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Ms. Danièle Nouy
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Basel Committe on Banking Supervision
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CH-4002 Basel

SWITZERLAND

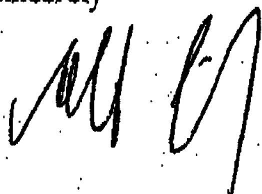
May, 2001

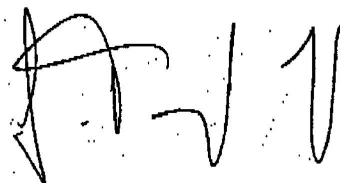
Dear Mrs Nouy

Re: Austrian response to the EU Review of Regulatory Capital Requirements

We have read with interest the second consultative paper on Regulatory Capital Review. In our view it is extremely well prepared and shows the substantial effort that has been made. Please find enclosed our general remarks on the new capital regime that we will also publish on our home pages.
We also would like to use this opportunity to thank you for the good design of the second quantitative impact study and that Non G-10 banks also have the opportunity to take part in this exercise. We hope that the results will help to calibrate a capital charge system that adequately reflects risks in the whole system of financial institutions and investment firms .

Yours sincerely





The new capital adequacy framework

General Remarks to the second consultative papers of the Basel Committe on Banking Supervision and the European Commission

The following general opinion on the new capital framework is meant to give an overview on the opinion of the Austrian Ministry of Finance (referred to as BMF) and Oesterreichische Nationalbank, the Austrian Central bank (referred to as OeNB). This text will be sent to the Basel Committe of Banking Supervision as well as to the European Commission.

Scope of Application

BMF and OeNB see the urgent need for consolidation up to a financial holding company level; sub-consolidation on any level , however, shall not be requested. In order to prevent wrong incentives within a banking group we suggest to introduce one exemption to this rule: Consolidation shall be required on the level of the sub- group that is headed by the highest credit institution within the whole group.

The principle of solo-supervision shall be maintained.

Pillar I

Credit Risk

BMF and OeNB are very supportive of the general thrust of the proposed new framework for credit risk in particular the broader recognition of credit risk mitigation techniques and the possible wider use of banks' internal ratings. The proposed regulation will considerably enhance the sensitivity of minimum capital requirements to credit risk and are well suited to encourage banks to improve risk measurement methods and risk management practices.

Nevertheless BMF and OeNB are of the opinion that some of the regulations would need further refinement and some minor adjustments to better meet the overall goals of the capital reform. We consider the following issues as being most important:

- **Risk sensitivity of the standardised approach:**
  Due to the very small number of externally rated borrowers the standardised approach is still not risk sensitive enough for most of the banks. We would therefore propose to increase the risk sensitivity in two ways. Firstly, the current discussion on the treatment of retail loans under the IRB approach should also be reflected by a separate treatment of such exposures under the standardised approach. We are in favour of a lower risk weight for retail loans compared to other types of exposure in both approaches. When determining the risk weight for the standardised approach a capital incentive for the IRB approach should be considered. However, a lower risk weight for retail loans is only acceptable if there is a harmonised definition of loans

falling into this category including which types of small and medium-sized companies may be included as well as a maximum exposure amount and a minimum number of loans in the portfolio. Secondly, we are supportive of any further work to extend the list of eligible collateral in the credit risk mitigation framework in particular physical assets. The focus here could be e.g. on insurance contracts with cash surrender value and on standardised leasing contracts. In this context we also would like to suggest to revisit the treatment of exposures secured by residential or commercial real estate. In our opinion it may be more consistent to treat these exposures in the standardised approach in the same way as in the IRB approaches.

- **Minimum requirements in the IRB approach for banks using data pools:** The majority of banks will only be in a position to develop internal rating systems with meaningful estimations of risk parameters when they have access to additional data sources, preferably data pooled with other credit institutions. For a broad usage of data pools some of the regulations seem to be formulated in a too narrow way. Technical alleviation are explicitly mentioned for the internal audit function and for the distribution of loans in the different rating grades. In our view it would be necessary to complement these by further alleviation, e.g. with regard to the credit review function, to stress and performance testing, and to disclosure. Additionally we would suggest to clarify that data pooling is available for all types of banks and portfolios irrespective of size, business activity and membership in certain banking sectors.

