# APPLYING CORE PRINCIPLES OF BASLE COMMITTEE FOR AN EFFECTIVE SUPERVISION

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*Keywords*
*- Basle Committee - Banking supervision - The core principles - Inspector -*

Governors of central banks from G10 group countries established at the end of 1974 the Basle Committee, as a body intended to make banking regulations and organize supervision practices. This committee does not have a supervisory authority and its conclusions do not have any legal power. The committee formulates broad supervision standards, prepares guidelines and recommendations for the best practices that individual authorities may apply in their national system.

The main target of the Basle Committee on banking supervision is:

'No foreign banking establishment should escape supervision; and supervision should be adequate'.

Weaknesses in the banking system of a country, whether developing or developed, can threaten the financial stability both within that country and internationally. The need to improve the strength of financial systems has attracted growing international concern. On this basis, the Basle Committee has prepared a document called 'The core principles for effective banking supervision'.

In developing the Principles, the Basle Committee has worked closely with non-G10 supervisory authorities. The Basle Core Principles comprise twenty-five basic Principles that need to be in place for a supervisory system to be effective. The principles relate to:

- Preconditions for effective banking supervision;
- Licensing and structure;
- Prudential regulations and requirements;
- Methods of ongoing banking supervision;
- Information requirements;
- Formal powers of supervisors;
- Cross-border banking.

These principles are minimum requirements that are implemented according to particular conditions of a relevant country in spite of its development level.

In drawing up these core principles for effective banking supervision the following precepts are fundamental:

- The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and creditors;
- Supervisors should encourage market discipline;
- Supervisors must have operational independence and legal power to gather information and the authority to enforce its decisions;
- Supervisors must understand the nature of the business undertaken by banks and ensure that the risk incurred by banks are being adequately managed;
- The risk profile of individual banks should be assessed and supervisory resources allocated accordingly;
- Supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective internal control systems; and
- Close cooperation with the supervisory authorities of other countries is essential.

The Bank of Albania, in implementing its role of supervising the banking system has drafted a set of prudential regulations. Commercial banks are required to implement these regulations in order to reduce the risk they undertake while exercising their activity.

In drafting the regulatory system, the Supervision Department of the Bank of Albania is based on the international experience and also on 25 core principles for an effective supervision of the Basle Committee.

Treating the core principles of banking supervision, we will analyze their implementation in the legal and regulatory system of the banking supervision.

## PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

### PRINCIPLE 1

An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

The Law 'On the Bank of Albania', Article 12 clearly defines that the Bank of Albania is the responsible authority for the banking supervision:

'The Bank of Albania shall be exclusively responsible for the licensing and supervision of all banks in the Republic of Albania.'

The independence of this supervisory authority finds utterance in the Law no. 8269, dated 23 December 1997, 'On the Bank of Albania', where article 1, paragraph 3 states that: 'The Bank of Albania shall be entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks.'

Article 3 of the same Law defines the Bank of Albania objectives and responsibilities. Paragraph 4 of the same article asserts that: *'The Bank of Albania's duty is to license or revoke and supervise banks that engage in the banking business in order to ensure the banking system stability'*.

Hence, the legal framework of the Bank of Albania to successfully achieve the supervision of commercial banks is complete.

Legally sanctioned duties and responsibilities as well as international standards on bank supervision are vividly expressed in the Regulation 'On the Functioning of Supervision Department'. In addition 'The operational job manual' describes the responsibilities and objectives for each individual engaged in banking supervision.

This principle is further detailed in Article 41 of Law no. 8365 dated 2 July 1998 'On Banks in the Republic of Albania', which stipulates that: *'Banks or a foreign bank branches are subject to the supervision performed by Bank of Albania's inspectors'*.

In this context, to provide adequate regulatory support for the inspectors, the various adopted regulations concern bank and non-bank licensing, liquidity, the required capital, loan classification and provisioning, their open foreign exchange position, foreign exchange activity as well as market risks.

Article 44 of the Law 'On Banks in the Republic of Albania' envisages punishments and penalties as well as measures to be undertaken against banks or their administrators in case of legal infringement, violation of regulations or any other restriction found by the Bank of Albania's supervisors.

To fully apply this principle, it is required:

- The improvement and the completion of all regulations and operating job manuals with clear responsibilities and well-designed targets for everyone engaged in the department;
- Necessary legal changes to ensure the legal safety of supervisors.

