

AUSTRIA

**Answers of Oesterreichische Nationalbank, Financial Market Authority and
Federal Ministry of Finance to the Questions contained in the**

BASEL COMMITTEE ON BANKING SUPERVISION'S CONSULTATIVE DOCUMENTS

Strengthening the Resilience of the Banking Sector

**International Framework for Liquidity Risk Measurement, Standards and
Monitoring**

Management Summary

Austria agrees that the global financial system has to be strengthened. An internationally consistent regime for capital and liquidity has to be a precondition to achieve this objective. Austria therefore supports the objective of introducing a package of reforms that are closely aligned with the changes to the international capital and liquidity standards that the Basel Committee is currently consulting on.

It will be essential to ensure that the aggregate impact of the full package of regulatory reforms agreed by the G20 is assessed, and that this assessment is taken into account when calibrating and implementing CRD IV. It must be ensured that regulation strikes a balance between enhancing financial stability and supporting strong and sustainable economic growth.

Within the overall package of proposed reforms to the CRD set out in the Commission services Staff Working Document, we have identified the following key issues:

Capital

We support the Commission's efforts to enhance the quality of capital and simplify the current capital structure. Adequate calibration and timing of the proposed measures will be crucial. The following points are of particular importance for Austria:

- The exact proportion of core tier 1 to other tier 1 components should be based on the results of the QIS; however, we believe that in any case a definition of "predominance" close to 50% would be most appropriate;
- Capital received from minorities shall be included in core tier 1 if directly contributed to credit institutions within the same group;

- Holdings of credit institutions which receive a zero percent risk weight as an intragroup exposure under the standardized approach for credit risk, shall not be deducted from the own funds given that the consolidated capital requirements are fulfilled;
- Adequate grandfathering-rules that ensure recognition according to the current classification of capital instruments shall be preserved; and
- A level playing field has to be established between joint-stock companies and non joint-stock companies on the basis of a principle-based approach.

Liquidity

Austria fully supports the harmonisation of liquidity standards throughout the EEA, as it will enhance the stability of the banking system.

The following points are of particular importance for Austria:

- The suggested stress scenarios are too excessive and should be amended accordingly.
- The narrow definition of liquid assets is seen as detrimental; negative consequences in times of system-wide liquidity stress thus will be unavoidable. A well diversified portfolio of liquid assets is seen as crucial, where central bank eligibility should be a main criterion.
- The design of liquidity requirements should ensure that business models which have proven to be stable in times of crisis (like retail banking) will be fostered (or at least not be put at disadvantage compared to other business models).

Countercyclical measures

Austria generally supports efforts to mitigate cyclicity in the current regulatory regime.

The following points are of particular importance for Austria:

- Austria supports measures to dampen procyclicality. In order to fulfil this objective, these measures must not lead to a permanent increase in capital requirements in the sense of the proposed fixed target buffer. The built-up buffers only dampen procyclicality if they can be used/reduced when necessary over the economic cycle, otherwise they may have even procyclical effects.
- Measures to dampen procyclicality have to take different business concepts and their impact on financial stability into account.
- The system of conservation buffers needs to be thoroughly calibrated. We consider the proposed constraints on distributions as too severe. The suggested calibration

would have to be thoroughly evaluated keeping in mind not to disproportionately impede the credit institutions' ability to raise capital on capital markets.

Strengthening the global capital framework

We support the efforts to improve the quality of own funds and to raise overall capital levels. For this purpose, we consider the proposed criteria for classification of capital instruments as common equity, additional going concern capital and Tier 2 to be sound and robust. We equally support the initiative to introduce a simplified and transparent capital structure. However, the introduction of a principle-based approach must not lead to unwarranted competitive distortions between different types of companies.