- **Calibration of risk weights:** The first preliminary results of the Quantitative Impact Study indicate that capital requirements under the foundation IRB approach will be considerably higher compared to the standardised approach. It seems that this is due to the fact that the IRB approach for corporate, sovereign, and banks exposures has been calibrated to cover both expected as well as unexpected losses. Within the current proposal we see two possible solutions to this problem, namely higher risk weights in the standardised approach and a lower risk weight function in the IRB approaches respectively. Since there are only very few externally rated borrowers, higher capital requirements in the standardised approach can only be achieved by raising the risk weight for unrated assets. Given the additional capital charge for operational risk, this could easily conflict with the goal of leaving overall capital requirements in the financial industry unchanged. The Austrian supervisory authorities would therefore prefer a lower risk weight function in the IRB approaches.

- **Permanent partial use:** For a number of banks even in then longer term the application of the IRB approaches in all business units and to all portfolios will not be possible due to their specific business focus. However, most of this specialised banks have well developed internal rating systems in their core business, mostly corporate and/or retail lending, which should be made available for supervisory purposes. The parallel application of

standardised and IRB approaches for certain portfolios and business units should generally be available for a broad range of banks. The use of the standardised approach should be restricted to immaterial portfolios/business units only, whereas all other portfolios/business units have to be on the IRB approach. It is of vital importance to define "immaterial" by harmonised criteria for size and risk profile. In addition we would deem it necessary to allow more flexible transition periods for banks moving from standardised to internal measurement methods. The transition periods of three years for data requirements and application of the rating system should be available for all banks independent of the date of implementation of the new regulations.

- **Degree of determination and harmonisation:**
  Due to the ambitious time framework of the reform some of the underlying concepts and definitions seem to be still quite general and leave room for discretion by national supervisors and banks. In order to ensure a harmonised application of the new rules we would therefore ask for as much guidance as possible on the interpretation of the regulations. We would find it extremely helpful to include a separate glossary with definitions of the central concepts.

Other Risks

While we believe that the risk category of other risks is an important risk category that deserves supervisory treatment, we believe that some adjustment will have to be made to ensure a level playing field capital allocation. First we agree with the idea of implementing an approach that takes account of the characteristics of different business lines. Nonetheless it seems that further work will have to be undertaken to better define business lines (e.g. in our consultation process with the banking industry concerns were raised as the business lines as chosen in the consultative documents are a mix between business orientation and customer orientation; others raised the question if a orientation on IASC would be a viable solution). As far as the level of capital is concerned we are of the opinion that 20% (respectively 30% in the basic indicator approach) are by far too high. First results of our impact study banks show, that this regime does not necessarily oblige banks with high operational risks to hold the highest level of capital. We believe in the concept that risk mitigation techniques do not fully hedge credit or market risks but bear other risk elements. Therefore we are of the opinion that internationally diversified banks using highly sophisticated risk mitigation techniques (e.g. credit derivatives, ABS-transactions) run higher other/operational risks than banks that operate in a more conservative way in a local environment. The stipulations as currently set out are not a suitable mean to circle banks with high level of other/operational risks. Banks with high level of gross income are not necessarily prone to higher other/operational risks.

As far as level playing field considerations are taken into account we got the impression that the impact study will have to show if banks with highest risk level also have to hold appropriate amounts of capital. For the moment we have the impression that locally operating banks might end up with too high levels of capital.

As far as internal models are concerned we strongly recommend to give the industry a change to independently evaluate different concepts of measurement for other risks. Major concerns are raised concerning the internal measurement approach as currently set out in the consultative documents. According to literature time series analysis is not the best method to quantify other risks in general and operational risk. We therefore believe that no direction should be given to the industry but the general will to accept internal models for other risks in the future as soon as an industry standard has emerged.