## LICENSING AND STRUCTURE

### PRINCIPLE 2

The permissive activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.

This principle finds expression in Article 26 of the Law 'On Banks in the Republic of Albania' where the permissive activities of such institutions licensed as banks and subject to the Bank of Albania supervision are clearly defined. Article 6 (3) of this Law states: 'No person or entity will be permitted to use the word 'bank' or its derivatives, without being previously licensed by the Bank of Albania'.

### PRINCIPLE 3

The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan internal controls, and its projected financial condition, including its capital base, where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Article 2 of the Law, dated 2 July 1998 provides the definition for the terms, 'bank' and 'bank activity'; permitted for operation only on license granted by the Bank of Albania.

In chapter II (from Article 7 to 14) of the Law: 'On Banks in the Republic of Albania', the Bank of Albania is endorsed exclusive authority on bank licensing. More specifically, Article 10 (2) of the Law provides the criteria for the Bank of Albania granting preliminary permission for bank licensing. In Article 3 of the same Law, it is stated that 'When the Bank of Albania decides to reject the preliminary license it explains the reasons for doing so'.

Chapter II of the same Law deals with the Bank of Albania's licensing authority and some general requirements further expanded in licensing regulations. Approved regulations on bank licensing include the Regulation 'On bank licensing in the Republic of Albania', the Regulation 'On granting a license to non-bank entities to exercise financial activity in the Republic of Albania' and the Regulation 'On compulsory requirements to be met by foreign bank and foreign bank branch administrators'.

Banks, foreign exchange bureaus and non-bank entities exercising financial activity are subject to Bank of Albania's licensing.

The regulation 'On bank licensing in the Republic of Albania' details the:

- The proposed banking organisation ownership structure, including the assessment of the shareholders' activity, their reputation, their financial condition and capital base to support the bank, if needed. The above regulation and the Law do not extend on the assessment of the shareholders' direct control, as required by the Basle Committee Principles;
- The proposed bank operating plan, its monitoring system and its internal structure. The operating plan includes the analysis and description of the market place the proposed bank intends to occupy, the activity it hopes to perform and its ongoing strategy. In addition, it describes the way the bank is managed and controlled.
- The information on bank directors examining whether they are morally and professionally appropriate or not. The licensing authority must be provided with sufficient information to assess the proposed bank's managing and

senior administrators' reputation, skills and experience. The regulation 'On the requirements to be met by foreign bank and foreign bank branch administrators' contains all the Bank of Albania's requirements for the assessment of any of the proposed bank directors or seniors.

- The financial project, including capital. The licensing authority must decide whether the bank has adequate capital to finalise the financial project suggested. The minimum capital adequacy, actually required by the licensing authority to perform banking activity, is Lek 700 million (or about US$ 5 million);
- The prior consent of the supervisory authority of the home country where the bank's shareholder is a foreign bank. When the owner is a foreign bank, Article 4.2.1 of the licensing regulation, specifically requires *'the prior consent from the respective supervisory authority for the financial activity of the head office of the foreign bank interested …'*

PRINCIPLE 4

Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

In Article 13 (2) of the banking law, the provided cases concern those cases when the granted license may be revoked. One of these cases included in paragraph (2) is when *'The owner of significant interests in the existing bank's capital has transferred or lost this right without the Bank of Albania's preliminary written consent….'*

In relation to the specification of Article 2 (e) of this Law 'significant or controlling interests' imply the direct or indirect possession of 10 percent or more of the joint-stock capital. As stated in Article 17 of the regulation 'On Bank licensing in the Republic of Albania', shifting significant ownership or controlling interests (10 percent or more) requests the delivery of the written permission by the Bank of Albania, after having observed the bank partners' consent, previously.

To grant a similar permission, the Bank of Albania requests from the proposed bank shareholder, the submission of the same documentation as in the case of approving preliminary consent for licensing.