Core Tier 1 Capital

We recognise that common shares serve as a useful benchmark for defining Tier 1 instruments of the highest quality. However, it is inconsistent with a principles-based approach to base the recognition of an instrument as Core Tier 1 capital on whether said instrument is designated a common share under the relevant (national) laws. We favour an approach that enforces stringent standards without referring to any type of capital instrument. A definition should be sought that – in line with Rec. 6 of Council Regulation (EC) No 1435/2003 and the Resolution adopted by the General Assembly of the 88th plenary meeting of the United Nations, 19 December 2001 (A/RES/56/114) regarding a supportive environment in which cooperatives can participate on an equal footing with other forms of enterprise – is independent of the legal form of the credit institution or of the issued instrument. A strict principles-based regulation should be maintained. For the sake of consistency with the principles-based approach we therefore suggest referring to any capital instrument that is fully compliant with the criteria governing inclusion in the common equity component of Tier 1 - irrespective of whether it is, in fact, a common share or a fully equivalent instrument, and whatever the legal form of the issuer. In particular, a level playing field has to be maintained between joint-stock companies and non-joint stock companies. In this vein we welcome the commitment expressed in footnote 19.

The exact proportion of core tier 1 to other tier 1 components should be based on the results of the QIS; however, we believe that in any case a definition of “predominance” close to 50% would be most appropriate. Furthermore, we believe that holdings of credit institutions which receive a zero percent risk weight as an intragroup exposure under the standardized approach for credit risk, shall not be deducted from the own funds given that the consolidated capital requirements are fulfilled.

Additional Going Concern Capital

We also support that any type of hybrid – whether it is an accounting liability or equity – has a mandatory principal write-down or conversion feature. This feature should not be dependent upon whether the instrument is classified as a liability or an equity instrument.

Tier 2 Capital

We welcome the re-definition of Tier 2 capital, including the elimination of Upper Tier 2. Tier 2 capital is in our view an important source of funding for credit institutions. It serves a particular purpose in gone concern situations and should be preserved in times of crisis.

As the “gone concern”- situation cannot be strictly linked to a particular point in time or to specific legal actions (e.g. the start of insolvency proceedings), a lock-in clause could facilitate or avoid further insolvency proceedings during a gone concern situation. The notion of gone concern capital does not contradict requiring lock-in clauses. These can be very helpful during the onset of a gone concern situation and should be included in the definition of tier 2 capital. We therefore consider lock-in clauses to be an efficient feature. As an alternative to lock-in clauses, we support conversion features bearing a fixed conversion rate.

Tier 3 capital

We welcome the abolition of Tier 3 capital.

Prudential filters and deductions

We are generally supportive of the harmonisation of prudential filters and deductions. However, all Austrian banks still rely on national accounting standards for purposes of calculating their own funds; therefore most filters will have very limited impact.

We acknowledge, and share, the concerns about the inclusion of minority interest in the common equity component of Tier 1 as it has been shown in many cases that minority interests do not adequately support the risks on the consolidated level. However, to meet these concerns, it would not be necessary to fully and indiscriminately exclude all minorities from core Tier 1. We therefore suggest a more differentiated approach: If capital received from minorities is directly contributed to subsidiaries which are regulated and adequately supervised credit institutions, there is limited concern that such capital does not effectively support banking risks on a consolidated level. Therefore, minorities should still be included in core Tier 1 if they are provided to regulated credit institutions.

General remarks

Generally speaking, we strongly recommend a reformulation and/or recalibration of both the standardized and the current exposure method for Credit Counterparty Risk (CCR) in order to keep sound incentives for banks to develop and/or employ CCR models. Nevertheless, current proposals to a large extent concentrate on banks with advanced procedures only. Taking together the proposed changes in the calculation of capital requirements and the proposed heightened modelling requirements we consider a development of internal models in future to be very costly to banks and hence unattractive.

Based on the information provided, we consider several topics to be quite “early staged”. Hence a final positioning is not yet possible.

Computation of Effective Expected positive Exposure (EEPE)

Given the high volatility of EAD figures arising from CCR, we agree that there is a need to smoothen the EEPE estimate (pro-cyclicality issue) and the requirement of harmonized procedures across risk types. However, we think that the proposed “stressed EEPE” calibrated on a three year period, including one year of stress, may not adequately capture general wrong way risk. The effectiveness of the measure will hinge on the introduction of an appropriate stress definition. Given the primary goal of capturing the effect of systemic shocks on CCR (“general wrong way risk”), and given the frequency of their occurrence, it is doubtful whether a historical stress framework is the conceptually correct way to address this systemically important issue. General wrong way risk might be better captured by other measures, such as higher asset value correlations for big financial institutions.

