

# FACTS AND FIGURES TRENDS **2019** AND STRATEGIES



# **FACTS AND FIGURES, TRENDS AND STRATEGIES 2019**

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FMA Executive Board

# FMA EXECUTIVE BOARD: STRATEGY FOR 2019–2024

It is now ten years since US investment bank Lehman Brothers collapsed, triggering the global financial crisis. This anniversary prompted intensive debate in 2018 during many rounds of talks, conference presentations and symposia, as well as in international committees. What were the true causes of the crisis and have we learned the lessons of 2008?

**W** We too have frequently addressed these questions, in both national and international forums, with experts from nearly every discipline, with practitioners who found themselves tackling the crisis head on, and with analysts who have drawn their own conclusions with the benefit of hindsight. Surprisingly, nearly everyone we have spoken to basically agrees on one thing, namely that we have essentially learned the right lessons. However, opinion is somewhat more divided when it comes to how well we have done in implementing these lessons. For our part, we firmly believe that the huge package of reforms has been successful.

### **THE LESSONS LEARNED FROM THE CRISIS**

Regulators and supervisors are cooperating with one another effectively across Europe. In this way we are able to engage closely with the financial industry on the European market. This is a market that has no borders, serves more than 510 million customers, and stretches from the Arctic to the Mediterranean. With the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB), we now have a common institutional framework for all of the Member States in the EU. As far as the eurozone is concerned, we have gone a step further still and are building the banking union with its three strong pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Board (SRB) and the common European Deposit Insurance Scheme (EDIS). The first two pillars are already firmly in place and have withstood their first impact tests. The third pillar, the EDIS, is still a work in progress, although the pots have already been filled. No firm date has been set for their “Europeanisation”, but this will also take place soon.

The fact that a common European supervisory architecture for all of the Member States has emerged from nothing in the space of just a few years, along with the establishment of a banking union in the eurozone, is a huge achievement. We now have strong and credible regulatory and supervisory institutions in Europe.

What we have also done is analyse, evaluate and revise all of the European rules in the wake of the financial crisis. With Basel III for the banking sector and Solvency II for insurance activity, we have established new solvency, capital and supervisory regimes. We have fundamentally overhauled and further harmonised the rules governing trade in listed securities and, through MiFID II, the PRIIPs Regulation and IDD, have created the basis for transparency and for fair and comparable information with regard to the distribution of financial instruments, thereby vastly improving protection for consumers and investors. And these are just the most prominent examples.

We have also taken consistent action to close regulatory loopholes. To take just some examples from regulatory and supervisory practice:

- It took months at the time of the financial crisis to determine the volume of credit default swaps (CDS) based on Greek bonds on the market, to find out who the major providers were and to ascertain who was actually exposed to the risk. Today, the derivatives sector is closely regulated, covered by institutions, and transparent. This information is now available at the click of a button.
- At the height of the financial market crisis, some financially strong players attempted to exploit the turbulence to make a lot of money. By engaging in naked short selling, they simply added fuel to the fire. At the time, this short selling could only be tackled at a national level with short-term and creative ad-hoc measures. Today, we have a uniform regulatory framework in Europe for short selling.
- Before the crisis, excessive bonus systems created inappropriate incentives, pushing managers to relax their internal control systems and to take on excessive risks. We now have regulations in place to avoid this type of incentivisation with remuneration systems geared towards sustainability.

The creation of this new European institutional framework, the updating of the existing rules and the closing of regulatory loopholes have all been aimed at making operators on the market more resilient to crisis, creating a level playing field for all and making huge improvements to the protection of consumers, investors and savers.

The FMA, in its capacity as an integrated supervisory body that brings the entire financial market under one roof, has been and remains perfectly placed to embrace the major challenges of breathing life into this reform project. We have consistently implemented and applied an integrated approach to supervision. We have leveraged synergies and worked to become even more efficient and effective.

We have, however, also worked hard to ensure that Austrian financial service providers learn the right lessons from the crisis. We have worked together to analyse business models in depth, to question organisational structures and risk management, to simulate crises in the form of stress tests, to identify areas of weakness and to address these consistently. And we have been successful! Today, Austrian financial service providers are more resilient than they ever were before the crisis.

Allow us to provide a rough comparison of Austrian banks' key figures before the crisis, in other words from late 2007, with the same key figures ten years later.

While the total assets of Austrian banks have shrunk by around 12% from € 1 074 billion to € 949 billion, the issue of stability is not just about size. What matters is that over

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**One of the most important tools for guaranteeing successful, efficient and effective supervision in Austria is the integrated approach to supervision adopted by the FMA, with its concept of bringing together supervision of practically the entire financial market under one roof.**



this period the banks' capital resources, in other words their risk buffer, have increased significantly, actually improving from a Tier 1 capital ratio of 8.1% to a ratio of 15.1%. At the same time, the quality of this capital, in terms of loss-absorbing capacity, has also improved. The liquidity buffer, the reserve needed to remain solvent even under huge stress, has risen by roughly € 20 billion over this period to € 50 billion. Meanwhile, risk positions have been consistently reduced. The volume of outstanding foreign currency loans has been slashed from its 2008 high of € 53 billion to a current level of € 15 billion. And the proportion of non-performing loans, in other words those loans that are not being properly serviced, has been reduced from 8.7% of all outstanding loans in 2012 to approximately 3.8% today. Foreign business is based on a solid and sustainable foundation.

So as you can see, we have already achieved a great deal. It is, however, clear that these efforts, particularly as regards banks' cost management, must be rigorously continued and driven forward.

One of the most important tools for guaranteeing successful, efficient and effective supervision in Austria is the integrated approach to supervision adopted by the FMA, with its concept of bringing together supervision of practically the entire financial market under one roof. This approach also proved its worth during the years of the financial market crisis, during the long months of active crisis management and during the years of institutional and regulatory restructuring and development. Austria is a small country with a relatively big financial market, and many major market participants are closely linked to one another at many different levels, such as in terms of capital holdings, through sales cooperation agreements, and on the basis of mutual exposures and reciprocal customer relationships. At the same time, the traditional distinctions between different sectors and products are becoming increasingly blurred to the point of disappearing altogether. Above all, however, having several parallel supervisory institutions operate alongside one another would create many redundancies and be much more expensive.

Our experience from our supervisory practice is in any case that an integrated financial market such as Austria, with such close links between the different market participants, needs an integrated supervisor. A supervisor that examines the financial market from every possible perspective, from prudential supervision through to conduct supervision and with a linking up of micro and macro-supervision, ensuring that the individual pieces in the puzzle are considered as part of the bigger picture, and that interactions and contagion channels are observed, all in the interests of a cost-efficient and effective system.

## EVALUATION OF THE EXISTING RULES

We are also aware that, as regulator and supervisor, we have demanded a great deal of our financial market participants over recent years. However, it was imperative that we learned the lessons of a global financial crisis that also rocked our market and our industry to the core. And we firmly believe that we have learned the right lessons.

Just as it was so important to learn the right lessons and tackle the right areas, it is now important that we question and evaluate whether we have actually achieved what we set out to do with our reforms, with our measures, and with our new and revised regulations, and whether we are doing it efficiently and effectively.

This practical evaluation of the rules and regulations now in place will be one of our most important targets over the coming years. In this regard, experience from the market, and the experiences of all participants on the market, will be of particular value to us.

We are therefore committed to open dialogue with every single one of our stakeholders. We, the FMA, base our evaluation of the reforms on four main principles, alongside efficiency and effectiveness, namely:

- The principle of subsidiarity – in other words, regulation and supervision take place at the level that offers the greatest efficiency, effectiveness and proximity to the market
- The principle of proportionality – in other words, regulation that is commensurate with the complexity and risk inherent in the business model
- The principle of a risk-based approach – the higher the risk, the more intense the regulation and supervision should be
- The principle of technology neutrality – the key factor is the objective of the financial product, not its technological basis. However, regulation must not impede innovation.

Wherever possible, the FMA also adheres to the principle of helping supervised entities to help themselves. This involves implementing a system of checks and balances within these entities, a system of mutual internal control based, for example, on the three lines of defence model with clearly allocated roles and responsibilities. The first line of defence is operational management, with compliance and risk management forming the second line, and ultimately the internal audit function providing the third line of defence. The external control system then operates on the basis of this internal system with the supervisory board and statutory auditors acting in the capacity of external bodies appointed by the company concerned and, finally, the state supervisory body in the capacity of a fully independent regulatory authority.

Just as we are continuously evaluating regulation, reviewing our supervisory activity

and checking our organisational structure, workflows and processes, the policy-makers are also regularly checking that the supervisor is in fact meeting the aims and requirements expected of it. If the policymakers detect potential for optimisation, wish to set new priorities or intend assigning new tasks, reform packages are prepared and subsequently implemented. This is what happened in 2017 when a strategy group involving all stakeholders evaluated the organisational structure of supervision in Austria and put together a comprehensive package of measures.

### **THE 2017 SUPERVISORY REFORM**

The 2017 package of supervisory reforms entered into force on 3 January 2018. This reform had four key strategic aims: improving the transparency of supervisory actions, simplifying administrative processes, improving legal certainty and further developing a risk-based and proportionate approach to supervision.

Consequently, one of the priorities of the FMA's work in 2018 was to consistently implement this reform in practice, turning it into everyday reality. This involved getting rid of rules that were no longer needed, streamlining existing processes and optimising new processes. Despite the additional workload, we were able to tackle this challenge with a workforce that has remained the same size for four years. This was achieved by leveraging synergies and improving efficiency, enabling us to reallocate human resources to these new tasks.

### **ENSHRINING THE PRINCIPLE OF PROPORTIONALITY IN BANKING SUPERVISION**

The FMA's concept of strengthening its risk-based and proportionate approach to supervision has been rolled out as far as possible with this reform. There are currently seven Austrian banking groups subject to direct supervision by the European Central Bank (ECB), while 550 credit institutions are directly supervised by the FMA. Implementation of the FMA's proportionality concept has resulted in significant benefits for smaller institutions (total assets of less than € 5 billion), with relaxed requirements regarding committees. Nomination, remuneration and risk committees are now no longer needed at all, while the audit committee is only required to convene once per year in the case of banks with assets of up to € 5 billion. The legal requirement to set up a dedicated, independent risk management department has now also been lifted for banks with total assets of less than € 5 billion. Similarly, the requirements in terms of internal audit structures have been simplified for smaller banks and those that form part of a banking group or sector association.

We are confident that the proportionate approach, which the FMA has been foremost in developing, will continue to relieve the burden on smaller financial service providers and those providers with a less risky business model. After all, the FMA's initiative, promoted within the European and international bodies, of applying greater proportionality in regulation and supervision is winning ever stronger support. Both the EBA and the ECB, as well as the global standard-setting body, the Basel Committee, have made strengthening the supervisory principle of proportionality one of their main goals. Meanwhile, the European institutions are also focusing on the proportionate design of the legal basis for supervision during the current evaluation and revision of the supervisory regime for banking in the form of the Capital Requirements Regulation (CRR) and the fourth Capital Requirements Directive (CRD IV).



**One of the priorities of the FMA's work in 2018 was to consistently implement this reform in practice, turning it into everyday reality. This involved getting rid of rules that were no longer needed, streamlining existing processes and optimising new processes.**

In those areas where the current regulations allow, the FMA consistently applies the principle of proportionality, be it with regard to the fit and proper requirements made of managerial staff, board members or holders of key functions or with regard to the rules on governance and control functions.

Within Austria, the supervisory reform package has created the legal basis for the simplification and streamlining of on-site inspections of banks: on this basis the FMA has optimised its working relationship with the OeNB, sped up the process to remedy faults, and improved the flow of information between management, bank auditors, the state commissioner and the bank's supervisory board, as well as improving communications with the official supervisor. The state commissioner function, a supervisory body of the FMA, has been strengthened, and we have intensified the flow of information, communications and the exchange of ideas, while improving training and CPD. Any outsourcing of essential bank functions must now be reported to the supervisory authority.

The FMA's aim is to reinforce the risk-based and proportionate approach to supervision with regard to asset managers, investment firms and the market infrastructure too.

#### **ENSURING TRANSPARENCY AND LEGAL CERTAINTY**

As of this year, the FMA is required to set and publish the thematic focuses of its work in all supervisory areas for the coming year. We are meeting this new statutory obligation in a variety of ways including through our annual publication "Facts and figures, trends and strategies", which is released in December of each year. Additionally, our priorities for our supervision and inspection activities for the coming year are published on the FMA website ([www.fma.gv.at](http://www.fma.gv.at)) and presented to the general public during a press meeting.

The evaluation procedure for the FMA's regulations, circulars, guides and minimum

standards has been extended, with the result that all drafts are now subject to public consultation on the FMA website, with all incoming responses also published online.

In the form of the administrative decision in response to a request for information (Auskunftsbescheid), a new system for the issuing of binding legal information by the FMA has been introduced based on the model set out in the Federal Fiscal Code (BAO; *Bundesabgabenordnung*). This does not affect the existing administrative practice whereby supervised entities may obtain legal advice from the FMA free of charge. Further information about these administrative decisions can be found on the FMA website<sup>1</sup>.

The supervisory reform package also enables the “accelerated conclusion of proceedings” (both in relation to administrative proceedings as well as administrative penal proceedings), in the event that the party waives its right of appeal in advance. This option is already proving popular with the supervised entities and is being used intensively. It helps to make significant cuts to processes, quickly creates legal certainty, saves time and resources, and thus improves efficiency.

In addition, the FMA’s discretionary powers to desist from imposing a fine for less significant infringements have been substantially extended. This is in keeping with the FMA’s guiding principle of issuing a warning and advice rather than imposing a punishment wherever possible in the case of minor infringements. It goes without saying, however, that serious infringements will meet with the full force of the law.

Furthermore, in financial market penal law the “principle of accumulation” i.e. the additive imposing of several fines for each individual infringement, has been removed and replaced by the “principle of absorption” i.e. the imposing of a single administrative penalty, even in the case of multiple infringements. The aim is to avoid disproportionately high fines.

### **OPTIMISING THE FMA’S ORGANISATIONAL STRUCTURE**

With effect from this year, managerial positions for second level senior management of the FMA must be publicly advertised, while an internal recruiting procedure is prescribed for third level senior management positions. The only exceptions to the above are short-term deputising appointments and reappointments.

The FMA’s Supervisory Board has been extended by two members; it now comprises eight voting members, with half being appointed by the Federal Minister of Finance (BMF) and the other half by the Oesterreichische Nationalbank (OeNB). The Board also has two additional co-opted members, who do not have voting rights, nominated by the Austrian Federal Economic Chamber (WKO). Given the FMA’s constant efforts to achieve a gender balance, we are very pleased that the BMF and OeNB ensured that an equal number of men and women were appointed as voting members of the Supervisory Board.

The 2017 supervisory reform package thus marks an important step forward in the development of Austria’s integrated supervision system, improving the efficiency of processes and procedures, extending the principle of proportionality and having a preventive effect as a result of better transparency and optimised legal certainty.

We, the FMA, not only support an integrated approach to supervision that observes,

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<sup>1</sup> [www.fma.gv.at/en/cross-sectoral-topics/administrative-decisions-in-response-to-a-request-for-information-pursuant-to-article-23-fmabg-from-3-january-2018/](http://www.fma.gv.at/en/cross-sectoral-topics/administrative-decisions-in-response-to-a-request-for-information-pursuant-to-article-23-fmabg-from-3-january-2018/).

analyses and supervises the entire financial market in Austria from every angle and all perspectives. We also support an approach that seeks out and fosters open, critical and constructive dialogue with the supervised entities and with the business community. Ultimately, it is only by working together that we can achieve our aims of making the Austrian financial market stronger and of boosting consumer confidence in a financial centre that operates fairly and properly.

## ANALYSING THE RISKS

As important as it was to learn and implement the lessons that the crisis taught us, we must also make sure that we are not focusing too heavily on the problems of the past. There will no doubt be another crisis in the future, but it is very likely to take on a different form. Or, as one clever man once put it: “History repeats itself, first as tragedy, then as farce”.

In our capacity as regulator and supervisor, we must keep a watchful eye on the current day and also look into the future if we are to identify new risks and threats, and take the necessary preventive steps. Ultimately, the most effective form of crisis management involves addressing potential risks in good time so that they do not actually occur and trigger a crisis in the first place.

So are we already seeing the first warning signs of a crisis? Actually, yes!

We are concerned about excessively high prices on the real estate markets, on the stock markets, and in the crypto economy, and we are monitoring the situation closely. Above all, however, we are checking that the companies supervised by us are exercising the requisite level of caution and prudence in these markets.

In our view the danger zones include the “too big to fail” problem, the shadow banking sector and the fact that government borrowing remains problematic in some states. The crisis in multilateralism is also very worrying to us, as committed international cooperation was one of the most important assets in crisis management. We are also very aware of major risks in relation to IT and cybersecurity, resulting in our making this area one of the focuses of our supervision and inspection activities.

The biggest risk, however, is that we err collectively, that together we fail to recognise a risk or underestimate its impact. We only need to think of the example of securitisation and the period leading up to the subprime crisis in the USA. Back then, this pooling, securitisation, division and distribution of these credit instruments was viewed as minimising risk, as if the risk was being broken down into tiny particles that then evaporated across the globe and disappeared. What we subsequently learned was that the securitisation processed had created inappropriate incentives, pushing down lending standards and, ultimately, infecting markets around the world.

It is all the more important that we have an institutionalised approach to identifying and analysing risk. We do this through our yearly review of our five-year medium-term supervision strategy, on the basis of which we set the focuses of our supervision and inspection activities for the year ahead.

With regard to our strategy for 2019 to 2024, we have identified the following categories of risks requiring targeted action:

- Economic and political risks
- Risk culture in the good times
- Digitisation risks.

**In our capacity as regulator and supervisor, we must keep a watchful eye on the current day and also look into the future if we are to identify new risks and threats, and take the necessary preventive steps.**

**The western world's financial system is now more stable than before the crisis, has more capital resources and is less indebted. Globally, leverage has however increased, primarily in the emerging markets. The world as a whole has therefore grown more fragile again.**



## ECONOMIC AND POLITICAL RISKS

The western world's financial system is now more stable than before the crisis, has more capital resources and is less indebted. Globally, leverage has however increased, primarily in the emerging markets. The world as a whole has therefore grown more fragile again.

According to data from the McKinsey Global Institute, global borrowing is now \$ 72 trillion higher than it was just ten years ago. The International Monetary Fund (IMF) is already issuing urgent warnings about the risks associated with this mountain of debt. A good two thirds of this dramatic increase in worldwide borrowing can, however, be attributed to emerging markets and newly industrialised nations such as China, Turkey, Chile and Vietnam. Government liabilities in China alone have increased five-fold to almost \$ 30 trillion in the space of a decade, now amounting to more than two and a half times the country's annual economic output. This represents a serious risk for the global financial markets, particularly if there is a normalisation of interest rates, as a large proportion of these debts is financed in foreign currency.

As in the USA, government borrowing in the euro area has grown by around 38% since 2008 and now amounts to just over 250% of the area's annual gross domestic product (GDP). The reasons for this rapid increase can be found in the banks' aid packages but also in government economic stimulus programmes designed to get economies moving again.

In some states borrowing has reached such high levels that its long-term affordability is in doubt. At the same time, efforts to cut government debt are not going far enough.

There is also the issue of worrying developments on the capital markets. We have got to a situation where some individual global asset managers, despite being barely regulated, are managing volumes of up to € 6 trillion, which is more than the economic power of most of the world's states. Additionally, there is a trend in asset management away from active management towards passively managed funds (which simply rep-

licate indices), which now account for two thirds of this volume. This poses the risk of trends being intensified and exacerbated in the event of a crisis. The same applies to algorithm-based trading systems that make automated buy and sell decisions and have a tendency to make the same decisions. Derivatives clearing must, having learned its lesson during the crisis, be carried out via strong, regulated clearing houses nowadays. This means that these institutions are now highly system-relevant and themselves pose particular risks were they to fail. Moreover, the largest European derivative market and its clearing operations are based in London, where daily trading in interest rate derivatives reaches a volume of around € 1 000 billion. There is some justifiable concern at how Brexit will impact on this very sensitive market in particular. Consequently, the economic and political risks should not be underestimated.

## **BREXIT**

The United Kingdom's withdrawal from the European Union poses major challenges for the remaining Member States. Consequently, there are intensive, tough negotiations in progress between the EU and the UK on a Brexit deal and on a long-term agreement on the future relationship between the former partners. The European financial sector will be hit particularly hard by Brexit. London is, after all, the most important financial centre in Europe.

At the time of preparing our medium-term strategy and setting our priorities for supervision in 2019, the negotiations had yet to be concluded, with the prospect of a no-deal Brexit still not entirely discounted.

It is therefore very important that Austrian financial service providers that do business with the UK, and Austrian customers of UK financial service providers prepare for all eventualities. This has been one of our priorities for some time now, with the result that our preparations are well advanced and in some cases already complete. One positive factor is that the volume of bilateral trade between our two markets is not significant and therefore manageable.

Nevertheless, we cannot ignore the fact that nobody currently knows what the impact of a no-deal Brexit would actually be on Europe, given the UK's close links with the EU. Turbulence on the financial markets and cross-border contagion effects are a real possibility, with the potential to trigger a serious economic crisis. It is therefore vital that developments surrounding Brexit continue to be closely monitored.

## **EXAGGERATED ASSET PRICES**

Ever since the global financial crisis, so for more than ten years now, the central banks have been pushing interest rates ever downwards to unparalleled lows while at the same time pumping the markets full of liquidity on an unprecedented scale. Their aim has been to contain the collapse of the real economy, stabilise the markets and stimulate an upturn. This policy of cheap money, however, has also pushed up the prices for certain assets such as equities and real estate.

In some markets this has created exaggerated prices, which merit close attention from the supervisors given the risk of huge corrections.

The FMA, OeNB and Financial Market Stability Board (FMSB) have also analysed this significant rise in property prices in Austria, concluding that there is not currently any threat to financial market stability. There are several reasons for this view: the Austrian housing market is very different from the market in other countries as owner-

occupied housing is comparatively insignificant, while rented, cooperative and social housing account for an exceptionally high proportion, especially in urban conurbations where the price increase has been particularly marked. Furthermore, rising prices in Austria have not tended to be credit-driven but have been created by the flight into property as a form of capital investment. More generally, real estate prices in Austria have demonstrated considerable catch-up potential by international standards, for both historical and legal reasons. The proportion of loans for residential property is also low by international standards when measured against the total assets of Austrian banks.

Nevertheless, we must continue to monitor the price rises in certain asset classes very carefully, ensuring that effective measures can be introduced quickly in the event of any price bubbles that could threaten financial market stability.

#### **LOW INTEREST RATES/TURNAROUND IN MONETARY POLICY**

After a decade with an extremely relaxed monetary policy that has kept interest rates as low as they will go, a turnaround is also to be expected in Europe in the not too distant future, with rates starting to return to normal. In the USA, the Federal Reserve Bank started this process some time ago now by raising interest rates.

Higher rates bring a risk of sudden large-scale corrections to exaggerated asset prices created out of cheap money. At the same time, higher rates make borrowing that was once favourable more expensive and also make it more expensive to service outstanding loans. A change in rates also means that funds will be shifted between different asset classes and between debt and equity financing on a huge scale.

Ensuring that financial service providers prepare appropriately for a change in monetary and thus in interest rate policy will be a major challenge.

#### **MULTILATERALISM IN CRISIS: NATIONAL VERSUS INTERNATIONAL ACTION**

The USA's withdrawal in many areas from a multilateral approach creates many risks in a globalised world. The financial crisis was a clear example of how important international cooperation is for containing risks and managing a crisis. Trade conflicts, triggered by a unilateral move away from tried-and-tested multilateral agreements, therefore pose a huge threat to world trade, global economic development and financial market stability.

Economic distortions and shocks are much more likely during periods when countries are pursuing nationalised economic policies.

Given the global crisis in multilateralism, it is all the more important that the Member States of the European Union adopt a strong common position.

It is therefore particularly important that the banking union be completed as quickly as possible and that its institutions be strengthened further. This applies in particular to the European deposit insurance scheme, the pots for which have already been filled at national level. Yet in order for this scheme to be put into operational practice, even greater joint efforts are required to reduce the volume of non-performing loans.

At the same time, efforts are needed to ensure that Basel III, the global capital adequacy regime for banks, is actually applied globally. We cannot have a situation in which the regulatory standard is undermined by certain jurisdictions in order to obtain a national, egoistic edge in cross-border competition.

We, as the Austrian supervisor, will pursue an approach of thinking as globally as pos-

sible while always being ready to act locally: where global or multilateral solutions are taking too long, being questioned or even failing, we must be brave enough to take European or even national solutions forward. A pragmatic approach is required.

## RISK CULTURE IN THE GOOD TIMES

### LENDING STANDARDS FOR REAL ESTATE AND CONSUMER LOANS

Loans granted too freely amid the optimism of an upturn become ailing loans when the economy changes direction. In line with our strategy of looking forward and taking a counter-cyclical approach, the FMA monitors close compliance with appropriate lending standards, particularly in the case of real estate and consumer loans.

The first step involves work with the individual institutions that are pursuing an aggressive market strategy, addressing their lending policy and the suitability of their risk management. The second step involves the entire sector, with us very clearly communicating our expectations regarding an appropriate lending policy. If these two measures are not sufficient, we will also not hesitate to implement our macro-prudential tools in cooperation with the FMSB in order to avoid the accumulation of new, disproportionate risks from the outset.

### “TOO BIG TO FAIL”

One of the major outcomes of the financial crisis was the call for everything possible to be done to solve the “too big to fail” problem, namely the problem of some “systemically important” banks being deemed too big and too integral to the wider system to be allowed to go bankrupt or to be wound up without jeopardising the stability of the financial market. At the time, there was much talk of breaking up the larger banks and disentangling their links with other participants on the market. However, many of the problems facing large banks, particularly in the USA, were actually solved through mergers with or takeovers by other players. The end result was even bigger and even more complex institutions. Variations of the “too big to fail” mantra now already include “too big to save” (i.e. too big to be rescued by the state) and “too big to control” (i.e. too big to be effectively regulated and supervised).

Given that it is obviously going to be difficult politically to break up huge banking groups, and in light of the political interest in maintaining large banks as different locations compete with one another for business on the global, European or national stage, we as regulators are attempting to address the “too big to fail” issue from a different angle:

- One of our approaches involves additional capital requirements according to how systematically important an institution is (G-SIB buffer).
- And we are also working to ensure that a strong and effective resolution regime is applied to the largest banks.

The EU’s Single Resolution Mechanism for banks and investment firms focuses on two preventive tools in this regard:

- During the good times, recovery and resolution plans are drawn up that clearly show the business models and organisational structure of institutions and groups, as well as their workflows, in order to identify and eliminate resolution obstacles.
- Additionally, over and above their capital with loss-bearing capacity, large institutions must also have sufficient assets for recapitalisation in the event of a crisis,

**It is particularly important that the banking union be completed as quickly as possible and that its institutions be strengthened further. This applies in particular to the European deposit insurance scheme, the pots for which have already been filled at national level.**

**The aim is to ensure that it will no longer be the state and taxpayers who have to pick up the bill if a systemically important financial service provider fails. Rather, the owner and creditors will pay. We must put an end to the situation in which profit is privatised while losses are shared by all.**

known as the minimum requirement for own funds and eligible liabilities (MREL). The MREL is set for each institution by the resolution authorities based on the level of risk. This requirement is generally met through bonds that can be converted into liable equity in the event of a crisis.

The aim is to ensure that it will no longer be the state and taxpayers who have to pick up the bill if a systemically important financial service provider fails. Rather, the owner and creditors will pay. We must put an end to the situation in which profit is privatised while losses are shared by all.

The recovery and resolution plans have already been drawn up, evaluated and reviewed over the past few years. They are also permanently being updated in line with the institutions' business development and strategy. With effect from 2019, the relevant Austrian banks will be notified of their MREL by the SRB and FMA in the form of an administrative decision. It will therefore take another two to three years before these measures are actually fully effective.

How to resolve a bank efficiently and effectively was demonstrated by the FMA in Europe's first case of its kind when HETA Asset Resolution AG, which previously formed part of the Hypo Alpe Adria Group, was wound down in accordance with the new resolution regime. The FMA also gained a great deal of practical experience in the provision of regulatory and supervisory support during the private-sector resolution of KA-Finanz AG (previously Kommunalkredit) and immigon portfolio abbau AG (previously ÖVAG).

As far as the banking sector is concerned, the regulatory and institutional framework for recovery and resolution is already well developed. In other sectors there is still some catching up to do. In our capacity as the integrated supervisory authority, we will, however, also do everything in our power to improve how well prepared companies in other sectors are for potential and specific crises. In particular, we will be reviewing whether insurance undertakings have the requisite contingency plans in place that also take account of new risks such as IT and cybersecurity and whether they are sufficiently prepared to withstand a crisis. Moreover, previous crises have shown that certain capital market infrastructures have a central role to play in successful resolution. We will therefore be entering into dialogue with the key players in order to define the infrastructure requirements for efficient resolution processes.

#### **SHADOW BANKS: EVADING REGULATION AND SUPERVISION**

As mentioned above, banks' capital resources today are much better than they were before the crisis, in terms of both quantity and quality.

However, some of this improvement has been achieved by selling off risk positions, such as packages of non-performing loans (NPL), to hedge funds, private equity firms, large asset managers or venture capitalists. Consequently, the risk has been shifted out of the strictly regulated banking sector in to areas of the financial market that are barely regulated, if at all, and referred to informally as the "shadow banking sector". According to an estimate from the Financial Stability Board (FSB), this sector accounted for a volume of \$ 45 trillion as at the middle of 2018, which equates to 13% of the assets on the global market. According to data from the US Treasury Department, lending from banks to shadow banks in the USA has quadrupled to \$ 250 billion over the period from 2010 to 2017. This means that this outsourced risk finds its way back into banks' balance sheets.

From a global perspective, this shifting of risk to the shadow banking sector poses a serious threat to financial market stability, not just because gigantic volumes of financial assets are being moved to this sector but also because the providers are barely subject to any regulation, which justifiably raises questions about their approach to risk management.

With regard to Austria, the OeNB has calculated that the proportion of finance (lending and purchase of debt securities) outside the banking sector rose from 18% to 22% between 2008 and 2016, to a volume of around € 170 billion (2016). However, as far as Austria is concerned, this shadow banking sector is largely still subject to FMA regulation and supervision, with approximately one half of the financings being carried out through investment funds, just over one third through insurance, approximately one tenth through other regulated financial institutions and a mere 3% accounted for by unregulated financial service providers.

This highlights once again the benefit of having an integrated supervisory authority with such a broad and comprehensive overview of the market as a whole. The relationship between banks and shadow banks is permanently on the FMA's radar, and the Authority keeps a close eye on any attempts to escape regulation and supervision.

#### **STABILITY OF THE BANKING SECTOR**

The capital resources held by Austrian banks have improved massively, as demonstrated by the rise in the CET1 capital ratio from 7.5% in 2008 to a current level of 15.1%. Meanwhile, the quality and loss-bearing capacity of this capital base has also been strengthened. The EBA's 2018 stress test revealed that the major Austrian banks would continue to have a CET1 ratio of more than 8.5% even in the most adverse scenario. However, this does not mean that efforts to improve the capital base further can be relaxed. Austrian banks still lag behind the European average. In terms of leverage ratio (Tier 1 capital as a proportion of total exposure, not risk-based), Austrian banks are positioned in the top 25 per cent of European major banks, both before (just over 6%) and during the adverse scenario (approx. 5%).

This reflects the massive reduction in risk positions. The proportion of NPLs held by Austrian banks is now 3.8%, compared with an EU average of 4.4%. The outstanding volume of foreign currency loans has been more than halved since peaking at € 32 billion in 2008, totalling € 15 billion in mid-2018. Allowing for exchange rate fluctuations, the total has fallen by two thirds. The FMA's sustainability package for Austrian banks' operations in the CESEE markets has helped to cut the loan-to-deposit ratio from 117% to 79%, so that growth is being financed by the local markets. These successes must also be maintained.

Over the coming years Austrian banks will be required to build up an additional buffer in the form of the MREL, as referred to above.

What this means is that the banks must continuously optimise their business models, improve their cost efficiency, and strengthen their income, thereby aligning their cost-to-income ratios with those of their rivals and increasing their profitability. As supervisor, it is our role to support them closely during these processes.

#### **GOOD GOVERNANCE – CONDUCT AND SUSTAINABILITY**

Employee misconduct is one of the most serious risks facing financial service providers today. Failure to apply due care and observe the statutory anti-money laun-

dering (AML) rules, for example, can result in the supervisory authority imposing severe penalties, ranging from large fines to the removal of an operator's licence. This similarly applies to a lack of compliance when distributing financial instruments, which could also trigger huge compensation claims from customers. Enormous risks and losses can also arise if financial institutions fail to monitor their proprietary trading properly. In other words, conduct and legal risks are increasingly impacting on operational and prudential risk in a huge way.

Adherence to the principles of good governance is therefore growing more and more important. The FMA is particularly focused on financial service providers implementing a strong internal control system, so that a strong in-house system of checks and balances comes into play before the need for external control bodies to intervene in the form of the state supervisor, supervisory board or auditors. A strong compliance and risk management function, alongside a good internal control system, is vital. This is key to creating a genuinely sustainable organisational and management structure, and thus to a sustainable business model.

### DIGITISATION RISKS

The digital revolution has turned our world into a global village. National borders are becoming less and less relevant, both in communication and in business, as global networks grow. There is barely any sector where this is more relevant than on the financial markets. At the same time, many other groundbreaking innovations are currently taking off, from biometrics and self-learning systems based on AI, to the analysis of big data and advances in robotics.

Many disruptive technologies are currently radically changing the financial markets in an evolutionary process. Most importantly, however, this process of change does not respect any type of boundary, be it between different products, different sectors or different countries.

What does this mean as far the business models of established financial service providers are concerned? And what does it mean for new start-ups, FinTechs and Big Tech? What does it mean for customers, consumers, savers and investors? As regulators and supervisors we must find answers to these questions.

### IT AND CYBER RISKS: LEGACY, INFRASTRUCTURE, AWARENESS

Digital business models and the rapid increase in the use of global telecommunications networks and the Internet are creating new risks. The question arises as to whether the frequently fragmented IT infrastructures that financial service providers have developed over time are up to the challenges of the digital age. There is also the question of whether security systems and business continuity plans are sufficient, and we must work to ensure an awareness of these risks. Cyber attacks are another growing threat.

The FMA has therefore made the IT systems of supervised entities, along with data security and cybersecurity, one of its main supervisory focuses. It has already published guides on these topics and will continue to review the suitability and security of systems, using simulated cyber attacks or by conducting stress tests on the relevant infrastructure.

**Many disruptive technologies are currently radically changing the financial markets in an evolutionary process. Most importantly, however, this process of change does not respect any type of boundary, be it between different products, different sectors or different countries.**

## **DIGITAL BUSINESS MODELS: FINTECHS & BIG TECH VERSUS THE ESTABLISHED PROVIDERS**

Established financial service providers, which are regulated and supervised, are facing increasing competition from FinTechs and Big Tech like Amazon, Google and Facebook. These major technology companies are offering new and innovative financial products and services, or using their sales and marketing power to penetrate ever further into markets with low-cost standard products.

We must make sure that the established providers evaluate and adapt their business models and products in response to the challenges of digitisation and other technological innovations. As ever, it will only be those players that actively embrace technological progress that are successful.

Yet we firmly believe that the established financial service providers can also master these challenges, as their function as financial intermediaries extends well beyond standardised mass products, not least also encompassing advisory-intensive, customised and complex products.

At the same time, we must avoid a situation in which innovation on the financial markets is held back by regulation and supervision. Instead, it must be promoted. Consequently, the FMA will be continuing to expand on its service-oriented approach to technology and innovation. In addition to the FMA's FinTech point of contact, a one-stop shop guiding FinTechs through the entire regulatory process, plans are also in place for a regulatory sandbox. This would be available to selected FinTechs, enabling them to try out their business model in practice subject to simplified regulatory conditions but under close financial supervision.

## **THE CRYPTO ECONOMY**

The crypto economy is a world of its own, deliberately created and designed to evade regulation and supervision, establishing a counterweight to the power of governments and politicians, and to the clout of the central banks and global financial players.

Our experience as a supervisory authority has taught us, however, that self-regulation does not work and in practice is synonymous with no regulation at all. And in the absence of regulation and supervision, it is all about the survival of the fittest, or of the most ruthless in the long run, as that is simply human nature. Ultimately, this then destroys the basic principle of every financial market, namely mutual trust among all market participants.

In this lawless zone, the participants with reputable business models come up against those with less honourable intentions who are looking to rip off the idealists, the inexperienced and the trusting operators. According to some studies, 80% of initial coin offerings (ICO) were launched with fraudulent intentions. Sadly, the FMA's experience is consistent with this finding, as half of the complaints made to us, and around one half of all criminal cases that we refer to the public prosecutor relate to suspected criminal offences in the crypto world.

There is therefore a need for regulation.

It is our view that the best approach does not lie in the creation of new rules for the crypto economy. Rather, in keeping with the principle of technology neutrality, our rules governing the analogue world should be expanded to also include the digital world. The basic rule is quite simple: anything that has the same effect as a financial instrument or investment product must also be treated, regulated and thus super-

vised in the same way as a financial instrument or investment product, based on the principle of “same purpose, same risks, same rules”. This is necessary even just from the perspective of creating a level playing field for all, ensuring fair competition with no disadvantages for the established providers that are already subject to strict regulation and supervision.

The first step has been taken in this regard with the inclusion of wallet providers and crypto asset exchanges in the AML rules that will apply with effect from 2020. The next step will be the consistent expansion of the prospectus regime to include ICOs. The draft proposals are already on the political agenda, with the next steps due to follow soon.

For the avoidance of doubt, we fully acknowledge the value and great potential of the technologies that lie behind the crypto economy, such as distributed ledger, blockchain and smart contracts. What we need, however, is an appropriate framework within which they can be harnessed and used on the financial markets properly and with due regard for risk, including by the already established financial service providers.

### THEMATIC FOCUS OF FMA SUPERVISION AND INSPECTIONS IN 2019

Based on this medium-term risk analysis, we have drawn up and agreed on the main focuses of our supervisory activity and inspections in 2019.

We must use what remains a good economic position to bolster capitalisation and solvency on the financial market. It is, however, amid the optimism of an upturn that the seeds of future risks are sown. Consequently, in our forward-looking and counter-cyclical strategy, we focus on prevention by pressing for a strengthening of governance systems and for the proper, risk-aware and appropriate distribution of financial services. On this basis we have set the following priorities for supervision and inspections in 2019:

- **Digitisation:** We want to support digitisation on the Austrian financial market, embracing the digital revolution and ensuring that the related risks are properly managed.
- **Resilience:** We want to improve the financial sector’s readiness for future crises, improving the ability of the FMA and Austria as a financial centre to withstand difficult periods.
- **Collective consumer protection:** We want to expand consumer protection, using targeted information to create greater risk awareness, improving product transparency to bolster trust, and creating top quality in sales for greater fairness.
- **Comprehensive risk monitoring:** We want to further develop risk monitoring by using strong compliance and consistent AML measures to make supervised entities more stable.
- **Governance:** We want to improve corporate governance, thereby strengthening resilience in a changing risk environment.
- **Sustainable business models:** We want to secure the long-term viability of business models during the economic upturn by adopting a forward-looking mentality and acting counter cyclically.

How exactly we plan to do this is detailed in the following article (see page 24).

No matter how seriously we have tried to learn the right lessons from the global financial crisis and no matter how hard we have worked to make regulation and super-

vision more efficient and effective, we must correct one myth, namely that by doing so we will have succeeded in preventing crises and the collapse of financial institutions for ever more.

There will continue to be financial institutions that have to leave the market because they are no longer competitive. And there will continue to be crises here and there on the financial market from time to time. However, we are confident that we – and the institutions that we supervise – are better prepared to manage any such crisis.

At the same time, it is increasingly clear that the more the crisis is pushed into the realms of history, the louder the calls grow for deregulation. “Financial disaster is quickly forgotten” wrote John Kenneth Galbraith in his renowned analysis of the global economic crisis of the 1930s. Obviously, everyone likes to try and forget about things that were unpleasant.

For our part, in our role as regulators and supervisors, we have to adopt a countercyclical approach. We must look ahead and anticipate the future, offering a cautionary word of warning when the economy is performing well. We must remember where the blind rage of deregulation led us. In the global village that is today’s financial markets, we must also think globally while not being afraid to act locally and to move forward with local solutions where they are needed.

**The more the crisis is pushed into the realms of history, the louder the calls grow for deregulation. For our part, in our role as regulators and supervisors, we have to adopt a countercyclical approach. We must look ahead and anticipate the future, offering a cautionary word of warning when the economy is performing well.**

# THEMATIC FOCUS OF FMA SUPERVISION AND INSPECTIONS IN 2019

**B**

ased on the challenges facing the Austrian financial market and the FMA's medium-term strategy, the following priority areas have been set for the Authority's supervisory and inspection activities in 2019:

## **AIM: ACCOMPANYING DIGITISATION ON THE FINANCIAL MARKET: SUPPORTING DIGITAL CHANGE, MANAGING THE RISKS**

As the digitisation of society progresses, all areas of the economy, including the financial market, are being fundamentally overhauled. Digital change – the fourth industrial revolution – brings new opportunities for everyone who participates in the financial market, but it also poses completely new risks. New technologies are set to bring sweeping changes to many business models. Digital channels are being used in addition to personal contact between providers and consumers, and increasingly even replacing personal contact altogether. The concept of big data is turning customer data into a new asset. By linking up and evaluating a range of data sources on customers' status, behaviour and preferences, the financial products on offer can be tailored more effectively to individual customers' requirements. Digitisation is also increasingly providing companies with the opportunity to make their internal processes quicker and more efficient, and thus to cut costs.

For companies that are already established on the financial market, this transformation forces them to question whether their existing business models are still fit for purpose in a digital world or whether changes are needed to keep them competitive. Often, major investment in IT infrastructure, knowledge and corporate processes is needed in order to fully exploit the opportunities presented by digitisation.

FinTech companies, more than companies already operating on the market, can focus

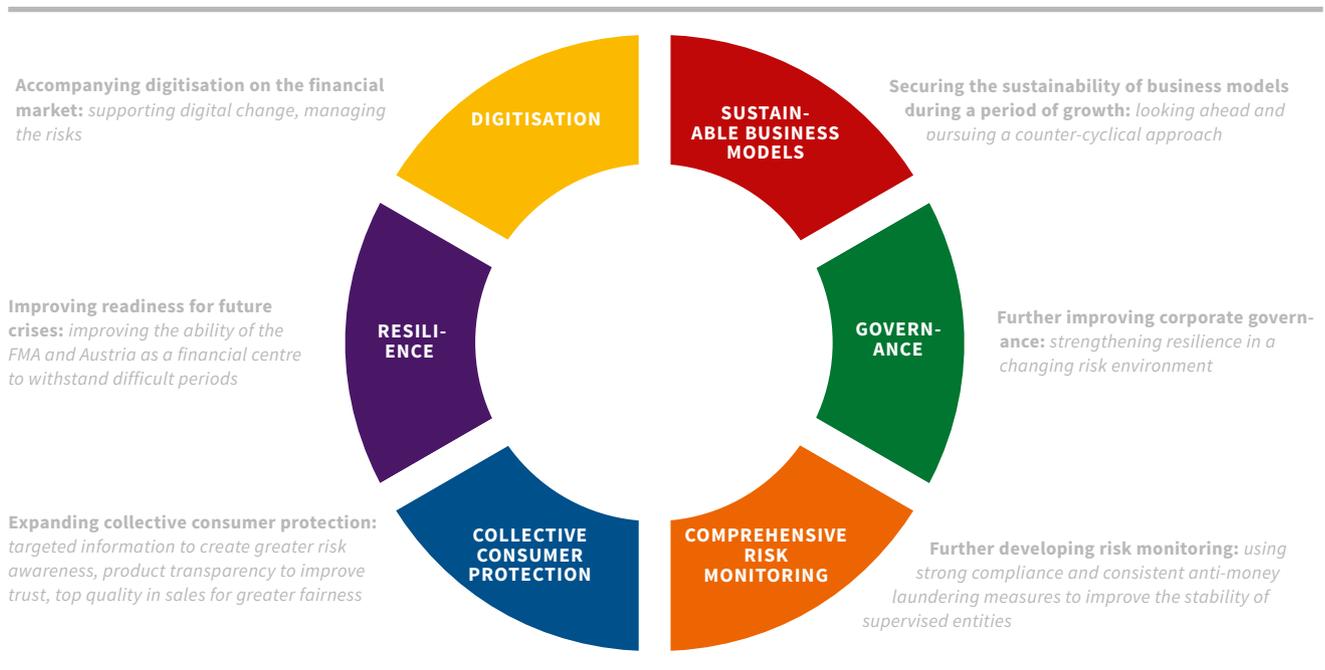
all of their efforts on new, digital business models. This makes them important drivers of innovation. The question for them, however, as they enter the market, is the extent to which their business models are subject to financial market regulation. Obtaining a licence as a financial company brings with it wide-reaching conditions, which are frequently a particular challenge for this type of company.

In light of the digital change on the financial market, the FMA has committed to the principle of technology neutrality. The same business models and the same risks must be subject to the same regulatory and supervisory requirements, regardless of the technology being used. Yet, for the FMA, technology neutrality does not mean technology passivity. Rather, the FMA has assumed a proactive role, helping to shape digital change on the Austrian financial market. One of its main tasks lies in creating the regulatory and supervisory framework for the digitisation of those business models that are being used by companies already under supervision, eliminating any obstacles where possible. In terms of the FMA's contact with FinTech companies, this means acting as an unbureaucratic point of contact for the regulatory and supervisory requirements upon market entry.

The use of modern information technologies involves both opportunities and risks. IT and cyber risks are taking on new importance, and are now ranked by companies and customers alike as among the top categories of risk. While digital processes can improve efficiency, they can also become the target of cyber attacks. Large volumes of customer data offer huge possibilities. But that data is also sensitive and must be protected in order to maintain customer confidence. Companies operating on the financial market must focus correspondingly strongly on IT and cyber risks and be able to adequately identify, monitor and control such risks.

The FMA will make digitisation in the financial market one of the main focuses of its supervisory and inspection activities in 2019. In particular, it will analyse business models and review how companies are handling IT and cyber risks.

Figure 1: **Priorities for supervision 2019**



**FOCUS: IMPACT OF DIGITISATION ON BUSINESS MODELS**

Current business processes and models are being transformed by digital change while new models are also being created. The accompanying adjustment and market entry processes are being tackled in a structured way together with the supervised entities:

- The FMA will provide proactive regulatory and supervisory support to companies as they make this transition.
- The FMA will also be further intensifying its communications with the corporate sector on the basic regulatory and supervisory parameters associated with this change.
- Effects of digitisation on business models are being incorporated into companies' individual risk assessment processes.
- With regard to the use of robo-advisors (automated systems used to provide investment services), the FMA will ensure that the rules of conduct applicable to the sale of securities are being observed.

In terms of payment services, the FMA will be focusing on the licensing and registration of the payment initiation and account information services created by the EU's new Payment Services Directive (PSD2) and now entering the Austrian market for the first time.

The crypto assets market has developed particularly dynamically over the past few years. Crypto assets form the basis of many new business ideas. These must be assessed on a case-by-case basis to determine whether they are subject to financial market regulation and thus supervision by the FMA.

- Consequently, the FMA will be focusing on analysing these business models in terms of the applicability of financial market regulation, thereby further improving the transparency and legal security of this market's regulatory and supervisory environment.
- Greater focus will also be placed on the KYC requirements of new business models, in particular during the preparation of new anti-money laundering rules for platforms that deal in crypto assets.

**FOCUS: IT SECURITY AND CYBERSECURITY**

In 2018 the FMA published guides on IT security for all sectors of the financial market. The aim of these is to provide the supervised companies with transparency regarding the FMA's requirements for their organisational structure and processes in relation to IT security and cybersecurity.

- In order to ensure that market participants and customers can rely on uniform standards of protection, a review of the practical implementation of the requirements set out in the FMA guides has been made a priority.
- IT risks and IT security are the main areas of focus during on-site inspections.
- The FMA will be particularly focusing on outsourced functions and cloud computing, which is a special form of outsourcing. As with any type of outsourcing, cloud computing must take place within a clearly defined structure and must not involve companies handing over business areas or applications to a black box and failing to fulfil their overall responsibility.
- For the first time, the FMA will be making operational IT security and cybersecurity one of its priorities in 2019. Also in 2019, the FMA is set to organise the first simulation game for the banking sector. The idea behind this digital game is to give

banks the opportunity to detect any weaknesses in their cyber defence mechanisms. Additionally, the resulting findings will be incorporated into the FMA's future IT supervisory activity.

### **AIM: SECURING THE SUSTAINABILITY OF BUSINESS MODELS DURING A PERIOD OF GROWTH: LOOKING AHEAD AND PURSUING A COUNTER-CYCLICAL APPROACH**

The last few years have seen a period of economic recovery in Europe in general and Austria in particular. Economic growth in the EU and in the eurozone has been based on a broad foundation. The EU's GDP figures have been growing for five years, with four years of growth in the eurozone figures. The first interest rate hikes by the US Federal Reserve, coupled with the announcement of further, moderate increases, and the state of the economy and inflation in the eurozone itself point to a gradual move away from the ECB's very laid-back monetary policy.

Economic growth and persistently low interest rates have contributed to high rates of credit growth. Currently, banks are able to expand their lending business across all sectors. Real estate loans have been rising strongly in Austria for some years now. At the same time, property prices have been increasing since 2011, including in Austria and mainly in the conurbations. For the first time in many years, there was positive growth in consumer lending in 2017. There are also structural reasons for this development, which is a direct result of digitisation. The fact that loans are available via websites and apps means that credit can be obtained anywhere at any time. It has never been as easy for consumers to borrow money from a bank. More than at any other time, during periods of low interest rates banks must ensure that they grant credit responsibly and in compliance with risk-based standards. Particularly as far as long-term real estate finance is concerned, there must be a guarantee that the customers will still be able to repay the loan out of their disposable income when interest rates start creeping up again. In Austria, not least as a result of pressure from the FMA, the proportion of new variable-interest loans has fallen dramatically. Increasingly, new loans are being offered on a fixed-rate basis, providing borrowers with some insurance against rising rates.

It is not just banks that face risks from the market environment. Insurance undertakings too are affected, with the need to finance long-term guarantees from the return made on their investments, while the long phase of low rates also presents a particular challenge for Pensionskassen (pension companies) and fund companies. The pressure to generate a return cannot mean that high investment standards are sacrificed.

Sustainable business models avoid a situation in which errors committed during an upturn place a burden on the financial market during more difficult times. Major efforts have been made in the European banking sector over recent years to eliminate the impact of the financial crisis. Nevertheless, many banks still have large portfolios of non-performing loans (NPL). Tackling the issue of credit quality is therefore one of the main priorities facing the European supervisory authorities and the eurozone's Single Supervisory Mechanism (SSM) in particular. Austrian banks have already successfully reduced their NPL portfolios. In a positive economic environment in particular, it is the role of the FMA to adopt a counter-cyclical approach and to prevent large stocks of non-performing loans from being built up again.

Given the indicators of a normalisation in monetary policy, the companies on the financial market need to face up to the potential impact on their business models of an interest rate rise, and adopt specific measures in response. The financial market must remain stable and resistant even when the basic parameters change, maintaining its functions for companies and consumers.

As part of its focus on securing the sustainability of business models during a period of growth, the FMA will introduce the following measures in 2019:

**FOCUS: DEVELOPMENT OF RISK ON THE REAL ESTATE MARKET**

Given the rise in property prices and increasing volume of real estate loans, the lending standards applied to the financing of private and commercial real estate must be closely monitored.

- Risk indicators, developed on the basis of a market analysis, will be incorporated into the assessment and analysis of lending standards and practices.
- The supervisory reporting system for these standards will be expanded.
- The FMA will review the long-term granting of real estate loans, including from the perspective of collective consumer protection.

**FOCUS: RISKS ASSOCIATED WITH PERSISTENTLY LOW INTEREST RATES**

With interest rates remaining low, it is important to check that supervised companies are continuing to operate a sustainable risk policy.

