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SPI Albania Project: Reviewing the Capital Adequacy Regulation

Main Findings of the Survey with Banks on Costs and Benefits and the Impact on the banking system of the new Capital Adequacy Framework

1. Summary findings of the survey

1.1. **Respondent banks represent a large share of the banking market; therefore the results of the survey may be considered as relevant and be generalized to the entire banking system[1]. However, not all the responding banks answered to all parts of the questionnaire, which makes it difficult to come to general conclusions.**

1.2. **The respondents' opinion validates the PWG's cost-benefit qualitative analysis to the extent that the new methodology on requirements for capital will bring higher costs during the implementation process, and higher long run benefits for banks and authorities, and slightly lower costs for the consumers.**

1.3. **Only 3 out of 8 responding banks (38% out of responding banks and 19% out of the total number of banks) have already applied or are under implementation of a new methodology to calculate the regulatory capital and the total minimum capital requirements for credit risk, different from those prescribed by Bank of Albania. In addition, 4 banks (50% out of responding banks and 25% out of the total number of banks) are calculating capital requirements to cover for operational risk.**

1.4. **The Basel II methodologies used for credit risk are Simplified Standardized Approach (SSA) and the Standardized Approach (SA), with the following steps to follow for implementation: Specification of requirements; Infrastructure building (systems); Data collection; Methodology assessment; Categorization of bank commitments.**

1.5. **The process of implementing new methodologies to calculate capital requirements for credit and operational risks has been demanding in terms of time (up to 3 years) and human resources. It has also implied several changes in banks' reporting systems.**

1.6. **The banks that ran the calculation of the minimum capital requirements for credit and operational risk, using the Standardized Approach for credit risk and the Basic Indicator Approach for operational risk, remain capitalized at a ratio above 12%.**

2. Detailed presentation of the survey findings

[1] The respondent banks cover different types of operational and ownership structures.

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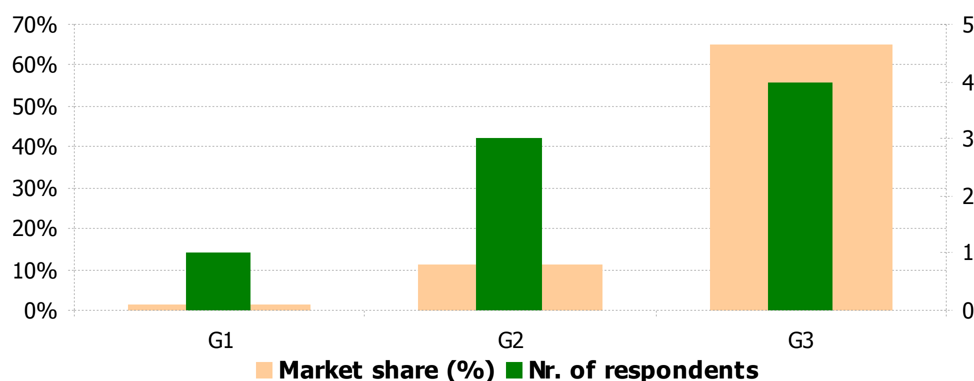
2.1. Characteristics of the surveyed sample

Conclusion:	
There were 8 banks that responded to the questionnaire, representing all three groups (G1, G2 and G3) of small, medium and large banks, with an aggregated market share (taking as reference indicator their total assets) of 77.7%. Consequently, the survey results could be considered relevant and representative for the banking system.	
Total members of AAB (no.):	**16 banks**
Market Share (100%):	**100%**
Total respondent banks (no.):	**8 banks**
Respondent ratio:	**50%**
Market share of the respondent banks:	
(reference indicator: total assets)	**77.7%**
Size of the respondent banks:	**small, medium, large**

Graph 1. Respondent banks by size and market share



The presence of all 3 groups of banks in the respondent banks' panel is important, since they deal with different amounts and natures of risks, and also have different internal control, risk assessment and management structures employed.

2.2. **Impact on the banking system of the new Capital Adequacy Framework - Cost and Benefit Qualitative Analysis**

Conclusions:
- The results from the survey validate PWG's cost-benefit qualitative analysis on the impact of the new methodology on requirements for capital on banks, thus higher costs during the implementation process, and higher long run benefits.

- Regarding the impact on consumers, banks agree that they will face slightly lower costs as consequence of a better capitalized and hedged banking activity.

- Banks agree that the central bank will have to face some one-off costs related to the process of implementation of the new regulations, but the benefits will be higher.

Only 5 of the 8 respondent banks gave their opinions on the qualitative cost-benefit analysis intended to assess the readiness to implement the new methodology on the calculation of the capital adequacy ratio, and the impact of the new methodology on requirements for capital.

2.2.1. Qualitative cost – benefit analysis for banks

The overall opinion is that operational costs to banks will increase as the modifications in the Capital Adequacy framework might require training of the technical and management staff, and potential revisions in the banks' current risk management strategies. Changes will also be required in their methodologies of calculating capital requirements for credit and operational risks leading to higher costs in accounting and reporting.

