Ardian Fullani: Basel II, its implications, opportunities and challenges ahead for Albania and Southeastern Europe

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Southeastern European Financial Forum, the Second Edition, Bucharest, Romania, 11 November 2005.

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Ladies and Gentleman,

The topic to be discussed at this forum is certainly timely. You need not look any further than news headlines to understand why risk management matters so much. Several events remind us that when banks lack the commitment to manage their risk prudently, they will fail to uphold their responsibilities to their shareholders and public at large. Consequently, the cost to society can be high and the impact on the economy devastating.

Sound corporate governance comes about only when there is a genuine commitment to do the right thing and to manage risks in whatever form they may arise. Risk managers must provide timely, objective and accurate information to their management. In turn, senior management and board of directors need to make sure that there is an atmosphere of transparency within the firm, one that promotes healthy and disciplined risk taking.

In order to improve understanding and management of risk, the Basel Committee has been formulating regulatory approaches to foster a safe and sound banking system and greater stability within financial sector. It has become clear, though, that the 1988 Accord and many of its amendments have become outdated and overtaken by advances in the banking and the financial sector, and other economic developments. As a consequence, the Basel Committee has come up with a new proposal known as Basel II. This proposal is intended to be more risk sensitive than the 1988 Accord, in order to provide a better alignment and calibration of regulatory capital and capital adequacy with the underlying economic risks that banks face. Categorizing debtors into a fewer risk ‘buckets’ was certainly a progress in 1988, but it open the gap between the regulatory risk measurement of any given transaction and its actual economic risk. This favours high risk loans over the low risk ones, given the 100% risk weight charged, irrespective of the risk profile of firms receiving the loan. Consequently, it adversely affects the accuracy of assessing capital requirements and allocation. The most concerning side-effect has been the distortion of financial decision-making which is, loans and investments made on basis of regulatory constraints rather than genuine economic opportunities.

The new Basle II accord tries to improve on these issues by encouraging banks to become more sophisticated in their risk assessment and aligning more rigorously regulatory requirements with internal risk measurement methodologies. It is important to recognize that the application of the New Accord is principally intended for large international banks, which are complex institutions usually operating in developed countries. Therefore, Basel II has often been questioned about its implications and appropriateness for banking in emerging market economies, and it is on this point that I would like to focus my remarks.

In principle, the three-pillar structure of the New Accord provides more precise directions to regulators to strengthen bank supervision and incentives to banks to become more sophisticated in risk management. Implementation of Basel II eliminates “one size fits all” methodology to assess risks and offers instead a wide range of methods to evaluate risks based more on failure likelihood. But the supervisory authorities in several emerging markets and many developing economies are concerned that Basel II puts a challenge they cannot meet.

Probably our greatest concern relates to the need of the standardized approach to rely on external rating agencies for calculating minimum capital requirements. Currently domestic rating agencies are totally absent in Albania and not well developed as in many other non-OECD countries. On the other hand, in most of our economies many small enterprises cannot afford to be clients of international rating agencies. Since borrowers unrated from rating agencies will be assigned a 100% risk according to Basel II, initially most domestic credits may end up under this 100% category. This could reduce risk sensitivity of the new system brining it close or similar to that of Basel I.

On the other hand, Albanian banks hold a significant share of government treasury bills and notes. Actually, under Basel I to this exposure of the banking system denominated in local currency is assigned 0% risk independently whether credit risk of the sovereign debt is rated or not. Under Basel

II, standardized approach, it is possible that sovereign debt is assigned a risk weight between 0% to 150%, most likely 100% since it falls under unrated category. This means that banking system in Albania may have to increase capital allocation to comply with the minimum level of the capital adequacy ratio.

An important intention of Basel II is to strengthen market discipline by developing a set of information disclosure requirements. In our countries there is plenty of room for improvement in this respect to allow market participants to assess key information on risk exposure, risk assessment process, and hence capital adequacy. This is important since it increases public pressure on banks to have a better performance in assessing and monitoring risk. However, in short run information disclosure might also have some adverse implication, say in Albania. Let me explain myself better on this issue. Public is usually more sensitive to bad news than positive developments. In countries like Albania, reactions between good or bad news are even more asymmetric than in mature market economies. Public in Albania is particularly over-reactive toward grim news on banking sector or on a certain bank while tend to ignore what falls in the positive side. This could be due to both historical factors, e.g. the crisis of financial system in 1997, and culture factors e.g. low level of bank business understanding, e.g. the overreaction of public to the introduction of the Deposit Insurance Law in 2002. This means that enhanced information disclosure required by Basle II, could be problematic if not supported by a proper public understanding.

