

## Implementation of Pillar 2 in Austria

### General criteria and methods applied in the review and assessment of a credit institution's risk management and risk coverage pursuant to Article 39a Austrian Banking Act (BWG)

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## Preface

This document has been drawn up by the Austrian Financial Market Authority (FMA) in fulfillment of Art. 69b No. 4<sup>1</sup> Austrian Banking Act (BWG), which requires the FMA to publish "the general criteria and methods applied in the review and assessment of a credit institution's risk management and risk coverage pursuant to Article 39a" (i.e., the supervisory procedure under Pillar 2) on the Internet. The purpose of this general description of the FMA's Supervisory Review Process and of the Oesterreichische Nationalbank's role in the process is to help ensure efficient interaction with supervised institutions and to inform the interested public.

Through international cooperation,<sup>2</sup> an agreement was reached with regard to the depiction and level of detail of the disclosures prescribed by the directives. The descriptions below (cf. Section 2 ff.) are therefore based on the fundamental structure described in the CEBS [Guidelines on Supervisory Disclosure](#) (Nos. 70 to 89).

The provisions regarding Pillar 2 were implemented under Austrian law in Articles 39 (General Due Diligence Obligations) and 39a (Internal Capital Adequacy Assessment Process) as well as Article 69 paras. 2 and 3 (ongoing supervision) of the Banking Act. In this context, Article 70 Banking Act defines the respective areas for which the FMA and the Oesterreichische Nationalbank (OeNB) are responsible.

The specific implementation of Pillar 2 in Austria is based on international standards. In particular, the [Core Principles of Banking Supervision](#) published by the Basel Committee on Banking Supervision and the CEBS [Guidelines on the Application of the Supervisory Review Process under Pillar 2](#) were used as general guidelines for implementation in Austria.

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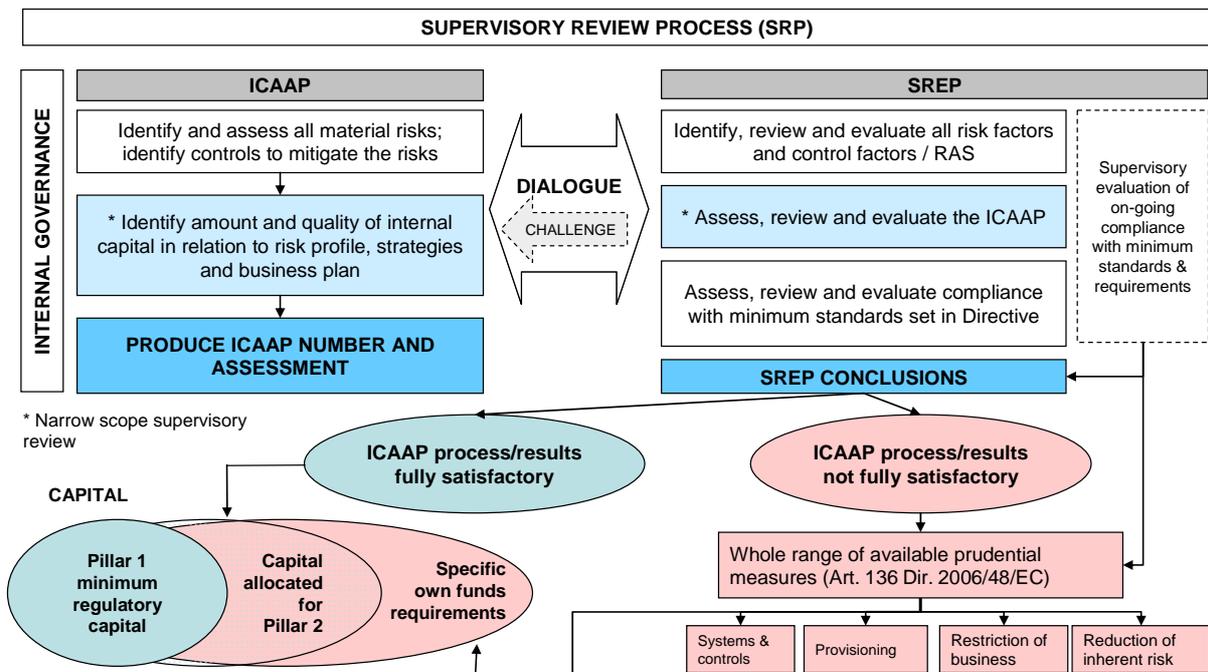
<sup>1</sup> This provision transposes Article 144 (c) of Directive 2006/48/EC into Austrian law.

<sup>2</sup> Committee of European Banking Supervisors (CEBS): Task Force on Supervisory Disclosure (SDTF).

# 1 GENERAL INFORMATION ON PILLAR 2 IMPLEMENTATION IN AUSTRIA

In addition to describing methods for calculating regulatory capital requirements (Pillar 1) and disclosure requirements (Pillar 3), the European directives implementing the Basel II framework (Directives 2006/48/EC and 2006/49/EC) also place increased emphasis on risk management and integrated bank-wide management. In this context, Pillar 2, also known as the Supervisory Review Process (SRP), contains provisions which apply to the institutions supervised as well as provisions which describe the obligations of the supervisory authorities themselves.

The fundamental interrelationships between each component of Pillar 2 are depicted as follows in the CEBS Guidelines on the Application of the Supervisory Review Process under Pillar 2:



**Figure 1:** Supervisory Review Process (SRP)

**Source:** CEBS (2006), Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised), p. 8

## 1.1 Internal Capital Adequacy Assessment Process (ICAAP)

Credit institutions are required to employ suitable processes and systems in order to ensure that they maintain adequate capital resources with due attention to all material risks. In the international discussion, these processes and systems are referred to collectively as the

**ICAAP (Internal Capital Adequacy Assessment Process).** The specific design of an institution's ICAAP is based on the nature, scope and complexity of the banking transactions conducted, meaning that this process must be designed individually by each credit institution.

The relevant legal requirements are derived from Articles 22 and 123 as well as Annexes V and XI of Directive 2006/48/EC. In the Austrian Banking Act, the ICAAP was mainly implemented in Articles 39 and 39a:

- Article 39 para. 2: Proportionality with regard to administrative, accounting and control mechanisms (proportionality principle, cf. Section 2.3)
- Article 39 para. 2b: Primary types of risk to be included
- Article 39a: Internal Capital Adequacy Assessment Process

According to Article 39 para. 2 Banking Act, credit institutions are required to:

*"have in place administrative, accounting and control mechanisms for the capture, assessment, management and monitoring of risks arising from banking transactions and banking operations. These mechanisms must be appropriate to the type, scope and complexity of the banking transactions conducted."*

In this context, the *potential* risks arising from banking transactions and banking operations also have to be taken into account. It is also necessary to ensure that the risks arising from *new transactions* as well as *concentration risks* are captured and assessed to the greatest possible extent. In terms of structural and process organization, any and all conflicts of interest and of competences are to be avoided.

