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BASEL III CHALLENGES IN THE ALBANIAN BANKING SYSTEM

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Abstract

Due to the economic and financial difficulties worldwide, action being made and the developments that follow are to be monitored. In point of fact the Bank for International Settlements, more precisely the Basel Committee on Banking Supervision, has well analyzed the needs and has introduced a new update to the international agreement on banking regulations and supervision, the Basel iii. The implementation of this kind of international agreements aims a harmonic international financial and economic interaction, avoiding so potential “domino” failures and promoting equity among different markets and different banks. On the investor’s side, the emerging countries banks are very important and it is substantial to focus on the international development and implications. Still, some questions rise. Are the international supervisory and prudential regulations a thread or an opportunity for the emerging markets? Do they fulfill the needs of the emerging banking systems? My target is actually the Albanian banking system, one of the emerging markets of the Eastern Europe. To achieve the proper information on the “challenge” on the Basel iii implementation, I have compiled a survey based analysis, followed by personal interviews with top management bankers to achieve information on the recognition and differences of the national banking supervisory and prudential regulations and the international ones. In this paper you may find first, a description on the need of supervisory and prudential regulations, some specifications of the Albanian banking system and its transformations and also the implications and recommendations on the potential implementation of the Basel iii agreement into the Albanian banking system.

Keywords: Banking regulations, Banking supervision, Basel iii accords, Emerging countries, Albania

1. INTRODUCTION

The banking system can be seen as an indicator of the “health” of a country’s economy. A sound banking system means an opportunity for investors and tranquility for all economic

agents operating, leading to excellent actions and transactions that ensure the best equilibrium of capitals. Although we're far from the traditional banking, as for the quick changes in the sector, the banking system still remains the core of all financial chains. Starting from this tremendous importance, one cannot allow a failure or a degradation of the banking system. As a matter of fact, the several financial/bank crisis have alerted the need of supervision and regulations¹, not only on the national ground but also on the international one. Going global has immense opportunities and facilities, but has also implications not only on the level of banking and financial activity but also on behalf of the regulatory and supervision agreements. Logic, to ensure a global harmony, several accords and agreements aim for equality and equitable treatment among international banks in order to avoid abuse and potential failures.

Nobel cause, but the question stands: how do these agreements really impact on the different national basis?! In previous works (Avis Andoni, *Financial crisis and banking supervision; the Basel III improvements*) I have clearly stated the trend of the banking system or any other financial system, to avoid regulations in order to maximize their profits, creating ruptures in the system and depending on their gravity following potentially by "domino effect" collapses and worldwide crisis. The banking system "needs" supervision, and the most adequate one, no matter the economic environment in which we are located. So, I am pursuing my "research journey" deeply in the real implications of those regulations, apart the scope of doing good, especially in the Albanian case, which is categorized as an emerging market. Indeed, the Albanian banking system has been in permanent transformation. It has been only 17 years since the privatization of the banking system has happened. And afterwards, the Albanian bank market has been "wide open" to foreign investors and foreign banks augmenting so the competitiveness in the market.

For these reasons strategic actions come to ease for everyone of the banks present in the Albanian market being in the same time subject of control and supervision both in the national legislation as in the international regulatory agreements. The purpose of this paper is precisely to "measure" the impact and implications of the international regulations on the strategic specter of the Albanian retail banks in order to create the correct idea on the proper adaptation and coherence of the international prudential agreement. I have to mention that this work/project is still ongoing to complete the procedure with all the Albanian market banks. With the potential findings concerning the impact, this paper focuses on clearing out first of all the scale of awareness of the several international agreements, their real application, the scale of penetration and of course the opportunities or threads presented by them. Do these agreements/accords *form* or *deform* the Albanian banking system?!

¹ "Regulations" stands for a set of laws and rules applicable to banking, and "supervision" stands for monitoring by authorities of the banks activities and the enforcement of banking regulations. Barth, Nolle, Phumiwasana and Yago (2003, page 70,)

With this paper you will be able to get a resumed global trend on supervisory and regulatory norms on the banking system, also faced with the Albanian market reality. First you will be finding a targeting through the field of interest. Second, the potential problems will be revealed and the methodology used for this research. The article is followed at last, by the results and conclusion leading to the potential expectations, some critiques and further openings.

