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# FMA MINIMUM STANDARDS

## FOR THE CREDIT BUSINESS AND OTHER TRANSACTIONS ENTAILING COUNTERPARTY RISKS

(FMA-MS-K)

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This English translation of the authentic German text serves merely for information purposes. In the event of a dispute the German text shall prevail.

## **FMA Minimum Standards for the Credit Business and other Transactions entailing Counterparty Risks of 13 April, 2005 (FMA-MS-K)**

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## 1 Preliminary remarks

**1. Due to developments and standards in the international arena, the Financial Market Authority (FMA) has decided to present FMA Minimum Standards for the Credit Business and other Transactions entailing Counterparty Risks to the Austrian credit institutions. The main purpose of the FMA-MS-K is to create transparency with regard to the relevant provisions under banking law. The Minimum Standards are intended to provide the Austrian credit institutions with guidelines on how to structure the credit business in terms of organisation and processes in greater detail. With reference to section 39 paras 1 and 2 of the *Bankwesengesetz* (BWG; Austrian Banking Act), the FMA expects credit institutions to adhere to this recommendation when granting and managing loans and other transactions with counterparty risks.**

The Austrian Financial Market Authority (FMA) particularly refers to the Basel Committee's Principles for the Management of Credit Risk (September 2000), the Framework for Internal Control Systems in Banking Organisations (Basel 1998), the New Basel Capital Accord (Basel II, June 2004) as well as the efforts under Community law to amend the Banking Directive and the Capital Adequacy Directive in the course of the implementation of Basel II (COM(2004) 486 final). The present Minimum Standards lean towards Germany's *Mindestanforderungen an das Kreditgeschäft* (Minimum requirements for the credit business of credit institutions), not least because some Austrian credit institutions already orient themselves towards the German minimum requirements.

**2. The main goal of these Minimum Standards is to further develop credit risk management. This shall be accompanied by an adequate limitation of counterparty risks, the enhancement of risk controlling, the avoidance of clashes of interests, the strengthening of risk (cost) awareness as well as an increase in the efficiency of internal processes.**

Against the backdrop of the emerging new capital requirements regime, the recommendations laid down in these Minimum Standards have been drawn up neutrally in the sense that they can be implemented regardless of the capital calculation method used.

Furthermore, international regulatory developments should be pointed out, where it can be seen that an ever greater number of supervisory authorities have started to provide credit institutions with guidance papers serving as guiding principles when it comes to supervisory requirements. In this context, the work of the CEBS (Committee of European Banking Supervisors), the level 3 committee in the field of banking supervision, should be referred to, which also works with guidance instruments. In this context, the FMA-MS-K may form the basis for Austria's position with regard to the future CEBS work.

These FMA Minimum Standards do not regulate the circumstances and conditions

under which (sub)segments of the credit business or of other transactions entailing counterparty risks may be outsourced. They shall also apply to the partial or complete outsourcing of such transactions to external third parties.

For additional reading, the "Credit Approval Process and Credit Risk Management" (Vienna 2004) guideline published by the *Oesterreichische Nationalbank* (OeNB) in co-operation with the FMA is especially recommended.

**3. These FMA Minimum Standards shall constitute a recommendation for designing organisation, processes as well as risk management and risk controlling. This is not a regulation. The FMA Minimum Standards take the heterogeneous structure of credit institutions and the diversity of credit business into account since the methods included shall be deemed proposals to achieve the targeted objectives. Credit institutions may therefore use alternative methods. Furthermore, in the case of low-risk transaction types, the recommendations laid down in these FMA Minimum Standards may be implemented in a simplified manner appropriate for the risk situation on the basis of clear regulations put into force by the managers, provided that this is justifiable in consideration of the risk level.**

In that respect, alternatives to the methods suggested in the FMA-MS-K shall be admissible where they are within the scope of legal obligations. In the course of continued supervision, the FMA will evaluate if and to what extent these methods are suitable to achieve the goals and are compatible with the provisions under banking law.

In this context, the FMA would like to point out that the statutory requirements for the strategic framework conditions, the design of the organisation, of the processes as well as risk management and risk controlling follow from section 39 paras 1 and 2 BWG in particular. The managers of the credit institution shall be responsible for complying with and specifically implementing this provision; this will be examined by the FMA within the scope of continued supervision. This responsibility shall not be affected by the FMA-MS-K.

When drawing up the FMA-MS-K, the heterogeneous structure of credit institutions and the diversity of the credit business, particularly decentralised structures, were sufficiently taken into account by ensuring the corresponding flexibility, adequacy and proportionality of the recommendations. The Minimum Standard also make sure that the design remains flexible vis-à-vis the ongoing development of the processes, systems and procedures in the credit business.

The FMA-MS-K are deemed a suitable means to achieve the above-mentioned goals, particularly considering their flexibility: both the credit institutions and the FMA may apply the FMA-MS-K, adapted to the respective situation in an appropriate manner.

A simplified implementation depending on the risk level seems to be appropriate if the types of transaction or credit transactions bear a low risk. In contrast, a significant risk level exists in particular if types of transaction or credit transactions might have a major impact on the risk situation of the credit portfolio and/or the earnings situation of the

credit institution. A significant risk level may exist, for example, with respect to concentration risks, parallel risks, high probabilities of default, significant business volumes or significant collateral risks. Effects on the earnings situation may also be of substantial significance. Therefore, the proportion of an individual exposure or the amount of such an exposure, of a portfolio or a transaction type to the risk situation of a credit institution, i.e. its or their impact on the credit institution's solvency, is significant.

In that respect, the standardised retail banking business (consumer credit business, retail-customer credit business, home loans in combination with the amount of the exposure), for example, may be a low-risk business, depending on the above-mentioned factors.

In the case of some credit transactions, for example those of some home loan banks and in the case of standardised building society business (loans extended by building societies and bridging loans), it might seem appropriate to simplify the implementation due to the low risk level and existing statutory provisions (e.g. the *Bausparkassengesetz* (BSpG; Building Society Law), the implementing regulation pertaining to the BSpG) or limitations under company law (e.g. as set out in the articles of association) in consideration of the principle of proportionality.

In the case of simplified implementation, the credit institutions shall ensure that the individual sections are uniformly implemented considering the nature, scope, complexity and risk level. This might be supported, for instance, by introducing standardised forms.

In the case of trading transactions and participating interests, it may be appropriate to refrain from implementing some points of the recommendation given the special features of these types of transaction. This facilitation may affect the recommendation on monitoring loan payouts, for example. It should be pointed out, however, that decisions on participating interests, as a rule, have a higher risk relevance than comparable lending decisions, as no claim to the assets may be asserted in the case of insolvency. For this reason, this exemption should be used restrictively and the risk relevance of acquiring participating interests should be constantly considered. The exemption from the recommendations for the organisational structure and procedure for strategic interests is mentioned in the comments on clause 9.

**4. These FMA Minimum Standards shall not prevent credit institutions from setting higher standards. On the other hand, it shall not be ruled out that existing legal obligations may require credit institutions to go beyond these Minimum Standards. Other FMA Minimum Standards shall remain unaffected.**

The FMA would like to point out that it is the personal responsibility of the managers to actually design the requirements as set out in section 39 paras 1 and 2 BWG in particular; it shall particularly be guided by the size and nature of the credit institution as well as the nature, scope, complexity and risk level of its business activities. Therefore, based on the banking law requirements pertaining to the diligence to be exercised by the managers in particular, it may be necessary to go beyond the recommendations as set out in the FMA-MS-K. At any rate, the legal basis shall remain unaffected by the FMA-MS-K.