In particular, Article 39 para. 2b Banking Act stipulates that the following risks must be taken into account:

1. *"credit risk (Article 2 no. 57),*
2. *concentration risk (Article 2 no. 57b),*
3. *risk types in the trading book (Article 22o para. 2),*
4. *commodities risk and foreign exchange risk, including the risk arising from gold positions, where these are not covered by no. 3,*
5. *operational risk (Article 2 no. 57d),*
6. *securitisation risk (Article 2 no. 57c),*
7. *liquidity risk (Article 25),*
8. *interest rate risk arising from any transactions not already covered by no. 3,*
9. *the residual risk from credit risk mitigation techniques (Article 2 no. 57a) and*
10. *risks arising from the macroeconomic environment."*

According to Article 39a Banking Act, credit institutions are also required to

*"have in place effective plans and procedures in order to determine on a regular basis the amount, the composition and the distribution of capital available for the quantitative and qualitative coverage of all material risks from banking transactions and banking operations and to hold capital in the amount necessary."*

Due to the considerable degree of freedom granted to credit institutions in this context, it is not possible to define an ideal "one-size-fits-all" ICAAP. For this reason, the FMA published guidelines in cooperation with the OeNB ("Guidelines on Bank-Wide Risk Management – Internal Capital Adequacy Assessment Process") in January 2006 in order to help develop a common understanding between the supervisory authority and credit institutions with regard to the practical ICAAP implementation.<sup>3</sup>

## **1.2 Supervisory Review and Evaluation Process (SREP)**

Article 124 of Directive 2006/48/EC defines the duties to be fulfilled by supervisory authorities in the Supervisory Review and Evaluation Process:

- 1. Taking into account the technical criteria set out in Annex XI, the competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the credit institutions to comply with this Directive and evaluate the risks to which the credit institutions are or might be exposed.*
- 2. The scope of the review and evaluation referred to in paragraph 1 shall be that of the requirements of this Directive.*
- 3. On the basis of the review and evaluation referred to in paragraph 1, the competent authorities shall determine whether the arrangements, strategies, processes and mechanisms implemented by the credit institutions and the own funds held by these ensure a sound management and coverage of their risks.*
- 4. Competent authorities shall establish the frequency and intensity of the review and evaluation referred to in paragraph 1 having regard to the size, systemic importance, nature, scale and complexity of the activities of the credit institution concerned and taking into account the principle of proportionality. The review and evaluation shall be updated at least on an annual basis.*
- 5. The review and evaluation performed by competent authorities shall include the exposure of credit institutions to the interest rate risk arising from non-trading activities. Measures shall be*

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<sup>3</sup> For more information on the FMA/OeNB Guidelines, please refer to the [Guidelines](#) on the FMA web site.

*required in the case of institutions whose economic value declines by more than 20% of their own funds as a result of a sudden and unexpected change in interest rates the size of which shall be prescribed by the competent authorities and shall not differ between credit institutions.*

Article 124 and Annex XI of Directive 2006/48/EC were transposed into Austrian law in Article 69 Banking Act. In particular, Article 69 para. 2 Banking Act governs the review of internal capital adequacy and of the procedures pursuant to Article 39 paras. 1 and 2 as well as Article 39a Banking Act. Article 69 para. 3 Banking Act provides for the review and assessment of interest rate risk.

The supervisory measures indicated in Article 136 of Directive 2006/48/EC can be found in Article 70 Banking Act, with para. 4a governing the possibility of imposing additional capital requirements (cf. Section 5).

Under Article 69b no. 4 Banking Act, the FMA is required to publish the *general criteria and methods* it applies in the review and assessment of a credit institution's risk management and risk coverage pursuant to Article 39a Banking Act (i.e., the supervisory procedure within the SRP). In the course of developing the CEBS Guidelines on Supervisory Disclosure, the participating supervisors agreed that it is necessary to disclose information on fundamental ICAAP requirements as well as their own procedures in the context of the SREP. In this regard, the following four categories were identified:

- Scope and classification (including proportionality) (cf. Section 2)
- Individual risk assessment (Supervisory Review Process) (cf. Section 3)
- Review and evaluation of ICAAP (cf. Section 4)
- Overall assessment and supervisory measures (cf. Section 5)

As the four categories overlap with one another in practice and are heavily influenced by the interaction or dialog between the supervisory authority and the supervised institutions, the supervisory authorities also agreed to disclose information on the form and means of communication with supervised institutions (cf. Section 6).

## 2 SCOPE AND CLASSIFICATION

### 2.1 Classification of Austrian Credit Institutions

As of December 31, 2007, a total of 871 credit institutions were licensed to conduct banking transactions in Austria in accordance with Article 1 para. 1 Banking Act. This figure also includes those 25 branches of credit institutions incorporated in other Member States which operate in Austria based on the freedom of establishment under Article 9 Banking Act (and which must comply with certain provisions of the Austrian Banking Act; see Article 9 para. 7). Figure 2 provides an overview of the *sectoral and geographical distribution* of credit institutions in Austria.<sup>4</sup> The "Special-purpose banks" segment includes credit institutions with a limited or special scope of authorization.

	2006	2007
Branches of Member State credit institutions	25	25
Exchange bureaus and remittance services	12	12
Severance and retirement funds	9	9
Investment fund management companies	28	29
Building and loan associations	4	4
Mortgage banks	10	11
Volksbank credit cooperatives	66	70
Raiffeisen credit cooperatives	564	558
Savings banks	56	56
Joint-stock and special-purpose banks	102	97
	876	871

**Figure 2:** Sectoral distribution of credit institutions in Austria

**Source:** Oesterreichische Nationalbank ([www.oenb.at](http://www.oenb.at), [Number of Banks](#))

The FMA's web site<sup>5</sup> provides a list of all credit institutions licensed in Austria (as well as those credit institutions from the EEA which operate in Austria on the basis of the freedom to provide services and the freedom of establishment), representative offices, investment fund management companies, and licensed severance and retirement funds. In addition, it is also possible to query the *scope of licenses* issued to credit institutions in Austria (*Konzessionsdatenbank*, available in German only).

The definition of *system-relevant banks* which underlies the FMA's/OeNB's supervisory approach is based on business size as well as risk relevance from the supervisory

<sup>4</sup> Current statistical data can be found under "[Statistics and Reporting](#)" on the OeNB web site ([www.oenb.at](http://www.oenb.at)).

<sup>5</sup> See [www.fma.gv.at](http://www.fma.gv.at) (Providers > Banks > [Overview](#)).

perspective. As a result, several categories of credit institutions have been defined on the basis of size and type; these categories are analyzed and reviewed at different levels of detail and at different intervals (see Section 3.3).

## 2.2 Legal Scope of Pillar 2

In general, superordinate credit institutions incorporated in Austria are required to fulfill ICAAP requirements on a consolidated basis.<sup>6</sup> As they are covered by their parent credit institutions' internal processes, all subordinate credit institutions (as defined in Article 30 paras. 1 and 2 Banking Act) incorporated in Austria are therefore exempt from the requirement to establish an ICAAP at the individual level. This does not apply to subordinate credit institutions with subsidiaries in third countries (Article 39a para. 5 Banking Act): Such institutions are responsible for setting up suitable systems and processes for the subgroup.

