SPI Project on Reviewing the Capital Adequacy Regulation

Project Objective

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

Project Management Team

Project Owner (PO): Indrit Banka, Supervision Director, BoA
Project Manager (PM): Miranda Ramaj, Supervision Deputy Director, BoA
Deputy Project Manger (DPM): Adela Xhemali, VP, Head of Finance Department, Intesa San Paolo Bank

Minutes

Second meeting
January 22, 2009—AAB premises

Attendees: Miranda Ramaj, BoA (PM)
Adela Xhemali, ISPB (DPM)
Admir Ramadani, FIB (member)
Entela Gjyzari, BP (member)
Sokol Pellumbi, BKT (member)
Majlinda Gjata, RB (member)
Plator Ulqinaku, UB (member)
Lyela Rama, AMF (member)
Ermira Curri, BoA (member)
Altin Koci, ICB (member)
Adela Leka, PCB (member)
Jola Dima, ISPB (member)
Gerond Ziu, BoA (observer)

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Elvis Zaimi, BoA(observer)
Gerti Caushi, BoA (observer)
Ervin Sahatciu, BoA (observer)
Elvana Troqe, BoA (observer)

Elona Bollano, SPI Albania, Director of Analysis and Policy
Anuela Ristani, SPI Albania, Director of Operations

AGENDA

I. Welcome Note—Project Manager

II. Presentation of SPI Albania and Introduction of Participants.

III. Project Terms of Reference presentation (Discussion and approval)

IV. Presentation of the Draft Note on International Experience (Discussion and approval)

V. Presentation of the Scoping of the Problem Document (Discussion and approval)

VI. Presentation of the Cost-Benefit Analysis (Discussion and approval)

VII. Presentation of Intesa SanPaolo Bank on Credit Risk Methodology

VIII. Sub-working groups for each individual component of Capital Adequacy Framework:

   a. Regulatory Capital
   b. Credit Risk
   c. Operational Risk

IX. Conclusions and Distribution of Tasks

X. Closing Remarks

I. Welcome Note and Introduction of the Participants

PM and SPI Secretariat welcomed all the PWG members and introduced the PMT, and the SPI Albania Secretariat. All members introduced themselves and the institutions they were representing. Upon the suggestion of the PMT and initial PWG members, of the SPI Secretariat sent invitation to all banks out of which 14 appointed their representatives to participate as Project Working Group Members.

II. Presentation of SPI Albania

In order for the PWG members to have a better understanding on the SPI work process. SPI Secretariat held a short presentation focusing on the SPI Albania Project management and Methodologies.

The SPI Secretariat presented to the PWG the organizational and Project Management structures that lead all the SPI project initiatives from the conception of the project proposal until the enactment procedures for each project outcome. The partnership is lead by a high level public private Committee with representatives from BoA (First Deputy Governor), AAB (Chairman) and the Head of Convergence Program (World Bank) as well as 3 Permanent Observers (MoF, AMF and Market Surveillance Department-MoE). SPI Secretariat orchestrates different working groups for each SPI Project.

SPI Secretariat presented the role and responsibilities of the PMT and PWG members as well as the role of the Secretariat throughout the entire project process from the initial initiative to enactment monitoring.

SPI Secretariat shortly presented the methodology followed for every SPI Albania – EU Better Regulation Approach and its 11 steps which will be applied for this project as well as for every other SPI Albania project.

III. Project Terms of Reference presentation (Discussion and approval)

SPI Secretariat presented the Project Terms of Reference as the outlining document that will guide the PWG through all the project steps.

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.

The methodology used in the current framework calculates the (minimum) regulatory capital to cover only for credit risk. BoA intends to improve risk management in line with Basel II, by enhancing the methodology for calculating risk weighted assets to credit risk and by including the operational risk in calculating the capital requirement. In this way in the banking regulations the first pillar on minimum capital requirements of Basel II will be introduced.

Basel Committee recommendations for calculating credit risk charges permit banks to choose between two broad methodologies to measure credit risk: the Standardized Approach and the Internal Ratings-based Approach; the second approach is subject to the explicit approval of the banks' 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** 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.
Committee encourages banks to move along from the spectrum of available approaches [starting from (i)] as they develop more sophisticated operational risk measurement systems and practices. The other more sophisticated approaches require long time data series and experience in operational risk identification and management

Therefore, the project objective is to prepare the necessary regulatory amendments to introduce the above two mentioned risk management methodologies and to define an implementation timeframe.
The objective of the project will be achieved by undertaking the following actions:

1. The identification the legal framework that regulates the capital requirements for banks
2. The acquisition of 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 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. The assessment of the possible impact of the new methodologies on credit and operational risk and run consultations on the regulatory design and impact;
5. The identification of the implementation plan.