## 2 Scope and definitions

**5. These Minimum Standards shall apply to all credit institutions licensed to carry out one or more banking activities as laid down in section 1 para 1 nos. 1 to 12, 15 to 18 BWG whose total required capital was or exceeded EUR 30 million as of the last balance-sheet date. The FMA would like to point out that credit institutions which are outside the scope of this recommendation are also requested to orient themselves towards these Minimum Standards when designing their organisation, processes and risk management and consider the FMA-MS-K guiding principles in this connection. The duty of diligence pursuant to section 39 paras 1 and 2 BWG shall in any case apply to the managers of all credit institutions.**

The FMA-MS-K shall not apply to the following credit institutions due to their specific business activities:

- investment fund management companies,
- investment fund management companies for real estate,
- equity fund companies;
- e-money institutions only,
- staff provision funds,
- exchange offices only,
- money transmitters only.

These credit institutions were exempted from the scope as they do not conduct "credit business" within the meaning of these Minimum Standards when performing their specific business activities and therefore the recommendations would not be suitable.

Total required capital shall mean the total of the requirements listed in section 22 para 1 nos. 1 to 4 BWG.

**6. The FMA-MS-K shall also pertain to Austrian credit institutions if they are active in other Member States (section 2 no. 5 BWG) under the freedom to provide services and/or the freedom of establishment (section 10 BWG).**

**7. The recommendations for strategic framework conditions as well as for risk management and risk controlling are also directed towards group risk management and risk controlling of groups of credit institutions (section 30 paras 7 and 8 BWG).**

With regard to the application to group risk management and risk controlling of groups of credit institutions where parts of the group have their head office in other Member

States or third countries, it has to be pointed out that the recommendations of these Minimum Standards cannot apply if the legal systems of the home countries conflict with these recommendations. This may affect aspects pertaining to data protection law in particular.

The FMA-MS-K shall not apply to subordinated credit institutions with their head offices situated abroad (Member State, third country).

Irrespective of the fact that for groups of credit institutions - with regard to group risk controlling - only the recommendations concerning strategic framework conditions (chapter 3) as well as risk management and risk controlling (chapter 6) have to be followed, it has to be pointed out that the duty of diligence pursuant to section 39 BWG shall also apply to managers of superordinate credit institutions with regard to groups of credit institutions (cf. section 30 para 6 BWG). However, the FMA takes the view that the responsibility does not include the risk controlling of the individual credit institution belonging to a group of credit institutions.

The superordinate credit institution should be in the position to summarise, assess and manage the risks of the individual banking subsidiaries, including its own risks (cf. section 30 para 8 in conjunction with section 39 paras 1 and 2 BWG). The group-wide system shall primarily focus on the risks at portfolio level.

**8. The scope of these Minimum Standards shall generally apply to all transactions entailing counterparty risks. For the purpose of these Minimum Standards, counterparty risks shall mean the risks of a counterparty's partial or complete default, taking into account any existing country risks; these risks may take effect both with on-balance sheet transactions (asset items of the balance sheet) and off-balance sheet transactions and special off-balance sheet transactions. For the purpose of these Minimum Standards, all transactions entailing counterparty risks shall be called "credit transactions".**

The term "counterparty risk" is more comprehensive than the term "credit risk" as set out in section 2 no. 57 BWG: While, according to this provision, "credit risk" shall mean the exposure consisting in the danger of a partial or complete failure of contractually agreed payments in the case of credit transactions, the term "counterparty risks" shall mean all risks due to defaults of counterparties, not only in the case of credit transactions. For the sake of simplicity, however, and for the purposes of these FMA-MS-K, all transactions entailing counterparty risks shall be called "credit transactions".

**9. Any decision on new loans, overdrafts, loan increases, extensions, deferrals and other risk-relevant decisions in connection with credit transactions, irrespective of whether they are made only by the credit institution itself or jointly with other credit institutions (e.g. syndicated lending) shall be deemed a "lending decision" within the meaning of these Minimum Standards. Furthermore, the setting of borrower-related limits and the decision on participating interests shall also be deemed lending decisions. The definition of counterparty limits for trading transactions as well as the setting of issuer limits of credit institutions shall also be deemed lending decisions.**

With regard to participating interests, it has to be mentioned that only participating interests substituting for loans are fully covered by the recommendations set out in the FMA-MS-K, but strategic interests are not. However, the recommendations on risk strategy as well as risk management and risk controlling refer to all participating interests, irrespective of whether they are securitised or not. For facilitations concerning participating interests, please see clause 3.

However, decisions on loans for strategic interests are covered.

Decisions on collateral or the purpose of use, for example, may be considered "other risk-relevant decisions in connection with credit transactions".

### **3 Strategic framework conditions**

#### ***3.1 Responsibility of managers***

**11. With regard to the credit business and other transactions entailing counterparty risks, the managers shall be responsible for the strategic framework conditions, the proper organisation, the structuring of the processes of lending and loan processing and their further development as well as the proper risk management and risk controlling of the credit business within the scope of section 39 BWG.**

The management of counterparty risks should be incorporated into a comprehensive bank management strategy in an appropriate manner. Interdependencies between different types of risk (counterparty risk, market risk, liquidity risk, operational risk etc.) should be addressed by the procedure. The FMA is aware of the fact that comprehensive bank management instruments are currently often only at a development stage.

#### ***3.2 Risk strategy***

**12. Within the scope of the business strategy, the managers shall also define a risk strategy. In this context, risk strategy shall mean a forward-looking, written definition of risk parameters to be achieved by the credit institution. This definition shall be based on the analysis of the initial situation and the assessment of the risks associated with the credit business, taking into account the risk-bearing capacity of the credit institution. The responsibility for the risk strategy must not be delegated. The development of the counterparty risk shall be planned based on the risk strategy, continuously adapted based on current data and co-ordinated with the ongoing development of the risk-bearing capacity.**

The methods for determining the risk-bearing capacity may include, for example:

– orientation towards regulatory provisions under banking law,

- methods based on the profit and loss account,
- methods based on the balance sheet,
- methods based on the profit and loss account and the balance sheet,
- methods based on the market value.

The appropriateness of the risk strategy shall depend on the size and nature of the credit institution as well as on the nature, scope, complexity and risk level of the credit transactions in particular. The credit institution shall be responsible for the detailed design of the risk strategy.

Supporting sectoral risk strategies may partly cover this issue.

The decision on the risk strategy lies with the management and should not be delegated. Its preparation may be delegated.

**13. The risk strategy shall cover the entire credit business, taking into account the nature, scope and risk level of the transactions. This shall comprise, for example, the planning according to credit types, industry focuses, geographic dispersion (including regions, countries) and the distribution of the exposures in the risk classification procedure as well as according to size categories. Parallel risks (section 39 para 1 BWG) shall be considered and adequate attention shall be paid to limiting them.**

The items listed in sentence 2 are to be understood as examples. It is the credit institution's responsibility to specify towards which categories the risk strategy is to be oriented; this will depend on the business structure of the credit institution in particular. The segmentation criteria should have a logical and appropriate connection with the envisaged goals and core business areas.