2. BANKING SUPERVISION AND REGULATIONS

It has been years now, since the late 1970, that banking supervision is a great deal and very important to ether national or international financial and economic harmony. The final destination of all regulations is to protect the depositor. In fact, the depositor is fuel for the motor of the baking engine, without this one, banks wouldn't function. Even though is important to them, the depositor is quickly forgotten, and bankers trend to risk big for bigger profit, needing so an intense supervision and regulation framework. In order to protect the depositor and to ensure the harmony in the system there are several scenarios and risks to be weighted.

We can start from the systemic risk that means the risk of banking panic spreading like a disease in all the banking system, through "healthy" or "unhealthy" banks (solvable or non solvable ones) from their connections and cross activities. That's why the prudential regulations tend to push banks into better understating and not underestimation of the risks they take and supervise the financial structure of their capitals in order to be prepared and cover the potentials losses. The solvability norms are one of the most important of the supervisory framework, and they tend to be more exigent because of the tremendous role of the capital in the stability of the entire banking system in the national ground as well as in the international one, in order to also adopt common standards. The bank's capital influences its solvability, its profitability and of course the risks that will be taken. So the capital ratios based on the risks taken are a very important component of a sound system preventing banks from failure.

In Albania the first private bank to operate was "Banka e Kursimeve" (the Savings Bank) in 1996. In the emerging Albanian market, the financial liberalization raised the first problems and the potential flows that trend to weaken the system. Indeed, in moments of observing vulnerability in the system, institutions and authorities find the need to build a framework; calculating and trying to overcome the risks that a private bank tends to take in order to maximize its profit. The Bank of Albania is in permanent alert to be fitting all the needed and required regulatory and supervisory frameworks connecting the system nationally and internationally, facing loan risk, solvency risk, systemic risk, market risk etc. Nowadays we can count in Albania 16 banks, with foreign parenting, franchised or national capital banks, a mixed composition system being also supervised by mixed frameworks.

Indeed on the international ground, the several financial crisis, as negative as they could be, they have inspired the supervisory authorities in improving the regulatory framework from concrete and potential flows. As we speak there exists an international agreement, under the name of Basel iii, where we can find the most important set of changes in the financial services industry to prevent a repetition of the bank collapses of 2007 and 2008. Regulators and central bankers have gathered to determine global safety standards. In fact the Basel iii accord, being the continuum of the first two accords, represents a complex series of reforms, which first of all aim to cover the previous flows and then enrich the accord with updates relevant to the evolution of the financial market itself. The accord is developed in two axes, the micro prudential regulations targeting the individual banking institutions and the macro prudential regulations targeting risks in the entire banking system. The focus is of course the capital that is indeed a “cushion” for unexpected losses. The first thing on the list was de facto the definition of the capital. Under Basel iii there is a tightening in the definition of what can count as capital in order not to artificially overestimate it. The accord aims to strengthen the quality, transparency and consistency of the capital to ensure that banks will be able to absorb losses. In Basel iii the level of minimum capital adequacy has been raised from 4% to 9.5%. Calculation based on risk weighted assets, rose another problem, the correct weighting form the banks. In order to standardize the banks risks, risk weighting is not calculated from the banks models anymore. Basel iii, introduced an internationally leverage ratio, but also liquidity requirements. Until the Lehman Brothers collapsed, there was no liquidity requirement, but now Basel iii introduced a liquidity cover ratio in order to prepare banks in overcoming short term problems². It is precisely the actuality that this accord represent that attires my attention.

3. BANKING REGULATION AND THE ALBANIAN BANKING SYSTEM

Fitting all the requirements of the Basel iii accord is truly more expensive for the banks in fact. Why? Having to hold their equity they are forced into lowering their profit. As a matter of fact Basel iii penalizes the high risk activities, logic, as they are found to always be the impulses of potential failures. Indeed I can state that in order to maintain a safe and sound banking, the banking profession should be “boring”. On the other hand in the Albanian case the “problem” doesn’t stand only on the components of the accord but also on the compatibility with the developing economy. Is Basel iii a thread or an opportunity for the Albanian banking system?!

