Co-ordinated Position of Austrian Authorities (BMF, FMA, OeNB)
on the Third Consultative Document on
The New Basel Capital Accord
July 31, 2003

General Comments

The Austrian competent authorities highly appreciate the progress made towards the New Capital Accord. The QIS3 exercise also contributed to the fine-tuning of stipulations and improved the consistency of the framework. The intense discussion with market participants and credit institutions gave us the impression that a lot has been achieved but the price to pay are high administrative burdens that in some cases are not justified by an improvement in risk management. This is especially true for small and medium-sized banks that frequently have to join larger entities if they choose to use more advanced risk management practices, such as the IRB approach.

We therefore aimed to identify the stipulations that, after thorough consideration, can be considered as too burdensome and therefore hamper the development of prudent risk management practices.

Scope of Application

We appreciate the application of the new Accord on all three levels (consolidated, subconsolidated and individual) for banking groups operating across borders, including the possibility to waive subconsolidation by a full deduction of holdings in banking subsidiaries. In order to achieve a level playing field, we would welcome a consistent approach concerning the possible deduction of insurance, as we see little use in introducing national discretion in this area.

Pillar 1, Minimum Capital Requirements

We see the necessity to ensure a risk-adequate capital requirement for equity. However, existing organisational structures should not be put at a disadvantage if they are irrelevant for risk considerations. We would thus highly welcome a permanent partial use of equity holdings in ancillary banking undertakings.

As QIS 3 has shown, the calibration of approaches for operational risk is not working as intended regarding the incentive structure. A more adequate calibration of statistical parameters, especially with the Advanced Measurement Approaches, is necessary, if a phased development towards more complex approaches should be reached.

Pillar 2, Supervisory Review Process

The banks' internal Capital Assessment Process should result in an internal capital target, as mentioned in Art. 684. We would thus appreciate referring consistently to "adequate internal capital" throughout Principle 1 of the SRP. On the other hand we assume that supervisory action requiring banks to hold additional capital raises the regulatory capital requirement above pillar 1.

To us it is not clear whether banks have to address all risks or all material risks within their Capital Assessment Process (Art. 678 refers to all risks, whereas Art. 690 mentions all material risks). We would prefer sticking to all material risks throughout the text, as a matter of practicability.

Pillar 3, Disclosure

Compliance with pillar 3 as a binding requirement for the application of IRB and CRM: In the draft Accord compliance with all rules stated under pillar 3 is a prerequisite for banks' application of IRB approaches or CRM techniques. Although we regard compliance with the rules of pillar 3 as essential, this close tie seems disproportionate and should thus be eliminated from the rules for the IRB approach (Art. 500) and CRM (Art. 87).

Specific Issues

Scope of Application

Art. 6: Details on the methods – how such an adjustment might look like – would be appreciated.

Art. 8: We see the method described in 8 (full deduction instead of consolidation) as a possibility to avoid the burden of subconsolidation, but we see no possibility to deduct instead of consolidating at the top level.

Art. 11- Art. 15: We have concerns that an inconsistent approach concerning the treatment of insurance subsidiaries and significant minority investments in insurance entities across countries might lead to distortions in competition, as this might have significant impacts on the capital ratios of competitors. We thus prefer to eliminate the last sentences of Art. 11, Art. 12 and Art. 13 entirely.

Art. 16- Art. 17: We would appreciate a further differentiation between commercial entities and ancillary banking services undertakings, for which a full deduction of significant minority investments seems to overestimate the risk inherent in such investments.

Comments on Standardised Approach Specificities

Art. 44: We welcome the change of the granularity criterion as the old formulation had the potential to discriminate against small credit institutions. Nonetheless we should consider developing further "soft" criteria to evaluate the granularity of the retail portfolio under pillar 2. Thus we propose to shift Art. 44 bullet point three to pillar.2

Art. 47, Footnote 21.: Concerning the stipulations of the "hard test" for commercial real estate in highly developed and long-established markets we are sceptical about the very strict conditions. In our view the hard test involves the following risks:

- it can be pro-cyclical;
- it generates planning uncertainty;
- it is not sufficiently empirical founded;

- it is not sufficiently specified;
- it involves high administrative costs.