Exceptions were also made in order to account for the special situation of Austria's *special-purpose credit institutions* (Article 3 Banking Act). Article 39a does not apply to:

- the conduct of exchange bureau business (Article 1 para. 1 no. 22 Banking Act) and remittance services (Article 1 para. 1 no. 23 Banking Act);
- Guarantee schemes (i.e., credit institutions as defined in Article 5 no. 3 Corporate Tax Act 1988 [KStG 1988]);
- Investment fund management companies (i.e., credit institutions licensed in accordance with Article 1 para. 1 no. 13 Banking Act);
- Real estate investment fund companies (i.e., credit institutions authorized to conduct real estate investment fund business pursuant to Article 1 para. 1 no. 13a Banking Act); and
- Severance and retirement funds (i.e., credit institutions authorized to conduct severance and retirement fund business pursuant to Article 1 para. 1 no. 21 Banking Act).

In the course of the Supervisory Review Process, the FMA and OeNB review compliance with ICAAP requirements in accordance with the relevant scope of application. In this context, they examine the credit institution's ICAAP at the group level and assess the

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<sup>6</sup> For a detailed explanation on levels of ICAAP application within groups of credit institutions, see: OeNB/FMA, Guidelines on Bank-Wide Risk Management – Internal Capital Adequacy Assessment Process (2006), pp. 20ff.

integration of each credit institution into the group's ICAAP in their analyses at the individual institution level.

### **2.3 The Concept of (Dual) Proportionality**

The principle of proportionality accounts for the fact that different requirements will be appropriate for banks which conduct business activities of only low complexity and low risk levels as compared to large, internationally active banks with complex business structures.

In the context of Pillar 2 implementation, credit institutions are required to implement and integrate the ICAAP into their systems; however, this must be done in accordance with the institution's individual circumstances (Article 39a para. 1 Banking Act: "*These plans and procedures must be based on the nature, scope and complexity of the banking transactions conducted*"). In other words, banks which conduct less complex business activities may – in line with the principle of proportionality – define less complex systems, methods and mechanisms for the calculation of internal capital on the basis of a self-assessment using risk indicators.

For its part, the FMA is required by Article 69 para. 2 Banking Act to carry out its supervisory activities under Article 39 paras. 1 and 2 as well as Article 39a Banking Act "*in consideration of the nature, scope and complexity of the banking transactions conducted by credit institutions and groups of credit institutions*". Therefore, both the requirements imposed on credit institutions as well as the intensity of their supervision must be based on the principle of proportionality. In this respect, therefore, we can speak of "dual" proportionality.

### **2.4 Supervisory Cooperation and Exchange of Information**

The FMA and OeNB explicitly advocate the enhancement of international supervisory cooperation. For this purpose, the FMA and OeNB rely on formal instruments such as international agreements (Article 77a Banking Act) as well as the increased exchange of information between the competent supervisory authorities.

Bilateral and multilateral cooperation agreements (memoranda of understanding, or MoUs) with foreign authorities in the fields of banking, insurance and securities supervision contribute to the creation of efficient and effective supervisory processes. These agreements, which do not alter the respective legal frameworks for supervisory activities, make it possible

to simplify and accelerate practical supervisory activities in situations requiring cross-border cooperation. In particular vis-à-vis non-EEA countries, such agreements are also a trust-building measure and an important instrument in the FMA and OeNB's efforts to enhance operational cross-border cooperation, especially in Central and Eastern European (CEE) countries. As a result, between 1994 and 2007 a total of 25 MoUs were concluded with 17 countries in the fields of banking, insurance and securities supervision. Essentially, these agreements provide a practice-oriented definition of each supervisory authority's tasks and obligations with regard to contacting and informing the other authorities. They also form the basis for regular meetings of the participating authorities.

In the case of cross-border model approval procedures, which are governed by Article 21g Banking Act, the FMA assumes its role as the home or host supervisory authority in accordance with international standards. In order to strengthen the cooperation between the relevant supervisory authorities, the FMA (in its capacity as Consolidating Supervisor in the Colleges of Supervisors) established *Cooperation Meetings* which involve the OeNB as well as the competent supervisory authorities, supervisory authorities from third countries (optional; e.g., from EU candidate countries) and the credit institution in question. In addition to exchanging information, the participants coordinate further preparatory steps and specific processes at such meetings.

Colleges of Supervisors not only deal with Pillar 1 procedures (e.g., coming to joint decisions in IRB approval processes), but in terms of content they also cover the SREP (e.g., performing joint risk assessments). Depending on the topic at hand, the Colleges include the home supervisory authority and either all or a selected group of host authorities. The general conditions for carrying out the SREP are specified in multilateral agreements, the form and content of which are based on the specifications of the CEBS Subgroup on Operational Networks.

Another important instrument in connection with the exchange of information is the FMA's *Restricted Area*, a password-protected Internet platform on which the FMA can make relevant information on current approval processes as well as the SREP available to the other relevant competent authorities in a secure, efficient and structured manner.

### **3 INDIVIDUAL RISK ASSESSMENT – SUPERVISORY REVIEW PROCESS**

#### **3.1 Fundamental information**

The Supervisory Review Process (SRP) requires national supervisory authorities to carry out an individual assessment of a bank's measures, strategies, processes and mechanisms on a standardized basis. The supervisory authority should be able to assess the risk situation with its *own systems* (Risk Assessment System, or RAS).

Under Article 69 para. 1 Banking Act, the FMA is required to monitor compliance with all laws applicable to credit institutions<sup>7</sup> in its banking supervision activities. With regard to Pillar 2 of the Basel II framework, the FMA is specifically responsible for supervising compliance with the requirements of Directives 2006/48/EC (Capital Requirements Directive, or CRD) and 2006/49/EC (Capital Adequacy Directive, or CAD), with particular attention to the following:

- Compliance with license requirements and the scope of licenses (Articles 4 and 5 Banking Act);
- Accurate calculation of minimum capital requirements (Articles 22 to 24 Banking Act, Articles 21a to 21g Banking Act);
- Coverage of minimum capital requirements with sufficient own funds of the quality prescribed by law (Article 23 Banking Act);
- Proper consolidation pursuant to Article 24 et seq. Banking Act;
- Compliance with liquidity requirements (Article 25 Banking Act);
- Compliance with large exposure limits (Article 27 Banking Act);
- Notification and reporting requirements (Articles 73 to 75 Banking Act);
- The adequacy of the processes pursuant to Article 39 paras. 1 and 2 as well as Article 39a Banking Act (quantitative, methodological and qualitative requirements for the ICAAP);
- The adequacy of capital available for the quantitative and qualitative coverage of all material risks arising from banking transactions and banking operations (Article 69 para. 2 Banking Act);
- Limitation of interest rate risk (Article 69 para. 3 Banking Act);
- The adequacy of the capital held by a credit institution in respect of assets which it has securitized, with due attention to the economic substance of the transaction, including the degree of risk transfer achieved (implicit credit support).