- Changes in insurance undertakings' risk appetite in terms of their investments and product policy will be reviewed in terms of risk-bearing capacity and risk management.

**FOCUS: PREPARING FOR A NORMALISATION OF MONETARY POLICY**

The FMA will be implementing a range of measures to prepare supervised companies for rising interest rates and a change in the ECB's liquidity policy.

- Stress tests will be conducted in order to review the resistance of banks, insurance undertakings and asset managers to interest rate and liquidity shocks.
- Particular attention will be paid to the management of interest rate risks in the banking book.

**FOCUS: ANALYSIS OF THE SHADOW BANKING SECTOR**

- The FMA analyses the situation in Austria with regard to the shadow banking sector and attempts to escape the regulation and supervision associated with regulated banking.
- Based on this analysis, the FMA will be investigating possible contagion risks to determine whether risks from the shadow banking sector could spread to the regulated financial sector. The results will be incorporated into future supervision activities.

**AIM: FURTHER IMPROVING CORPORATE GOVERNANCE:  
STRENGTHENING RESILIENCE IN A CHANGING RISK ENVIRONMENT**

Governance, and in particular clearly defined internal decision-making structures and processes, strong risk management, and fit and proper members of executive bodies

and key persons, are all critical to the stability and resilience of the supervised companies. The global financial crisis showed that weaknesses in companies' governance can very often be the reason behind financial problems, imbalances and collapses. Consequently, high standards of corporate governance are imperative when it comes to guaranteeing the stability of the Austrian financial market and its ability to function properly. Yet good governance also means curbing the appetite for risk in a market environment featuring an economic upturn and persistently low interest rates, and maintaining a sustainable business policy. Risks change, and new risks also emerge. Systems of governance must be able to cope with new risks by detecting, measuring and managing them.

The FMA considers governance in its entirety, as a system of effective checks and balances that ensures proper, transparent decision-making and due process. The governance system in the supervised entities is therefore located upstream of FMA supervision and forms part of the multi-layer model of supervision in place in Austria. The FMA expects good governance from the supervised companies to mean that:

- Decision-making and workflows in these companies are not impeded or disrupted by conflicts of interest.
- Particularly during a time of external change, companies' risk management policies are able to identify, measure and manage all risks comprehensively.
- Key areas such as compliance, money laundering prevention, risk management and internal audit are equipped with the necessary resources and able to operate independently.
- The managerial and supervisory functions of the supervised entities are able to fulfil their tasks with the requisite degree of autonomy.
- There is a guarantee that those in managerial and supervisory functions, and also other key personnel, have the personal and specialist skills needed to perform their role. This also means that they must be suitably qualified.

For the FMA, governance is not simply a formality. In formulating and enforcing its governance requirements, it is consistently risk-oriented in its approach, based on the principle of proportionality. Depending on a company's individual risk, size and business model, the requirements made in terms of governance will vary in degree. Larger, more complex businesses and those with more risky business models are required to comply with more stringent standards.

#### **FOCUS: INTRODUCTION OF THE FOLLOWING GOVERNANCE MEASURES IN 2019**

- Governance workshops will be held with selected supervised companies in order to demonstrate best practice and so that the findings can be integrated into the companies' overall risk assessment.
- The compliance officer and internal audit functions, in the capacity of internal governance functions, are key contact points for the supervisory authority. Cooperation with these functions will be stepped up.
- Good governance must be a daily reality in order to be effective. Consequently, in the insurance sector, the FMA will focus on reviewing whether key functions are actually performing their role in practice. This will involve checking whether the defined decision-making processes are being observed and whether all relevant key functions are being involved.
- With regard to asset management, a further priority will be governance in manage-

ment companies, encompassing checks on the management of delegation processes (the outsourcing of services) and the overall integration of risk management into the investment process.

- The FMA will tighten up its requirements of the new function of compliance officer in banks pursuant to Article 39 para. 6 of the Austrian Banking Act (BWG; *Bankwesengesetz*) and engage in transparent market communication.
- With regard to the fit and proper nature of those in executive and key functions, the FMA will focus on compliance with the new fit and proper guidelines used to assess the suitability of members of the executive body and holders of key functions.

### **AIM: FURTHER DEVELOPING RISK MONITORING: USING STRONG COMPLIANCE AND CONSISTENT ANTI-MONEY LAUNDERING MEASURES TO IMPROVE THE STABILITY OF SUPERVISED ENTITIES**

Conduct risks arise when companies on the financial market fail to comply with the rules and regulations governing:

- the distribution of financial products to customers
- transparency and conduct on the capital market, with regard to securities trading for example
- the prevention of money laundering and the financing of terrorism.

In relation to product distribution and conduct on the capital market, the FMA also considers conduct risks from the perspective of the customer (see also focus on collective consumer protection: product transparency to improve trust, top quality in sales for greater fairness). There is however another side to conduct risks which is increasingly neglected, namely that, if they do materialise, they can have a significant impact on a company's reputation and economic stability, ultimately also posing a threat to financial market stability.

According to an ECB study, the costs of legal disputes in the European banking sector amounted to € 71 billion over the period from 2008 to 2016<sup>1</sup>. The potential costs of fines have long ceased to be the only fall-out from conduct and money laundering risk. A lack of measures to prevent money laundering and the financing of terrorism in financial companies is no longer tolerated on the market and could result in a direct loss of confidence. In one particular case in 2018, public reports of money laundering at a bank in the eurozone triggered a massive spate of customer withdrawals and, subsequently, to the ECB withdrawing the institution's licence.

These examples have shown that the conventional separation of stability-related solvency risks and behaviour-based conduct risks is no longer appropriate. Conduct and money laundering risks form part of companies' business risk and must be considered in the context of an integrated risk assessment. In extreme cases, conduct and money laundering cases could even damage confidence in the financial market as a whole and thus take on systemic relevance.

In its capacity as an integrated supervisory authority, the FMA recognised at an early stage the need for diverse risks to be considered in an integrated way and for these different risks to be incorporated into the supervision strategy for the companies that it supervises. In particular, the FMA supports a zero tolerance policy in relation to the

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<sup>1</sup> *European Central Bank: Financial Stability Review, May 2016.*

misuse of the Austrian financial market by supervised entities for the purposes of money laundering and the financing of terrorism. This is a view that is also gaining traction at European level. In September 2018 the European Commission announced stronger anti-money laundering supervision, from both a legal and an institutional perspective, to tackle the problem in the EU. Meanwhile, the EBA has incorporated conduct risks into its regular stress testing of banks.

#### **FOCUS: INTRODUCTION OF THE FOLLOWING CONDUCT RISK MEASURES IN 2019**

- The FMA will focus even more strongly on the interactions between conduct, money laundering and solvency risks. Analysis results will be used to raise awareness among the supervised companies and incorporated into supervisory measures.
- In line with the integrated approach to overall risk, the tried-and-tested single point of contact (SPOC) concept will be extended, bringing together the supervisory findings from all sectors.
- As part of this integrated approach, supervised entities will be called upon to reflect conduct and money laundering risks in their risk management processes.
- The FMA's comprehensive experience of linking up conduct, money laundering and solvency risks will be fed into the international debate on developing supervision of money laundering prevention as best practice.

#### **AIM: EXPANDING COLLECTIVE CONSUMER PROTECTION: TARGETED INFORMATION TO CREATE GREATER RISK AWARENESS, PRODUCT TRANSPARENCY TO IMPROVE TRUST, TOP QUALITY IN SALES FOR GREATER FAIRNESS**

Consumer confidence in the Austrian financial market and its providers is not just a pillar of financial market stability but a key condition for economic growth. Trust in regulated financial markets and their providers was severely shaken by the global financial crisis of 2008.

In order to rebuild and foster investor and consumer confidence again, a raft of new legislation has been introduced in the EU in the years following the crisis in the form of the Markets in Financial Instruments Directive (MiFID II), the Insurance Distribution Directive (IDD) and the Regulation on packaged retail and insurance-based investment products (PRIIPs). This legislation has been in force since early 2018 and has considerably strengthened collective consumer protection. This protection begins with the companies and obliges them, when concluding transactions with retail customers, to provide all relevant information, to give fair and transparent advice and to offer financial products that will suit them. At the same time, the supervisory authorities have been given more scope to tackle providers who act unfairly. They may impose sanctions with a deterrent effect where necessary and introduce restrictions or bans if companies are engaging in damaging business practices or offering inappropriate products.

Alongside the fall-out from the financial crisis, digitisation of customer business is also bringing new challenges. Financial transactions are increasingly being offered and taken up online. This means that the relationship of trust build up between the financial service provider and the customer through personal contact is less defined.

New and innovative products, and globalised financial markets are also presenting investors and consumers with new opportunities. Yet these also involve new and complex risks. Consequently, collective consumer protection must keep pace with the markets, tackling new developments such as digitisation and financial innovations so that investors are protected and can have greater confidence in the financial market again.

In order to meet these challenges, the FMA will be addressing the risks associated with certain products for consumers in 2019, while also focusing on the issues of market transparency and information obligations, as well as on high, uniform standards governing the distribution of financial products.

#### **FOCUS: RISKS OF CERTAIN FINANCIAL PRODUCTS FOR CONSUMERS**

Consumer lending has soared over the past two years. One of the reasons for this increase is that access to loans is growing ever simpler and quicker thanks to the range of digital offerings and proactive advertising. The danger in such an environment is that consumers are increasingly taking on loans to fund the purchase of non-durable consumer goods and are then struggling to make the subsequent repayments.

- In the form of an awareness campaign, the FMA will be informing consumers about the specific risks of consumer credit and trying to raise awareness of the issues at stake.
- The FMA will be paying greater attention to the consumer credit market and engaging in supervisory dialogue to address any specific irregularities detected in relation to individual banks.

As a result of digitisation, assets, or opportunities to invest, have emerged in the crypto economy that partly resemble investment products on the regulated financial market. More recently, such products have proved to be highly speculative and volatile. There have also been repeated incidents of fraud involving crypto assets. Although this is not an area that is regulated or supervised by the FMA, negative developments could very quickly damage consumer confidence in financial products in general. Targeted public information is a tried-and-tested way of highlighting consumer trends and risks quickly, even in unsupervised areas.

- The FMA will therefore be further expanding its targeted consumer communication measures in the area of market innovations as part of its preventive activities.

#### **FOCUS: MARKET TRANSPARENCY AND INFORMATION OBLIGATIONS**

Good, easy-to-understand information from providers about their financial products forms the basis of informed, independent decision-making by consumers on whether to invest.

- Last year's supervisory focus, namely compliance with the information obligations arising from MiFID II, the IDD and the PRIIPs Regulation in relation to securities and insurance-based investment products will be maintained. Following an initial phase in 2018, the focus during 2019 will, however, be on how these requirements are implemented and enforced.
- A further priority will be compliance with information obligations in the area of corporate provision funds (new severance pay scheme).

Cost transparency is an important aspect of market transparency. Particularly in the current environment of low interest rates, it is important that consumers are familiar

with the cost structure of financial products as these can considerably shrink the return on the investment.

- The FMA will be focusing on the provision of transparent cost and fee information by insurance undertakings, Pensionskassen and investment funds.
- As far as Austrian investment funds are concerned, the FMA will also be paying close attention to the charging of management fees in cases where a passive investment strategy is offered (closet indexing) and to performance-based management fees. The FMA will take action in the event of abusive practices being identified.

Investment funds engage in securities financing and lending transactions during which they lend securities out of the fund assets to other financial companies, primarily banks, in exchange for a fee. Consumers who hold units in investment funds must be informed about these lending transactions and the associated risks for the fund assets.

- The FMA will be focusing on ensuring that the management companies are meeting these information requirements in full.

#### **FOCUS: STANDARDS FOR THE DISTRIBUTION OF FINANCIAL PRODUCTS**

In addition to market transparency and comprehensive information, consumers must also be able to rely on fairness and quality from their financial advisors. With regard to the distribution of financial products, the FMA continues to guarantee high and uniform standards across every sector of the financial market.

- In the context of its integrated sales supervision, the FMA will be focusing on a review of the qualifications and training of sales staff in the supervised entities.

#### **AIM: IMPROVING READINESS FOR FUTURE CRISES: IMPROVING THE ABILITY OF THE FMA AND AUSTRIA AS A FINANCIAL CENTRE TO WITHSTAND DIFFICULT PERIODS**

Regulation and supervision aim to make companies on the financial market as resistant as possible to shocks and crises so that they can continue to provide their services to corporate and retail customers during difficult periods. Over recent years, however, the crises on the financial markets have highlighted the need for companies to prepare better for crisis situations. Companies are increasingly being required to prepare contingency or recovery plans setting out specific steps and measures that could be used to handle a crisis. Yet should these measures not suffice, companies must also be able to exit the market in an orderly fashion where necessary, without casting doubt on the stability of the market as a whole. This was the reason for the creation three years ago of the European resolution regime for the banking sector.

The national bank resolution authorities and the Single Resolution Mechanism (SRM) in the eurozone have been expanded and given more staff. The first development phases in the resolution plans, preparing for a bank's orderly exit from the market, have been concluded.

Nevertheless, the first instances of the resolution regime being applied to banks in the eurozone have demonstrated that the banks themselves and the resolution authorities need to step up their preparatory work for future resolution cases in order to make a substantial contribution to financial market stability.

**FOCUS: STRENGTHENING READINESS FOR RESOLUTION**

The FMA has set itself the goal of improving its readiness to deal with resolution cases in 2019, prioritising how to put the individual resolution tools into practical effect.

- In line with the other resolution authorities throughout Europe, the FMA will be finalising national concepts for the implementation of its tools, with regard to both creditor bail-ins (haircut) and transfer strategies, another key aspect of resolution.
- These concepts will be incorporated into national and cross-border resolution planning in 2019 for the first time.
- Additionally, in consultation and cooperation with the European Single Resolution Board (SRB), plans have been made for the first resolution simulation games, which the FMA will also be involved in.

**FOCUS: STRENGTHENING THE RESISTANCE OF THE SUPERVISED SECTORS AND COMPANIES TO CRISIS**

The FMA will not only be working to improve its own ability to act faced with a bank resolution process, however. It will also be adding to the measures in place to make the banking sector more resistant to crisis in 2019.

- The FMA will be implementing binding MREL (minimum requirement for own funds and eligible liabilities) rules in 2019 for the first time, and
- a further priority will be the ability of banks to provide data in the event of their resolution.
- With effect from 1 January 2019, the deposit guarantee schemes provided by the individual associations will be replaced by the common deposit guarantee scheme or by institutional protection schemes (IPS) if the latter are recognised by the FMA as deposit guarantee schemes. The FMA will review the systems and processes involved in the new scheme to ensure that they function properly.

The first international experience of the resolution regime for banks has shown that close and ongoing liaison between banking supervision and banking resolution provides the basis for and is a basic prerequisite of effective and successful resolution.

- Consequently, the FMA will be further expanding the benefits of an integrated supervisory authority in 2019, working on even greater streamlining of the processes between the banking supervision and resolution function.

Although banking regulation is already more advanced than the regulation of other sectors, with its own resolution regime and institutions, action is also needed beyond the banking sector to improve how prepared the corporate sector is for potential crises.

- The FMA will therefore be reviewing whether companies in the insurance sector are sufficiently well prepared for crises in terms of their contingency planning and consideration of new risks.
- The FMA will also review whether significant capital market infrastructures are prepared for crises.
- Previous crises have shown that certain capital market infrastructures have a central role to play in the successful resolution of banks. With this in mind, the FMA will enter into dialogue with these significant infrastructures in order to define the requirements on these infrastructures so that potential bank resolutions under the bank resolution regime can be implemented efficiently.





# A FINANCIAL MARKET WITHOUT BORDERS

Regulatory and supervisory challenges

## THE CHANGING FINANCIAL MARKET

**T**here is new impetus on the financial market right now. Globalisation and new technologies are accelerating the pace of integration and development. Technologies that were still in their infancy just a few years ago, such as the Internet, are already deemed old and are forming the basis for more new technologies. Just as the Internet sparked the creation of distribution networks, blockchain technology is now the latest source of new developments. While automation formed the basis for modern customer services, the first forms of artificial intelligence are now replacing human advice. And as computers become ever more powerful, we can process and evaluate huge quantities of data (big data) more and more easily. At the same time, consumer behaviour has also fundamentally changed. The smartphone has become an indispensable part of people's lives, even on the financial market. This is one of the reasons why the relationship between financial service providers and customers is constantly changing, away from relationship banking in a move to transaction banking. Many customers now no longer rely on their house bank for all of their banking transactions but will pick and choose products from individual providers. Meanwhile, access to financial services is being similarly updated. More and more contracts are being concluded online without any human interaction and often without any advice. Customers are using the Internet to get all the information they need in advance. Customers also expect more. User-friendly interfaces and intuitive applications are taken for granted, enabling them to enter into an agreement using their tablet or via a chat bot. They also expect to be able to access their contracts at any time or even to be able to make an insurance claim using an app or chat function, and then they expect fast settlement of their claim.

**Europe's single market, the harmonisation of the law in the EU Member States, and digital interconnectivity are making it easier for companies to gain a foothold in other Member States. Meanwhile, the Internet, new technologies and lower language barriers are bringing consumers closer to companies located outside their country's own borders.**

Obviously these developments are not unique to Austria. The European single market is growing markedly closer, not least as a result of new technologies. Language barriers appear to be falling and harmonised laws across the European Union (EU) are lowering the entry barriers for companies from other European Economic Area (EEA) states, while the Internet and new technologies are helping to reduce the distance between consumers and companies located in different countries.

Yet it is not just the technical and national borders in the financial sector that are becoming blurred. The distinctions between sectors and products are also becoming less clear. Investments, for example, may be designed as a banking product or an insurance product, or as a financial instrument, or even designed in such a way that they evade regulation and thus supervision altogether. The global financial crisis and the prolonged period of low interest rates that has followed have generated tough losses on many investment products, while laying bare the extent to which investors' legal status can vary from one financial product to another.

The reaction, on a Europe-wide basis, has been to focus regulatory and supervisory activity on the provision of proper information and advice in the area of selling. The regulatory response in terms of conduct has been focused around new legislation governing markets in financial instruments (MiFID II)<sup>1</sup>, the distribution of insurance products (IDD)<sup>2</sup>, payment services (PSD2)<sup>3</sup>, and packaged investment products (PRIIPs Regulation)<sup>4</sup> (and IPID<sup>5</sup> and LIPID<sup>6</sup> with effect from 1 October 2018). These new directives and regulations increase and harmonise product transparency, as well as the quality of advice, and extend the rules on conflicts of interest, creating a new gold standard applicable across all sectors.

In this financial market with no borders and complex regulation, collective consumer protection is growing increasingly important as one of the core tasks facing the Austrian Financial Market Authority (FMA). In its capacity as supervisory authority for the Austrian financial market, the FMA must maintain equidistance between the supervised entities and their customers. This means that it may not take sides in any individual disputes between financial service providers and their customers but must protect the interests of the community of consumers by consistently supervising the financial market rules. In its capacity as an integrated supervisory authority, bringing together regulation and supervision for the entire financial market under one roof, the FMA is optimally equipped to supervise the standards and requirements needed across all sectors for an efficient and effective form of collective consumer protection. It pools information and data covering the entire financial market, is familiar with that market's interdependencies, and can leverage synergies across all sectors and products. What this means is that the FMA is not simply a bystander playing the role of observer. Rather, it is at the heart of this paradigm shift playing a key role. It is an active participant in the process of change on the capital market as the technological developments affecting the supervised entities are also changing supervisory activity.

<sup>1</sup> MiFID II: Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

<sup>2</sup> IDD: Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

<sup>3</sup> PSD2: Directive (EU) 2015/2366 on payment services in the internal market.

<sup>4</sup> PRIIPs: Regulation (EU) No 1286/1014 on key information documents for packaged retail and insurance-based investment products.

<sup>5</sup> IPID: Insurance Product Information Document.

<sup>6</sup> LIPID: Life Insurance Product Information Document.

Consequently, checks are needed to ensure that this activity is still appropriate and to determine whether new business models may even be pursued with or without a licence. The FMA's FinTech point of contact set up in October 2016 is operating efficiently in this area and has received good feedback.

## **CROSS-BORDER FINANCIAL SERVICES**

### **INTERNATIONAL PAYMENT TRANSACTIONS**

The European single market for retail payment services has experienced significant technical innovation over recent years, more than in any other sector, and is strongly connected internationally. For its part, the Austrian market for payment transactions is indeed international in character: 178 e-money institutions and 408 payment institutions from the EEA are authorised to operate in Austria. This development goes hand in hand with the rapid growth in the number of electronic and mobile payments, and with the emergence of new types of payment services. It is becoming ever simpler and quicker for consumers to pay electronically, via the Internet for example. This also means that providers hold a huge quantity of customer data. For consumers, alongside the clear benefits of being able to make international payments quickly and economically, this creates risks. These relate to how customer data is stored and used, but also to the possibility of customers triggering payments unintentionally and to the (international) legal enforcement difficulties that customers could face in the event of misconduct by their provider.

The European Banking Authority (EBA) has responded by developing eleven regulatory technical standards and guidelines based on the revised Payment Services Directive (PSD2). These cover a variety of topics including the EBA register and cooperation between national supervisory authorities, strict security measures for the triggering and execution of electronic payments, the definition, application and monitoring of security measures to tackle the operational and security risks, and also rules on complaints-handling. At national level, the Payment Services Act 2018 (ZaDiG 2018; *Zahlungsdienstegesetz*), transposing PSD2 into Austrian law, entered into force on 1 June 2018. Based on PSD2, the new Act limits the exceptions previously stipulated in the ZaDiG and increases consumer protection by reducing liability in relation to unauthorised payments and by providing for an unconditional right to a refund of direct debits. A consumer's bank, as the account servicing payment service provider, remains the first point of contact in the event of improper or incorrect payments as it is always liable regardless of whether new payment service providers were used.

### **CROSS-BORDER DISTRIBUTION OF FINANCIAL SERVICES**

The increase in market participants from elsewhere in the EU targeting consumers in Austria can also be seen from the comparatively high number of notified investment firms with their registered office in another EU country. In 2017 there were 111 companies based in Austria compared with 2 755 investment firms with their registered office in another EEA country and authorisation to provide investment services in Austria. As at the end of 2017, there were also 21 branches of EEA investment firms operating in Austria on the basis of notification. Compared with 2016 (2 622), the

number of EEA investment firms entitled to provide investment services in Austria has therefore increased by 5.8% year-on-year. As at August 2018, 525 EEA credit institutions were authorised to operate under the freedom to provide services and 22 EEA credit institutions operated a branch in Austria under the freedom of establishment.

A significant example of the darker side of the Austrian market growing more international is the presence of unlicensed, and generally fraudulent, providers from abroad who cold call customers (a practice that is actually illegal in Austria) in order to talk them into acquiring “investments”, and use manipulative sales techniques and aggressive methods to force them to sign up (“boiler rooms”). The investor begins by paying small amounts that gradually grow into substantial sums of money by the end, generally by means of a transfer to an account abroad. Initially, the provider will report back on how well the investment is performing from the start, repeatedly “recommending” new trades and demanding additional payments. What generally happens next is that after a few weeks the customer will be told that the investment has made a loss. The provider will claim that this can be offset through new, even better deals, for which more significant payments are needed. As soon as the customer starts to get concerned and asks for their money back, the company will become impossible to contact or will refer to disadvantageous contractual terms and conditions or business terms, or even threaten the customer with legal action. Investors can lose everything. The fact that the money is transferred abroad and that the providers are often based offshore makes it virtually impossible to pursue the matter through the civil courts.

Complaints from consumers are a particularly important source of information to the FMA in this regard. The FMA takes such complaints seriously and always follows them up. A frequently raised issue is international investment fraud involving crypto assets in a variety of different forms, including pyramid or ponzi schemes, pretend hacker and exit scams (in this type of scheme money is collected, frequently via initial coin offerings, after which the fraudsters pretend that they were hacked; contact with the company then comes to an abrupt end and the investor loses everything) or scams involving crypto asset mining packages. Complaints are also mounting up in relation to global money transfer services, which are frequently abused by fraudsters.

Additionally, the FMA has observed that customers in Austria are increasingly being targeted via social media and online advertisements placed in forums for people with an interest in the financial market. These types of offer frequently pick up on current trends such as crypto assets, gold investments and imaginative combinations of these products, which are not generally subject to FMA supervision. Short video clips filled with sensational claims of amazing profits for little or no risk are used to lure investors. Much will be made of supposedly algorithm-based trading software or a promising sales/investment system (“Guarantee yourself a passive income for life!”). The actual nature of the investment is not clearly stated, and any mention of risk, if at all, will be relegated to a brief, general mention in a footnote.

MiFID II introduced strict requirements for the sale of financial instruments and provision of financial services, creating a model for similar rules in the insurance sector (IDD) and in relation to payment services (PSD2). Particular attention is paid to ensuring that customers are only sold products that are suitable or appropriate, and that any conflicts of interest during the selling process are avoided. This begins at a very early stage in the sales process, namely with the decision on which product may

**MiFID II introduced strict requirements for the sale of financial instruments and provision of financial services, creating a model for similar rules in the insurance sector (IDD) and in relation to payment services (PSD2).**

be sold to which target group (product governance). This principle also drives the strict rules applicable to customer information (including a detailed breakdown of costs) and advice, particularly as regards the qualifications of advisors and the documentation of the advisory process (e.g. recording telephone calls, written reports on suitability). A legal framework has also been created for advice based solely on a fee (independent investment advice), and the companies concerned are subject to wide-ranging documentation and reporting obligations.

Despite far-reaching good conduct rules to protect consumers, the practical application and supervisory control are nevertheless complex and difficult, not least due to the allocation of responsibilities at European level (home/host responsibility). The supervisory authority in the host member state (i.e. the state in which a company develops its business activity) only has limited supervision options in relation to most supervisory issues, while most of the power lies with the home authority (i.e. with the authority in the country where the entity is based). Consequently, in the absence of far-reaching powers to intervene, it is often very difficult for the national authority alone to protect the national market. Also needed are close liaison and cooperation between the national supervisory authorities and coordination by the European Supervisory Authorities (ESAs). Another factor impacting on the ease of international cooperation is the sometimes divergent implementation and/or interpretation of EU law at national level. Additionally, international exchange and liaison takes longer than purely national processes, which creates the risk of delays.

## **CROSS-BORDER DISTRIBUTION IN THE FUNDS SECTOR**

The increasing internationalisation of the Austrian financial market, as well as being clearly demonstrated by the extreme case of unauthorised business activities, is also particularly evident from the fund market. Over recent years the number of notified undertakings for collective investment in transferable securities (UCITS), investment funds governed by EU law, has risen from around the 5 500 mark to more than 7 300. More than 1 000 alternative investment funds (AIFs) have now also been authorised for sale (to professional investors) in Austria. Alongside economic and commercial considerations, the simplification of the notification procedure in the form of the European passport has contributed to this internationalisation. In addition to cross-border distribution at product level, management companies frequently avail themselves of the freedom to provide services (UCITS: approx. 80 investment fund management companies; AIFs: approx. 110 AIFMs) and the freedom of establishment (UCITS: 4 investment fund management companies; AIF: 2 AIFMs) in order to sell their fund units directly.

The potential investment universe of an AIF, and the related investment strategies, are far more diverse, and in some cases also more risky in nature, than in the case of UCITS. This is why, from the perspective of investor protection, the Austrian lawmakers opted only to approve certain AIFs for retail customers. It is not possible for foreign AIFs to circumvent this restriction as it is only those funds that are materially equivalent to this type of AIF that are allowed to be sold to retail customers in Austria.

In order to protect Austrian consumers from selling by providers who are not authorised to operate on the market, the FMA lists all notified investment funds on its website. This enables prospective investors to check for themselves before investing

whether a fund product is licensed for sale in Austria and whether a particular AIF may be sold to retail customers. The FMA website also contains a wealth of information on investment funds and their characteristics. If there is a need for official action in relation to a foreign investment fund, the FMA may introduce various measures to protect consumers and in the interests of market integrity. These range from measures to restore compliance with the statutory provisions to a ban on sales, with the FMA also informing the competent supervisory authority in the home state.

### CROSS-BORDER DISTRIBUTION IN THE INSURANCE SECTOR

The insurance industry is another industry that is growing ever more international and modern. Under the freedom to provide services and freedom of establishment, significantly more premiums were written in Austria in 2017 by insurance undertakings from the EEA than in the previous financial year (+63%). Germany ranks as the number-one home state by a long margin, followed by France and the UK. EEA insurance undertakings are already embracing new technologies and offering their products digitally. In terms of cross-border selling, responsibility for supervising overall business activity lies with the respective home authority. Measures on the part of the host authority are generally only of subordinate importance, and in other words only become relevant if the home authority takes no action, if the measures adopted are ineffective, or if there is an urgent need for action. In practice, this can mean that other authorities or complaints bodies consider themselves not to be responsible or support a different legal view, or that the procedures involved create delays. In order to guarantee effective consumer protection even when insurance undertakings operate on a cross-border basis, the FMA has been given new product intervention powers and, with effect from 1 October 2018, may itself introduce the required measures in relation to EEA insurance undertakings directly subject to certain conditions and after informing the home authority. This power relates to all insurance products sold in Austria and extends to imposing a ban on the activity altogether. The IDD also obliges the Member States to set up complaints bodies, which must also work together to settle any cross-border disputes.

Regardless of distribution channel and technical design, one area that the FMA particularly focuses on when monitoring activity in Austria is compliance with the pre-contractual and ongoing information obligations. Cross-border operations must always comply with the information obligations in the host country, in other words Austria. Pre-contractual information must be provided before the customer submits a contract declaration. As far as situation insurance is concerned, this can pose a particular challenge. Take, for example, the customer who only decides to take out breakage insurance for skis minutes before hitting the slopes.

### PRODUCT INTERVENTION: TACKLING PARTICULARLY FROWNED-UPON PRODUCTS

MiFID II (in the case of financial instruments) and the PRIIPs Regulation (for insurance-based investment products) have introduced new direct intervention options for the national and European supervisory authority in the event that particularly “toxic” products are being distributed, topical examples of which include binary options and

contracts for difference (CFDs). This phenomenon has grown in importance over recent years as foreign companies have gained easier access to Austrian consumers, not least by means of direct cross-border selling through online platforms.

CFDs and binary options are highly complex products that enable (retail) investors to speculate on the short-term price movements in financial instruments. They often involve a high level of leverage and/or the automatic closing of the customer's position if the aggregated account balance drops below a defined minimum. The result is products that are frequently opaque and difficult for retail investors to understand. Yet they are generally sold online with no investment advice, supported by aggressive marketing. Studies have shown that a large proportion of investors who invest in this type of product suffer big losses. It has also been noted that the products tend to be offered and sold illegally by unlicensed companies. This makes it particularly difficult for retail investors to claim compensation.

Against this background, the European Securities and Markets Authority (ESMA) made use of its intervention powers for the first time, as granted to it under Article 40 of the Markets in Financial Instruments Regulation (MiFIR<sup>7</sup>) with effect from 1 January 2018. ESMA duly introduced a fixed-term ban on the marketing, distribution or sale of binary options to retail investors anywhere in the EU as of 2 July 2018. The aims of this Europe-wide measure include guaranteeing a regulatory level playing field in the single market, avoiding supervisory tourism and ensuring a harmonised European approach to the collective protection of European consumers. With regard to the sale of CFDs to retail investors, ESMA imposed special conditions, again on a temporary basis, as of 1 August 2018 to limit the risk<sup>8</sup>. In this regard ESMA is only authorised to introduce temporary intervention measures (of no more than three months), and any extension of the measure requires detailed review and/or justification. The measures relating to binary options and CFDs were extended by three months. Additionally, the FMA will continue to protect consumers in Austria by means of targeted information and warnings, and through the consistent enforcement of product intervention at national level.

Detailed information on the new product intervention tool is provided in the article "Collective consumer protection" on page 90 of this publication.

## **WARNING NOTICES: INFORMATION IN THE INTERESTS OF COLLECTIVE CONSUMER PROTECTION**

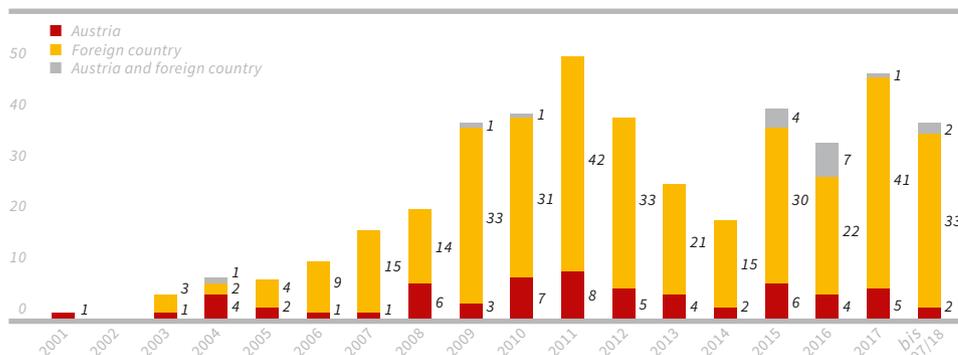
As demonstrated by current ESMA product intervention measures, the providers of high-risk, non-transparent products like binary options and CFDs in Austria tend to be either service providers that are licensed abroad (frequently in Cyprus, Malta or the UK) or providers that are not supervised, and thus operating illegally depending on the business model. It is doubtful whether unlicensed/illegal providers, and particularly those with their registered office elsewhere (in the EU), will adhere to the product intervention measures. In many cases, the potential loss is not related to the fundamental design of the product, as in the case of binary options or CFDs, but to

**The distribution, marketing and sale of certain toxic financial products to retail investors can now be banned altogether or at the very least restricted. With regard to binary options and CFDs, ESMA has already made use of its new powers.**

<sup>7</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (MiFIR).

<sup>8</sup> By way of example, certain leverage limits and lower thresholds for the margin to be made available by the investor have been specified, a ban on customer incentive programmes formalised, and clear, easy-to-understand risk warnings prescribed.

Chart 1: Warnings published by the FMA according to location of registered office



the (sales) conduct on the part of the provider. For some time now the FMA has therefore been focusing on consumer information, so that consumers can make independent and informed decisions. Prior to the product intervention powers being introduced, the use of warning notices has also proved very effective in the past. Nearly all of the supervisory laws enforced by the FMA give the Authority the power to inform the general public, by publishing information on the Internet for example, that certain providers are not authorised to provide services requiring a licence. During 2017 there were 47 such warning notices published. As at the end of July 2018 the number was 37.

Chart 1 shows the development and number of warnings published by the FMA broken down according to whether the companies have their (alleged) registered office in Austria (red), in a foreign country (yellow) or in both Austria and a foreign country (grey).

Around 82% of the warnings currently listed on the FMA website relate to providers that are (allegedly) based abroad. Approximately four per cent of the providers claim to have a registered office in Austria in addition to a base abroad. This type of company that claims to be registered in Austria frequently takes the form of a “clone firm” or “clone individual”. These companies create the false impression of being a licensed company in order to gain customers’ trust, making fraudulent use of the name of a real Austrian company that is licensed to operate (often insurance intermediaries) and pretending to operate for that company. Such companies tend to have sophisticated websites focusing on asset management/optimisation or investment opportunities. In reality, the companies will not actually be licensed to provide such services, however. The actual companies that have been licensed are recorded in the supervisory authorities’ databases as being registered and licensed, and the clone will pretend that this information relates to it. As well as leading to warnings being published, investigations based on information received about such providers generally result in the illegal operations being banned and nearly always lead to criminal charges being brought against the clone.

### NEW TECHNOLOGIES, BIG DATA AND ARTIFICIAL INTELLIGENCE

It is not just the financial market’s geographical borders that are becoming increasingly blurred. Technological advances and ever more digital links are generating new distribution channels and business models, and also new potential as well as new risks, which will be considered below.

The use of new technologies is impacting on all participants in the financial market. Greater competition and/or better transparency (through comparison sites for example) may place greater pressure on companies' margins. The possibility of losing customers, particularly from branch business, contrasts with the opportunity to target and acquire new customers via new distribution channels. The use of new technologies can make companies more efficient and generate new business models based on the evaluation of customer data (cross-selling, data mining). If a financial service company's technology provider encounters problems, this can have a detrimental impact on that entity's business operations, which in turn could result in an elevated level of IT and reputational risk.

Thanks to better transparency (e.g. comparison sites) and 24/7 availability via the Internet and apps, consumers can enjoy easier access to a broader range of products. On the other hand, some customers may feel overwhelmed by the technical progress and no longer fully understand the terms and conditions that have in some cases grown more complex as a result. Given the sheer quantity of data being compiled and the innovative processing options available, how data is handled is increasingly relevant in terms of collective consumer protection. For this reason the supervisory authorities are increasingly focusing on this area.

Austrian companies recognise the risks associated with technical progress and are placing ever greater value on cybersecurity as a result, as evidenced by various studies and surveys. Data is growing in importance as a valuable commodity and is the subject of growing attention. Yet criminals are also able to exploit any gaps or weaknesses in data systems. They might, for example, exploit data relating to particular individuals or sell huge quantities of data illegally. These risks manifest themselves in the type of data leak already experienced by credit card companies. This means that data protection in the broader sense is also consumer protection. Moreover, a leak can have serious repercussions for a company's commercial basis and reputation. Customer confidence can be difficult to rebuild if damaged, and in extreme cases there may be dramatic consequences for the company concerned and even for its future solvency.

Another striking trend is the increasing link between big data and artificial intelligence (AI), opening up unprecedented opportunities but also creating new risks. AI involves learning methods and processes from the patterns that occur in data, and then applying these to other data. The financial sector is a particularly fertile sector for big data and AI, as it has had access to huge quantities of different types of digital data for many years. Bank accounts have been managed electronically for a long time now, payments and transfers are made electronically, nearly all securities trading is carried out electronically, and these are just some examples.

Big data and AI are also increasingly being used with consumers directly. Patterns can be derived from transaction histories, on the basis of which consumers can be issued with a reminder that a payment transfer is due. In terms of sales, chat robots and robo-advisors are increasingly replacing human advisors. As well as the known benefits and potential efficiency gains, this development also poses a serious threat for consumers. A detailed review of big data can be found in the article "Big data – Opportunities and risks from a supervisory perspective" on page 147.

Information about transactions can also be used to draw conclusions about such sensitive areas as gender, sexuality, ethnic origin etc., without this information ever being

**The use of new technologies is impacting on all market participants. These technologies can help providers to optimise their activity and to enter new markets in new regions, while also creating new products and refining existing ones. They improve transparency for consumers, not just with regard to individual products but also in terms of the market range as a whole, and open up access to offers in the remotest corners of the world.**

explicitly asked for. This is why guarantees are needed to ensure that algorithms and AI methods do not lead to discrimination against or disadvantages for certain groups of consumers. Female insurance customers in a certain age group, for example, could be subject to higher premiums for health insurance if they are statistically likely to fall pregnant in the near future.

Moreover, defective software in general can often have a direct impact on customers as a whole beyond the mere availability of online services, as IT security could be compromised or incorrect or unauthorised transactions may go undetected.

Consequently, the review of algorithms and AI software is crucially important to collective consumer protection. As well as mastering these new threats, the systems must also be compliant with the existing regulations such as MiFID II or IDD (e.g. in terms of the quality of advisory) in the interest of technology neutrality. The FMA must therefore be able to understand and evaluate these technically complex programs. For their part, the supervised entities must ensure that their decision-making processes remain transparent, including when use is made of AI.

In terms of its inspections, the FMA will therefore be focusing more closely on financial service providers' obligations to apply due care when implementing and using automated solutions. This will cover the entire life cycle, from the design and development phase through to testing and ongoing maintenance. In particular, the phenomenon of artificial intelligence merits greater attention. Companies are increasingly turning to agile, in the sense of permanently evolving, software solutions. The FMA's challenge in both cases is to continue to build on its technical expertise and the skills needed to monitor this type of moving target.

#### **CASE STUDY: CRYPTO ASSETS**

Another challenge for the supervisory authority lies in how to handle "crypto assets", which are generally built around new technologies such as blockchain, distributed ledgers or smart contracts. These assets are basically designed to avoid regulation, supervision and government control. They pose a huge challenge in terms of efficient and effective investor protection, and not just in Austria. The FMA faces both domestic and foreign business models, often targeted very specifically at retail investors. These models tend to be opaque in character and very high-risk given their dependence on the extremely volatile crypto assets market. Generally, what happens is that capital is gathered from several people – including in the form of crypto assets – in order to generate a form of common return on the investment. The FMA has recently been contacted on many occasions regarding mining models based on crypto assets. If a specific product meets all of the criteria for an alternative investment fund, it is covered by the AIFMG<sup>9</sup> regime, which means that the business model – depending on design – needs to be registered with or licensed by the FMA and that the product may not be sold to retail investors.

In the case of domestic companies that exercise this activity without the FMA's (prior) consent, the FMA may prohibit the commercial operation or take action to restore compliance with the statutory provisions. The FMA has already made use of this option. In order to raise market awareness of the issues at stake, the FMA has published relevant information on its website. The Authority is also available to help

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<sup>9</sup> AIFMG: Alternative Investmentfonds Manager-Gesetz (*Alternative Investment Fund Managers Act*).

interested parties determine the extent to which a potential business model would be subject to obligatory licensing. If foreign AIFs are suspected of distributing mining models in Austria, the FMA may prohibit distribution of the product concerned, also publishing details of this ban in the interests of collective consumer protection.

### **CASE STUDY: INSURANCE INDUSTRY**

The increasing activity of insurance comparison sites on the Austrian market is clearly in evidence. These sites enable consumers to compare different products and providers at a glance. However, this approach does create a risk of customers being influenced too much by price to the detriment of product terms and specific product design. A product with low premiums could, for example, feature a high excess in the event of a claim, and this might not have been taken into account at the time of purchase. The European Insurance and Occupational Pensions Authority (EIOPA) has issued a “Report on Good Practices on Comparison Websites”<sup>10</sup> with its recommendations for comparison sites. It should also be noted that under certain conditions<sup>11</sup> comparison websites will come under the scope of the IDD as of 1 October 2018.

The use of innovative distribution channels and changing customer behaviour are creating a need for new products. Customers are focusing ever more on flexibility in terms of premium, cover and policy term. The IDD introduces new rules for the product development process in this regard (in the same way as MiFID II for financial instruments). In future, insurers will have to give more thought to customers’ requirements, considering what they want and need from insurance products and how these products can meet their requirements throughout the product term. Examples of new products include telematics insurance, “pay as you live/drive” policies, smarthome deals and situation-specific insurance.

The European lawmakers and the FMA have a neutral stance on the trend towards (partly) automated advice. The question here, however, is what technical requirements these automated systems should have to meet. The IDD implemented a general obligation for insurance undertakings to provide advice. It is the insurance undertakings who are responsible for fulfilling this obligation, regardless of technical implementation, as also applies in the area of financial instruments.

### **CONSUMER CREDITS**

Another trend has emerged over recent years as customer behaviour has changed, namely a huge rise in consumer loans. Consumer borrowing has been driven by the advance of new sales channels and is reflected in the current market data. While lending to households collapsed in the wake of the economic crisis, the volume of new loans picked up again from 2014 onwards and has been growing strongly ever since. The growth in the volume of new lending in 2017 was particularly marked, up by as much as 10.5% on the previous year’s figure (+2.8%). The total volume of new loans in 2017 was € 3.8 billion.

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<sup>10</sup> EIOPA-CCPFI-13/100.

<sup>11</sup> The definition of insurance distribution includes the provision of information concerning one or more insurance contracts in accordance with criteria selected by policyholders through a website or other media and the compilation of an insurance product ranking list, including price and product comparison, or a discount on the price of an insurance contract, when the policyholder is able to directly or indirectly conclude an insurance contract using a website or other media.

**Digitisation is completely changing the relationship between customers and financial service providers in a shift away from relationship banking towards transaction banking: customers' relationship with their house bank is no longer as important. Instead, customers are prepared to search globally for the best deal.**

Digitisation has changed the relationship between customers and their banks, with a move away from relationship banking towards transaction banking. Instead of staying loyal to their house bank, customers are increasingly looking to source different products from different banks, with more and more products being taken out online. Customers have fewer inhibitions about taking out a loan nowadays as there is no longer any need to explain in person to a bank manager why they need to borrow money. Loans can be taken out online at the click of a button. Given that customers no longer need to take out all of their loans with one single bank, there is the risk during the process of awarding credit that the customer might provide incomplete or incorrect information, particularly in relation to existing debt. From the bank's perspective, this increases the risk of insufficient lending standards (e.g. affordability, term of loan, amount of loan, charges) being applied to finance deals and, subsequently, to a higher risk of default.

The question of location is becoming less and less significant to the consumer, with loans increasingly being offered online on a cross-border basis. This also changes the intervention system, as Austrian authorities and courts only have limited (if any) responsibility for providers based abroad. It is not always immediately obvious to the customer who their contractual partner actually is, or that this partner is based in another country. If problems arise, it may be difficult get in touch with a contact person abroad or to resolve any conflicts. Consumers may find themselves confronted with a different legal system and enforcement options or different lending customs. This similarly applies to savings deposits. In the event of insolvency, it is not the deposit guarantee scheme at the customer's place of residence that is responsible for compensation but the scheme located at the place where the bank is licensed.

Aggressive advertising and the pressure of the consumer society also lead customers astray, prompting them to act rashly and take out a loan without properly thinking it over. Loans are increasingly being offered at the point of sale, such as when completing a purchase online or at the till in an electronics shop, sometimes with the customer not actually realising that they are entering into a consumer loan agreement. Additionally, loans are often offered with an attractive fixed interest rate at the start of the term that is then subsequently replaced with a higher fixed or variable rate. Consumers' lack of knowledge about loans, interest rates, excess borrowing and similar issues is also contributing to this problem. Another particularly critical aspect for investors is when the term of the loan does not match the life of the item being financed. This can mean still paying for a mobile phone years after replacing it with another device. Loans also tend to be used on a cumulative basis in that as well as having a personal loan or even loans, consumers will also be using an overdraft facility. This can result in them losing sight of their overall financial position, while problems in repaying one loan can impact negatively on other borrowing.

The FMA uses complex microprudential and macroprudential supervision tools to monitor and safeguard the stability of the financial market as a whole and individual financial institutions in relation to lending. This means that consumers in Austria are directly protected from their bank defaulting while benefiting indirectly from the impact of such prudential measures, as these influence credit institutions' lending standards. With regard to conduct supervision, the Consumer Credit Act (VKrG; *Verbrauchercreditgesetz*) creates far-reaching information obligations rules in relation to credit checks (obligatory checks and compulsory warnings if negative). The FMA

regards the task of ensuring compliance with customer information obligations as forming part of credit institution managers' due diligence remit pursuant to Article 39 of the Austrian Banking Act (BWG; *Bankwesengesetz*), which means that the FMA derives indirect powers, particularly where malpractice is suspected, for example on the basis of complaints made to the FMA.

An obligatory warning is required if the result of a consumer credit check is negative. The BWG also contains rules regarding the knowledge and skills of employees involved in offering and concluding loan agreements (Article 33 para. 1 BWG) and in relation to conflicts of interest and remuneration policy (Article 33 para. 3 BWG).

These provisions form the basis of the FMA's supervision with regard to conduct around loan products. They are not, however, either as far-reaching or as detailed as those governing financial instruments (MiFID II), insurance (IDD) or payment transactions (PSD2). Given that consumer loans also involve serious risks, a harmonised level of protection is required. The lawmaker therefore needs to create a regulatory level playing field straddling the entire financial market, providing the FMA with the basis for effective protection of all consumers by means of effective intervention options in all areas.

## THE FMA'S APPROACH TO SUPERVISION

Austria's financial market – be it the insurance sector, payment transactions or the distribution of investment services and classic banking products – finds itself in a period of rapid transformation. While these changing times are creating new opportunities and potential for consumers and financial service providers, they are also, as demonstrated here, generating new risks and making existing threats more serious. There is a complex balance to be struck between mastering these risks and guaranteeing a market environment that is conducive to innovation on the one hand, and strengthening Austria as a base for business on the other. This is also one of the main tasks facing the FMA, and a challenge that it is embracing with self-confidence and competence.

The FMA is demonstrating a sense of proportion and a technology-neutral stance as it deals with the complex interweaving of national and European regulation and changing basic parameters. As well as enforcing the legal framework, the FMA also builds strongly on consumers' individual responsibility. To this end, it provides a broad range of information across diverse media and in a variety of forms in order to break through the increasing complexity of the financial market and even out any information asymmetries, enabling consumers to make informed, independent decisions. This is all the more relevant in cross-border distribution, which the FMA monitors particularly carefully, ensuring there is effective cooperation with the European and other national supervisory authorities.

The FMA pursues an integrated approach to overcome the complexity of the market and leverage synergies across different sectors. By bringing together prudential supervision and conduct supervision within a single institution, the FMA guarantees a standardised exchange of information and knowledge among microprudential, macroprudential and conduct supervision. It uses its comprehensive data and its proximity to the entire financial market for targeted market monitoring across all sectors. This provides the basis for integrated measures, making a key contribution to the stability

**The FMA adheres to four principles in relation to regulation and supervision: risk orientation, subsidiarity, proportionality and technology neutrality.**

of the Austrian financial market. Above all, the FMA uses preventive measures to guarantee compliance with supervisory standards and thus improve market participants' confidence in a well-functioning financial market in Austria.

With the existing powers and options for intervention provided by MiFID II and IDD, the FMA is well equipped, particularly in relation to the distribution of financial products and insurance-based investment products, to intervene as soon as the interests of investors or policyholders are at risk. The FMA pursues an integrated approach to conduct and sales supervision, with responsibility for both. This ensures that cross-sector knowledge is shared across the sectors with convergent supervision in the interests of investor protection. The integrated approach guarantees that the level of consumer protection for any type of service, as long as provided for by law, is of the same standard regardless of whether the customer is using a bank or investment service or buying an insurance product. The current legal situation still features a degree of imbalance, ranging from the gold standard in the form of MiFID II for investment services and IDD, which is following suit for insurance products, through to relatively rudimentary and sporadic conduct rules for banking services. The transformation of the financial market and resulting consequences for consumers are, however, increasingly highlighting that convergent rules of conduct are needed that straddle the different sectors and that the FMA must be granted further-reaching powers to intervene accordingly.

As far as new technologies and business models are concerned, the FMA once again has its finger on the pulse, identifying trends at an early stage, bringing together the required skills and expertise, and introducing the required measures to guarantee qualified and effective supervision and to ensure that it is a competent contact person for policymakers and industry. The FMA's FinTech point of contact is making a particular contribution to transparency in supervision in this regard.

By networking internally, but also internationally, on new topics and legal issues, and in particular by participating in international working groups, the FMA promotes efficient, consistent and cross-border action to cope with a market that is developing at an ever faster pace.

In order to keep up with rapid technological change, and respond to big data and AI in particular, the FMA has set up its own IT centre of excellence in the form of its IT Security Circle. Employees from all departments of the FMA are represented in the IT Security Circle, which provides in-depth training in IT issues, as well as providing a forum for the exchange of information and experience between the departments and for the further development of the FMA's IT strategy.

Detecting trends and risks from an early stage also remains of central importance to the FMA, so that appropriate measures can be taken to steer behaviour in good time. Structured dialogue and exchange with industry represent an important tool in this regard. This intensive and direct contact guarantees the FMA's ability to act and react on a timely basis. A cross-sector market survey on digitisation was also initiated in 2018. Supervised entities from all sectors have been surveyed on the current state of the technologies being used and on the trends to be expected in the future. The survey results will help the FMA obtain an overview of developments on the market and to equip itself effectively for future challenges.

At both European and national level, the FMA has worked very hard on the creation and implementation of new standards in consumer protection, be this through MiFID II

with regard to financial instruments and services, in conjunction with the IDD in the insurance sector or the legislative input during implementation of the PSD2 through to the development of the EBA guidelines. The FMA reacts quickly and in a forward-looking manner to new developments. In the context of FinTech enquiries, for example, initial work was done on fundamental interpretations of the new licensing cases set out in ZaDiG 2018, thereby improving market transparency.

