

BANK SUPERVISION AND EXAMINATION

STANDARD REPORT OF

I. BANK SUPERVISION

I. 1. What is bank supervision?

Bank supervision is the regulatory process of monitoring the condition of an individual bank within the banking system, as well as the system as a whole.

It begins with the establishment of licensing standards and their implementing; it continues with evaluation and assessment a bank's activity and performance; and when necessary, includes taking remedial measures and applying penalties to ensure that laws and sound industry practices are followed. These remedial measure may ultimately include revoking the bank's license.

I. 2. Why is bank supervision needed?

Banks and their activities are subject to much closer official supervision, than other kinds of businesses, because of their role in the economic and financial life of a country. Banks accept deposits from the public and government. By doing so they assume a role of major trust for society's financial assets.

They occupy a central place in the payments mechanism for households, business and government.

And, they play a major role in the allocation of financial resources of a country, mediating between deposits of surplus funds and would-be borrowers, on the basis of active judgments as to the latter ability to repay.

This stands in marked contrast to the practice under conditions of central planning, where banks would typically act merely as passive conduits for the distribution of funds without the necessity to make credit decisions.

Because of the special role banks play, the primary justification for banking supervision is to limit the risk of loss of depositors, and by so doing to maintain public confidence in the system as a whole.

I. 3. What is the supervisory process?

Banking supervision is an ongoing process that begins with licensing. It is at that time, that the individuals and / judicial persons are evaluated, as to their acceptability for being allowed permission to commence the banking business.

Standards regarding initial capitalization, qualifications of management and the appropriateness of the bank's proposed business and strategic plans must be met.

Supervision continues with reporting requirements, which are reviewed and evaluated on an "off-site" basis. Inspectors from Bank of Albania will also visit the bank to conduct "on-site" inspections.

These "on-site" inspections are designed to verify information provided by the bank and to review first hand operations and performance of the bank.

The latter inspections may be general in their scope (full scope inspections), or they may be focused in a particular area or aeries (partial inspections).

The findings and recommendations on each on-site inspection are presented on a written format that is called the Report of Examination.

Banks engaged in unsafe and unsound practices will be required to cease such operations and develop and implement corrective actions.

Likewise, deficiencies, identified during the supervisory process - whether from an off-site inspection, - are required to be corrected.

Article 44 of the banking law (law no. 8365) provides for several means by which Bank of Albania may deal with a bank's failure to comply with the supervisory requirements.

4- CONFIDENTIAL SECTION

II. THE REPORT OF EXAMINATION

II. 1. What is the Report of Examination?

Report of Examination is the written communication used to present to the administrators of Bank of Albania, and the Board of the examined bank the most significant findings, conclusions and the recommended corrective actions, drawn by an on-site inspection.

Since the Report of Examination communicates significant findings and recommendations, it bears a key role in the overall supervisory process. The Report of Examination in almost cases serves as a justifiable document for all corrective measures undertaking.

To ensure uniformity in the presentation of inspection findings, their smooth reading and immediate identification of main matters and conclusions, a standardized Report of Examination format has been adopted.

This format begins with a front page listing overall conclusions on the most significant findings. This in turn is followed by another page where the most significant matters, deserving Board attention of the inspected bank are listed.

Afterwards, summary comments are rendered on each element of CAMELS¹ system as well as other matters deemed necessary.

These pages are associated with tables and other data intending confirm on conclusions listed at the front of the report.

II. 2. The Structure of the Report of Examination

The report of examination is composed by 4 main components:

- 1- CONCLUSIONS AND RECOMMENDATION
- 2- EVALUATION
- 3- ADDITIONAL INFORMATION

¹ CAMELS is a standard evaluation system on second-tier banks. Each letter stands for an element on which the bank is evaluated. C- Capital; A- Assets; M- Management; E- Earning; L- Liquidity; S- Sensivity. The evaluation provided on each element scales from 1 up to 5 where 1 represents the best evaluation and 5 the poorest evaluation

II. 2. 1- Component 1: Conclusions and recommendations

This component is evaluated as one of the most significant parts of the report of examination which gives a brief and concise account of:

- A. main examination findings and conclusions;
- B. matters requiring the Board attention of the examined bank;
- C. violations of current laws and regulations.