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<sup>7</sup> In this context, Article 69 para. 1 Banking Act specifically mentions compliance with the provisions of the Banking Act, the Savings Bank Act, the Building Society Act, the Regulation Implementing the Mortgage Bank Act and Mortgage Bond Act, the Mortgage Bank Act, the Act on Funded Bank Bonds, the Investment Fund Act, the Depository Act, the Participation Fund Act, the E-Money Act, the Severance and Retirement Fund Act, the Real Estate Investment Fund Act and the Financial Conglomerates Act, notwithstanding the duties assigned to the FMA in other federal acts.

In accordance with its legal mandate, the FMA cooperates very closely with the OeNB in this area. Through their different activities in this field, both institutions make an important contribution to the stability of the financial market within the scope of their legally defined duties and objectives.

The instruments available in the Supervisory Review Process (SRP) include on-site inspections, ongoing analysis and assessment of banks and – on that basis – the imposition of supervisory measures where necessary.

The various elements of the Supervisory Review Process (SRP) are depicted schematically in the diagram below:

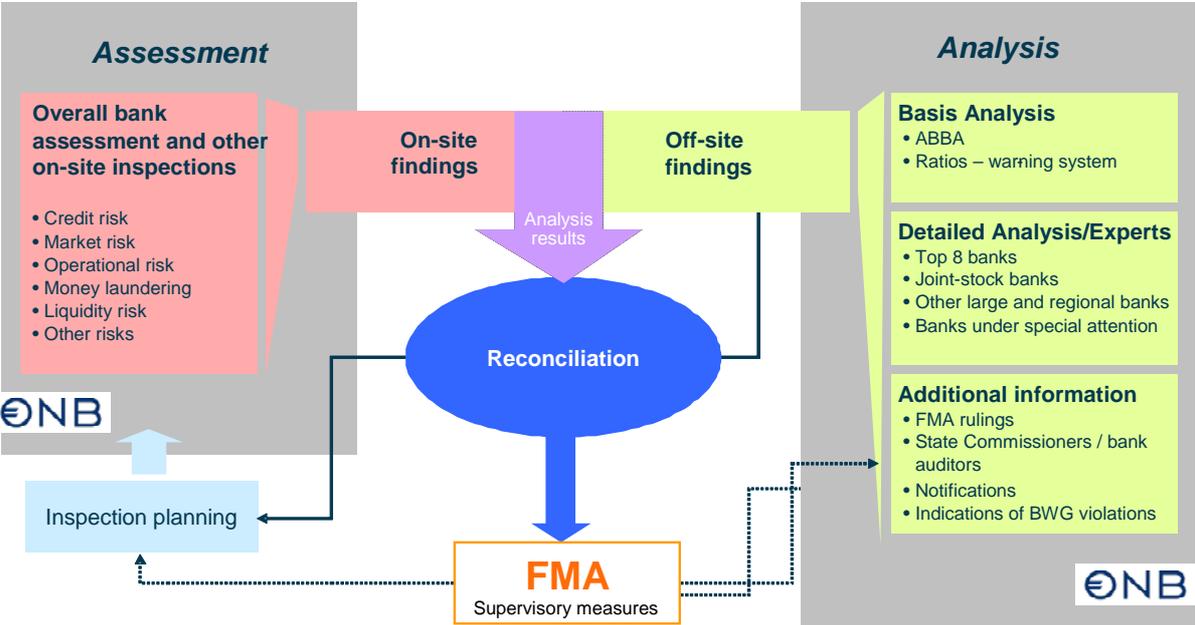


Figure 3: Schematic Diagram of SRP Implementation

The OeNB's individual bank analysis (cf. Section 3.3 for more detailed information) generally covers all credit institutions with due attention to all available information, but the form (scope/intensity) of the analysis is determined by the principle of proportionality. On the basis of the available regulatory reporting data, institutions are subjected to a quantitative analysis which consists of an automated, model-based scoring process and an indicator-based warning system. In addition, information from other sources is also taken into account (qualitative analysis). Furthermore, large banks, joint-stock banks, other system-relevant institutions and any other banks identified as conspicuous on the basis of the quantitative analysis or other information are also subjected to a detailed analysis (expert assessment). Detailed analyses may also be required on the basis of the FMA's official functions, and

certain special analyses generally have to be conducted at the FMA's request (e.g., in the case of bank mergers).

The objective pursued in designing this analytical framework was not to limit off-site analysis to the mere evaluation of data from annual financial statements, but to include all regulatory reporting data and complement them with qualitative elements in the form of individual bank analyses. The analysis results obtained in this way are stored in a joint information system and serve as the basis for any necessary supervisory measures to be taken by the FMA.

Duties related to the on-site inspection of credit institutions are assigned to the OeNB under Article 70 para. 1 no. 3 Banking Act, and the FMA has the right to take part in such inspections. In order to enable the systematic integration of on-site inspection results into individual bank analyses, the inspection and analysis modules are harmonized with one another. The inspection mandate issued by the FMA to the OeNB generally makes reference to the relevant fields of inspection and analysis in each case.

In cases where Austrian banking groups conduct substantial cross-border activities, an intensive dialog with the credit institution as well as the supervisory authorities in the other relevant countries is provided for in any case. In line with the relevant CEBS guidelines (GL09, GL10), the FMA arranges for the exchange of information in this context.

### **3.2 Sources of Information for Austrian Banking Supervision**

Under Article 79 para. 4a Banking Act, the OeNB is required to subject all data relevant to banking supervision and other supervisory information to ongoing comprehensive evaluation for the purposes of banking supervision and for the purpose of preparing supervisory investigations. In this context, any cases in which the risk situation has changed materially or a violation of supervisory provisions is suspected must be communicated to the FMA without delay.

The OeNB's analysis activities in the course of ongoing supervision are generally based on the following sources of information:

- (A) Reporting;
- (B) Regulatory reporting (supervisory statistics);
- (C) Ad-hoc information requests and structured dialog.

### **(A) Reporting:**

Under Article 44 para. 1 Banking Act, credit institutions and branches of foreign credit institutions are required to submit audited annual financial statements, annual reports, consolidated financial statements and group annual reports, as well as audit reports (including the Annex to the Audit Report on the annual financial statements) to the FMA and the OeNB at the latest within six months after the close of the business year.

Additional sources of information used by the OeNB and FMA include the annual and ad-hoc reports of bank auditors (Article 63 para. 3 Banking Act), the reports of State Commissioners on their activities (Article 76 para. 8 Banking Act) and the reports of auditing associations and deposit guarantee organizations; in the future, the disclosures of credit institutions under the Disclosure Regulation (OffV; implementation of Pillar 3) will also be taken into account.<sup>8</sup>

Article 39a Banking Act (ICAAP) was explicitly taken into account in the revision of the Annex to the Audit Report (FMA Regulation on the Annex to the Audit Report [AP-VO] as last amended by Federal Law Gazette II No. 2007/269) and must therefore be confirmed by the bank auditor annually in the process of auditing the financial statements. In addition, information requirements were introduced with regard to the methods and assumptions used in risk calculations (Part VI AP-VO) and with regard to the amount of the value-at-risk measure calculated for each risk type compared to the respective capital requirement (Part V AP-VO).