Table 1. Impact on banks

	Impact	Agree	No response	Reject
Costs	**Higher**			
One-off	**Higher**			
Operational	+	5		
Infrastructure	+	4	1	
Accounting and reporting	+	4	1	
Other	+	3	1	1
On going	**Lower**			
Human resources	+	4		1
Benefits	**Higher**			
Additional products / additional business	=	3		2
Cost saving / + revenues	+/=	3		2
Equity requirements	=/+	3		2
Total impact	**Higher costs and Higher benefits**	**4**	**1**	

Some other costs of banks may also increase, as some banks might need to add capital in order to comply with the increased capital adequacy requirements. Not all banks agree to this since not all of them will need to add more capital; it will depend much on the risk undertaken by each bank, and it remains however to be seen in a real life situation when the changes are implemented.

Most banks agree that human resources costs might increase with the increased complexity of reporting in the new regulatory framework in terms of more time allocated to this activity.

On the other side, 3 out 5 banks agree on some benefits from a more prudent framework and methodology for the calculation of the capital adequacy. Optimal business and risk mix will be sought without affecting the business negatively and yet focusing risks adequately. In addition, a better coverage of banking credit and operational risk with capital should have little effect on cost savings. However, 2 of the responding banks have argued that the lack of management estimation when applying this method might stiffen the capital.

The general opinion is that since the new methodology will require banks to account for the operational risk, some banks might need to increase their capital, unless other charges are released from the introduction of the credit risk method. An argument to that, coming from one bank, is that the purpose of Basel II is to reduce capital requirements but increase the prudent business.

Overall, 4 banks have agreed that the total impact of the new CA framework would be higher costs during the implementation process and higher long run benefits.

2.2.2. Qualitative cost – benefit analysis for consumers

Regarding the impact on consumers, banks agree that they will face lower costs as consequence of a better capitalized and hedged banking activity.

Table 2. Impact on consumers

	Impact	**Agree**	**No response**	**Reject**
Costs	**Slightly lower costs**			
Higher risks	-	4		1
Higher prices	+/=	3	1	1
Lower quality of service	=	2	1	2
Benefits	**No effect**			
Better choice	=	2	3	
Price reduction	=	2	3	
Improved access	=	1	3	1
Total impact	**Lower costs**	**3**	**2**	

4 out of 5 banks agree that safer banking system would reduce risk and increase protection for depositors and investors. Nonetheless, it is argued that, in order to foster safety, the efficiency of operations could be decreased posing thus other risks to the stakeholders such as that of marginalizing the potential business.

3 out of 5 banks believe that the additional one - off costs would not have any significant effect on the prices. Although any burden is passed on to the clients, higher costs are expected to be compensated by lower capital requirements.

Banks are divided between those that think that the new framework will not affect the quality of service and those who believe that it will. The argument for the latter opinion is that the new framework will bring either lower access to banking or higher prices charged from the risk-anathematized segments with a direct impact in how the service is perceived by clients.

On the benefits side, 2 out of 5 banks believe that consumers will have more transparent choices and lower prices due to low risk and less capital requirements.

2.2.3. Qualitative cost – benefit analysis for the authorities

Regarding the impact on the authorities, banks agree that there will be some one-off costs to the central bank, related to the process of new regulations, but the benefits will be higher.

Table 3. Impact on Authorities

	Impact	Agree	No response	Reject
Costs	**Higher**			
One-off	+	4	1	
On going	+	3	1	1
Direct Indirect	+ =	3	1	1
Benefits	**Higher**			
Statutory goals	++	3	1	1
Increase income to state budget	=	3	2	
Others	=	1	4	
Total impact	**Higher costs / higher benefits**	**3**	**2**	

4 out 5 banks agree that there will be higher costs of the Banking Supervision Authority related to the drafting, enactment and implementation of the modified regulations, as well as related to the training of the supervisors and/or external assistance.

Also the supervision process will be more complex which will bring to higher direct costs as validated by 3 out of 5 banks.

Meanwhile the benefits to the Supervisor are expected to be higher, especially considering that the banking supervisory authority accomplishes its statutory obligations of ensuring the financial stability.

2.3. **Alternative methodologies to the current BoA regulations to calculate capital requirements**

Conclusions:

- 3 banks have applied or are under implementation of a new methodology to calculate the regulatory capital and the total minimum capital requirements for credit risk.

- 4 banks have applied or are under implementation of a methodology to calculate capital requirements for operational risk, for internal purposes.

- The main reason for banks not applying any extra methodology to calculate the capital requirements for credit risk or for operational risk is that the capital requirements set by BoA cover for the risk profile of their banks, or they do not have the necessary historical given their newness in the market,, or the risk coverage provided by their parent banks.

- Implementing new methodologies to calculate capital requirements for credit and operational risks has been a long process for banks (up to 3 years) and has

involved a considerable number of employees (up to 65), depending on their size . It has also implied several changes in banks' reporting systems.

- The Basel II methodologies used for credit risk are Simplified Standardized Approach (SSA) and the Standardized Approach (SA), with the following steps to follow for implementation: Specification of requirements; Infrastructure building (systems); Data collection; Methodology assessment; Categorization of bank commitments.