In order to ensure that the new gold standard in collective consumer protection can also be effectively implemented on a cross-border basis, various steps have already been taken to improve and accelerate these international processes at European level. Harmonised workflows and forms for notifications in cross-border services and the exercising of the right of establishment have been set up, and several working groups deployed to coordinate the national supervisory bodies with the active involvement of the FMA, in order to guarantee harmonised supervision. Nevertheless, the ESAs, in their central coordination role, must work even harder towards convergence, efficiency and effectiveness.

Specifically, in terms of the sustainable granting of consumer credits, the FMA, as well as relying on legal enforcement, also relies on a variety of further measures to protect consumers in Austria, particularly in the absence of sanctioning powers that can be enforced on a uniform basis. The FMA uses a combination of three packages of measures: market monitoring, dialogue with market participants and consumer information.

Raising consumers' awareness of the risks associated with consumer credits is a central issue, as informed decision-making relies on information asymmetries being eradicated. By means of an information campaign, consumers are to be made aware of the need to think carefully before taking out any loan and given advice on what to consider before signing. For the purposes of this campaign, the FMA uses a range of communication channels as part of an intensive strategy, including its own website, press releases, tweets, presentations and interviews.

As part of its operational supervision, the FMA focuses particularly strongly in an integrated and cross-sector manner on selling and in particular on the use of new technologies, in order to understand and accompany new developments, but also to ensure that the standards critical to collective consumer protection are observed directly at the point of sale.

As an integrated authority that brings together the supervision of the entire financial market in Austria under one roof, the FMA is ideally placed to tackle these challenges with the optimum organisational structure.

**MiFID II, IDD, PSD2 and the PRIIPs Regulation all make financial products more transparent. They also help to make information easy to understand and comparable, and improve the quality of advice, setting a new gold standard in investor protection.**

# BREXIT

## Challenges for the Austrian financial market



On 23 June 2016, in a referendum of the population of the United Kingdom of Great Britain and Northern Ireland (UK), 51.9% voted to leave the European Union (EU). On 29 March 2017, the UK Government notified the European Council of its intention to leave the EU pursuant to Article 50 of the Treaty on European Union, formally triggering the withdrawal process informally referred to as “Brexit”. According to the statutory deadline, and provided no other consensual solution is negotiated in the meantime, the United Kingdom will cease to be a Member State of the EU at 11pm local time on 29 March 2019 (0:00 CET).

### DEAL, OR NO DEAL

The negotiations on whether the EU and the UK can agree on an orderly procedure for the latter’s withdrawal from the former, and how the legal and economic relations between the EU of the remaining 27 Member States and the UK are to be structured after Brexit, had not yet been concluded as of this article being filed. The withdrawal scenarios range from a hard Brexit, in which the UK becomes a third country in its relationship with the EU from 30 March 2019 without any bilateral agreement, to a formal withdrawal on 29 March 2019 and a subsequent transitional period of up to two years for further negotiations, during which time the UK would comply with all EU rules and continue to pay its contributions, but no longer have any say in the EU bodies. In terms of what the common economic relations could look like in the future, a range of options is under discussion. These include the UK being demoted to the status of a third country vis-à-vis the EU under the World Trade Organization (WTO)<sup>1</sup>

<sup>1</sup> *The WTO is a multilateral institution that regulates international trade and economic relations, and monitors compliance with the relevant treaties. It aims to reduce trade barriers and promote free trade, and is also responsible for settling trade disputes.*

treaties, or alternatively a bilateral free trade agreement like the one the EU has concluded with Canada (CETA). There is also the possibility of the UK acquiring a status similar to Norway or Switzerland, with which it would remain a member of the European Economic Area (EEA), required to adopt all EU law but with no power to participate in decision-making. At the other end of the spectrum of options is an “exit from Brexit”, which, however, would require a complete shift in the political balance of power in the United Kingdom.

How political and economic relations between the two sides will ultimately develop in the future therefore remains unclear. Since this is the first time that a Member State has wanted to leave the EU, and given the close ties that have existed between the UK and the EU for decades, not to mention the enormous importance of the UK economy for Europe, it is vital to prepare for the occurrence of any scenario, including the worst case scenario of a hard Brexit.

The great challenges facing the European Union and the United Kingdom are illustrated by the fact that almost 21 000 EU laws and regulations are relevant to the Brexit process, but only insofar as they have not been amended by the UK Parliament and no longer match EU law, or even repealed. Agreements that the EU has concluded with other countries will no longer include or bind the UK. In those areas where the EU has already had sole competence – such as competition, state aid, trade agreements – the UK must create a new legal basis of its own.

What this means in specific terms is outlined briefly here using an example from the financial market, the EU principle of single authorisation (passporting). In the European single market, the principle applies that any financial service provider licensed in a Member State in accordance with EU law and thus subject to supervision there under the freedom to provide services and freedom of establishment may also offer its financial services in any other market of the EEA. UK banks are thus allowed to accept savings deposits from any other EU country and lend money in any other EU country. In return, Austrian banks may also offer their financial services in London, for example. The same applies to insurance undertakings, which are allowed to sell their policies throughout Europe, as well as to asset managers, payment service providers and many other financial services requiring a licence. After Brexit this will no longer be possible with immediate effect. Or, it will only be possible under changed conditions which are best clarified and addressed in advance. A great many questions arise in this context:

- How can we ensure that financial services provided under the freedom to provide services or freedom of establishment can continue to be provided after Brexit?
- Will this still even make business sense under the changed conditions? Will it still be worth it?
- What happens after Brexit to the contracts concluded before Brexit?
- Can these even be fulfilled if the provision of the financial service is subsequently prohibited, and if so, how?
- How can such contracts affected by Brexit be terminated or modified while ensuring consumers and investors remain protected?
- What will happen to existing life insurance or pension products with very long terms, or to current non-life, accident or health insurance policies?
- What will happen to the clearing of foreign exchange or derivative contracts, which is currently focused mainly in London, for contracts with terms beyond Brexit, and thereafter in general?

**In the European single market, the principle applies that any financial service provider licensed in a Member State in accordance with EU law and thus subject to supervision there under the freedom to provide services and freedom of establishment may also offer its financial services in any other market of the EEA. After Brexit this will no longer be possible with immediate effect.**

These are just some of the many, possibly countless, unanswered questions to which answers must be found before time is up and Brexit is upon us. Otherwise there is the threat that the ensuing chaos will result in massive distortions on the markets, not least since the UK has such close economic ties with Europe, and London's financial market in particular is of prime importance.

### THE UNITED KINGDOM – THE MAJOR ECONOMIC PARTNER OF THE EU-27

In terms of gross domestic product (GDP), the United Kingdom is the second-largest economy in Europe and the fifth-largest in the world. The EU is also the UK's largest trading partner. In 2017 around 46% (Eurostat<sup>2</sup>) of UK exports went to the EU, and 53% (Eurostat) of all UK imports came from the EU. UK imports from the EU, however, accounted for only 6% of all EU exports.

Brexit will be a particular challenge for the financial sector, however, as the City of London is undisputedly still the most important financial centre in Europe: 60% of the EU's capital market business is transacted there, and 40% of all European assets are managed there. The spectrum of financial services is extremely broad, ranging from traditional banking services to investment banking, from clearing to securities, derivative and currency settlement, from stock exchange trading to asset management, and from pension funds to insurance and reinsurance, to name but a few. Clearly, the financial sector is therefore also important to the UK economy, contributing around 8% of value added every year.

### UK-AUSTRIAN ECONOMIC RELATIONS IN FINANCIAL SERVICES

Levels of direct trade between Austria and the United Kingdom are comparatively low: according to Eurostat<sup>3</sup> 2017, the trade volume<sup>4</sup> (sum of income and expenditure) between Austria and the UK amounted to around € 11 billion. This corresponds to about 2.8% of Austria's total foreign trade. Trade in goods accounted for € 6.6 billion and trade in services for € 4.4 billion. According to the Oesterreichische Nationalbank<sup>5</sup>, this corresponds to 4% of Austria's total cross-border trade in services. The UK was thus the fourth most important trading partner in this sector after Germany, Switzerland and Italy, with Germany a long way out in front of the other countries at € 38.7 billion.

A sectoral view of Austria's trade in services with the UK shows that while financial services are the fifth largest category at € 246 million, the absolute volume is negligible. At € 127 million, the insurance and pension services category ranked seventh. In financial services in general there was a slight surplus of about € 32 million, while in insurance there was a deficit of € 111 million (see Chart 2). With a total value of € 1.2 billion, other business services accounted for the largest share of trade in services between Austria and the UK in 2017.<sup>6</sup>

The United Kingdom is Austria's fourth-largest trading partner for financial services,

<sup>2</sup> Figures as at 31 October 2018.

<sup>3</sup> Figures as at 31 October 2018.

<sup>4</sup> For comprehensive impact analyses of the economic consequences of Brexit, see HM Treasury (2016), Brakman et al. (2017), Dhingra et al. (2017), Felbermayr et al. (2017), and Oberhofer and Pfaffermayr (2017).

<sup>5</sup> [www.oenb.at/isaweb/report.do?lang=EN&report=9.2.02](http://www.oenb.at/isaweb/report.do?lang=EN&report=9.2.02), accessed on 31 October 2018.

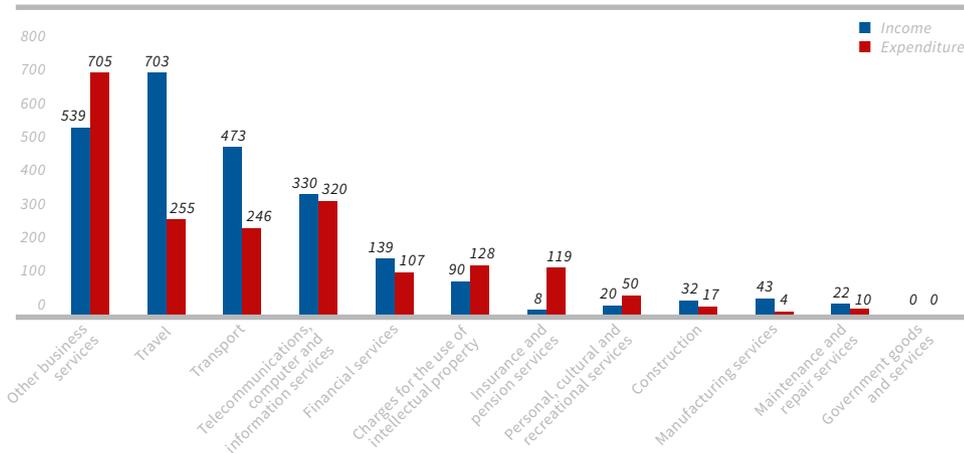


Chart 2: Trade in services between Austria and the United Kingdom by sector (2017, in € millions; source: Eurostat)

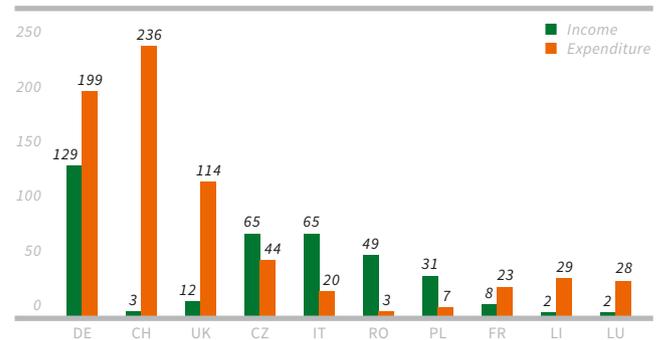
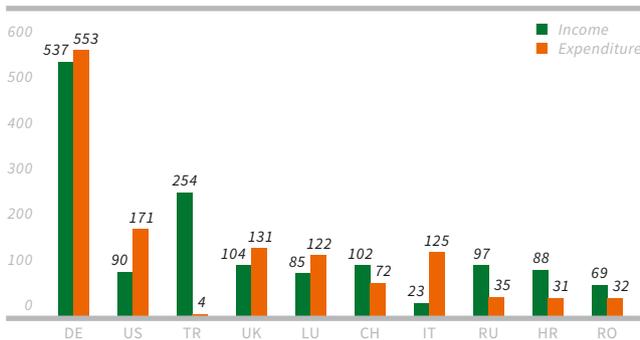


Chart 3 (left): Financial services between Austria and other countries (2016, in € millions; source: Eurostat)

Chart 4 (right): Insurance services between Austria and other countries (2016, in € millions; source: Eurostat)

but lags a long way behind Germany in terms of volume (see Chart 3). In the insurance sector, Germany and Switzerland lead the way, with the UK in third place (see Chart 4), with premiums and benefits in the life insurance business accounting for the bulk of expenditure (€ 98 million).

Austrian banks' exposure to the UK amounted to around € 18 billion in the second quarter of 2018, which corresponded to approximately 1.7% of their total foreign exposure. The direct exposure of the Austrian fund market amounted to € 6.5 billion, a share of 3.73% of total assets.

The direct effects of Brexit on the Austrian economy are therefore negligible due to the minor importance of bilateral trade in goods and services. Indirect and knock-on effects may, however, create serious risks.

## BREXIT NEEDS A EUROPEAN RESPONSE

Given the importance of economic relations between the EU-27 and the United Kingdom for both sides, and the close links that have developed over time, a hard Brexit that terminates relations overnight with no transitional regime could push entire business sectors over a cliff edge and into uncertainty. This could trigger significant distortions in the markets. It is therefore all the more important that companies in the European Economic Area that are affected make timely, appropriate preparations for

<sup>6</sup> The category "Other business services" includes research and development services (€ 108 million), professional services and management consulting services (€ 463 million), technical services, trade services and miscellaneous business services (€ 430 million). The figures in brackets refer to the sum of income and expenditure in 2016.

**It is important that companies in the European Economic Area that are affected make timely, appropriate preparations for the risks of a hard Brexit. Since Brexit is a pan-European challenge, Europe must adopt an approach that is as unified as possible.**

the risks of a hard Brexit. Since Brexit is a pan-European challenge, Europe must adopt an approach that is as unified as possible.

As far as the EU financial markets are concerned, efforts are being coordinated by the relevant European supervisory institutions, in particular the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). As Austria's national supervisory authority responsible for these areas, the FMA represents the country's interests and concerns as a voting member in these institutions and is actively cooperating to ensure appropriate preparation for Brexit throughout the EU and at the same time to ensure a level playing field for all. As an integrated supervisory authority that encompasses the entire Austrian financial market under one roof, the FMA has the major advantage of being able to use and contribute synergies to optimally assert Austria's interests.

Moreover, the FMA is committed to the principles of subsidiarity, i.e. that problems are addressed at the level where this is most effective, efficient and closest to the market, and of proportionality, i.e. that a problem-solving approach must also be proportionate to the risk and complexity of the business relationship.

Furthermore, the FMA aims to take preventive action wherever possible to minimise any damage to supervised entities and their clients arising from existing business relationships and contracts with business partners from or in the United Kingdom. In particular, this involves companies drawing up appropriate contingency plans and informing customers as early and transparently as possible about the potential effects on their business relationships while offering them alternative options for action.

The European supervisory authorities EBA, EIOPA and ESMA have already prepared and published working papers (Opinions<sup>7</sup>) in which they identify the specific risks of Brexit both from the point of view of businesses in the EU-27 and from the point of view of those in the UK in their respective supervisory areas, in order to address them jointly with the national supervisory authorities, such as the FMA. The most important points identified in these opinions are:

- Survey and analysis of existing business relationships with financial market participants in or from the United Kingdom:
  - Mutual direct exposures
  - Existing contracts
  - UK financial market infrastructures (FMIs) in use, in particular central counterparties (CCPs) and similar ancillary services
  - Storage of data in – and transfer of data to – the UK
  - Impact of Brexit on financing markets (for banks including those for the issuance and placement of MREL-eligible<sup>8</sup> instruments).
- The impact of being affected by Brexit risks against the business model and strategy of a given company must be assessed, in particular with regard to solvency and liquidity positions.
- If withdrawal from the UK market seems sensible, measures must be developed to deal with existing business relationships and contracts. In doing so, particular attention should be paid to the obligations towards customers (customer communications).

<sup>7</sup> EIOPA, EBA and ESMA Opinions see page 59.

<sup>8</sup> Minimum Requirement for Own Funds and Eligible Liabilities.

- In order to be able to carry out existing or new business, action is needed to ensure that the necessary licences are granted in good time.
- If the organisational structure of a supervised entity is to be changed, risk management must be adjusted accordingly. In this context, excessive outsourcing of core functions should be avoided (avoidance of empty shell companies).
- For existing or future contracts affected by Brexit, appropriate measures must be worked out to adapt the contracts appropriately (contract amendments or supplements, for example).
- The transfer and storage of data must be verified. In particular it is necessary to assess whether appropriate data security and access measures are in place for cross-border transfers, and whether the terms of the General Data Protection Regulation (GDPR) are still being observed.
- Where access is required to FMIs, in particular CCPs, provision must be made for a transfer to alternative FMIs within a reasonable period of time, where appropriate.
- In the event of dependence on cross-border financing affected by Brexit (e.g. inter-bank loans), the sustainability of the arrangement must be examined and, if necessary, alternative financing provided.
- Where the Bank Recovery and Resolution Directive (BRRD) applies to supervised entities, some of these issues will have already been considered in the context of resolution and recovery planning. This may be very useful for Brexit preparations. However, these companies must in any event review all MREL-eligible liabilities issued under UK law, since such liabilities may no longer be MREL-eligible after Brexit.
- The FMA should be informed about the findings of the risk assessment, planned measures and the intended schedule.

## CONTINGENCY PLANNING: PREPARING FOR ALL EVENTUALITIES

The passport regime plays a central role in the risk analyses. Under this regime, a provider of a financial service requiring a licence that is licensed and supervised in one Member State may also offer its services in all other countries of the European Economic Area under the freedom to provide services and freedom of establishment. However, in the event of Brexit without any new agreements or transitional provisions, the UK will become a third country and any provider wishing to offer such a financial service in the other economic area will have to set up a local branch with an appropriate licence for that economic area.

Since it can be assumed that a substantial portion of the cross-border financial transactions between the EU-27 and the UK will continue after Brexit, this will mean that subsidiaries or branches will have to obtain a licence in the other economic area, assuming that they do not already hold one, or relocate the company's registered office. To ensure that these processes are initiated in good time and that the door is not opened to regulatory and supervisory arbitrage as different locations compete with one another, appropriate EU-wide working and coordination groups have been set up. ESMA, for example, has established the Supervisory Coordination Network (SCN) in its area of supervision. The network meets regularly and reports on and discusses all relocation applications submitted to the national supervisory authorities.<sup>9</sup> The

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<sup>9</sup> See also ESMA's Public Statement of 4 July 2018 (ESMA42-110-998) [www.esma.europa.eu/document/timely-submission-requests-authorisation-in-context-united-kingdom-withdrawing-european](http://www.esma.europa.eu/document/timely-submission-requests-authorisation-in-context-united-kingdom-withdrawing-european).

aim of all these bodies is to adopt a common approach among the European supervisory authorities in order to ensure adequate preparation for Brexit across the EU and at the same time to strengthen the concept of a level playing field.

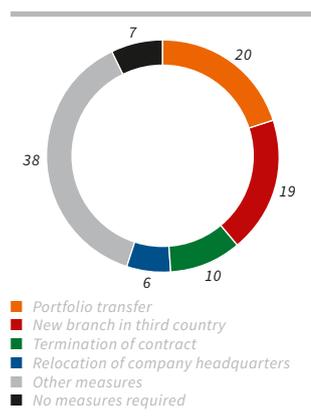
European supervisors have raised awareness and urged that such licence applications be submitted as early as possible to ensure a smooth transition to the future regulatory and supervisory regimes. A clear trend is emerging, with licensing in the EU particularly focused on Germany, France, Ireland and Luxembourg.

Contracts that were concluded before Brexit pose a particular challenge. In principle, these will remain valid even after the UK leaves the EU, although the regulatory requirements for the provision of financial services may change fundamentally as a result of Brexit. For example, the provision of financial services under the freedom of establishment or freedom to provide services may be prohibited.

Since insurance contracts in particular often have very long terms, and obligations extend over long periods, EIOPA has focussed on ensuring that insurance companies define measures to deal with existing insurance contracts in their contingency plans.

According to an EIOPA survey, 72% of insurance undertakings (353 companies) with cross-border operations between the UK and the EU had already developed contingency plans by June 2018. The remaining 28% are companies with a very small market share in cross-border business. Businesses were somewhat more sceptical about whether all contingency measures could be implemented on time: only 53% were convinced that it was possible at the time, although only 2.2% considered it to be completely unrealistic.

Chart 5: Contingency plan measures



The measures defined in the respective contingency plans for dealing with existing insurance contracts are relatively varied (see Chart 5): 10% will simply terminate the contracts in the event of a hard Brexit, 20% will transfer the portfolio to another insurance undertaking that is still able to perform the service in accordance with the law. 6% of insurance undertakings will relocate or establish a licensed branch in order to continue providing the service in question. On the other hand, 7% of the companies concerned believe that, despite Brexit, no specific measures will be necessary. The remaining 38% is accounted for by a large number of very diverse and very specific measures.

Only nine Austrian insurance undertakings in the areas of life and non-life/accident insurance are affected, with the total premium volume of around € 9 million (2016) representing a less pressing problem. In comparison, the premium volume affected across the EU as a whole amounts to in excess of € 26.5 billion.

All Austrian insurance undertakings with business relations with the United Kingdom have also drawn up contingency plans. Although the range of planned measures is broad, the focus is clearly on foregoing new business and transferring portfolios of existing contracts. Moreover, all assume that they will be able to implement the planned measures in good time.

It is of particular concern to the FMA that policyholders and customers are fully informed at an early stage about the possible consequences of the planned measures for their existing contracts. For example, in the event of a transfer of the undertaking's registered office or the transfer of the insurance contract portfolio to a company domiciled in the EU, they must be informed about the future contractual partner and the jurisdiction that will then apply to the contract. Further essential information in this case includes details of the conciliation bodies and supervisory authorities that will then be responsible for the contracts.

## OPINIONS PUBLISHED BY THE EUROPEAN SUPERVISORY AUTHORITIES

The European Banking Authority (EBA) has published the following opinions:

[www.eba.europa.eu/documents/10180/2137845/EBA+Opinion+on+Brexit+preparations+%28EBA-Op-2018-05%29.pdf](http://www.eba.europa.eu/documents/10180/2137845/EBA+Opinion+on+Brexit+preparations+%28EBA-Op-2018-05%29.pdf)

[www.eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+Brexit+Issues+%28EBA-Op-2017-12%29.pdf](http://www.eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+Brexit+Issues+%28EBA-Op-2017-12%29.pdf)

The European Insurance and Pensions Authority (EIOPA) has published the following opinions:

[eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-119-Opinion%20on%20Disclosure.pdf](http://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-119-Opinion%20on%20Disclosure.pdf)

[eiopa.europa.eu/Publications/Opinions/2017-12-21%20EIOPA-BoS-17-389\\_Opinion\\_on\\_service\\_continuity.pdf](http://eiopa.europa.eu/Publications/Opinions/2017-12-21%20EIOPA-BoS-17-389_Opinion_on_service_continuity.pdf)

The European Securities and Markets Authority (ESMA) has published the following opinions:

### *On the general principles*

ESMA Opinion on general principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union (ESMA42-110-433): [www.esma.europa.eu/sites/default/files/library/esma42-110-433\\_general\\_principles\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_context\\_of\\_the\\_uk\\_withdrawing\\_from\\_the\\_eu.pdf](http://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf)

### *On asset management*

ESMA Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union (ESMA34-45-344): [www.esma.europa.eu/sites/default/files/library/esma34-45-344\\_opinion\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_area\\_of\\_investment\\_management\\_in\\_the\\_context\\_of\\_the\\_united\\_kingdom\\_withdrawing\\_from\\_the\\_european\\_union.pdf](http://www.esma.europa.eu/sites/default/files/library/esma34-45-344_opinion_to_support_supervisory_convergence_in_the_area_of_investment_management_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf)

### *On investment firms*

ESMA Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union (ESMA35-43-762): [www.esma.europa.eu/sites/default/files/library/esma35-43-762\\_opinion\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_area\\_of\\_investment\\_firms\\_in\\_the\\_context\\_of\\_the\\_united\\_kingdom\\_withdrawing\\_from\\_the\\_european\\_union.pdf](http://www.esma.europa.eu/sites/default/files/library/esma35-43-762_opinion_to_support_supervisory_convergence_in_the_area_of_investment_firms_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf)

### *On trading places*

ESMA Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union (ESMA70-154-270): [www.esma.europa.eu/sites/default/files/library/esma70-154-270\\_opinion\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_area\\_of\\_secondary\\_markets\\_in\\_the\\_context\\_of\\_the\\_united\\_kingdom\\_withdrawing\\_from\\_the\\_european\\_union.pdf](http://www.esma.europa.eu/sites/default/files/library/esma70-154-270_opinion_to_support_supervisory_convergence_in_the_area_of_secondary_markets_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf)

## POST-BREXIT SECURITIES BUSINESS – A REGULATORY MINEFIELD

The consequences of a hard Brexit on securities business will be particularly challenging, as the switch from EU Member State to third-country status may have a specific, particularly serious impact.

Currently, 2,006 UK banks and investment firms offer their products and services in Austria under the freedom to provide services, while an additional four UK investment firms (as at year-end 2017) exercise their rights under the freedom of establishment. The regulatory and supervisory regime within the EU is clearly and simply divided up between home and host supervisors. However, a hard Brexit will turn the UK into a third country. Yet in order to make full use of the provisions of the Second Markets in Financial Instruments Directive (MiFID II) and its associated Markets in Financial Instruments Regulation (MiFIR) for cross-border activities between EU Member States and third countries, a separate still-to-be-negotiated cooperation agreement is required between the FMA and the competent UK authority.

The fallout for asset management is particularly complex, since UK management companies of undertakings for collective investment in transferable securities (UCITS), as certain investment funds are referred to in EU law, and alternative investment fund managers (AIFMs) will become non-EU AIFMs. As a result, these products will not only lose distribution rights under the passport regime. Their managers will also no longer be allowed to provide certain services such as the management of EU-27 funds, or certain MiFID II activities such as individual portfolio management. As at the end of 2017, seven UK UCITS management companies provided such services in Austria.

If UCITS managed by UK management companies (UK UCITS) become non-EU AIFs, their distribution to retail investors may in turn be prohibited under national legislation relating to Article 43 of the AIFM Directive. As at 31 December 2017, 500 UK UCITS had been notified for distribution to retail investors in Austria. Investor protection for EU-27 investors in UK UCITS may be undermined as the investor protection rules for UCITS do not necessarily apply to non-EU AIFs. The provisions of the Alternative Investment Fund Managers Directive (AIFMD), such as those relating to depositaries, will no longer be mandatory for UK AIFs.

Many EU-27 investment firms offer services in the UK or have outsourced certain functions to UK providers. These will then become third-country companies in the United Kingdom and, depending on the national regulations there, may lose their right of establishment as well as their right to provide cross-border services in the UK (passporting). Since the MiFID II rules will no longer be mandatory, these companies will have to cease their activities in the UK if they are unable to comply with the rules subsequently in force there.

UK companies to which certain functions are outsourced by EU-27 companies will become companies from a third country. Outsourcing to non-EU companies, however, makes it more difficult to monitor the outsourced functions and increases the risk of being classified as purely mailbox companies. The MiFID II framework allows companies to outsource critical and important functions only under very strict conditions. In particular, the outsourcing of portfolio management to providers in a third country (inter alia) requires there to be an appropriate cooperation agreement between the competent authority of the entity in the EU-27 and the supervisory authority of the third country.

At year-end 2017, only 25 Austrian banks and investment firms offered investment services and activities in the UK under the freedom to provide services and one Austrian bank under the freedom of establishment. The activities of Austrian UCITS management companies in the United Kingdom are minor, but there are 48 cases of portfolio management being outsourced to UK companies.

Furthermore, EU market participants will no longer be able to fulfil their trading obligations for shares or derivatives pursuant to Articles 23 and 28 MiFID II through UK trading venues. It would also no longer be possible to trade at these locations via trading screens from within Austria without first determining equivalence. And UK central counterparties (CCPs) will lose their authorisation to clear derivative transactions in the EU-27 under the European Market Infrastructure Regulation (EMIR).

### **HOPES FOR A SOFT BREXIT**

As shown here, many questions remain unanswered about what will happen when the United Kingdom leaves the European Union. It is to be hoped, however, that it will still be possible to come to an amicable agreement on the terms of the withdrawal, on the post-Brexit cooperation regime, and on appropriate transitional periods in order to ensure the smoothest and least disruptive exit possible. The idea put forward by the UK in its European Union (Withdrawal) Act of simply allowing European law to continue to exist for the time being and only gradually amending or replacing it – step by step – where necessary, seems to be a perfectly valid approach, as does the provisional agreement on a transitional period of up to two years. However, it is ultimately up to the negotiators on both sides to actually bring about a deal.

As the bilateral exposure between the United Kingdom and Austria is manageable, the direct impact of even a hard Brexit can be expected to be relatively limited. As already mentioned, however, much greater risks are associated with possible knock-on effects, such as serious distortions on the European financial markets triggered by Brexit or huge disadvantages for Austria's major economic partners, especially Germany. And these risks increase with the risk of a hard Brexit.

**It is to be hoped, however, that it will still be possible to come to an amicable agreement on the terms of the withdrawal, on the post-Brexit cooperation regime, and on appropriate transitional periods in order to ensure the smoothest and least disruptive exit possible.**

# GOOD GOVERNANCE

as an integrated regulatory and supervisory approach

**A**ppropriate, reliable and transparent internal structures for management and monitoring within a company, as well as the corresponding reporting and decision-making channels, are critical to long-term and effective corporate governance in the interests of all stakeholders.

With this in mind, and in light of the experiences of the global financial crisis, the European lawmakers have fundamentally revised the relevant legislation, adopting in particular the Capital Requirements Directive (CRD IV)<sup>1</sup>, the new supervisory regime for insurance undertakings in the form of Solvency II<sup>2</sup>, the rules governing the markets in financial instruments (MiFID II<sup>3</sup> and MiFIR)<sup>4</sup>, and the directives governing European investment funds and their management companies, particularly UCITS<sup>5</sup> and AIFMs<sup>6</sup>. On this basis, the European Supervisory Authorities (ESAs)<sup>7</sup> have adopted Binding Regulatory Standards (BRT) and Binding Technical Standards (BTS) to flesh out further detail. The EU legislation has been transposed into Austrian law through the Austrian Banking Act (BWG; *Bankwesengesetz*), the Insurance Supervision Act 2016

<sup>1</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

<sup>2</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.

<sup>3</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

<sup>4</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

<sup>5</sup> Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

<sup>6</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

<sup>7</sup> The ESAs comprise the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

(VAG 2016; *Versicherungsaufsichtsgesetz*), the Securities Supervision Act 2018 (WAG 2018; *Wertpapieraufsichtsgesetz*), the Investment Fund Act 2011 (InvFG 2011; *Investmentfondsgesetz*), the Alternative Investment Fund Managers Act (AIFMG; *Alternative Investmentfonds Manager-Gesetz*) and the Financial Markets Anti-Money Laundering Act (FM-GwG; *Finanzmarkt-Geldwäschegesetz*), as well as through the related regulations. The FMA has communicated its expectations and legal view in the form of FMA Circulars and Minimum Standards.

## THE PRINCIPLES OF GOOD GOVERNANCE

The rules make a distinction between internal governance in the narrow sense of the term, encompassing the organisational framework, and internal governance in a broader sense, namely the use of fit and proper tests and ongoing monitoring to ensure that the individuals in positions of responsibility are capable of performing their role and do not present any risk.

### INTERNAL GOVERNANCE – WHAT IT MEANS FOR COMPANIES

Internal governance in the narrow sense of the term relates to organisational framework and structure, encompassing the allocation of roles and responsibilities within the organisation and its functions. Particular attention should be paid to the division of labour between the various different bodies:

- The executive body – in the form of a board or managing director – should establish an appropriate governance structure and ensure that it is observed.
- The supervisory body, generally the supervisory board, is responsible for discussing the principles with the executive body, for monitoring implementation of these and for critically reviewing managerial decisions.
- Within a clearly defined system of checks and balances, an internal control system should monitor current operations and compliance with the rules. In this regard the “three lines of defence” organisational model with clearly allocated roles and responsibilities has a proven track record. The first line of defence is operational management, with compliance and risk management forming the second line, and ultimately the internal audit function providing the third line of defence. The executive and supervisory bodies ensure that this allocation of responsibilities is in place and adhered to, and establish clear and direct reporting channels.

The defined structure for the internal control system, its core elements and the reporting channels should be communicated to the entire company and form a fixed component of the corporate culture.

The interaction of all of these elements of internal governance in the narrow sense of the term should create and embed a risk culture and strategy, and an appropriate risk management framework within the company, adherence to which should be guaranteed. The specific features of the individual areas, and their control and supervision priorities, as well as the potential measures to be implemented, are set out below in the relevant chapters.

### INTERNAL GOVERNANCE – WHAT IT MEANS FOR INDIVIDUALS

Internal governance in the broader sense, in other words the requirements in terms of the suitability of individual persons, is generally referred to as a fit and proper test.

**Primary responsibility for the appropriate composition of its executive bodies and functions lies with the company itself. However, the FMA, as Austria's financial market supervisor, monitors whether the persons appointed also meet the fit and proper requirements for the position in practice.**

The mere existence of an appropriate organisational structure and a risk management framework, as well as of a risk culture, is not enough to sufficiently limit the risk of unsuitable candidates being appointed to corporate bodies or key functions.

Individuals are deemed to be fit and proper if they:

- possess sufficient knowledge and skills, i.e. the required theoretical expertise and practical experience in the relevant area,
- are personally reliable,
- are not subject to any conflicts of interest, and
- can demonstrate having sufficient time to dedicate to the role and remit in question.

Executive and supervisory bodies should be composed such that, collectively, they cover all of the essential business and control areas with a suitable level of qualification.

Primary responsibility for the appropriate composition of its executive bodies and functions lies with the company itself. However, the FMA, as Austria's financial market supervisor, monitors whether the persons appointed also meet the fit and proper requirements for the position in practice. Where necessary, it will carry out a tailored fit and proper assessment upon an appointment, taking into account the function and the person's individual knowledge and experience. It should also be ensured that the person continues to meet the requirements until such time as they cease to hold the position in question. If a criminal charge were to be brought against the person, or in the event of the person actually being convicted of a criminal act, this would call into question their personal reliability. If, as a result of serious illness or an accident, the person is restricted from carrying out their role, to a significant extent in terms of physical ability or time, this could also call into question their continued suitability for the position. If the company does not draw the necessary conclusions in such cases, the FMA is required to intervene.

The lawmakers have rolled out these good governance principles across practically all regulated and thus all supervised providers on the European financial market over the past few years, albeit with certain differences in the specific detail of how they have been implemented, reflecting the specific characteristics of individual markets. The specific internal governance requirements, in the narrow and in the broader sense, are set out below for the different types of financial service provider.

The FMA is an integrated supervisory authority that brings together the regulation and supervision of all licensed providers on the Austrian market under one roof, making it ideally placed to ensure that the principles of good governance are applied as uniformly as possible across the entire financial market, while at the same time taking account of the individual features of different sectors and submarkets. In this way it can work towards a level playing field where everyone in the EU is subject to the same rules and competition conditions regardless of sector and national borders. The FMA also adheres to the principles of subsidiarity and proportionality in this regard.

## **BANKING AND SECURITIES SUPERVISION**

Many regulatory and also prudential requirements covering the governance structures of credit institutions have been agreed just recently, while existing rules have been extended and tightened up. The starting signal for this development was the

publication of the Basel Committee on Banking Supervision's Guidelines entitled "Corporate governance principles for banks"<sup>8</sup>. These were followed by the EBA's Guidelines on internal governance (EBA/GL/2017/11)<sup>9</sup> and the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12)<sup>10</sup>. The Austrian lawmakers responded to these transnational and European initiatives by revising the country's Banking Act accordingly (Federal Law Gazette I No. 36/2018). The FMA Fit and Proper Circular covering suitability tests for managers, supervisory board members and key function holders<sup>11</sup> was also revised in order to provide an interpretation of the new legal basis and resolve any ambiguity.

## INTERNAL GOVERNANCE STRUCTURE IN CREDIT INSTITUTIONS

Credit institutions must have an appropriate and transparent organisational and operational structure that is in keeping with the institution's business model. In particular, this structure must guarantee the effective identification, monitoring and control of risks, help to avoid conflicts of interest, and safeguard a consistent separation of front and back office functions. The executive body of a credit institution is responsible for ensuring that the appropriate internal processes are in place, modifying these where necessary after consultation with the supervisory body (supervisory board), which also monitors these processes. These processes should also encompass clear and easy-to-understand reporting channels and responsibilities.

An appropriate corporate structure also includes properly designed executive bodies in accordance with the statutory requirements:

- With regard to management, it is especially important to appoint an appropriate number of fit and proper persons<sup>12</sup> based on the size of the institution and complexity of its business model and to ensure that the areas of responsibility (including in the event of deputising) are clearly defined.
- With regard to the supervisory board, which has an advisory and monitoring role, it is particularly important to ensure that the effectiveness of the collegial body is guaranteed. According to the BWG, significant institutions<sup>13</sup> (particularly those with total assets of at least € 5 billion) must have a remuneration, a nomination and a risk committee<sup>14</sup>. These committees should pool specialist knowledge and be able to tackle specific topics intensively thanks to their clearly defined remit. Care should be taken to ensure that the committees do not all have the same members and that not all of the committees are chaired by the same person.

The EBA's Guidelines on internal governance<sup>15</sup> and the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key

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<sup>8</sup> Available online at: [www.bis.org/bcbs/publ/d328.pdf](http://www.bis.org/bcbs/publ/d328.pdf).

<sup>9</sup> Available online at: [www.eba.europa.eu/documents/10180/1972987/Final+Guidelines+on+Internal+Governance+%28EBA-GL-2017-11%29.pdf/eb859955-614a-4afb-bdcd-aaa664994889](http://www.eba.europa.eu/documents/10180/1972987/Final+Guidelines+on+Internal+Governance+%28EBA-GL-2017-11%29.pdf/eb859955-614a-4afb-bdcd-aaa664994889).

<sup>10</sup> Available online at: [eba.europa.eu/documents/10180/1972984/Joint+ESMA+and+EBA+Guidelines+on+the+assessment+of+suitability+of+members+of+the+management+body+and+key+function+holders+%28EBA-GL-2017-12%29.pdf](http://eba.europa.eu/documents/10180/1972984/Joint+ESMA+and+EBA+Guidelines+on+the+assessment+of+suitability+of+members+of+the+management+body+and+key+function+holders+%28EBA-GL-2017-12%29.pdf).

<sup>11</sup> Available online at: [www.fma.gv.at/download.php?d=3600](http://www.fma.gv.at/download.php?d=3600) (in German).

<sup>12</sup> Further information on suitable persons is provided in the section on fit and proper tests.

<sup>13</sup> Article 5 para. 4 BWG.

<sup>14</sup> All credit institutions with total assets of more than € 1 billion also require a fourth committee in the form of an audit committee.

<sup>15</sup> EBA/GL/2017/11.

function holders<sup>16</sup> introduced the concept of “independent members”. According to the Guidelines, a certain number of the members of the supervisory board should not have any other link with the company in order to ensure that decisions can be made completely independently, objectively and in a balanced way without external influences. The Guidelines set out explicit criteria on the basis of which independence is judged to be excluded. At national level, these were implemented with the amendment to the BWG and will enter into force on 1 January 2019 subject to a transitional period lasting until 1 July 2019. Significant credit institutions are required to have at least two members of the supervisory board who meet these independence criteria, while one member is required in the case of all other credit institutions. In addition, two members and the chair of the risk committee must be independent. With regard to credit institutions classed by the FMA as global (G-SIIs) or other systemically important institutions (O-SIIs), the majority of the members of the risk committee must comply with the independence criteria.

The internal control function required pursuant to the BWG<sup>17</sup> encompasses the risk management department, the BWG compliance function and the internal audit. Significant institutions must have a compliance function and a risk management function. Subject to certain conditions<sup>18</sup>, however, the internal audit function need not be performed by a dedicated organisational unit. Key features of the internal control function include its independence and direct reporting to the management. This function should be headed by an individual who is personally reliable and has the requisite expertise<sup>19</sup>.

An institution’s internal governance is assessed on an ongoing basis as part of the Supervisory Review and Evaluation Process (SREP)<sup>20</sup>. The SREP requirements are defined in detail in the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)<sup>21</sup>. A comprehensive review of internal governance is carried out every two or every three years depending on size, structure and internal organisation, and also based on the nature, scale and complexity of an institution’s business activity. During the years when no review is scheduled, a summary is prepared and thus a review of the up-to-date nature of the SREP overall evaluation.

The main focus in terms of internal governance during the SREP lies in assessing the internal control functions (compliance function, internal audit, risk management function), the organisational structure in general (including outsourcing), the risk management framework, risk culture and risk infrastructure, data processing, reporting and the whistleblower systems in place in the institution. Changes in the regulatory environment are permanently incorporated into the analysis.

Any shortcomings or weaknesses found in the internal governance system are assessed on the basis of the criteria in the Guidelines and scored from 1 to 4, with

<sup>16</sup> EBA/GL/2017/12.

<sup>17</sup> Further information on the WAG compliance function and AML officer is provided in the relevant section.

<sup>18</sup> See Article 42 para. 6 BWG: total assets of less than € 300 million, fewer than 50 employees or total assets of up to € 1 billion if the credit institution belongs to a group.

<sup>19</sup> As defined in Article 5 para. 1 nos. 6 and 7 BWG; see section on fit and proper tests.

<sup>20</sup> The legal basis is provided by Articles 97 and 104 of CRD IV, transposed into Austrian law through Article 69 paras. 2 and 3 BWG, and Article 70 para. 4a BWG.

<sup>21</sup> EBA/GL/2014/13; the revised Guidelines on SREP have been in force since 1 January 2019, see Final Report published on 19 July 2018 and available via the following link: [www.eba.europa.eu/documents/10180/2282666/Revised+Guidelines+on+SREP+%28EBA-GL-2018-03%29.pdf](http://www.eba.europa.eu/documents/10180/2282666/Revised+Guidelines+on+SREP+%28EBA-GL-2018-03%29.pdf).

1 signifying “no discernible risk” and 4 indicating a high level of risk. Depending on the impact that these shortcomings or weaknesses have on an institution’s risk situation, they will be addressed with quantitative<sup>22</sup> and qualitative<sup>23</sup> measures.

## FIT AND PROPER TESTS

Over and above the organisational framework referred to above, credit institutions must also ensure that those persons who are given the corresponding responsibilities and functions are suitable for their role and that this suitability is maintained throughout their term of office. To this end, the institution should implement appropriate internal guidelines and processes (policy) in order to guarantee appropriate fit and proper tests (proportionality) and to maintain relevant subject knowledge and expertise (training).

Following a positive internal review, the FMA must be informed immediately of the decision to appoint a new member to a corporate body.<sup>24</sup> On the basis of the submitted documents and, if necessary, after consulting further information sources, the FMA will review the suitability of the individual in question. If the submitted documents and information are not sufficient to enable the FMA to reach a final conclusion, the individual will be invited to an interview at the FMA in order to determine whether that person has the requisite expertise and sufficient knowledge about the institution, its control systems and the intended function. This interview is referred to in the banking sector as a “fit and proper test”. Given that fitness and propriety are not static elements but are required throughout the entire term of office, they are not just reviewed by the FMA at the time of the appointment but are also monitored as part of the FMA’s ongoing supervision activity.

The checks focus on personal reliability, decency and impartiality, as well as on the requisite expertise and experience. There must not be any doubt that individuals who are appointed to executive functions in a bank are capable of managing that bank judiciously and reliably. Above all, all such individuals (managers, members of the supervisory board and key function holders) must always act independently, and thus not be influenced by any conflict of interest.

In addition, members of the executive bodies and key function holders must also be able to demonstrate that they have sufficient time to dedicate to the position, both quantitatively and qualitatively. An absolute (quantitative) numerical limit applies to officers (managers and supervisory board members) of significant institutions pursuant to CRD IV<sup>25</sup>. The qualitative limit applies to all credit institutions and is based on various factors such as the number of commercial and professional activities and their time requirements.

In addition to internal governance requirements (institution-specific) and requirements in terms of individual members of corporate bodies (person-specific fit and proper requirements), there is also the concept of collective suitability. This focuses on the contribution that the individual makes to collective corporate governance and monitoring.

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<sup>22</sup> Article 70 para. 4a no. 1 BWG.

<sup>23</sup> Article 70 para. 4a nos. 2 to 12 BWG.

<sup>24</sup> Any change in the suitability criteria must also be notified without delay.

<sup>25</sup> Implemented in Austria through Article 5 para. 4 BWG: main criteria are total assets of at least € 5 billion or being systemically relevant.

### INTEGRATION OF SECURITIES COMPLIANCE INTO GOVERNANCE STRUCTURES

The European lawmakers' response to the lessons learned from the global financial crisis has been to also introduce a diverse range of initiatives in the area of capital market law. These aim to improve the transparency and integrity of the markets and to boost investor protection. By means of MiFID II, for example, the obligations on credit institutions and investment service providers with regard to their conduct and organisation have been extended to improve investor protection, and stricter transparency and information rules have also been imposed, while the supervisory authorities have been given stronger monitoring and intervention powers (with, for example, the harmonisation and tightening up of sanctions and the creation of the power to restrict or even completely ban the marketing, distribution and sale of particularly toxic products to retail investors).

The securities compliance function, as part of these far-reaching rules, obliges managers to introduce appropriate organisational arrangements and measures to guarantee that companies and their employees behave properly and that any breaches of the law are quickly detected and sanctioned. As well as obligatory rules and standards, some voluntary provisions have also been introduced in this area.

Securities compliance was originally established as a way of taking effective and preventive action against insider dealing. In the early 1990s there was still no clearly worded legal definition of securities compliance, resulting in a broad range of interpretations with credit institutions retreating towards a more limited interpretation of what a compliance function should be. In the meantime, however, a clear definition has been provided in banking and capital market law. The concept of compliance was broadly enshrined in Austrian law for the first time in 2007 with the implementation of MiFID I<sup>26</sup> through the Securities Supervision Act (WAG 2007; *Wertpapieraufsichtsgesetz*).

Today, securities compliance is an established component of good corporate governance and has become an integral part of credit institutions' statutory and de facto regulatory framework.

Credit institutions (as well as investment firms, investment service providers and other undertakings that provide investment services) must set up a properly functioning compliance structure for their securities transactions. The starting point for the specific design of this compliance structure comes from an analysis of their business activity in securities and investments, and the level of risk in this area in particular. Another factor that needs to be considered is the extent to which employees regularly have access to compliance-relevant information.

In accordance with the statutory provisions of the WAG 2018 and the directly applicable EU regulation<sup>27</sup>, credit institutions must define and adhere to appropriate strategies and procedures in order to make sure that the company itself and its employees comply with the law.

In particular, the securities compliance function must be set up to be durable and effective, and be able to perform its remit independently. Independence refers to technical, personal and organisational independence. While the management is

**Today, securities compliance is an established component of good corporate governance and has become an integral part of credit institutions' statutory and de facto regulatory framework.**

<sup>26</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

<sup>27</sup> Commission Delegated Regulation (EU) 2017/565.

responsible for setting up a properly functioning compliance function and for monitoring its effectiveness, the compliance function should perform its role independently of both the management and the company's other departments. The management must therefore ensure that other business units are not permitted to issue compliance employees with instructions or to influence them in their work in any other way. Upholding the independence of the compliance function also means keeping it separate from the other operational business units, in other words separating the supervisor from the supervised.

Securities compliance is responsible for defining the basic organisational parameters and for performing the function of an advisory, monitoring and control body. Many of the statutory rules apply the principle of proportionality to take account of the heterogeneous structure of companies in the sector and the diverse range of business activities. Depending on the size of the company, its main business areas and its risk position, a simplified compliance organisation may be possible.

It is the management that bears original responsibility for creating the compliance function and appointing a compliance officer. Every single credit institution must appoint a compliance officer on the basis of its licence to provide investment services, the principle of proportionality notwithstanding.

Previous supervisory practice, according to which credit institutions had to report the appointment of their compliance officer to the FMA, was simplified in 2018 to the extent that it is now only significant institutions that must report to the FMA their appointment of a securities compliance officer pursuant to the terms of the BWG. Institutions may also outsource their compliance function. If they choose to do so, they must inform the FMA accordingly, as the securities compliance function is defined in the BWG as an essential operational task.

Compliance – just like the setting-up of an internal control system (ICS) – is one of the obligations that the management may not delegate. It must be the responsibility of the full management board. It is, however, possible for one member of the executive board to be given responsibility for the compliance portfolio. Yet even in such a situation, final decision-making power in all compliance issues lies with the management board as a whole. The management is responsible for ensuring that the compliance function is properly resourced in terms of personnel and other resources, taking account of the type and scope of securities and investment services, and ancillary services.

The original tasks of the compliance function include advisory, monitoring and control obligations to ensure that the statutory rules and internal guidelines are being observed. The compliance function may not rely on ex post checks. Rather, a successful compliance function must adopt a process-based, preventive approach. Based on the maxim that the better advice you provide, the less you will need to control, it makes sense, in terms of prevention, to involve the compliance function in the relevant approval and advisory processes for individual products, distribution structures and areas of business. The monitoring measures applied must follow a risk-based approach building on the regulatory requirements for the specific compliance risks in the respective credit institution's workflows.

The compliance function is also responsible for developing, formulating and evaluating internal guidelines and procedures, and for advising and supporting the business areas and management. In order to establish a good "tone at the top" compliance

culture in a company, the compliance officer, as well as regularly reporting to the management, should also be in permanent contact with the managers on all relevant issues. The compliance manager is also responsible for regular compliance training and CPD for employees. Additionally, the compliance manager should regularly check and assess whether the employees involved in securities and investment services are sufficiently familiar with the company's principles and procedures and with the current statutory requirements, and whether they are applying them correctly.

The new European legislation that entered into force in 2018 has created a diverse range of additional tasks for the compliance function, such as with regard to product development and sales (product governance), the monitoring of compliance with the rules on algorithm-based trading systems and trading algorithms, and in relation to the complaints process.

### **SPECIALIST QUALIFICATIONS AND PERSONAL RELIABILITY OF THE COMPLIANCE OFFICER (FIT & PROPER)**

The provisions of WAG 2007 that applied up to 2017 had already stipulated that the person responsible for the compliance function needed to have sufficient technical expertise as well as a broad range of knowledge and experience. The current legal provisions<sup>28</sup> flesh out the detail of and further develop these requirements in terms of specialist knowledge. After all, compliance officers are among those employees of a credit institution who can exert a material influence on that institution's business activity by virtue of their position. They are key function holders. As such, they must be personally reliable, as well as possessing the requisite level of specialist qualifications.

Against this background, companies must check the specialist qualifications and personal reliability of their compliance officer by carrying out an internal fit and proper assessment at the time of the appointment. Each company may decide on the criteria, type and scope of its own internal assessment applying the principle of proportionality, in that due account should be taken of the complexity of the company's transactions, the nature and volume of transactions and the company's risk structure.

Particularly important here is sufficient relevant training and sector-specific professional experience, as well as theoretical and practical knowledge acquired through further training and CPD. The documents submitted during the internal fit and proper test, as well as the test process and its outcome, should be recorded and presented to the FMA. In the event of any irregularities or if it has its own observations, the FMA may also subject the compliance officer to a fit and proper test of its own.

### **ASSET MANAGEMENT**

In Austria, investment business<sup>29</sup>, real estate fund business<sup>30</sup> and corporate provision fund activities<sup>31</sup> are all classed as banking business that requires a licence. This means that the licence holders, as well as being subject to the relevant laws governing their

<sup>28</sup> WAG 2018, EBA/ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12).

<sup>29</sup> Article 1 para. 1 no. 13 BWG.

<sup>30</sup> Article 1 para. 1 no. 13a BWG.

