STRENGTHENING THE REILIENCE OF THE BANKING SECTOR
Consultative Document by the Basel Committee dated December 2009)
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POSITION PAPER SUBMITTED BY THE AUSTRIAN RAIFFEISEN BANKING GROUP

First, as a matter of principle we shall state that new and tightened (in terms of quality and quantity) capital requirements shall only be introduced after the current crisis has ended, in order to avoid an actual credit crunch.

Level Playing Field for all Market Players and Legal Structures

The reforms shall not result in the elimination of certain legal structures from the market. In this context, diverse accesses to the capital markets should be borne in mind. Equal competition opportunities shall be provided for, irrespective of legal structures, legal systems and the markets, particularly in an international context.

1) Inclusion in Core Tier 1 Capital

- Since Core Tier 1 Capital shall focus on its so-called "predominant form", particularly the initial capital of cooperative shares and any reserves shall be included in Core Tier 1 Capital. We welcome footnote 19 in the Basel paper, which ensures that cooperative instruments are in compliance with the permanence criteria.

- Otherwise, a significant lack of capital would have a substantial adverse impact on the capability to provide financing to the economy and consumption.

2) Flexible Capital Elements

- We suggest that besides common shares and retained earnings, there shall be at least one additional instrument viable for the capital market, in order to ensure an adequate flexible management of Core Tier 1 Capital.

- Thus, for the future it is of utmost importance that capital elements like participation capital and preference shares without voting right are eligible for inclusion in Core Tier 1 Capital. In the future, the marketable instrument of participation capital should continue to facilitate an adequate and prudent capital composition. In the past, the Austrian legislator made no distinction between preference shares and common shares in application of the Capital Requirements Directive (89/299/EEC).

Deduction of Investments in Capital of Banking and Insurance Entities

- According to the Basel paper, investments in non-consolidated financial entities shall no longer be deducted at 50% from additional capital and at 50% from common equity, but rather at 100% from Core Tier 1 Capital (provided the investment relates to Core Tier 1 Capital). Even investments in the capital of banking and insurance entities shall be entirely deducted from Core Tier 1 Capital.

- Given the typical size of these investments, they are neither subject to full consolidation, nor *pro rata* consolidation. Thus, smaller investments, which do not constitute a cluster risk (that potentially would lead to gone concern situations), are the rule.

- BCBS sets forth a rule according to which common equity (Core Tier 1 Capital + additional Tier 1 Capital) should be fully loss absorbent in going-concern situations. On the other hand, the deduction scheme that used to apply to both Tier 1 Capital and Additional Capital, shall merely apply to Core Tier 1 Capital in the future.

- From the economic and systemic perspective, however, it would be more appropriate, if the entire deduction scheme applied to the aggregate common equity, rather than to Core Tier 1 Capital only. This shall also be considered against the backdrop of the fact that, pursuant to the BCBS proposal, additional common equity would be subject to a strict rule set (compared to CRD II), in particular regarding loss absorbency. Therefore, it is not appropriate to challenge loss absorbency of additional common equity. Regarding loss absorbency there is no difference between Core Tier 1 Capital and other common equity. If so, it is rather of technical nature, but would not justify a different treatment in terms of deductions.

- Therefore, any deductions should apply to the entire common equity.

- **Minority Interest**
  - According to the Basel proposal, minority interests (ie, third party shares in consolidated financial entities of a banking group) should cease being eligible for inclusions in the consolidated common equity component of Core Tier 1 Capital. Arguably, this will have a significant negative impact on the structures of group institutions.
  - Of course all market players endeavour to avoid the abuse of existing regulations. However, it is inacceptable to disparage an instrument, because of a small number of potential abuses. Pillar 2 must take the aforesaid into account. In addition, minority interests in subsidiaries feature similar capital quality like majority interests and are equally loss absorbent in going-concern situation.
  - Therefore, minority interests shall remain eligible for inclusion in the common equity component of Tier 1.

Grandfathering

- Any existing and issued capital components should – accompanied by long grandfathering periods - be allocated to capital categories that correspond to the current ones (“Grandfathering”). The aforesaid should include any deductable items, in particular third party investments.

- In particular, grandfathering rules shall ensure that any forms of participation capital – thus, “common” participation capital, as well as capital that was subscribed in the course of recent state aid packages – continue to be eligible as Core Tier 1 Capital.

- The tightening of deductable items shall also be accompanied by long grandfathering periods.

- The absence of grandfathering rules would result in an abrupt shortfall of eligible instruments and cause a shortage of capital, motivated by regulatory intervention (only). This would have a negative impact on global economy.

Cumulative Intensification of the Requirements

- We explicitly refer to the twofold intensification that the new – more restrictive – definitions of common equity on the one hand and the contemplated – increased – quantitative requirements on the other would generate.

- Numerous intensifications provide for increased requirements, whose aggregate impact will only become evident once the results of the impact studies are available.

- We reiterate that the respective sudden lack of capital will negatively impact banks’ ability to provide indispensible financing to the economy and consumption.

- In this context we repeat our substantial concerns towards capital buffer and a leverage ratio.

- **Capital Buffer**
  - We oppose the corridor solutions being set forth in the Basel paper as bans and constraints of discretionary distributions of earnings.
  - From an investor’s perspective, capital buffers would render investments in banks unattractive, because institutions could not fulfil the market’s expectations regarding ROE anymore. When introducing capital buffers, market would indirectly claim additional - above the minimum amount - capital (according to the present proposal, the distribution constraint shall not apply, if the minimum capital requirement is exceeded by 100%).

- If it is envisaged that additional capital buffers shall be built up in times of economic upturn, financial institutions would have to charge their customers a surcharge on the investor's mere solvency based price. Even from this perspective the intentions at hand must be opposed.
- Furthermore, we doubt that under such scheme, capital buffers could be dissolved in times of crisis, because the market simply would not accept it.

- **Leverage Ratio**
  - The introduction of a leverage ratio violates the existing solvency system, which does not refer to the risk level of a credit institution, but on the balance sheet total and off-balance sheet items only.
  - Moreover, the EU has already adopted regulation that provides for the significant increase (by 200% to 300%) of the minimum capital requirement concerning the trading book risks.
  - The provision at hand would significantly affect credit institutions that engage in comparably low risk activities (consumer business, SME-financing, public financing); the conduct of low risk activities would equally be penalized by a leverage ratio. It is to be feared that such provision will cause an increase in risk taking and a decrease of financing of comparably low risk businesses; thus, the opposite of the intended goal.
  - It is of decisive importance not to seek for the introduction of a leverage ratio, prior to the harmonization of the different accounting standards (US-GAAP, IFRS, local accounting standards). At present, there is no equitable competitive environment. The latter, however, would be prerequisite for the introduction of a leverage ratio that is comparable on an international level and does not distort competition.

Vienna, 26 March 2010