



SUBJECT TO PMG AGREEMENT  
*Draft prepared by Evis Gjebrea,  
 SPI Financial Modernization Program*

## “Scoping of Problem” Document

### Project: Revising Foreign Currency Open Position Project

#### Section 1 Project information

PUBLIC-PRIVATE FINANCIAL SECTOR MODERNIZATION MATRIX					
Italian Banking Association CRITERIA	European Central Bank CRITERIA				
	<i>Asymmetric information reduction</i>	<i>Completeness of the market</i>	<i>Increased opportunities to engage in financial transactions</i>	<i>Reduced transaction costs</i>	<i>Increased competition</i>
Business development		X			
Industry competitiveness					
Industry reputation					

**Short description of the context:** Bank of Albania is seeking to improve and expand the coverage of the regulation on Foreign Currency Open Position in order to capture a wider range of risks faced by the banks. The range of financial instruments is very diverse due to the fact that the financial sector is a dynamic one with products which are becoming more and more sophisticated. But the current regulation on FX Open Position does not account for the product development dynamics of the financial sector. Specifically, the current methodology on FX open position does not account for such risks.

This situation may have negative consequences for the:

- Banks being exposed to greater FX risks;
- Worsening supervision role of the Central Bank of Albania;
- Consumers bearing the risks and paying higher costs.

Therefore, BoA proposes to improve foreign exchange risk management function by improving the methodology for calculating open positions in foreign currency and by including a wider range of risks.

**Stakeholder proposing the project: Bank of Albania**

**Other Stakeholders involved (sponsors): AAB and Banking community**

**Project objective:**

To enhance banks' foreign exchange risk management by reviewing the current regulatory framework according to international guidelines and best practices and introducing a new method of calculation on FX open positions.

**Description of the project contribution toward financial modernization:** By improving the regulation on FX open position through the new methodology for capturing a wider range of risks, banks are provided with tools for a better identification, measurement, monitoring and controlling. The better capturing of risks means that banks benefit from having a real dimension of their exposure to foreign currency risks and to adjust them to regulatory capital. A better risk management promotes banking system stability and gives an enhanced coverage for the customers. On macro level, the investments could increase and therefore economic development would be stimulated.

**Project Working Group:**

Bank of Albania -PO & PM  
One of the banks -Co-PM  
Intesa San Paolo Bank –member  
Raiffeisen Bank-member  
Banka Pro-credit-member  
Tirana Bank-member  
Banka Popullore-member  
All other banks-member

<b>The EU Better Regulation Approach</b>	
<b>Steps</b>	<b>Purpose</b>
<b>Scoping of problem</b>	
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. “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”).

<b>Section 1: Scoping the problem</b>
<b>1.1. Problem identification</b>
<i>Background Information</i>
<p>The authority of the Bank of Albania in establishing rules for foreign currency open position is defined by Law no. 8269 dated 23.12.1997 “On the Bank of Albania” chapter VII, article 26 and Law no. 8365 dated 02.07.1998 “On banks in the Republic of Albania”, article 27. On the basis of these laws, a regulation on Foreign Exchange Open Positions no. 59 has been issued on 05.05.1999.</p> <p>In their activity to satisfy their customers’ demands through extending loans, accepting deposits in foreign currency etc, banks undertake the risks of foreign exchange fluctuations. A bank has a net open position in a certain foreign currency when its assets and liabilities are different. When assets are bigger than liabilities we have a purchasing position (+) long, whereas when liabilities are higher than assets we have a selling position (-) short.</p> <p>The above mentioned regulation determines rules for measuring the open foreign exchange positions of banks. The rules are intended to limit the losses of banks from both foreign exchange transactions and precious metal ones. All the banks when performing banking transactions in foreign currencies shall monitor the process and shall not exceed the following rates at the end of each day:</p> <ol style="list-style-type: none"> <li>1. A maximum ratio of 20% of the net open foreign exchange position in each foreign currency to bank regulatory capital;</li> <li>2. A maximum ratio of 30% of net total open foreign exchange position to bank regulatory capital.<sup>1</sup></li> </ol>

1. Defined in the Regulation no. 59 dated 05.05.1999 of the Bank of Albania

The current regulation on FX open position does not account the dynamics of the financial sector and of its instruments. For example, under the current framework, banks have discretion to value the off balance sheet items expressed in foreign currencies, which is one of the components taken into account when calculating FX open position. This creates difficulties in the process of valuating the foreign open position since it is not specified which items have to be included.

Another important aspect when calculating FX open positions is the foreign exchange rate used in calculation. According to the current framework foreign currency reevaluation is done using either the reporting day exchange rate or the historical exchange rate, whereas according to IFRS foreign currency reevaluation is done using exchange rate of the transaction date, which reflects the reality better.

This situation may have negative consequences for the:

- Banks being exposed to greater FX risks;
- Worsening supervision role of the Central Bank of Albania;
- Consumers bearing the risks and paying higher costs.

Looking at the experience of other countries in the region many Central Banks have adopted new regulations which take into consideration real exposure of FX risks through a better capture of product development trends in the financial sector.

For the reasons mentioned above, there is a need to amend the relevant regulation on FX Open Positions through revising the calculation method on FX positions in accordance with international standards and best practices.

In addition, the adoption of the International Financial Reporting Standards (IFRS) in 2008 raised the emergency for the Bank of Albania to adjust the banking regulatory framework and align it with the new accounting and reporting standards. In the framework of the SPI Albania project on “Amending the Banking Regulatory for IFRS implementation”, which was closed in 2008 the Project Working Group<sup>2</sup> recommended a comprehensive list of banking regulations that would need future amendments. With reference to the amending priority, the regulation on FX Open Positions was considered as high priority.