<sup>31</sup> Article 1 para. 1 no. 21 BWG.

area of activity, are also bound by the terms of the BWG. As far as collective portfolio management is concerned, the creation of a supervisory board is a statutory requirement, and a state commissioner plus deputy must also be appointed. Moreover, alternative investment fund managers (AIFMs) are authorised to manage alternative investment funds (AIFs) pursuant to the AIFMG, and may also take the form of (real estate) investment fund management companies.

## **INVESTMENT FUND BUSINESS**

Investment fund business is carried out by investment fund management companies that are subject to the terms of the Investment Fund Act 2011 (InvFG 2011; *Investmentfondsgesetz*). At a European level, this type of business is governed in the first instance by the UCITS Directive<sup>32</sup>.

Managers must have the technical skills needed, have experience of management and have the practical experience required to operate a management company. Furthermore, at least two of the managers must also have sufficient practical and theoretical experience of the type of UCITS (or AIF) that the management company manages. If management companies are authorised to provide investment services (individual portfolio management or investment advice), the managers must also have the skills and experience needed to provide such services.

Any change of manager should be notified to the FMA immediately in writing. Based on the documents submitted, the FMA will check whether the fit and proper requirements have been duly met. If the documents are not sufficiently detailed to enable the FMA to reach a final conclusion, the FMA may carry out its own fit and proper assessment in the form of a personal conversation.

The cornerstone of fund business is the separation principle, according to which assets are invested and managed by the management company but the assets belonging to the fund are held by a custodian bank. The custodian bank<sup>33</sup> must be a credit institution that is authorised to carry out custodian activities, or a corresponding foreign branch of an EEA credit institution<sup>34</sup>. The appointment of a custodian bank is only permitted if it can be assumed that the credit institution will perform the role of custodian bank. During the process of approving the custodian bank, the FMA will also check whether the managers of the custodian bank have sufficient experience in relation to the relevant type of UCITS (or AIF). This is another aspect that must be reported to the FMA, with an obligatory fit and proper assessment.

In order to guarantee independence between the management company and depositary, certain personal links and relationships between the two are prohibited<sup>35</sup>. The incompatibility rules stipulate that an individual may not be a manager of the management company and of the depositary at the same time. Similarly, an individual may not be a manager of the management company and an employee of the depositary at the same time, and an individual may not be a manager of the depositary and an employee of the management company at the same time. The operational independence of the management company, including situations in which safekeeping functions are delegated, offers an additional layer of investor protection.

**The cornerstone of fund business is the separation principle, according to which assets are invested and managed by the management company but the assets belonging to the fund are held by a custodian bank.**

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<sup>32</sup> Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

<sup>33</sup> Article 1 para. 1 no. 5 BWG.

<sup>34</sup> Article 9 para. 4 BWG.

<sup>35</sup> Articles 21 and 24 of Commission Delegated Regulation (EU) 2016/438.

Management companies must appoint a supervisory board. Any changes to the membership of the supervisory board must be reported to the FMA immediately, alongside evidence of the relevant conditions<sup>36</sup> being met. The FMA must also be informed<sup>37</sup> of who has been elected as chair of the supervisory board. This is another area in which the result of the fit and proper test can result in an oral interview. The EU's related regulation also states<sup>38</sup> that no more than one third of the members of the management company's supervisory board may consist of members who are at the same time members of the management body, the supervisory board or employees of the depositary. This applies conversely to the supervisory board of the appointed custodian bank.

If the management company and custodian bank belong to the same group of companies, at least one third of the members or two individuals on the supervisory boards must be independent.

The members of the management company's supervisory board are deemed to be independent if they are not in a commercial, family or other relationship with the management company, the depositary or another company within the group that could result in a conflict of interest and affect their judgement. This provision also applies to members of the custodian bank's supervisory board.

#### **REAL ESTATE FUND BUSINESS**

Real estate fund business is carried out by real estate investment fund management companies that are subject to the terms of the Real Estate Investment Fund Act (ImmoInvFG; *Immobilien-Investmentfondsgesetz*). With the entry into force of the AIFM Directive, the AIFM regime also applies to real estate fund business. Those persons who actually engage in AIFM activity must be sufficiently reliable and have appropriate experience in relation to the investment strategies of the AIFs being managed by the AIFM. While the AIFMG does not contain any rules on supervisory boards, the ImmoInvFG makes a supervisory board compulsory. The Act also includes provisions on incompatibility. For example, a member of the supervisory board of a real estate investment fund management company may not be a manager or supervisory board member of the custodian bank. Similarly, a manager or authorised signatory of the real estate investment fund management company may not be a manager, supervisory board member or authorised signatory of the custodian bank.

Real estate investment fund management companies are also subject to the "Special Requirements for Bodies of Credit Institutions"<sup>39</sup>, and these must be reviewed when appointing managers or supervisory board members.

In terms of the qualifications for managers, it is now solely the terms of the AIFMG that apply, making requirements of managers that are analogous to those in the InvFG 2011. The appointment of managers and any change of manager must be reported. The corresponding documents are subject to a fit and proper assessment.

#### **CORPORATE PROVISION FUND BUSINESS**

Corporate provision fund business is carried out by corporate provision funds, which

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<sup>36</sup> Article 28a paras. 3 and 5 BWG.

<sup>37</sup> Article 28a para. 4 BWG.

<sup>38</sup> Article 21 of Commission Delegated Regulation (EU) 2016/438.

<sup>39</sup> Article 28a BWG.

are subject to the terms of the Company Employee and Self-Employment Provisions Act (BMSVG; *Betriebliches Mitarbeiter- und Selbständigenvorsorgegesetz*). The latter has no European basis, as this type of business is specific to Austria. The corporate provision funds take the form of special-purpose credit institutions and are therefore bound by key provisions of the BWG, which includes provisions on the appointment of managers and on the requirements for supervisory board members. Pursuant to the BMSVG, corporate provision funds are required to set up a supervisory board. The law also requires that they carry out corresponding fit and proper tests. One particular aspect is the composition of the supervisory board, which must be made up of four representatives of the nominal capital elected by the general meeting and two employee representatives appointed by a voluntary employee interest group with the authority to engage in collective bargaining.

### **ALTERNATIVE INVESTMENT FUND MANAGERS**

Alternative investment fund managers (AIFMs) are licensed to manage AIFs. Given that management companies are allowed to manage AIFs, the former may hold a licence pursuant to the BWG (in conjunction with InvFG 2011) as well as in accordance with the AIFMG. What this means for management companies is that their managers must fulfil the requirements of both laws, InvFG 2011 and AIFMG. As referred to above, real estate investment fund management companies are also AIFMs. In addition to these AIFMs designed as special-purpose credit institutions, there are also other AIFMs that do not have the status of credit institution and thus do not need to have a supervisory board.

Those persons who actually engage in AIFM activity must as a general rule be sufficiently reliable and have appropriate experience in relation to the investment strategies of the AIFs being managed by the AIFM. The corresponding fit and proper assessments based on the documents submitted with the notification are mandatory.

AIFMs that hold an extended licence may offer investment services. In such cases, the managers must have appropriate expertise and experience and be able to document these. The FMA will evaluate whether the statutory conditions are met.

European Venture Capital Funds (EuVECA<sup>40</sup>) and European Social Entrepreneurship Funds (EuSEF<sup>41</sup>) are subject to the EuVECA and EuSEF regulations respectively. These stipulate that the people who actually carry out these transactions must be of sufficiently good repute and have sufficient experience of the relevant investment strategies. Consequently, the licensing procedure for EuVECA and EuSEF managers involves documenting and reporting compliance with these requirements and having this assessed by the authority. The appointment of a manager must also be reported, with checks carried out to ensure that the fit and proper requirements are met.

### **INTERNAL AUDIT**

Investment fund management companies, real estate investment fund management companies, corporate provision funds and AIFMs must as a general rule have an internal audit function. The notification procedure will also involve an assessment of whether the relevant individual has the requisite skills and experience.

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<sup>40</sup> Regulation (EU) No 345/2013.

<sup>41</sup> Regulation (EU) No 346/2013.

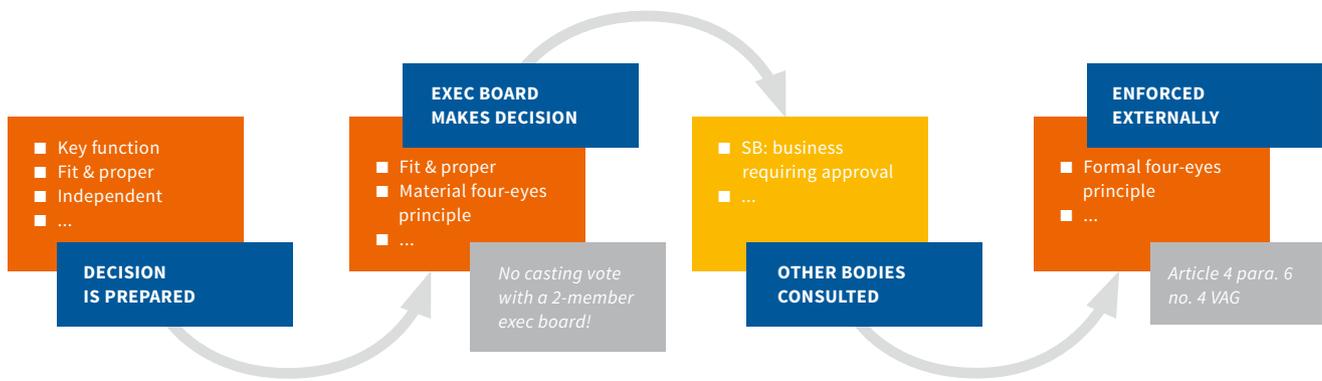


Figure 2: Decision-making requirements

**INSURANCE SUPERVISION**

Investigations into the causes of problems at insurance and reinsurance undertakings have revealed that misconduct by the management is often the main factor. Consequently, the requirements made of the executive board have been significantly tightened up in the new supervisory regime for the insurance sector, Solvency II. The material four-eyes principle, according to which all key decisions must be made jointly by at least two of the undertaking’s managers, is now enshrined in law. Additionally, this process must always be clearly documented. A formal four-eyes principle also applies, in that the executive board must comprise at least two people and sole representation is not permitted (see Figure 2).

In conjunction with the stricter requirements made of the executive board, the requirements of the supervisory board have also been tightened up in relation to monitoring the lawful and proper conduct of business and the economic expediency of activities.

**GENERAL GOVERNANCE RULES**

It is a general governance requirement that an appropriate organisational structure be put in place with a clear allocation of responsibilities and a clear division of roles in conjunction with measures to guarantee the avoidance of conflicts of interest and the effective transfer of information.

In accordance with the general requirements of a governance system, (re)insurance undertakings must adopt written guidelines approved by the executive board on risk management, internal control, internal audit, remuneration and, where applicable, outsourcing. All of these guidelines must be consistent with each other and with the overall business strategy. The guidelines should be written clearly and comprehensibly, and must in any event cover the aims being pursued, the tasks to be performed and the responsible persons/functions, and the processes and reporting procedures to be applied. They should be reviewed annually, updated if necessary, and immediately modified in the event of significant changes.

**INCIDENT MANAGEMENT**

Appropriate incident management and business continuity management (BCM) are included in the general governance requirements. The aim is to have precautionary measures in place to guarantee continuity and the proper implementation of the (re)insurance undertaking’s activities. Overall, the resilience of the undertaking’s

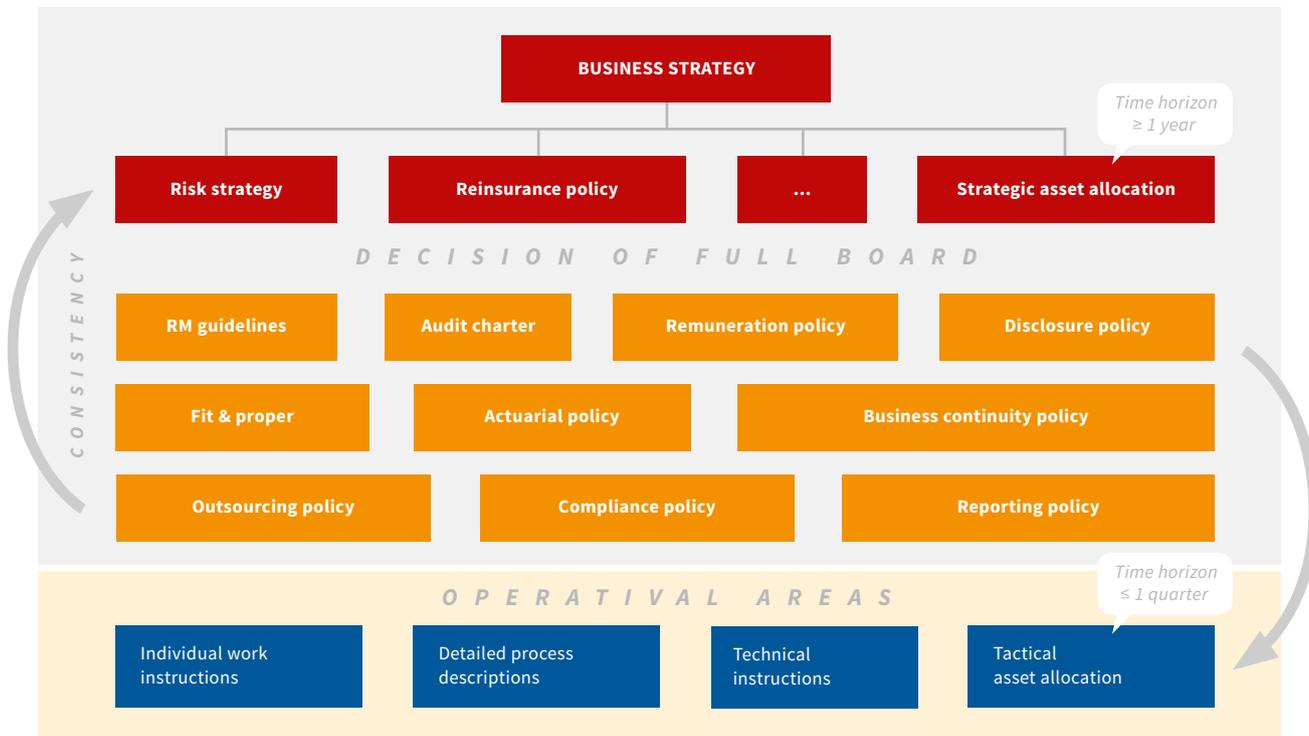


Figure 3: Guidelines as a corporate governance tool

time- critical business processes and the continuity of the insurance and reinsurance activities are increased, thereby protecting the insured parties' interest in consistent performance. The FMA Guide on IT Security in Insurance and Reinsurance Undertakings<sup>42</sup> issued in July 2018 provides an overview of the various phases of IT incident management. Based on the business impact analysis – which is used to identify time-critical business processes, their interdependencies and the resources required – and on the risk analysis, plans are drawn up for incident strategies. This development phase is followed by implementation, encompassing training or the testing of incident plans. Based on the results of the testing, the incident plans are adjusted accordingly. In 2017 the FMA carried out a survey on incident plans in (re)insurance undertakings. Based on the documents submitted, the structures and processes in place were for the greater part judged to be appropriate.

### SPECIFIC GOVERNANCE FUNCTIONS

(Re)insurance undertakings must have four governance functions (see Figure 4):

- Risk management function
- Compliance function
- Internal audit function
- Actuarial function

“Function” in this context refers to the administrative capacity to handle certain tasks. As a general rule, each governance function should have one single manager.<sup>43</sup>

<sup>42</sup> FMA, FMA Guide on IT Security in Insurance and Reinsurance Undertakings. [www.fma.gv.at/download.php?d=3518](http://www.fma.gv.at/download.php?d=3518)

<sup>43</sup> Cf. FMA, Structured dialogue in preparation for Solvency II – Part 1: Governance & ORSA (publication in German), p.59 et seq., [www.fma.gv.at/download.php?d=1721](http://www.fma.gv.at/download.php?d=1721).

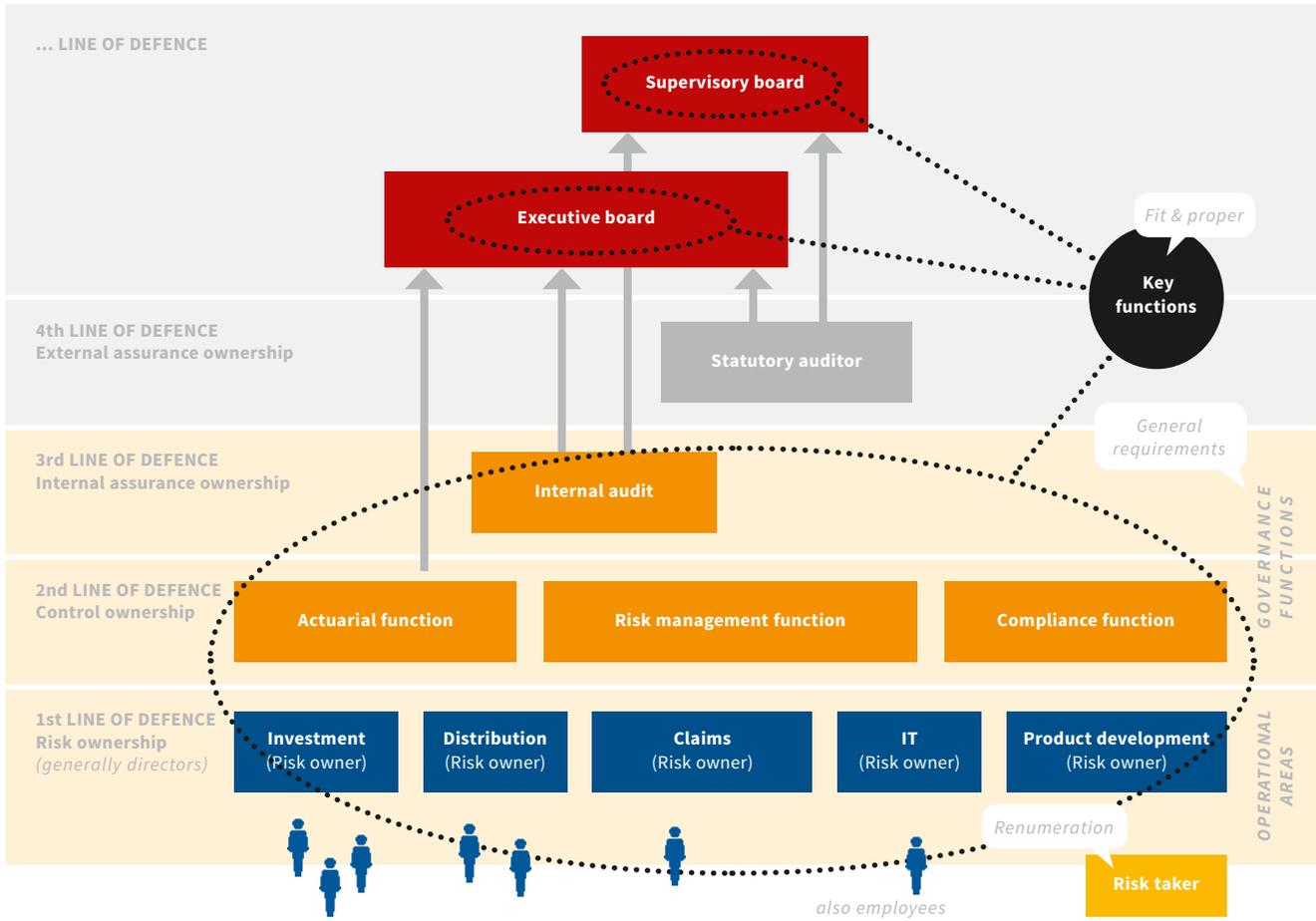


Figure 4: Functions and roles

The role should not be performed by a committee or several people together. Exceptions may arise in accordance with the principle of proportionality, provided that operational independence is guaranteed. For example, in some cases it might be appropriate for the same person to manage both the risk management function and the actuarial function. Governance functions may also only be performed by natural persons.

**OUTSOURCING**

The most important governance rule for outsourcing is the clarification that the full responsibility of the (re)insurance undertaking to comply with the supervisory requirements must remain within the (re)insurance undertaking. Outsourcing is any form of agreement reached between a (re)insurance undertaking and a service provider to the effect that the latter will perform, directly or by means of further outsourcing, a process, service or activity that would otherwise have been performed by the (re)insurance undertaking itself. The FMA must be notified before any critical or major operational function or activity is outsourced. The FMA’s approval is required if the service provider is not an EEA (re)insurance undertaking. Measures must be in place to ensure that the service provider is appropriately supervised by the FMA.

**REMUNERATION POLICY**

A (re)insurance undertaking’s remuneration policy should promote the undertaking’s

long-term success. Incentives to engage in excessive risk-taking and/or to avoid effective risk management must be avoided. The remuneration policy applies to the entire undertaking, with specific provisions on variable remuneration components only applying to holders of key functions. If provision is made for the latter, ensuring a balance between fixed and variable components must be a priority. The fixed component must in any event be high enough to enable the respective individual to earn a living. Where remuneration is performance-based, additional rules on the applicable criteria and deferred payment must be observed. As a general rule, 40% of variable pay can be deferred.<sup>44</sup>

## RISK MANAGEMENT

Risk management provisions are designed to help in the early identification of potential risks, to optimise corporate governance and to calculate the solvency capital requirement in a risk-based way. The executive board has a key role to play. It defines the undertaking's risk appetite and tolerances, adopts the risk management strategy and specific guidelines, and ensures that the risk management system is effective. A risk management function to facilitate the implementation of the risk management system is required. The latter encompasses all strategies, processes and reporting procedures that relate to the treatment of risks and the factors on which they depend (see Figure 5). The rules on the undertaking's own risk and solvency assessment (ORSA) are a particularly important part of the risk management system. Risk must be considered in its entirety and from the undertaking's specific perspective, in the form of an assessment of overall solvency needs.<sup>45</sup> Potential future risks should also be addressed. In particular this guarantees that risks that are not adequately covered in the standard formula or not covered at all can be appropriately managed by the (re)insurance undertaking and incorporated into strategic decision-making.

The suitability and effectiveness of the governance system should be monitored and reviewed internally at least annually.

## QUALIFICATIONS

In accordance with the general governance rules set out in Solvency II, all (re)insur-

Criterion	Own funds requirements (standard formula)	Overall solvency needs
Risks covered	Material, quantifiable risks to which an insurer is (typically) exposed	Company-specific holistic approach to risk
Calculation methods	Standardised, defined confidence level and time horizon	Based on principle of proportionality, confidence level and time horizon can be selected
Influence of corporate governance	(Secondary) condition that must be observed	Direct basis of strategic decisions
Risk-bearing capacity	Own funds	"Sufficient financial resources"
Consequences derived by supervisor	Standardised procedure	Individual consideration of undertaking

Figure 5: Assessment of overall solvency needs versus calculation of own funds requirements

<sup>44</sup> Saria. *Solvency-II-konforme Gestaltung von Vergütungen [Solvency II-compliant design of remuneration]*. VR 2017, p. 38.

<sup>45</sup> Cf. FMA Guide on Own Risk and Solvency Assessment (ORSA) (publication in German), 2nd edition, October 2015, [www.fma.gv.at/download.php?d=1593](http://www.fma.gv.at/download.php?d=1593).

ance undertaking staff must have the skills, knowledge and expertise needed to perform the tasks assigned to them properly. The FMA must be provided with details of the individuals who manage the undertaking, as well as other persons in key functions, with this information being provided when the function is assumed. Individuals who manage the undertaking include any persons with a particular influence on its decision-making. This applies to all members of the executive board. Other key functions cover those persons with a particular influence on monitoring and/or control. The term is to be interpreted restrictively. Examples include supervisory board members or the holders of governance functions. If key functions are outsourced, suitably qualified and personally reliable outsourcing officials are to be appointed in the (re)insurance undertaking and given overall responsibility for the outsourced key functions and the role of assessing and monitoring the performance and results of the service providers.

Those persons who manage a function, rather than those who exercise it, should be notified to the FMA. By means of these notifications, the FMA can be sure that the standards regarding specialist qualifications and personal reliability are being met. Based on the information provided by the undertakings, the FMA carries out proportionate, dynamic and function-based assessments of suitability. It can generally be assumed that an individual is sufficiently qualified in the area if he or she has completed a relevant course of study and can demonstrate having at least three years' relevant professional experience.<sup>46</sup>

Additionally, a fit and proper test approved by an FMA team must be passed by any individual before becoming a member of an executive board. This test may be sat up to three times. If the FMA has justified doubts about the qualitative standards being met, it will request the appointment of an alternative, suitable candidate.

### **FIT & PROPER REQUIREMENTS IN RELATION TO THE PREVENTION OF MONEY LAUNDERING AND TERRORIST FINANCING**

For the purposes of preventing money laundering and the financing of terrorism, procedures are needed to assess the expertise and personal reliability of members of the executive and supervisory body<sup>47</sup> and of persons who as a result of their position have a material influence on the undertaking's business activity without formally being members of the executive body,<sup>48</sup> referred to as key functions such as the function of anti-money laundering (AML) officer.

The specific requirements in terms of suitability and the supervisory mechanisms for reviewing these are based on the FM-GwG, the individual supervisory laws and European legislation, including relevant guidelines from the European Supervisory Authorities, particularly the EBA/ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders<sup>49</sup>. Based on the legal provisions, the FMA may also carry out its own fit and proper assessments of members of executive and supervisory bodies and of AML officers.

However the undertakings themselves are also obliged to check the specialist qualifi-

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<sup>46</sup> Cf. FMA, *Structured dialogue in preparation for Solvency II – Part 3: Fit & proper, own funds & ORSA* (publication in German), p. 9 et seq., [www.fma.gv.at/download.php?d=1723](http://www.fma.gv.at/download.php?d=1723).

<sup>47</sup> Executive body as defined in Article 23 para. 4 FM-GwG.

<sup>48</sup> As defined in Article 23 para. 3 FM-GwG.

<sup>49</sup> EBA/GL/2017/12.

cations and personal reliability of members of the executive body (executive board, managers), supervisory board members and the AML officer by means of an internal fit and proper assessment upon any new appointment or change of persons. The form and scope of internal fit and proper assessments on members of the executive and supervisory body and on the AML officer may be determined by each undertaking while also, in keeping with the principle of proportionality, taking account of the nature, scale and complexity of the undertaking's business activities and of its risk structure. The documents submitted during the internal fit and proper test, as well as the test process and its outcome, should be recorded and presented to the FMA.

## **THE FMA STRATEGY FOR THE IMPLEMENTATION OF GOOD GOVERNANCE AMONG THE SUPERVISED UNDERTAKINGS**

In terms of its conduct supervision, the FMA adheres to the strategic principle of helping the entities to help themselves. This is about ensuring that the supervised entities have an internal system of checks and balances, and develop and practise a risk culture that is commensurate with the size of the undertaking and with the risk and complexity of the business model. It also attaches particular importance to upholding the principle of proportionality in the requirements made of supervised undertakings. The riskier and the more complex a business model, the further the requirements need to go and the stricter they need to be. In the interests of helping entities to help themselves, the FMA engages in open dialogue with the supervised entities on all aspects of good governance, reports on and evaluates regulatory developments in this area at events, and publishes guides that provide practical interpretations and explanations of outstanding issues and that openly disclose what the FMA expects from the entities that it supervises.

While adhering to the principle of advising rather than punishing during conduct supervision, the FMA will nevertheless not hesitate to tackle serious infringements with the full force of the law. After all, a good governance structure in an undertaking is the first and also the most important step in ensuring that employees behave in accordance with the rules and in establishing an efficient and effective risk management approach.

An exemplary form of internal governance in the narrow sense, creating an organisational framework and structure, and clearly governing the allocation of roles and responsibilities within the organisation, is vital. An internal control system using the “three lines of defence” model – 1st line of defence: operational management, 2nd line of defence: compliance and risk management, 3rd line of defence: internal audit – has proven very effective in this regard. On the basis of this internal system, the control functions that look beyond the undertaking to the outside world – auditors, supervisory board and the state supervisor – can perform efficiently.

Ultimately, the success or failure of an economic action, or whether the law is observed or broken, always depends on the person behind the action, and on the person responsible for that action in particular. This is why internal governance in the broader sense is as important as it is, making clear demands in terms of the suitability of managers, key function holders and supervisory board members, and reviewing and monitoring ongoing compliance with these demands. Such requirements must also be made of the decision-making bodies collectively, however. All managers and

**The development of the internal control system using the “three lines of defence” model – 1st line of defence: operational management, 2nd line of defence: compliance and risk management, 3rd line of defence: internal audit – has proven very effective.**

all decision-making bodies must meet the fit and proper criteria. Ensuring that an entity can be properly managed starts with hiring the right staff. Consequently, the FMA attaches great importance to compliance with the principles of good governance.

# CONDUCT RISKS

The interlinking of conduct supervision with prudential supervision

**T**he Austrian financial market is characterised by an exceptionally high degree of integration among many providers, especially across sector, product and industry boundaries. The market features strongly interlinked ownership structures, large-scale sales cooperation agreements, interdependencies based on financial transactions and guarantees, as well as a large number of vehicles for non-competitive joint action. The integrated supervisory approach of the Austrian Financial Market Authority (FMA) has proven its value as the optimal means to identify and assess the economic interrelationships and processes, possible linkages and contagion channels, as well as the resulting additional and cumulative risks at the individual companies.

Integrated supervision combines at least three levels of oversight and regulation: integration across all industries, sectors and products, integration of prudential and conduct supervision, integration of micro and macroprudential supervision. An integrated approach looks at the market from different perspectives: from the perspective of the figures as well as from the perspective of the people, from the perspective of the companies as well as from the perspective of the customers, from the perspective of the individual providers as well as from the perspective of the industries and the economy as a whole, from the national perspective as well as from the international – especially European – perspective.

The integrated supervisory approach thus makes it possible:

- To identify, monitor and address cross-sectoral risk transfers
- To act rapidly and in a coordinated manner in all areas of the financial market
- To enforce broadly uniform standards in all areas of supervision and thus contribute to a level playing field, i.e. fair competitive conditions across all sector, industry and product boundaries

**The Austrian financial market is characterised by an exceptionally high degree of integration. The market features strongly interlinked ownership structures, large-scale sales cooperation agreements, interdependencies based on financial transactions and guarantees, as well as a large number of vehicles for non-competitive joint action.**

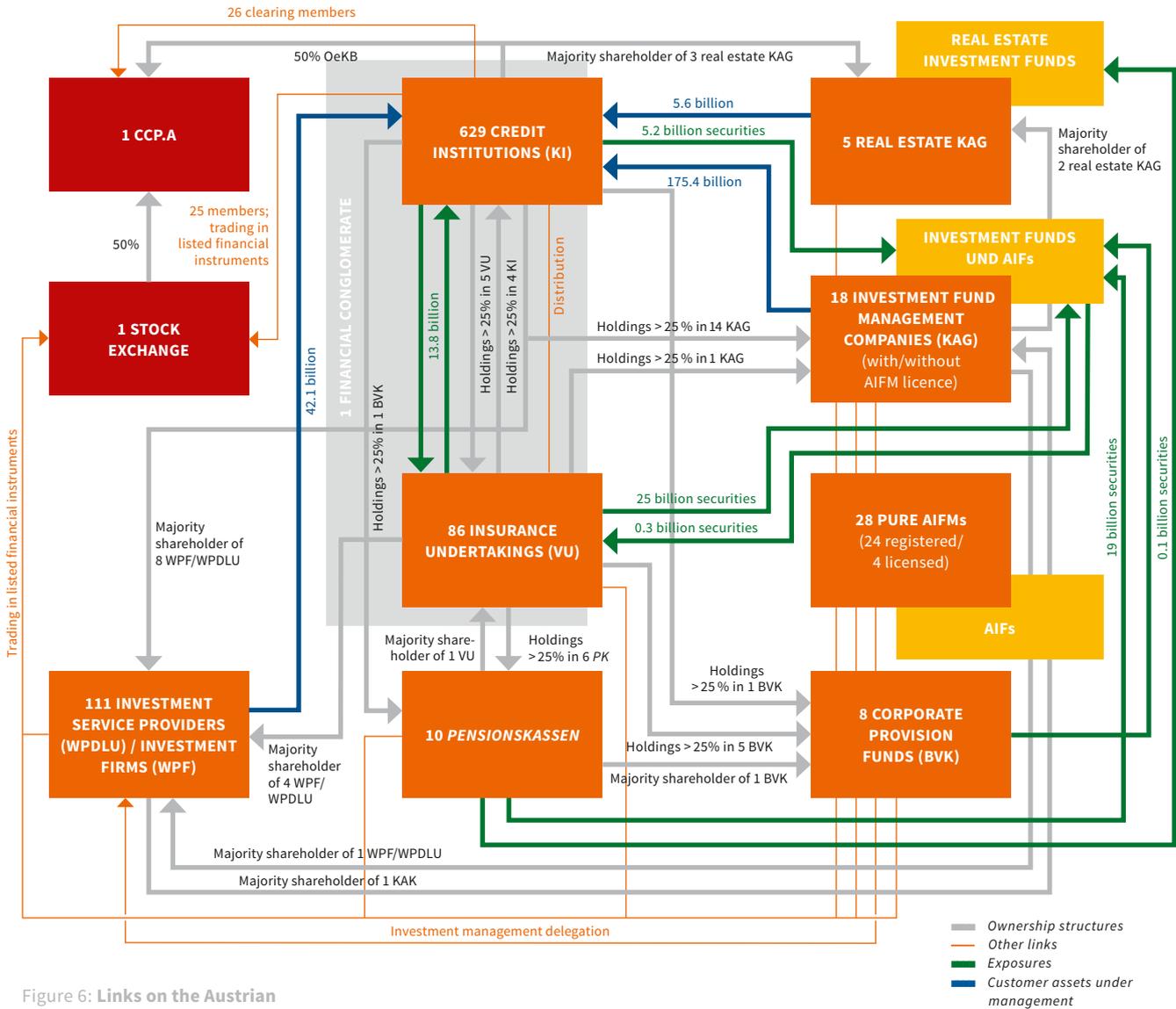


Figure 6: Links on the Austrian financial market

- To prevent regulatory arbitrage, i.e. exploitation of differing levels of regulation and supervision in different areas of the market
- To prevent possible evasive reactions on the part of supervised entities by shifting business activities or risks to other sectors.

Moreover, it gives financial market participants, financial service providers and consumers alike a central point of contact for all regulatory and supervisory questions as part of a “one-stop shop” concept.

In short, integrated supervision enables a holistic view of risk cascades, strengthens transparency across the entire financial market, establishes fair competitive conditions and regulation that is as uniform as possible across markets, while ensuring equal protection of consumers throughout the entire financial market.

However, the most important factor when it comes to optimally leveraging all synergies of integrated supervision is a smooth interlinking of prudential and conduct supervision.

## INTERLINKING OF PRUDENTIAL AND CONDUCT SUPERVISION

The aim of prudential supervision is to ensure that the supervised entities are solvent at all times and are able to fulfil their contractual and legal obligations.

Conduct supervision aims to ensure that market participants and employees of financial services companies always behave in accordance with the rules in order to achieve equal, fair and transparent conditions for all market participants.

Combining the findings from both of these supervisory perspectives is the only way to gain a complete overview of the situation of a supervised company and to take co-ordinated, targeted action to ensure the fulfilment of all legal obligations, effectively control risks and solve problems holistically.

To this end, market and conduct supervision prescribes organisational duties and minimum standards for management practice, as well as for the selection and qualification of executives and holders of key functions. In addition, prudential and conduct supervision pursue a joint approach in the context of fit and proper tests for managers and relevant key personnel. Fit and proper tests are conducted jointly in particular when newly appointed managing directors are responsible for securities compliance or sales and the credit institution's business model revolves around investment business or if the managing director is responsible for the prevention of money laundering and terrorist financing.

Market and conduct supervision also monitors compliance with rules governing the provision of proper information and advice to customers, due diligence requirements for the prevention of money laundering and terrorist financing, and seeks to prevent unauthorised provision of financial services transactions requiring a licence.

Some recent financial scandals have dramatically demonstrated the importance of the smooth interlinking of prudential and conduct supervision.

For example, an underdeveloped compliance and risk culture and a lack of due diligence in the prevention of money laundering have caused serious difficulties for some important players in the financial markets and undermined their economic foundations. Some institutions even had to file for bankruptcy or had their licences revoked. Overly aggressive business strategies and lax controls have resulted in traders and asset managers losing billions; breach of trust and fraud have been encouraged and the door has been opened to manipulations of many kinds, involving currency rates, indices or benchmark lending rates. In the rivalry to win wealthy customers, market share and profitable transactions, due diligence obligations to prevent money laundering have been neglected or completely ignored. In many cases, this has resulted in fines ranging into the billions (in addition to higher reserve requirements), a massive loss of reputation for the institutions concerned and doubts cast on entire business models, up to and including licence revocation.

Misconduct by employees is among the most severe business risks today. This also greatly impacts prudential risk as it erodes the capital base through substantial operational risk and requires corresponding financial reserves.

Accordingly, in its 2016 stress test, the European Banking Authority (EBA) placed a special emphasis on the effects of conduct risks as an operational risk to the solvency of companies. The Financial Stability Review conducted by the European Central Bank (ECB) in May 2016 also identified rising legal costs due to misconduct at banks as a critical driver of costs. The numbers speak for themselves: according to the EBA,

**Misconduct by employees is among the most severe business risks today. This also greatly impacts prudential risk as it erodes the capital base through substantial operational risk and requires corresponding financial reserves.**

**As an integrated supervisory authority, the FMA has placed a strategic emphasis in recent years on optimally interlinking prudential and conduct supervision and thus ensuring a synthesis between the two.**

operational risk losses from litigation and conduct risks at all major European banks totalled € 71 billion in 2016. Based on an overall total of € 105 billion, this represents a good two thirds of operational risk costs.

These costs also burden the future profitability of the banks – on the one hand due to provisions created for possible misconduct and, on the other, due to increased precautions with regard to compliance and internal controls to prevent future misconduct and related costs.

As an integrated supervisory authority, the FMA has therefore placed a strategic emphasis in recent years on optimally interlinking prudential and conduct supervision and thus ensuring a synthesis between the two. Compliance, conduct and anti-money laundering (AML) supervision is carried out by integrated centres of competence and by cross-departmental teams. They make synergetic use of cross-sector expertise and conduct convergent supervision pursuing a “same purpose, same regulation, same supervision” strategy. Although prudential supervision is sector-specific, it is strategically coordinated by joint, integrated and cross-industry working groups, where relevant information is institutionalised and necessary measures are coordinated.

From the point of view of the investor to be protected, it is ultimately irrelevant from which provider in which industry a product or service is sourced. The crucial factor is that the product or service is appropriate to individual financial needs and that transparent information and fair advice are provided. In this context, integrated supervision can ensure uniform standards across all industries.

How the FMA optimises the interlinking of prudential and conduct supervision is illustrated here using a few concrete examples: the sale of bail-in able securities by banks, efficient compliance, the prevention of money laundering and terrorist financing and sustainable real estate and consumer lending.

#### **EXAMPLE: SALE OF BAIL-IN ABLE SECURITIES**

The new European system for the recovery and resolution of banks and investment firms, laid out in the Bank Recovery and Resolution Directive (BRRD<sup>1</sup>) and implemented into Austrian law in the Bank Recovery and Resolution Act (BaSAG; *Bankensanierungs- und Abwicklungsgesetz*), sets the legal framework for crisis management in the financial sector. Austrian lawmakers have appointed the FMA as the national resolution authority.

The aim of the new resolution regime is that any bank or investment firm, regardless of size and complexity, can be wound up without jeopardising the stability of the financial market. To this end, the supervisory authority must, where possible, also act preventively and take all precautions necessary to ensure that steps can be taken without delay and obstruction in the event of a crisis. An important instrument in this context comes in the form of recovery and resolution plans. In these plans, impediments and obstacles to resolution are identified, addressed and subsequently removed.

The financing of the resolution, the coverage of the relevant liabilities and losses must be implemented primarily through the participation of the owners and creditors. A

<sup>1</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU and Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council.

central instrument for this is the write-down of liabilities (haircut) and a conversion of debt into equity, the so-called bail-in. For this purpose, financial instruments and claims of creditors are divided into legally defined classes and treated as liabilities in a predetermined order (the “liability cascade”). Only when a class of liabilities has been used in full and this is not sufficient to offset losses enough to stabilise the bank can the next class in the liability cascade be written down or converted.

The first class affected by resolution measures concerns the Common Equity Tier 1 capital and thus the shareholders of the bank (i.e. holders of shares and other equity instruments). Thereafter, the Tier 2 capital is used. Here, subordinated creditors (e.g. holders of subordinated debt) are affected. This is followed by unsecured subordinated financial instruments/liabilities that do not meet the requirements for Additional Tier 1 or Tier 2 capital. The next level is unsecured non-subordinated financial instruments and liabilities (such as senior bonds). Finally, the deposits of natural persons and small and medium-sized enterprises that exceed the maximum amount of € 100 000 insured by the statutory deposit guarantee are used.

Securities included in this liability cascade qualify as bail-in able securities as they may be used to cover liabilities and losses.

Each bank must hold a minimum amount of bail-in able positions, the so-called MREL (minimum requirement for own funds and eligible liabilities). This is designed to ensure that equity and bail-in able liabilities are available in sufficient quantity and quality in the event of bank resolution. In Austria, the FMA is charged with determining the level of MREL a bank must hold in excess of its equity capital following a detailed analysis of the institution and its business model.

By 2018 Austrian banks had placed around € 88 billion of bail-in able securities on the market, € 20 billion of which with retail investors. And roughly € 20 billion must be replaced each year. Moreover, in the near future it is to be expected that the banks will issue additional high volumes of bail-in able financial instruments in order to meet the MREL targets set by the FMA or the European Single Resolution Board (SRB) as of 2019. The persistent low interest rate environment, limited access to foreign markets given the adverse interest rate level of such Austrian issues and a limited absorption capacity of institutional investors have created an incentive for banks to sell large volumes of these securities to their own customers. This carries the risk of conflicts of interest and mis-selling, i.e. customers being given insufficient or incorrect advice and sold a product that is unsuitable for them.

Bail-in able securities are “loss-bearing” in the event of resolution and are exposed to the risk of haircuts, or even total loss. Accordingly, they are unsuitable as a substitute for traditional savings accounts.

Soon after the BaSAG came into force, the FMA therefore focused its supervision on the proper selling of bail-in able securities and urged the banks to comply with the relevant MiFID rules of conduct when advising on and selling such securities:

- Investors must be provided with up-to-date, complete and comprehensible information on the product and its features; in particular, they must be informed about the risk of creditor bail-in, which can lead to total loss. Proper information also includes making it unmistakably clear that such instruments are not protected by deposit guarantee schemes.
- Any conflicts of interest, in particular in connection with own issues of bail-in able financial instruments, must be disclosed and appropriately managed.

- It must be ensured that the product offered is suitable and appropriate for the investor. In the selling process, this may entail the need to obtain additional information from the customer.

Moreover, the FMA has made sure that, in addition to new investors, those who already held securities that became bail-in able (and thus fully loss-bearing) only after the BaSAG came into force were duly and properly informed.

Crises of banks in other EU countries have also shown that too high a proportion of bail-in able liabilities held by retail customers can be an obstacle to resolution given the great potential for political resistance to including them in creditor bail-in and loss coverage. This, in turn, may result in credit institutions having to build up additional MREL positions that are not held by retail customers.

Risk-based and effective supervision by the FMA with regard to banks' compliance with rules of conduct in the sale of bail-in able financial instruments may serve to counteract this potential obstacle to resolution implementation.

This example shows how important it is to interlink prudential supervision, which targets capital adequacy, with the resolution authority, which prescribes the necessary MREL, and conduct supervision, which is concerned with protecting customers and investors.

If conduct supervision determines that the sale of bail-in able securities was improper because MiFID II obligations were not complied with by the credit institution, this may, from the point of view of the resolution authority, result in a reassessment of the MREL requirement to cover operational risk and imposition of a higher MREL target. Breaches of rules of conduct or due diligence obligations in the area of conduct supervision can lead to sanctions and fines as well as civil claims, such as claims for damages, which, from a prudential standpoint, can also result in increased operational risk and thus in higher capital requirements for the credit institution.

Conversely, as shown above, the imposition of additional capital requirements by prudential supervision may lead credit institutions to sell more bail-in able financial instruments to retail customers and investors, which in turn raises investor protection issues. Additional capital requirements may also prompt credit institutions to issue and place highly innovative financial instruments, such as contingent convertible bonds (CoCos), which are not automatically converted into equity instruments or bail-in able until certain prudential trigger levels are reached. Such equity instruments entail particular risks for retail investors, which they themselves cannot recognise and certainly cannot understand. The banks, however, have an increased interest in selling them given that they are prudentially qualified as equity – another example of the close link and interaction between prudential and conduct requirements.

These examples show how important it is for the different supervisory approaches and perspectives to be interlinked. Prudential supervision benefits from the observations, findings and measures of conduct supervision, from which important information can be derived about the actual risk situation of the bank, allowing appropriate prudential measures to be implemented. In turn, conduct supervision benefits from the observations, findings and measures of prudential supervision as specific risks are made known at an early stage, allowing the supervisor to set appropriate priorities and thus take preventive steps to protect consumers.

#### **EXAMPLE: SECURITIES AND MARKET SUPERVISION**

Capital market law stipulates that banks must keep retail trading and proprietary trading physically separate in order to avoid conflicts of interest between the two. Conduct is monitored as part of securities supervision. However, any breach of this fundamental principle is also relevant for prudential supervision since an inadequate organisational structure also constitutes a serious breach of the organisational rules for credit institutions. In a recent case, a systemic violation of this kind identified by the conduct supervisor for securities ultimately led – since it was not remedied despite an order to do so – to the dismissal of the managing director by prudential banking supervision.

In a reverse scenario, the OeNB repeatedly makes findings on the management of operational risk or inadequate organisational structures in the sale of financial instruments within the framework of on-site inspections initiated by prudential supervision, which also provide important reference points and information for conduct supervision.

In the context of crisis management during the insolvency of Constantia Privatbank (CPB) at the height of the global financial crisis, the interaction between prudential supervision and market and securities supervision was of crucial importance. From a purely prudential perspective, CPB was insolvent and had to be declared bankrupt as it was not a systematically important institution. However, because it was a custodian bank at the time and held assets for more than 550 investment funds, it was necessary from the point of view of securities and market supervision to continue the bank's operations for the time being and to organise an orderly private-sector resolution.

Insolvency proceedings would have frozen these funds' assets for at least six weeks and prevented their management in the midst of the most severe financial market turbulences. The cash positions would legally have become part of CPB's bankruptcy assets. This would have been a very negative signal about Austria as a financial centre during this time of immense crisis: while only around a dozen investment funds were blocked throughout Europe, the number in Austria would have been around 550.

The privately organised and orderly resolution of the bank was very successful, involved owners and creditors in covering losses, proved to be asset-preserving and contributed to maintaining confidence in the Austrian financial market during the crisis.

#### **EXAMPLE: PREVENTION OF MONEY LAUNDERING AND TERRORIST FINANCING**

Current scandals show how important it is today for financial service providers to meticulously comply with the legal regulations for the prevention of money laundering and terrorist financing. Lack of due diligence can lead to severe sanctions: harsh fines, dismissal of executives, severing of important business relationships (e.g. with the USA), insolvency, licence revocation and criminal prosecution (see also the article about money laundering on page 97).

Virtually all financial service providers licensed and supervised by the FMA, be they banks, insurance undertakings, investment firms or investment funds, are subject to the legal regulations governing the prevention of money laundering and terrorist financing. For this reason, Austrian lawmakers have entrusted the FMA with the supervision of compliance with the relevant due diligence obligations by these enter-

prises. As an integrated supervisory authority, it can ensure that the rules are applied uniformly and consistently across all industry and product boundaries.

Financial service providers are required to have adequate organisational arrangements in place to ensure proper due diligence in relation to the relevant risk of being misused for money laundering and to the size of the business; this includes appointment of a suitable anti-money laundering officer, definition of processes for application of the regulations, ongoing training of employees and internal monitoring of compliance with the due diligence obligations.

The FMA performs this conduct supervision through an integrated, cross-sector centre of competence. Since breaches of due diligence obligations also entail – as mentioned above – massive legal, reputational and operational risks, close interlinking with prudential supervision is crucial. To this end, the FMA has instituted a standardised and formalised exchange of information between the responsible prudential supervisory teams and the anti-money laundering centre of competence. In addition, close coordination already takes place between prudential supervision and conduct supervision in the area of policy, for example in the preparation of FMA Guides as well as in the preparation of guidelines of the European supervisory authorities, in which the FMA takes part and votes as the competent national supervisory authority and actively participates in all relevant working groups, representing the interests of Austria.

A lack of due diligence in dealing with AML provisions is also an indication of an inadequate risk culture in the company as well as weaknesses in the compliance and governance system in general and, accordingly, is of great importance from a prudential perspective. At the same time, prudential supervision regularly uncovers indications of specific money laundering risks, such as particularly intensive business relationships with high-risk destinations and offshore centres, during the assessment of business models and on-site inspections. In some cases there is a business focus on financial services and products that are particularly vulnerable to misuse for money laundering purposes. Moreover, the highly differentiated and effective arsenal of prudential supervision, which not only focuses on administrative penalties and imposed measures, but can also leverage capital adequacy requirements, contains additional instruments for enforcing proper handling of AML obligations and for raising awareness about the issue.

**Conduct supervision aims to ensure that market participants and employees of financial services companies always behave in accordance with the rules in order to achieve equal, fair and transparent conditions for all market participants.**

#### **EXAMPLE: SUSTAINABLE REAL ESTATE AND CONSUMER LENDING BY BANKS**

There are also interactions between prudential and conduct supervision in the context of real estate and consumer lending, especially in boom times.

In order to ensure sustainable lending, prudential supervision must monitor that the credit institution has adequate capital resources and employs appropriate risk management procedures to match the risk incurred. In particular, credit default risk, legal risk and reputational risk must also be monitored.

Requirements in the area of conduct supervision – such as the provision of appropriate client information, implementation of appropriate remuneration practices to prevent excessive risk-taking, and ensuring that client advisors have sufficient knowledge and experience – may also have an impact on prudential supervision. Unsuitable processing of loan applications, for example, can result in customers providing inadequate or even incorrect information in the lending process, as a result of which credit is not administered in accordance with proper lending standards, leading to an

increased risk of default. In the event of full or partial defaults on loan payments, the bank may incur a loss if no or insufficient collateral can be realised. Such a loss can ultimately impact the capital adequacy of the credit institution.

### **SUCCESSFUL MODEL: INTEGRATED SUPERVISION**

These examples clearly illustrate the advantages of the FMA's integrated supervisory approach, which promotes a standardised exchange of information and knowledge between all supervisory areas and all supervisory perspectives, in particular through close interlinking of prudential and conduct supervision. In this way, the FMA ensures:

- As prudential supervisor, that institutions are stable and crisis-proof
- As conduct supervisor, that financial institutions treat their customers and investors fairly
- As integrated supervisor, that a level playing field applies across product and sector boundaries
- As microprudential and macroprudential supervisor, that findings and measures are interlinked and transparent at the level of individual institutions and across the market as a whole.

This allows the FMA to monitor the Austrian financial market from all perspectives and points of view, to assemble the many puzzle pieces into a “big picture” and thus derive integrated measures that take all interactions into account. In this way, supervision of the closely interwoven Austrian financial market is designed to be effective, efficient and of the highest quality. The FMA thus fulfils its role in helping strengthen confidence in a functioning Austrian financial market, acting preventively to ensure compliance with supervisory standards, protecting investors, creditors and consumers, and maintaining the stability of the financial market in Austria.

# COLLECTIVE CONSUMER PROTECTION

Market supervision and product intervention

**T**he global financial crisis has severely shaken many consumers' and investors' trust in the markets and in established providers such as banks, insurers and investment funds. The environment of consistently low interest rates that has been in evidence since then has made many of them turn their back on their usual safe, but low-yield investments and, in a quest for higher yields, turn to the unknown territories of incomprehensible financial products. This often resulted in additional, even higher losses, further undermining trust in the financial markets.