The reasons are that the monitoring of yearly loss rates for such a small market segment may, for statistical reasons, lead to frequent changes of the risk weight regime for such loans. Additionally, the limits become effective only ex-post, when losses due to a downturn of the market are already realized. Therefore we think that the yearly loss rates are of little value for this purpose. The proposed limits are not based on sufficient empirical evidence and thus arbitrary. Data collection on this restricted market segment can be quite burdensome for both, the competent authorities and the institutions.
Thus, we think the benefit from these quantitative limits is not worth the effort and complicates matters further. We would therefore propose to link the application of the preferential risk weight to a general requirement for the competent authorities to have evidence that this is a well-developed and long-established market.

In addition to that, further elaboration on the treatment of mixed used buildings might be helpful.

Art. 50: We reject this new provision as there is no prudent reason for recognising additional collateral instruments for past due loans.

Comments on Internal Ratings-Based Approach Specificities

The Austrian competent authorities welcome the consultative paper.

However we would like to comment on the following IRB topics.

Art. 184: As to the categorisation of exposures, the new proposal in CP3 leaves open two issues:

- the treatment of fixed assets under the IRB approach;
- the classification of exposures that do not fully meet the classification criteria for the exposures categories I Art. 186 to Art. 212, e.g. private foundations or associations.

In the case of fixed assets, which cannot be rated and thus cannot be assigned PDs, we would propose to treat them according to the Standardised Approach and to assign a uniform risk weight of 100%. For other exposures we would propose to require a rating and to treat these exposures under the risk weight rules for corporates.

Art. 194: The definition of IPRE contains – in our opinion – an inconsistency between the examples given in brackets in the first sentence and the more generic definition in the second sentence. In particular in the case of hotels we would normally not consider that cash flows from lease or rental payments or the sale of the assets are the primary source for repayment. Hotels should thus be excluded from the listing.

Art. 195: The definition of HVCRE is still not sufficiently clear. In particular, we would propose that any type of lending secured by residential real estate be explicitly excluded from HVCRE.

Art. 200: The SME use test gives rise to concerns on its proper implementation. To our understanding there are, from a risk perspective, two main distinguishing features between corporate lending and SME exposures:

- Type of financing: In corporate lending borrowers demand individually specified products as regards facility structure, collateralisation and monitoring. The credit risk is thus very specific to each individual transaction. In SME lending borrowers normally are offered fairly standardised financing products which may be customized according to borrower characteristics in a predefined way. The credit risk of different SME exposures is rather uniform.
- Number of exposures: Corporate lending refers mainly to a restricted number of large firms whereas SME loans are part of a large pool of exposures.

The requirement of a large number of exposures is already contained in the first sentence of Art. 200. The use test should therefore concentrate on the distinction between SME lending and corporate lending instead of referring to similarities between SME exposures and other retail exposures. In our opinion it would make more sense to require banks to demonstrate that SME exposures are treated in a different way than corporate exposures as regards financing processes. This general principle could be complemented by an indicative list of areas banks should cover, such as range of financing products offered, loan acquisition, loan approval, and risk management.

Many Austrian banks have specific risk management processes for SME exposures that differ in some aspects from retail exposures as well as from corporate exposures (see also comment on Art. 364 below). Some banks are concerned whether it would be permitted to form retail pools for SME exposures only. In our opinion this possibility should be explicitly mentioned.

On the adoption of the IRB approach across **asset classes,** we have the following comments.

Art. 228: We would ask for clarification whether the permanent partial use for “non significant asset classes” can only be applied if the requirement is met on the basis of the whole banking group (option 1) or if it could also be applied on the basis of individual business units (option 2). The second option would imply that business units may use the Standardised Approach for asset classes that are immaterial in their portfolio but may be material on the group level. On the one hand we see the need to avoid cherry picking within banking groups, on the other hand we have to be aware of the fact that a proper calibration of systems for immaterial portfolios is impossible especially on an international level.

Additionally we would welcome a permanent partial use for equities in ancillary banking undertakings, such as outsourced IT centres.

Some banks have also expressed their preference for a wider application of permanent partial use. We would therefore ask the Committee to examine under which circumstances a more flexible partial use, i.e. to allow partial use even for material portfolios, would be possible. In particular a permanent partial use for exposures to banks and sovereigns should be allowed.

Regarding the **transitional arrangements,** we have the following comments:

Art. 233: In order to achieve proportionality and more consistency within the different IRB approaches, in particular between the rules for retail and for corporates, we would favour a transitional provision for the LGD and EAD observation period in the AIRB. In accordance with the transitional provision for the PD observation period we suggest a minimum length for the time series of four years.