### PRINCIPLE 5

> Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Bank's principal investments are permitted only based on legal restrictions of Article 30 and 33 of the Law 'On Banks in the Republic of Albania'. This principle finds application in the regulation 'On significant risks' where the maximum limits of bank exposure against a single or a group of beneficiaries are set. In the regulation 'On the participation of banks and foreign banks' branches in the commercial companies' capital', it is determined that the permitted investment should not exceed 15 percent of the regulatory capital of banks. Investments, exceeding 15 percent but no more than 25 percent of the regulatory capital must be accompanied with the preliminary authorisation submitted by the Bank of Albania. Based on this Law requirement, a regulation has been drafted where the established criteria concern receiving a similar authorisation by the Bank of Albania. The regulation is intended to balance banks' free activity through the participation of commercial companies' capital and the obligatory adherence to some supervisory ratios to prohibit banks face non-bank or financial risks.

## PRUDENTIAL REGULATIONS AND REQUIREMENTS

### PRINCIPLE 6

> Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that banks must undertake and must define the components of capital bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those set in the Basle Capital Accord and its amendments.

Article 1.4 of the regulation 'Bank licensing in the Republic of Albania', sets the minimum capital adequacy to commence banking activity (Lek 700 million). Article 30, of the banking Law decides banks' liability to maintain the regulatory capital as established by the Bank of Albania.

The bank's component elements of the regulatory capital are specified in the guideline 'On banks' regulatory capital'. In the regulation 'On capital adequacy', assets and off-balance sheet items are classified according to the risk, giving respective coefficients, as well. The allowed minimum between the regulatory capital and off-balance sheet item average weighted by risk is termed adequacy rate. This ratio is fixed at 12 percent. If the adequacy rate falls below this limit, banks are forced to propose a new plan to reach or return to this required rate.

Article 48 of the Law 'On Banks in the Republic of Albania' specifies that when bank's capital adequacy is less than 50 percent of the required rate (thus less than 6 percent), the bank must readjust its statement within a six-moth term. If at the end of the six-month term bank's capital adequacy still remains less than 50 percent of the required rate, the Bank of Albania nominates bank's custody to take over bank management and control for no more than 12 months' term. If the situation does not improve, then it proceeds with the process of bank custody and bank liquidation after it.

Banks that have started operation before the approval of the regulation 'On bank licensing in the Republic of Albania', dated 31 March 1998 based on decision no. 143, dated 31 March 1998 of the Bank of Albania's Supervisory Council must complete the capital adequacy to no less than Lek 700 million within 31 March 2001.

PRINCIPLE 7

An essential part of any supervisory system is the evaluation of bank's policies, practices and procedures related to granting of loans and making of investments and the ongoing management of the loan and the investment portfolios.

Articles 28 and 29 of the Law 'On Banks in the Republic of Albania' specify the legal obligatory documentation that banks must maintain on the activity they have carried out. Based on its internal regulatory acts, the bank creates a set of necessary documents to successively proceed with its own activity, which is also monitored by the Bank of Albania. A component part of this documentation is credit papers, including credit policies and granting procedures. To track the performance of credit portfolio and reserve funds' provisions for covering the loss from loans, the Bank of Albania has approved the regulation 'On loans' classification and reserve fund provisioning to cover the loss from loans' where the specified standards of loan provisioning and classification are banks obligation.

To diversify the risk undertaken by banks, the Bank of Albania has approved these regulations:

The regulation 'On significant risks' defines bank's maximum exposure to 20 percent concentration of regulatory capital to a single beneficiary or to 700 percent for all beneficiaries that exceed 10 percent of the regulatory capital.

The regulation 'On open foreign currency positions' and the respective guideline, where maximum limits of open foreign currency positions are set for each foreign currency in particular and for all of them in general.

## PRINCIPLE 8

> Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

Pursuant to Articles 28 and 29 of the Law 'On banks in the Republic of Albania', which defines banks' essential documents (including procedures and written policies), Article 31 (2), underlined banks' duty to classify and evaluate assets, loans provisioning and fix the time when the return on assets will no more be accounted.

During on-site inspections, Supervision Department inspectors perform estimations in accordance with the regulation 'On loan classification and reserve funds to cover the loss from loans', related to bank's capital adequacy provisioned assets, and the regulation 'On the capital adequacy' concerning the classification of assets and off-balance sheet items average weighted by risk.

At the end of on-site inspections, banks are given respective recommendations.

PRINCIPLE 9

> Banking supervisors must be satisfied that banks have information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict banks exposures to single borrowers or groups of related borrowers.