Capital add-on to capture Credit valuation adjustment (CVA) risk

We appreciate the move to capture the risk of losses arising from volatility in the PD of the counterparty, as it leads to more conservative behaviour. The proposed solution using a bond equivalent position seems reasonable.

It is however not clearly stated how banks without internal market risk models should proceed in order to compute the charge in the proposed way and questions remain with regard to the precision of scaling 1d/10d Value at risk (VaR) to a 1y figure. Proper incentives must be assured when a standardized or internal model approach is used.

In addition, we would like to note that the current proposal is (pro-)cyclical in nature and may increase a major shortcoming of the current regime.

Implement and explicit Pillar 1 capital charge for specific wrong way risk

The current proposal differentiates between specific and general wrong way risk based on whether there exists a legal relationship between counterparty and the underlying reference name (in a CDS or equity put contract). If an exposure is defined to have “specific” rather than “general” wrong way risk, a much more punitive capital charge will be applied (see below).

It is not clear whether this definition encompasses “specific” wrong way risk to the desired extent. To give an example:

Bank A has a subsidiary in country B. If Bank A sells protection on its subsidiary, we have a case of specific wrong way risk due to a clearly defined legal relationship. What if the Bank sells protection on country B? Clearly a default/moratorium declared by B would seriously impact A’s rating. To us this risk seems specific rather than general.

A somewhat broader definition of “specific” wrong way risk would give supervisors more power to act on a case by case basis. As an example one might define “specific” wrong way risk as risk arising from direct legal and material economic relationships.

A multiplier for the asset value correlation for large financial institutions

We consider this topic to be rather a general credit risk issue (for both IRB *and* standardized approach) and should not be addressed by an isolated CCR amendment.

However, since the potential impact of such a multiplier can be immense we consider strong statistical support for the supposed relationship between institution size/leverage ratio and correlation among assets and a careful calibration of parameters a condition. There is still no quantitative support for the appropriateness of the proposed proxies (size and type of firm) in the long run, not speaking about the concrete (re-)calibration.

Again, we would like to point out that there is no suggestion how to address the discussed problem within banks using the standardized approach.

The results from the ongoing QIS are expected to provide further quantitative evidence in this specific field. Nevertheless, it must be stated that banks applying the IRB approach not necessarily have an internal rating system in place for “financials”. Therefore, a multiplier for the asset value correlation possibly may only play a role for a very limited number of banks.

Collateralized Counterparties and margin period of risk

We fully agree with the analysis and support the forwarded proposals.

Due to the netting issue it remains unclear to what extent these proposals affect banks that have no internal model for the assessment of CCR. Again, it should be made clear that proper incentives to switch to an internal model approach should be set.

Margin Calls

We agree with the analysis and welcome the forwarded proposals. Likewise we share the view that a sound and prudential risk management and capitalization of CCPs is crucial in order to prevent new systemic risks that may arise. In connection with the intended high specific level of initial margins and an on-going collateral posting requirement we like to acknowledge that margin calls obviously can substantially impact the liquidity situation of an institution and give raise to new (pro-)cyclical effects. Therefore, an additional up-front margin, based on the overall exposure to the CCP, might serve as a reasonable buffer for crisis situations, provided that thorough calibration leads to reasonable results concerning the costs of entry into the system (especially for smaller institutions) and the relation to margin calls, which then might be lower.

Enhancing counterparty credit risk management requirements

We generally support that stress testing needs to be pronounced in CCR management, especially for banks using internal models (which usually have comparatively big exposures). The same is true for back-testing. As regards the implementation of a regular reporting framework for (general and/or specific) wrong-way risk we like to underline that a clear-cut definition (and distinction to similar issues, e.g. inter-risk concentrations) has to be established first.

Own estimates of Alpha

We are open to a recalibration of Alpha based on potential new insights resulting from the QIS. A general prohibition of own estimates of Alpha can only be a measure of last resort. Instead we share the point of view that current floors should be re-evaluated.