### **(B) Regulatory reporting (supervisory statistics)**

As Austria does not have the number of on-site inspectors which would be required for across-the-board on-site inspections each year, the supervisory authority relies on a well-equipped *regulatory reporting system* in order to obtain information for the purpose of off-site analysis. At the end of 2006, the following regulations<sup>9</sup> were issued in Austria in order to implement regulatory reporting requirements which are standardized in key areas at the European level:

- FMA Regulation on Financial Statements and Consolidated Financial Statements (*Jahres- und Konzernabschluss-Verordnung – JKAB-V*);
- FMA Regulation on Asset, Income and Risk Statements (*Vermögens-, Erfolgs- und Risikoausweis-Verordnung – VERA-V*);

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<sup>8</sup> Article 2 Disclosure Regulation requires credit institutions to disclose their risk management objectives and policies separately for each individual risk category.

<sup>9</sup> The regulations can be downloaded from the FMA web site ([www.fma.gv.at](http://www.fma.gv.at); [Providers](#) > [Banks](#) > [Regulations](#)).

- FMA Regulation on Proof of Compliance with Regulatory Standards (*Ordnungsnormenausweis-Verordnung – ONA-V*);
- FMA Regulation on Major Loan Reporting (*Großkreditmeldungs-Verordnung – GKM-V*);
- FMA Regulation on Master Data Reporting (*Stammdatenmeldungs-Verordnung – STD-M-V*);
- FMA Regulation on Loss Data Reporting (*Verlustdatenmeldungs-Verordnung – VTDM-V*);
- Amendment to the Regulation on Reserve Reporting (*Reservenmeldungsverordnung*).

Credit institutions were required to fulfill the new regulatory reporting requirements upon transition to the Basel II framework, that is, starting on January 1, 2008 at the latest. The supervised institutions are generally required to submit the following reports to the FMA (Articles 74 and 75 Banking Act):

- **Asset and Income Statement** (quarterly): Information on the balance sheet, off-balance-sheet items, income statement, and obligatory disclosures in the notes to the financial statements.<sup>10</sup>
- **Risk Statement** (quarterly): This statement must specifically provide information which enables the authorities to assess and monitor compliance with risk-specific due diligence obligations pursuant to Articles 39 and 39a Banking Act (ICAAP).<sup>11</sup>
- **Reports on Compliance with Regulatory Standards** (monthly): These reports must contain information on the review of compliance with regulatory standards (Articles 22 to 22q, 23 to 25, 27 and 29 Banking Act) as well as the information relevant to their derivation.<sup>12</sup> In addition, the reports must include the following: the amount of each large exposure, the amount of open positions with foreign exchange risk, the determination of compliance with provisions pertaining to liquidity based on residual maturities, and information on the trading book pursuant to Article 22n Banking Act.
- **Loss Data Report** (annual): Where the minimum capital requirement for operational risk is calculated using the Standardized Approach (Article 22k Banking Act) or the Advanced Measurement Approach (Article 22l Banking Act), a report on the loss data collected in

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<sup>10</sup> In the case of a group of credit institutions, this information is to be prepared by the superordinate credit institution pursuant to Articles 59 and 59a Banking Act.

<sup>11</sup> This information is to be prepared by the superordinate credit institution.

<sup>12</sup> Superordinate credit institutions must prepare these reports on behalf of their groups.

the course of the year must be submitted on an annual basis.<sup>13</sup> These data must comprise the threshold for loss entries which is used in each case and which is to be defined internally by the institution.

- **Master Data Report** (semi-annual): Reports of master data on the undertaking and on foreign credit institutions which are fully consolidated in the audited group financial statements pursuant to Articles 59 and 59a Banking Act (the immediate reporting of any changes in master data is independent of this report).
- **Report to the Central Credit Register** (monthly): Credit institutions which have exposures to a single obligor (after the deduction of short-term interbank exposures) exceeding a total of EUR 350,000 or the equivalent in foreign currency must report the following information: the amount of unweighted exposures, information on the obligor, the amount and exposure value of other exposures to the obligor, the approach chosen for the calculation of capital requirements for credit risk as well as details depending on the approach chosen (rating system, credit rating, weighted exposure amounts calculated by the credit institution, expected loss from the exposures, value of collateral, amount of specific value adjustment, probability of default, past due exposures), and the group of connected customers<sup>14</sup> to which the customer belongs.
- **Reserves Report** (annual): Hidden reserves as of the most recent balance sheet date must be reported within six months.

The OeNB handles the automated data processing of these notifications and reports as a service provider pursuant to the Austrian Data Protection Act (DSG) for the FMA. In this context, all data pertaining to supervisory statistics are subjected to a review. These figures provide the basis for OeNB analyses at the level of individual banks and banking groups as well as that of the overall financial system. The results of these comprehensive analysis activities are in turn made available to the FMA (see Section 3.3).

### **(C) Ad-hoc information requests and structured dialog**

For the purpose of monitoring credit institutions and groups of credit institutions on an ongoing basis, the FMA has the legal power to request information on all business matters from the management bodies of credit institutions and to inspect their bookkeeping records, documents and data media (Article 70 para. 1 no. 1 Banking Act). The FMA made use of its

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<sup>13</sup> This report must be submitted by superordinate credit institutions and credit institutions which do not have any subordinate credit institutions as defined under Article 30 Banking Act.

<sup>14</sup> Group of connected customers pursuant to Article 27 para. 4 nos. 1 to 3 and para. 4a Banking Act.

right to request information in approximately 150 cases in 2007; in most cases, the bank auditor was also involved.

In addition to these ad-hoc information requests, the FMA also held standardized meetings with the management of numerous credit institutions. These *Management Meetings* are an important part of routine analyses and are held regularly with large banks. In particular, such meetings serve to maintain contact with the management and to examine the credit institutions' risk assessment and strategies more closely. In addition, the Management Meetings are complemented by *Risk Management Meetings*. Intensifying the dialog with the supervisory authority is considered especially important in connection with Pillar 2 (see Section 6).

In addition, the OeNB and FMA also maintain close and regular contact with the bank auditors of all Austrian credit institutions. In this context, it is especially worth mentioning the regular meetings held with the auditing associations of decentralized sectors and with bank auditors. This exchange of information, which has proven useful over a number of years, is just as important a part of supervisory activities as the FMA's meetings with deposit guarantee associations, which perform an early warning function for their sectors under the Banking Act.

### **3.3 Risk Evaluation Methods (Off-Site Analysis)**

The analysis framework is built on three pillars: Supervisory Analysis, Model Analysis (ongoing model supervision) and Business Analysis. Business Analysis is further subdivided into an automated, model-based quantitative Basis Analysis and a Detailed Business Analysis.