The purpose of this study is precisely to strengthen the knowledge first of all on the development and evolvments in the field of banking supervision and regulations, especially the international ones, which are actually subject of important changes. Second it is very important to detect the scale of penetration of these international regulations on banking supervision. And the most important aim is to detect the “pure influence” of the mentioned

² To get a detailed view of the Basel iii accord you may find it in Annex 1.

regulations on the everyday activity of the retail banks and their strategy. Why do I consider this axis such important to be doing a field research in order to determine the implications? It is clearly because of the tremendous cost that these accords have, and the sensibility depending on the scale of development for the economy to be implementing them. If the real influence of the accord happens to be positive and of course considerable, the suggestions following will be a boost in trying to speed up the implementation process.

The approach that has been chosen to use in order to perform this quantification of impact is an empirical assessment. Indeed, I have compiled a survey form and enriched it with several interviews to complete even with informal opinions or “feelings”. The surveys were destined to employees directly coping with the reporting to the central bank and the risk management department that implements several of the proposed norms. Aligned, to enrich the quality of the exact but short response appearing in the survey, I have realized several interviews with members of the top management of several retail banks in Albania. The interviews deepened the opinion based information on the timing, the comparison, the components being not adapt to the Albanian situating and mostly an opinion on the recommendations for a potential implementation of the Basel iii accord. Afterwards a long process of resuming, analyzing and estimating followed. As a matter of fact in order to well manipulate the data obtained I have been using research methods such as cluster analysis, hierarchic classification, as well as Principal Component Analysis, Factorial Component Analysis and of course the typical cross tabulation analysis³.

In order to have a better understanding of the components that will be quantified I would like to guide you through the several sections of the survey. First of all I ask for general information according to the beginnings of the international regulations and supervision in the Albanian banking system. How did their importance evolve and which ones did? I wanted to quantify the awareness of their existence and the way or scale of their implementation. Second, we can find the comparison with the national regulations and supervision. Based on the fact that the Albanian banking system is part of emerging market types and really “late” to all current development worldwide, there are potentially and a priori differences with the international basis accords. What are those differences? Which one is more rigid or flexible? I wanted also to get information from on the real perception if they are seen as limiting, orienting or are just imposed rudely. Is there coherence in their being? A very important issue is also to deepen the knowledge about the involvement of national economic, social or even cultural components. To be more specific, I have asked the bank employees more questions on certain parts of the regulations. These specific points have been paralleled with the strategic orientation of the bank being studied in order to withdraw information on the most influent components, the real time relation with the strategic action field, the help or obstacles that the regulations incite to the banks strategic actions and also the threads and opportunities that the regulation components represent for them. Not only I have treated in parallel the evolvement

³ I would like to inform that the final results aren't yet reached because of the big amount of time needed to obtain the survey forms.

of the personal strategy of the bank and the deviations (positive or negative) caused by the international regulations on banking supervision but I have also found a way to gather a let's say "wish list" considering their form, measure and scale of penetration. In this way it was much easier to detect the concrete influence of the international prudential regulations. Which ones are the most influent? In which strategy do they mostly interfere? Is there a positive influence or are they purely obstacles? These measurements are importantly paralleled also with the context. At the end of the survey, enriched as stated above by the interviews, the information gathered streams to the agreements or disagreements that banks may have also the suggestions of their part.

4. IMPLICATIONS

The Basel iii supervisory and prudential regulations are in fact compiled by the G20 members of the Basel Committee on Banking Supervision, so the interest that they target the most are their proper financial and bank market. We can say that the adaptation with the emerging markets is absent. But what is still seen as an opportunity, even though the implementation of Basel iii seems to be a "rollercoaster" story for the Albanian banking system? It's clearly the investor's comfort. In fact, foreign investors are very interested in investing also in banks in the Albanian market, so if there are too many differences with the regulatory framework they are used to cooperate with, they may tend to avoid their investments in the country. On the other hand, as long that there exist a harmony and coherence worldwide on the supervisory and prudential regulations, a fluid investments flow will be assured, and the Albanian market's opportunities will still attire the foreign investors.

5. RESULTS AND CONCLUSION

As I stated it before this study is still in progress to ensure the complete coverage of all the banks in Albania. A considerable part of the information needed was assured and you may find below the most important results.