Furthermore we think that it would be better not to restrict the transitional provisions to 2007 and the following years. Similar to the transitional provision for the application of the AMA for operational risk, we suggest reducing the length of the time series required for the estimation of PDs and LGDs whenever the bank moves to the more advanced approach.

The third bullet point on the use of the internal rating system is still not sufficiently clear. We would therefore propose to add that national supervisors may relax compliance with minimum requirements as regards both the time of implementation as well as the degree of compliance.

Art. 244, Art. 247, Art. 249 and Art. 252: The current wording of these articles does not clearly specify under which circumstances banks may use the foundation or advanced IRB for SL exposures. The requirement on PD estimates could be understood in two ways:

- Banks must be able to estimate specific PDs for their SL rating grades
- Banks may map their SL rating grades into the corporate rating grades based on expert judgement and use the PDs of the respective corporate rating grades

We would strongly favour the second interpretation and propose to clarify the wording accordingly.

Additionally we would propose to clarify that the mapping procedure for the slotting approach described in Art. 244 is based on expert judgement and not on quantitative methods.

Art. 313: Regarding the risk-weighted assets for equity exposures, we would like to stress the importance of the possibility to use both methods, the PD/LGD approach and the internal models approach, in parallel for different types of equity holdings.

One comment of special importance to the Austrian supervisory authorities regards the issue of **rating dimensions**:

Art. 364: Many Austrian banks have risk classification systems for retail loans which distinguish between borrower risk and transaction risk and which therefore deliver PD estimates for borrower classes and LGD and EAD estimates for transaction classes. Due to the banks' client focus, risk classification and measurement for retail is similar to corporate exposures. A strict interpretation of the segmentation criteria for retail loans would make this practice not eligible for the IRB approach since it is required to assign retail exposures to pools based on borrower and transaction characteristics and to estimate risk parameters on the basis of these pools. However, we would consider the practice of Austrian banks in terms of risk measurement as at least as accurate as the product-focused approach of the current proposal. One might even expect that this practice delivers a more detailed view of the risk situation than the examination of risk parameters over a pool of exposures. We would therefore strongly propose to clarify that risk classification and measurement based on distinct borrower and transaction classes would also qualify for the retail IRB approach.

Art. 383: As to the issue of rating system documentation, we would welcome a more detailed specification of the minimum documentation requirements for the use of external models.

Art. 391 and Art. 395: The combination of these two articles suggests that banks are required to store scoring and transaction data on each individual retail loan. In our opinion this would be overly burdensome, in particular for the tens of thousands of revolving loans and credit card facilities. We would therefore recommend that the Accord should stipulate that for retail exposures data maintenance requirements may be fulfilled by storing data for a representative sample of exposures.

Art. 396 to Art. 399: To ensure a level playing field the standard for the stress tests should be laid down more precisely, since the result of the stress tests that are obligatory for IRB banks could lead to an additional capital requirement under pillar 2 regulations. It should be clarified whether the stress tests for concentration risk in Art. 734 and Art. 736 may be an integral part of a more general stress test or whether separate stress tests are required in all cases. We therefore suggest defining minimum scenarios for stress tests under pillar 1.

More refined comments are necessary to deal with the question of **risk quantification**:

General

Art. 424: In order to ensure data quality, we would like to propose to add the following requirement to the first bullet point: "The organisation of the data pool shall ensure accurate and consistent identification of default events and losses and a uniform application of the particular rating systems to comparable borrowers from the outset and on an on-going basis."

Art. 434, Art. 435, Art. 440 and Art. 441 Many banks have signalled us that it would be extremely burdensome for them to integrate all historical default events and to keep track of all historical

recovery procedures in order to fulfil the requirements for minimum observation periods as laid down in Art. 434, Art. 435, Art. 440 and Art. 441. We would therefore like to ask the Committee to give guidance under which circumstances these requirements could also be fulfilled by examining a representative sample of historical default and loss events only, and how these samples could be defined; at least up to the date of implementation of the new Accord. This could be similar to the relaxation of the application of default definitions when using internal data sources as laid down in Art. 418 (last sentence).

Art. 471: The link between the classification as IPRE and the non-qualification of mortgages on the underlying real estate is, in our opinion, inconsistent with the slotting criteria in Annex 4, where collateralisation forms an integral part of risk classification. Any positive correlation between the borrower and the collateral is already captured by the general eligibility criteria in Art. 470. This article is therefore redundant.