General remarks

We agree that one of the lessons drawn from the current crisis is that size and leverage of financial institutions must be better captured. To address this we generally support the adoption of a non risk-based capital measure (leverage ratio) to supplement and reinforce the current risk sensitive framework. We see a leverage ratio as a further (early warning) indicator and as a corrective to restrict excessive balance sheet growth. Apart from the scheduled calibration given the QIS results, the measure's accuracy to meet the underlying target should thoroughly be reviewed in due course.

Limitations and weaknesses of a leverage ratio

- Unintended incentives: In the absence of risk-based components, the leverage ratio could give unintended incentives as it does not distinguish between different types of bank assets. This may encourage banks to build up relatively riskier exposures or reduce the scale of hedging instruments. Prudent institutions holding substantial portfolios of highly liquid, high-quality securities and hedged exposures with strong risk management may argue that they are being punished for their conservatism.
- Accounting issues: We encourage a full adjustment for accounting differences (IFRS vs. US-GAAP vs. local GAAP). In our view a full harmonisation would call for a consistent use of accounting standards for both the numerator and the denominator. For solvency purposes currently all Austrian banks rely on local GAAP to determine their own funds. However, almost all larger banks use IFRS/IAS for accounting purposes. As a result, the scope of consolidation differs due to differences in consolidation practices under prudential and accounting requirements.
- Level playing field: The proposed leverage ratio is not neutral in terms of effects on competition. Even if the accounting issue can be solved, the impact on the build-up of leverage will depend on the business model of the credit institution.
- Crisis reinforcing tendencies: if the leverage ratio were made binding, this would have a strong crisis reinforcing effect (forced deleveraging, credit crunch)

Given the limitations and weaknesses of a leverage ratio and the considerable heterogeneity of business models across internationally active banks we prefer an implementation under Pillar 2.

Capital Measure

We support the intentions with regard to employing a going concern measure of capital in the leverage ratio. We therefore strongly object basing the proposed leverage ratio on an overly restricted definition of capital (i.e. Core Tier 1 only). At a minimum, the capital measure in the numerator should encompass Core Tier 1 as well as Non-Core Tier 1 capital components as both absorb losses on a going concern basis.

Total Exposure Measure

Concerning the proposed options for capturing the overall extent of an institution's derivatives business the use of the gross positive fair value appears an appropriate approach given the objective of a simple and non-risk sensitive measure.

Not allowing netting of derivatives (especially in cases where enforceable netting agreements exist) seems overly conservative but would support the objective of a simple non-risk sensitive and internationally harmonised measure. In our point of view a fully harmonised leverage ratio can only be achieved either by requiring all exposures to be measured on a gross basis, or by specifying a single approach to netting for the purpose of calculating leverage.

General remarks

Generally speaking, we support both measures to mitigate cyclicity in current regulatory regimes, through-the-cycle provisioning as well as anticyclical capital buffers. We consider dynamic provisioning as a particularly effective measure to dampen cyclicity. We also generally support the concept of capital conversion requirements as this provides supervisors with a standardised tool to enforce the build up of capital buffers. However, the current concept just establishes new minimum capital requirements above the current levels.

For a final assessment, further work is necessary on the precise design of the measures. In our view the conservation buffer and the countercyclical buffer currently share a potential for negative implications in downturns, which should not be underestimated. With this in mind, we suggest to reconsider the proposed measures and seek for more clarity about their impact.

Austrian authorities would welcome further consideration of alternative measures to dampen procyclicality, especially measures that focus on the output of the capital requirements calculation.

Impacts

As the new capital definition already poses a challenge to banks, any additional capital requirement will mean additional efforts to secure appropriate capital levels due to cumulative effects, especially as the introduction of capital buffers will presumably fall into a period of economic distress or at best slow recovery. The one-off implementation costs of building up such buffers should not be underestimated.

Furthermore, potential negative implications on the ability to raise fresh capital when dividend payout is restricted must be considered.