Table 1. The most important results of cross survey and interview research

The component measured	The converging result	Opinions
The importance of the supervisory regulations	Growing	The national or international regulations are seen as really important, and this importance is growing while the market itself is in perpetual trend of failure
The regulations being applied	Mixed between national/international	The actual situation imposes a mixed system of regulations, national ones being mandatory, and international ones being orientating or depending on the

		bank mandatory from the “mother” banks
The comparison	<p>The Albanian regulations being more strict in some point (coverage on RWA)</p> <p>The international regulations being more detailed and richer in plenty of missing components of our market</p>	<p>The most important financial product of the Albanian banks (being almost the only one) is the classic loan, and the Albanian banks cover it in collateral 90-110%.</p> <p>Not yet a stock market, so lack of several financial products/services.</p>
The evolution	Relatively quick / more and more	The large penetration of the foreign banks and their “spirit” make evolving the market and its needs fast enough to be requiring an evolved supervision also.
The most changing components	Liquidity and Risk (operational and credit)	Due to the actuality the past crisis these two components are the core alert for prudential regulations, being revised and updated especially the operational risk that is a “new entry” .
The perception of the comparison	Different among banks	Depending on the ownership of the bank, views and perceptions are different because of the importance being given by the foreign banks to the common international standards.
The most known accords	FSB, BCBS, EU Directives	Still being some employees that have not quite the complete information on international directives and authorities responsible for the supervision regulations.
Strategic canalization	Their influence on the strategic sphere is augmenting	The prudential and supervision regulation re being more and more strict and detailed so the specter of their influence is apprehended as augmenting and influencing directly some of the strategic decision making of several banks.

The prudential weight	Growing / as a result of the international economic situation	Directives are being transformed from orientating to obligatory because of the economic development worldwide.
Approaching Basel II	More and more	While other countries are started the implementation of Basel iii, in the Albanian market is Basel ii that is still on call.
Concrete obstacles	<p>Limitations</p> <p>Reducing the decision making horizon</p> <p>Reducing profitability</p> <p>Conditioning the international exposition</p> <p>Conditioning the investment's plans</p>	As a matter of fact, the Albanian market has been a "free ground" for foreign investments in banks, not being strictly frame worked in international common regulations and having the freedom of "playing" in exposition and profitability, so on the shareholders side, as everywhere else, these regulations are being seen more as an obstacle.
Advantages	<p>Ameliorating the CARs</p> <p>Orienting to the international markets</p> <p>Orienting the risk models</p>	On the other side, the bank employees prefer this international guidance because of the evolved and developed research on risk models and advanced market products and trends.
The most concerned strategies	<p>Diversifications</p> <p>Specification</p> <p>Internalization</p> <p>Expansion</p>	The bank size or its scale of penetration in the market models the bank's strategy so it is clear that depending on that the precise strategy being canalized and modified due to the regulations are different.
Wish list	<p>Lightening</p> <p>Changing according to the economic context</p> <p>Changing according to the</p>	<p>The most important suggestion is to take consideration of the Albanian market, the economic and social situation, in order to best adapt the regulations.</p> <p>The point of incoherence being</p>

	<p>Albanian market components</p> <p>Taking notice of the national culture and regulations</p>	<p>the incompatible market types in emerging markets.</p>
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Based on this study, which is still in progress, I will be able to get further detailing on the strategic interactions. The limitations of this kind of studies are for sure the “shyness” or fear of the interviewed individuals that sometimes tend to lie and cover the truth. On the other hand the most “loquacious” individuals represent a positive advantage of the interviews. Overall, the most important result of this research is for sure the immense importance given to the prudential and supervisory regulation being either national or international. The impact of these regulations on the banking strategic actions exists and this impact is positive for the banking system’s health. As long as the prudential framework is seen as an obstacle for shareholders, the depositor is safer, even though sometimes the cost will be absorbed by this last one. So, in order to deepen the research and determine if Basel iii is really the “salvation boat” to overcome future collapses I will pursue on other axis such as the implementation cost, the opportunity cost, and of course the compatibility with emerging market type. Is it worth? Is it needed? Is it in the right place? We will see.

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