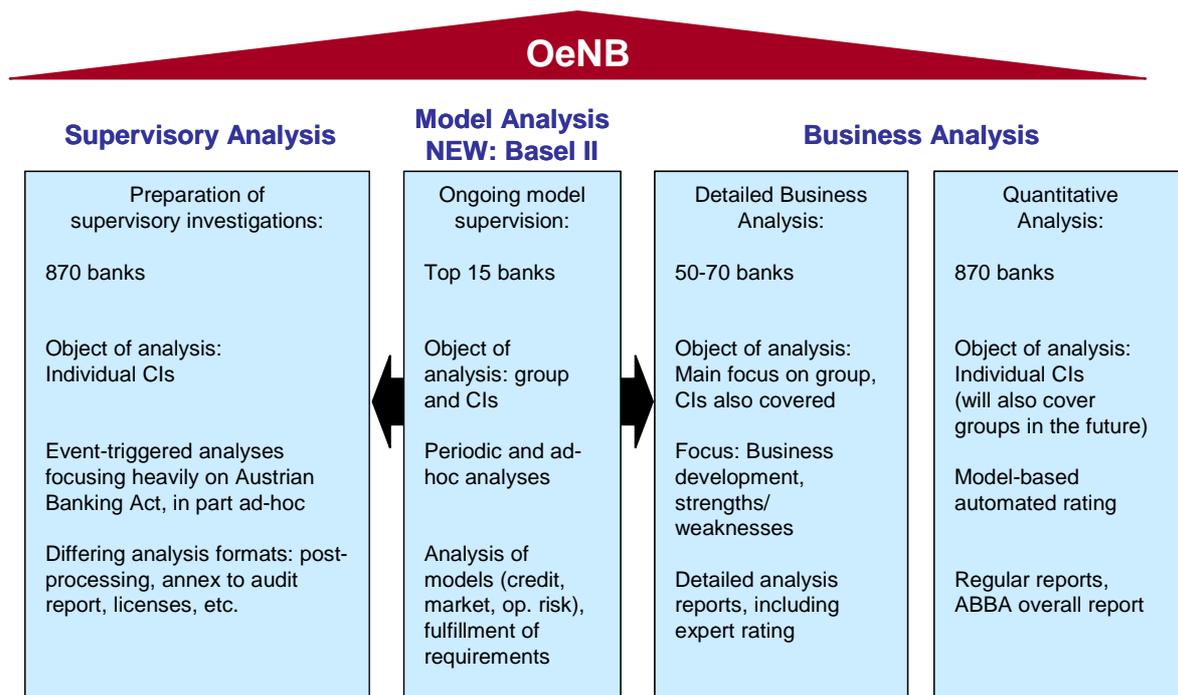


Figure 4: Schematic Diagram of Off-Site Analysis

### a) Basis Analysis

As it would not be economically feasible to carry out a detailed business analysis of all (approximately 870) banks in the Austrian banking system, a two-stage, risk-based analysis process is required. In the first step, the credit institutions undergo a screening process in the course of Basis Analysis. In the second step, the Detailed Business Analysis is performed for all banks identified as "risky" in the Basis Analysis (as well as large banks and joint-stock banks, which are defined as risk-relevant in any case).

Basis Analysis primarily relies on automated model outputs which provide an overall assessment of each bank.<sup>15</sup> The final result of this analysis is summarized in a score for each bank on a scale of 1 to 6 (1 = very good / minimal risk, 6 = unsatisfactory / danger to creditors). This automated bank scoring process is based on unaggregated and aggregated univariate analyses, multivariate analyses and simulations.

The automated analysis tools employed in off-site analysis make a substantial contribution to the efficient and targeted use of available supervisory resources. On the basis of the available data material, it is possible to identify problem areas and to create a sound basis

<sup>15</sup> Financial Market Authority, Oesterreichische Nationalbank: Off-Site Analysis Framework of Austrian Banking Supervision (2005).

for more in-depth individual analyses. However, the analytical framework for banking supervision described here should not be considered equivalent to a short-term early warning system, especially as there is a considerable time lag between the origination and delivery of data in some cases.

**b) Detailed Business Analysis**

Banks which are identified as conspicuous based on the results output by one of the analytical tools mentioned above (or by all tools taken together) are subjected to the Detailed Business Analysis. However, in order to ensure that conspicuous developments are also detected in individual risk areas which do not manifest themselves in the overall assessment of the bank, additional indicators are defined for various risk categories; these indicators trigger a warning as soon as certain risk thresholds are exceeded.

In addition to the banks identified as conspicuous in the Basis Analysis, the institutions defined as risk-relevant in any case (essentially the Top 8 banks in Austria as well as other system-relevant banks and joint-stock banks) are always subjected to a Detailed Business Analysis regardless of their score. In the case of large banks, the analysis always starts from the overall group perspective (consolidated top-down approach).

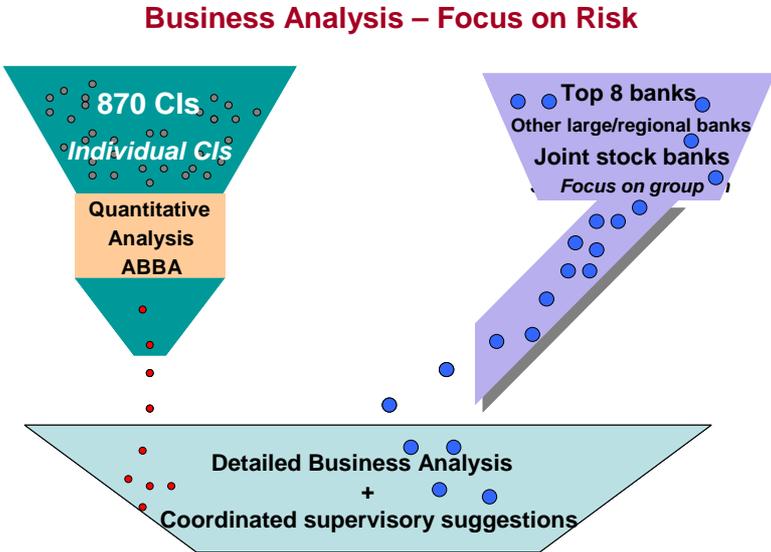


Figure 5: Schematic Diagram of Business Analysis

While the off-site analysis models rely exclusively on quantitative data from regulatory reporting, the Detailed Business Analysis also incorporates additional qualitative information. The main sources of information used in the Detailed Business Analysis are external auditors' reports, regulatory reporting data, information obtained through structured dialog

(direct contact with the bank), market information, insights from the Annex to the Audit Report, and reports from the State Commissioners. In contrast to the Basis Analysis, in which each bank is scored automatically using a model, the score resulting from the Detailed Business Analysis is determined by experts.

The result of this in-depth expert assessment is known as the Analysis Report, which is drawn up according to a standardized outline. As banks of varying size and complexity are subjected to the Detailed Business Analysis, analysis formats of differing scope have been defined. The most comprehensive analysis format is primarily applied to the Top 8 banks.