Comments on Credit Risk Mitigation

Art. 50: As Art. 116 and Art. 117 specify the collateral instruments which are eligible for recognition in the standardised approach it is not clear why additional forms of collateral should be eligible when considering past due loans. Therefore Art. 50 should be cancelled without substitution.

Art. 104: Banks should not be allowed to change the method for calculating haircuts arbitrarily. Therefore we suggest additional requirements in cases where banks switch from using own estimates of haircuts to using standard supervisory haircuts. After that step a new approval for the use of own estimates of haircuts should be required.

Art. 125: The modified duration should not necessarily be taken into account when determining relevant categories, if the definition of relevant categories already comprises the residual maturity of the security. An additional inclusion of the modified duration leads to an undue level of complexity in such cases.

Art. 161a): We suggest a refinement of the wording concerning additional operational requirements for guarantees: it is not clear whether only monies outstanding up to the time of default/non-payment or the obligation as a whole are to be promptly paid by the guarantor on request. In our opinion banks may only demand the prompt payment of monies outstanding up to the time of default/non payment from the guarantor while the remaining payments can be made according to the original repayment plan.

Art. 162a): Restructuring should constitute a credit event in any case, because a supervisor can hardly determine whether a bank is “de facto“ able to prevent a restructuring or not.

Art. 171: We explicitly welcome the recognition of sovereign counter-guarantees as this is a reliable business practice in Austria.

Comments on Securitisation

Art. 517c): The current rules regarding non-recognition of guarantees from SPVs might not reflect current market practice and unduly discriminate against **synthetic** securitisations. We would therefore welcome a more detailed analysis of this issue.

Art. 528, Art. 585: We propose to approximate the risk weights for lower rated tranches (BB and BB-) in the Standardised Approach and the IRB Ratings Based Approach (RBA). The current differences in the risk weights create a comparative advantage for banks using the Standardised Approach over IRB RBA banks. As a consequence it could be expected that the high risk tranches would be held by banks with a relatively simple credit risk management, which should be avoided.

Art. 530: As originators must deduct all retained positions rated below BB- the current rules put originators at a disadvantage compared to investors. We suggest that both, originators and investors, have to deduct retained position rated below B-.

Art. 538, Art. 602: We welcome the proposal to avoid **double-counting** of capital requirement in the case of overlapping liquidity facilities in the IRB approach. We would suggest including a similar provision in the Standardised Approach and extend the wording to cover overlapping positions more generally and not in the context of liquidity facilities only.

Art. 551, Art. 557: The proposed rules regarding the lower conversion factors to be applied to securitisations of uncommitted, unconditionally cancellable retail credit lines subject to **early amortisation clauses** is based on a build-up of capital as the level of excess spread approaches the trigger point. We would suggest introducing a wording to recognise triggers other than excess spread to be able to use lower risk weights also under these circumstances.

Art. 568: The current proposal regarding the provision on which **approach** has to be **used** in relation to a situation where there is no specific IRB treatment for the underlying assets is not entirely comprehensible. Under the current rules originating institutions which have permission to use the IRB approach must use the Standardised Approach, while investing institutions with permission to use the IRB approach must use the IRB RBA.
The phrase “where there is no specific IRB treatment for the underlying asset” in the context that the institutions have permission to use the IRB approach is not entirely evident to us. We would therefore welcome an explanation of this phrase as well as a rationale for the unequal treatment of investor and originator in this context.

Art. 585: Concerning the **granularity** adjustment, we propose to define how often the effective number of underlying exposures and the seniority of the positions should be calculated.

Due to the fact that investors do not always have current data necessary for the calculation of the effective number of underlying positions, we think that a minimum refresh period of this data should be defined in pillar 3.

Comments on Operational Risk

Footnote 91: The current proposed methodologies allow in fact a large set of possible alternatives, creating a spectrum of alternative approaches between the BIA and the STA. We doubt that such a spectrum of approaches makes much sense, and we would therefore, from today's point of view, appreciate eliminating the possibilities of aggregating material business lines. Additionally we would prefer presenting the ASA as a full additional approach, as some aspects remain unclear in the current structure, e.g. no explicit qualifying criteria are set out, questions of partial use remain open (see below), should there be the possibility to switch between the STA and the ASA from one year to the other (which we would not appreciate so as to avoid cherry picking).