The PWG members representing the banks stressed the degree of difficulty in applying Basel II. There are different challenges arising from the standards of data recording before any other calculation/estimation is made. Since the Banks have different data entry systems, it comes as a need that they enter the data manually in order for these data to represent the same information for the entire system. Raiffeisen has started to prepare for the implementation of Basel II earlier than all the banks and they might provide for a valuable case-study for BoA and the PWG to assess the methodology and procedures to be followed. Raiffeisen has already started to apply the Standardized approach and by 2012 they will be ready for partial AMA application.

PWG representing the banks expressed their interest in developing an implementation strategy. BoA is committed to make this timeline acceptable and adaptable for all second level banks in Albania, considering the fact that some of them (RB), based on

the experience of their parent companies, have already started to work for the adaptation of AMA in calculating capital charges in line with Basel II for internal purposes, and others who have not.
RB representative invited the PMT and SPI Secretariat to have a meeting in order to study and share more of their information and implementation studies as well as steps followed so far on Basel II.

After agreeing on the objectives, the PWG approved the Project Terms of Reference

IV. Presentation of the Draft Note on International Experience

Basel Committee on Banking Supervision has the mandate to establish the framework on capital adequacy for credit institutions. The revised framework on Capital Accord Basel II is a comprehensive and extensive framework that describes exhaustive measures and minimum standards for capital adequacy. While in Europe, in 2006 the European Commission issued two directives on capital requirements for credit institutions. The European Directives reflect Basel II and are mandatory for the EU member countries.

The Committee permits banks a choice between two broad methodologies for calculating their capital requirements for credit risk, the Standardized Approach and the Internal Ratings-based Approach.

In the **Standardized Approach**, credit risk is measured in a standardized manner, supported by external credit assessments. In determining the risk weights in the standardized approach, banks may use assessments by external credit assessment institutions recognized as eligible for capital purposes. It is the responsibility of the national supervisors to determine whether an external credit assessment institution (ECAI) meets the defined requirements / criteria. Exposures should be risk-weighted net of specific provisions.

The alternative methodology is the **Internal Ratings-based Approach.** This methodology is subject to the explicit approval of the bank's supervisor and would allow banks to use their internal rating systems for credit risk.
The risk components include measures of the probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M). In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components.
The IRB approach is based on measures of unexpected losses (UL) and expected losses (EL). The risk-weight functions produce capital requirements for the UL portion.
Basel Committee introduced the operational risk in 2001 and defines it as *"…the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk."* EU Directive [2006/48/EC] provides the same definition.

Operational risks exist as a company is using employees and/or systems in processes or is subject to external impacts and, therefore, they emerge long before credit or market risks. By its nature, operational risk is characterized:

- as inherent to business, i.e. inseparably linked with almost all business activities;
- as specific, i.e. its precise form and, therefore, all measures to control and mitigate it strongly depend on the specific company profile; and
- as a cultural risk, because the handling of so varied and networked risks, summarized under the heading of operational risk, is a question of a company's risk culture, i.e. its approach and practices in treating risks especially in day-to-day business.

The Basel Committee permits banks a choice between three broad methodologies for calculating their capital requirements for operational risk: (i) the Basic Indicator Approach, (ii) the Standardized Approach and (iii) Advanced Measurement Approaches (AMA).

PWG discussed further the methods on credit and operational risk. With regards to the credit risk, BoA considers the Simplified Approach and/or Simplified and Standardized Approach and for Operational Risk the Basic Indicator Approach (BIA) approach as most suitable for initiating the Basel II implementation process. For credit risk, BoA intends to adopt the General rules for risk weights presented in the Simplified and Standardized Approach, Annex 11 of the International Convergence of Capital Measurement and Capital Standards, (Basel II, new Capital Accord)..

Regarding the transposition of the Capital Requirements Directive, EU member states have followed different patterns in revising their regulatory framework. In some countries, like Romania, the supervisory authorities for banking and for securities have amended the entire legal framework (banking law, regulations, and orders), in cascade, in order to reflect the capital adequacy principles and requirements.