Such principle finds application in Article 30 of the Law on banks and in the regulation 'On significant risks' where commercial banks are requested to control their risk exposures and not create large concentrations.

During on-site inspections, Supervision Department inspectors make estimations in compliance with the regulation 'On significant risks', the guideline 'On interest rate risk management' and 'On bank liquidity' guideline.

PRINCIPLE 10

> In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lead to related companies and individuals on arm's length basis, that such extensions of credit are effectively monitored and that other appropriate steps are taken to control or mitigate the risks.

Chapter V (Articles 35, 36 and 37) of the Law 'On Banks in the Republic of Albania' provides the definition for related individuals to the bank: 'A person related to an administrator through marriage or a second blood relation or business interests, as defined in the Bank of Albania's regulation (Article

35 (b)).' The terms and conditions for granting credits will be the same as for bank customers.

As far as banks' related persons are concerned, there has been enforced a restriction in the new regulation 'On the classification of loans and provision of reserve funds to cover the loss from loans'. If those loans are not adequately collaterized or guaranteed, then the amount of non-collaterized loans is discounted from the bank's regulatory capital.

## PRINCIPLE 11

> Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities for maintaining appropriate reserves against such risks.

As previously mentioned in Article 29 (d) of the banking law, banks must be equipped with appropriately written policies and procedures for identifying, managing or controlling country risks, including international risks, unless there is no law or specific regulation to address 'the country risk and the transfer risk'. Lending activities recently applied by banks in Albania are limited to relationships with Albanian customers or those establishing relationships with the parent bank in their country. Investments are limited to Albanian Government treasury bills. Meantime, these activities are expected to expand by international community. Similar overall requirements, as specified in Article 29, are currently adequate.

Considering the expansion of bank activity pursuant to this principle, it is intended to draft a regulation that will cover market risk and transfer risk.

## PRINCIPLE 12

> Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/ or a specific capital charge on market risk exposures, if warranted.

As previously mentioned in Article 29 (d) of the banking law, banks must have written policies and procedures to accurately identify, manage and adequately control market risks. In Article 30 of the Banking Law, the authority to enforce specific limits and/or a specific capital reserve for market risk exposures, if warranted, is granted to the Bank of Albania. To fix these limits the Supervisory Council approved the regulation 'On market risks'. The cases specified concern additional capital quota, where applied. This regulation is currently little applicable by banks, and this may be due to their limited activity. The new recommendations of Basle Committee on capital adequacy foresee involvement and analysis of market risks and off-balance sheet items; however, they are still at a study phase.

PRINCIPLE 13

Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and where appropriate, to hold capital against these risks.

The above-cited Article of the Banking Law gives the Bank of Albania the appropriate authority to practice an appropriate assessment of market risk as requested by this principle.

While performing on-site inspections, the supervisors must be based on the Supervision Manual and make a detailed analysis of risk management by banks.

PRINCIPLE 14

Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions, accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Article 29 of the Banking Law requires that there must be written policies and procedures. Pursuant to that, the Supervision

Department has drafted a regulation 'On the internal audit of banks'.

This regulation requires from each bank to develop an effective independent internal audit system and to make a combination of these audits, in order to make sure that banks have a safe and sound operation.

Article 39 (1) of Banking Law stipulates that banks must be assigned an independent and certified accounting expert. In Article 41 of the banking law 'All banks are subject to Bank of Albania's performed inspections and audits from independent certified accounting experts'.

This principle is legally applied but not yet fully realized, as some difficulties exist with the licensing of distinguished companies as international experts from the Institute of Certified Accounting Experts.

PRINCIPLE 15

Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, internationally, by criminal elements.

This principle finds application in the Banking Law, Article 26 and in the regulation 'On money laundering prevention' approved by the Bank of Albania's Supervisory Council decisions, dated 3 March 1997 and 16 January 1997. Pursuant to these decisions, the Supervision Department estimates at any inspection the adequacy of 'know-your-customer' practices.

The law made effective in December 2000 'On money laundering prevention' requires the establishment of the Agency for the Co-ordination of the Fight against Money Laundering' at the Ministry of Finance.

## METHODS OF ONGOING BANKING SUPERVISION

### PRINCIPLE 16

An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Part of the Supervision Department is On-Site Supervision Division which performs banking supervision. This division includes analysts actually serving as data collectors and as centre for data processing and preparing reports and analysis.