That's why I feel a bit concerned about the effectiveness and appropriateness of an immediate implementation of Basle II. Therefore a more gradual approach may be necessary. This approach could take the form of an interim standard between Basel I and Basel II that could offer banks in emerging market economies some of the benefits of Basel II without having to face a prohibitive cost. This means that Basel II adoption should not be made mandatory in financial assessments (of WB, IMF for example) and countries should be left with the option to keep Basel I.

EU banking directives are mandatory for our countries that opt to join EU. As Basel II elements are embedded in EU Directives, and as our countries are making progress toward integration in the EU, we shall be faced with the challenges of Basle II implementation. I'd like to point out three challenges in particular.

Albania as many other East European Countries host a considerable number of foreign banks. These consist mostly of branches or subsidiaries of banks from EU countries which eventually may have to implement the new system including its most advanced elements if their head offices decide to adopt it throughout the network for consistency and competitiveness reasons. Bearing in mind there is a high degree of standardization in the risk management practices of a banking group - which is, same risk management techniques being applied uniformly throughout the group - the host country banking supervision might choose to rely entirely on the validation conducted by the home country supervision, provided that the adequacy of the model fits local conditions. If this is not the case, the host country supervision will probably have to rely on its own assessment of Internal Ratings Based (IRB) models. However, the latter raises two other sensitive issues. First, the feasibility of IRB application is complicated by the lack of reliable data on at least a full business cycle. Second, it requires training and preparation of banking supervisors with new rules, and thereby to improve their ability to examine and evaluate IRB approaches for consistency, integrity and accuracy in order to properly measure risk, otherwise, the whole capital allocation system could become faulty. On the other hand, this new environment calls for better cooperation and coordination across countries' banking supervision in order to avoid over regulating banks and to save resources.

The second challenge relates to the need of developing our own domestic rating industry for assessing borrowers. This is indispensable to gain the potential cost reduction of intermediation out of the implementation of the new system. It will make possible for some borrowers to obtain better ratings and consequently better risk weights compared to the actual 100% unrated system. However, this is not an easy task by any mean. Rating agencies should satisfy several criteria in order to be eligible. These criteria, as you might already be aware of comprise experience, freedom from external influence, publicly available assessments, requirements to disclose assessment models and approaches, sufficient resources and finally validation or recognition by supervisory authorities in our countries.

Third but certainly not the least, the new system poses a challenge to all banks to improve their capacities in order to comply with the new framework to successfully compete and survive. Banks should start adopting a more dynamic and forward looking approach to the evaluation of risk and provisions since under a risk sensitive approach there is always the risk of pro-cyclicality[1], which means bank capital ratios are likely to fluctuate more over the course of business cycles.

In spite of the above challenges, in Albania we have already started addressing some of these issues.

> First, by making sure that we have consolidated the achievements of our supervisory function by completing the requirements of Basel I. We are glad that the good progress has been confirmed also by the FSAP assessment during their mission in February-March, this year. Certain recommendations related with requirements about consolidated supervision, will be followed very attentively;
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> Second, we have been pushing already our supervisory process and the banks, toward a more risk oriented attitude. At the same time we intend to keep a higher minimum level of capital adequacy ratio than the European standards, in order to provide for some cushion for other forms of risk like operational risk;
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> Third, we try to gain as much as possible out of the experience and knowledge of other countries in the region, which are in a more advanced stage in their efforts of adopting Basel II requirements either partly or fully. We have also the privilege of being close to the euro area member countries, like Italy and Greece, with their banks playing an important role in our financial system. This gives us the possibility to benefit out of expertise of the supervisory authorities of these countries, in the process of adopting new requirements;
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> Fourth, we have expanded our cooperation with other "peer" countries in the region, as the variety of problems found in our countries is very similar and the experience sharing in this respect, is very practical;
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> Fifth, we are trying to promote an environment where issues of Basel II are being discussed in a professional level. We are not focusing only on directly involved parties (including government, other supervisory authorities of the financial market) but also on relevant clients of the banking and the financial sector.

Concluding, I would like to stress that Basel II represents a logical and appropriate successor to Basel I. It embeds recent and past lessons and gives excellent directions to financial system and supervision authorities how to move ahead. On the other hand, its implementation may be a bit too ambitious and a difficult task for our countries. Therefore it is in our interest to find ways to make it more suitable to our needs by following a gradual approach rather than jeopardising its success through an uninformed adoption.

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1 According to Basel II, the assessment of the borrower's credit risk will depend on the performance of the economy, whether it is in a upward or downward trend. In the worst case, when the economy will be wholly swept in recession, banks will have automatically either to increase the level of capital, or shift towards less risky assets, that most intuitively calls for a slow down to provide loans thus engendering credit crunch and further recession.