When designing the risk strategy, macroeconomic aspects, in particular the economic situation, shall be adequately taken into account.

**14. When defining the risk strategy, the staff capacities necessary for its implementation as well as the technical and organisational facilities shall be taken into account.**

**15. The managers shall be responsible for the proper implementation of the risk strategy. They shall review and adapt the risk strategy annually, if necessary. The credit institution's supervisory body under company law shall be informed of the risk strategy and any amendments to it.**

"Supervisory body under company law" within the meaning of these Minimum Standards shall mean the supervisory board or the supervisory body competent under the law or the articles of association. This supervisory body shall be informed of the risk strategy and any amendments to it.

It is deemed appropriate to document the submission to the supervisory body under company law.

The annual review shall not affect the specification of the planning period of the risk strategy.

**16. The definition of the risk strategy and any amendments to it shall be documented in a verifiable manner and communicated within the credit institution in an appropriate manner.**

### ***3.3 New types of business transactions***

**17. Prior to taking up new types of business transactions – in new products, types of transaction or in new markets (including new distribution channels) – a corresponding plan shall be drawn up and put down in writing. The plan shall be based on the findings of the analysis of the risk level of these new types of business transactions and the resulting effects on the processes of lending and loan processing, on risk management and risk controlling as well as on the risk strategy.**

The credit institution shall be responsible for designing the plan, which shall follow the principle of proportionality, i.e. shall be dependent on the complexity and risk level of these new types of business transactions.

In the case of products which are composed of standard components, in the case of product modifications or the launch of existing products in new markets, the recommendations of chapter 3.3 need not be considered, provided that a considerable increase in risk is ruled out. As a rule, the recommendations laid down in this chapter do not apply to one-time transactions, unless this seems necessary in consideration of the associated risk level. If the new business is initiated and arranged by a third party, in particular by a central unit, and the credit institution is mainly involved in the distribution, parts of the recommendations laid down in this chapter may be met by the initiator. In this case, the recommendations laid down in the clause shall be met if the distributing credit institution has made sure that the initiator meets the recommendations. Parts of the recommendations may also be covered by a general product launch process, even such processes that are performed once per product in a group of credit institutions.

If new types of business transactions are launched in a market for test purposes, a simplified plan shall suffice due to the limited risk.

The recommendation concerning the drawing up of the plan does not refer to existing products in existing markets.

**18. The plan shall present the major effects associated with the taking up of business in terms of economics, staff, organisation, IT, accounting and law that are of considerable significance. When drawing up the plan, the key units shall be involved.**

The internal auditing unit may be included in the planning of new types of business transactions in the course of the project within the scope of its duties. In this context, reference should be made to the explanations on clauses 15 to 19 of the FMA Minimum Standards for Internal Auditing. "If the internal auditing unit's independence and ability to function (in particular also with regard to the available capacities) is guaranteed, it may as part of its duties, by way of an exception, perform consulting activities at the credit institution, in particular within the scope of project support. This shall be particularly admissible if the internal auditing unit is thus given the opportunity to show potential problems, threats and risks in advance. In this way it may avert risks, and it may also ensure that its own auditing interests are considered in the projects (such as matters of verification and traceability)."

Regarding new types of business transactions with respect to which there exists no experience as to the risks involved, due consideration shall be given to the security of third parties' moneys entrusted to the credit institution and the preservation of own funds, in particular when determining the scope of such transactions (section 39 para 1 BWG). Furthermore, administrative, accounting and control procedures shall be established to record and evaluate as far as possible the potential risks resulting from new business (section 39 para 2 BWG).

**19. The manager responsible for risk controlling has to approve the plan. The approval may be delegated in consideration of the risk level, provided that clear guidelines have been issued for this purpose and the managers are informed about the decisions.**

In the case of delegation, a corresponding reporting procedure shall be established. The product catalogue shall be presented to the managers.

## 4 Organisation

### 4.1 Internal guidelines

**20. The managers shall make sure that the credit business will only be carried out under framework conditions that are specifically laid down in internal guidelines.**

The internal guidelines shall be defined, for example, in credit manuals. In parts of decentralised sectors, manuals exist that have been drawn up centrally (e.g. organisation manuals (OHB)). If these manuals are in line with the recommendations of the FMA-MS-K and if they are actually employed, the recommendation is also met at the level of individual credit institutions.

**21. The internal guidelines shall be put down in writing, be written clearly and comprehensibly und communicated to the employees concerned as amended in an appropriate manner. The managers shall make sure that the internal guidelines are adapted annually, if necessary.**

Of course, the specific review as to whether the internal guidelines are up-to-date may

be delegated. The managers shall make sure that the need for updating is investigated on a regular basis and that proposals for updates are submitted.

**22. Taking into account the nature, scope, complexity and risk level of the credit business, the internal guidelines shall refer to the following areas in particular:**

- a. rules governing the assigning of tasks, the assignment of competencies and monitoring;**
- b. instructions and processing principles for the processes of lending, further processing of loans, monitoring of loan payouts, intensified handling and dealing with problem loans as well as risk provisioning;**
- c. instructions and processing principles for the processes of risk analysis and for risk classification procedures to assess the counterparty risk and, if necessary, the sectoral risk as well as the country risk and the specific risk associated with property/project financing;**
- d. creating, valuing, examining, administrating and liquidating collateral;**
- e. ongoing assessment of the exposures, particularly with regard to any necessary risk provisioning measures;**
- f. monitoring the timely submission and ensuring the timely evaluation of the documents required for the assessment of the counterparty risks plus the dunning procedure for missing documents;**
- g. handling of overdrafts and arrears along with the dunning procedure;**
- h. early identification, recording, representation, aggregation, planning, managing, limiting and monitoring of the counterparty risk and, if necessary, the sectoral risk as well as the country risk and the specific risk associated with property/project financing;**
- i. definitions regarding in what way and for what transactions alternative methods and simplified implementation measures (clause 3) may be used;**
- j. reporting;**
- k. IT processes.**

The appropriateness of the internal guidelines shall depend on the size and nature of the credit institution as well as on the nature, scope, complexity and risk level of its credit transactions in particular. The credit institution shall be responsible for the detailed design of the internal guidelines.

In decentralised sectors and groups of credit institutions, some of the tasks listed are partly handled by central units. Where the central definitions are in line with the recommendations of the FMA-MS-K and are adopted by the individual credit institution,

the present recommendation is also fulfilled at the level of individual credit institutions.

The question of which different risks shall be considered to what extent in lit. c and h depends on the size and nature of the credit institution as well as on the nature, scope, complexity and risk level of its credit transactions in particular.

## **4.2. Organisational structure**

### **4.2.1 Functional separation**

**23. The key principle for defining the processes in the credit business shall be a clear functional separation of the following units:**

- **Front office ("Markt"):** units that initiate transactions and have a vote in lending decisions.
- **Back office ("Marktfolge"):** units that do not belong to the front office and also have a vote in lending decisions that is independent of that of the front office unit.

There is a basic division into front office and back office. This functional separation aims particularly to further develop risk management, with its main focus lying on the avoidance of clashes of interests. Earnings-based interests should not push risk-based interests into the background; these two fields of interests should rather be of equal value and complement each other, which should result in unbiased lending decisions.