In a move to restore and strengthen investors' confidence in the financial markets, European lawmakers have evaluated the efficiency and effectiveness of existing regulations, revised them and also created numerous new regulations to protect investors and consumers. In early 2018 the revised Markets in Financial Instruments Directive (MiFID II)<sup>1</sup> and the accompanying regulation (MiFIR)<sup>2</sup> both entered into force, as did the Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs Regulation<sup>3</sup>) and the Insurance Distribution Directive (IDD)<sup>4</sup>. These new directives and regulations improve, expand and enhance investor protection, while also driving forward a paradigm shift in supervision.

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

<sup>2</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

<sup>3</sup> Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products.

<sup>4</sup> Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

## PARADIGM SHIFT IN INVESTOR PROTECTION

Until now, supervision has centred on the providers of financial services, ensuring that they comply with solvency and capital requirements as well as risk management rules. Consumer protection has been largely carried out indirectly: by ensuring that companies remain solvent it was guaranteed that those supervised companies could also fulfil all of their contractually agreed obligations vis-à-vis their customers, the consumers.

Based on the lessons learned from the global financial crisis, increasing attention is now also being paid to how the supervised companies act towards their business partners, customers and investors. Nowadays supervision increasingly extends to the financial products themselves, including their conception, to the definition of the target market, as well as to providing advice when those products are sold, to the transparency of products, and particularly also to the provision of extended, standardised and comparable information for investors.

### THE CONCEPT OF COLLECTIVE CONSUMER PROTECTION

The FMA has been pursuing the concept of collective consumer protection for many years now. Given its statutory obligation to maintain an equidistant position from both supervised entities and their customers and therefore not to side with individual consumers, helping them to enforce any individual claims, the Authority's goal is to safeguard and protect the interests of all consumers together as a collective group. Individuals are therefore protected indirectly as part of that collective. It is the role of collective consumer protection to uphold the interests of the community of savers vis-à-vis banks, to protect the community of borrowers from being cheated, to guarantee policyholders benefits that match their policies, and to ensure that the community of investors receives proper and fair advice, to name just a few examples. In its capacity as an integrated supervisory authority, bringing together regulation and supervision for the entire financial market under one roof, the FMA is optimally placed to meet the requirements of an efficient and effective form of collective consumer protection. It pools information covering the entire financial market, is familiar with that market's interdependencies, and can leverage synergies across all sectors and products.

The FMA's collective consumer protection is based on three main pillars:

- As the authority responsible for prudential supervision, the Authority ensures that the supervised companies are stable and able to withstand crises, also monitoring the ability of financial service providers to meet their obligations.
- In its capacity as the body responsible for conduct supervision, the FMA monitors whether companies are properly organised, providing correct information and advice, and applying the statutory rules.
- As the micro and macro-supervisor, the Authority ensures that findings and measures at the level of individual institutions are linked to those at an aggregated level, and vice versa.

However, the aim of collective consumer protection is not just to protect individual consumers, but to strengthen confidence in Austria's financial market as a whole and to contribute to its stability.

The new product-based provisions contained in the MIFID II / MiFIR / PRIIPs package equip the FMA with new powers and tools to protect consumers:

**“A pan-European approach is the best way to address these important consumer protection issues, particularly in the case of financial products that are offered via the Internet and on a cross-border basis. National and European supervisors should work together closely, carefully monitoring any impact on the markets and together considering any further steps.”** *Helmut Ettl, FMA Executive Director*

- The power to supervise the markets for structured deposits, financial instruments and insurance-based investment products
- Powers in terms of product invention, authorising the FMA – under certain circumstances – to restrict or even completely prohibit the marketing, distribution and sale of a product to retail investors.

The product intervention tool is to be used by supervisors as a last resort. Basically, the new provisions on product conception including the obligation to define the target market in which the product is to be sold, and the obligations relating to product information should suffice to reach the desired level of investor protection. To counter any malpractices or breaches of the rules, the law grants supervisory authorities corresponding powers to take the necessary measures and to impose penalties.

### MARKET SUPERVISION POWERS

MiFIR and the PRIIPs Regulation oblige the European and national supervisory authorities to monitor their markets for financial instruments, structured deposits and insurance-based investment products that are distributed within the European Union on a regular basis, namely in terms of the marketing, distribution and sale of such financial products. This type of targeted market supervision also forms the basis for justified and lawful product intervention.

#### ANALYSIS OF REPORTING DATA

Market supervision requires data, which the supervised entities need to report to the FMA in compliance with the relevant supervisory laws. The Authority then assesses and analyses this data, uncovering and questioning any irregularities. In this context, the FMA focuses on market data for products sold to retail investors that are in particularly high demand or entail a high level of risk.

#### CONSUMER ENQUIRIES AND COMPLAINTS, WHISTLEBLOWER REPORTS

Consumer enquiries and complaints, as well as reports from whistleblowers, are an important source of information for the FMA. These are analysed systematically, partly supported by relevant software programs, in order to recognise trends early on and filter out problematic products or types of product. New products and market trends can often be identified through such enquiries.

#### DIALOGUE WITH STAKEHOLDERS

The ongoing and open dialogue with market participants and other stakeholders such as interest groups, associations and the Austrian consumer protection organisations is also an important and helpful tool in these efforts. These stakeholders view the market from a different perspective, have additional information about it and thus help to keep track of the current situation. The aim is to recognise early on any problems and irregularities by looking at the market from various perspectives, and getting to know it better by linking up different information.

#### INTERNATIONAL COOPERATION

In addition, the FMA is in regular contact with its partner authorities and the European supervisory authorities. Findings on market trends from other European coun-

## PRODUCT INTERVENTION MEASURES ADOPTED BY ESMA IN RELATION TO BINARY OPTIONS AND CFDs

The European Securities and Markets Authority (ESMA) adopted the following product intervention measures in 2018:

Taking effect on 2 July 2018, ESMA temporarily prohibited the marketing, distribution or sale of binary options to retail clients for three months. Subsequently, it renewed the prohibition until 1 April 2019.

Taking effect on 1 August 2018, a restriction on the marketing, distribution or sale of contracts for differences (CFDs) to retail investors temporarily applied for three months. This restriction consisted of:

- leverage limits on opening positions, which vary according to the volatility of the underlying asset;
- a margin close-out rule and a negative balance protection on a per account basis;
- preventing the use of incentives by a CFD provider and a firm specific risk warning delivered in a standardised way.

Subsequently, ESMA extended the prohibition until 30 January 2019.

ESMA justified its decision by stating that both binary options and CFDs are complex products that are frequently offered to retail investors using aggressive marketing and non-transparent information. This makes it hard if not impossible for retail investors to grasp the risks entailed with these products. Additionally, the costs and charges associated with such products are complex and not immediately obvious to retail investors.

Specifically with regard to binary options, ESMA concluded that there was a structural expected negative return and that investors, when considering all aspects, are more likely to lose money the more positions they open.

In the case of CFDs, retail investors usually find it particularly difficult to estimate the expected return taking account of all of the associated costs. NCAs' analyses on CFD trading across different EU jurisdictions shows that 74–89% of retail accounts typically lose money on their investments.

NCAs' analyses for binary options also found consistent losses on retail clients' accounts.

Ongoing compliance with these product intervention measures imposed by ESMA lies with the national competent authorities, or the FMA in Austria.

ESMA and FMA cooperate closely on product intervention, with the FMA as the national competent authority for Austria having a seat and a vote at ESMA and actively contributing to the relevant working groups. Both authorities regard the new supervisory tool and its first-time application as a major step forwards in investor protection. The measures taken in relation to CFDs ensure that retail investors cannot lose more money than they put in, restrict the use of leverage and incentives, and provide comprehensible risk warnings for them.

tries – such as, for example, new marketing, distribution and sales techniques relating to financial products – provide important information as to which areas might need further scrutiny. Experience has shown that financial products which are sold from individual countries rapidly spread within the entire European Union, owing to the single European market and the increasing possibilities to sell online.

### **ON-SITE INSPECTIONS, EXAMINATIONS AND MANAGEMENT TALKS**

Where the analysis of reported data, consumer complaints and enquiries, information gathered from stakeholders or communications with partner authorities point to specific problematic products or providers, the FMA may carry out management talks, examinations or on-site inspections to gather additional information.

Each of these sources of information is important to identify inappropriate marketing, distribution and sales practices or especially risky and potentially toxic products, and particularly so when viewed together. The FMA also uses state-of-the-art IT tools for analysis and assessment. All data, such as data from complaints, is entered and evaluated electronically where possible.

If, in the course of regular market supervision, the FMA uncovers irregularities, it will follow them up and examine whether they have led to malpractices in the market or whether specific risks arise for investors from the distribution, marketing or sale of products. In the event of malpractice, the FMA will decide how to put an end to it as efficiently and effectively as possible using the least severe means.

In this case, following its motto of “communication and prevention not sanction”, the FMA focuses its efforts on communicating with the supervised entities concerned as well as other stakeholders, and on informing investors and consumers. As a rule, individual malpractice can usually be rapidly resolved this way. Investors and consumers, in turn, are informed of the financial products concerned, of marketing, distribution and sales practices, as well as of any related risks in easy-to-understand and clear language. In those instances where communication and information do not achieve the desired result, the FMA will make use of all of its statutory tools. This includes intensifying individual supervision efforts by prescribing information and reporting obligations, or taking official measures and imposing sanctions or even, as a last resort, product intervention measures.

### **THE PRODUCT INTERVENTION TOOL**

In accordance with MiFIR and the PRIIPs Regulation, competent authorities have been allowed since January 2018 to impose a prohibition or restriction on supervised companies marketing, distributing or selling certain particularly risky and complex products. Such a ban or restriction may even be imposed before marketing commences, meaning that intervention is possible at all stages of a product’s life cycle, provided that certain conditions are met. It may be imposed by both the European and the national supervisory authorities, with the FMA being the competent authority in Austria. This supervisory measure is directed at licensed and, consequently, supervised companies such as banks, insurance undertakings and investment firms. National competent authorities (NCAs) may impose product intervention measures on a permanent basis, while the European supervisory authorities have only temporary intervention powers.

Legally speaking, the FMA may address certain groups of legal entities in the form of a regulation or one or more legal entities in the form of an administrative decision.

### **CONDITIONS**

The conditions justifying the introduction by the authority of a product intervention measure focus in particular on investor protection and the orderly functioning of the financial market. Product intervention is therefore possible where the product:

- gives rise to significant investor protection concerns,
- poses a threat to financial markets or commodity markets,
- poses a threat to the stability of the financial system, or
- where a derivative has a detrimental effect on the price formation mechanism in the underlying market.

Investor protection concerns are particularly relevant in the case of products that are particularly difficult for retail investors to understand, owing to the complex and non-transparent design, functioning and risks. Any potential damage for investors is assessed by looking at the type and transparency of any underlying or reference assets, the degree of transparency in relation to costs and charges, as well as the complexity of calculating performance. Particular attention must be paid as to whether the return on the investment depends on the performance of one or more underlying or reference assets. Where a financial product is also vulnerable to being abused for criminal activities, or where it is sold to an unsuitable target group on a large scale, this will further increase the risk for retail investors.

### **BAN ON DISCRIMINATION**

Any national product intervention action must not have a discriminatory effect on financial products or services or activities provided from another Member State. In this case, the competent authority is obliged to properly consult competent authorities in other Member States that may be significantly affected by the action.

### **PROPORTIONALITY**

Where a competent authority is considering taking action, it must ensure that it will be proportionate, even if all other conditions are met. The action should not have any disproportionately negative effects on the financial markets' efficiency or on investors. The irregularity must also be of material significance, and the problem it entails must have reached major proportions, for example affecting a large number of market participants.

### **MATERIALITY**

The materiality threshold is exceeded when there is a strong increase in the number of enquiries or complaints about a certain financial product or a sudden spate of complaints. This is usually an indication that investors have not understood the design, usually detrimental to them, of a complex product, its characteristics and associated risks, or its costs and charges.

### **MEASURES OF LAST RESORT**

Even if all conditions are met, there is proportionality and the irregularity is of material significance, a product intervention measure is only an option if the risks to

**Product intervention is possible where the product gives rise to significant investor protection concerns, poses a threat to financial markets or commodity markets, or to the stability of the financial system, or where a derivative has a detrimental effect on the price formation mechanism in the underlying market.**

**The product intervention tool available to supervisors to protect consumers is an extremely harsh tool. Despite this type of intervention being available to supervisory authorities, consumers should always be aware that highly risky products will continue to be sold on the financial markets, including to retail investors.**

be averted cannot be tackled using other supervisory tools. Product intervention is a measure of last resort, used by a supervisory authority to protect investors from acquiring highly speculative products or assuming unknown risks.

As a rule, consumers are extensively informed about the market or even warned before any product intervention takes place. This should create awareness in the market and among consumers about the risks, and also help avoid undesired effects and uncertainties on the financial market. Additionally, the Regulations lay down that the European and national authorities must notify each other of all details connected with a planned product intervention measure in good time before it becomes effective.

The product intervention tool available to supervisors to protect consumers is an extremely harsh tool. Despite this type of intervention being available to supervisory authorities, consumers should always be aware that highly risky products will continue to be sold on the financial markets, including to retail investors. Investor protection aims to make such products more transparent, ensuring that their impact is explained in clear language and that all opportunities and risks are presented fairly. Before making an investment, investors should always look closely at any information provided, take heed of any warnings of risks typically associated with the financial product in question, and come to a decision based on their own financial means and needs. Without exception, higher yields always mean higher risks!

# DEFICIENCIES IN MONEY LAUNDERING PREVENTION

An existential risk

**T**he international community has massively stepped up its efforts to combat money laundering over the past few years. Originally, anti-money laundering efforts were all about fighting organised crime and drug and human trafficking. Today, these efforts also focus on combating tax evasion and corruption, and on fighting terrorism and the proliferation of weapons of mass destruction. In all of this, the financial markets play a special role given that they are particularly suited, if not predestined, to being used to hide illicit funds, conceal their source and feed them into the legal economy.

The international community has therefore imposed special due diligence obligations on financial market participants to prevent the abuse of the financial system for money laundering purposes. The global standards for these due diligence obligations are drawn up by the Financial Action Task Force (FATF), which is housed at the OECD (Organisation for Economic Co-operation and Development) headquarters in Paris. The European Union has incorporated these standards into its body of law by way of several anti-money laundering directives. The standards are intended to prevent illicit funds from being channelled into legal markets, but they are also aimed at ensuring that all financial transactions leave a trail and have an identifiable beneficial owner. In this way, if illicit funds are detected further down the line, they can be traced back from their final use to their original source.

This does not mean that financial market participants are given the task of criminal prosecution but that they are obliged to take preventive action by adhering to certain due diligence and reporting obligations in order to avoid the misuse of the financial system for money laundering purposes. This obligation must not be taken lightly. Any entity that does not follow the FATF recommendations is considered something of a financial market pariah these days. Financial markets that do not consistently adhere

to the agreed regulatory and supervisory standards are named and shamed in a dedicated FATF blacklist<sup>1</sup>, earning themselves a global reputation as “dodgy” destinations.

Financial service providers that do not effectively implement anti-money laundering (AML) measures and measures to combat the financing of terrorism (CFT) are increasingly also faced with a serious operational risk, leading to high costs and ultimately possibly even to insolvency or the withdrawal of their licence. The 2016 EU-wide stress test conducted by the European Banking Authority (EBA), which involved the 51 largest banks in the EU, found that conduct risk losses amounted to € 71 billion of the overall operational risk losses of € 105 billion, i.e. two thirds of operational risk. Recent examples highlight the dramatic effects strategic AML/CFT deficiencies can have on financial service providers.

### A TSUNAMI OF GLOBAL MONEY LAUNDERING SCANDALS

**“We have a zero tolerance approach to money laundering.”** *Helmut Ettl, FMA Executive Director*

To conceal the source of illegal assets, to launder these assets and to channel them into the legal business cycle, money launderers frequently carry out fictitious transactions and foreign payments using offshore banks, letterbox companies, sham companies and dummies in countries with serious AML/CFT deficiencies. Global research platforms for journalists have been sent tremendous amounts of leaked data relating to global financial transactions and complex company structures in the past few years, apparently reflecting the concealment of assets and laundering of illicit funds. The Panama Papers, Paradise Papers and Russian Laundromat have been dominating public debate for months, if not years now.

Journalists have researched myriad forms of laundering illegal assets, linked specific company structures and transactions to well-known names and ensuring the culprits hit the headlines for all to see. Ministers and heads of government have had to resign, criminal proceedings have been initiated against numerous prominent figures for money laundering and tax evasion, some have been imprisoned and charged, and the Panama-based law firm Mossack Fonseca, which had specialised in complex company structures with offshore centres, was forced to close its doors. Many financial institutions through which those transactions were carried out failed to provide explanations for their deeds and are now under close scrutiny by the relevant authorities.

Parliaments have been setting up enquiry committees and many governments have commissioned special prosecutors and committees to bring the facts of these cases to light, to analyse regulatory and supervisory deficiencies and to present proposals for improvements.

The fight against money laundering has remained at the very top of many a political agenda ever since, and the enhanced attention and awareness is dragging more and more institutions into the supervisory and media spotlight; institutions that have created an illegal competitive edge for themselves by neglecting to comply with AML obligations.

<sup>1</sup> The FATF identifies “high-risk and other monitored jurisdictions” whose legislation and AML/CFT measures show deficiencies in relation to the FATF standards and publishes them in two public documents: *FATF Public Statement and Improving Global AML/CFT Compliance: Ongoing Process Statement*. Apart from reputational risks, another consequence is that financial market participants are obliged to engage in enhanced monitoring of their business transactions with these countries.

- In early September ING agreed to pay a settlement of € 775 million following an investigation into money laundering and breaches of AML obligations at the Dutch bank. The authorities accused the largest financial service provider in the Netherlands of not properly vetting the beneficial owners of client accounts. The settlement amount is one of the highest sums ever agreed in connection with financial crime in the Netherlands, and has also had a negative impact on the bank's share price.
- The boss of Denmark's biggest bank, Danske Bank, was fired after a series of major deficiencies were found in its Estonian branch's controls to prevent money laundering. Internal investigations by the bank have shown that this has been ongoing for several years, and concerned transactions worth € 200 billion. Official proceedings have not been completed as yet, but Danske is expected to be fined billions of euros.
- ABLV Bank, Latvia's third-largest bank with a branch in Luxembourg, became insolvent in 2018 after the US Treasury's Financial Crimes Enforcement Network (FinCEN) had accused it of money laundering and violating sanctions imposed on North Korea; the bank was banned from keeping any business relationships in the USA. Subsequently, customers withdrew more than € 600 million overnight from their accounts with ABLV. The bank was then forced to liquidate its assets.
- Deutsche Bank had to pay more than \$ 700 million to US regulators in 2017 for helping its Russian customers to move \$ 10 billion to the West in disregard of its AML obligations.
- London-based HSBC had to pay a \$ 2 billion fine to US regulators for having helped Colombian and Mexican drug cartels launder money.
- French banking giant BNP Paribas was ordered to pay \$ 8.9 billion in fines to US authorities after carrying out illegal financial transactions in Sudan, Iran and Cuba.
- The European Central Bank (ECB) has revoked the licence of Versobank AS, a small Estonian bank with 5 600 clients, of which 3 600 are non-residents, over breaches of anti-money laundering laws. The ECB withdrew the licence after a request from the Estonian financial watchdog, which had accused the bank of AML/CFT deficiencies and of not properly managing operational risk.
- The ECB has also acted on the request from the Malta Financial Services Authority (MFSA) and withdrawn the licence of Pilatus Bank. The EBA had previously reprimanded the MFSA for not sufficiently complying with its obligations to monitor adherence to anti-money laundering rules. As early as in March 2018 the Iranian chairman of Pilatus Bank was arrested in the United States following accusations that he and the bank had engaged in money laundering and violated US sanctions against Iran.
- Valartis Bank withdrew from the Austrian market after the FMA removed two of its board members for serious breaches of AML rules and imposed hefty fines.

This list is not exhaustive, it merely includes some particularly representative examples.

These scandals leave no doubt that many financial service providers continue to be highly vulnerable to being abused for money laundering, tax evasion and corruption purposes. Supervision of compliance with rules of conduct, corporate governance and AML/CFT rules is therefore of the utmost importance.

**“Fighting money laundering is an important part of our efforts to reduce the risks in the financial sector and to win back confidence in our financial system.**

**The EU has adopted ambitious reforms. What we must do now is make sure that these are applied throughout the entire EU and monitored effectively.”**

*Hartwig Löger, Federal Minister of Finance*

## SUPERVISION AND THE FIGHT AGAINST MONEY LAUNDERING

Supervision of compliance with legal regulations governing the fight against money laundering must not just be viewed from the perspective of good governance and compliance, however. These risks are also growing increasingly important in relation to the prudential supervision of individual institutions.

As an integrated supervisory authority, the FMA brings together supervision of compliance with the legal provisions on the prevention of money laundering, compliance and conduct supervision, and prudential supervision of individual institutions in Austria. In this way, all of the relevant information, data and findings are pooled under one roof, using the synergies generated in all of the different yet related areas of supervision, and ensuring that the overall system of supervision is one that is both efficient and effective.

The ECB relies on findings brought forward by the national competent authorities for the prevention of money laundering as it performs its role within the eurozone’s Single Supervisory Mechanism (SSM), which has been operational since 2014. It is the ECB that holds ultimate responsibility within the SSM and that is also responsible for granting and withdrawing licences. While it is the national authorities that are entrusted with monitoring compliance with AML obligations, this can also impact on an institution’s economic situation and necessitate intervention by the ECB. Following the many cross-border money laundering scandals there is currently intensive debate on whether to confer responsibility for certain aspects of money laundering prevention to a common European institution. The European supervisory authorities, namely EBA, EIOPA and ESMA, are already working closely with the ECB and other European political institutions to improve cooperation and the exchange of information. As yet no political decision has been reached, however.

As the Austrian competent authority, the FMA is obliged to monitor the companies it licenses and supervises in order to make sure that they are complying with the statutory AML provisions, have appropriate organisational measures in place and generally adhere to the principles of good business conduct. Within its conduct supervision activities, the FMA particularly focuses on organisational structures, allocations of responsibility and principles of good business conduct.

## MANAGEMENT OF CONDUCT RISKS

In order to efficiently implement the existing requirements relating to the prevention of money laundering and terrorist financing and to react appropriately to risks, suitable structures at company level are needed. Companies must foster risk awareness and create a strong risk culture within their institutions, as this will influence any decisions the management and employees make and greatly impact on the risks that they take. Conduct and compliance requirements should always include AML requirements too.

### MANAGEMENT BOARD

Prevention of money laundering is first and foremost the responsibility of the management board. The board has overall responsibility for the institution, including approval of its strategic goals, governance framework and corporate culture, and

monitoring their implementation. The board members must at all times hold all of the necessary qualifications for their position – including those required to deal with AML issues – and must be capable of understanding their role as a body with responsibility for monitoring and leading the company, in order to reach clear and objective decisions in relation to all corporate matters. They must define appropriate governance structures and work processes, and highlight the importance of them being adhered to, as well as ensuring regular controlling.

Led and supervised by the board, the senior management leads the activities of the institution in a manner that is consistent with the company's strategy, risk propensity and remuneration scheme, as well as other internal guidelines. Individual responsibilities must be clearly assigned to individual members of the senior management.

Where there is a group structure, the parent company's management board bears overall responsibility for the group and for ensuring that a clear governance framework is in place. This must be commensurate with the structure, business and risk of the group and its branches. The senior management must know and understand the group's structure and any risks that might arise as a consequence of it.

Finally, the management board must ensure compliance with the regulatory guidelines on corporate governance.

#### **GOALS AND STRATEGIES**

The goals and strategies, commensurate with the institution's corporate culture and values, must be clearly defined, and expectations regarding employees' behaviour clearly expressed and communicated to all.

Remuneration policy should support solid corporate governance and strong risk management. Bonus and incentive schemes should be transparent and in line with the corporate culture.

The institution's governance should also be appropriately transparent to all relevant stakeholders and market participants.

#### **RISK MANAGEMENT**

An effective and independent risk management function should be set up in each company. The risk managers report to a chief risk officer (CRO), who should be fit and proper as well as independent and have the necessary resources and an active reporting line to the management board.

Risks must be identified, monitored and controlled throughout the whole institution. Risk management and infrastructure should be regularly adapted to reflect any changes in the institution's risk profile, in the external risk landscape or common practice within the industry to ensure appropriate internal controls.

For a risk governance framework to work well it needs compelling communication about risks within the institution, specifically in the form of regular and ad-hoc reporting to the management board and the senior management.

#### **COMPLIANCE**

The management board is also responsible for monitoring compliance risks. The board must set up a compliance function, and approve any guidelines and processes in place within the institution to identify, assess, monitor, report and advise on compliance risks.

**INTERNAL AUDIT**

The internal audit function must be independent and report directly to the management board. It assists the management board and senior management in promoting effective governance processes and ensuring the institution's long-term stability and creditworthiness.

**TRUST IS GOOD, CONTROL IS BETTER:  
THE “THREE LINES OF DEFENCE” MODEL**

The “three lines of defence” model has proven to be an efficient way of controlling systemic risks. The model divides various corporate control functions into three separate lines of defence with different roles and responsibilities. It may be applied irrespective of the size and structure of a company, and it improves internal communication and coordinates compliance and risk management.

- **First line of defence – operational management:** Operational managers are responsible for day-to-day operations and face most of the business and operational risks first hand. Their role is to identify, analyse, control and mitigate risks.
- **Second line of defence – risk management:** The second line of defence is often represented by functions relating to risk management, compliance and controller-ship. This line controls and monitors the implementation of risk management practices by the first line of defence to ensure that they are as effective as possible. To this end, risk management methods and procedures, guidelines and a regular and uniform reporting process to senior management are defined.
- **Third line of defence – internal audit:** Internal auditors fulfil an independent and objective controlling and advisory role. They assist and assess the first and second lines of defence, and examine internal control mechanisms as well as their effectiveness.

On top of this internal control system, there is also an external one: supervisory board, statutory auditors and government regulators. They also play an important role in monitoring the company from outside.

Exemplary governance and compliance structures are important prerequisites for establishing an appropriate risk culture within a company; a culture that, above all, also attaches the necessary importance to AML obligations. This requires, as mentioned, appropriate organisational structures, allocated responsibilities, defined and implemented processes, and regular training for employees, as well as monitoring of all processes. This is the only way to appropriately curb operational risk arising from breaches of AML provisions.

In the past few years, companies have stepped up their efforts to limit these risks, specifically by updating their equipment, expanding their resources and knowledge base, training their employees etc. All of this has primarily been done to comply with statutory requirements. However, another goal has been to avert reputational risks and financial loss.

**AUSTRIAN FINANCIAL MARKET**

Just a few years ago, many market participants in Austria regarded regulations to prevent money laundering and terrorist financing as excessive and verging on damaging to business. Since 2010 when the FMA took over responsibility for AML supervision of

the financial service providers subject to its regulation, this mentality has changed: the prevention of money laundering and terrorist financing is now no longer only viewed as a mere cost factor but also as a location factor, with a critical impact on a financial place's reputation. Financial market participants are now much more aware of the importance of the issue.

This is in no small part thanks to the open dialogue in which the FMA engages to address the risks associated with deficiencies in dealing with AML issues, as well as to the FMA's consistent supervision strategy: while the FMA is wholly committed to engaging in an open dialogue with the companies it supervises, keeping them up to date with regulatory progress in this field and discussing practical and reasonable application with the companies concerned, the Authority is also very strict in enforcing the related rules, pursuing a zero tolerance policy. There cannot and must not be any trade-offs in the fight against money laundering and terrorist financing.

This approach has been rewarded with deep respect. Both the supervised companies and top regulators have shown their appreciation for the work of the FMA: in its recent country evaluation, the FATF remarked favourably on the FMA's efforts in relation to the prevention of money laundering on the Austrian financial market.

Criminals are always on the lookout for new vulnerabilities, aiming to funnel proceeds from criminal activities into the financial system and thus launder their illicit funds. This is a challenge that must be tackled by regulators and supervisors on the one hand and by market participants on the other, which is why the tools used to combat money laundering must be continuously developed and advanced.

A particular challenge today is the booming crypto economy, ranging from Bitcoin and other crypto assets to initial coin offerings (ICOs). Crypto assets are a world in themselves, in many regards designed and built to evade official regulation.

In the digital world, the threat of funds being abused for money laundering and terrorist financing purposes is particularly high and virulent due to the ability to carry out transactions anonymously. The existing infrastructures are distributed and cross-border in design, and consequently difficult to trace and supervise. It is therefore very positive that the EU's Fifth Anti-Money Laundering Directive<sup>2</sup> now expressly also obliges providers engaged in exchange services between virtual currencies and fiat currencies as well as custodian wallet providers to comply with the provisions to prevent money laundering and terrorist financing.

However, the problem is not solved simply by including the crypto world in these provisions. Rather, compliance with due diligence obligations must also be demanded where this world interfaces with established and licensed financial market participants, i.e. wherever proceeds, income or assets from the crypto world may flow into the regulated financial market.

The FMA takes a neutral stance on technology in its regulation and supervision efforts so that innovation, if not actually promoted, will at least not be hindered. This is why regulation and supervision must be continuously developed further, a challenge to which the FMA is highly committed in order to strengthen the stability of the financial markets and increase market participants' confidence for the benefit of the Austrian financial market as a whole.

Chart 6: Suspicious transaction reports in Austria\*

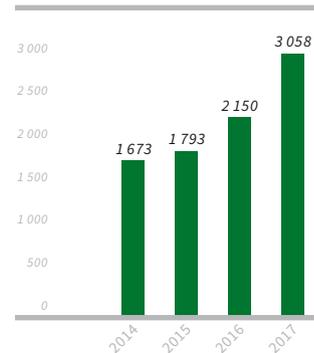
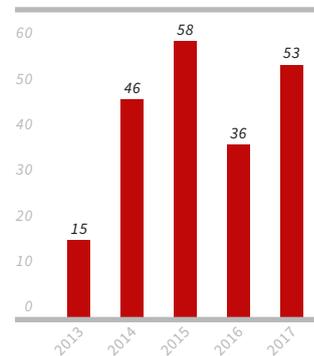
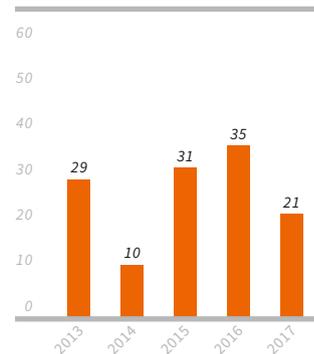


Chart 7: Money laundering convictions in Austria\*



\* Source: Money laundering report 2017, Federal Office of Criminal Investigation (BK).

Chart 8: Administrative penalties imposed by the FMA for money laundering violations



<sup>2</sup> Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU.

# MACROPRUDENTIAL SUPERVISION

Real estate lending during the good times

**Bankers jokingly referred to “subprime” loans as NINJA loans: loans extended to borrowers with “no income, no job and no assets”.**

**T**he bursting of real estate bubbles, as with other asset bubbles, is one of the most frequent triggers and causes of recession and severe financial and economic crisis. The Panic of 1873, which originated in Vienna, but also the global financial crisis triggered by the collapse of US investment bank Lehman Brothers in 2008, both had their roots in a real estate bubble, specifically in US subprime loans in the case of Lehman Brothers.

To make citizens’ dream of owning their own home come true, US administrations had relaxed what had previously been relatively strict rules on mortgage loans. This enabled US banks to offer home loans to customers with poor credit histories. These borrowers were referred to as “subprime” borrowers, i.e. borrowers with low credit ratings (“below” prime). The term is an euphemism. Even then, bankers jokingly referred to these loans as NINJA loans: loans extended to borrowers with “no income, no job and no assets”. In the 1990s the US subprime market was still only worth about 30 billion dollars but by 2005 this figure had exploded to 625 billion dollars.

Alongside this deregulation of the mortgage market, motivated by sociological and ideological considerations, a new tool in the form of securitisation also helped to create the wrong incentives. Subprime loans were packaged up, securitised, in the form of mortgage-backed securities (MBSs), and sold around the globe. This meant that banks were able to get rid of the risk from their own balance sheets, freeing up funds to grant new loans. No longer having to enter the payment default risk in their own books, the banks set their lending standards lower and lower, further intensifying the lending boom. The only collateral for these loans was the properties themselves, and the booming market allowed their prices and values to go up and up. In 2007 the real estate bubble burst, the subsequent turbulences brought down Lehman – and what happened next is painfully well known.

The recent financial crisis has reminded everyone of the importance of keeping track of macroeconomic developments, of identifying the formation of asset price bubbles – such as the real estate bubble – and of preventively addressing those risks wherever possible. The European Union has learned these lessons and established its own macroprudential supervisory regime, organising it in a decentralised and subsidiary manner.

## THE MACROPRUDENTIAL SUPERVISION SYSTEM IN AUSTRIA

In Austria, the Financial Market Stability Board was set up in 2014 to oversee national macroprudential supervision, which involves the identification and monitoring of potential risks to guarantee the stability of the Austrian financial market. The FMSB is composed of senior representatives of the Federal Ministry of Finance (BMF), the Fiscal Advisory Council, the Oesterreichische Nationalbank (OeNB) and the Financial Market Authority (FMA). The Board meets every quarter to identify, analyse and discuss potential risks for the domestic market. It can issue risk warnings and make recommendations or suggestions on how to react to certain risks in the best possible way.

The FMA is the authority responsible for macroprudential supervision. It is obliged to implement the FMSB’s risk warnings and recommendations in accordance with the principle of “comply or explain”, i.e. it must either do as recommended or explain why it chose not to (or only to a limited extent). The OeNB supports the FMA in the assessment of existing risks by preparing expert opinions and economic analyses.

At European level, the European Systemic Risk Board was set up and given responsibility for macroprudential supervision. While the ESRB is based at the European Central Bank in Frankfurt, it is an independent body. The ESRB can also issue warnings and recommendations addressed to the European Union as a whole, to individual Member States or to national and European supervisory authorities. There is no specific follow-up to ESRB warnings, recommendations must be followed through “comply or explain”.

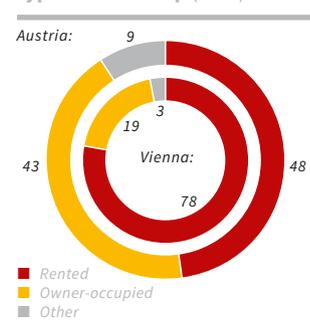
In 2016 the ESRB adopted warnings for eight<sup>1</sup> Member States, among them Austria, as it had determined vulnerabilities in the residential real estate sector caused by the continuing housing boom and price rises in those national markets.

## THE CURRENT POSITION OF THE AUSTRIAN RESIDENTIAL PROPERTY MARKET

Particularly from 2011 onwards, the increased demand in Austria for residential property, both homes and investments, has driven prices steadily upwards. This trend has been further fuelled by the persistently low interest rates in evidence since the global financial crisis began. It opened up cheap financing opportunities, with residential property promising more attractive returns while also being relatively safe compared with other investment products in this field. The last few years have clearly documented the trend: while the year-on-year increase in residential property prices averaged 3.8% in 2017, the figures were +7.3% in 2016 and +4.2% in 2015 (see Chart 10).

<sup>1</sup> Apart from Austria, warnings were also addressed to Belgium, Denmark, Finland, Luxembourg, the Netherlands, Sweden and the United Kingdom.

Chart 9: Principal residence by type of ownership (in %)



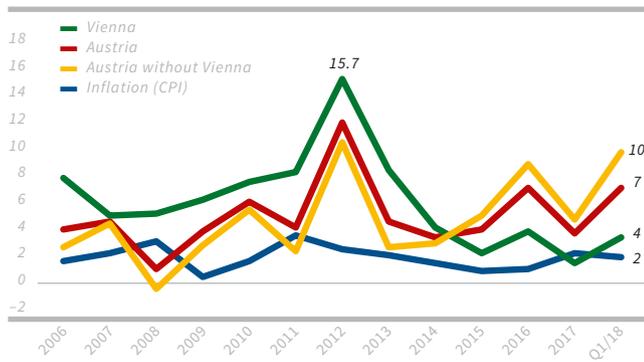


Chart 10 (left): **Real estate price growth in Austria** (in %)

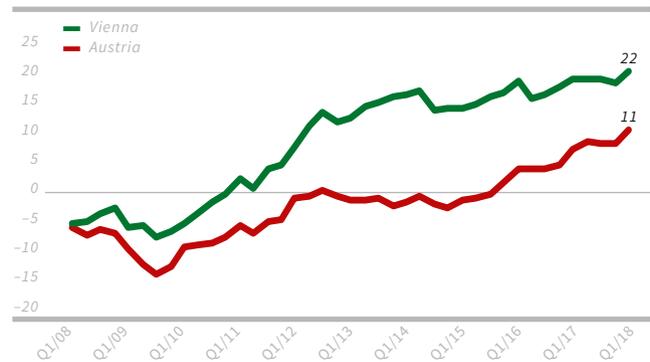


Chart 11 (right): **OeNB fundamentals indicator** (in %)

Since the outbreak of the global financial crisis, the annual increase in housing prices has always been above the inflation rate in Austria<sup>2</sup>.

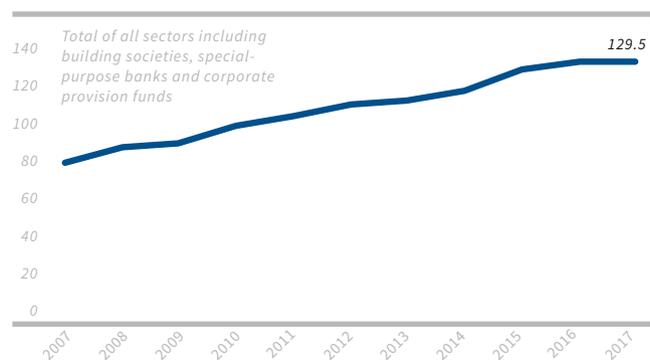
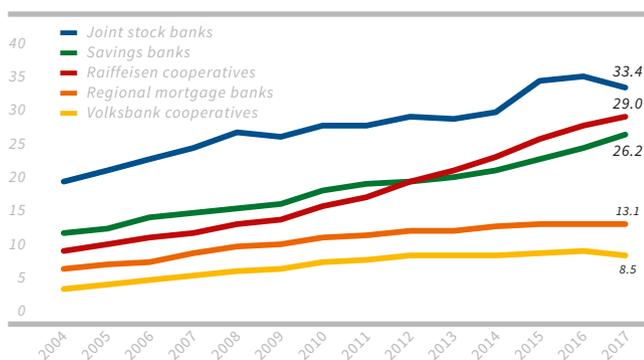
In Vienna, prices started rising shortly after the financial crisis broke out, peaking in 2012, at 15.7%. In the federal provinces, the price rises were initially more restrained, but have significantly picked up speed in recent years. Studies are pointing out that these steady price rises over many years have led to the property market being overvalued in both Vienna and the rest of Austria. According to the OeNB fundamentals indicator for residential property prices, which compares current prices in relation to a number of macroeconomic fundamental factors, real estate is overvalued by some 22% in Vienna, and by around 11% in Austria overall (see Chart 11).

In the past few years, it is not only property prices that have risen continuously, growth in real estate lending has also been more dynamic. While the total volume of housing loans granted by Austrian banks domestically had amounted to approximately € 94 billion in 2010, this figure had climbed to nearly € 124 billion by 2017, an increase of 32% (see Chart 13).

Home loans are becoming ever more important to Austrian banks' books too. The proportion of housing loans to non-banks in the aggregate total assets of Austrian credit institutions has risen constantly since the onset of the global financial crisis. Compared with an average of 8% before the financial crisis, the proportion of these loans doubled to nearly 15% in the space of ten years – partly owing to credit growth, and partly due to a fall in total assets. If the aggregate bank balance sheets are adjusted to exclude those credit institutions that do not include home financing in their balance sheets because of their business model, the share rises to as much as 20%.

Chart 12 (left): **Housing loans, by bank** (in € billions; source: OeNB)

Chart 13 (right): **Housing loans, total figures** (in € billions; source: OeNB)



<sup>2</sup> Source: OeNB Factsheet on Austria's residential property market – July 2018.

Source: OeNB. Total includes all sectors including building societies, special-purpose banks and corporate provision funds.

## REAL ESTATE FINANCING RISKS

As with any other type of financing, real estate loans will also pose a threat to financial market stability when lending standards become too lax. For example, when the assessment of whether the customer can really afford the loan, and will be able to service it, is too optimistic. Or when the likely profitability of a real estate project is assessed too optimistically at the time of the loan being granted. This can lead to a situation in which loans can no longer be serviced in economically difficult times. With consumers and households, income development is often judged too positively and the actual regular payments required are often underestimated, which also jeopardises future repayment. With real estate financing for businesses, potential returns are frequently overvalued, for example because the assumptions regarding rental income, vacancy rates or resale prices are too optimistic while fixed costs are underestimated. In addition, the assumed stress scenarios in the event of rising interest rates, which need to be considered during the lending process, can be unrealistically mild. With mortgage loans (most real estate financing is mortgage-backed), the potential risk lies in overly optimistic property valuations. Particularly in times of rising real estate prices, credit institutions are inclined to value the real estate serving as collateral too highly to ensure that the loan is sufficiently secured by the mortgaged property. Regulatory incentives are also playing a role in this regard, since banks need to appropriate less capital for loans that are fully secured by mortgages than for unsecured loans.

Lax lending standards and overly optimistic valuations taken together pose the risk of rising loan defaults in the event of an economic downturn. A decline in demand can additionally also trigger a fall in real estate prices. With properties having been valued too optimistically in the beginning, the proceeds from realising the collateral would then not turn out to be as high as expected, which in turn increases the losses. Where not enough loan loss provisions have been set aside, these losses will have a direct bearing on a bank's capital position. Another aggravating factor is the danger of contagion effects, i.e. adverse developments spilling over into related sectors, such as construction companies, building suppliers and property developers, increasing the likelihood of loan losses in these sectors too. Ultimately, if several banks are hit hard by such losses, this can shake up and threaten the stability of the financial market as a whole.

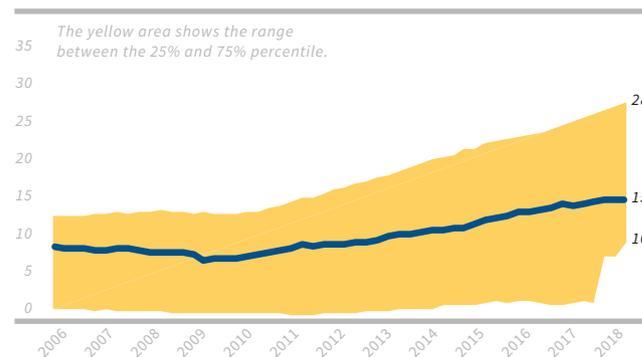
## MACROPRUDENTIAL TOOLS TO ADDRESS PROPERTY RISK

In the case of systemic risks arising from real estate financing being identified in Austria, the FMA has a variety of macroprudential tools at its disposal, which it uses in a risk-based manner. These tools are based both on regulations harmonised across the EU and on national laws. The European tools are laid down in the Capital Require-

**Real estate financing must be consistently based on sustainable lending standards to prevent systemic risks and ensure that there is no speculation in residential property financing.**

*FMSB 2016*

Chart 14: **Receivables from housing loans as a proportion of total assets** (in %; source: asset, income and risk statements, FMA calculations)



ments Regulation (CRR) with the aim of reducing systemic risk in real estate financing. Specifically, this refers to measures being taken in accordance with Article 124(2) and Article 164(5) CRR, pursuant to points (2) and (10) of Article 458 CRR, as well as the relevant national provisions contained in Articles 21b and 22a of the Austrian Banking Act (BWG; *Bankwesengesetz*).

#### **CHANGE OF RISK WEIGHTS (ARTICLE 124 AND ARTICLE 164 CRR)**

Article 124(2) of the CRR enables competent authorities to lift the risk weights for exposures secured by mortgages on residential property or on commercial immovable property for banks using the standardised approach to credit risk from 35% and 50% respectively to up to 150% where this is warranted by financial stability considerations. This increases the capital to be set aside for such exposures to cover unexpected losses.

Article 164(5) of the CRR provides for a similar regulation governing those banks that use an internal model for calculating credit risk. The competent authority may set higher loss given default (LGD) floors for exposures secured by residential or commercial immovable property if banks were too optimistic in their LGD assumptions when they calculated their own funds requirements.

For the purpose of implementing a measure under Article 124(2) or Article 164(5) CRR, the FMA is obliged to issue a regulation pursuant to Article 21b para. 1 BWG and to inform the relevant institutions within the Single Supervisory Mechanism (SSM), i.e. the common system of banking supervision in Europe, and the European Banking Authority (EBA) beforehand.

#### **NATIONAL FLEXIBILITY MEASURES (ARTICLE 458 CRR)**

In addition to Article 124(2) and Article 164(5), points (2) and (10) of Article 458 of the CRR also allow for the adjustment of the risk weights for targeting asset bubbles in the residential and commercial property sector. In contrast to the tool described above, Article 458 CRR gives the competent authorities much greater leeway in determining the way in which the risk weights are to be adapted.<sup>3</sup> To prevent the circumvention of the single rulebook (the set of common rules applicable across the entire EU), this CRR provision may only be invoked if a number of conditions and notification requirements are met and approvals granted.<sup>4</sup> Specifically, the authority must notify the European Parliament, the Council, the Commission, the ESRB and EBA of any action in advance and submit detailed reasons for intending to take it. Even if the ESRB and EBA deem the measure necessary, the Council may adopt an implementing act to reject it, acting on a proposal from the Commission. If the measure is allowed, the Member State concerned may adopt it for a period of up to two years at most.

In Austria, a measure under Article 458 CRR may only be adopted pursuant to Article 22a BWG on the basis of a recommendation by the FMSB. Here too, the FMA must issue a regulation, obtaining the consent of the Federal Minister of Finance beforehand. In addition, the FMA may also obtain an expert opinion from the OeNB before adopting the regulation.

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<sup>3</sup> For example, banks can not only be prescribed an LGD floor under the IRB Approach but also a direct minimum risk weight for real estate exposures under the IRB Approach.

<sup>4</sup> Less strict requirements apply to measures that result in an increase of the risk weights for residential or commercial immovable property of no more than 25%.

## **DEBT INSTRUMENTS (ARTICLE 22B BWG)**

Since 1 July 2018 the FMA has been able to make use of a number of national macroprudential instruments pursuant to Article 22b BWG, in addition to the CRR tools available to it, to reduce the systemic risks arising in connection with real estate financing arrangements. These instruments were newly created following proposals made by the FMSB to the Federal Ministry of Finance in 2016, which then suggested the creation of a legal basis for borrower-based macroprudential instruments. The International Monetary Fund (IMF) as well as other international institutions have also repeatedly called upon Austria to create additional national instruments, considering that such are standard in the majority of the other EU Member States, and that Austria would not have been able to react appropriately to increased risk in connection with the real estate price hike. The ESRB also issued a related warning, as referred to above, and additionally recommended closing real estate data gaps (ESRB/2016/14).

In contrast to the tools provided for in the CRR, which basically mitigate risks by prescribing higher capital requirements, the instruments laid down in Article 22b para. 2 BWG aim at enforcing sustainable lending standards.

More specifically, the FMA may stipulate the following clear criteria for real estate loans in accordance with the provisions in Article 22b BWG:

- Loan-to-value ratio: caps on the maximum amount of the loan in proportion to the value of the security (property)
- Debt-to-income ratio: caps on the amount of the loan (borrower's debt level) in relation to the borrower's income
- Debt service-to-income ratio: caps on the regular interest payments and repayments in relation to the borrower's monthly income
- Restriction of terms: requirements regarding maximum terms
- Repayment requirements: the time frame within which a certain proportion of the total loan must be repaid.

In contrast to the CRR tools, these instruments only target new loans and not existing lending. Consequently, they are primarily intended to mitigate risks during an economic upturn. In addition, to take account of the heterogeneity of real estate financing, the FMA may restrict the scope of those instruments' application in terms of their content and geographical range, and determine free and exemption quotas for new loans to which those caps then will not apply. The FMA may use these instruments individually or combine them to create a package of measures.

As with any measure taken in accordance with Article 458 CRR, an FMA regulation issued pursuant to Article 22b para. 2 BWG must also comply with a number of conditions. Similarly, the FMSB must first identify a possible risk for financial market stability or an increase in the intensity of risk caused by real estate financing arrangements. If this is the case, the FMSB will recommend that the FMA use appropriate instruments as listed in Article 22b para. 2 BWG to mitigate this risk. The FMA will first obtain an expert opinion from the OeNB on these risks and then issue a regulation defining caps, which must be approved by the Federal Minister of Finance. As in Article 458 CRR, any measure pursuant to Article 22b BWG is limited to a maximum term of three years, with the possibility of this term being extended by up to two years if the risks still apply.

## THE FMA'S INTEGRATED APPROACH TO MITIGATE SYSTEMIC RISKS USING THE EXAMPLE OF REAL ESTATE LENDING

**The systemic risks arising from residential property financing arrangements are limited at the moment, mainly because of the high risk-bearing capacity of the lenders and the comparatively low rate of household debt.**

*FMSB 2018*

In Austria, private housing is mostly financed by banks. Banks also play a central role in commercial housing and other commercial real estate, with insurers and real estate investment funds acting as additional providers of capital; they use those commercial properties as investments. The FMA therefore focuses its analysis of potential systemic risks on banks' real estate lending activities.

The Austrian supervisor takes the warnings issued by the ESRB as well as the IMF's critical statements very seriously. However, after an in-depth analysis of the developments on the Austrian real estate market and its financing arrangements, the FMA found that the potential risks for financial market stability are currently limited. This finding is based on the following reasons:

- In Austria, the continuing surge in real estate prices is not primarily credit-driven but largely the result of equity capital being invested in property.
- Despite the recent upward trend, residential property loans still account for a negligible percentage of total assets, compared with other European countries.
- The comparatively low home ownership rate (particularly in conurbations) and the highly developed market of rented and cooperative housing also help to mitigate the risk, since Austrian households do not necessarily have to borrow money in order to have their own home.
- Where lending standards are concerned, there is no general relaxation in evidence. Those credit institutions that have shown a greater risk appetite in the recent past are contacted by the FMA individually and reminded of the importance of following a more risk-based lending approach. The FMA has also clearly communicated its interpretation of sustainable lending.

At its meeting on 21 September 2018, the FMSB also stressed that it considered the systemic risks arising from residential property financing arrangements to be limited, mainly because of the high risk-bearing capacity of the lenders and the comparatively low rate of household debt. Nevertheless, the FMSB provided explicit details of its understanding of sustainable real estate lending:

- Borrowers must have a minimum amount of own funds, with less than 20% being viewed as critical.
- The maturity of the loan must not be disproportionately extended, and must take account of the borrower's income development over the entire life of the loan. Specifically, loans with maturities of more than 35 years may only be granted in exceptional cases.
- Borrowers' debt repayments must not exceed 30 to 40% of their net income, and household income and expenses must be calculated conservatively during the lending process. Only income that is verified, regular and sustainable is eligible for consideration.

Due to competitive pressure, persistently low interest rates and the high demand for loans owing to the current economic situation, this issue continues to demand close attention from the supervisory authority. The FMA therefore keeps a very close watch on the developments in the Austrian market. In its capacity as an integrated supervisory authority, it has the added benefit of having an insight into the entire financial market, and of being able to analyse financing flows in the real estate

sector and to identify any herd behaviour and correlations across the different financial sectors.

Both the FMA and FMSB have made it abundantly clear that they would react immediately were risks relating to real estate financing to intensify. In the event of individual institutions being affected, the FMA would approach them at the level of microprudential supervision. Were systemic risks to arise and threaten financial market stability, the Authority would cooperate with the FMSB and use the macroprudential instruments to address them.

# MARKET TRANSPARENCY IN THE FUND INDUSTRY

Fair conditions for markets and investors

**I**nvestment funds are a popular form of investment with retail investors. The ability to invest in several different assets at the same time means that the investment risk can be spread and the risk-reward profile controlled according to the type of fund chosen. Funds can be selected according to the investor's individual risk appetite and investment aim, and offer the prospect of higher reward than classic standardised financial products such as savings passbooks. Investment funds represent investments of customer assets and often retail investors' assets, either directly or indirectly (e.g. as an investment instrument used by corporate provision funds, *Pensionskassen* or insurers). The legislator has therefore imposed strict requirements relating to investor and consumer protection. The management, custody and distribution of funds are strictly regulated, but there are also extensive transparency requirements, allowing investors to inform themselves comprehensively, clearly and fairly and to reach an informed investment decision. In Austria, the Financial Market Authority (FMA) is responsible for monitoring compliance with the statutory provisions. In its supervision activities in relation to retail funds<sup>1</sup>, the Authority aims at ensuring fair and transparent conditions on the markets, thus granting all investors access to the same material information.