In the heading "*Main examination findings*", the financial condition of the bank, the capital, assets quality, the loans and investment portfolio, the overall framework of policies and practices, profitability, liquidity etc are evaluated in accordance with "CAMELS" system as well as it is explained the quality and tendency of each component.

Therefore, it is explained any significant change or future tendency deemed necessary. This heading is signed by the head inspector and the director of the supervisory department.

Matters requiring Boards attention are presented under the heading, "Matters requiring Boards attention", listing them according to the constituent elements of the CAMELS system in view of Board's measures for improving examination findings i. e. policies drafting, approval of regulations and instructions, drafting necessary programs, or undertaking administrative measures for infringements redress or improvement of the financial condition of the bank; problems marked during examination and cited in the final report of examination.

Each member participating the Board of the bank under inspection is responsible for the full analysis of the entire Report of Examination.

Each member of the Board should sign the page under "Signatures of the members participating the Board of Directors" in order to confirm that each of them has thoroughly reviewed the report.

(The table has the following outline)

Name, Surname	The function in the board of directors	Date	Signature

Violations of laws and regulations, found by the Bank under examination, are included under the heading "Violations of laws and regulations" where the first ranked are law violations followed by violations of regulation violations according to their risk exposures of the bank.

II. 2. 2. - Component 2: Evaluation

This part is composed by 6 elements of the CAMELS system. This section presents the evaluation for the financial condition of the bank reviewed in all its aspects. Supposing that the normal order of the CAMELS system was followed, then evaluation would begin with capitalization. But, considering the overall significance and influence borne by management, this evaluation is good to begin with management and administration.

A - MANAGEMENT / ADMINISTRATION

Management is estimated on account of all indispensable factors for the safe and sound administering of the institution in compliance to all accepted practices. The attention should be focused on the technical competence, leadership and administrative capabilities; compatibility with regulations and statute; capability to plan and react to the changing conditions; effectiveness of systems used for managing information; adequacy and applicability of domestic policies; the response against recommendations made by inspectors and supervisory authorities; and management quality. More concretely this section deals with:

Management assessment in view of the daily routine of bank administration as well as in the long-term. Judgment on board's policy in view of basic function of the bank (deposits, credits, securities, etc). Matters deserving the board's attention. Implementation or not of the internal and external audit recommendations and nominally indicating managers rendering explanation.

Evaluation on adequacy policies of the bank. Judgment on the identification and evaluation of risks exposures from managing. Judgment on the bank assets dealing with internal related group of people.

B - CAPITAL ADEQUACY

The capital adequacy is evaluated with respect to the regulations in effect on regulatory capital and own funds adequacy; as well as on the overall financial stock; the nature, tendencies and the volume of assets classified as substandard; intangible assets, off-balance sheet items and profit; growth rates , etc.

There to, basing on the capital necessities, considerations are rendered on: bank profit; overall risk of interest rate; reasonability of paid out dividends; as well as on plans regarding capital maintenance at adequate range, or on undertaking appropriate corrective measures. To pass a judgment on capital level and its adequacy, the following ratios are to be studied:

Capital ratios and tendencies

<u>RATIOS</u>	Current examination (Date)	Previous examination (Date)	Previous examination (Date)
The total of doubtful – substandard own funds items			
Base capital assets total			
Own – funds assets aggregate			
Base capital corrected assets			
	Current examination (Date)	Previous examination (Date)	Previous examination (Date)
Divident net income			
The growing rate of assets			
Profit/previous years loss/ the average			

of share holding capital			
--------------------------	--	--	--

Furtherly, it is briefly commented on, capital quality with respect to assets quality, profits, assets growth as well as management philosophy on capital position.

the past due and suspended in interest reckoning; capability to demonstrate, identify, administer and recover/collect non-performing loans.

C - ASSETS GROWTH

The assets growth is evaluated with respect to the level, distribution, tendency as well as classification of non-performing assets. The current concept relates to the level, composition and tendency of matured assets, which are

There to, it is also evaluated the investment quality on securities; the adequacy of investment policies, investment risk, etc., or the efficiency of lending policies and practices of loans administration.

Ratios on assets growth and tendencies

RATIOS	Current examination (Date)	Previous examination (Date)	Previous examination (Date)
Classified assets/the total of assets			
Classified loans/the total of assets			
Classified loans /credit aggregate			
Classified loans /own funds			
Loans substandard & doubtful/own funds			

These ratios enable: evaluation on the overall financial stock and volume of classified assets.

and the future operations, coverage of losses and maintaining of capital adequacy, level and tendency of profitability; profits structure and quality; net spread interest; as well as profit exposure to interest rates change.