Another group of countries have included all the changes brought by the new directive on capital adequacy in one single document. Poland and the Czech Republic for example, have issued a single document on the capital requirements against particular risks and the detailed principles to be applied in determining those requirements, in a very comprehensive resolution on capital.

PWG members considered the note as very useful and suggested BoA to consider the idea of opening the possibility for AMA implementation by the more advanced banks.

V. Presentation of the Scoping of the Problem Document (Discussion and approval)

This document analyzes the market, the participants and the regulatory framework that governs this market. In the analysis it is specified that the regulatory framework on capital requirements 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 SPI Secretariat's 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 such situations in the future. This regulatory failure threats Bank of Albania's objective to ensure the banking stability.

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.
The capital adequacy framework might be revised in a comprehensive manner (Option 1) by transposing the two methodologies in credit risk and the three methodologies in operational risk or (Option 2) in a more tailored manner by improving the credit risk methodology and, as suggest by the Basel Committee, by introducing in the first stage the Basic Indicator Approach for operational risk and in a latter stage complete the operational risk requirements by introducing the two other approaches.

The PWG agreed with the assessments made by the SPI Secretariat in Scoping of the Problem document and approved it without objections. .

VI. Presentation of the Cost-Benefit Analysis (Discussion and approval)

The calculation of the Cost and Benefits to stakeholders is done individually. For regulated firms the costs will be mainly operational, infrastructural and on human resources, while the benefits will consist in additional products/business, savings and equity requirements. For the regulated firms the costs will be higher during the implementation process but they will translate in higher benefits in the long run. For consumers the costs will consist on higher risks, higher prices, lower quality of service while the benefits will be better choices, price reductions, improved product access. All considered, for the consumers there will be lower costs as a consequence of a better capitalized and hedged banking activity. For the authorities the costs will mainly consist on training and external assistance, while the benefits imply statutory goals achievements, increase income to state budget and together with other indirect benefits, For the Authorities there will be one-off costs related to the process of new regulations, but also higher benefits as a result.
All stakeholders considered, PWG generally agreed that there will be some costs related to the initial implementation of the revised framework, but in the long run the benefits, in monetary and non-monetary terms, will exceed by far the identified costs.

VII. Presentation of Intesa San Paolo Bank on Credit Risk Methodology

ISP Bank made a presentation of their simplified technique for the capital requirements for credit risk under the standardized approach, as asked and instructed by their mother company.

The first step was the calculation of the supervisory capital. The calculation method is very similar to current CB regulation.
The main difference related to items currently applicable to all banks consists on the P&L of the period, which can be entirely included.
The second step is to calculate capital requirements for credit risk which include: the assignment of exposures to 16 classes of assets based on the nature of the counterparty or the technical characteristics of the transaction or the manner in which it is carried out and the assignment of diversified risk weights to each portfolio. Basel II links each Risk Weight with a Credit Quality Step. The latter is used by the rating agencies as well, matching to each Credit Quality Step rating. ISP assigned the weights according to Moody's Investors Service for the first sovereign rating assigned to Albania, June 29, 2007.
In order to calculate the credit risk associated with guarantees and commitments issued, the bank shall first calculate the credit equivalent amount of the exposure. The credit equivalent amount shall be calculated by applying credit conversion factors that take account of the higher or lower probability that the guarantee or commitment could be transformed into an on-balance-sheet exposure. Specifically, one of the following credit conversion factors shall be applied to the exposures: (i) low risk, 0%; (ii) medium-low risk, 20%; (iii) medium risk, 50%; (iv) full risk, 100%.
This was ISP first attempt towards Basel II, but a good example of how to get started for the banks that have little or no experience. The main limitation in the ISP application was that the assets portfolio is not considered item by item but in its entirety (e.g. the retail loans and mortgage loans were not considered individually but all together).

PWG will receive this presentation for their reference along with all other meeting documents.

VIII. Conclusions and distribution of tasks

The sub-working groups will be created during the next PWG meeting after the PMT consultation with RB. PMT appreciated that the implementation examples provided by Raiffeisen Bank could help in a better shaping of these sub-working groups.

SPI Secretariat will coordinate with RB and PMT to organize a meeting with RB for the purpose of RB experience sharing in Basel II application.

SPI Secretariat will draft the cost-benefit questionnaire (Impact on the banking system of the new Capital Adequacy Framework) and will seek for PMT's and Raiffeisen Bank PWG member's validation before distributing it to the PWG.

VII. Closing Remarks

The second PWG meeting is preliminarily scheduled to take place in February 2009.