- Most of the responding banks that are implementing operational risk management are using Basel II Basic Indicator Approach (BIA).

- The banks that account for operational risk have had to make several changes in their reporting systems. One type of change brought by introducing the operational risk management is referring to the implementation of a new database (Risk event database).

In the table below the information on the banks that have introduced or are under implementation of new methodologies to calculate capital requirement to cover for banking risks are summarized.

Table 4. Other methodologies applied by banks on:

No. of banks	**Yes**	**Under implementation**	**No**
Regulatory Capital	2	1	4
Credit Risk	2	1	4
Operational Risk	2	2	3

2.3.1. Regulatory Capital

Only 3 out of the 8 responding banks have applied or are under implementation of a methodology to calculate the regulatory capital different from the one presented by BoA in the guideline on "On bank's regulatory capital".

There are no reported divergences between the approach developed by the SPI Secretariat/ PWG in the spreadsheet of the questionnaire and the one developed by banks.

2.3.2. Credit Risk

The same 3 banks are also applying or are under implementation of a methodology to calculate the minimum capital requirements for credit risk different from the one presented by BoA in the regulation on "Capital Adequacy".

The reported alternative methods are the Simplified Standardized Approach (SSA), the Standardized Approach (SA), and a specific internal model for one bank. In all the cases, the methodology used was adopted as developed by the parent company.

Depending the size of the bank, the process of transposition was from 1 month to 3 years long and involved from 2 to 65 persons.

The three banks have had to make changes in their reporting systems to reflect the new methodologies on credit risk. The level of changes is shown in the table below.

Table 5. Changes in the reporting systems due to new method of calculating credit risk

	Some changes	**Significant changes**
No. of responses	1	2
Size of banks	G2	G3

The banks that do not apply any other, extra, methodology to calculate capital requirements for credit risk for internal purposes, have stated the following reasons for doing so:

- 3 banks – (1 G2 and 2 G3) have stated that according to their experience, the capital requirements set by BoA cover for the risk profile of their banks;
- 1 bank (G1) having been established in 2006 with the majority of loans extended over the last two years, has found it impossible to build any method in lack of historical data.

Asked on their plans to adopt and apply any of the methodologies as proposed by Basel II / the EU Directive 2006_48_EC, 3 banks (1 G2 and 2 G3) have responded positively. They are planning to apply SSA and SA methodologies on credit risk, although there are not any data on when such transposition process is planed to start. Furthermore, there are no concrete plans to implement any software for more advanced calculations.

2 banks that have used the Simplified Standardized Approach and the Standardized Approach have reported the following steps and issues as very important while implementing their new methodologies:

- Specification of requirements;
- Infrastructure building (systems);
- Data collection;
- Methodology assessment;
- Categorization of bank commitments, which are classified according to their characteristics and assigned to: portfolios (by nature), sub-portfolios, and parents company sub-sub portfolios. Some portfolios are determined by the nature of the counterparty, others by the nature of the transaction and others by combination of these two elements

2.3.3. Operational Risk

4 out of the 8 responding banks (3 G3, 1 G2) have applied or are under implementation of a methodology to calculate capital requirements for operational risk, for internal purposes.

3 of these banks are using the Basic Indicator Approach (BIA) and one the Standardized Approach (SA). Meanwhile, one of the banks already using the BIA is also implementing the Advanced Measurement Approach.

In one of the banks, the methodology used was developed internally while in the other three it was adopted as developed by the parent company.

In the case when the methodology was internally developed, only one person was involved in the process. In the other banks, the number of persons involved in the process varied from 2 to 65 persons. The process of transposition was 1 year for a G2 bank and 2 - 3 years for G3 banks.

The banks that account for operational risk have had to make several changes in their reporting systems.

Table 6. Changes in the reporting systems due to accounting for operational risk

	Not significant	**Some changes**	**Significant changes**
No. of responses	1	2	1
Size of banks	G3	G2, G3	G3

One type of change brought by introducing the operational risk management is referring to the implementation of a new database (Risk event database).

Banks that do not apply any methodology to calculate capital requirements for operational risk for internal purposes have stated the following reasons for their decision:

- 1 bank (G3) - the capital requirements set by BoA cover for the risk profile of their bank;
- 2 banks (G1 and G2) - newness in the market and their parent banks calculating for their operational risk.

The respondent bank applying the Standardized Approach for operational risk has reported that the framework, developed at group level, covers the following requirements:

1. Calculation of Operational Risk Capital Charges;
2. Loss Data Collection;
3. Risk and Control Self-Assessment (RCSA): a qualitative methodology for the identification, assessment and control/mitigation of operational risk.

2.3.4. **Result of the simulation**

Conclusion:

The banks that ran the calculation of the total minimum capital requirements for credit and operational risk, (using the SA for credit risk and BIA for operational risk) remain capitalized at a ratio above 12%.

6 out of 8 responding banks have filled up the spreadsheets with the calculations for the regulatory capital, risk weighted assets and capital requirement for the operational risk in line with Basel II framework. All of them remain capitalized with the new calculations, supposing that the capital adequacy ratio remains at 12%.