Assets structure.

The structure of loans portfolio in domestic and foreign currency according to their maturity; the structure of investment portfolio, etc.

Therefore, it should be also taken account of expenditure adequacy for reserve funds in covering losses from loans (provisions); share of exceptional items, bonds transactions, tax effects on net income and dividend payments, etc.

D - INCOMES

Income quality and quantity is evaluated in connection with the capacity to support present

Indicators and Tendencies

RATIOS	Period (Date)	Period (Date)	Period (Date)
Net income after tax/average assets			
Net income after tax/own funds average			
Operation expenditure/gross operational income			

Besides accounting the above indicators, the current section deals with:

Evaluation of profits plan and the would-be factors influencing it in the future.

Evaluation of the profits level and their effect on capital

Judgment on the adequacy level of provisions for credits.

Evaluation of expenditure, especially for the most exceptional ones

Analysis on income composition (incomes from dealings with other banks , incomes from customers dealings and clients lending.)

E - ASSETS / LIABILITIES LIQUIDITY AND MANAGING

Assets and liabilities liquidity and managing is evaluated with respect to deposits structure and stability; level and tendency of support on short-term and largely liquid fund resources; difficulties in funds provision; and forecasted liquidity from securities and other assets.

Besides this, it is also taken account of the adequacy of liquidity, funds practices and policies including dispositions on fund alternative resources, management of the interest rate risk; or nature, tendency, and volume of out of balance assets.

Special importance should be attached to the implementation of Bank of Albania's regulation "On Banks Liquidity". The following are decided on this element account

The qualities of fund resources for meeting credits demands and deposits draw-downs.

The bank's mode for calculating liquidity ratio Deposit structure in domestic and foreign currency and the comments made on it.

Attendance of the committee for managing assets and liabilities (ALCO) and its operating efficiency.

F - SENSITIVITY TO MARKET RISK

The sensitivity of the market risk component reflects the range by which changes in the interest rates, foreign exchange rates or consumer prices and share-holdings, influence the capital base and profits of the institution.

While evaluating this component, it should be taken account of: the managing capacity to identify, measure, monitor and control the market risk; size of the institution; nature and complexity of own assets; as well as own profits and capital adequacy regarding banks exposure to market risk. This matter accounts for the following conduct :

Evaluation of factors affecting the interest and exchange rates.

The evaluation of the managing system used to monitor and control these factors. Comment on their influence in the institution's profits.

G - RISK MANAGING

The following points help the examiner for the assessment of risk and indicate the way bank directors are supposed to deal with the risk managing.

Evaluate the risk managing program of the institution, comment on how managing identifies, measures, controls and monitors the risk formally and informally.

This item requires a broader assessment of risk managing, monitor and monitoring practices. This does not necessarily require detailed descriptions for each practice and policy.

On the contrary, it is proposed to define the adequacy of mechanisms to identify internal and external risks exposures that bank is going to take over and the way they are measured, etc.

When referring to the adequacy mechanisms used to identify internal and external resources of risks, it should be paid heed of:

a) External resources of risks - are risks controllable from managing. They include technological changes, economic competition, political events. The managing duty is to identify and then respond to the influences of these resources.

b) internal resources of risks - are controllable because they derive from managing decisions as strategic planning and division of resources. In case that the strategic plan specifies growth in a certain area, does the institution share the appropriate human resources to stand up to these objectives? Is the information system of the institution capable for dealing with these changes?

This element defines whether the practices and risk line for each function of the bank (credits, deposits, securities) coordinate to the overall strategic plan.

2. Evaluate written practices of the institution and the credit administration including documentation, approval and report requirements. Evaluate the lending policies, practices and credit collecting in view of lending complexity and portfolio composition.

This element is commented on the policy of lending and credit administering regarding their completeness and appropriateness.

3. Evaluate the process of loans revision and the internal system of classification. Evaluate the institution's methodology in deciding the adequacy of provisions for covering losses from the loans.

4 Evaluate policies and practices for assets and resources management. Evaluate investments recommendations, the strategy of funds, the objectives on liquidity targets and risk management from interest rates.

This element is specifically commented on bank's liquidity, funds administration and risk exposure of interest rates.