Forward looking provisioning

The IASB's decision whether to follow the method of expected loss for calculating provisions is crucial to the implementation of dynamic provisioning. Although the IASB seems to be eager to follow an expected loss approach one of the main impediments to a consistent application of expected loss for IASB and dynamic provisioning objectives is the different time concepts between IASB and IRB. Whereas IRB calculates expected loss for a one year period, IASB expected loss refers to the entire maturity of an instrument.

We agree with the current proposal to build the buffer above the line in order to have an anticyclical effect on the balance sheet. Off-balance-sheet items should at the same time be included in the calculation of the provision.

Building buffers through capital conservation

While we consider procyclicality as an important issue and welcome proposals to dampen or avoid it in future, we fear, however, that several concerns remain with regard to both the suggested capital conservation buffer and the counter cyclical buffer. Currently, the proposed measures effectively establish new minimum capital requirements above the current thresholds (with no anticyclical effect).

When reflecting upon the effectiveness of the measures possible negative effects in a downturn must not be underestimated. In a period of economic distress, a restriction on dividend payout might worsen the situation as the bank might not be able to raise fresh capital from primary markets at affordable conditions. This problem will be especially hard in the period following the implementation of such a buffer as potential shareholders will anticipate the severe restrictions on dividend payout.

We consider the proposed constraints on distributions as too severe. The suggested calibration would have to be thoroughly evaluated keeping in mind not to disproportionately impede the credit institutions' ability to raise capital on capital markets.

The introduction of capital buffers will presumably fall into a period of economic distress in most States and banks have not been able to build up substantial buffers in the last years. The mechanism of anti-cyclical capital buffering will only work, if banks are given sufficient time to build up these buffers especially in the first few years of application. Only when sufficient capital buffers have been built up should the implementation of restrictions to capital distributions be considered.

Excessive credit growth

Suitable macro variables to assess the extent to which in any given jurisdiction there is a significant risk that credit has grown to excessive levels would be GDP, GDP net government expenditure and individual GDP components (consumption/investments/net exports). In some markets, housing market variables might also be useful. Macro variables such as GDP output gap or potential GDP should not be used as they display a high degree of uncertainty.

International framework for liquidity risk measurement, standards and monitoring

General Remarks

Austria welcomes the introduction and international harmonisation of quantitative minimum requirements for banks' liquidity and a functional approach taken to their determination.

Liquidity Coverage Ratio

The focus on a single short-term measure will not significantly increase the institutions' resilience to liquidity risk, because the time horizon of the stress tests is quite short (cliff effect!) and the scenario is similar to scenarios tested by banks anyway. It is important that banks do not only rely on the stress tests incorporated in legislation, but conduct their own range of liquidity stress tests. In addition, the product oriented definition of the scenario and the focus on a single measure provide strong incentives for banks to innovate products and to engineer funding circumventing the measures.

We are particularly concerned that a narrow definition of liquid assets is inconsistent with the functional approach. It will lead to unintended consequences such as increased concentration risk, negative systemic impact in times of system-wide liquidity stress (second round effects), and increased vulnerability to sovereign risk. Prudent risk management calls for a functional approach to the counterbalancing capacity as well (and not only to the cash flows); i.e. the scenario should entail parameters for a range of liquid assets and leave the composition of the counterbalancing capacity to banks given the quantitative minimum requirement in the LCR and the parameters of the scenario. Furthermore, the narrow definition will provide strong incentives for banks to off-load low quality collateral at central banks and hold high quality collateral as liquid assets.

Concerning the pricing of products we expect that higher costs of liquidity will be priced in those bank assets that are particularly liquidity intensive and where banks have some price setting power. Under the draft CEBS Guidelines on Liquidity Cost Benefit Allocation the additional opportunity costs of holding a higher and narrower liquidity buffer must be accounted for by the internal funds transfer price. Given the low margins in Austria and the fierce competition for deposits, higher internal fund transfer prices will be reflected in the pricing of bank products predominantly on the banks' asset side (increased loan rates), but also on the banks' liability side (increased rates for long-term bank deposits, such as savings accounts).