Interest rate risk in the banking book

As the second consultative paper of the Basel Committee for Banking Supervision deems it most approproate to treat interest rate risk in the banking book under the supervisory review pillar (Pillar 2) of the new framework BMF and OeNB cannot share this opinion.

While we do agree that the judgement on the mentioned behavioural assumptions is highly institution specific, we cannot acknowledge this problem as a sufficient motivation for treating the interest rate risk in the banking book under pillar 2 instead of pillar 1.

We do certainly recognize a gradual difference between trading and banking book as concerns the judgement on the mentioned behavioural assumptions; but we can not find an abrupt difference between the behavioural characteristics of the interest rate instruments to be treated in the banking book, compared with the trading book, to such a degree that this could provide a sufficient motivation for the treatment of the former under pillar 2 instead of under pillar 1.

A distinction between national supervisory authorities according to the respective national customs in banking business (in respect of the regulatory capital requirements for interest rate risk), as set out in para number 630 of The New Basel Capital Accord, appears to us to be by far more problematic than a general treatment of interest rate risk under pillar 1, with sufficient national discretion for supervisors in the spirit of an implicit application of methods from pillar 2 (as addressed above).

We highly recommend to resume this latter original consideration from the First Consultative Document(s); and we might still hope that from a corresponding EU proposal there could even result a changing effect on the discussed proposals put forward by the Basel Committee, still in time before the final release of the New Basel Capital Accord.

The two quantitative criteria for a materiality threshold as set out in para number 160 of the present Second Consultative Document appear to be indeed helpful in saving supervisory resources and to avoid excessive burden on firms bearing immaterial interest rate risk. However, there might be a certain danger that credit institutions with a very high proportion of gross fee income (or other income) compared to the proportion of gross interest income, which institutions might still bear considerable interest rate risks in refinancing business on the liability side (in relation to capital available for taking these risks), might yet end up below this materiality threshold suggested in para number 160 –

unjustly so: In general, gross interest income (in relative or in absolute terms) is not a good measure for interest rate risk.

We agree in principle with the definition for outliers suggested in para number 155 (and before that, also in para number 144) of the present Commission Services' Second Consultative Document; in particular in respect of the underlying methodical definitions in Annex 2 to 4 of the Basel Supporting Document Principles for the Management and Supervision of Interest Rate Risk listed above (also regarding a supervisory reporting framework).

Having recommended a ‚return' to the treatment of interest rate risk in the banking book under pillar 1 in our response to the first question above, we think that the outlier institutions not only deserve special supervisory scrutiny, but even a minimum capital requirement under pillar 1 to be calculated on the basis of the degree to which the respective institution is above the outlier level. The First Commission Services' Consultative Document (November 1999) would have been on the ‚right track' from our point of view, from which the Commission Services have again deviated since then, under the strong influence of the Basel Committee (according to our impression). We would express our hope that both (the Commission Services and the Basel Committee) should return to a pillar 1 treatment of interest rate risk in the banking book still during the last few months of the preparation process for the proposed Council Directive, resp. for the New Basel Capital Accord – even if this might seem too hopeful

Trading Book Issues

Besides the three areas mentioned in the EU Consultation documents (e.g. internal deals and internal hedges; switching of items between portfolios; treatment of specific instruments and techniques (notably credit derivatives, CIU and ETF), for which we agree that there is an urgent need for specific additional guidance on the allocation of items between the TB and the BB, more consideration should be given to para number 203 of the present Consultation Document: We agree in principle with the statement there, that neither the expected holding horizon, provided that it is "short-term", nor the liquidity of the market for a certain position should be used as absolute criteria for allocating items to, or excluding them from, the TB. This formulation leaves the question unanswered, however, if and how these two criteria taken together can determine the allocation of items between TB and BB. Instead of the misleading absolute assessment of these two criteria individually, we propose to pass on to a „relative" assessment of these two criteria taken together, in the spirit of a two-parameter criterion for allocating the respective items to, or excluding them from, the TB. In particular, positions for which both, the expected holding horizon is not „short-term" and the market liquidity is very poor by market standards, should take priority of being transferred from the TB to the BB („extreme case treatment").