The functional separation is connected with the procedural and organisational principle of double voting in particular (clause 28). At this point, reference should be made to the exemptions from functional separation laid down in clause 31. Accordingly, the functional separation may be waived in units with low risk relevance. This means that in this case lending decisions may be taken exclusively on the basis of a vote belonging to the back office.

Risk controlling tasks (cf. chapter 6) should be executed by the back office and not by the front office. In the case of some large credit institutions, however, a division into three parts (front office, back office and risk controlling) may seem appropriate due to the complexity and risk level of the transactions against the backdrop of section 39 paras 1 and 2 BWG.

Alternative methods – as mentioned in clause 3 – may be possible with the functional separation as well.

Decisions involving the supervisory body under company law shall not affect this functional separation, i.e. the functional separation of the management should be taken into account with these decisions as well. The supervisory body's consent shall not be a substitute for the vote of the back office.

Especially in the case of decentralised sectors and groups of credit institutions, parts of the function of the back office may be performed by centrally organised credit risk control units that are established outside the credit institution, provided that the same purpose, namely avoiding clashes of interests, is achieved and the final responsibility for the lending decision remains with the managers.

The FMA takes the view that functional separation does not conflict with the binding requirements under company law.

The recommendation to separate functions shall not apply to units which are assigned to the joint management according to mandatory provisions under company law. Furthermore, the collective responsibility of the management under company law and the managers' comprehensive supervisory powers stipulated by company law shall not be affected either. The possibility of the entire management board to take charge of areas of responsibility at any time does not contradict the FMA-MS-K.

**24. The front office shall be separated from the back office in terms of organisational structure. The separation of the two units shall be taken into account in the case of representation as well.**

A regulation on representation within the meaning of this clause may be stipulated both at a horizontal and vertical level. It should be designed in such a way that the functional separation will be maintained in the case of representation as well. This should apply to any case of representation, not just for the first representative.

In connection with double voting, clause 30 should also be observed, according to which one manager may take a lending decision in certain cases.

The functional separation should be followed up to and including the level of managers. In consideration of the nature, size and core business areas of the credit institution, alternative methods may seem acceptable as long as the goal of avoiding clashes of interests at managerial level as well as strengthening risk control is achieved.

**25. In the case of computer-aided loan processing, functional separation shall be guaranteed through appropriate procedures and precautionary measures.**

**26. The following tasks shall be performed outside the front office:**

**a. responsibility for the development and quality of the processes and sub-processes of lending and loan processing (clause 39);**

**definition and the regular review of the criteria which govern the reclassification of exposures as requiring intensified handling or problem loan processing (clause 41);**

**c. definition of guidelines for risk analysis and monitoring adherence to them (clause 51);**

**d. assessment of certain collateral (clause 52);**

- e. responsibility for the development, quality and monitoring of the use of risk classification procedures (clause 56);
- f. responsibility for the restructuring or recovery procedure or the monitoring of these procedures (clause 68);
- g. preparing the decision on the amount of risk provisioning or write-downs for certain exposures (clause 72);
- h. risk controlling tasks (clause 75), in particular drawing up the risk report (clause 87).

Assigning certain tasks to a unit that is independent from the front office, for example, the responsibility for the development of certain processes, the drawing up of guidelines or the development of criteria, shall not affect the responsibility and any existing decision-making powers of the joint management. This rather refers to the possibility to create "departmental competencies" as established under stock corporation law.

The fact that certain tasks are executed outside the front office does not mean that all of them have to be assigned to the back office. A tripartition (front office, back office and risk controlling) is also possible and sometimes advisable (cf. clause 23 above).

Furthermore, tasks that have so far been performed by the internal auditing unit such as the drawing up of guidelines and quality assurance may remain with this organisational unit, provided that the internal auditing unit is sufficiently separated from the front office. The doubling of the control structures should not be necessary.

Outside the recommendation listed in clause 26 for assigning tasks, there is plenty of leeway for assignment to a certain unit.

In decentralised sectors and groups of credit institutions, some of the tasks listed in clause 26 are partly handled by central units. If in the central units the responsibility also lies outside the front office, it may be assumed that the present recommendation is met.

The recommendation of such assignment of tasks shall not rule out the inclusion of front office know-how in the processes in an appropriate manner.

It shall be noted that an expert body from outside the front office should participate in the review of credit documents pursuant to clause 35.

**27. In the case of trading transactions, the vote of the front office may be exercised by the traders in the course of setting counterparty limits; in this case, the proper review of the counterparty risks shall be ensured as well. The same shall apply to the setting of issuer limits for trading transactions.**

When dealing with counterparty and issuer limits, it shall be ensured that the limits from the credit and trading units are properly combined for a total limit. All types of trading positions and participating interests – both strategic interests and participating interests substituting for loans – shall be included; external ratings may also be used.

Conversely, the vote of the trading unit shall not be exercised by the back office.

#### 4.2.2 Voting

##### **28. In general, a lending decision shall require a consenting vote both from the front office and the back office.**

As in the case of functional separation, the main target here is to avoid any clashes of interests and to strengthen the quality of the lending decision through a standardised inclusion of risk aspects.

The term "in general" implies that exemptions are possible (cf. clauses 30 and 31 in particular).

The term "vote" means a consenting or rejecting comment on a credit application after proper processing that serves as preparation for a lending decision. The vote itself does not constitute the lending decision but a preparatory action for the same. In this context, the competence to decide on a loan may deviate from the competence to vote. The credit institution alone is in the position to define the competencies. For example, the mere fact that the front office has initiated the business may be deemed its affirmative vote.

The vote of the back office should be based both on a borrower-related and an overall business assessment of the credit application.

The assignment of a rating by a unit independent from the front office employing a procedure or system that has been both developed by a unit independent from the front office and is independent from the front office when the rating is assigned, may itself constitute the vote of the back office if it is also ensured that the overall business risks in connection with the specific credit application have been assessed outside the front office.

If the decisions are taken by several persons (e.g. a credit committee), the majority ratio within a committee shall be defined in such a way that the back office cannot be outvoted.

Any further-reaching provisions on adopting resolutions, for example, pursuant to the *Aktiengesetz* (AktG; Stock Corporation Act), *Gesetz über Gesellschaften mit beschränkter Haftung* (GmbHG; Act on Limited Liability Companies), *Genossenschaftsgesetz* (GenG; Cooperative Association Law), the BWG and the articles of association shall remain unaffected. This concerns particularly the four-eye principle established by law in section 5 para 1 no. 12 BWG: pursuant to this, the articles of association shall prohibit individual power of representation or individual *Prokura* (full power of commercial representation within the meaning of § 48 Commercial Code) or individual commercial power of attorney for the entire business operation and, as concerns credit cooperatives, the management of the business shall be limited to the managers.

**29. If the votes differ, clear decision-making rules shall be defined: in these cases, the loan shall either be rejected or forwarded to a higher decision-making level for a decision (escalation procedure).**

If no agreement can be reached at managerial level, the lending decision shall be negative. The FMA-MS-K do not stipulate an escalation to the supervisory body under company law; however, this may be specified by the credit institution itself.