## **TRANSPARENCY: FAIR AND CLEAR INFORMATION AS THE BASIS FOR APPROPRIATE INVESTMENT DECISIONS**

From the perspective of investors, transparency rules are of particular significance.

<sup>1</sup> The following legal fund categories are subsumed under retail funds eligible for sale to the general public: UCITS pursuant to the InvFG 2011, pension investment funds pursuant to Article 48 AIFMG and Article 168 InvFG 2011, other special assets (where approved for retail investors) pursuant to Article 48 AIFMG and Article 166 InvFG 2011, as well as real-estate retail funds pursuant to Article 48 AIFMG and the ImmoInvFG.

Only properly informed investors will be in a position to reach an informed investment decision that reflects their risk and reward preferences.

All relevant transparency rules in the material supervisory laws must follow one overriding principle: all information addressed to clients must be fair, clear and non-misleading.<sup>2</sup>

Retail funds must provide a variety of statutory transparency instruments: fund prospectus, fund rules, reports on activities and half-yearly reports, and of particular relevance to retail investors: the key investor information document (KIID)<sup>3</sup>.

The KIID is a legally defined document that must include the following information in clear, standardised and comparable form on no more than two pages, or three in exceptional cases:

- Objectives and investment policy
- Risk and reward profile
- Presentation of charges
- Past performance

The document must be provided to investors before they make an investment decision.

#### **TRANSPARENT INVESTMENT STRATEGY**

The investment strategy comprises a written set of rules including those relating to conduct of business, and procedures according to which asset managers select investment products for a portfolio. This strategy must be clearly defined, adhered to, and disclosed and explained to investors.

Funds can be categorised differently depending on the investment strategy chosen: for example, according to the invested assets (e.g. equity, bond or mixed funds) or according to the strategy approach (actively or passively managed funds in particular).

With actively managed funds, asset managers pursue an investment strategy where they themselves decide on asset selection and portfolio composition. They make their own investment decisions thereby actively adapting their selection of assets and the composition of the fund portfolio depending on the prevalent market situation and specific investment strategy.

With passively managed funds, the investment strategy is designed to mirror the composition of an index as closely as possible with an investment portfolio. In this case, asset managers do not decide themselves in which financial instruments to invest. For index funds pursuant to the Investment Fund Act 2011 (InvFG 2011; *Investmentfondsgesetz*)<sup>4</sup>, the investment strategy is even defined by law: it is only allowed to replicate a stock or debt securities index recognised by the FMA by investing in that index's underlying assets or derivatives.

The defined investment strategy must be disclosed to the investors. Accordingly, the principles according to which the securities, money market instruments and liquid financial assets have been selected must be described in the fund rules<sup>5</sup>. The KIID<sup>6</sup>

**Retail funds must provide a variety of statutory transparency instruments: fund prospectus, fund rules, reports on activities and half-yearly reports, and the key investor information document (KIID) which is particularly relevant for retail investors.**

<sup>2</sup> Cf. Article 49 WAG 2018, Article 252 para. 8 VAG 2016, Article 128 para. 2 and Article 134 para. 2 InvFG 2011.

<sup>3</sup> The KIID is legally defined in Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, in Commission Regulation (EU) No 583/2010 (KIID Regulation) as well as in the Austrian Investment Fund Act (InvFG).

<sup>4</sup> Article 75 InvFG 2011.

<sup>5</sup> Article 53 para. 3 no. 2 InvFG 2011.

<sup>6</sup> Article 7(1) of Commission Regulation (EU) No 583/2010.

**An investment strategy comprises a written set of rules including those relating to conduct of business, and procedures according to which fund managers select investment products for a portfolio. This strategy must be clearly defined, adhered to, and disclosed and explained to investors.**

must also cover the essential features of the fund, as well as the objectives and investment policy.

Indices are also used to measure or compare the past performance of an investment fund, to calculate possible performance fees and to determine the composition of the portfolio. These are referred to as benchmarks and play an important role in investment strategies, be they passive or active.

In the case of transferable securities or other investment products (including funds) that reference a benchmark and for which a prospectus was published in accordance with the Prospectus Directive<sup>7</sup> or the UCITS Directive<sup>8</sup>, the prospectus<sup>9</sup> must include, pursuant to the Benchmarks Regulation<sup>10</sup>, clear and prominent information stating whether the benchmark is provided by an administrator included in ESMA's<sup>11</sup> Benchmarks Register. The KIID must also include information on whether the fund's investment strategy includes or implies a reference to a benchmark. If this is the case, the performance of that benchmark<sup>12</sup> should be included in the chart showing the fund's past performance.

If asset managers purport to implement an active investment strategy involving higher costs but actually manage the assets in a passive manner, they are misleading investors. This practice is referred to as "closet indexing".

In 2016, ESMA conducted a study and found that there was the potential for some European collective investment funds to be "closet index trackers". In a statement it admonished asset managers, calling on them to provide information about their investment strategy that is fair, clear and not misleading, and informed stakeholders and investors accordingly. ESMA also found it necessary to provide further guidance for asset managers and recommended to investors that they should make use of all the documentation available to them when selecting a product.<sup>13</sup>

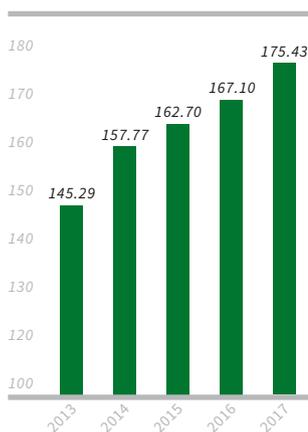
Regardless of the type of fund chosen or the investment strategy, investors must be aware that, as a general rule, the higher the income opportunities, the higher the risk. And funds are no different.

### TRANSPARENT RISKS AND REWARDS

The risk and reward profile of a fund varies depending on investment strategy. This profile is to be included in the KIID, including a presentation of past performance, an explanation of potential risks and information about the fund's risk category.

The information about the past performance of a retail fund must be presented in a bar chart covering the annual performance of the fund for the last ten years, where possible. The calculation of past performance figures must be based on the net asset value (NAV) of the fund, assuming that they are calculated on the basis that any dis-

Chart 15: Fund assets of investment funds 2013–2017 (in € billions)



<sup>7</sup> Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

<sup>8</sup> Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

<sup>9</sup> Article 29(2) of the Benchmarks Regulation.

<sup>10</sup> Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.

<sup>11</sup> European Securities and Markets Authority.

<sup>12</sup> Article 7(1)(d) in conjunction with Article 18(1) of Commission Regulation (EU) No 583/2010.

<sup>13</sup> See ESMA Statement – Supervisory work on potential closet index tracking (ESMA/2016/165) of 2 February 2016. [www.esma.europa.eu/sites/default/files/library/2016-165\\_public\\_statement\\_-\\_supervisory\\_work\\_on\\_potential\\_closet\\_index\\_tracking.pdf](http://www.esma.europa.eu/sites/default/files/library/2016-165_public_statement_-_supervisory_work_on_potential_closet_index_tracking.pdf)

tributable income of the fund has been reinvested (accumulating funds). In Austria, Oesterreichische Kontrollbank AG (OeKB) calculates the performance of Austrian funds on a uniform basis, using the NAV provided by the investment fund management companies for each fund.<sup>14</sup> In addition, changes in the NAV are to be published in the fund's annual reports on activities; both the report on activities and the half-yearly report must also include detailed statements of net assets.

In addition to past performance, the fund's risk profile must also be described in the KIID. This includes an explanation of the potential risks and information about the fund's risk class in the form of the synthetic risk and reward indicator (SRRI). The SRRI is based on the historical volatility of the fund and ranks it over a scale from 1 to 7: the higher the indicator, the higher the risk. The indicator enables investors to assess a fund's risk in an easy-to-understand manner before deciding whether or not to invest in it.

### TRANSPARENT ONGOING CHARGES AND FEES

Different investment strategies usually entail different costs. The typical fees charged to investors normally depend on the investment approach chosen.

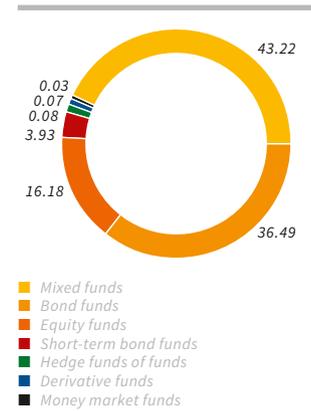
Any remuneration and reimbursement of costs for the management company, which is paid out of fund assets, as well as the way both are computed must be regulated and described in the fund rules. The charges for a fund must also be included in the KIID. The most important charges are the one-off entry charge, the exit charge, the ongoing charges for fund management to be paid per year, as well as any performance fees. It should be noted that the various share classes of a fund (categories of unit certificates) may vary in terms of use of income, currency of the unit and fund fees.

The maximum entry charge is the maximum percentage of the fee that must be paid upon the acquisition of fund units. In contrast to the management fee, this is a one-off charge, which is usually forwarded to sales as a finder's fee and varies depending on the share class of the fund. The maximum exit charge is the maximum percentage of the one-off fee to be paid when the fund units are returned. Unlike the entry charge, the exit charge is not usually applied by Austrian retail funds. The maximum entry and exit charges must be disclosed both in the fund rules and in the KIID.

The management fee must be stated in the form of an annual maximum fee as a percentage of the fund assets, and laid down in the fund rules. As a general rule, this fee covers most but not all expenses, with deposit fees, transaction costs and any performance-based management fees also being added.

The ongoing charges listed in the KIID must represent the actual annual charges as a percentage of the fund assets; they might therefore vary from year to year. These charges comprise all kinds of costs to be borne by the fund, irrespective of whether they constitute management fees or remuneration for individuals having rendered services for the fund. At any rate, ongoing charges cover management fees, deposit fees, investment advisors' fees, any payments incurred for outsourcing, application, supervision or similar fees, remuneration for the statutory auditor, remuneration for legal and business consultants, as well as other distribution fees. Costs that need not be counted towards ongoing charges include, for example, entry and exit charges, finder's fees, transaction costs, and performance-based management fees.

Chart 16: Net assets by fund category (as at 31 Dec 2017, in %)



<sup>14</sup> Details on the performance calculation of funds can be found in OeKB's Calculation of the key data of investment funds, applicable since 1 January 2007 (publication in German): [www.oekb.at/dam/jcr:0a44f765-cf16-42a7-b601-43ce13afaab6/OeKB-Kennzahlenberechnung-Investmentfonds-2007-01.pdf](http://www.oekb.at/dam/jcr:0a44f765-cf16-42a7-b601-43ce13afaab6/OeKB-Kennzahlenberechnung-Investmentfonds-2007-01.pdf).

Performance-based management fees depend on the fund's performance and are therefore only charged under certain circumstances. The exact calculation procedure for these fees may vary greatly from fund to fund, depending on the investment strategy pursued. They might be linked to the performance of the fund itself, or defined relative to an index in the form of a benchmark.<sup>15</sup> Fees that are linked to the fund's performance must be included in the fund rules and in the KIID.

#### THE FMA'S CONTRIBUTION TO INCREASED TRANSPARENCY

Orderly and fair markets are based on appropriately transparent products, risks and opportunities, charges and fees. To ensure collective consumer protection, one of the FMA's main tasks therefore is to improve and increase transparency on the markets. To be able to fulfil this task, the legislator has awarded the Authority important new regulatory tools within the past few years, such as a set of new rules governing the markets in financial instruments, revised European directives and regulations relating to investment funds, as well as standardised information documents for consumers which must be designed in a clear and simple manner and written in easy-to-understand language.

The primary objective the FMA pursues in collective consumer protection is to ensure that consumers and investors are informed in a fair, clear and non-misleading manner. This is the only way to ensure that they can reach an informed decision on which product or financial service is best suited to their financial needs and risk appetite.

In this article we have described the transparency rules using the example of investment funds, particularly those sold to retail investors. This is a remarkable market, with some 1 130 Austrian retail funds managing approximately € 96 billion as at the end of 2017, or about 52% of the entire investment fund volume in Austria.

However, the FMA does more than watch over asset managers, ensuring that they provide clear and non-misleading information about the fund's investment strategies, income opportunities, risks and charges to enable informed investment decisions. The Authority also monitors that asset managers are actually sticking to the investment strategy communicated to investors when managing the fund, and adhering to all regulatory requirements relating to company organisation, risk management, governance and compliance.

Specifically, the FMA is entrusted with the task of ensuring during the approval process of the fund rules that the investment strategy complies with the provisions laid down in the InvFG, as well as being transparent and comprehensible. The fund name must also not be misleading. Compliance with the transparency rules and the defined investment strategy is also reviewed during random on-site inspections and off-site analyses.

In an annual study<sup>16</sup>, the FMA also collates, compares and publishes the fees charged in the Austrian market for retail funds and thus helps to improve market transparency. Investors can then compare the amounts of the fees charged for their fund with those in the market as a whole, with funds of the same category and with alternative invest-

**The FMA's annual market study on the fees typically charged by Austrian investment funds contributes significantly to transparency in the fund market. It makes it easy for investors to compare their fund's fees with the market average.**

<sup>15</sup> One example of an absolute performance-based management fee would be a defined percentage of unit value growth relative to the last value of the unit used to determine performance-based fees. An example of a relative performance-based management fee would be a defined percentage of unit value growth relative to the growth of a defined benchmark using high-water marks. A high-water mark ensures that a performance-based fee is only paid when the previous peaks are matched and the performance of the fund then continues to rise.

<sup>16</sup> See: [www.fma.gv.at/en/fma-thematic-focuses/fma-focus-on-fees-charged-by-funds/](http://www.fma.gv.at/en/fma-thematic-focuses/fma-focus-on-fees-charged-by-funds/).

ment strategies. This increases the transparency for investors and makes the fund market more efficient.

It is one of the FMA's core tasks to protect investors, savers and other users of financial services in accordance with the law. To fulfil this legal remit in terms of collective consumer protection, the FMA concentrates its efforts on the provision of fair, comprehensible and comparable information. Promoting, improving and strengthening market transparency in the investment fund sector are vital components of these efforts.

# INDUCEMENTS

## MiFID II in the battle against conflicts of interest

**Varying rates of commissions among products can act as an incentive to offer the client a product carrying a higher commission, even though another product would better fit the client's needs.**

**F**inancial products have several special features that distinguish them from other economic assets: the positive outcome of the investment is often seen only months or years later, while such products are frequently complex and not easily understood by people inexperienced with financial products on a daily basis. What is more, investments in the capital market entail by nature risks that are hard to assess.

One highly significant factor that makes selling financial instruments a special matter is the situation existing in German-speaking countries, where in the majority of cases the person selling the financial instrument is not paid directly by the retail client for brokering the transaction but instead receives remuneration in almost every case based on commissions paid by the product provider.

This can lead to conflicts of interest: while the client should be recommended the financial instrument best meeting their financial needs, varying rates of commissions among products can nonetheless act as an incentive to offer the client a product carrying a higher commission, even though another product would better fit the client's needs.

### MIFID I – THE FORMER REGIME

Recognising this inherent conflict of interests, European lawmakers tackled the issue early on, with the Investment Services Directive (ISD)<sup>1</sup> in 1993 and with the Markets in Financial Instruments Directive (MiFID I)<sup>2</sup> in 2004.

*With the kind consent of Bank-Praktiker and Finanz Colloquium Heidelberg, [www.FC-Heidelberg.de](http://www.FC-Heidelberg.de). FMA expert Roland Dämon additionally published this article in the November issue of CompRechts-Praktiker.*

<sup>1</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.

<sup>2</sup> Directive 2004/39/EEC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

To deal with conflicts of interests, MiFID I provided for a three-stage process:

- First, the company is to be evaluated to identify the areas of activity or business relationships where a conflict of interest might arise.
- Second, appropriate measures are to be taken to tackle the conflicts of interest identified, with the goal of preventing conflicts of interest from having any detrimental impact on clients' interests. Such measures can vary depending on the conflict of interest:
  - Blocking information (putting Chinese walls in place)
  - Harmonising remuneration policies
  - Special training measures
  - Separation of activities prone to conflicts of interest
  - Other targeted control measures.
- Third, where the organisational steps taken are still inadequate, conflicts of interest are to be disclosed in order to avoid any risk of compromising clients' interests.

Commissions paid by product providers in the context of securities distribution (kick-backs) are a classic example of a conflict of interest. Even back when introducing MiFID I, European lawmakers considered this subject to be so fundamental and significant that they put issues related to third-party payments under a special rule<sup>3</sup>, separate from the general rules governing conflicts of interest.

This provision prohibited the payment or receipt of any fees or commissions in the context of providing investment services. The only exceptions were direct payments by clients as well as payments:

- disclosed prior to providing the investment service,
- designed to enhance the quality of the service provided to the client, and
- designed not to impair compliance with the investment firm's duty to act in the best interests of the client.

This provision allowed summary disclosures under the condition that details were provided at the client's request. MiFID I included no other related provisions.

As a result of the rule described above, the information packages handed out in practice to clients often contained generic wording referring to inducements, such as the following: "For our activities we receive payments of 0 to 10 per cent of the invested amount from third parties. These are used to enhance the quality of our investment services. Details are available on request."

Clients gained only limited added value from such information. An individual client

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<sup>3</sup> Article 26 of the MiFID Implementing Directive.

## INDUCEMENTS

The term refers to commissions, benefits, fees and other payments as well as financial benefits which are paid by a third party to an investment service provider or by an investment service provider to a third party. This includes in particular any sales commissions or trailer fees in the context of securities transactions. Such payments are permitted only under very tight conditions: they must not oppose the client's interests and must be designed so as to enhance service quality, while the investor must be provided in advance with comprehensive, understandable and clear disclosure of how such benefits are granted and of their nature and scope.

could only obtain information on the system of payments by third parties through enquiring directly in relation to a specific client transaction.

The provisions on inducements were evaluated in detail as part of the MiFID review. While the provisions of MiFID II were the subject of negotiations<sup>4</sup>, the legislative process took in new aspects not yet anticipated when MiFID I was being prepared.

One factor was the financial crisis in 2008, which resulted in stronger investor protection in many areas of capital market legislation. While visible in many provisions of MiFID II, this also comes to light in the Insurance Distribution Directive (IDD)<sup>5</sup> and in “new” regulatory initiatives such as the PRIIPs Regulation<sup>6</sup> for packaged investment products.

In addition, significant differences of opinion had in the meantime arisen among the EU Member States as to whether it is at all to be considered legitimate to pay commissions in the context of providing investment services. Governments in several countries such as the Netherlands and the United Kingdom had imposed a general ban on accepting third-party payments. But markets also existed where the distribution of financial instruments, at least to retail customers, was largely based on commissions, Germany and Austria being examples here.

## MIFID II – THE NEW REGIME

As a result, the MiFID II provisions on inducements were among the aspects of the regime causing the most controversy during the negotiations leading to the Directive. This can already be seen from the fact that the majority of provisions for implement-

<sup>4</sup> From 2010 to 2014 in the case of level 1 and then until 2016 in the case of level 2.

<sup>5</sup> Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

<sup>6</sup> Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

## REGULATORY HIERARCHY WITHIN THE MIFID II REGIME

### LEVEL 1

- MiFIR: Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
- MiFIR: Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

### LEVEL 2

- Commission Delegated Regulation (EU) 2017/565
- Commission Delegated Directive (EU) 2017/593

### LEVEL 3

- Guidelines and recommendations by the European Securities and Markets Authority (ESMA):
  - Interpretations and specific explanations of level 1 and level 2 legal acts to ensure consistent interpretation
- ESMA Q&As (questions and answers):
  - Continuously updated interpretations relating to details

ing those MiFID II obligations that relate to organisation and good conduct were packed into Commission Delegated Directive (EU) 2017/565, which, harmonised to the maximum degree, is directly applicable European legislation. Only a few highly controversial aspects – in particular product governance and inducements – were placed in Commission Delegated Directive (EU) 2017/593, since this legislation is to be implemented in national law for application. This allowed special aspects at national level to be taken into consideration on implementation.

Just how controversial the subject of inducements was is also seen in the fact that in this case European lawmakers diverged from the principle of maximum harmonisation, allowing the Member States to retain other (stricter) rules while complying with defined criteria.<sup>7</sup>

### “INDEPENDENT ADVICE” AND “NON-INDEPENDENT ADVICE”

Policymakers could lastly only reach a compromise by introducing two different business models for advising clients in MiFID II: “independent advice” and “non-independent advice”.

- Firms providing “independent advice” are required to offer a correspondingly broad selection of products and are no longer permitted to accept and retain any benefits (except for minor non-monetary benefits).
- Investment firms providing “non-independent advice” are still allowed to accept benefits as long as they meet the requirements under law.

Experience gathered in practice in Austria and Germany reveals independent advice to be rather the exception. Advice is provided on this basis mostly to wealthy private clients or in the context of advice-only consulting, where the advisor does not subsequently pass on any orders. Independent investment advice is also provided in specialised niche markets.

In German-speaking countries, by far the majority of business involving advice to retail clients is conducted in the context of “non-independent advice”. The provisions on non-independent advice<sup>8</sup> are similar to the inducement provisions familiar from MiFID I.

Accepting (monetary or non-monetary) inducements in the context of providing investment services is generally not permitted, unless the commission or benefit:

- is designed to enhance the quality of the relevant service to the client and
- does not impair compliance with the investment firm’s duty to act in accordance with the best interest of its clients.

The existence, nature and amount of the fee or commission, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Where applicable, the investment firm is also to inform the client on mechanisms for transferring to the client the fee, commission, monetary or non-monetary benefit received in relation to the provision of the investment or ancillary service.

The most significant change in MiFID II (level 1) compared with the provisions of MiFID I is that, when informing customers about inducements, investment firms are no longer allowed to summarise information in generic wording.

**In German-speaking countries, by far the majority of business involving advice to retail clients is conducted in the context of “non-independent advice”.**

<sup>7</sup> Article 24(12) of MiFID II.

<sup>8</sup> Under level 1, these provisions are found in Article 24(9) of MiFID II.

MiFID II (level 1) also authorises level 2 measures, which potentially allows provisions on inducements to be defined in detail. The Implementing Directive mentioned above, which was issued on this basis, contains the following provisions:

- It is assumed that any fee, commission or non-monetary benefit is for the purpose of enhancing the quality of the service provided to the client if all of the following conditions are met:
  1. The benefits are justified by providing an additional or higher level service to the relevant client that is proportional to the inducements received. Examples:
    - the provision of non-independent investment advice on and access to a wide range of suitable financial instruments including an appropriate number of instruments from third-party product providers having no close links with the investment firm;
    - the provision of non-independent investment advice combined with either an offer to the client, at least on an annual basis, to assess the continuing suitability of the financial instruments in which the client has invested or with another ongoing service that is likely to be of value to the client such as advice about the suggested optimal asset allocation of the client;
    - the provision of access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the client, including an appropriate number of instruments from third-party product providers having no close links with the investment firm, together with either the provision of added-value tools, such as objective information tools helping the relevant client to take investment decisions or enabling the relevant client to monitor, model and adjust the range of financial instruments in which they have invested, or providing periodic reports of the performance and costs and charges associated with the financial instruments.
  2. The benefits do not directly profit the recipient firm, its shareholders or employees without tangible benefit to the relevant client.
  3. The benefits are justified by the provision of an ongoing benefit to the relevant client in relation to an ongoing inducement.
- A fee, commission, or non-monetary benefit is not considered acceptable if the provision of relevant services to the client is biased or distorted as a result of the fee, commission or non-monetary benefit.
- Investment firms are required to fulfil these requirements on an ongoing basis as long as they continue to pay or receive the fee, commission or non-monetary benefit.
- Investment firms additionally have the duty to hold evidence that any fees, commissions or non-monetary benefits paid or received by the firm are designed to enhance the quality of the relevant service to the client:
  - by keeping an internal list of all fees, commissions and non-monetary benefits received by the investment firm from a third party in relation to the provision of investment or ancillary services; and
  - by recording how the fees, commissions and non-monetary benefits paid or received by the investment firm, or that it intends to use, enhance the quality of the services provided to the relevant clients and the steps taken in order not to impair the firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client.

- In relation to any payment or benefit received from or paid to third parties, investment firms are required to disclose to the client the following information:
  1. Information on the payment or benefit concerned prior to the provision of the relevant investment or ancillary service<sup>9</sup>. Minor non-monetary benefits may be described in a generic way. Other non-monetary benefits received or paid by the investment firm in connection with the investment service provided to a client are to be priced and disclosed separately.
  2. Where an investment firm was unable to ascertain on an ex-ante basis the amount of any payment or benefit to be received or paid, and instead disclosed to the client the method of calculating that amount, the firm is to also provide its clients with information of the exact amount of the payment or benefit received or paid on an ex-post basis.
  3. At least once a year, as long as (ongoing) inducements are received by the investment firm in relation to the investment services provided to the relevant clients, the investment firm is required to inform its clients on an individual basis about the actual amount of payments or benefits received or paid. Minor non-monetary benefits may be described in a generic way.

Accepting and retaining benefits has been completely prohibited within the framework of independent investment advice or portfolio management. Minor non-monetary benefits are the only exception to this rule.

By way of summary, compared with the previously applicable legal arrangements under MiFID I, MiFID II has resulted in the following main changes in inducement rules for non-independent advice:

- A list of circumstances potentially enhancing service quality was expressly included in the legislation.
- Express mention is now required that the benefits may not directly profit the recipient firm, its shareholders or employees without tangible benefit to the relevant client.
- Any ongoing inducement presupposes the creation of an ongoing benefit.
- The circumstances that shape the benefits so as to enhance the quality of the investment service have to be recorded in detail.
- Specific requirements for (regular) disclosure to the client.

## WHAT CIRCUMSTANCES ENHANCE QUALITY?

Unlike MiFID I, MiFID II lists (by way of illustration) circumstances to be considered as enhancing quality, provided they are proportional to the scope of inducements received. Items included are (in summary form):

- Access to a wide range of suitable financial instruments while requiring an appropriate number of instruments from third-party product providers.
- An offer to the client, at least on an annual basis, to assess the continuing suitability of the financial instruments in which the client has invested.
- Another ongoing service that is likely to be of value to the client such as advice about the suggested optimal asset allocation of the client.
- The provision of access, at a competitive price, to a wide range of appropriate

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<sup>9</sup> In accordance with the second subparagraph of Article 24(9) of Directive 2014/65/EU.

financial instruments (including such from third parties) together with added-value services such as special information.

While the circumstances enhancing quality are listed only by way of illustration, the relevant Directive also allows flexible implementation at national level. Some of the Member States have therefore included additional criteria in national provisions of law. One example here is similar provisions in German<sup>10</sup> and Austrian<sup>11</sup> law that refer to an additional quality enhancement in the case where access to advisory services is made possible through local professional advisors, in particular in rural areas.

The list of circumstances enhancing quality is not exhaustive, neither in EU legislation nor as implemented in German and Austrian law. Considering this fact, the length of the list and the various elements referring to circumstances that are contained in the list are therefore not decisive. What is decisive, though, is whether the corresponding measure taken by a firm does in fact result in enhanced quality for the customer that is proportional to the inducement the firm receives.

Therefore, when taking action to enhance quality, firms must consider two questions. First, does the measure involve more than the statutory obligations already existing? Second, will the average customer also perceive the measure as a benefit of appropriate magnitude (in comparison with the payment collected for it)?

MiFID II contains a large set of highly detailed and comprehensive obligations which firms are required to comply with in their dealings with clients. These especially include rules of conduct and information requirements. Obviously, any service a firm is obliged to provide based on a provision of law cannot mean an additional enhancement of quality for a client.

The question of client benefit is more intriguing. Not every circumstance that a firm offers a client will be subjectively perceived by that client as enhancing quality. The point here is that the average client ought to perceive the circumstance as valuable or helpful, in other words as enhancing quality; yet, whether every client shares this view is not a decisive consideration. This question has to be answered in the affirmative after considering the average case in abstract terms. This circumstance will need to be judged by supervisory authorities – and, if necessary in the event of action for damages, by civil courts.

The fact that a firm supplies a client with additional marketing leaflets is not likely to be viewed as a circumstance enhancing quality.

The situation is different, though, if the advisor keeps an eye on the client's portfolio by carrying out regular suitability assessments. This results in concrete material value for the client, a result for which the firm ultimately bears liability. An extensive network of branch offices, in contrast, will only be perceived by the client as a benefit enhancing quality if the client does indeed receive professional investment advice at those branches. Branches not offering high-quality advice on securities cannot, in this context, be considered as enhancing quality. The situation is again different if an investment service provider provides advice on the client's own premises.

Accordingly, there are no limits to the imagination shown by firms when it comes to creating benefits for clients.

**Not every circumstance that a firm offers a client will be subjectively perceived by that client as enhancing quality. The point here is that the average client ought to perceive the circumstance as valuable or helpful, in other words as enhancing quality; yet, whether every client shares this view is not a decisive consideration.**

<sup>10</sup> Article 6 para. 2 of the German Regulation specifying the concrete code of conduct and organisational requirements for investment service providers (WpDVerVO; Verordnung zur Konkretisierung der Verhaltensregeln und Organisationsanforderungen für Wertpapierdienstleistungsunternehmen).

<sup>11</sup> Article 52 para. 1 of the Austrian Securities Supervision Act 2018 (WAG 2018; Wertpapieraufsichtsgesetz).

## HOW MUCH DOES A FIRM HAVE TO SPEND TO ENHANCE QUALITY?

According to a provision (level 2)<sup>12</sup> contained in MiFID II, the quality of the particular service to the client cannot be assumed to be enhanced if the benefits directly profit the recipient firm, its shareholders or employees without tangible benefit to the relevant client. The same Delegated Directive contains another provision<sup>13</sup> requiring the legal entity to provide evidence that any benefit received by the firm enhances the quality of the relevant service to the client.

Interpreting these provisions poses difficulties, since the wordings do not unequivocally state how much of the received benefits have to be effectively spent on enhancing quality.

It needs to be asked whether the amounts received are to be compared with the amounts spent on enhancing benefits or with the quality enhancements generated. In this context, the German Federal Financial Supervisory Authority (BaFin) requires an “inventory of benefits” and an “inventory of use”, showing how the benefits received enhance the quality of the services provided; these inventories are specified in the BaFin Circular entitled Minimum Requirements for the Compliance Function and Additional Requirements Governing Rules of Conduct, Organisation and Transparency (MaComp).<sup>15</sup>

The term “inventory of use” suggests that each and every payment has to be “used” to create benefits to the client, in other words, has to be spent. This view is not substantiated, however, by the recitals of the specific Delegated Directive<sup>16</sup>, where it is stated that the value of the quality enhancements that the investment firm provides to the clients has to be proportional to the inducements received by the investment firm. This does not permit one to conclude that the entire amount has to be fully and exclusively spent on enhancing quality.

It also needs to be considered here that in the German and Austrian markets a large number of freelance investment advisors operates mostly on the basis of receiving third-party payments. Requiring these firms to use all of the inducements they receive to enhance quality would make it impossible for them, using their business revenues, to cover their overhead expenses as well as the expense of fulfilling statutory requirements. This interpretation would have the effect of once again abolishing, indirectly, the possibility of accepting inducements from third parties on a legal basis.

Yet, among credit institutions in Germany and Austria as well, non-independent provision of advice is by far the more common business model. Unlike freelance investment advisors, credit institutions are also able to generate revenues from other banking activities. A strict interpretation would require such institutions to cross-finance the costs of fulfilling the statutory minimum requirements under MiFID II using income from other business activities – which would make non-independent advice pointless as a business model – or force them to switch to the business model of providing advice on an independent basis.

Insisting on the interpretation requiring every single euro of benefits received to be spent on enhancing quality for the client would defeat the purpose pursued by legis-

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<sup>12</sup> Article 11(2)(b) of Commission Delegated Directive (EU) 2017/593.

<sup>13</sup> Article 11(4) of Commission Delegated Directive (EU) 2017/593.

<sup>14</sup> BaFin Circular 05/2018 – Mindestanforderungen an die Compliance-Funktion und weitere Verhaltens-, Organisations- und Transparenzpflichten (in German), under BT 10 (recording obligations).

<sup>15</sup> In particular, recital 22 of Commission Delegated Directive (EU) 2017/593 opposes this view.

lation in defining separate advice models. In practice, this would be tantamount to abolishing all legal third-party payments – in effect, although not actually legislated. It is in fact not necessary, nor would it suffice, to demonstrate that all third-party payments received have been effectively spent on quality enhancements. The point is not how much quality enhancement costs but how it ultimately benefits the client.

A firm that spends all payments it receives on enhancing quality but does not manage to achieve any worthwhile quality enhancement on behalf of clients does not fulfil the statutory requirements. In contrast, a firm that succeeds in enhancing quality for the client to a proportional and adequate extent using a portion of the inducements received has fulfilled the statutory requirements.

The decisive factor therefore is not how much is spent on quality enhancement but what benefit it provides to the client in the end (refer to the observations above on circumstances enhancing quality).

Nonetheless, when examining the circumstances under which benefits to the client are generated, aspects relating to client protection must be considered, by applying a strict standard when assessing the quality of a benefit.

Firms that succeed in achieving a real benefit for clients, at little but adequate expense and proportional to the outcome, will accordingly have a competitive advantage.

#### WHAT IS AN ONGOING BENEFIT?

According to a provision<sup>16</sup> included in the Commission Delegated Directive on MiFID II, investment firms are under obligation to fulfil quality enhancement requirements on an ongoing basis, as long as they continue to pay or receive inducements.

No such provision existed under MiFID I. The provision clearly requires that any periodic third-party payment must be reciprocated by an ongoing benefit to the client which meets the general conditions applying to client benefits (appropriate quality enhancement and greater benefits than required under law).

In practice, this provision will frequently apply to trailer fees, which are payments received by the investment service provider for clients maintaining certain products in their portfolio (usually products entailing a management fee).

The requirements relating to ongoing quality enhancement should also not be interpreted too loosely, however. The recitals of the Commission Delegated Directive<sup>17</sup>, for example, clearly require investment firms, once they have fulfilled the quality enhancement criterion, to maintain the enhanced level of quality. This does not imply, however, that firms are obliged to continually improve over time the quality of the services they provide. In its MaComp<sup>18</sup> Circular, BaFin states this in more explicit terms.

This means in effect that firms fulfilling certain of the criteria specified in MiFID II implicitly fulfil the criterion of continued enhanced quality, where the general conditions have been met. This applies, for example, to monitoring a portfolio to determine whether it meets the client's needs over time, or to providing tools that can be used on an ongoing basis, or to providing clients with periodic information.

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<sup>16</sup> Commission Delegated Directive (EU) 2017/593.

<sup>17</sup> Recital 23 of Commission Delegated Directive (EU) 2017/593.

<sup>18</sup> Under BT 10.4.

In contrast, one-time quality enhancement measures resulting in benefits, such as those taken when the client chooses an investment, do not qualify as ongoing benefits; examples here include providing advice on a broad selection of products or offering a competitive price for access to a broad selection of products.

## HOW ARE THE DOCUMENTATION REQUIREMENTS TO BE MET?

Investment firms are required to hold evidence<sup>19</sup> that each and every inducement is designed to enhance the quality of the relevant service to the client. Lists are to be maintained, one showing the origin of funds and another containing the benefits that correspond to the inducements received (see the discussion above on the relation between the amounts received and the benefits generated for the customer).

In the MaComp Circular, BaFin refers to these lists as an “inventory of benefits” and an “inventory of use”.

The inventory of benefits does not necessarily have to be detailed for each individual client. It must, however, allow clear identification of the product provider from which each of the inducements was received. Non-monetary benefits are to be priced whenever exceeding the de minimis threshold.

The inventory of use, on the other hand, is to list the service quality enhancements in relation to the benefits received. Here it also necessary to price the enhancements. A record should also be kept of the particular groups of clients actually profiting from the specific benefits, whether all of one firm’s clients or only certain groups. While the inventory of use need not be kept so as to show individual amounts for each client, it must be specific enough to allow a picture of the types of benefits and the particular clients and client groups ultimately profiting from each. It is therefore not enough to simply refer to abstract beneficiary groups that cannot be broken down to the level of individual clients.

Ultimately, the requirements relating to the documentation of inducements are intended to serve two goals:

- First, the specific benefits are to be shown in relation to the payments received for each. This should, in turn, allow the firm as well as supervisory authorities to determine after the fact whether benefits are for an additional or higher level service that is proportional to the level of inducements received.<sup>20</sup> Or, phrased as a question, are the benefits created for the clients great enough of themselves to basically justify accepting the corresponding payments?
- The documentation should also allow a determination of whether the groups of clients on the basis of whose contracts the payments are accepted actually receive the corresponding benefits. A firm is not permitted, on the basis of the payments accepted, to create benefits that, while being proportional as defined in the above paragraph, are of a kind that does not profit the clients or client groups. Such a problem can arise, for example, where payments are generated in the course of providing advice to clients (and afterwards when accepting orders) but where asset management clients profit from the benefits (through special information tools, for instance). Or, phrased as a question, does the benefit reach the corresponding client?

**Investment firms are required to hold evidence that each and every inducement is designed to enhance the quality of the relevant service to the client. Lists are to be maintained, one showing the origin of funds and another containing the benefits that correspond to the inducements received.**

<sup>19</sup> Article 11(4) of Commission Delegated Directive (EU) 2017/593.

<sup>20</sup> Article 11(2) of Commission Delegated Directive (EU) 2017/593.

The documentation requirements thus help to monitor compliance with statutory standards relating to inducements. To achieve this goal, it is not necessary to keep individual inventories of benefits and use for the various clients. The lists must, however, be able to be related to individual details so as to allow identification of the benefits received on the basis of a contract with a specific client – a fact needing to be disclosed to the client anyway (see below) – as well as the resulting benefits to the client. Only in this way will supervisory authorities be able to evaluate the questions raised above.

#### WHAT SPECIFIC DETAILS ARE TO BE DISCLOSED TO THE CLIENT?

The provisions governing the disclosure to clients of benefits received are completely new in MiFID II.

Based on the MiFID I provisions, it was enough to provide the client with a summary of benefits received.

Disclosure requirements relating to inducements have now been defined in great detail and structured according to ex-ante and ex-post disclosure requirements. The exact amount of any benefit must always be disclosed on an ex-ante basis, and where the amount cannot be ascertained in advance, the firm must first disclose the method of calculating the amount and then the specific amount once it can be ascertained. On an ex-post basis and at least once a year, the actual amounts of the benefits received are to be disclosed.

These disclosure rules differ remarkably from the provisions under MiFID II governing the disclosure of costs. Under MiFID II, costs can be disclosed in advance based on examples of realistic, assumed investment amounts. This is also logical from a legislator's point of view, because the UCITS<sup>21</sup> Directive and PRIIPs Regulation contain the very same definition in relation to product risk and costs for key investor information documents. It would otherwise be difficult to understand why the information contained in such documents would not be adequate for meeting ex-ante disclosure requirements under MiFID II.

Any benefits received from third parties are not, however, explicitly included in key investor information documents in accordance with the UCITS Directive and PRIIPs Regulation, even though they obviously represent a part of the cost figures as posted. By deciding to additionally require ex-ante disclosure of the specific amount of any inducements, legislators have underscored the intention of establishing an especially strict rule (which was probably also necessary in order to achieve a compromise).

In any case, firms are to provide their clients with the specific amounts paid to the firm based on a specific transaction carried out. Firms' accounting systems have to be set up so as to allow the supervisory authorities to verify the accuracy of the amounts reported to clients.

Before MiFID II entered into force, this rule was strongly debated (and subject to criticism by market participants). Some cases will indeed arise in practice where it will be difficult to match the amounts received with specific clients. Yet the responsibility lies with firms to design payment flows so as to allow specific individual amounts to be disclosed to clients.

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<sup>21</sup> UCITS (*Undertakings for collective investment in transferable securities*).

To begin with, firms often expressed the concern that disclosing specific amounts (on an ex-ante or ex-post basis) would be harmful for business. Yet this concern is allayed somewhat when it is considered that the requirement applies throughout the European market (wherever inducements are even permitted), resulting in a level playing field for all.

In preparing the provisions governing inducements for advisory services provided under MiFID II, as a result of many and varying interests, European lawmakers had a tricky dilemma to solve. In conclusion, two different regimes now exist side by side: one for independent advice, under which it is essentially not permitted to accept any third-party payments, and another for non-independent advice, which still allows benefits to be accepted but under stricter rules than under MiFID I. The resulting complexity will pose considerable challenges for the industry and regulators. It is therefore all the more important to identify practical solutions and mechanisms for implementation that are appropriate to the market and do not defeat the purpose pursued through the rules.



# CYBERSECURITY

## Regulatory and supervisory strategies

**A** ccording to The Global Risks Report 2018 of the World Economic Forum, more than 25 billion devices worldwide were already connected via the Internet in 2016, and by 2020 the figure will be at least 50 billion. Rapidly advancing digitisation, exponentially increasing capacities for data processing and storage, as well as the enormous progress in telecommunications technology span a globally networked cyber and information space, the integrity of which is becoming increasingly vital for private, entrepreneurial and government action in the globalised world. The growing digitisation and progressive networking of individuals, companies and states, which permeates all areas of life, is uniquely shaping the opportunities of our present and future. It is also making economies, societies and governments particularly vulnerable to cyber risks: whether these are caused by force majeure, human or technical failure or simply criminal energy is ultimately of secondary importance. Attacks from cyberspace, favoured by the increasing dependence of enterprises on their IT systems and their growing degree of connectivity, have generally become an immediate threat to the functioning of the economy – particularly for financial markets and financial service providers, academics and civil society. Such attacks have increased in scope and frequency, as well as in their disruptive potential, and can seriously affect daily life. The question today is no longer if, but when the next attack will occur and whether it will even be identifiable as such. How ubiquitous cyber risks are today has been dramatically demonstrated by malware such as the Stuxnet, Wannacry and NotPetya bugs, which have infected computers around the globe, causing damage totalling in the hundreds of millions. According to a representative study by the Ponemon Institute, almost two thirds of medium-sized and large companies have already fallen victim to a web-based attack. And the list of possible effects of cyber attacks is long: loss of output, loss of knowledge, damage to image and reputation, competitive disadvantages, financial and physical

**The consequences of a cyber attack can be dramatic: downtime, loss of output, competitive disadvantages, financial losses, physical damage, restoration costs, legal sanctions, loss of reputation and personal consequences for managers and employees. This list is only a small sample.**

damage, restoration costs, legal sanctions and even personal consequences for managers and employees; and this list is only a small sample. Criminal cyber attacks are becoming increasingly cunning, and the damage caused is drastically increasing:

- In a 2018 study, the Center for Strategic and International Studies (CSIS) and McAfee<sup>1</sup> estimate that nearly \$ 600 billion, almost one per cent of global economic output (GDP), is lost to cybercrime every year. In the previous report back in 2014, global losses were still estimated at \$ 445 billion.
- In the World Economic Forum's<sup>2</sup> Global Risks Report 2018 cyber attacks rank third among the top 5 global risks by probability of occurrence, after extreme weather events and natural disasters. In 2017 cyber risks were not even among the top five.
- The European Network and Information Security Agency (ENISA)<sup>3</sup> ranks ransomware as number 1 in its 2017 ranking of cyber threats. This is followed by web-based attacks, attacks on web applications, phishing and spam.

Cyber attacks are only one aspect of cyber risks. In a study the University of St. Gallen<sup>4</sup> categorised key cyber risks using a simple cause-effect model. The causes are the risks, while financial or non-financial damage is the effect. The study authors distinguish between "non-criminal causes" and "criminal causes" and divide each into three sub-categories.

#### **NON-CRIMINAL CAUSES OF CYBER RISK**

- Force majeure – Floods or earthquakes, power outages or fires, acts of terrorism or civil unrest and the like can lead to serious losses of data or at least limit their availability.
- Technical failure – Hardware failures, computer overheating, short circuits, storage media crashes and the like can also cause serious data degradation. Access to company data from all corners of the world presents companies with particular security challenges: when the virtual office moves to the train, the plane, the Internet café or even the beach, it is particularly difficult to enforce security standards, both technically and through governance. Managers see the greatest risk potential in the human factor.
- Human failure – Employees may unwittingly, inadvertently or wilfully fail to observe data or security standards and cause or enable harm through their behaviour.

#### **CRIMINAL CAUSES OF CYBER RISK**

- Hacker attacks – Hacker attacks and cyber attacks can have different motivations, applying a broad array of methods and pursuing a variety of goals. In addition to financial motivations, attacks may also be initiated for purposes of sabotage and espionage.
- Physical attack – Such attacks do not use hacking tools but attempt to reach their target by physically penetrating relevant parts of the building.

<sup>1</sup> Center for Strategic and International Studies (CSIS) and McAfee. *Economic Impact of Cybercrime – No Slowing down (2018)*; [www.mcafee.com/content/dam/enterprise/en-us/assets/reports/restricted/economic-impact-cybercrime.pdf](http://www.mcafee.com/content/dam/enterprise/en-us/assets/reports/restricted/economic-impact-cybercrime.pdf).

<sup>2</sup> World Economic Forum. *The Global Risks Report 2018, 13th Edition*; [www3.weforum.org/docs/WEF\\_GRR18\\_Report.pdf](http://www3.weforum.org/docs/WEF_GRR18_Report.pdf).

<sup>3</sup> European Network and Information Security Agency (ENISA). *ENISA Threat Landscape Report 2017, 15 Top Cyber-Threats and Trends*; [www.enisa.europa.eu/publications/enisa-threat-landscape-report-2017/at\\_download/fullReport](http://www.enisa.europa.eu/publications/enisa-threat-landscape-report-2017/at_download/fullReport).

<sup>4</sup> Biener/Eling/ Matt/Wirfs. *Cyber Risk: Risikomanagement und Versicherbarkeit [Cyber risk: risk management and insurability]*. St. Gallen: Institute of Insurance Economics. 2015.

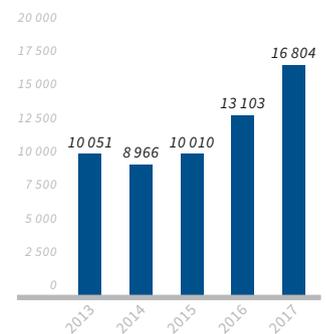
- **Extortion** – Extortion using viruses and Trojans containing ransomware or malware is one of the most frequently occurring scenarios, in particular for small and medium-sized enterprises, whose security systems are less developed given the high costs involved. For instance, computers and/or data can be blocked or data stolen and released only after payment of a ransom.

Published estimates generally show a wide range of financial losses specifically associated with cyber risks, which is due not only to the varied and usually difficult-to-measure nature of losses but also to the constant evolution of the risks. The Hiscox Cyber Readiness Report 2018<sup>5</sup>, for example, outlines some challenges associated with generating estimates. Out of 4 100 respondents in five countries (USA, Netherlands, United Kingdom, Spain, Germany) – including large and small organisations in the public and private sectors – the 1 853 whose organisations had been exposed to a cyber attack were asked about the financial damage suffered over the previous 12 months. Almost one third of these companies, however, were unable to assess the damage. The average loss for the remaining two thirds of victims was \$ 229 000, albeit with substantial differences depending on the size of the company or the country in which it does business.

In an internationally networked world, Austria is not immune from the threat of cyber risks. As can be read in Austria’s Cybersecurity Report 2018<sup>6</sup>, the danger has intensified and attacks are likely to become significantly more frequent and more complex. The Cybercrime Report 2017<sup>7</sup> of the Federal Office of Criminal Investigation (BK) shows that the number of reported cybercrime incidents has risen continuously since 2014, increasing by around 60% to 16 804 between 2015 and 2017 (see Chart 17).

It is one of Austria’s top priorities to work nationally and internationally to secure cyberspace. Accordingly, the Federal Government drew up and adopted an Austrian Cyber Security Strategy as early as 2013. It provides the basis for national cooperation to protect cyberspace and the citizens of Austria in the virtual world.

Chart 17: **Reported cybercrime incidents in Austria** (source: Federal Office of Criminal Investigation – BK)



## CYBER RISKS: DEFINITIONS AND LIMITATIONS

Although almost everyone agrees that cyber risk has risen and will continue to rise,

<sup>5</sup> Hiscox, *The Hiscox Cyber Readiness Report 2018*.

<sup>6</sup> Cybersecurity Steering Group. *Cybersecurity Report 2018 (in German)*; [www.bundeskanzleramt.gv.at/documents/131008/780563/Cybersicherheit\\_Bericht2018/769cb7b7-614c-49d8-8055-068d2f36009c](http://www.bundeskanzleramt.gv.at/documents/131008/780563/Cybersicherheit_Bericht2018/769cb7b7-614c-49d8-8055-068d2f36009c).

<sup>7</sup> BK. *Cybercrime Report 2017*; [https://bundeskriminalamt.at/306/files/Cybercrime\\_17\\_web.pdf](https://bundeskriminalamt.at/306/files/Cybercrime_17_web.pdf).

## CORE OBJECTIVES OF THE AUSTRIAN CYBER SECURITY STRATEGY

- Creating a secure cyberspace for the exchange of data
- Building a resilient infrastructure against cyber threats
- Raising awareness and promoting new initiatives in the national cybersecurity dialogue
- Expanding the necessary ICT infrastructures
- Strengthening the legal framework for cross-border law enforcement
- Promoting public and private cooperation to protect cyberspace
- Protecting citizens’ identity and privacy

there is currently no universally accepted definition of cyber risk and directly related terms such as cybersecurity.

Most recently, in July 2018, the Financial Stability Board (FSB) published a draft of a Cyber Lexicon<sup>8</sup>, comprising 50 key terms on cybersecurity and cyber resilience.

Cyber risk is defined in this document as the combination of the probability of cyber events occurring and their consequences. A cyber event is any observable occurrence in an information system, which sometimes provide indication that a cyber incident is occurring. In simple terms, cyber risks are all risks that can arise in connection with cyberspace. Accordingly, in the case of financial service providers, they can also be seen as a component of operational risk, and sources of material cyber risks can be found in people, processes and systems. Material cyber risks can include data deletion, destruction of software, operational disruptions or interruptions, extortion payments or direct monetary theft, physical damage or investigation costs relating to cyber incidents.

Cybersecurity is concisely described by the German Federal Office for Information Security (BSI): It refers to all aspects of security in information and communication technology systems, in which conventional IT security is extended to the entire cyberspace environment.<sup>9</sup> By contrast, the FSB defines cybersecurity as “Preservation of confidentiality, integrity and availability of information and/or information systems through the cyber medium. Note: In addition, other properties, such as authenticity, accountability, non-repudiation and reliability can also be involved.”<sup>10</sup>

In addition to the challenge of agreeing on a uniform definition of cybersecurity, the differentiation between cybersecurity, information security and IT security is also the subject of nuanced debate.

Information security deals in particular with the aspects of integrity, confidentiality and availability of analogue and digital information.

IT security is aimed at handling the risk resulting from information and communication technologies (ICT)<sup>11</sup>. This is the current or future risk of losses due to the unsuitability or failure of the hardware or software of technical infrastructures, which may affect the availability, integrity, accessibility and security of such infrastructures or data.

Concluding, the above terms are closely intertwined. A distinction between cybersecurity, information security and IT security is de facto impossible because cybersecurity cannot be considered without also considering information security and IT security. For companies that have to coordinate these aspects in practice, theoretical superordination or subordination of these terms is of little importance. Important is rather the awareness that – due to technological developments – risks are increasingly shifting to cyberspace.

## HOT SPOTS OF CYBER RISK

In a sector comparison, financial services represent the sector most affected by cyber risk. This is clearly shown by the ranking of average annual cybercrime costs based on

<sup>8</sup> FSB. *Cyber Lexicon – Consultative Document*; [www.fsb.org/wp-content/uploads/P020718.pdf](http://www.fsb.org/wp-content/uploads/P020718.pdf).