We strongly support the proposal from para number 206 in the present Consultative Document, to drop the reference to a list of financial instruments for the purposes of regulation on capital and to adopt instead a general definition of financial instrument for the purposes of the capital review, notably for the identification of items to be included in the TB. The arguments in favour of this proposal, as put forward in para number 209 of the Consultative Document, appear convincing to us.

The need for additional mechanisms to facilitate a common approach as regards the definition of financial instrument is considered as a rather minor need, for the very reason that according to para number 209 practically any kind of item – that can be held by a bank or an investment firm – may be allowed to be treated as a trading book item (provided that the more stringent requirements related to trading intent, trading evidence and prudent valuation, are met). However, we support the consideration at the end of para number 209, to introduce additional mechanisms (convergence, guidance) to support consistent application.

As far as revisions of the methodology for calculating the exceptions from the TB „de minimis“ rule are concerned we would suggest the following possible alternative for an improved methodology: On the one hand, the minimum capital requirement calculated according to the provisions by the future Solvency Directive for credit risk (as prepared by the present Consultative Document) could at first always be calculated separately for the trading business alone (without the remaining banking business), and the resulting minimum capital requirement only for trading business could be put in proportion to the total minimum capital requirement (for total business). For this proportion number there could then be defined a well-calibrated materiality threshold, and in the case of this threshold proportion being exceeded, the minimum capital requirement for the trading book would have to be determined by the methods for market risk (CAD) in place of the original methods for credit risk (from the future Solvency Directive).

A return to the calculation of the minimum capital requirement by the methods for credit risk also for the trading business would have to be provided for after a certain observation period (as also currently). In this period, the minimum capital requirement calculated for the trading business by the methods for market risk, put in proportion to the minimum capital requirement calculated for the remaining banking business by the methods for credit risk, would have to not exceed a certain (other) maximal ratio, in turn.

This possible alternative would have the advantage that the credit institutions would not have to calculate at any time both the minimum capital by the methods for market risk and by the methods for credit risk – the only additional effort would be the separate calculation of the minimum capital requirement by the credit risk methods for the trading business, as long as the materiality threshold for the resulting proportion is not being exceeded.

Furthermore, this „de minimis" exemption rule for the trading business should also provide for an additional qualitative examination.

Supervisory Review

BMF and OeNB are generally supporting the idea of the Supervisory Review Process and understand it as an important tool in order to fulfil supervisory practices in the future. We believe, however, that a crucial factor for success of the Supervisory Review is a refined system of supervisory actions for banks of different size and complexity. We therefore recommend to define a set of criteria for those banks.

To achieve a level playing field will be one of the biggest challenges. But due to the different legal, cultural or traditional demands and due to different situation in connection to ressources of the Member States, we are of the view that sufficient level of flexibility has to be guaranteed in order to give the possibility to either modify already implemented practices or to set up new systems which are supporting these national distinctions.

Furthermore we believe that it is important that interest rate risk in the banking book either has to be included under Pillar 1 or that it is necessary to set out clear rules for treatment, measurement and quantitative methods to be used under Pillar 2. This would save supervisory ressources and would also protect supervisors from endless discussions about the appropriateness of the chosen method.

Market Discipline

The proposal to increase transparency is deemed to be a good tool to improve risk management processes of banks. But we do believe, that it is important to bear in mind the appropriateness and cost- and time-effectiveness. Therefore it is necessary to graduate the information by complexity and size of the bank which means to reduce the requirements for smaller banks. Furthermore we do believe that not all of the required information will be of public interest. Misinterpretation by market participants or exaggerated reactions on the market might be the negative results.

We do not support the idea to disclose supervisory capital ratios as we do believe that the market participant is not in the position to interpret the figure without additional information correctly. Overreaction on the market and the replacement of independent assessments are possible consequences. We also think that publication of the economic capital might have the same negative effects.