**30. Every manager may take lending decisions independently within the scope of his/her individual decision-making powers. However, above certain limits (cf. clause 31), s/he shall have to ask for the vote of the respective other unit. If the lending decision differs from the vote of the other unit or if it has been taken by a manager who is not responsible for the front office, this decision shall be documented in the risk report (cf. clause 89 lit. g).**

In this case, a negative vote need not necessarily have the consequence of not reaching a lending decision but a note will be made in the risk report stating that a negative vote exists. However, in these cases it is also necessary that the loan is properly processed and two votes are obtained, and it shall be possible to obtain the second vote only after the lending decision was taken. Thus, the four-eye principle is also maintained in these cases, although a dissenting vote cannot prevent the lending decision.

**31. The managers can decide that only one vote shall be required for lending decisions concerning certain types of transaction or credit transactions not exceeding a certain amount, which shall both be defined in accordance with their risk levels. These definitions shall be explained in the internal guidelines. In this respect, the separation of the organisational structure between front office and back office shall only be relevant for those types of transaction and credit transactions where two votes are required. In the case of transactions that are initiated by third parties it may be specified that the vote of the front office shall not be necessary.**

The standardised retail banking business (consumer credit business, retail-customer credit business, home loans in combination with the amount of exposure) may serve as a typical example of a business segment that, as a rule, has a lower risk relevance. However, other transactions may also be considered; this shall not least depend on the business structure of the credit institution. Moreover, the amount of the exposures – in connection with the risk classification, if applicable – may be used as a limit; in this context, the quantitative definition will depend on the distribution according to size categories, in particular. The respective definitions shall be at the discretion of the credit institutions and shall be explained in the internal guidelines.

The four-eye principle customary in banking should be applied below the limit for double voting. It may also be ensured by precautionary measures embedded in the computer system.

The vote in cases below the limit mentioned in clause 31 may be exercised by the front

office or the back office. The functional separation as stipulated in clause 23 ff may be waived in units with low risk relevance. This means that in this case lending decisions may be taken exclusively on the basis of a vote belonging to the back office.

The facilitation mentioned in clause 31 shall primarily serve to protect existing business models. Newly created business models, however, should be integrated in the suggested organisational structure and procedure.

### ***4.3 Staff***

**32. The employees entrusted with the individual processes of the credit business as well as their deputies shall have the necessary expertise for assessing the risks of credit transactions. Suitable training and education programmes shall ensure that their level of qualification is state-of-the-art. Suitable measures, especially rules on substitution, shall be taken to make provisions for unforeseeable shortages of staff. The structuring of the remuneration and incentive systems shall not contradict the goals set forth in the FMA-MS-K, in particular the goal of avoiding clashes of interests.**

### ***4.4 Technical and organisational facilities***

**33. The efficiency of the technical and organisational facilities, in particular the IT systems, shall be appropriate for the nature, scope, complexity and risk level of the transactions. The functioning of the IT systems, IT and computer processes, databases and contingency plans as well as the quality of the data contained in these databases shall be reviewed on a regular basis and suitable measures shall be taken to ensure this functional viability.**

In decentralised sectors and in groups of credit institutions, some centrally designed procedures and systems (sector solutions and group solutions) exist that are partly provided by computer centres. If these procedures and systems are in line with the recommendations of the FMA-MS-K and if they are actually employed, the recommendation is also met at the level of individual credit institutions.

**34. A written contingency plan shall make sure, among other things, that backup solutions are available and can be used in a timely manner if the technical and organisational facilities necessary for performing the credit business fail, including errors in the applied software.**

## **4.5 Documentation**

**35. The credit institution shall use standardised credit documents as far as this is possible and appropriate with regard to the respective types of business; the design of the credit documents shall depend on the nature, scope, complexity and risk level of the transactions. The credit documents shall also be reviewed by an expert body outside the front office.**

This refers to the forms and basic documentation. The term "review" means a legal review in particular.

**36. The credit documents necessary for the initial and ongoing evaluation of the transactions shall be written systematically and in a way that is easily verifiable by third-party experts and kept in accordance with the documentation requirements. It shall be ensured that the documents are kept up-to-date and complete.**

The parameters used for the lending decision in particular shall be documented in a manner verifiable at every decision-making level. Documentation requirements shall mean the documentation requirements according to banking law as well as commercial and tax law in particular.

**37. Collateral, evidence of collateral and documents shall be kept in such a way that protects them adequately against misuse and destruction.**

38. The major actions and definitions made when implementing the recommendations laid down in these FMA Minimum Standards shall be documented systematically and in a manner that is traceable for third-party experts.

## **5 Lending and loan processing**

### **5.1 General**

**39. The processes for lending and loan processing as well as the related tasks, competencies and responsibilities shall be clearly defined and co-ordinated. The responsibility for the development and quality of these processes and sub-processes shall lie outside the front office.**

For the assessment of counterparty risks, including country risks, external sources may also be used.

In the case of non-standardised business processes or high-risk exposures it is particularly important to create various scenarios. In the case of standardised business processes, especially in the standardised retail banking business, the creation of various scenarios shall not be required. "Various scenarios" shall include, in particular,

worst-case scenarios.

**40. The internal guidelines contain different processing principles structured by types of transaction, the borrowers' creditworthiness and also by limits (lending amount, borrower's limit, limit of a group of affiliated customers).**

The types of transaction, for example, may be differentiated by consumer loans, investment financing, property development financing, property/project financing, participating interests substituting for loans etc.

**41. The definition and the regular review of the criteria which govern the reclassification of exposures as requiring intensified handling or problem loan processing must lie outside the front office.**

Front office know-how may contribute to the definitions in an appropriate manner.

**42. The decision-making hierarchy shall define the criteria for assigning the decision on an exposure to a certain decision-making level.**

The criteria for assigning the decision to a certain decision-making level may include, for example, the risk classification or the amount and collateral of the credit transaction to be approved.

**43. Where acceptable in terms of risk, the recommendations laid down in chapter 5 may be implemented in simplified fashion for overdrafts and extensions on the basis of clear rules issued by management.**

These facilitations shall only be taken advantage of if they seem acceptable in terms of risk. Overdrafts in particular can be a warning sign for the credit institution, and in such case it is strongly recommended to take restricted advantage of the simplification.

## ***5.2 Lending***

**44. The lending process encompasses all steps of required operations up to the provision of the loan, the fulfilment of the contract or the establishment of a line of credit. All major criteria for assessing the counterparty risk will be adequately analysed as to their risks.**

**45. Contractual agreements shall be concluded on the basis of legally validated and correct documentation. Legally validated standard texts that are constantly updated shall be used for each loan agreement. Where a deviation from the standard texts is necessary for credit transactions, which are defined by their nature, complexity and risk level, for example in the case of customised agreements, a review shall be conducted by an expert body prior to signing the agreement.**

Contrary to clause 35, this refers to individual loan agreements. The expert body shall have the required expertise for assessing the risk associated with the deviation from the

standard text. Detailed legal knowledge and knowledge of the internal guidelines and procedures as well as the ability to assess risks for the credit institution are a prerequisite. The expert body can be, for example, the legal department of the credit institution or an external body (e.g. a lawyer).

## **5.3 Risk analysis**

### **5.3.1 Evaluating creditworthiness and collateral**

**46. An adequate risk analysis of the qualitative and quantitative aspects significant for the counterparty risk of a credit transaction shall be carried out, with its level of detail depending on the nature, scope, complexity and risk level of the exposure. High-risk features of the exposure shall be highlighted and, if necessary, displayed under the presumption of various scenarios. The documents used for the assessment shall be reviewed by the employees responsible for the assessment.**

Methods of analysing risk can be, for example: credit assessment (assessment of creditworthiness), risk classification or an assessment based on a simplified procedure (e.g. scoring procedure). The selection of the suitable and adequate method shall depend on the risk level of the exposure. Different scenarios shall mainly be created in the event of high-risk exposures.

