

2 KEY ACTIVITIES OF SUPERVISION IN 2016

In the light of the supervision function, the Bank of Albania has focused on the objectives for continuous monitoring, through on-site inspections and off-site analyses regarding the banks' risk level and management. Special attention has been paid to monitoring risks to which the financial institutions are more exposed, as well as systemically-important financial institutions for the sound functioning of the financial system in Albania. Year 2016 was characterized by volatility in the non-performing loans indicator. This indicator decreased, as evidenced at the end of 2016, due to the settlement/restructuring and write off of non-performing loans. Compared to the previous year, the main indicators of banks' profitability has shown a less favourable position as a consequence of the net result from lower interest rates and higher provision expenditures levels. The level of capitalization of the banking system has remained stable and we continued to monitor the practices and policies of foreign banking groups that have subsidiaries in Albania. Regarding operational risk, notwithstanding the increase in the capital specifically allocated for this risk, the emphasis is on further improving the identification process and reporting operational losses in the system.

The supervision function is performed in parallel with the development of internal capabilities, the review and improvement of the supervision structure, roles and responsibilities, as well as the cooperation and coordination with other regulatory authorities, domestically and abroad. In addition to the normal supervision activity on licensed entities, the resources of the Department are concentrated in the implementation of the medium-term strategy objectives of the Bank of Albania.

Amongst the main activities during 2016 we may highlight:

2.1 ADDRESSING NON-PERFORMING LOANS

In compliance with the national plan for addressing non-performing loans (NPLs), during 2016 several changes were undertaken consisting in the clarification of the loan write off from the balance sheet, the review of the supervision treatment of real estate taken into ownership as a result of judicial processes for the execution NPL collaterals, the review of the regulatory framework to facilitate the sale of NPLs and some necessary improvements in the credit registry.

Special attention was given also to the advancement in the implementation of the national plan of measures for addressing NPLs. Two important issues



of this plan, which are also a responsibility of the Bank of Albania, are the coordination of banks' efforts on solving 35 large borrowers and the out of court debt restructuring. These have been discussed with representatives of the World Bank in order to obtain international expertise on these issues based on similar experience in international jurisdictions. This cooperation is expected to finalize two important documents: the guideline for loans restructuring, which is the comprehensive review of current guidelines, bringing the best international principles; and, a framework for cooperation between banks to properly address the issues of common borrowers.

During 2016, we undertook a reinforced horizontal review of the situation of the NPLs and the banks efforts to address the phenomenon. There has been communication in parallel with the banks of the system by addressing the issue of portfolio quality, both in terms of dealing with non-performing borrowers and the writing off of loans categorized as lost, in compliance with the regulatory obligation. At the same time, they are required to draft and present Recovery and Resolution Plans for large borrowers as defined in the relevant regulatory framework for the management of major risks. At the end of 2016, the Supervision Department has also asked banks to formalize strategies for reducing non-performing loans, the method how they are implemented, and projections for their impact on the budget, accompanied by the requirement for periodic monitoring. These phenomena will continue to be monitored at a higher frequency in 2017.

2.2 REVIEW OF SUPERVISORY PRACTICES ON CORPORATE GOVERNANCE

The Bank of Albania, in the framework of its objectives for the harmonization of supervision practices with applicable practices in European Union countries, as well as for the development of the regulatory framework and methodologies reflecting the latest developments in this regard, has cooperated with the European Bank For Reconstruction and Development on a project that will review issues of governance and risk management for banks. The aim is to review the structures of governance, the Steering Council and the committees, their composition, responsibilities and role in promoting an efficient and transparent control environment; governance with a focus on risk management, especially credit risk; assessment and regulation of remuneration policies; assessment and regulation of compliance and internal control functions. To analyse the adequacy and potential needs for review and reassessment of the above elements, the European Bank for Reconstruction and Development will focus on assessing the extent of their implementation in the legal and regulatory framework, as well as in internal documents that support this process. The project started in 2016 and is expected to continue during 2017 as well.



2.3 REVISION OF THE SUPERVISION STRUCTURE

In view of fulfilling the objectives of the medium-term development strategy of the Bank of Albania, in 2016, the structure of the Supervision Department was revised. The goal was to re-dimension work practices for enhancing the efficiency of processes as well as adapt to market developments. The new structure aimed to harmonize off-site analyses with on-site inspections for individual entities. In addition, focus was placed on the horizontal risk analyses of all licensed entities, a similar structural approach was provided to entities with similar activities, and new work processes were created. These changes also reflected the need to increase the available capacities, as well as revise workflow processes and individual responsibilities in each position.