These analysts compile monthly analysis on the financial situation of the banking system, including main indicators and supervise the application of established standards by regulations on supervision. Banks' full or partial inspections are made on previously established schedules. Full inspections are exercised once a year.

The interval between two inspections is constantly tracked through banks reported data on a monthly or quarterly analysis. Analysts also accomplish the preliminary data supply for the inspectors' group. The co-ordination of operation between analysts and inspectors within these sectors produces bank supervision in consistency.

### PRINCIPLE 17

Banking supervisors must have regular contacts with bank management and thorough understanding of the institution's operations.

It has been set a regular monthly contact between bank managers made official by the monthly meeting with banks and foreign bank branch managers.

More contacts are urged by problems found during on-site inspections and during the examination of data reported from banks. As operating practice, the Supervision Department presents the problems found during inspections to managers before they are made official by the Bank of Albania.

Before approving new regulations of banking supervision, bankers' specialised opinion is provided and the application of these regulations by commercial banks is analysed.

PRINCIPLE 18

Banking supervisors must have a means of collecting reviewing and analysing prudential reports and statistical returns from banks on solo and consolidated basis.

In Article 38 and 43 of the Law 'On Banks in the Republic of Albania' banks are required to maintain appropriate data and prepare brief reports for the Bank of Albania. These reports must be prepared on solo or consolidated basis (Article 43).

PRINCIPLE 19

Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

The Law 'On Banks in the Republic of Albania' (Article 39 and 41) assigns the performing of on-site inspections to Bank of Albania's inspectors and external auditors. The current Law (Article 39) requires the Bank of Albania approve the external auditors. Supervisors' or external auditors' validations are independent, however supervisors have the legal duty to inform the Bank of Albania in case of fraud, defects or deficiencies that lead to bank losses. Thus, in Article 39 of the Law, it is clearly defined that a copy of the opinion of the certified accounting expert on the performed inspection must be sent to the Bank of Albania.

PRINCIPLE 20

An essential element of banking supervision is the ability of the supervisors to supervise the banking group on consolidated basis.

Based on Article 43 of the Law 'On Banks in the Republic of Albania', Bank of Albania's supervisors are provided with a similar opportunity to perform the validation of bank's or foreign bank branch financial statement according to the banks' consolidated data. Performing on-site inspections of bank branches outside the country is conditioned by mutual agreements of supervisory authorities of respective countries.

This principle is not fully applicable as we have a regulatory system on solo basis.

## INFORMATION REQUIREMENTS

### PRINCIPLE 21

Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business and that the bank publishes on regular basis financial statements that fairly reflect its condition.

In Article 38 and 40 of the Law 'On Banks in the Republic of Albania', banks are required to maintain adequate data and publish them in their annual report.

From January 1, 1999, banks have been consistently reporting to the Bank of Albania through using the 'Accounting Manual'.

## FORMAL POWERS OF SUPERVISORS

### PRINCIPLE 22

Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Chapter VII, VIII (Articles 44-65) of the banking law provides penalty measures and punishments that might be undertaken by the Bank of Albania in case of violation of law, regulations or any guideline included. License revocation is also included in these measures (Article 44 (2) (g)).

## CROSS-BORDER BANKING

### PRINCIPLE 23

Banking supervisors must practice global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations world-wide, primarily at their foreign branches, joint ventures and subsidiaries.

Banking activity in Albania is limited. Bank branches or subsidiaries do not extend outside the country.

For this reason, the activity of Bank of Albania's supervisors is limited only in domestic activities.

### PRINCIPLE 24

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

On 18 January 1999, the Governors of the Bank of Albania and the Bank of Greece approved a common memorandum on banking supervision - Memorandum of Collaboration.

Albania records the operation of three Greek banks or branches, currently.

## PRINCIPLE 25

Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying consolidated supervision.

Based on Article 4 (1) (c) of the Banking Law, foreign bank branches are licensed by the Bank of Albania pursuant to all normative acts established by law and regulations. All operating banks in Albania, being bank branches or not are licensed as banks by the Bank of Albania.

In Article 58 (2) (i) of the Law 'On the Bank of Albania' it is permitted the exchange of Bank of Albania's information with other central banks or other supervisory authorities. This ensures more extensive information and helps to attain a consolidated supervision of foreign bank branches and subsidiaries.

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