5. Evaluate the internal control and management of information system. Evaluate the independence, inspection and frequency of internal and external audit. Comment on the application of recommendations provided by internal audit.

6. Evaluate the institution's policy with respect to transactions with its own employees or the conflict of interests. Comment on other matters regarding administration, supervision and audit namely from directors and managing.

7. Evaluate managing acknowledgment and the tendency to behave in conformity with the laws and regulations.

This elements cites the violations of laws and regulations.

8. Identify any individual or interest controlling the institution as well as the controlling range and method.

II. 2. 3- Component 3 : Additional information

The heading of "Additional information" provides detailed accounts of the main tables concerning the financial stock of the bank, as follows:

	In million Lek	
	31/12/19xx	31/12/19xx
<u>Assets</u>²		
<i>Cash</i>		
<i>Transaction with Central Bank</i>		
<i>Other bank transaction</i>		
<i>Loans</i>		
<i>Investment on securities etc ...</i>		
THE TOTAL OF ASSETS		
<u>Liabilities</u>		
<i>Deposits</i>		
<i>Other liabilities</i>		
<i>etc...</i>		
THE TOTAL OF LIABILITIES		
THE SHARE HOLDING CAPITAL		
THE TOTAL OF LIABILITIES AND THE TOTAL OF SHARE HOLDING CAPITAL		
Off balance of sheet items		

As noted, the front position of the managing/administering page reflects the significance born with the actions and inaction of bank

administrators in view of the overall financial condition of the bank, or financial institution.

² Assets and liabilities on this table are introduced according to the balance-sheet of the bank under examination.

Synopsis on the items subject to classification and special attention.

Categories	Classified items			
	Substandard	Doubtful	Lost	Total
Loans and leasing Bons Other stock Other assets (e.x "Debitors on accounted interests and past due in income")				
Total in 31/12/19xx				
Total in 31/12/19xx-1				
Total in 31/12/199xx-2				
Total in 31/12/199xx-3				

The sum, description and commentary	CATEGORIES		
	Substandard	Doubtful	Lost
1.			
2.			
3.			

Items subject of classification include assets and off-balance of sheet items specified under the following categories.

Substandard assets represent assets which are insufficiently safeguarded from the current, sound equity and repaying capacity of the debtor, or collateral, if there is any. The asset, classified after this method, should restrain a well defined invalidity or/that risks the debt repay. They are characterized by a definite probability that the institution will retain the losses if the deficiencies are not corrected.

Doubtful assets bear all transmissible deficiencies like substandard assets with supplementary characteristics.

Describe and comment in details all categories of classified assets as above.

LOAN LOSS PROVISIONS RECONCILIATION

	31/12/19xx	31/12/19xx	31/12/19xx
The balance sheet at the beginning			
Gross loss from loans			
Recoveries			
Provisions on losses from loans			
The balance sheet at the end of the peroid			

This part also includes the coordination of the managing assessment with the evaluation of other constituent elements of CAMELS which in

the long run indicate the financial condition and management of the bank.

PROFIT ANALYSIS

COMPARATIVE TABLE OF INCOMES AND EXPENDITURES

	31/12/19xx	31/12/19xx	31/12/19xx
Incomes from interests			
Expenditures for interests			
Incomes from interests			
Incomes from non interests			
Expenditures from non interests			
Provisions to loans loss and leasing			
Profits (Loss) from securities			
Loss (Profit) from foreign exchange operations			
Net operational income (before tax)			
Applicable tax on incomes			
Net operating income (after tax)			
Net income			
Divident payment			
The net change in the account of share holding capital			

The additional information, is logically placed after the evaluation component, grouped according to the CAMELS system needed to

back up the comments made under the section of evaluation, or conclusions and recommendations.

THE RATIOS OF PROFITABILITY COMPONENTS AND TENDENCIES

RATIOS	31/12/19xx	31/12/19xx	31/12/19xx
Net income from interests/average assets profitability			
The total of expenditures for non interests/average assets			
Net income/average capital			
Net loss/average total of loans			

Of Significance is the page of risk managing which needs account and requires from the inspector, the evaluation of the level of tolerance for the overall managing of risk, as well

as assessment of the local economy and the mode bank is affected as well as how well managing monitors this effect.

Arian Kraja

**Chief inspector for commercial banks group
On-site inspection unit**

Bank Supervision Department