In the case of subsidised loans and loans extended by building societies, specific characteristics resulting from the subsidy shall be taken into account. If terms are altered at a later stage – in particular those of consumer loans – the requirements pertaining to consumer protection, which, of course, remain unaffected by these FMA Minimum Standards, shall be considered.

In the case of property/project financing, the risk analysis shall ensure that not only the economic aspects but also, and in particular, the technical feasibility, the construction progress as well as the use of funds are examined and the legal risks associated with the property/project are assessed. The economic aspects can include the following: project analysis, financing structure, capital ratio, possibility of liquidation, collateral assessment and calculation. With respect to technical feasibility, third-party expert opinions may be obtained, and for assessing the construction progress, the stages of construction can be inspected and/or monitored.

**47. If necessary, the sectoral and country risks will also be assessed on the basis of adequate quantitative and qualitative analyses in particular.**

**48. The value and enforceability of collateral shall generally be assessed before a lending decision is made. Existing information on collateral values may be used if there is no indication of changes in value.**

An automatic update of collateral values without an explicit review shall not be considered sufficient.

**49. If the value of collateral depends significantly on the financial situation of a third party, the creditworthiness of the third party shall be reviewed.**

The value of collateral depends on a third party especially in the case of a guarantee, a letter of comfort or a collateral promise.

The present recommendation should be followed in particular if the collateral is recognised with regard to the regulatory provisions.

**50. If external bodies are consulted for the risk analysis, they shall have the required expertise.**

**51. Depending on the nature, scope, complexity and risk level of the credit transactions, different internal guidelines shall be defined for the risk analysis. The responsibility for defining guidelines and monitoring their adherence shall lie outside the front office.**

**52. The types of collateral accepted by the bank and the methods and systems of calculating the value of each type shall be set out clearly in the internal guidelines. The assessment of certain collateral which has been specified with regard to the risk situation of the credit institution shall not be carried out by the front office.**

The criteria for determining the risk level of collateral can be, for example: amount of coverage, legal enforceability, possibility of liquidation.

Here, sectoral methods and systems can also be applied. If they are in line with the recommendations of the FMA-MS-K and if they are actually employed, the recommendation is also met at the level of individual credit institutions.

Outside the front office, at least a material plausibility test should be carried out.

**53. The risk analysis results shall principally be taken into account when defining terms and conditions.**

### **5.3.2 Risk classification procedures**

**54. The credit institution shall establish meaningful risk classification procedures for the initial, regular or ad-hoc assessment of counterparty risk and the assignment to a risk class. The internal guidelines shall define criteria which ensure that - in the course of their assessment - risks are logically assigned to a risk class.**

Principally, the credit institutions should establish risk classification procedures for all transactions entailing a counterparty risk. These include IRB procedures but, of course, also simplified procedures, such as scoring-based models, for credit institutions that apply the standardised approach.

It needs to be pointed out that section 2 para 2 no. 4 of the

*Großkreditmeldungsverordnung* (GKMVO; large exposure reporting regulation) advises credit institutions to provide for an internal rating of the creditworthiness of large-amount borrowers.

If sectoral procedures are in line with the recommendations of the FMA-MS-K and if they are actually employed, the recommendation is also met at the level of individual credit institutions.

If the low risk level of certain credit transactions or types of transaction does not seem to justify the risk classification procedure, such transactions can be disregarded for that procedure.

The information value of the results of the risk classification procedure shall be adequately taken into account in the lending decision.

With regard to the regular assessment of the counterparty risk, reference shall be made to clause 60: it stipulates that such a risk analysis shall be performed at least once a year with each borrower.

**55. It shall be ensured that any sectoral and country risks as well as specific risks of property/project financing are adequately assessed in the course of the risk classification procedures.**

**56. The responsibility for the development, quality and monitoring of risk classification procedures shall lie outside the front office.**

**57. The key indicators for determining counterparty risk in the risk classification procedure must include not only quantitative criteria but, wherever possible, qualitative criteria (soft facts).**

In addition to quantitative assessment there is also purely qualitative assessment – in particular in the case of expert ratings – where quantitative criteria are factored in on a case-by-case basis only. Such cases shall be adequately taken into account in the risk classification procedure.

**58. The risk classification procedures shall be incorporated especially into the lending procedures and loan processing. The internal guidelines shall define how this is to be done.**

In the initial stage in particular, it shall be considered that the risk classification procedure may still have some weaknesses. This fact shall be adequately taken into account in lending and loan processing.

#### ***5.4 Further processing of loans***

**59. The further processing of loans is intended to monitor whether the borrower is fulfilling the terms of the contract. In the case of special-purpose loans, the institution shall monitor whether the funds made available are being used as**

**agreed (monitoring the loan purpose).**

The earmarking of the funds made available shall be assumed in particular if the borrower is liable under a contract to use them for a specific purpose, e.g. in the case of subsidised loans or property/project financing, and in those cases where they are used for items that also represent collateral for the exposure.

**60. At least once a year, the counterparty risk of each borrower shall be adequately analysed, with the level of detail of this analysis depending on the risk level of the exposure.**

In business sections with a low risk level, for example the standardised retail banking business (consumer credit business, retail-customer credit business, home loans in combination with the amount of exposure), the annual risk analysis can be limited to examining the proper servicing, any overdraft lists and, if necessary, the proper assignment to a risk class, provided that there are no indications of a deterioration of creditworthiness which seem to warrant a more detailed risk analysis. In such cases, it should be documented that an appropriate procedure has been installed and the appropriate reviews have been performed.

The risk analysis of risky exposures should include a case-by-case documentation of the compliance with the corresponding guidelines for analysis.

**61. The value of collateral shall be examined at suitable intervals during the further processing of loans. The schedule for examining the individual types of collateral shall be defined in the internal guidelines.**

The present recommendation should be followed in particular if the collateral is recognised with regard to the regulatory provisions.

**62. Ad-hoc risk analyses of exposures, including collateral, shall be conducted immediately whenever the credit institution receives information from internal or external sources which indicate a substantial adverse change in the risk assessment of the exposures or the collateral.**

**63. The timely presentation of the documents required to assess the counterparty risk shall be monitored and their evaluation in a timely manner shall be ensured. A dunning procedure shall be instituted for documents that have not been submitted.**

### ***5.5 Monitoring loan payouts***

**64. For loan processing, control measures shall be established to ensure that the prerequisites for payouts are met. It shall particularly be checked whether the specified decision-making hierarchy has been adhered to and whether the requirements and/or conditions set forth in the loan agreement were met before payout.**

The loan payouts can be monitored by employing the customary four-eye principle. There is no need to establish a separate functional unit.

The results of the loan payout monitoring shall be documented.