By amending the FX Open Positions regulation banks will benefit from having a real dimension of their exposure to FX risks and to control foreign currency risk. Also, it promotes banking system stability by a better coverage of risks with regulatory capital. A better risk management gives an enhanced coverage for the customers. On macro level, the investments could increase and therefore economic development would be stimulated.

### *1.1.2 Market Analysis*

*General market:* Banking Market

*Specific segment:* Risk management under prudential framework

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<sup>2</sup> The IFRS Project Working Group included representatives from the Bank of Albania, Banks, Ministry of Finance, Financial Supervisory Authority, Pricewaterhousecoopers, KPMG, Ernst & Young, Deloitte & Touche.

*Sub segment: Foreign Currency open position activities*

### *1.1.3 Legal framework*

Law no. 8269 dated 23.12.1997 “On the Bank of Albania” chapter VII, article 26

Law no. 8365 dated 02.07.1998 “On banks in the Republic of Albania”, article 27.

Regulation no. 59 dated 05.05.2009 of the Bank of Albania on open foreign positions

Methodic guideline on foreign exchange risks

### *1.1.4 Stakeholders - Institutional framework*

- **Bank of Albania:** Bank of Albania is the supervisory authority for the subjects licensed by it. According to the law no. 8269 dated 23.12.1997 “On the Bank of Albania” the Bank of Albania has the right to issue by-laws, decrees, regulations, guidelines and orders to fulfill its mission as supervisory authority. BoA issues general and prudent regulations and guidelines for banks. All these create the supervisory regulatory framework for subjects licensed by BoA. The authority of the Bank of Albania in establishing rules for foreign currency open position is defined by the Law no. 8269 dated 23.12.1997 “On the Bank of Albania” chapter VII, article 26 and the Law no. 8365 dated 02.07.1998 “On banks in the Republic of Albania”, article 27. On the basis of these laws a regulation on open foreign currency positions no. 59 has been issued on 05.05.1999. According to the current regulation all the banks when performing banking transactions in foreign currencies shall monitor the process and shall not exceed the following rates at the end of each day:

- A maximum ratio of 20% of the net open foreign exchange position in each foreign currency to bank regulatory capital;

- A maximum ratio of 30% of net total open foreign exchange position to bank regulatory capital.

- **Commercial banks.** The Albanian banking system consists of 16 commercial banks having as main area of activity lending to individuals, companies and Government.

## **1.2. Market/regulatory failure analysis (nature and evidence)**

The current regulatory framework on foreign currency open position has not been updated to the product development dynamics of the financial sector. The methodology used in the current regulation on FX open position does not cover all types of risks having an impact on the regulatory capital for the banks. According to the Bank of Albania assessment, this situation in the near future may lead to regulatory failure, as the regulation would be wrongly prescribed for the market. Therefore, the Bank of Albania as the banking supervisory authority should act in a prudent manner to prevent occurrence of banking instability in the future.

Also, the adoption of International Financial Reporting Standards (IFRS) in 2008 raised the emergency to the Bank of Albania to adjust the banking regulatory framework and align it with the new accounting and reporting standards. In the framework of the SPI Albania project on “Amending the Banking Regulatory for IFRS implementation”, which was closed in 2008 the Project Working Group recommended a comprehensive list of banking regulations that would need future amendments. With reference to the amending priority, the regulation on foreign currency open position was considered as high priority.

**1.3. Policy Goal(s) threatened by the failure** [e.g. financial stability, market integrity, market confidence, consumer protection, facilitating innovation, enhancing competition]

**General Objectives:**

- To enhance the banking system stability.

**Specific objectives:**

- To strengthen the supervision function of the Supervisory Authority
- To ensure sound prudential risk management techniques for more adequately preventing financial disruptions and protecting the depositors
- To advance in the process of convergence with international regulatory capital measurement and standards.

**Operational:**

- To improve the methodology on foreign currency open position calculation.
- To revise the regulation on FX open position.

## 1.4. “Do nothing” option

**1.4.1 Possible medium-term (max 2 years) self – corrective market actions** (e.g. mechanisms through which the “Do Nothing” option would address the market/regulatory failure).

The banking system in Albania is in the process of convergence with international capital adequacy requirements and standards. This convergence requires that banks adjust their methodologies and regulations to such requirements to ensure sound prudential risk management. The non-revision of the regulation on foreign currency open position would make banks more vulnerable to risks and involve additional costs with impacts on regulatory capital. Also, the situation would involve a weakened supervision role of the Bank of Albania with impacts on financial system stability.

### 1.4.2. Impact of the “Do Nothing” option to the various stakeholders

**Impact on authorities:**

- worsened supervision role of the Bank of Albania

**Impact on banks:**

- exposure to greater FX open position risks
- additional costs on human capital to manage risks
- worsened bank profitability

**Impact on consumers:**

- bearing higher costs with less opportunities to bank products and services

## 1.5. Alternative policy option(s)

**1.5.1. Description of Option 1:**

Revision of the regulation on FX open position

<b>Summary Problem Scoping</b>			
<b>Revising the Debt Contracting Regulatory Framework</b>			
<b>Market failure</b>			
Asymmetric information	Market power	Positive externalities	Negative externalities
<b>(Existing) Regulatory failure</b>			
Regulation wrongly prescribed for the market	Regulations succeeded in addressing the failure; a different market failure (e.g. side effect)	Regulation made it worse	Regulation so far has failed to work; maybe in due course
X			