Some scenario parameters should be reconsidered. To some extent the scenario parameters seem arbitrary, inconsistent, and lack sound economic foundations. For example, the assumed cash-outflow of 100 percent of undrawn liquidity lines for non-financial corporates is clearly unrealistic even under the most severe stress conditions and inconsistent with a severe economic downturn that underlies the stress scenario.

The scenario has unintended consequences that are detrimental to financial stability. For example, the very restrictive treatment of interbank deposits will lead to a decrease in interbank market activity and stability. This reduces the ability of the market to redistribute liquidity within the system, and impacts the monetary transmission mechanism and the implementation of monetary/liquidity policy by central banks. More banks would have to participate in open market operations, the structural liquidity deficit will increase, and banks will have to hold higher precautionary liquidity reserves (on top of the LCR and the respective buffer), since their access to the money market would be severely restricted. The parameters should be determined after a cost-benefit analysis based on the QIS data.

Also corporate bonds, covered bonds and other liquid assets should be part of the portfolio of liquid assets. The scenario should entail stressed haircuts for these assets but leave the composition of the portfolio to the banks. The current approach contradicts the CEBS Guidelines on Liquidity Buffers and Survival Periods and prudent liquidity risk management, and exposes banks to substantial concentration and sovereign risk. Including central eligibility as criterion increases the options for diversification and reduces negative repercussions for market liquidity in many asset classes currently not included in the portfolio of liquid assets. However, it must be clear that banks must not rely on extraordinary liquidity providing operations of central banks.

We favour a broad and well diversified composition of the buffer with stressed haircuts for broad categories. The definition of deep and liquid markets provided in Annex I is not suitable for smaller countries and puts banks from these countries at a substantial disadvantage vis-à-vis those from large financial centres. Some of the mentioned criteria are too detailed, static and without proper empirical foundation (e.g. the criteria regarding bid-ask-yield spreads) so that as a consequence all “additional” assets might be excluded in practice.

Net Stable Funding Ratio

The Net Stable Funding Requirement might increase banks’ resilience to liquidity risk in the given scenario, but at the expense of restricting banks to conduct one of their major functions in society, namely that of liquidity and maturity transformation. The impact might be substantial, both in terms of increased long-term funding which leads to increased funding interest rates and in terms of reduced liquidity and credit lines for businesses and households. The additional long-term issuance volume triggered by the NSFR is estimated to amount to between EUR 1,100 bn and EUR 3,000 bn at EU level¹. The parameters should be determined after a cost-benefit analysis based on the QIS data.

While consideration concerning the franchise value of banks should play a role in determining the actual liquidity of assets such as short-term loans, the assumptions in the NSFR are counterfactual, both with respect to corporate and retail clients. In particular, it is not warranted that retail client loans carry a significantly higher weight than corporate clients

¹ Citi Bank, 2010; Liquidatum Ltd., 2010

as the rollover rate of retail loans is usually lower. Both should be reconsidered after a cost-benefit analysis based on the QIS data.

The low weights assigned to retail and corporate deposits as well as to wholesale-funding (non-maturing or residual maturity < 1 year) are unwarranted; large shares of household financial wealth are invested with non-bank financial intermediaries. To curtail the access of the banking system to these sources could be inefficient for banks and non-bank financial intermediaries. The weights should be reconsidered after a cost-benefit analysis based on the QIS data.

In Annexes I and II the assumed cash-outflows from retail deposits are too high. During the crisis funds flowed from mutual funds and other non-bank financial intermediaries to the banking sector. For insured deposits the run-off rate should be less than 5 percent in LCR; the run-off rate for uninsured retail deposits should be 10 percent; that of unsecured wholesale funding by non-financial corporates 25 percent and that of other legal entities 50 percent. Also the run-off rate of repos in assets which are not eligible for the buffer is by far too high. This category needs more differentiated treatment. However, if a very general category for repos is to be maintained the run-off rate should be 50 percent. The parameters should be reconsidered after a cost-benefit analysis based on the QIS data.

Monitoring Tools

In general, we appreciate the introduction of harmonized monitoring tools based on the "Liquidity ID Card" as proposed by CEBS.