The Analysis Report begins with the **Management Report**, which provides a brief profile of the bank, the score table and reasons for the scores assigned, as well as an analysis of any need for supervisory action and a description of the bank's supervisory history. The Management Report concludes with a "newsflow" section which briefly summarizes the most important press reports from the analysis period.

As an annex to the Management Report, the **Detailed Report** provides a comprehensive analysis of the bank (corporate profile, earnings situation, balance-sheet development, regulatory capital, material risk categories). The Detailed Report also discusses whether there is a need for supervisory action with regard to the bank in question.

Any resulting supervisory measures are taken on the basis of detailed analyses. In cases where the analyses reveal circumstances which warrant further supervisory action, the FMA is informed accordingly. In addition, the FMA may also request special analyses on relevant topics in the course of official procedures. All Analysis Reports are stored in the joint information system.

### **c) Ongoing Model Supervision**

The ongoing supervision of models includes all measures pertaining to the use of models subject to approval requirements under Article 21a et seq. Banking Act once they have been approved. This task comprises the ongoing analysis of models subject to approval and of their use; such analyses are primarily the responsibility of the OeNB. In this context, the functionality and adequacy of the models as well as compliance with the approval requirements defined under Article 21 et seq. Banking Act are analyzed on the basis of information from other sources, such as validation reports from banks, reporting data and evaluations. The findings from ongoing model supervision are communicated directly to the FMA and used in the scoring process for the OeNB's overall assessment of a bank. The FMA

is then responsible for continuing the procedure and for imposing any necessary supervisory measures (in cases where the approval requirements are no longer fulfilled).

Broken down by individual area, the duties involved in ongoing model supervision include the analysis of validation reports (credit risk, market risk, operational risk) and reports on the fulfillment of requirements, the administration of changes in models (Article 21 et seq. Banking Act), the analysis of disclosure requirements (Article 26 et seq. Banking Act) and an assessment of whether the requirements for permanent partial use are still fulfilled. Finally, an overall analysis is performed (Article 21 et seq. and Article 79 para. 4a Banking Act). This model-specific analysis is carried out on an annual basis in order to provide a general impression of the scope and quality of the models used (also for any other authorities involved in the model approval process). Among other things, this analysis includes the findings of the aforementioned reports from the previous year (especially the validation report and report on the fulfillment of requirements). For the purpose of assessing credit risk, data from regulatory reporting (especially the Central Credit Register) are also taken into account in this context.

#### **4 REVIEW AND EVALUATION OF ICAAP**

ICAAP assessment can generally be regarded as an additional duty within the OeNB's existing analysis activities. This assessment is embedded as an additional element in existing processes and responsibilities. With regard to the scope and intensity of evaluation, the procedure followed in this context complies with the principle of dual proportionality.

ICAAP analysis involves an examination of the credit institution's internal processes for the assessment of capital adequacy as well as a comparison of the quantitative data generated internally by the credit institution with the information collected by the authorities themselves (cf. Section 4.2).

In the examination of a credit institution's individual processes and methods, the following points must be addressed (with due attention to the principle of proportionality):

- Strategy for securing capital adequacy (existence and plausibility of the institution's risk strategy, proportionality);
- Integration of ICAAP into the internal control system (risk management, internal auditing, compliance);
- ICAAP use test (basis for business decisions);

- Independence of functions (including the segregation of duties);
- Responsibility of directors;
- Complete consideration of risks taken (see Article 39 para. 2b Banking Act) as well as an assessment of their materiality;
- Consideration of macroeconomic risks (including stress-testing);
- Methods used to determine risks and coverage capital (e.g., method for determining the eligibility of components, consistency with methods and risk quantification, especially with regard to hedging objectives);
- Adequacy of methods for quantifying and aggregating risks (consideration of correlations and diversification, consistency of metrics for different types of risk);
- Allocation of risk capital;
- Credit approval process (Annex V CRD; credit approval based on sound and well-defined criteria; clearly established procedures for approving, amending, renewing and refinancing loans) and limit system (existence, adequacy);
- Comparison with solvency (plausibility of risk levels);
- Establishment of effective systems (Annex V CRD) for the ongoing administration and monitoring of various credit risk-bearing portfolios and exposures (also for the purpose of identifying and managing problem loans and for making adequate value adjustments and provisions);
- Diversification of credit portfolios (in line with the credit institution's target markets and overall credit strategy);
- Ongoing ICAAP review.

As key questions in this context could not be discussed directly with the senior management in sufficient detail at the Management Meetings carried out by the supervisory authority, the supervisory authority introduced special Risk Management Meetings as an additional communication channel in order to establish direct contact with the units in charge of the credit institutions' risk management processes (risk management operations / second-level management; cf. Section 6).

#### **4.1 Frequency of Evaluation**

In the course of *ongoing supervision*, the issues addressed under Pillar 2 are reviewed to varying degrees at all Austrian credit institutions on an annual basis (in line with the legally defined scope of application; cf. Section 2.2 above):

An annual update is carried out by the OeNB. The annual evaluation covers a limited number of areas and relies on all supervisory information sources available to the supervisory authority (cf. Section 3.2 above), including the bank auditor's report for the purpose of initial assessment. The facts collected in the course of analyzing the data in the bank auditor's report, the State Commissioners' reports, public information and ongoing communication with the credit institution are entered in the OeNB's integrated analysis system on an ongoing basis.

In addition, detailed information is collected in the course of **full evaluations** and in **on-site inspections**. In line with the principle of proportionality, these evaluations/inspections are carried out on the basis of the institution's system relevance as well as the nature, scope and risk level of its business activities.

#### **4.2 Risk Tolerance Analysis (Structural Model)**

In order to obtain a rough indication of compliance with risk-bearing capacity, the Austrian banking supervisor makes use of a *structural model* based on regulatory reporting data. This model was developed by the OeNB and FMA with the support of university researchers and has been in use since 2005. The purpose of the model is to capture a bank's risk structure as a whole and thereby gain insight into the individual risk categories from an economic perspective.<sup>16</sup> The results of the structural model's risk tolerance analysis, which is carried out automatically on a quarterly basis, serve to verify the plausibility of the data generated by the credit institution's ICAAP and are thus an essential component of the supervisory examination.

The structural model focuses on the detailed analysis of risk drivers and their potential impact on a bank's overall risk. The individual risk categories (market risk, credit risk, operational risk) are captured in a structured format and then merged into a uniform metric (risk integration/aggregation). For each credit institution, this provides details on individual risk categories and on the capital available to cover those risks as well as an aggregate comparison in the form of a distribution function (see Figure 6):

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<sup>16</sup> For a detailed description of the structural model, please refer to FMA/OeNB: New Quantitative Models of Banking Supervision (2004), pp. 33 ff.