<sup>9</sup> BSI. *Cybersecurity*. [www.bsi.bund.de/DE/Themen/Cyber-Sicherheit/cyber-sicherheit\\_node.html;jsessionid=E6F7AEB0FE23C7B4B5DC63B1FD1210AF.1\\_cid369](http://www.bsi.bund.de/DE/Themen/Cyber-Sicherheit/cyber-sicherheit_node.html;jsessionid=E6F7AEB0FE23C7B4B5DC63B1FD1210AF.1_cid369).

<sup>10</sup> FSB, *Cyber Lexicon – Consultative Document*; [www.fsb.org/wp-content/uploads/P020718.pdf](http://www.fsb.org/wp-content/uploads/P020718.pdf).

<sup>11</sup> It should be noted that the same risk is addressed under “IT risk”, “ICT risk” or “information system risk” and that these are synonymous terms.

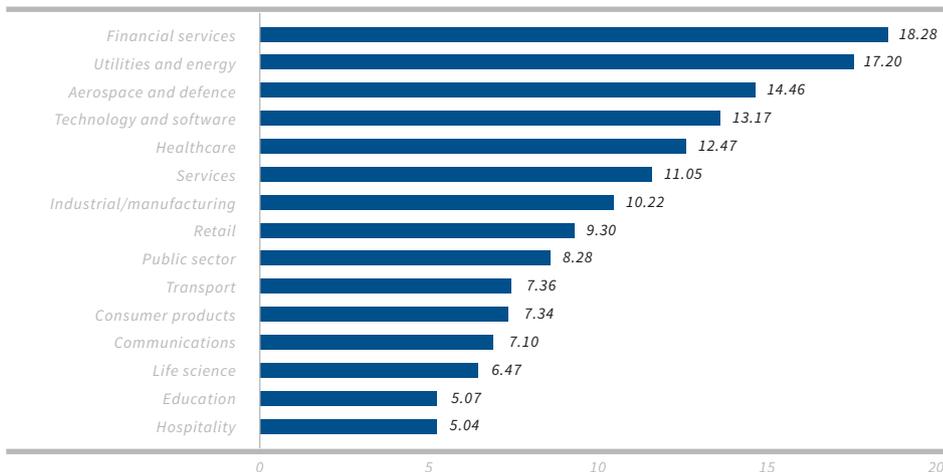


Chart 18: Average annualised cybercrime cost by industry sector (in \$ millions; source: Accenture, 2017 Cost of Cyber Crime Study – insights on the security investments that make a difference, p. 20<sup>12</sup>)

a comparison of 15 industries in a study carried out by international consulting firm Accenture<sup>13</sup>:

Offering intangible products and/or financial services on a digital, often cross-border, basis may itself account for the leading role of the sector in cybercrime. Immense volumes of sensitive data make the industry a prime target for potential cyber attackers. The rapid development of digital channels is influencing more and more financial market participants and their business strategies. The increased use of modern technologies has potential effects on all business processes and interfaces to customers. The increased digitisation efforts of financial services companies are particularly visible at the level of customer interfaces. Among other things, automated financial advice (robo-advice), app-supported sales channels or the conclusion of contracts via company websites are being increasingly used. IT systems cannot be completely decoupled from public networks due to digital communication with customers, but also due to the overall increase in networking with other market participants, and it is therefore particularly important to protect these systems. For example, attacks on payment transaction systems at banks can result in improper transfers or directly impact the solvency of an institution or its customers. In the worst case, the ability of the bank to render payments may actually be jeopardised. It is also conceivable that attackers could spy on the payment patterns of customers. The increasing use of cloud computing, in which IT infrastructure and services such as computing capacity or storage space are offered via the Internet, can also result in losses in the event of a cyber attack; these losses range from \$ 4.6 billion for a large event to \$ 53 billion for an extreme event, according to calculations by international insurance brokers Lloyd's.<sup>14</sup>

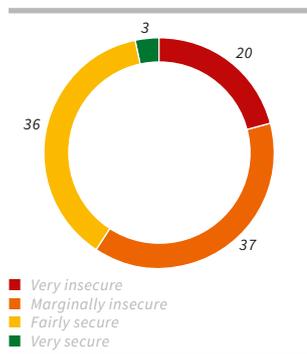
At companies almost all processes for generating efficiency and cost advantages are increasingly being implemented or controlled automatically. In addition to asset management, this also applies, for example, to risk management and accounting. Attacks on these systems can damage data processing and, consequently, the business of the companies. This endangers the availability, integrity, confidentiality and authenticity of the data. There is a risk that key figures required by companies, for

<sup>12</sup> The publication points out that the sample sizes in several sectors are too small for definitive conclusions.

<sup>13</sup> Accenture, 2017 Cost of Cyber Crime Study – insights on the security investments that make a difference.

<sup>14</sup> Lloyd's, Emerging Risks Report 2017, Counting the cost – Cyber exposure decoded.

Chart 19: **The security of cloud computing is viewed critically by companies' IT managers**  
(in %, source: Deloitte Cyber-Security Report 2017)



example, to comply with capital requirements and for reporting purposes may be falsified – even if this was not the actual objective of the attack.

So far, banks – rather than insurance companies – have been the prime targets of cybercrime attacks, which is why they have already taken increased measures to improve cybersecurity. KPMG sees this as the main reason why cybersecurity among insurers is lagging behind the other financial services sectors.<sup>15</sup> Now, in an environment where cyber attackers are increasingly looking for new, most likely weaker targets, it can be assumed that other financial market participants will also come under fire in the future. This can threaten the viability of individual financial service providers, but it can also have a negative impact on financial market stability.

## REGULATORY APPROACHES TO STRENGTHENING CYBERSECURITY

European efforts to strengthen cyber resilience are reflected in a wide range of Europe-wide initiatives, such as the objective of creating a digital single market in which the free movement of goods, people, services, capital and data is ensured. Another example is the European Agenda on Security, which also prioritises the fight against cybercrime. The NIS Directive and the General Data Protection Regulation, which aim at the protection of personal data, also make important contributions.

One of the current priorities of the European Commission is the FinTech Action Plan, which aims at more competitive and innovative European financial markets and also seeks to strengthen the European financial sector's resistance to cyber attacks. To this end, an intensive exchange of information with all relevant financial market participants has been initiated.

In addition, the Commission has invited the three European supervisory authorities, namely the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), to conduct a survey of supervisory practices on IT security and governance to form the basis for relevant guidance or a recommendation to the Commission on further legal improvements. The ESAs have also been instructed to conduct a cost-benefit analysis for the development of a coherent test framework for the cyber resilience of major market players and infrastructures in the European financial sector. The FMA is represented in the relevant working groups and contributes Austrian positions to the votes.

As already mentioned, cyber risk is assigned to operational risk in the legal requirements for supervised companies. Since Basel II and Solvency II the companies concerned have had to back this with own funds. However, it should be noted that operational risk excludes reputational risks and risks arising from strategic decisions. Therefore, thematic qualitative legislation is also important.

The main regulations governing Austrian credit institutions, insurance undertakings, *Pensionskassen* (pension companies), management companies, corporate provision funds, investment firms and investment service providers are outlined in the box "Austrian financial market legislation to strengthen cybersecurity" (see page 138). This table shows that the legal framework is most advanced for the banking sector.

<sup>15</sup> KPMG, *Closing the gap: Cyber Security and the insurance sector*; [https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2017/08/cyber\\_security\\_and\\_insurance\\_sector.pdf](https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2017/08/cyber_security_and_insurance_sector.pdf).

## CYBER RISK AS AN OPPORTUNITY FOR INSURERS

Unlike other sectors, cyber risk may hold out increasingly attractive business opportunities for insurance and reinsurance undertakings. Insurance policies covering cyber risks represent a new line of business with enormous growth potential. The possibilities lie not only in offering insurance protection against first-party losses and damage claims, but also in providing advice and assistance to protect against cyber attacks and in professional support following the occurrence of such events. This support service can consist of measures for faster crisis management, minimising costs or dealing with impending reputational damage.

The increasing demand for cyber insurance is due not only to the increasing frequency of cyber attacks but also to new regulatory requirements in the EU, such as the EU Directive on security of network and information systems (NIS Directive) or the rules on personal data protection. Estimates about the development of the market are subject to great uncertainty. Some studies predict a worldwide premium volume of \$ 14 billion by 2022<sup>16</sup> while auditing and consulting firm KPMG estimates \$ 10 billion by 2020<sup>17</sup>. It is also evident that the European market is lagging significantly behind the US market in this product category. According to the British insurance and risk management company AON, the 2015 European standalone cyber market was worth \$ 135 million in annual gross written premiums, compared to \$ 1.5 billion in the USA.<sup>18</sup>

The cyber insurance market is currently fairly opaque. For one, there are substantial differences in the definitions of what cyber insurance actually is. Moreover, the range of products and services in this segment is relatively heterogeneous. The German Insurance Association (GDV), for example, has published standard policy conditions for cyber insurance.<sup>19</sup> The GDV sees compensation in the event of business interruptions, reimbursement of costs for data recovery, assumption of third-party claims, payment of IT forensics, an offer of legal advice for data protection violations and payment of a crisis communicator and call centre costs included in a standard cyber insurance policy.<sup>20</sup> This demonstrates the potentially broad spectrum of this insurance segment in an evolving, increasingly competitive market.

When deciding whether to offer cyber insurance products, providers face the conundrum of seizing a first mover advantage to quickly gain market share vs. the need for risk-adequate premium calculation. Statistical experience and data are still sparse due to the high number of unreported cases of damage caused by cyber risks. The environment is also constantly changing. Appropriate premium calculation is therefore challenging, and the risk of underpricing should not be underestimated.

In Austria, the cyber insurance market is developing rapidly: premiums written increased by 190% to € 425 000 in 2017.

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<sup>16</sup> Allied Market Research, *Cyber Insurance Market to Reach \$14 Billion, Globally, by 2022*. Accessed on 7 September 2018.

<sup>17</sup> KPMG, *Seizing the cyber insurance opportunity*.

<sup>18</sup> Aon Inpoint, *Global Cyber Market Overview – Uncovering the Hidden Opportunities*.

<sup>19</sup> GDV, *Allgemeine Versicherungsbedingungen für die Cyberrisiko-Versicherung (AVB Cyber)* [General policy conditions for cyber risk insurance].

<sup>20</sup> GDV, *Das leistet eine Cyberversicherung [Cyber insurance and what it covers]*. Accessed on 7 September 2018.

Various standards and information platforms can be used to address IT risks, such as: ITIL (Information Technology Infrastructure Library)<sup>21</sup>, IT-Grundschutz (German Federal Office for Information Security)<sup>22</sup>, COBIT (Control Objectives for Information and Related Technology)<sup>23</sup>, ISO 27001 (International Organization for Standardization)<sup>24</sup>, Austrian IT Security Handbook<sup>25</sup> and CERT (Computer Emergency Response Team Austria)<sup>26</sup>.

## FMA GUIDES

In order to address the risks of increased digitisation and to provide the supervised entities with an overview of IT security precautions, the FMA has issued subject-

<sup>21</sup> [www.axelos.com/best-practice-solutions/itil](http://www.axelos.com/best-practice-solutions/itil).

<sup>22</sup> [www.bsi.bund.de/DE/Themen/ITGrundschutz/ITGrundschutzKataloge/itgrundschutzkataloge\\_node.html](http://www.bsi.bund.de/DE/Themen/ITGrundschutz/ITGrundschutzKataloge/itgrundschutzkataloge_node.html).

<sup>23</sup> [www.isaca.org/cobit/pages/default.aspx](http://www.isaca.org/cobit/pages/default.aspx).

<sup>24</sup> [www.iso.org/standard/54534.html](http://www.iso.org/standard/54534.html).

<sup>25</sup> [www.sicherheitshandbuch.gv.at/](http://www.sicherheitshandbuch.gv.at/).

<sup>26</sup> [www.cert.at](http://www.cert.at).

## AUSTRIAN FINANCIAL MARKET LEGISLATION TO STRENGTHEN CYBERSECURITY (EXCLUDING FMA GUIDES)

### CREDIT INSTITUTIONS

- Austrian Banking Act (BWG):
  - Article 39 para. 2b no. 5 and para. 4 BWG in conjunction with Article 11 of the Regulation on Credit Institution Risk Management (KI-RMV; *Kreditinstitute-Risikomanagementverordnung* – operational risk)
  - Article 25 BWG (outsourcing)
- Directive (EU) 2015/2366 on payment services in the internal market (in particular Articles 95 and 96 of PSD2)
- Directive (EU) 2016/1148 concerning measures for a high common level of security of network and information systems across the Union (NIS Directive)
- BCBS 239 – Principles for effective risk data aggregation and risk reporting
- EBA Guidelines:
  - EBA Guidelines on fraud reporting requirements under Article 96(6) of PSD2 (EBA/CP/2017/13)
  - EBA Guidelines on ICT Risk Assessment under the Supervisory Review and Evaluation process (SREP) (EBA/GL/2017/05)
  - EBA Guidelines on major incidents reporting under PSD2 (EBA/GL/2017/10)
  - EBA Guidelines on the security measures for operational and security risks of payment services under PSD2 (EBA/GL/2017/17)
- In consultation: EBA Guidelines on the management of ICT risk by institutions

### INSURANCE AND REINSURANCE UNDERTAKINGS

- Insurance Supervision Act 2016 (VAG 2016):
  - Article 107 para. 1 (governance system)
  - Article 110 para. 2 no. 5 (risk management of operational risks)
  - Article 111 para. 1 no. 1 (overall solvency needs)
  - Article 107 para. 4 (contingency planning)

specific guides. These present the relevant supervisory knowledge and are intended to promote development of a common understanding with the supervised entities on IT security issues:

- FMA Guide on ICT Security<sup>27</sup> in Credit Institutions<sup>28</sup>
- FMA Guide on IT Security in Insurance and Reinsurance Undertakings<sup>29</sup>
- FMA Guide on IT Security in Investment Service Providers and Investment Firms<sup>30</sup>
- FMA Guide on ICT Security in Management Companies<sup>31</sup>
- FMA Guide on IT Security in *Pensionskassen* (to be published shortly).

The Guides follow the principle of proportionality: the type, scope and complexity of the transactions as well as the risk structure of the respective companies must be taken into account in actual implementation. The supervised entities are required to

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<sup>27</sup> In line with the relevant EBA definitions and in order to ensure a common understanding with the banking industry, the term ICT was used in this Guide.

<sup>28</sup> [www.fma.gv.at/download.php?d=3370](http://www.fma.gv.at/download.php?d=3370).

<sup>29</sup> [www.fma.gv.at/download.php?d=3511](http://www.fma.gv.at/download.php?d=3511).

<sup>30</sup> [www.fma.gv.at/download.php?d=3598](http://www.fma.gv.at/download.php?d=3598).

<sup>31</sup> [www.fma.gv.at/download.php?d=3597](http://www.fma.gv.at/download.php?d=3597).

- Commission Delegated Regulation (EU) 2015/35:
  - Article 258(1)(h) (information systems point), (j) (safeguarding the security, integrity and confidentiality of information)
  - Article 258(3) (business continuity policy)
  - Article 260(1)(f) (operational risk management)
- EIOPA Guidelines:
  - EIOPA Guidelines on system of governance, EIOPA-BoS-14/253 (Guidelines 8, 17, 18, 21)
  - EIOPA Guidelines on own risk and solvency assessment, EIOPA-BoS-14/259 (Guidelines 2, 7, 8)

#### **PENSIONS KasSEN:**

- Amendment to the *Pensionskassen Act* (PKG) (government bill of 20 June 2018 in annex 206 to the shorthand verbatim records of the National Council, 26th legislative period):
  - Article 21a (risk management and risk management function)
  - Article 22a (own risk assessment)

#### **MANAGEMENT COMPANIES, CORPORATE PROVISION FUNDS, INVESTMENT FIRMS AND INVESTMENT SERVICE PROVIDERS:**

Individual organisational rules from the following legislation must be observed:

- Article 29 of the Securities Supervision Act 2018 (WAG 2018) for investment firms or investment service providers
- Articles 21, 22 and 23 of Commission Delegated Regulation (EU) 2017/565 for investment firms or investment service providers
- Articles 10, 12, 19, 20, 21, 28 and 30 of the Investment Fund Act 2011 (InvFG 2011) for managers of investment funds
- Articles 10, 16, 18 and 19 para. 17 of the Alternative Investment Fund Managers Act (AIFMG) and Articles 57 to 82 of the EU AIFM Regulation for real estate fund managers and alternative investment fund managers
- Article 3 of the Real Estate Investment Funds Act (ImmoInvFG) for real estate fund managers
- Article 39 BWG and Articles 3, 4 and 11 KI-RMV for corporate provision funds

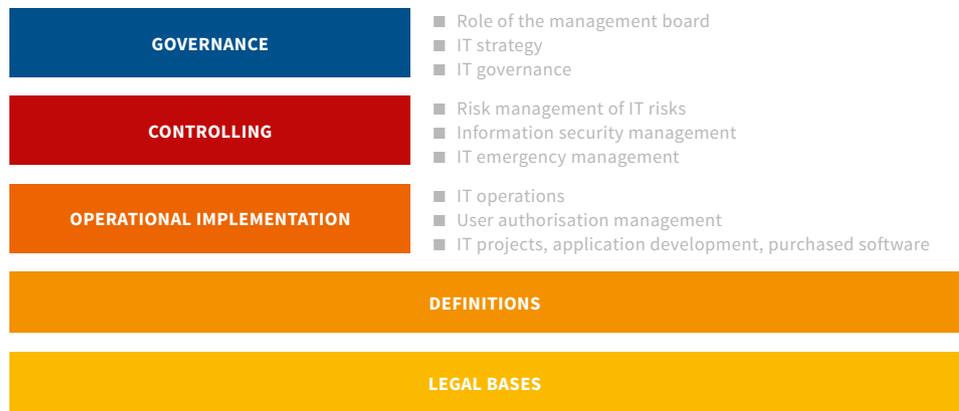


Figure 7: FMA IT Security Guide concept (source: FMA Guides<sup>32</sup>)

use the published criteria to determine which methods, systems and processes are appropriate with regard to IT security in the context of the services offered.

In the introduction to each Guide, the context of the current national and international standards (ITIL, COBIT, ISO 27001 etc.) is provided and essential definitions given.

The FMA then sets out its expectations regarding governance and management as well as the operational implementation and design of IT security measures within the companies. Adequate design of the IT strategy and a corresponding IT governance are discussed. In all cases, the directors of the companies have an important role to play in IT security. In particular, they are responsible for the IT strategy and the specifications of the IT structures and processes. They must take care to ensure that the company is technically and organisationally equipped and that conflicts of interest are avoided or addressed. Special care is also required in the case of IT outsourcing. In addition, the IT security aspects of risk management and information security management are addressed, which are to be set forth in information security guidelines. The aim of information security management is to protect information of all kinds, but in particular to guarantee the integrity, availability and confidentiality of data. An information security officer, whose central task is to oversee all matters of information security within the company and vis-à-vis third parties, is to be established as a key function while maintaining the principle of proportionality.

The Guides also contain: a framework for identifying and limiting risks to IT availability and continuity, including preventive measures; requirements for user authorisation management (need-to-know principle) and vulnerability management; in the case of in-house application development, purchased software, IT projects and significant changes in the IT systems, a requirement to evaluate the effects on the IT structures and processes in advance; in order to ensure trouble-free and smoothly running IT operations, a requirement for appropriate disruption and continuity concepts (dealing with failures and identifying causes), which also include an inventory of all IT systems to adequately address the risks of ageing IT systems.

All FMA Guides on IT security pursue the same set of intentions and objectives. However, there may be different details in the rules, and sector or product-specific

<sup>32</sup> FMA Guide on ICT Security in Credit Institutions, FMA Guide on IT Security in Insurance and Reinsurance Undertakings, FMA Guide on IT Security in Investment Service Providers and Investment Firms and FMA Guide on IT Security in Management Companies.

features must be observed. For example, the guides for management companies (managers of investment funds, managers of real estate funds, alternative investment fund managers, corporate provision funds), investment firms and investment service providers take into account special aspects such as the relationship with the custodian bank or, in the case of investment firms, the relationships with tied agents or securities brokers. In the case of insurance undertakings, the appointment of an information security officer is not mandatory, but the necessity of such an appointment must be evaluated.

The measures set out in the ICT Guides make a significant contribution to cybersecurity and mitigate cyberspace threats.

## **SUPERVISORY PRINCIPLES, STRATEGIES AND MEASURES**

The supervisory principles, strategies and measures of the FMA are interlinked as a modular system and continuously adapt to the changing environment and surrounding conditions.

### **LEVEL PLAYING FIELD: FAIR AND UNIFORM RULES**

As current developments, also in the virtual segment of the financial market, increasingly present themselves as integrated topics, a uniform interpretation and development of the law as well as a coherent design of supervisory measures are required. The integrated approach to the development, interpretation and enforcement of legislation creates a single legal framework and helps to avoid distortions of competition and to establish a level playing field. Regulations should be both understandable and consistent in terms of content. This must be ensured not only across national borders, but also between large and small providers, between established players and newcomers, and across product and industry boundaries.

### **RISK-BASED AND PROPORTIONAL**

Structures are very heterogeneous within the European financial market, which ranges from global players and major European or national institutions to numerous smaller regional institutions. Setting a high bar of regulatory requirements makes sense where significant risks – especially to the stability of the financial markets – are to be expected. As important as it is under a risk-based approach to strictly and closely supervise large, systematically important institutions, it is equally essential that market participants with lower risks are not disproportionately burdened by regulatory requirements. In particular, a “one-size-fits-all” approach can lead to competitive disadvantages for small and medium-sized enterprises, which is why the FMA consistently pursues a risk-based and proportional supervisory approach.

### **COMMON UNDERSTANDING OF SUPERVISION**

Newly required regulations are embedded in the existing supervisory structure and their implementation is monitored. In this context, it is essential that the supervisor and market participants have a common understanding and that standards are established that stand up to international comparison. New and necessary adaptations of circulars, minimum standards, guides and regulations are therefore discussed by the FMA with the stakeholders in an open dialogue and communicated transparently.

**As current developments, also in the virtual segment of the financial market, increasingly present themselves as integrated topics, a uniform interpretation and development of the law as well as a coherent design of supervisory measures are required.**

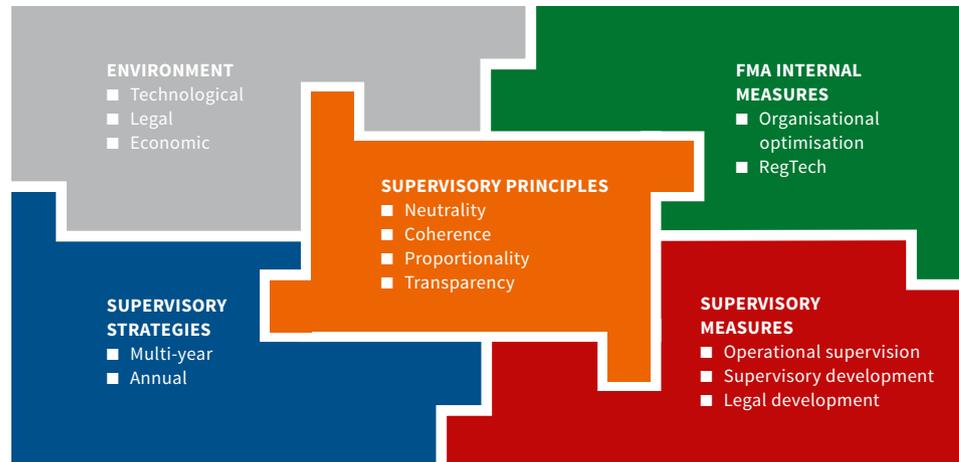


Figure 8: Supervisory principles, strategies and measures

### TECHNOLOGY-NEUTRAL REGULATION AND SUPERVISION

Due to rapid technological progress, the focus is increasingly on qualitative specifications: in addition to capital adequacy, the evaluation of risk management and compliance structures is therefore growing in importance. In this context, the FMA consistently pursues a technology-neutral regulatory and supervisory approach.<sup>33</sup> Technology neutrality means that, even under dynamic conditions, adequate risk management must be ensured at all times without favouring certain technological solutions over others, provided that they represent the current state of the art.

### MEDIUM-TERM STRATEGY

Based on the FMA Strategy 2018–2023 “Transparent, proportional and European supervision. Increase synergies and take advantage of digitalisation”, the FMA has defined two supervisory and inspection priorities for 2018 that make a significant contribution to strengthening cybersecurity: “Using digitalisation opportunities and managing its risks” and “Optimising internal control systems and governance structures”.<sup>34</sup> In concrete terms, the Authority has:

- intensified the dialogue with supervised entities on cybersecurity measures
- created FMA Guides on IT security in the supervised companies, including cybersecurity requirements
- placed a thematic focus on IT risks and governance
- established an obligation to report serious operational or security incidents at credit institutions and payment service providers
- intensified proactive communication with new providers and market participants via the FMA FinTech point of contact
- removed regulatory obstacles that stand in the way of digitisation (both for established and supervised companies and for FinTechs) to stimulate customer-oriented development of technologies and business models
- promoted the use of RegTech as regulator and supervisor of its own activities in order to exploit technological advances that increase effectiveness and efficiency.

In 2019, digitisation of the financial market will continue to be a focus of operational

<sup>33</sup> Ettl, *Finanzinnovation und Aufsicht – eine Annäherung*, [Financial innovation and supervision – an approach]. *Zeitschrift für das gesamte Kreditwesen* 15/2016, p. 16.

<sup>34</sup> [www.fma.gv.at/en/publications/thematic-focus-of-fma-inspections/](http://www.fma.gv.at/en/publications/thematic-focus-of-fma-inspections/).

supervision and resolution. The FMA-wide IT supervision strategy 2019 covers the following topics:

- IT security as a focal point of supervision
- Positioning the FMA as an “IT-fit” supervisory authority
- Active scouting of new, market-relevant IT trends
- Co-design of regulatory and supervisory developments in the national and European environment
- Targeted deepening of supervisory IT knowledge among FMA staff.

### **IT SECURITY CIRCLE (ISC)**

In order to leverage all the synergies of the integrated supervisory approach for IT and cybersecurity issues, the FMA established the IT Security Circle (ISC) in 2017, in which experts from all FMA departments work together and discuss these topics. The tasks and objectives of the ISC are: development of IT-specific expertise through training and education, exchange of information and experience on IT topics between the FMA departments, contact point for the FMA divisions on IT-specific supervisory topics, supporting contributions in the preparation of technical articles or working papers on IT risks, support for on-site inspections if necessary (also by non-department members of the expert group), support in the selection of external IT audit firms, as well as further development of the FMA IT strategy and implementation support.

The ISC has developed an integrated supervision strategy for assessing IT risks. It sets out the direction for cross-departmental implementation of the IT supervision strategy in everyday practice. To this end, the ISC presents uniform definitions, an overview of the IT risk categories, the regulatory framework of the respective supervisory areas and principles by which IT risks are appropriately addressed.

### **NATIONAL AND INTERNATIONAL COOPERATION**

The FMA actively participates at national and international levels in committees and working groups relevant to the financial market and represents the interests of the Austrian financial market. The aim is to ensure the most convergent and harmonious possible development of regulations while maintaining the principles of subsidiarity, proportionality and risk orientation, which are so important for the Austrian market.

In particular, the FMA participates in the following transnational working groups:

- EBA Task Force on IT risk supervision (TFIT)
- European Systemic Cyber Group (ESCG) of the ECB
- Project Group on data and IT security and governance, including cyber risks and cyber-incident tests of EIOPA
- Cybersecurity Forum of ESMA.

At national level, the FMA is active in the Austrian Cyber Security Platform (CSP), launched by the Federal Chancellery in 2015 as a public-private partnership, in which the private and public sectors work together in matters of cybersecurity and protection of critical infrastructures.<sup>35</sup>

### **CYBERSECURITY IN OPERATIONAL SUPERVISION**

As already mentioned, cybersecurity is a strategic focal point of operational super-

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<sup>35</sup> [www.digital.austria.gv.at/cyber-security](http://www.digital.austria.gv.at/cyber-security).

**Cybersecurity is a strategic focal point of operational supervision. Cybersecurity is actively addressed in management talks or company visits and is a focus of on-site inspections.**

vision. Cybersecurity is actively addressed in management talks or company visits and is a focus of on-site inspections. Frequency and depth of supervision in relation to individual companies are based on the results of qualitative and quantitative risk scoring, which ensures that the rules are applied proportionately.

In banking and insurance supervision, IT risks are also assessed as part of the Supervisory Review and Evaluation Process (SREP) and the evaluation of supervisory reports under the Own Risk and Solvency Assessment (ORSA).

At banks, for example, the SREP is used to evaluate the strategies, processes and procedures used. The Internal Capital Adequacy Assessment Process (ICAAP), in which credit institutions also have to back their operational risk (including IT risks) with own funds, is also examined. The SREP questionnaire, which is adjusted annually and sent to the credit institutions for answer, serves as the main source of information for evaluating the risks. If the SREP reveals inadequate capital, the FMA may prescribe additional funding by imposing a capital add-on. Accordingly, an inadequate limitation of IT risks by the credit institution may result in additional capital requirements. Insurance undertakings subject to Solvency II must submit a supervisory report to the FMA on each regular and irregular ORSA result. The significance of IT security in the undertaking can also be derived from analysis of these reports. A recent review has shown that 90% of undertakings address IT risks in ORSA reports. Risk mitigation measures are also presented for as much as 65% of these risks. However, stress scenarios have so far only been analysed in a few undertakings.

The vulnerability of the Austrian insurance industry to cyber risks was tested for the first time in 2018. This insurance stress test was based primarily on a qualitative analysis of the treatment of cyber risks. The study examined the degree of embedding in operational risk management as well as developments in the number and costs of cyber attacks and cyber insurance premiums earned. For 2019, the FMA plans to further develop the methods for assessing the vulnerability of the insurance sector to cyber risks. Payment institutions are legally obliged<sup>36</sup> to report serious operational or security incidents to the FMA within four hours. This early detection and early warning system (major incident reporting) also targets cyber risks. It makes an important contribution to identifying cyber incidents, monitoring them at national and international levels and incorporating the analysis results for these incidents into the risk management strategy.

<sup>36</sup> Article 86 para. 1 of the Payment Services Act 2018 (ZaDiG 2018; Zahlungsdienstegesetz).

## CYBERSECURITY: PERCEIVED AND ACTUAL THREATS

Where executives see the greatest threat of IT security leaks:

- Lax data security by employees (75%)
- Hacker attacks (50%)
- Use of mobile devices (49%)
- Misuse of data, such as unauthorised disclosure (34%)
- Use of obsolete technology (23%)

Most common targets of cyber attacks in medium and large enterprises:

- Paralysis of systems or servers (44%)
- Theft of data and/or knowledge (35%)
- Remote control of computers (10%)

(Source: Deloitte Cyber-Security Report 2017)

Financial market infrastructures (FMIs) typically operate in an integrated, highly automated and highly networked environment and are therefore exposed to significant cyber risk. As a first step, the FMA has therefore called for appropriate self-assessments in order to ascertain the appropriateness of the guidelines, procedures and standards (cybersecurity framework) implemented for managing cyber risks.

#### **FMA DIGITISATION SURVEY**

In 2018 the FMA conducted a nationwide survey on the status of digitisation among insurance undertakings, credit institutions, management companies, corporate provision funds, investment firms and investment service providers. It primarily comprised the following aspects: status of digitisation, business areas affected, effects on organisation, strategy and sales, legal framework, technologies used, cloud services used, incidents in the area of cyber risks, assessment of risks, precautionary measures implemented and individual cyber strategy. This survey provides important information for assessing the operational risk resulting from the use of IT systems. The results are also taken into account for risk classification as part of individual financial analysis.

The FMA Guides on IT security described above represent a first coordinated and cross-sectoral step to raise awareness of IT and cybersecurity in the Austrian financial market and to create a basis for further regulatory and supervisory measures that is as consistent as possible.<sup>37</sup> Drawing on the experience gained with these Guides, an evaluation will now be made as to whether further market-wide guidance is required in dealing with IT risks.<sup>38</sup>

#### **CYBERSECURITY PACKAGE: CYBER SECURITY SYMPOSIUM AND CYBER INCIDENT SIMULATION**

As the next step in banking supervision, the FMA has put together a cybersecurity package, which is also ultimately to be rolled out as part of integrated supervision. In this context, an FMA Cyber Security Symposium for credit institutions was held, in the course of which dangers and possibilities for protection against cyber risks were identified in industry-specific lectures and the different points of view were analysed and debated in panel discussions. A Cyber Incident Simulation, i.e. a stress test in the form of a simulated cyber attack, is planned for 2019. This will simulate a cyber attack within a given game scenario. The effects on the existing infrastructure will be tested and an assessment made as to whether the existing tools and processes are suitable for containing and overcoming the risks. Furthermore, the Cyber Incident Simulation will offer valuable training in terms of the procedures to be followed in the event of a cyber incident.

As a modern regulatory body, the FMA itself is highly digitised and intensively networked. It has huge volumes of very sensitive data at its disposal and is responsible for the secure exchange of information and data with the companies it supervises and its partner authorities. Accordingly, ICT and cybersecurity are also of utmost importance within the FMA, which is why the Authority has its infrastructure, processes and security management systems regularly audited and tested by external consultants in order to maintain them at the highest international standard.

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<sup>37</sup> [https://sp16.fma.gv.at/News/Dokumente/2018-05-08\\_PM\\_IKT-LeitfadenKI.pdf#search=Ettl](https://sp16.fma.gv.at/News/Dokumente/2018-05-08_PM_IKT-LeitfadenKI.pdf#search=Ettl).

<sup>38</sup> [www.fma.gv.at/download.php?d=3225](http://www.fma.gv.at/download.php?d=3225).

**AUSTRIA – A DYNAMIC, INNOVATIVE AND WELL-CONNECTED FINANCIAL MARKET**

In our globalised and digitised world, the secure, protected and free use of the cyber and information space is an elementary prerequisite for private, corporate and government action. The growing digitisation and progressive networking of individuals, companies, organisations and states, which permeates all areas of life, is shaping the opportunities of our present and future. However, it also makes the state, society and the economy particularly vulnerable to cyber attacks and requires appropriate risk awareness and precautionary measures.

Technical measures alone are not enough to protect companies from cyber threats. There is also a need for rules and codes of conduct that set the framework for appropriate risk management. And there is a need for supervision and control to ensure that these regulations are complied with and that a corresponding risk culture is lived by each individual employee.

Cyberspace is not a static structure; technological progress leads to constant change and rapid shifts are occurring all the time. Accordingly, the threat situation is also constantly evolving. Governments, companies and citizens are therefore called upon to continually find new answers to the challenges appearing in cyberspace.

As the integrated and national competent authority for the Austrian financial market, the FMA is fully prepared, in accordance with its supervisory principles and its strategic orientation, to develop appropriate regulatory and supervisory responses to the stream of new challenges from cyberspace in order to strengthen Austria as a stable, dynamic and innovative financial market in the heart of Europe.

# BIG DATA

## Opportunities and risks from a supervisory perspective

In almost everything we do in today’s digitised world, we leave behind more and more digital traces. This is true no matter what we do, whether it be scientific research, driving a vehicle, shopping, banking, listening to music, taking pictures, or talking on the phone. Digital traces like these represent valuable data that can be collected, stored, linked, analysed and utilised. While new telecommunications technologies enable huge volumes of data to be transferred and linked practically in real time, novel computer technologies allow the storing and processing of such gigantic amounts of data, and new data analysis technologies enable the data to be linked, analysed and evaluated, and new information to be generated. The catch-all term “big data” refers to this phenomenon, which involves generating ever greater amounts of data that allow very many uses.

### BRAVE NEW BIG DATA WORLD

Big data is nowadays generally described in terms of five dimensions – the 5 Vs of big data:

- **V as in “volume”**

It begins with huge volumes of data: user data collected from the Internet, social media, online retail trade, electronic banking and cashless payment systems; sensor data from machines and machinery such as vehicles and measuring devices; connection data from all telecommunications technologies of any kind; data from smartphones, web platforms and on-board systems, as well as data from intelligent household appliances, supply chains and payment systems. And these are just a few examples. These volumes of data are so huge that until recently they could hardly be stored, let alone analysed.

- **V as in “variety”**

Big data involves not only large volumes of data but also highly varying types of

data, including texts, tables, photos, videos, tweets, emails and voice recordings, to name just a few examples. Data in such formats travels through our networks in unsorted and unstructured form. The task in big data is to make these different formats compatible and to identify within the wealth of mixed data any patterns that allow commercial exploitation.

■ **V as in “velocity”**

Processing such volumes of data in such varying formats requires, in turn, complex computing operations involving large amounts of data. At the same time, information and results need to be generated rapidly, usually within seconds or even milliseconds. In addition to hardware with increasingly faster computing performance, such processing requires highly efficient and effective algorithms as well as optimum use of available storage space, even under heavy data loads.

■ **V as in “validity”**

The higher the data quality, the easier it is to process and analyse the data and the higher the validity of the computing results and the information derived. This is why it is important to optimise data quality, to cleanse the data of items that are incomplete, damaged or non-comparable or offer no additional information value, and to optimise the data formats as well.

■ **V as in “value”**

Data value means more specifically data utility, that is how well data can be exploited. This is about deriving new information from existing data to create new added enterprise value.

To sum up, the field of big data is about large volumes of data in potentially highly varying forms, which allow new information with an added value for someone to be derived at the highest possible velocity. This requires cost-effective and innovative information and communications technologies (ICTs) for the purpose of data processing and analysis.

Nowadays, data is available from numerous, highly diverse sources:

- Bank cards, credit cards, payment cards and customer cards
- Electronic communications, meaning not only call and connection data but also any geographic data on position or patterns of movement determined based on such data
- Electronic devices and systems used for private or business purposes, including health and fitness wristbands, or wearables such as activity trackers, smart watches or devices for ambient assisted living
- GPS-based navigation and position-tracking systems
- Social media such as Facebook, Instagram, WhatsApp and Twitter
- Search engines such as Google
- The Internet of Things, consisting of highly varied machines linked through a global network
- Networked household technologies (smart homes, smart metres)
- Motor vehicles, including data from navigation systems, computer-assisted and networked services such as driving assistants, and from the over 100 sensors built today into any mid-sized car
- Surveillance system (CCTV) recordings
- Data collected by public authorities and other institutions.

And this is only a small selection of data sources available in our brave new digital world.

**“Information about money has become almost as important as money itself.”**

*Walter Wriston, CitiBank, 1984*

The fact that such data can be highly sensitive, relating to individual privacy or business secrets, is obvious at first glance. Like any other innovation, a new tool such as big data can be equally used for good purposes or misused for harmful ones. It is clear, therefore, that many people are becoming concerned about their privacy, as more and more details about their lives and habits are recorded and analysed daily by businesses, agencies and governments. Other issues also arise, such as data sovereignty, data security and potential data manipulation. Such concerns are justified. What is needed is a well-balanced system of rules that ensure both adequate protection of individuals as well as sufficient freedom to encourage innovation and allow businesses to benefit from opportunities. Here regulation and supervision are called for.

Big data presents a challenge for companies too, with the brave new data world calling into question established business models while completely redefining the conditions for competition in many fields. Whatever else, big data enables companies to better understand customers and their “true” needs and to target new customers. Suggestions and information are generated for improving products or redesigning them to better meet customer needs, and ideas are even created for new products. Most of all, big data helps to optimise established processes for management, production, marketing and monitoring.

The insights resulting from analysis are nonetheless only as good as the data used as input for models and algorithms. In the case of financial companies, data analysis is a key management task, making data quality, consistency and scope even more important. Data therefore needs to be seen as a valuable corporate asset that requires extensive support through data management, to ensure the continued availability of high-quality, consistent and reliable data. It is similarly important that managers know the types and quality of any data that they themselves produce, any data additionally used, as well as the specific processes utilising this data.

The ability to analyse within a short time large volumes of structured and unstructured data originating from numerous sources requires extremely high-performance IT systems. With a surprising number of established financial providers, however, the ICT infrastructure used is dated, fragmented and internally compatible only under certain conditions. As a result of these limitations, such technical infrastructure can be used for big data only to a very limited extent, meaning such providers face the risk

**Like any innovation, a tool can be equally used for good purposes or misused for harmful ones. Regulation and supervision are called upon to define clear, unequivocal rules and to set limits.**

#### **BIG DATA IN FIGURES:**

The earth has **7 billion** inhabitants. Already **6 billion** mobile phones are in use worldwide.

Every month, **30 billion** items of information are shared on Facebook; the **200 million** active

Twitter users send **400 million** tweets every day.

Every trading day the NYSE produces **1 terabyte or 1 000 gigabytes** of data.

**One zettabyte** (or “1” followed by 21 zeros) of data existed worldwide in 2011; the figure will be

**40 zettabytes** by 2020.

of competitive disadvantages that are not to be taken lightly, especially when competing with FinTechs, big techs and established providers that have already upgraded their technologies.

Besides having extremely powerful IT and telecommunications systems, companies need in particular to build up appropriate internal expertise in order to utilise the full potential of big data. Accordingly, fierce competition is taking place to recruit the best minds in the IT industry. Additional recruitment efforts are also for staff who have a strong talent for analysis, are able to think systematically and are familiar with planning, implementing and interpreting analyses.

### **BIG DATA – IN APPLICATIONS**

Analysing data to understand and rate risks is a key task in economic life. The broader the database and the higher the data quality, the greater the accuracy with which risks can be recognised. Big data is providing tremendous benefits here. Big data also helps to better understand customers and consumers, while opening up new perspectives on strategies and operations relating to existing business.

#### **HOW HUGE DATA VOLUMES ARE PROCESSED**

Financial companies produce large volumes of more or less structured data, which they have to process and store themselves. Such data pools are supplemented by huge volumes of data from third-party sources. Novel big data applications such as Apache Hadoop allow intensive, distributed computing processes involving large amounts of data to be run on remote computer clusters. In this way, large volumes of data from numerous sources can be cleansed, structured and rapidly analysed. Applying machine-learning algorithms (artificial intelligence) makes it possible to continuously optimise, and thus also accelerate, computing processes.

Today many financial service providers already use big data software for reporting, planning, statistical forecasting and ad hoc analysis. In such high-performance analyses, various techniques are applied with the goal of quickly analysing large volumes of structured and unstructured data in order to harvest (business) intelligence, in real time if possible; examples of such methods include mass parallel processing (MPP), internal database analysis and in-memory analysis. In application, some of these techniques are already being linked in some cases. Visual analysis technology is adding a new dimension to data analysis: the capacity to rapidly and efficiently identify patterns and trends within large volumes of data.

#### **MANAGEMENT BY ANALYTICS**

Using high-performance analysis technology to generate new, additional information from huge amounts of data is one aspect of big data. It is another thing to recognise how such information and the new possibilities afforded will affect financial dealings. Digital transformation is catalysing a paradigm change in management, with decision-makers working for financial service providers in particular under pressure to embrace a new approach: management by analytics. Broadening and deepening analyses at a profound level through big data enables new fields of business and products as well as the redesign of existing ones for more profitability; more precise, differentiated and optimised pricing; holistic risk portfolio management; improved

fraud identification; and higher returns on investment. Such techniques can also be used for customer, risk and finance-based analyses. More stringent regulatory requirements, such as Basel III and IV for banking and Solvency II for the insurance sector, also provide incentives for management by analytics; specifically, within these complex supervisory models, big-data analyses allow targeted activities to optimise risk and meet minimum capital requirements. In all of these areas, the use of big data unleashes tremendous potential for commercial advantage.

## **PROGRAMMATIC MARKETING**

New potential for optimising marketing processes has been generated through merging and linking internal and external data and by automated processing of pooled data in real time. This approach, referred to as “programmatic marketing”<sup>1</sup>, makes it possible to tailor advertising messages to target either defined groups or individual customers, at the right time and in the proper context. Specifically, real-time data on individual impressions can be collected simultaneously from all channels and devices and analysed in real time using algorithms, with a fully automated response then prepared based on the information generated. For example, a personally tailored advertising message can be directed at a potential customer, depending on where the person is at the moment and on any website the individual previously visited or any topic they researched using a search engine. The message can be sent either directly to the person’s smartphone, tablet or PC or displayed as tailored advertising on their social media site. This simplifies online marketing, improving both efficiency and effectiveness and allowing optimum use of resources.

Programmatic marketing will be supplemented by “programmatic buying of all media” within the next few years. This will involve including other media channels – for instance conventional media such as television – in the process of tailoring advertising messages. According to current estimates, 30 to 60% of the European media market will be affected.<sup>2</sup>

## **BIG DATA – IN THE FINANCIAL SECTOR**

With digitisation omnipresent in the world of finance as well, big data will play a decisive role in whether providers will be able to compete in future, through mining their own big data or linking proprietary data with external sources. Analysing time series, determining correlations, identifying trends as well as the linking and/or restructuring of data and innovative segmentation of results – these activities make it possible to optimise processes, recognise new business opportunities and develop targeted marketing strategies.

Beyond this, financial sector digitisation has deeply affected relations between providers and their clients. While customers continue to require the same individual advice to meet needs related to investment, financing and old-age provision, the relationship between banks and banking customers, to name an example, has changed radically. Doing business with a bank branch used to be, and still is, highly personal, with customers usually taking the initiative to request extensive personal advice.

**Financial sector digitisation has deeply affected relations between providers and their clients. While customers continue to require the same individual advice to meet needs related to investment, financing and old-age provision, the relationship between banks and banking customers, to name an example, has changed radically.**

<sup>1</sup> *Programmatic marketing comprises programmatic buying (automated and scalable purchasing of media) and programmatic targeting (automated and scalable selection of appropriate target groups).*

<sup>2</sup> <http://digiday.com/agencies/programmatic-advertising-europe-country-country/>.

Electronic banking, in contrast, is impersonal and standardised, and can be initiated by either side. Smartphone banking is impersonal and standardised but interactive in real time, with the bank taking the initiative by offering tailored, individual products; this development has the potential of affecting the foundations of financial markets.

Big data technologies are being used in five fields in particular:

- **Business monitoring:** This involves monitoring business processes and controlling business performance, for example through benchmark analyses in relation to time periods, customer groups, product groups or similar variables. Applications in banking are in areas such as risk management, for comparing sales performance among branches or for benchmarking customer satisfaction.
- **Business insight:** Here big data is analysed with the goal of generating proposals for optimising current business models. An example in banking is the analysis of account usage data to enable product offers that are tailored to the customer's current situation. Another example would be to reactivate passive customers through targeted marketing.
- **Business optimisation:** This involves the integrated use of big data to optimise business processes on a continuous basis. One example is the use of algorithmic trading to optimise trading in securities and derivatives. Another example would be to monitor customer flows at branches or ATM use in real time, with the aim of minimising waiting times, for instance by reassigning additional staff or sending push-messages to customer phones suggesting alternatives.
- **Data monetarisation:** This refers to using big data to generate new sources of revenue, for example by selling data analyses to third parties, developing new products and services based on data analyses, or employing data analyses towards improved customer experience or stronger customer loyalty. One example would be to analyse bank account and credit card transactions to be able to automatically offer baggage insurance or foreign health insurance as soon as the customer makes a payment to a travel agency or airline.
- **Business metamorphosis:** This involves using big data relating to customers and products to exploit new business models. An example here would be to analyse customer account transactions to identify energy or telecommunications payments with the goal of offering and selling less expensive or better products from alternative suppliers.

In summary, financial service providers use big data technologies to monitor and optimise business processes, minimise costs, better exploit existing sources of revenue, and create new products, services and business models. Other goals include improved customer experience, as a means of strengthening customer loyalty or gaining new customers.

### **CUSTOMER EXPERIENCE/CUSTOMER SATISFACTION**

Through automated, ongoing monitoring and analysis of business relationships, a bank can, for example, deduce from an account transaction history when that customer will need to make a particular periodic payment, and remind the customer when the next transfer is due. Based on the transaction history, the bank can also recognise any impending costly overdraft resulting from irregular payments and, for example, recommend the transfer of corresponding funds from the customer's

savings or current account, or offer an inexpensive standardised loan to avoid the costly overdraft.

Using predictive methods, banks can identify any unsatisfied customers from transaction data, for example through automated analysis of complaints, call centre logs, or refused offers of products and services. This allows the bank to determine which customers are most likely to close their accounts. Such customers can then be approached specifically and offered better service or optimised products to encourage them to stay with the bank. Applying this method, credit card provider American Express discovered that almost one in four customers in Australia could cancel their accounts within the next four months, identified those customers and made them individual offers.

### **CROSS-SELLING/UP-SELLING**

Cross-selling<sup>3</sup> refers to the sale of an additional product to a customer who is in the process of buying or has previously bought a product. Up-selling means selling a better, more costly product to a customer who is interested in or has already purchased a product. Big data analysis is very helpful in both cases, since it allows the customer's personal circumstances, behaviour, financial situation and wishes to be deduced from the data. This helps in identifying the appropriate product and in tailoring advice and sales arguments to the customer.

An example here is Tokio Marine: the Japanese insurance undertaking has entered a cross-selling partnership with telecoms provider NTT docomo<sup>4</sup> to be able to analyse real-time data collected from connected user devices. This enables Tokio Marine to offer – and customers to accept – via a mobile app situation-dependent and personalised one-time insurance covering, for example, travel, skiing, golf and driving.<sup>5</sup>

### **ALGORITHMIC AND HIGH-FREQUENCY TRADING**

In automated or algorithmic trading of financial instruments – also termed algo-trading, black box trading, high frequency trading, flash trading and grey box trading – an algorithm embedded in a computer program automatically triggers a sales or purchase transaction, as opposed to an actual person taking a direct decision. The greater the amount of available data and the higher its quality, the more targeted is the algorithm's transaction decision. As speed is a consideration in this case too, it is essential for data processing to be as efficient and effective as possible to enable the system to take advantage of even very subtle signals at the earliest possible point in time.

Such algorithms can trigger or reinforce market movements intentionally or inadvertently, which can even lead to illegal manipulation of markets and prices. Thus, fake or actual trends can be triggered intentionally by entering orders openly or covertly, exerting pressure on market participants to take certain actions or sending out false signals to prompt other algo-traders to trigger automated orders. Another challenge is the increasing complexity of such algorithms, which makes it difficult to identify errors that can, in turn, result in losses to investors. For this reason, certain aspects of algo-

**Algorithms can trigger or reinforce market movements intentionally or inadvertently, which can even lead to illegal manipulation of markets and prices. Thus, fake or actual trends can be triggered intentionally by entering orders openly or covertly, exerting pressure on market participants.**

<sup>3</sup> Cross-selling is not used here in the legal sense as defined in, for example, the WAG 2018.

<sup>4</sup> [www.the-digital-insurer.com/dia/tokio-marine-partners-with-ntt-docomo-to-offer-one-time-insurance/](http://www.the-digital-insurer.com/dia/tokio-marine-partners-with-ntt-docomo-to-offer-one-time-insurance/).

<sup>5</sup> Nikos Kotalakidis, Jan Müller. Teil 4: Big Data in der Versicherungsbranche – Bestandsverwaltung [Part 4: Big data in the insurance sector – policy management]. Think with Google Deutschland.

rithmic trading are regulated even today, including access to exchanges and high-frequency trading. Banks using algo-trading are required, for example, to meet applicable compliance regulations to ensure that their trading systems are able to support the order load and in particular that any transmission of faulty orders is avoided.

### ASSET MANAGEMENT

Besides traditional sources such as company quarterly reports, financial analysis in the context of asset management is now increasingly drawing on, linking and analysing novel sources of data, including data from electronic banking and social media, and even weather data or satellite images where appropriate. The analysis of the linked data renders information that is used, for instance, as input for new investment fund strategies. In this way, big data is inherently changing conventional financial analysis<sup>6</sup> and becoming an integral part of the research process. Change is accelerating as the cost of technologies fall, machine-learning resources become more accessible and knowledge of analysis techniques improves. This makes it possible to utilise more and more data sources, improve investment models, and better evaluate customer behaviour patterns.<sup>7</sup>

Big data can also help improve the performance of actively managed investment funds. With an actively managed investment fund, the asset manager adapts the combination or the choice of assets to the market situation and any specific investment strategy. The goal here is to respond to any changes in the market and achieve the best possible return on investment, or supersede a benchmark. With a passively managed investment fund, the portfolio usually reflects a certain index, by selecting assets listed under the index or derivatives, with the goal of achieving the same return on investment as the index.