2.4 RECONSTRUCTION OF THE EARLY WARNING SYSTEM

During 2016, the Early Warning System was entirely revised, since the existing one did not fulfil the supervision needs and did not respond to development challenges, both internal institutional ones and those of the banking market. This system consists of periodic analysis of some key indicators of bank financial performance assessment and early warns about developments requiring increased supervisory attention. This methodology serves as a very good support of off-site analyses by focusing on the risks that need attention. For the new system, assistance was provided by the Bank of Italy, and its full functioning will be realized in 2017. However, its further validation is envisaged in cooperation with the Bank of Italy, to approximate it with the approach and practices of European institutions.

2.5 SUPERVISION CAPACITY BUILDING IN COOPERATION WITH THE BANK OF ITALY

In the light of achieving development objectives and fulfilling some recommendations of the FSAP assessment, in 2016 a cooperation project with the Bank of Italy was launched on several important aspects of the supervision work.

- Beginning of work for implementing supervision requirements under Basel III, which consists in reviewing the regulatory framework for liquidity risk. This project includes the need for assistance for a number of important elements in the implementation of the appropriate European regulatory framework and Basel principles, in which the Bank of Italy has the expertise to assist in building internal capacities.
- Revision of the Regulation "On Capital Adequacy Ratio" in order to harmonize it with the revised European directive and regulation on the activity of credit institutions, aiming at alignment with Basel II and Basel



III requirements.

- Enhancing internal departmental capacities to provide a better assessment of the criteria that banks use in lending. This is done by defining the criteria for assessing banks' financial analysis of their borrowers as well as the possibility of setting the limits of key financial indicators for various sectors of the economy.
- Review of the Early Warning System in order to improve the off-site analysis to provide a more comprehensive dimension to the risk-based approach through effectively identifying risks, according to a similar methodology to European counterpart institutions.
- Review of the supervisory requirements for electronic money institutions related to the further development of the licensing and supervision regulatory framework of these institutions, as well as gaining experience in improving the process of off-site analyses and on-site inspections, in particular to strengthen supervision requirements for insuring customer funds, preventing money laundering and transparency, as well as business model plans and their feasibility by entities and the assessment by the regulator.

2.6 IMPROVEMENT OF THE LEGAL AND REGULATORY FRAMEWORK

During 2016, interventions in the legal and regulatory framework were aimed at its completion and continuous improvement in line with European Union (EU) directives and regulations and best practices. The Supervision Department contributed to the drafting and finalization of the Law "On Recovery and Resolution of Banks" which was approved by the Albanian Parliament in December 2016. Also, in cooperation with the World Bank and other stakeholders the Law "On the functioning of savings and loan associations" was drafted and eventually approved by the Albanian Parliament in May 2016. Consequently, during the second half of 2016, the entire regulatory framework for the supervision of savings and loan associations was reviewed, which consists in the regulations on licensing and risk management in these institutions, as well as on the reporting system about their financial activity. Other legal acts prepared and consulted within the department throughout the year include the Guideline according to the requirements of Pillar 2 of the Basel Capital Accord and of the European Directive and Regulation on the requirements for the Internal Capital Adequacy Assessment Process (ICAAP) and the Regulation "On consolidated supervision"¹.

¹ Other details on the regulatory changes and improvements are provided in the "Regulatory Framework" section.



BOX 1 LAW ON RECOVERY AND RESOLUTIONS OF BANKS

The main objective of this law is to establish a clear legal basis for resolutions in banks, in cases where they face financial crisis, and aims to partially approximate the Albanian legislation with the Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 (Banking Recovery and Resolution Directive).

The Law provides the Bank of Albania, as the Resolution Authority, with a set of legal instruments to intervene at a sufficiently early and promptly in the case of an unsound bank in order to ensure the continuity of critical financial and economic functions of the bank, always minimizing the effect on the economy and the financial system.

This Law shall apply on the banks licensed by the Bank of Albania that exercise their activity in the territory of the Republic of Albania.

The law provides four key instruments on banking resolution, respectively: the bridge bank, sale of business, separation of assets and bail-in. While the bridge bank instrument is already known in the banking legislation, the other instruments are introduced for the first time in a legislation specific for the recovery and resolution of failing banks.

The implementation of the instruments provided by the Law will consider the principle of proportionality based on the nature of the activity, stock structure, legal form, risk profile, size and legal status, relation with other institutions and the financial system in Albania, purpose and complexity of their activity, their participation in protection schemes or any other common system.

In order to implement the instruments provided for by the law, specific provisions are set out regarding the creation, financing, use and management of the resolution fund. This fund is financed mainly by annual contributions and extraordinary contributions paid by banks, and managed by the Deposit Insurance Agency. The Fund's targeted level is envisaged to be completed within a transitional period of ten years from the entry into force of this Law.