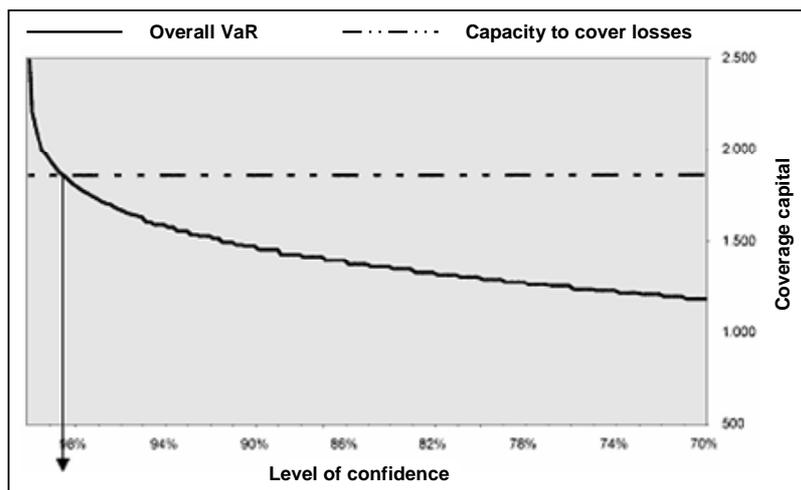


Figure 6: Capacity to Cover Losses

Source: FMA/OeNB, New Quantitative Models of Banking Supervision (2004), p. 76, trans.

Additional sources of information on the risk-bearing capacity of individual credit institutions include the following:

- Regulatory reporting includes general information on a monthly basis and detailed information on a quarterly basis with regard to risk tolerance calculations.
- The auditor of the financial statements confirms compliance with Articles 39 and 39a Banking Act.
- In the course of Risk Management Meetings, a selected group of banks is subjected to a detailed ICAAP review each year.

The OeNB takes this body of available information into account in its ongoing analysis activities. Any need for supervisory action is determined by the FMA on the basis of these analyses.

## 5 OVERALL ASSESSMENT AND SUPERVISORY MEASURES UNDER PILLAR 2

The FMA's overall assessment of the adequacy of the internal systems for calculating internal capital at individual credit institutions is based on all findings from on-site inspections and off-site analyses. On this basis, the FMA decides whether supervisory measures are necessary.

Article 69 Banking Act governs the duties and obligations of the FMA in its supervisory activities. In cases where a credit institution's ability to meet its obligations to creditors is in jeopardy, the FMA can order temporary measures by means of an administrative ruling

(Article 70 para. 2 Banking Act). In cases where a legal violation is identified but the institution's creditors are not endangered, the FMA must first issue an order to restore legal compliance within a reasonable period of time; in cases of repeated or continued violations, the FMA is to prohibit the directors of the credit institution partly or entirely from managing the institution, or revoke the institution's license if other measures cannot secure the functioning of the credit institution. In line with the proportionality principle underlying its activities, the FMA is required to use the mildest effective instrument to attain its objective (i.e., restoring legal compliance) in each case.

Under Article 69 para. 2 Banking Act, in the course of its ongoing monitoring activities the FMA is required to monitor the adequacy of the capital available for the quantitative and qualitative coverage of all material risks from banking transactions and banking operations as well as the adequacy of procedures pursuant to Article 39 paras. 1 and 2 and Article 39a Banking Act (especially the risks indicated in Article 39 para. 2b). Where a legal violation leads to the inadequate limitation of the risks arising from the banking transactions and banking operations of the credit institution and the group of credit institutions, the FMA is required, other measures notwithstanding, to impose a minimum capital requirement on the credit institution or group of credit institutions exceeding the minimum capital requirement pursuant to Article 22 para. 1 Banking Act.

Such an additional capital requirement is to be imposed immediately, if, given the factual circumstances, it is not expected that other measures will restore the proper capture and limitation of risks or legal compliance within a period of time which is appropriate in light of the circumstances.

From mid-2008 onward, the FMA plans to publish aggregate statistical data on the supervisory measures imposed on credit institutions and investment firms under Pillar 2 each year.<sup>17</sup> In the process of developing the CEBS Guidelines on Supervisory Disclosure, the participating authorities agreed to disclose data on their *supervisory activities* (number of on-site inspections, number of review measures) as well as data on the *supervisory measures* taken (number of institutions subjected to measures under Article 136 para. 1 of Directive 2006/48/EC<sup>18</sup>). However, due to fundamental differences in the national implementation of regulatory capital requirements and in the approaches and practices of national supervisory authorities in Member States, it is necessary to note that this table does

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<sup>17</sup> See FMA web site: FMA > [Supervisory Disclosure](#).

<sup>18</sup> Implemented in Article 70 Banking Act.

not allow a meaningful comparison of Pillar 2 implementation in each Member State. Therefore, any conclusions drawn without attention to the relevant national circumstances may be misleading.

## 6 SUPERVISORY DIALOG

Under Pillar 2, it is considered especially important to intensify the supervisory dialog with banks; one important reason for this imperative is the fact that analysis activities now also include ongoing model supervision. The Management Meetings held in the past are now being replaced by more formalized, structured contact with banks. In this context, the supervisory authority takes a differentiated approach: In the case of large, complex banking groups, a close and intensive dialog is established; for smaller banks in the decentralized sectors, on the other hand, contact with the auditing associations serves as the main source of information.

In the course of a year, the following cycle of meetings (each with a different focus) is held with banks selected according to risk criteria:

***Meetings with external auditors*** represent the first step, in which questions related to the annual financial statements (at the consolidated and individual institution level) are addressed in particular. Meetings with external auditors are held once per year.

The second step is the ***Management Meeting***, at which the balance-sheet analysis is expanded to produce an in-depth report. In this context, the bank's material potential risks are recorded and discussed. On the basis of the Detailed Analysis, a score table is created in order to assess the bank's risk potential. Management Meetings are to be carried out once per year. *CEE Meetings* are also held with large banking groups which conduct significant business activities in the CEE region. For this purpose, a meeting with the management board member responsible for CEE activities (at the group level) and the CEOs of the most significant CEE subsidiaries is held in the third or fourth quarter of each year. The primary objective of the CEE Meeting is to provide further insight into the structure, business activities and risks of CEE subsidiary banks.

***Risk Management Meetings*** represent the third step in the supervisory dialog. These meetings specifically involve the units in charge of risk management operations (or the second-level management) and serve to provide greater insight into the bank's risk

management activities. At these meetings, the management's business plans and the bank's liquidity plans as well as issues related to ongoing model supervision are discussed.

In the course of Risk Management Meetings, a selected group of banks also undergoes a *detailed ICAAP review* each year (cf. Section 4.1). These reviews make it possible to investigate irregularities and differences more closely and may bring about adjustments in analysis tools or ICAAP adaptations. The credit institution is informed of the supervisor's conclusions and recommendations regarding the ICAAP through the existing communication channels.

Prior to each Risk Management Meeting, a checklist containing questions for the credit institution (*self-assessment*) is provided. The responses are evaluated during the Risk Management Meeting, and this evaluation ultimately contributes to the overall assessment of the credit institution.

The results of each meeting, which are recorded, archived and made available to the FMA by the OeNB, form the basis for any further supervisory measures to be taken by the FMA. The information collected is available for further communication with the credit institution at all times and also serves as the basis for on-site inspections.