## ***5.6 Intensified handling***

**65. Intensified handling shall mean in particular that special attention shall be paid to credit transactions whose risk assessment has changed for the worse due to specific reasons but which should not yet be considered bad loans. The internal guidelines shall include criteria which specify in what event an exposure shall be given special attention with respect to the risk level.**

This recommendation aims at establishing a standardised process. Criteria for the transfer from ordinary to intensified handling could be, for example:

- overdrafts or unpaid instalments (exceeding a certain number of days)
- signs of a deterioration of creditworthiness, in particular a deterioration of ratings;
- hesitant submission of accounting documents and/or false and incomplete data;
- bill or cheque protests;
- damaging event on the borrower's side with substantial repercussions.

In the course of a risk classification procedure, the exposure can be transferred to intensified handling, provided that the relevant functionality has been implemented in the risk classification procedure.

**66. Exposures under intensified handling shall be reviewed according to a schedule and a procedure defined in the internal guidelines to determine what further treatment they require: further intensified handling, return to ordinary handling, transfer to or consultation of the department dealing with problem loans.**

In standardised retail banking business, "intensified handling" can also mean a certain procedure or system where a dunning procedure is initiated in the case of delayed instalments. The loan will then be transferred to the department dealing with problem loans, if the dunning procedure does not result in the corresponding payments.

## ***5.7 Dealing with problem loans***

**67. The internal guidelines shall define the criteria which govern the transfer of bad exposures to the employees, departments or external experts specialising in restructuring or recovering them or the event when they should be consulted**

**(dealing with problem loans).**

It needs to be pointed out that the credit institution may also choose to assign the restructuring and recovery work to external experts. However, the credit institution shall have the expertise to assess the work of external experts with regard to their plausibility.

The credit institution shall define the criteria for the transfer to the employees, departments or external experts specialising in restructuring or recovering exposures; this can be done by means of a risk classification procedure, provided that the relevant functionality has been included in the risk classification procedure. Existing and future definitions of default are of help but other criteria may also be used as long as they seem plausible.

**68. The responsibility for the restructuring or recovery procedure or the monitoring of these procedures shall not lie with the front office.**

Regardless of the risk level, lending decisions with regard to dealing with problem loans may only be taken with the vote of the back office, provided this had been specified beforehand by the credit institution.

**69. If, after a thorough examination, the credit institution decides to restructure the exposure, the parties involved in the restructuring shall develop and implement a restructuring strategy. The implementation of the restructuring strategy and the effects of the measures shall be monitored.**

The FMA-MS-K neither affect the credit institution's decision as to whether the exposure shall be restructured or recovered, nor the decision with whom to co-operate at the restructuring or recovery stage.

The term "restructuring strategy" denotes a strategy to restructure the exposure. The credit institution shall follow the principle of proportionality when deciding whether such a strategy should be developed.

**70. In the case of certain problem loans, which are defined according to their risk level, the managers shall be informed regularly on the status of the restructuring or recovery process.**

**71. If an exposure is to be recovered, the credit institution or external experts, depending on the amount and risk level of the exposure and on the complexity of the recovery process, shall develop a recovery strategy.**

Low-risk transactions, for example in the standardised retail banking business, usually do not require the development of a specific recovery strategy for exposures.

The credit institution shall follow the principle of proportionality when deciding whether a recovery strategy should be developed.

For highly standardised business sections, such as the standardised retail banking business, a generally applicable recovery procedure shall be specified. As a rule, it should not be necessary to develop a customised recovery strategy for individual cases.

## **5.8 Risk provisioning**

**72. The internal guidelines shall define objective and logical criteria which indicate the need for risk provisioning, i.e. valuation allowances and provisions, or the need for write-downs for the credit transaction, taking into account the applicable legal provisions, in particular the accounting standards. The responsibility for preparing the decision on the amount of risk provisioning or write-downs for credit transactions exceeding certain amounts, which shall be defined according to their risk level, shall not lie with the front office.**

The credit institution shall define the indicators for a need for provisioning or write-downs on its own account. Existing and future definitions of default can be such indicators, but other criteria may also be used as long as they seem plausible. The definition of the indicators shall exclusively serve to create transparency within the institution and affects in no way disclosure or reporting obligations.

In order to support this functionality, for example, a valuation method for receivables within the credit institution can be considered.

The managers shall be responsible for regularly deciding whether risk provisioning or write-downs shall be recognised and for specifying their amount. The responsibility for preparing this decision shall not lie with the front office, if the amounts exceed certain limits that have been defined according to their risk level. The limits, which depend on the risk level, shall be defined by the credit institutions, taking into account the plausibility of the specified limits. Either a percentage or a nominal value may be defined, based on the total debt or the risk provision or write-down to be recognised.

**73. The necessary risk provisioning or write-downs and the need for them shall be calculated and updated in a timely manner.**

In this context, "update" does not mean "enter". Entries depend on the valid accounting standards, which, of course, remain unaffected by these provisions. "Updating" means that risk provisioning and write-downs and the need for them shall be kept up-to-date and logical and shall build on the previous periods, i.e. be "updated".

**74. The managers shall be notified immediately if there is a substantial need for risk provisioning or write-downs. Internal guidelines shall be defined for such a situation.**

## **6 Risk management and risk controlling**

### **6.1 General**

**75. In accordance with the nature, scope, complexity and risk level of the transactions, an early-warning system, a risk management and risk controlling system or procedure as well as a corresponding reporting system shall be**

**established. The risk controlling tasks shall not be executed by the front office. The execution of these tasks shall be a routine and standardised procedure.**

"Systems" shall mean automated, in particular computerised procedures, whereas "procedures" are standardised but not necessarily automated processes, which are defined by procedural and organisational measures, especially by ensuring compliance with internal guidelines and handling principles. In both instances it is important that the tasks mentioned shall be routine and standardised procedures.

**76. The systems and procedures shall ensure that substantial risks in credit business are detected early, reported, described, aggregated, planned, managed, limited and monitored. They also guarantee permanent risk monitoring at portfolio level. In particular, they shall ensure that risk is balanced and compatible with the risk strategy.**

**77. Risk-relevant information shall be forwarded immediately to the decision makers specified in the decision-making hierarchy in order to enable the earliest possible initiation of adequate counter-measures.**

**78. The systems and procedures shall be adjusted to changing circumstances.**

## ***6.2 Early-warning procedure***

**79. The purpose of the procedure for early detection of risks is to identify undesirable developments with respect to borrower-related and overall business risks at an early stage. This should enable the credit institution to take countermeasures as early as possible. To this end, the credit institution shall develop strong indicators for early risk detection. The managers can decide that certain business and credit transactions below certain amounts, which shall both be defined according to their risk level in the internal guidelines, shall be exempted from the procedure for early detection of risks.**

The credit institution can select the procedure. To a certain extent, this subject may also be covered by intra-sectoral quality assurance measures, provided that they include an early-warning functionality.

The credit institution shall define the criteria for the early-warning procedure; this can be done by employing a risk classification procedure, provided that the relevant functionality has been implemented in the risk classification procedure.

Contrary to the regular risk analysis mentioned in clause 60, which takes place at certain dates, the borrower-related early-warning procedure consists of constant monitoring, with the focus on identifying risk assessment changes for the worse between the regular risk analysis dates.

Low-risk types of transaction and credit transactions may be exempted. The credit institutions shall specify the risk level on their own account.

### **6.3 Risk management and risk limitation**

**80. The managers shall take adequate measures to ensure that risks related to borrowers as well as to the overall credit business can be managed and limited.**

In the case of borrower-related risks, the creditworthiness of the borrower or third parties and the value and enforceability of collateral shall be taken into account in particular.