Art. 627: The soundness standard of AMA is too high, in order to give banks the incentive to develop towards the more advanced methods, as demanded in Art. 609. We would thus suggest lowering the required confidence level in order to ensure a proper incentive structure.
The confidence level is too high, also from a theoretical point of view, as an – although implicit - reference to the normal distribution is not valid for the shapes of distributions applicable in the case of operational risk.

Art. 629: Further clarification on the eligible methods to measure and account for EL exposures would be appreciated, as it is not clear to us under which circumstances the capital requirement can be calculated solely on the basis of UL. Further guidance on the possible consideration of correlations in the AMA approaches is needed. We currently assume that the operational risk exposure has to be calculated for each combination of business line and risk category. Aggregating these requirements to an overall result would require computing a correlation matrix, which is clearly far from being trivial.

Art. 637 - Art. 639: The limitation to allow risk mitigation for the AMA only seems appropriate at the moment. Nevertheless we see insurance coverage as a possible tool to reduce exposure to operational risk, especially for smaller and less sophisticated banks. We would thus appreciate keeping the discussion open whether insurance coverage might be recognised also for the less advanced approaches in the future, although we understand the complex interaction of pecuniary incentives for risk mitigation by insurance, the rather imprecisely known share of operational risk that can effectively be covered by insurance and not least the possible consequences from all that for the overall calibration topic.

Art. 640: It is not clear to us whether a partial use of the ASA together with the AMA or the STA is allowed in the current framework. We would however suggest allowing the temporary partial use of the ASA together with the AMA but not allowing the partial use of the ASA with the STA or BIA. Generally, we think that at no point of time an STA or ASA must stand in partial use simultaneously,

thus creating possibilities of capital arbitrage. As to the partial use of AMAs with the simpler approaches for certain business lines even when they are material, we would see this as an accommodation for a limited transition phase.

Footnote 155: We are not sure whether the definition set out there is correct and would appreciate clarification of the wording. An explanatory example could be useful.

Comments on Trading Book Issues

Art. 652: The implementation of the valuation methodology which requires the use of the more prudent side of bid/offer creates a substantial burden for IT systems. While we fully support the principle of prudent accounting we nonetheless are not convinced that the requirement under Art. 652 will automatically lead to a correct valuation. In addition to differing market practices, the stipulations of IAS (fair value) should be taken into consideration.

Pillar 2, Supervisory Review Process

Art. 690 - Art. 700: Since the inclusion of section C covers all risks which have to be covered in the SRP by banks and by the supervisor, we would recommend eliminating Art. 690- Art. 700 and including the main points of these articles in the corresponding articles in section C.

Art. 729 - Art. 736: Credit Concentration Risk.
The current lists for possible areas of concentration risk:

- Individual borrower or borrower group concentration
- Sector and regional concentration
- Activity and commodity concentration
- Collateral concentration

We agree that concentration risk can threaten a bank’s health. On the other hand we want to point out,that especially for regional and less sophisticated banks it might be difficult to establish a well-diversified credit portfolio, due to a lack of in-depth expertise in the new markets the bank starts to engage in. We would thus appreciate including some form of proportionality in the recommendations regarding credit risk concentration and a reference to the fact that by taking into account concentration risk, the specialisation of banks must not be impeded. Especially a possible additional regulatory capital requirement should always be at the discretionary power of the competent authorities.

In our opinion the first bullet point refers to the most important and most undisputed source of concentration risk. In the other three cases, concentration could also reflect a specific business expertise and may not add much concentration risk. We would therefore recommend demonstrating this rank order also in the text by splitting the paragraph into two parts: The first one should state the importance of the first bullet point as an essential risk, which always has to be taken into account, must be closely monitored and managed by explicit limits. The second part should refer to the other bullet points as forms of risk, which should enter banks’ strategies and business plans.

Pillar 3, Market Discipline

Art. 771: Scope of application: We welcome the principle that pillar 3 applies at the top consolidated level of the banking group only. We regard disclosure at any additional level of a banking group as of little value, even under special conditions. The last sentence of Art. 771 should thus be eliminated.

Table 9: The **disclosure requirements** should differentiate between investors and originators. Investors should be subject to reduced disclosure requirements to avoid an unduly high administration effort. We would thus recommend including an own table for investors, requiring only the publication of figures reflecting the economic risk taken by the investor.

Regarding information gathering, investing banks very much depend on the servicer of the transaction; therefore a potential violation of the disclosure requirements can often not be influenced or avoided by the investor. It should be ensured that originators disclose all information necessary for investors to fulfil the requirements for securitization transactions under this Accord.