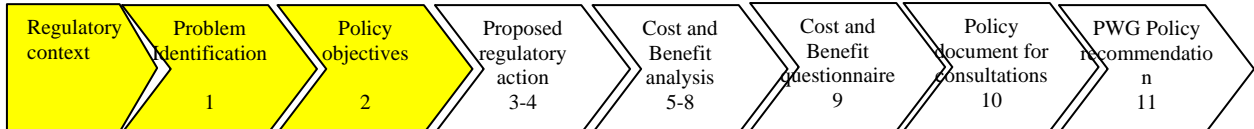
Planned steps to achieve project’s objective:

1. To identify the legal framework that regulates the capital requirements for banks
2. To acquire 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 formulate 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. To assess the possible impact of the new methodologies on credit and operational risk and run consultations on the regulatory design and impact;
5. To propose an implementation plan.

IV- Methodology: from kick off to the accomplishment of the project

A. First PWG Meeting

Preparation of PWG 1st meeting (PM/DPM and SPI Secretariat)



The Project Owner will appoint PM and AAB will appoint the DPM. SPI Secretariat will draft the invitation letter.

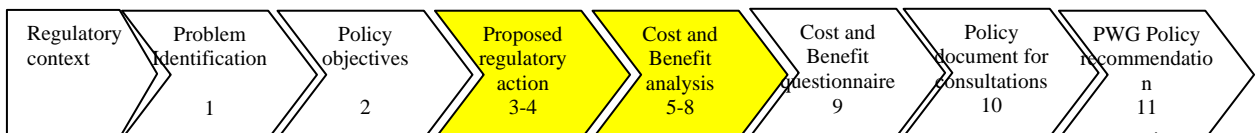
PMG and SPI Secretariat to prepare: a. a background note on current situation, including regulatory context; b. a note on international experience (Basel II provisions and experience in European countries).

Output: First Draft of “Scoping of Problem” for PWG discussion

After PMG clearance and before the 1st meeting, SPI Secretariat will send to PWG members the following documents:

1. Draft present TORs.
2. Draft of “Scoping of Problem” document.

PWG 1st meeting



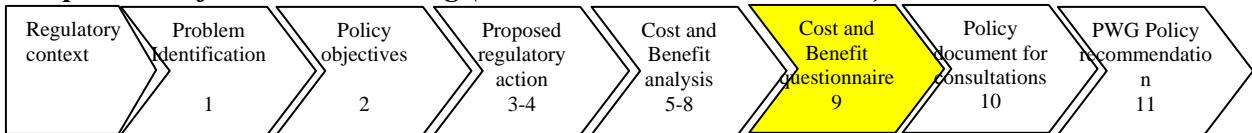
- Objectives:
- a. To understand the current context and the policy goals;
 - b. To formulate recommendations on policy implementation;
 - c. To analyze the impact for users, regulated firms and regulators of changing the capital requirements.

Output: Information to complete a document comprising the Scoping of the Problem and the Impact Assessment (Impact Assessment Analysis Document - IAAD) to be endorsed in PWG 2nd meeting. The IAAD covers steps 1-8 of the Better Regulation Template.

PM/DPM establishes **homework**: SPI Secretariat will prepare the minutes of the meeting

B. Second PWG Meeting

Preparation of PWG 2nd meeting (PM/DPM and SPI Secretariat)



PMG and SPI Secretariat to draft the questionnaire for data collection.

PWG 2nd meeting

Objective: To discuss and agree on the cost and benefit questionnaire;

Output: (a) Endorsement of IAAD (1-8) and (b) Final questionnaire.

PM/DPM establishes **homework**:

- SPI Secretariat: will prepare the minutes of the meeting will integrate the individual contributions on the cost and benefit questionnaire.

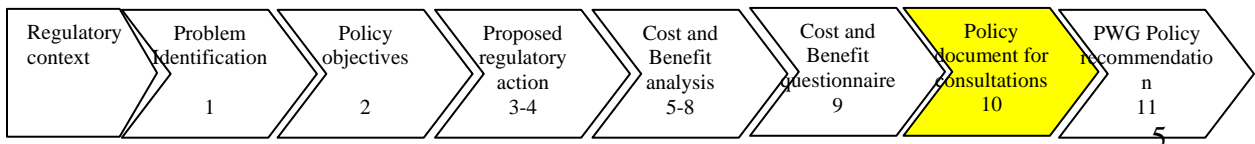
C. Third PWG Meeting

Preparation of PWG 3rd meeting (PM/DPM and SPI Secretariat)

SPI Secretariat to: collect data from PWG participating banks; and summarize questionnaire results and prepare draft “summary impact assessment” for PWG discussion and endorsement.

PMG and SPI Secretariat: to draft policy option consultation paper, including regulatory amendment proposals.

PWG 3rd meeting



Objectives: (a) To endorse Impact Assessment Analysis Document including “Summary Impact Assessment”; b) To finalize policy option consultation paper.

Output: a) IAAD; b) final policy option consultation paper.

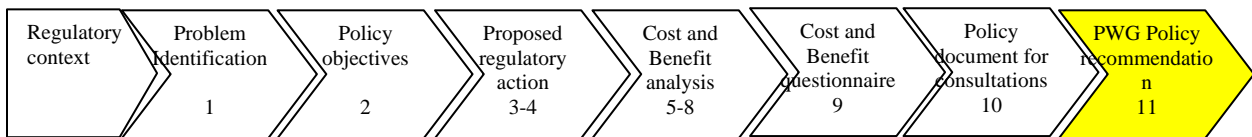
D. Forth PWG Meeting

Preparation of PWG 4th meeting (PM/DPM and SPI Secretariat :

PM/DPM and SPI Secretariat to:

- a. Run consultations with stakeholders based on the policy option consultation paper;
- b. Draft feedback document.

PWG 4th meeting



Objective:

- a) To discuss the consultation feedback document and the policy document; and
- b) To agree on the policy recommendations.

Output: Policy recommendations.

Following PWG 4th meeting:

Preparation of the SPI Committee paper.

VI - Project Team

The team is composed of:

- Bank of Albania
- Banks

VII – Tentative PWG meeting schedule

- First meeting October 2008
- Second meeting November 2008
- Third meeting November 2008
- Fourth meeting December 2008

VIII – Consulted documents

- Basel Committee on Banking Supervision, 2006, International Convergence of Capital Measurement and Capital Standards, A Revised Framework, June 2006.
- Basel Committee, 2003, Guidance on Sound Practices for the Management and Supervision of Operational Risk, February 2003.
- Law NO. 9662, dated 18.12.2006 “On Banks on the Republic of Albania”.
- Regulation on Capital Adequacy.
- Guideline on Regulatory Bank Capital.

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. Development of “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”).
Analysis of impact	
5. Costs to users	To identify and state the costs borne by consumers
6. Benefits to users	To identify and state the benefits yielded by consumers
7. Costs to regulated firms and regulator	To identify and state the costs borne by regulator and regulated firms
8. Benefits to regulated firms and regulator	To identify and state the benefits yielded by regulator and regulated firms
9. Data Questionnaire	To collect market structure data to perform a quantitative cost and benefit analysis
Consultations	
10. Policy Document	To learn market participant opinions on various policy options
Conclusion	
11. Final Recommendations	Final report to decision-makers, based on Cost Benefit Analysis and market feedback

Source: CESR-CEBS-CEIOPS 3L3 Guidelines, adjusted by the Convergence Program based on experience.