The following risks can especially be considered related to the overall business: sectoral risk, distribution of exposures by size categories and risk categories, and, where applicable, country risk and other parallel risks.

Those can especially be limited by implementing an adequate limiting system. However, other procedures can also be considered.

**81. The measures to limit the borrower-related and overall business risks shall be structured in accordance with the credit institution's risk-bearing capacity. The managers shall examine the interrelation between these measures and the risk-bearing capacity with regard to the risk strategy at appropriate intervals but at least once a year.**

**82. No lending transaction shall be concluded without a lending decision. In this context, a lending decision shall also mean the definition of a borrower-related limit (lending amount, borrower's limit, limit of a group of affiliated customers).**

In the case of personal loans, defining a borrower-related limit shall correspond to extending the loan or setting an overdraft limit.

As a rule, the limits will only be combined if amounts to be specified by the credit institution are exceeded, however, in all cases of amounts exceeding the limit for large exposures (section 27 BWG).

This recommendation does not mean that overdrafts are not allowed but that overdrawing a limit is based on a lending decision of the credit institution (cf. also clause 84 below).

Automated lending decisions or limit specifications, particularly if made by means of a risk classification procedure, can also follow this recommendation.

"Limits" do not only comprise external but also internal limitations which are unknown to the borrower.

**83. All transactions shall immediately count against the borrower-related limits. Depending on the credit transactions' risk level, adherence to the borrower-related limits shall be constantly monitored.**

**84. The credit institution shall establish a procedure which defines how to handle overdrafts and unpaid instalments, which measures to take and how to carry out**

## **dunning procedures.**

"Procedures" shall include standardised processes that are not necessarily automated but can also be defined by procedural and organisational measures, especially by ensuring compliance with internal guidelines and processing principles. In both instances it is important that the tasks mentioned shall be routine and standardised procedures.

An overdraft is the exceeding of an allowed limit and requires a lending decision.

**85. If no limits have been set for issuers in the trading unit, issuer limits can be defined at short notice for trading purposes on the basis of clear rules issued by the managers, without performing in advance the entire relevant handling procedure defined in the light of risk aspects in the internal guidelines. The relevant handling procedure shall be performed after three months at the latest.**

It needs to be pointed out that the procedure set forth in this clause shall not violate the provision under section 27 BWG regarding large exposures. "Clear rules issued by the managers" shall mean so-called matrix procedures in particular. The three-month period mentioned refers to the maximum holding period for these short-term procedures. If the holding period is longer, the corresponding process steps shall be carried out. Furthermore, it needs to be pointed out that defining issuer limits at short notice may involve great risks. The rules issued by the managers shall pay special attention to such risks.

**86. In addition, adequate measures shall ensure that overall business risks are managed and monitored.**

Limit systems can be such adequate measures, but other procedures may also be considered.

## **6.4 Reporting**

### **6.4.1 Risk report**

**87. A unit which is independent of the front office shall – depending on the risk situation in credit business – draw up regular, but at least quarterly, risk reports which contain the most important structural features of credit business; group risk reports shall be drawn up at least twice a year. This report shall be made available to the managers. The managers shall forward the report to the supervisory body under company law. The risk report to the supervisory body under company law may be abridged and condensed but must not omit any major risks.**

There is a certain correlation between clause 87 and the credit institution's risk strategy (clause 12 ff.): the risk report in particular provides the managers with feedback if and to what extent the risk strategy has been pursued. This enables the managers to take countermeasures to pursue the risk strategy or to adjust the risk strategy at an early

stage.

**88. The risk report shall be drawn up in a systematic, clear and meaningful manner and shall contain both a description and an assessment of the risk situation. The managers shall certify that they have read and acknowledged the report. The measures required and initiated on the basis of this report shall be documented clearly and verifiably.**

**89. Taking into account the nature, scope, complexity and risk level of the credit transactions as well as the type and size of the credit institution and its core business areas, the risk report shall contain the following overall business and borrower-related information, including, if necessary, a commentary on the relevant issues:**

- a. development of the entire credit portfolio, structured by major risk-relevant structural features, for example by sectors, countries, asset classes, risk classes and size categories;**
- b. development of the extent of the limits granted and information on whether they are utilised;**
- c. development of uncollateralised portions, structured by risk classes;**
- d. development of new types of business transactions;**
- e. development of risk provisioning and the need for risk provisioning, or write-downs and the need for write-downs;**
- f. individual exposures as well as overdrafts (extent, number of days) with significant risk level and their collateral;**
- g. lending decisions taken by managers acting within their individual competence, provided that they are different from votes of the relevant other unit (front office or back office) or if they were taken by a manager not responsible for the front office.**

Principally, it shall be noted that the existing reporting procedures were taken into account and that care was taken to keep the content of internal and external reports as similar as possible. Therefore, with regard to clause 89, the same definitions as commonly used in reporting can be used. Some clauses, however, are slightly different, as the purpose of internal and external reporting is different.

The credit institution shall be responsible for determining the risk report's level of detail. The nature, scope, complexity and risk level of the credit transactions as well as the type and size of the credit institution and its core business areas should be taken into account.

In the case of clauses that refer to the "development", at least the three previous periods should be included.

The utilisation of limits mentioned under lit. b shall refer, first and foremost, to overall

business-related limits (in particular at portfolio and sub-portfolio level), which were defined by the credit institution within the framework of a limit system or other portfolio management measures.

"New types of business transactions" under lit. d shall mean credit transactions within the meaning of clause 17.

With regard to lit. e, it needs to be mentioned that "risk provisioning" shall mean entered risk provisions, and "need for risk provisioning" shall mean risk provisions not yet entered; these risk provisions need to be recognised by the credit institution in line with the criteria defined in clause 72. The same shall apply to write-downs and the need for write-downs.

For documentation purposes, individual exposures and overdrafts should be included in the report even if there have been no changes over the previous period. Such a report may be abridged and shall include a reference to the last previous period where changes had occurred.

With regard to individual exposures with significant risk level as mentioned under lit. f, reference shall be made to the relevant explanations under clause 3.

"Lending decisions" as mentioned under lit. g shall only mean positive lending decisions.

## **6.4.2 Ad-hoc reporting**

**90. The managers and the decision-makers involved shall be immediately notified of events which have a high risk level for the credit institution. The report shall be documented.**

The following events can be considered high-risk, for example: development of problem loans and loans under intensified handling, substantial exceeding of limits or deterioration of creditworthiness of individual exposures with significant risk level, significant need for risk provisioning or write-downs, signs of organisational deficiencies or deficiencies with the processes, applied systems and procedures and resulting damage.

## ***6.5 Dealing with organisational deficiencies***

**91. If organisational deficiencies or deficiencies within processes occur, their causes shall be analysed, relevant conclusions drawn and any required measures shall be implemented immediately. Damage resulting from organisational or process deficiencies shall be adequately documented.**

The credit institution shall assign this task to an organisational unit of its choosing. It may be assigned to the internal auditing unit.

## **7 Implementation**

**92. The credit institutions are advised to adhere to the FMA-MS-K, as soon as Austria's implementation rules for Basel II have come into force. One year after this date, the FMA-MS-K will be evaluated. The evaluation will, among other things, focus on the 30-million-euro limit mentioned in clause 5.**