Nowadays, a market tendency towards passive investment funds can be observed, especially because this type involves significantly lower management fees, which consequently puts pressure on the profitability of the conventional business model pursued by asset managers. New, highly advanced machine-learning algorithms automatically analyse all past investment decisions to identify behaviour patterns that negatively impacted fund performance, for example because risk coverage in one case could otherwise have been more cost-effective, or decisions to buy or sell would have been taken differently if certain signals had been considered. Linking conventional and non-conventional data and analysing large and complex data sets can help asset managers: in improving fund performance, in gaining a competitive advantage, or in demonstrating the added value achieved through active fund management.<sup>8</sup>

In insurance and *Pensionskassen*, the use and analysis of big data can help improve asset-liability matching and optimise investment portfolios, while allowing embedded-value calculations and econometric modelling to be performed practically in real time. When calculating scenarios, both endogenous and exogenous parameters can be taken into account.

<sup>6</sup> *Joint Committee Discussion Paper on the Use of Big Data by Financial Institutions*. JC 2016 86, p. 9. [www.esma.europa.eu/sites/default/files/library/jc-2016-86\\_discussion\\_paper\\_big\\_data.pdf](http://www.esma.europa.eu/sites/default/files/library/jc-2016-86_discussion_paper_big_data.pdf)

<sup>7</sup> *Big data in asset management*. CRISIL 2017, pp. 4–6. [www.crisil.com/content/dam/crisil/our-analysis/reports/gr-a/whitepapers/big-data-in-asset-management-may2017.pdf](http://www.crisil.com/content/dam/crisil/our-analysis/reports/gr-a/whitepapers/big-data-in-asset-management-may2017.pdf)

<sup>8</sup> *An analytics approach to debiasing asset-management decisions*. McKinsey&Company, 2017, pp. 1 and 5. [www.mckinsey.com/~/media/McKinsey/Industries/Financial%20Services/Our%20Insights/An%20analytics%20approach%20to%20debiasing%20asset-management%20decisions/An-analytics-approach-to-debiasing-asset-management-decisions.ashx](http://www.mckinsey.com/~/media/McKinsey/Industries/Financial%20Services/Our%20Insights/An%20analytics%20approach%20to%20debiasing%20asset-management%20decisions/An-analytics-approach-to-debiasing-asset-management-decisions.ashx)

## “FAST QUOTES” IN THE INSURANCE AND BANKING INDUSTRIES

When determining premiums on non-life insurance policies or the terms of loans, models and algorithms based on big data enable “fast quotes” to be calculated almost instantaneously. To do this, customers need to provide only a few items of information, which are then, without the customer’s knowledge and practically in real time, automatically linked with big data to calculate the premium or terms of the loan.

United States-based health insurance start-up Oscar does without agents, brokers and branch offices, selling policies only via the web and a mobile app. With Oscar, fast quotes are calculated based on a few items of personal information (place of residence, age, income, family size and requested insurance package) which the customer enters in a simple online form.<sup>9</sup> The customer details are linked with big data to determine the individual risk level, and the premium is calculated in real time. Any subsequent communication or customer service takes place via the mobile app, while customers obtain first-level medical support, including prescriptions, through online consultations with doctors and nurses. Policyholders who wear an Oscar fitness wristband – essentially a pedometer and fitness tracker – receive a premium discount of a dollar a day. Oscar automatically collects data from interactions with customers via the app and from the tracker, linking this data with information from other sources to optimise customer service as well as the company’s business model.

Several years back, UK-based insurance provider Aviva already began to use forecast models based on standardised questionnaires as a substitute for costly health screening by physicians. Customers are asked to respond to questions relating to the area where they live, their income, hobbies, TV-watching habits and previous medical conditions. This information is then linked with data from big data sources and analysed. One research study<sup>10</sup> has shown this approach for predicting potential health risks to be equally effective as blood and urine testing but much more cost-effective and faster.

## TELEMATICS IN CAR INSURANCE

Today’s vehicles produce mountains of data. A mid-sized car, for example, has more than 100 sensors – for functions ranging from monitoring tyre pressure, fuel level and fuel consumption to measuring speed and displaying faults. This sensor data is first stored by the vehicle’s computer. Aids such as the parking assistant, cruise control and lane monitoring systems as well as the GPS system generate more mountains of data, which are transferred via telematics – the online transmission over telecommunications channels – to generate further additional data and information, including details of geographic position, mobility patterns and speed profiles. Telematics thus adds a huge dimension to capturing, processing and displaying vehicle data while providing detailed information about driving habits and typical vehicle usage.

Insurance undertakings can make use of the huge volumes of data collected from vehicles using telematics devices, to tailor car insurance policies and premiums to individual drivers. Data on factors such as kilometres driven, speed, driving habits

**Working with data and especially customer data has its limits where customer data protection or privacy is violated. Thus, financial service providers especially need to ensure that big data and analytics go hand in hand with compliance.**

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<sup>9</sup> Nikos Kotalakidis, Jan Müller. Teil 2: Big Data in der Versicherungsbranche – Produktentwicklung und Underwriting [Part 2: Big data in the insurance sector – product development and underwriting]. Think with Google Deutschland.

<sup>10</sup> Leslie Scism, Mark Maremont. Insurers Test Data Profiles to Identify Risky Clients. The Wall Street Journal.

and trip profiles are analysed in real time or later to improve risk assessments and enable appropriate rates to be determined. The results can also be applied towards creating entirely new products, such as usage and behaviour-based vehicle insurance policies. Rates can be set depending, for example, on actual kilometres driven or on the proportion of rural road to motorway driving.

#### **FRAUD DETECTION TOOLS**

Big data enables a number of predictive and quantitative techniques for automated detection of fraud attempts, for instance by identifying any deviation from business rules or any other anomaly, or through text analysis. Thus, the linking and analysis of highly diverse data sets from internal and external sources can indicate fraud. After a rear-end collision, the insurance company can, for example, automatically compare telematics data from the vehicle with details provided by the driver and any witnesses, and then link the information with the driver's accident history. This data is subsequently checked, using algorithms, for any typical features indicating probable fraud.

Credit card companies analyse customers' card usage and purchasing habits, broken down by location, specific sector or technical features, to detect any erratic deviations pointing to card misuse.

#### **REAL-TIME UNDERWRITING**

Using real-time data with behaviour-based insurance products enables real-time underwriting, that is personalised real-time quotations that can be signed immediately. Publication and subscription technology, such as Cloud Pub/Sub<sup>11</sup>, is used to transmit data in real time from the customer's user app (for example a wearable) to the insurance company, where the data is analysed, again in real time, using appropriate techniques. The real-time analysis allows the insurer to identify a product that is applicable to the customer's current, specific situation, to evaluate the individual risk profile and to offer the customer additional coverage. For example, when a customer enters a risky environment such as a steep ski slope or a boat on a lake or sea, this location data is automatically transmitted to the insurer and can be analysed in real time. Identifying a gap in insurance coverage, the insurer sends an automatic push message to the customer's smartphone, offering them appropriate coverage.

### **BIG DATA – APPLICATION IN AUSTRIA'S FINANCIAL SECTOR**

Despite the great potentials of big data, use of such data currently plays only a minor role among Austrian financial service providers, as shown by a recent FMA survey (see chart 20).<sup>12</sup> According to the FMA survey, already 26% of credit institutions and 24% of insurance undertakings apply big data techniques, yet only 85% of banks wish to make active use of this technology on a large scale, and only 42% of insurance companies. It also comes as a surprise that the investment firms and investment fund management companies surveyed are still hardly utilising this technology, with only

<sup>11</sup> <https://cloud.google.com/pubsub/docs/overview>.

<sup>12</sup> The chart shows the responses given by 33 insurance undertakings, 8 Pensionskassen, 8 corporate provision funds, 40 credit institutions, 16 investment firms and investment service providers, and 20 companies from the category of investment fund management, real estate investment fund management and alternative investment fund management.

one in five firms planning any active use at all. About 10% of *Pensionskassen* and corporate provision funds make active use of such data, but no additional activities are planned. With this reservation towards the new technology, Austrian companies risk losing competitiveness: compared with competitors in the national market and even more so with international providers, but also when compared with innovative providers such as FinTechs as well as providers from other sectors who meet the same consumer needs, or relative to big tech giants like Amazon, Google and Facebook, who plan to offer personalised standard products in a bid to dominate the financial markets as well.

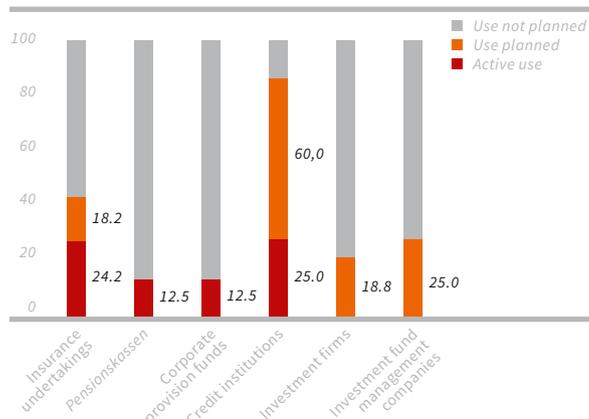


Chart 20: Use of big data by Austrian financial institutions (in %, FMA survey in 2018)

## BIG DATA – REGULATION AND SUPERVISION

Companies that are licensed and supervised by the FMA are faced with special regulatory requirements. Besides complying with the general obligation to identify, appropriately manage and where possible limit risks, such companies must also meet enhanced due diligence requirements.

### IT RISKS AND CYBER RISKS

Information and communications technology (ICT) encompasses all technical resources for the purpose of processing or transmitting information, according to the definition given in the FMA guides on ICT security.<sup>13</sup> Information processing includes the collection, capture, usage, storage, transmission, program-controlled processing, internal presentation and output of information.

The resulting ICT risk is defined as the current or future risk of losses due to the unsuitability or failure of the hardware or software of technical infrastructures, which may affect the availability, integrity, accessibility and security of such infrastructures or data. Also included within the scope of such risk are risks arising from ICT availability and service continuity, ICT security, ICT modifications, ICT integrity and ICT outsourcing.

Big data is included in the term “information”, so that when big data is collected, captured, used, stored, transmitted, processed in programs, internally presented or outputted<sup>14</sup>, the provisions of the applicable FMA guide on ICT security are generally to be observed.

Correspondingly, supervisory provisions relating to information sharing or even to data retention are to be applied at all times. Discerning the boundary between data and big data is somewhat challenging in the individual case. This is relevant because special, enhanced due diligence requirements apply to the use of big data. In the context of a specific application, it is primarily for the supervised company to decide from which step the data being processed is to be classified as big data. From that

<sup>13</sup> FMA Guide of 8 May 2018 on ICT Security in Credit Institutions, [www.fma.gv.at/download.php?d=3371](http://www.fma.gv.at/download.php?d=3371), p. 4; FMA Guide of 3 July 2018 on IT Security in Insurance and Reinsurance Undertakings, [www.fma.gv.at/download.php?d=3518](http://www.fma.gv.at/download.php?d=3518), pp. 4 and 5; FMA Guide of 29 August 2018 on IT Security in Management Companies (currently available in German only), [www.fma.gv.at/download.php?d=3597](http://www.fma.gv.at/download.php?d=3597), p. 4; FMA Guide of 29 August 2018 on IT Security in Investment Service Providers and Investment Firms (currently available in German only), [www.fma.gv.at/download.php?d=3598](http://www.fma.gv.at/download.php?d=3598), p. 4.

<sup>14</sup> To facilitate readability, “usage” and “processing” of big data are to be understood here in this broad sense.

**Data represents a huge, highly profitable market. Facebook, Google and Amazon are adept at using intelligent means to monetise their users' data. Financial service providers are still lagging far behind in this respect.**

point onwards, the supervised entity is obliged to define and observe, as special safeguards<sup>15</sup>, enhanced due diligence requirements relating to governance in particular.

The potential supervisory requirements relating to governance that need to be met when using big data concern in particular the directors' responsibility, the organisational structure required, control of risk appetite, outsourcing requirements, as well as internal control systems and the responsibilities of the internal audit department.

#### **RISK APPETITE**

The use of big data leads to a higher risk for a supervised entity. It is therefore necessary for the existing risk appetite framework to be considered in decisions related to big data use. One potential outcome is that comprehensive use of big data is not considered compatible with a conservative risk appetite.

#### **ORGANISATIONAL STRUCTURE**

Supervised companies are required to document those departments that use big data. This documentation has to be kept up to date, especially when any affected systems and processes are modified.

The first step in doing this is to define the point where data is aggregated and/or processed to an extent which would require the data to be classified as big data. The initial classification of the process step and organisational unit in which this state of processing is achieved is a matter falling within the responsibility of the competent specialist departments in consultation with the legal department or the compliance function. In accordance with the "three lines of defence" model, this classification is first to be verified internally by the compliance function and the internal audit function and then be put through an external audit, for example by an independent auditor, and finally be submitted to the FMA as the instance of state supervision.

Whether the data was originally generated by the company or originates from external sources is lastly irrelevant for the classification of the data as big data for supervisory purposes. When the data stems from an outside source or was aggregated or otherwise processed by a third party, the case has to be examined to determine whether this constitutes major outsourcing, since additional documentation and reporting requirements apply in such cases.

In a second step, referring to the company's own definition of big data, the supervised entity is required to identify where big data is used internally within the organisation and the processes. Use within the organisation here means those internal organisational units and/or third parties that use the big data at least during one step of a workflow. This broad definition of big data use is also to be applied when identifying the processes using big data. The outcome of the evaluation must be clearly documented.

Big data use is to be described in particular in the ICT strategy, which defines and documents the types, scopes and complexity of all ICT activities. The ICT strategy must be additionally modified the first and every time there is a change in big data use, with this strategy being an important source of information for tying in ICT with income and risk control and with ICT audits.

<sup>15</sup> Federal Financial Supervisory Authority (BaFin). *Big data meets artificial intelligence*. [www.bafin.de/SharedDocs/Downloads/EN/dl\\_bdai\\_studie\\_en.html](http://www.bafin.de/SharedDocs/Downloads/EN/dl_bdai_studie_en.html), p. 13.

## BIG DATA – A MACROECONOMIC VIEW

The rise of big data will undoubtedly change the way companies do business. Yet, what will be the aggregated effects, i.e. the impact at the macroeconomic level?

Several marked changes, listed in the following, can already be anticipated.

### ■ **Economies of scale lead to stronger market concentration**

Using and correlating large volumes of data has the potential of significant positive economies of scale. In other words, large firms benefit from inherent cost and revenue advantages. A company collecting a growing amount of data from a growing number of customers benefits from network effects that are amplified at a non-linear rate with size. Such economies of scale are observed especially when data from different fields of business are involved (for example banking and insurance). Thus, we can expect growing market concentration in the financial sector as a result of big data.

### ■ **Increasing market segmentation while excluding groups of participants**

In an environment of systematic uncertainty, markets can profit from a dearth of knowledge. Insurance works because it is not known beforehand who will and who will not be affected by a specific risk. Paradoxically, the insurer always has an incentive to resolve such uncertainty to the greatest possible extent. The technical possibilities opened up by big data therefore threaten the fundamental notion on which insurance rests: knowing beforehand who is exposed to detrimental risks undermines the principle of risk pooling, so that no insurance is taken out.

This paradox is not limited to the insurance sector. The lending model practised by banks also profits from this kind of effect. In lending it is not known beforehand which loans will default and which will not. Yet, by using large amounts of data and automated analysis techniques, an individual market participant can secure an advantage and pick out the better risks. The aggregated effect of this practice is, however, to worsen the average risk borne by the other market participants.

In the extreme case, when risk forecasting based on very broad data becomes almost perfectly reliable, the market can become segmented, with some market participants receiving insurance coverage or loans only on very poor terms and possibly even being eliminated completely from the market. In such cases, researchers refer to the danger of “pooling equilibrium” being replaced by “separating equilibrium”.

Pooling is also a factor in trading on securities markets. Liquidity depends on the existence of a sufficient number of market participants who trade based on non-privileged, idiosyncratic information. Where a large share of market participants has an information advantage gained from data analysis, an environment forms in which the participants can suddenly become unwilling to trade securities within very narrow price margins.

### ■ **Reduced price of services**

The systematic use of large volumes of data can reduce the costs of financial intermediation and subsequently reduce the price of financial services relative to other goods and services. Such price reductions could dominate on the whole, giving in total more people access to insurance and banking services. Similar changes can be observed for trading on securities markets. Some estimate that already 90% of trading volumes are to be attributed to data-driven algorithms. Prices for small transactions by retail investors have nonetheless dropped in recent years, and this trend has resulted in increased activity among this category of investors.

### ■ **Policy-based countermeasures**

Political responses could be made to counteract the potential negative impact and effects of these changes. Policymakers and the public increasingly turn their attention to the consequences of market concentration as it especially increases in data-heavy sectors. In the context of FinTech, big tech and big data regulation in the financial sector, competition authorities are considering measures to counteract the economies of scale brought on through data use. In response to the negative impact felt in the form of market segmentation, in the insurance industry in particular, policymakers expressly prohibited discrimination in the past and thereby forced risk pooling.

Existing documentation requirements can in future be supplemented by outcome checks. Such checks involve analysing the outcomes produced by an algorithm under the conditions of a test scenario specified by the supervisory authority.

#### **DIRECTORS' RESPONSIBILITY**

As part of the general due diligence requirements applying to them, the directors of a supervised entity are to obtain information on the specific risks and any modified risks resulting from the use of big data. The directors are under obligation to control, monitor and limit the additional or modified risk. The existing internal control mechanisms as well as internal reporting are to be adapted and expanded accordingly.

The directors are to be fully aware of their responsibility for the use of big data (as well as of algorithms) while considering in particular that such use does not limit their responsibility or even – were big data use to be regarded as a “black box” – exclude it. This should also not result in it becoming later impossible to understand why decisions were taken. Instead, a supervised company must at all times have a comprehensive understanding of where big data comes from and how it is processed within the enterprise. Big data use must be embedded in an effective and appropriate business organisation complying with regulations and in an effective control system, both of which are documented.

#### **OUTSOURCING**

The term outsourcing refers to any kind of agreement reached by a supervised entity and a third party (service provider). Based on such an agreement, the third party supplies – either directly or through further outsourcing – a process, service or activity that the supervised entity would otherwise be required to supply. Additional, special requirements apply when credit institutions or investment firms outsource to “cloud providers”.<sup>16</sup> Becoming an increasingly important factor in ICT outsourcing, such providers frequently also play a major part in big data outsourcing.

The supervised entity should first of all determine whether the outsourcing of services related to big data requires modification of its outsourcing policy. This may already be the case where, for example, such a provider supplies the software used with big data. The temporary or permanent storage of big data on an external server can also require modification of the outsourcing policy.

In addition to modifying the outsourcing policy, current outsourcing agreements as well as model clauses for new outsourcing agreements have to be reviewed and if necessary modified.

In detail, such agreements must stipulate that the service provider, when using big data, is also subject to enhanced due diligence requirements, which are to be applied as special safeguards. The supervised entity is to periodically verify application of such safeguards under the appropriate circumstances.

The supervised entity is required to comply with the documentation requirements relating to outsourcing, as well as any notification and reporting obligations that are set out in supervisory law.

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<sup>16</sup> Committee of European Banking Supervisors. *Guidelines on Outsourcing*, [www.eba.europa.eu/documents/10180/104404/GL02OutsourcingGuidelines.pdf.pdf](http://www.eba.europa.eu/documents/10180/104404/GL02OutsourcingGuidelines.pdf.pdf).  
EBA's *Recommendations on outsourcing to cloud service providers*. [https://www.eba.europa.eu/documents/10180/2170125/Recommendations+on+Cloud+Outsourcing+%28EBA-Rec-2017-03%29\\_EN.pdf/e02bef01-3e00-4d81-b549-4981a8fb2f1e](https://www.eba.europa.eu/documents/10180/2170125/Recommendations+on+Cloud+Outsourcing+%28EBA-Rec-2017-03%29_EN.pdf/e02bef01-3e00-4d81-b549-4981a8fb2f1e).

## INTERNAL CONTROL SYSTEM AND INTERNAL AUDIT FUNCTION

When assessing internal risks, for example when preparing the ICAAP in the case of banks, the financial service provider's risk management is to take big data into account. The risk management function is to consult the ICT strategy for details of the types of risk concerned, while assuming in the least that IT risk (as part of operational risk) will be impacted. The growing volume of data will, for example, result in higher exposure to external access while at the same time making it less possible to monitor the data that is used and distributed. Another factor needing to be considered is reputational risk, potentially resulting from data misuse or any information security holes. The compliance function is responsible for verifying whether big data use complies with supervisory requirements. These include in particular provisions to ensure IT security, to prevent money laundering, and to protect data privacy and consumer interests, the latter especially with regard to data sovereignty (in other words, the right of individuals to enjoy effective control over their personal data) and ensuring non-discriminatory access to financial products.

The internal audit function is to additionally include compliance with such provisions as a focus area when checking the organisational units and processes using big data.

The use of big data is not only the subject of monitoring but can also serve to optimise monitoring activities. It is conceivable for big data to be used, for example, in combination with artificial intelligence in activities to prevent money laundering and fraud, in risk assessment, or in the detection of anomalies and patterns. If they are to be forwarded, the results of such algorithm-based checks nonetheless must be able to be reproduced by the competent authority in the particular case.

The algorithms and the data processing used in monitoring procedures contribute to the effectiveness and efficiency of monitoring processes, as long as they do not represent an additional black box. Seen in this way, big data use does not necessarily always aggravate risk.

## BIG DATA – THE CHALLENGES

Digitisation and big data are affecting the financial sector fundamentally. With national boundaries becoming practically irrelevant in the digital world, future markets and market participants will become more closely interconnected than ever before. This trend opens up tremendous opportunities for new providers, products and services, while strengthening competition and challenging incumbent providers to continuously adapt themselves and their business models to changes in the market.

Yet digitisation and big data also entail risks not to be taken lightly. The resulting increased interconnection within the global financial system, especially across borders, often brings with it concealed yet serious risks of contagion. Turbulence and crises can spread at an especially fast rate. International cooperation — both in regulation and supervision — needs to be intensified on a broad scale in response.

Regulation and supervisory practices continue to differ widely in many areas, in terms of geography as well as in relation to products and sectors. As a consequence, there is a risk of providers running their businesses from locations with the lowest supervisory standards. A stop needs to be put to this sort of supervisory arbitrage, through stronger international cooperation in line with the principle of “the same rules for the same business with the same risk”. This also contributes to a level playing field for all.

**Digitisation and big data entail risks not to be taken lightly. The resulting increased interconnection within the global financial system, especially across borders, often brings with it concealed yet serious risks of contagion.**

At the same time, in view of the future trend towards automated decision-making using big data as well as artificial and self-learning intelligence, managers are called upon to consistently exercise their responsibility. Due diligence obligations and responsibility cannot and must not be shifted to machines, regardless of their “learning abilities” or how “intelligent” they are.

Nor should complex models be allowed to result in opaque decisions or to stand in the way of a properly structured business organisation. Governance, in other words control, will need to advance in step with technological progress. While supervisory authorities will have to further develop their own instruments, they will also need to ensure that companies upgrade their control instruments.

The use of big data entails potential threats for consumers as well. Algorithms as well as artificial and self-learning intelligence techniques can lead to discrimination against certain consumer groups, caused by opaque calculation methods or inappropriate use of personal data (transaction information allows conclusions relating to sensitive personal data, including gender, sexual orientation or ethnic group, even if such data is not explicitly collected).

What is more, consumers are disadvantaged through having an asymmetric amount of information compared with companies. Which data is used for what purpose is unclear in many cases, as is the way in which data is potentially shared. Consumers thus need to be made more strongly aware of the value of the data they disclose, as well as of the consequences that disclosure has for them personally and as a group. Citizens’ right to protection of their personal data can also be easily violated. The issue of who may use the data has to be resolved openly – even in the case of data rendered anonymous. This implies the key importance of measures aimed at supporting consumers’ sovereignty over their data.

Supervisory authorities need to target these issues, in particular through measures aimed at collective consumer protection.

In all of these areas, it is necessary to ensure efficient and effective compliance with regulatory requirements. The integrated approach to supervision, uniting responsibility for supervising the entire national financial market under the roof of the FMA, has proven highly effective for the small Austrian economy with its close network.

# ICOs

How this new form of crowdfunding fits into the regulatory framework

**I**ncreasing numbers of start-ups and innovative projects are turning to alternative forms of financing. Key in this context is the ability to independently procure investors and raise capital via new media in close proximity to the company's future customers and business partners. Initial coin offerings (ICOs) are a particularly popular alternative form of financing that is currently experiencing a boom in the digital world and the crypto economy.

However, this digital, and usually cryptoeconomic, form of financing frequently also poses regulatory challenges: on the one hand, the initiators are usually unfamiliar with financial market law and, on the other, some areas of the digital realm are uncharted legal territory for financial market regulators. Therefore, back in 2016, the FMA set up a "FinTech point of contact" as a one-stop shop where FinTechs and those planning an ICO can receive an assessment as to whether their digital business and/or financing model is subject to statutory regulation. This FMA service has been in high demand ever since.

Whether an ICO falls under supervision by the FMA depends largely on the structure of the individual financing model and can only be decided on a case-by-case basis. Nevertheless, it is important for the FMA to provide general guidance about areas which may be affected by compliance obligations under its supervision.

## **ICO – A NEW DIGITAL FINANCING MODEL**

The digital world and the world of ICOs bring with them a range of new terminology: crypto assets, coins, tokens, virtual currencies and many more. Recently, the term "crypto asset" has been adopted by many as an umbrella term for these digital financing instruments. A legal definition currently exists only for the term "virtual cur-

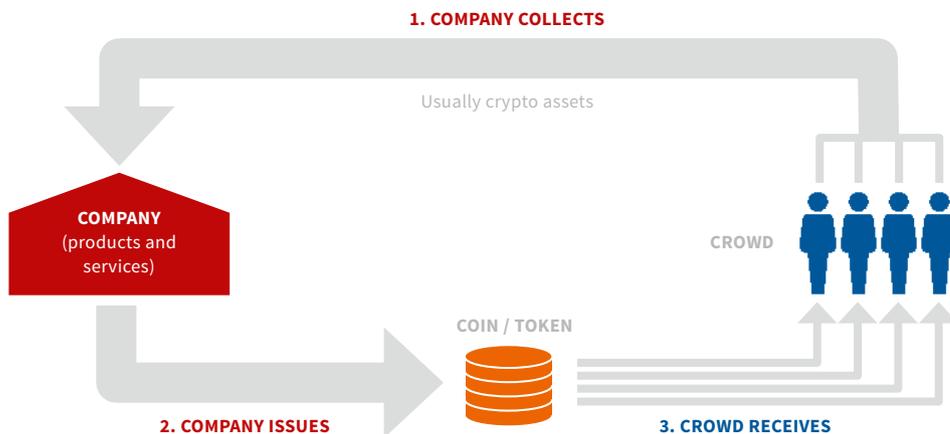


Figure 9: Model of an ICO

rency” (see Article 3(18) of Directive (EU) 2018/843). Despite the legal definition, however, the term “virtual currency” has come under strong criticism because the instruments involved lack essential characteristics of a currency in the conventional sense, in particular a stable exchange rate, general acceptance and functionality as legal tender, i.e. debt-discharging means of payment. “Crypto asset” will therefore be used here as a general designation. The terms “coin” and “token” are often used synonymously despite technical differences, and are also used as such in this article.

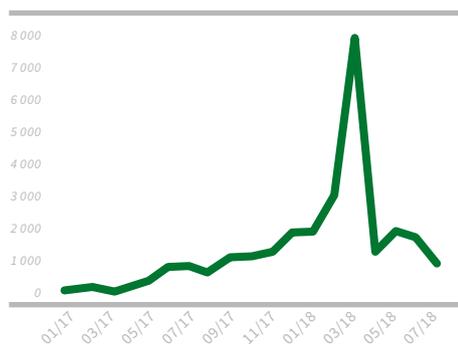
As a rule, an ICO is a form of corporate or project financing based on the blockchain technology. Capital is usually collected in the form of specific crypto assets (Bitcoin, ETH or similar coins or tokens). In return, the capital providers receive a coin or token from the issuer, which is linked to the company or project of the ICO organiser. The coin or token may, for example, constitute a shareholding in the company, frequently a start-up, or a claim to future profit.

### ICO – REGULATORY LINKS

The basic logic of ICOs is clear and simple, but in practice they often vary widely from a technical, functional and economic standpoint, which makes it impossible to define a generally applicable supervisory classification<sup>1</sup>. In addition, there are currently no specific supervisory regulations on ICOs at either European or Austrian level. However, depending on the specific design of the ICO, there may be links to existing supervisory law. The raising and use of capital, as well as the legal position of the coin or token holders, are of particular relevance in assessing these links.

To start with, a determination must be made in each case as to whether a financial service requiring a licence is provided in connection with the ICO or whether the obligation to publish a prospectus is triggered. Financial services may include payment services, banking activities, electronic money activities, investment services, insurance business or the operation of a stock exchange.

Chart 21: Financing volume of ICOs per month worldwide (in \$ millions; source: Bruegel Policy Contribution, No. 14/September 2018)



<sup>1</sup> The following regulatory classifications reflect the status of the laws and their interpretations as at 1 November 2018. Accordingly, they are subject to change, both at European level and through any modifications of the national legal framework, e.g. resulting from establishment of a legal definition.

## AUSTRIAN BANKING ACT (BWG)

- **Deposit business:** Where capital is not collected in the form of crypto assets, but in the form of a legal currency, and where the ICO provides for repayment of such capital, a licence for deposit business within the meaning of Article 1 para. 1 no. 1 (acceptance of funds from other parties for the purpose of administration or as deposits) may be required.
- **Issuance and administration of payment instruments:** If the ICO provides that the generated coin is usable as a means of payment, irrespective of the form of capital received (crypto assets or legal currencies), a licence for issuance and administration of payment instruments pursuant to Article 1 para. 1 no. 6 may be required, depending on the specific design of the ICO.
- **Third-party securities issue underwriting:** Article 1 para. 1 no. 11 BWG also defines a separate licensing requirement for participation in underwriting third-party issues of certain instruments (e.g. transferable securities). Realisation of a bond issuance in the form of a token via the blockchain (“tokenised” bond) for a company, i.e. the technical execution of an issue, the underwriting of securities/instruments and their placement including related services, could fulfil this licensing requirement.
- **Custody business:** The commercial safekeeping and administration of securities for other parties is subject to licensing as custody business pursuant to Article 1 para. 1 no. 5 BWG, irrespective of the technical means, e.g. also using blockchains and smart contracts, provided that a custody agreement exists. In this case, an agreement is concluded on the tokenisation of a security and smart contracts are made available for data storage and administration of all rights and obligations associated with the bonds.

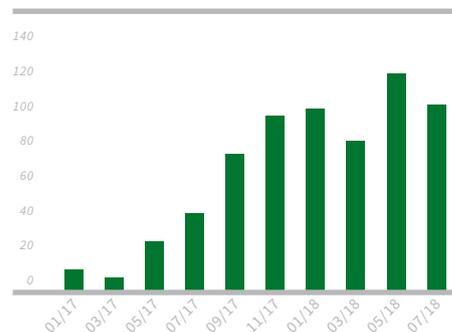


Chart 22: **Number of ICOs per month worldwide** (source: Bruegel Policy Contribution, No. 14/September 2018)

## GLOSSARY

- **Crypto asset:** A type of financial asset based on cryptography and distributed ledgers or similar technology. Crypto asset can be understood as an overarching category.
- **Coin/Token:** These two terms are not sharply differentiated from each other. Both refer to a kind of digital “container” which can embody a right or a claim. They can have different functions and also have different technical features. If an existing blockchain is used, “tokens” is the more frequently used term, whereas “coins” are spoken of more frequently where a separate blockchain is used.
- **Wallet:** An “electronic purse” through which crypto assets can be digitally assigned.
- **Virtual currency:** A digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically (Article 3(18) of Directive (EU) 2018/843).
- **Blockchain:** A blockchain is a continuously expandable list of data records, called “blocks”, which are linked together by cryptographic means.
- **Smart contracts:** Computer protocols that map or review contracts or technically support the negotiation or execution of a contract.

**The vast majority of Austrians who are basically interested in crypto assets have identified the problem of illegal Internet transactions and see a high risk of fraud and online theft, which is why they advocate strict government regulation of Bitcoin and similar coins.**  
*OeNB-Barometer Q2/2018*

### **SECURITIES SUPERVISION ACT 2018 (WAG 2018)**

Coins or tokens may constitute financial instruments as defined in the WAG 2018, in particular transferable securities. There is a strong indication for such classification if the rights associated with the coin or token are comparable with known classes of securities. In particular, the conferring of voting rights, rights to shares in profit, tradability, the promise of interest payments or the repayment of invested capital at the end of a specific term suggest the classification as a security (see also “Security tokens”). Even if it does not meet the criteria of a security based on its specific design, a coin or token could nonetheless be classified as a financial instrument within the meaning of the WAG 2018.

In such cases, depending on the further structure of the ICO, an investment service requiring a licence under the WAG 2018 may exist.

### **E-MONEY ACT 2010 (E-GeldG 2010)**

Pursuant to Article 1 para. 1 E-GeldG 2010, electronic money is defined as all electronically stored, including magnetically stored, monetary value in the form of a claim on the electronic money issuer, issued on receipt of funds for the purpose of making payment transactions as defined in the Payment Services Act 2018 (ZaDiG 2018; *Zahlungsdienstegesetz*)<sup>2</sup> and which is accepted by a natural or legal person other than the electronic money issuer. In the context of an ICO, payment tokens in particular may be functionally considered electronic money designed to conduct payment transactions and accepted by third parties in lieu of payment.

In contrast to some other crypto assets (e.g. Bitcoin), ICOs generally have a “central issuer”, which satisfies the criterion for the existence of an issuer. In order to meet the requirements of Article 1 para. 1 E-GeldG 2010, the issuance (of the token) must furthermore be made against payment of a sum of money. Such payment must be made using a legal means of payment, whether in the form of cash or book money. Payments in both domestic and foreign currencies are encompassed in this definition, including currencies from non-EU countries. Moreover, a claim must exist against the electronic money issuer.

Whether an ICO falls under the licensing obligation of the E-GeldG 2010 therefore depends on its specific design (case-by-case review) and whether it results in a payment in the form of “money” (legal tender).

### **PAYMENT SERVICES ACT 2018 (ZaDiG 2018)**

The commercial provision of payment services also requires a licence. An ICO may satisfy the criteria for the issuance of payment instruments or the acceptance and acquiring of payment instruments (Article 1 para. 2 no. 5 ZaDiG 2018).

A payment instrument is any personalised device(s) and/or personalised set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order (Article 4 no. 14 ZaDiG 2018). Typical payment instruments include online banking with a PIN or the use of a debit card (such as an ATM card) with a PIN. In principle, however, any instrument can be considered a payment instrument used to initiate a payment order, so the concept is to be understood in very broad terms. In the case of an ICO, designation as a payment

<sup>2</sup> Article 4 no. 5 ZaDiG 2018.

instrument depends on whether the issued token is personalised or designed in such a way that it can be used by any holder and is thus transferable.

As is the case under the E-GeldG 2010, the ZaDiG 2018 does not apply if there is no transfer of money (legal tender).

### ALTERNATIVE INVESTMENT FUND MANAGERS ACT (AIFMG)

An ICO may also fall within the scope of the AIFMG. Any undertaking that gathers capital from a number of investors in order to invest it according to a pre-determined investment strategy for the benefit of the token/coin holders is deemed to be an alternative investment fund (AIF) as defined in the AIFMG. The manager of such an AIF (usually the issuer in the case of an ICO) must therefore comply with the provisions of the AIFMG.

### CAPITAL MARKET ACT (KMG)

The public offering of securities or admission to a regulated market for securities or the public offering of investments in Austria are subject to the obligation to publish a prospectus in accordance with the KMG. In the case of a security as defined in the WAG 2018/KMG (as described above), a securities prospectus within the meaning of the KMG must be drawn up and published (see Figure 10). If a coin/token is not a security as defined in the KMG/WAG 2018, it may nonetheless be subject to a prospectus requirement as an investment. In such cases, an investment prospectus within the meaning of the KMG must be drawn up and published. This applies, for example, if a coin/token grants the respective holder proprietary rights vis-à-vis the ICO organiser and the investors form a risk-sharing group collectively or together with the issuer but a transfer of these rights is not possible or only possible to a limited extent.

## COINS AND TOKENS – CLASSIFICATION UNDER SUPERVISORY LAW

There is currently no legally recognised classification of tokens either in Austria or at European or international level. Generally speaking, there are three different types:

- Security/Investment tokens (hereinafter “security tokens”)
- Payment/Currency tokens (hereinafter “payment tokens”)
- Utility tokens.

This breakdown does not represent a regulatory classification, but merely provides an overview of the most common token types found on the market. Their differentiation

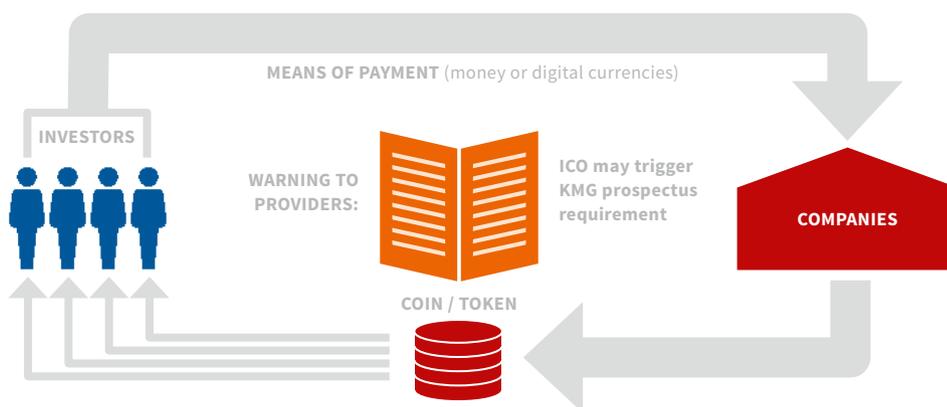


Figure 10: Prospectus obligation for ICOs

from one another is also not sharp; there are many mixed forms. Moreover, the list is not exhaustive; there are other types of tokens.

### SECURITY TOKENS

Security tokens embody claims to payments (“future cash flow”) from the issuer, which may be structured according to company law or the law of obligations. Furthermore, rights under company law, such as voting rights at a general meeting, may also be associated with security tokens. Such tokens therefore usually constitute claims to payment of capital, whether in the form of participation in the profits of the company or in the form of interest and repayment. In this context, it is not absolutely necessary for these claims to exist in legal currency. The design of such security tokens is similar to that of “traditional securities”, in particular shares and bonds. Security tokens are therefore frequently considered securities as defined in the KMG and the WAG 2018. A detailed description can be found in the adjoining text box “Security and regulation”, in which questions relating to prospectus and licensing requirements are also discussed.

### PAYMENT TOKENS

A payment token is a type of token, the primary purpose of which is a payment function. Payment tokens therefore represent a specific value with which goods or services can also be purchased from persons other than the issuer. Payment tokens are not intended for any other use.

Depending on the specific design of the ICO or the coin/token, there may be various circumstances requiring a licence. Issuing a payment token may fulfil the licensing requirements for the issuance and administration of payment instruments pursuant to Article 1 para. 1 no. 6 BWG and the issuance of electronic money as defined in the E-GeldG 2010. It depends on whether the token is accepted for payment by third parties and whether it can be purchased or exchanged for (or paid out as) money, i.e. legal tender. When issuing payment instruments in accordance with Article 1 para. 2 no. 5 ZaDiG, on the other hand, the key determinant is personalisation as described above.

The common feature of all these three cases is that there is no obligation to obtain a licence if there is only a “limited network”. The legislator does not intend for small and specific systems to fall under the strict supervisory regime. However, once a system enables a broad range of applications, it should be regulated. Open networks are therefore not covered by the licensing exemption, as they are generally intended for a steadily growing network of service providers. Coins/Tokens that are intended to achieve broad acceptance therefore do not fall under the definition of a limited network. Whether a system constitutes a limited network is determined based on the following criteria: the geographical range of the system, the number of accepting entities, the variety of available products and services, restrictions on validity and any limits on coin/token value.

The FMA bases its supervisory assessment of licensing obligations on the following questions:

- Who is the issuer, or who generates the payment token?

## SECURITY AND REGULATION

### WHAT IS A SECURITY?

For an instrument to be deemed a security as defined in the KMG/WAG 2018, all of the following criteria must be satisfied:

- **“Embodiment” of the right:** The right is dependent on possession of the security; according to prevailing legal opinion<sup>3</sup>, a conventional securitisation in the form of a (global) certificate is not necessary to fulfil the European definition of a security.
- **Tradability on the capital market:** The securities are structured identically in large numbers and are interchangeable (standardisation). They can be transferred and traded without restriction (transferability). It must be possible, at least in principle, for the securities to be traded on a capital market; concrete listing or inclusion in a market is not necessary (no requirement for specific tradability on the capital market).
- **Comparability with shares, bonds or similar securities:** European lawmakers have defined three typical classes of security by way of example, and listed shares, bonds and similar securities in particular. Basic comparability with these typical classes is a prerequisite.
- **Not an excluded instrument:** Certain instruments are excluded from the definition of securities, e.g. certain payment instruments, bills of exchange, savings passbooks or money market instruments.

### ARE “SECURITY TOKENS” SECURITIES?

Security tokens generally qualify as securities under the KMG/WAG 2018 as the above criteria are met:

- **“Embodiment“:** The proprietary right usually depends on “possession” of the token. In the event of a transfer, the various functions (legitimation, evidential, presentation and transport functions) are generally transferred to the new holder. Documentation using blockchain/distributed ledger technology can be considered sufficient.<sup>4</sup>
- **Tradability on the capital market:** As a rule, tokens are standardised and transferable without restriction. “Listing” or “inclusion” on a trading platform for crypto assets is usually possible without the need for further action.
- There is generally **“no exclusion” from definition as a security** since, as a rule, the focus is not on a payment function but on claims against the issuer.
- **Comparability with classes of securities tradable on the capital market:** This criterion depends on the legal claims against the issuer and is generally also satisfied in the case of claims to “future cash flows”.

### EXAMPLES

The following examples are intended to illustrate the classification of security tokens as securities:

- A token entitles the holder to participate in the profits of the issuer; five per cent of the profit stated in the balance sheet is distributed (similar to shares) to all token holders (pro rata based on units held).
- A token entitles the holder to receive three per cent interest per year, and the principal is to be repaid after ten years (similar to bonds).

If, based on its specific design, a token or coin is not a security as defined in the KMG/WAG 2018, it may still constitute an investment within the meaning of the KMG, in particular if the token/coin is not transferable or its transfer is limited but it embodies claims to capital or interest and a risk-sharing group exists. In the case of a public offering, an investment prospectus in accordance with the KMG is then required.

### WHAT ARE THE RESULTING OBLIGATIONS?

If a token/coin is classified as a security, this triggers various obligations under financial market law, depending on the precise business model. Below is an overview of the most important obligations: >

<sup>3</sup> Kalss/Oppitz/Zollner. *Kapitalmarktrecht*<sup>2</sup> [Capital market law], Article 11 para. 15; Zivny. *KMG*<sup>2</sup>, Article 1 para. 69.

<sup>4</sup> Dobrowolski. *GesRZ* 2018, p. 147 (156); Zickgraf. *AG* 2018, p. 293 (302); Hacker/Thomale. *Crypto-Securities Regulation* (see [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3075820](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3075820)).

**■ For offerors/issuers:**

The public offering of securities requires publication of an officially approved securities prospectus and is subject to the KMG (e.g. prohibition of misleading advertising and, if applicable, the obligation to prepare supplements to prospectuses), provided no exemption from the obligation to publish a prospectus exists.

**■ For trading venues that “list” or include such tokens:**

Depending on the type of trading, it is usually to be assumed that the operator of the trading venue is subject to a licensing obligation, for example as an exchange, a multilateral trading facility (MTF) or an organised trading facility (OTF). This is specified in the Stock Exchange Act 2018 (BörseG 2018; *Börsegesetz*) and the WAG 2018. In the case of listing or inclusion on a trading venue, for example on a regulated market or an MTF/OTF, the rules to prevent the abuse of inside information and market manipulation as well as various reporting and disclosure obligations also apply.

**■ For providers of investment services:**

Apart from the operation of an MTF/OTF as described above, the commercial provision of investment advice, the receipt and transmission of orders as well as portfolio management in relation to tokens that are classified as securities also require a licence under the WAG 2018.

**■ For commercial safekeeping of tokens for third parties:**

If custody business within the meaning of the Securities Deposit Act (DepotG; *Depotgesetz*) is provided, this results in a licensing obligation as banking business under the BWG.

**■ In addition, the following rules may apply:**

Depending on the precise procedure or business model, a wide range of rules and regulations must be observed in conjunction with securities transactions, for example: DepotG, European Market Infrastructure Regulation (EMIR), Securities Financing Transactions Regulation (SFTR), Benchmarks Regulation, prohibition of short selling, Central Securities Depositories Regulation (CSDR), Nationalbank Act (NationalbankG; *Nationalbankgesetz*) or the Settlement Finality Act (FinalitätsG; *Finalitätsgesetz*).

**■ Other (licensing) requirements may also apply:**

Depending on the design of the token, the BWG, the AIFMG or other rules and regulations, such as the ZaDiG 2018 or the E-GeldG 2010, as well as anti-money laundering provisions may also be applicable. In the case of listing or inclusion on a trading venue, for example on a regulated market or an MTF/OTF, the rules to prevent abuse of inside information and market manipulation also apply.

- Is the payment token used to pay third parties for goods or services?
- How large is the network within which the payment token fulfils a payment function?
- Are payments made in a legal currency

Depending on their design, payment tokens that are not intended for use only within a limited network may therefore trigger an obligation to obtain a licence under the BWG, ZaDiG 2018 or E-GeldG 2010.

## UTILITY TOKENS

Utility tokens are primarily intended to provide the holder with a benefit in relation to a particular product or service. Frequently, they permit access to a digital platform operated by the issuer, which can be used in a specific fashion by the holder of the utility token. However, utility tokens occur in many different forms and often also fulfil the function of payment tokens or security tokens (hybrid design), making the definition complex and the regulatory classification difficult. In particular, utility tokens may be associated with the right to participate in the design of a product or service, to use a product or service or to redeem the token for a product or service. Utility tokens are frequently accompanied by an intrinsic payment functionality vis-à-vis the issuer or other users of the issuer's platform.

Some examples:

- Co-design of a product: a social media platform wishes to offer various functions. Holders of the token can help determine which functions the network should offer.
- Use of a product or service: a token allows holders access to a database.
- Redemption for a product or service: a web designer issues a token for website design. The token can be redeemed with the issuing web designer for design of a website.

If the token can only be used for the design of a product or service, and is not associated with any other claims, or if the token merely grants access to a product or service without simultaneously serving the purpose of payment, then there is generally no relevant link under supervisory law. However, depending on the nature of the business model, a licence obligation may still exist in individual cases.

If, on the other hand, the token can be redeemed with the issuer or other users of the platform for the use of a product or service, it fulfils a payment function and is therefore comparable to a payment token. Accordingly, the same criteria and exceptions as for payment tokens are relevant for regulatory classification. However, the exemption for "limited networks" often applies (see "Payment tokens").

Utility tokens may also have an investment component, especially in the case of claims for payment of capital, interest or similar rights, or if the investment function is the primary focus. In such cases, the token could also be deemed a security or an investment (see "Security tokens"). Precisely when a utility token is to be regarded as a security in such individual cases is currently the subject of European and international regulatory discussion and cannot as yet be definitively summarised.

Given the wide range of different design possibilities and the frequent existence of hybrid forms, it is always necessary to examine on a case-by-case basis whether there are relevant links under financial or capital market law, especially in the case of utility tokens.

**“I am convinced that crypto assets are here to stay. Despite the recent turbulence, the market is growing steadily. ICOs in particular have the potential to become a sustainable form of alternative corporate financing.”**

*Valdis Dombrovskis, EU Commissioner for Financial Stability, Financial Services and Capital Markets Union*

## THE FMA'S SUPERVISORY STRATEGY

The crypto economy, which is also the source of ICOs, was deliberately constructed and created in such a way that it avoids regulation and supervision as far as possible, that it forms a counter-world to the power of governments and politics, the power of central banks and global financial players. Nevertheless, some business models do have interfaces with the regulated financial market, and these are subject to supervision. This article has demonstrated such regulatory links using the example of ICOs and related tokens and coins.

However, the legal framework created for the analogue financial world does not translate to many areas of the digital world of the crypto economy – or does so only inefficiently and ineffectively. As with any lawless spaces created by a lack of regulation and supervision, a range of crooks, sharks and dilettantes enter in to fill the vacuum and take advantage of the idealists, the inexperienced or the naive. Recent studies indicate that 80% of all ICOs today are fraudulent from the outset, and that the business model is ultimately successful for a maximum of just one or two out of every 100 ICOs. The observations of the FMA also bear out this finding: currently, around 50% of all investor complaints and whistleblower reports received by the FMA pertain to problems with the crypto economy. And already every second criminal complaint that the FMA has to lodge with the public prosecutor's office concerns the suspicion of criminal violations in connection with the world of “crypto”.

Thus, there is a need for regulatory action.

The FMA is convinced, however, that no new regulations are necessary for the crypto world. Instead, the regulation designed for the analogue world must be adapted in such a way that it also includes the digital crypto world. The imperative here is quite simple: everything that has the same effect as a financial instrument or investment product must be identified, regulated and supervised as a financial instrument or investment product. This also ensures a level playing field between the regulated incumbents and the new players from the digital world.

A first step has been taken with the inclusion of wallet providers and crypto asset exchanges in the regulations for the prevention of money laundering. The consistent expansion of the prospectus regime to encompass virtual IPOs in the form of ICOs will be the next step. The FMA has already submitted regulatory proposals in this regard, which have found their way onto the political agenda. Further steps will follow quickly. The FMA's aim in regulation and supervision is always to achieve the set objective with the least possible effort for the supervisor and as little burden as possible for those affected. This has been accomplished in the past through consistent adherence to four principles:

- **The principle of subsidiarity:** regulation must be aimed at the level where it is most efficient and effective.
- **The principle of proportionality:** each measure must be implemented in a manner commensurate with the complexity of the business model and the risk to financial market stability.
- **The principle of risk-based regulation and supervision:** resources should be concentrated where the risks are highest.
- **The principle of technology neutrality:** regulation must neither favour nor hinder a particular technology.

# AUSTRIANS' ATTITUDE TOWARDS CRYPTO ASSETS

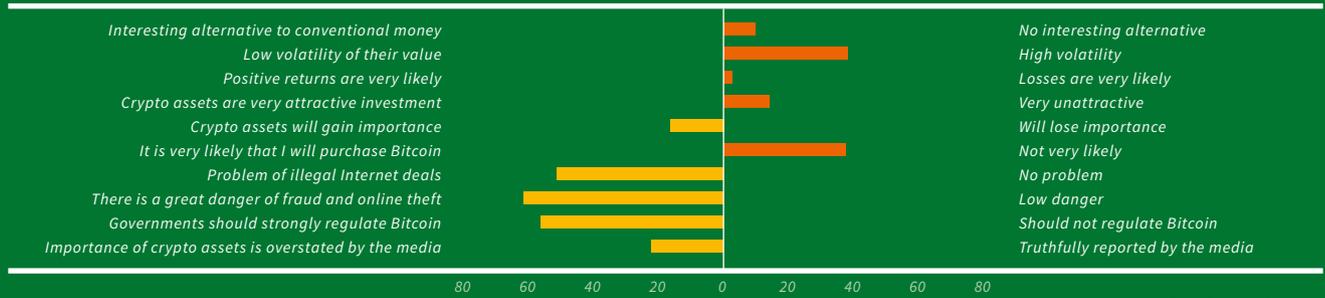


Chart 23: Attitude of Austrians towards crypto assets (respondents who agree minus those who disagree, in %; source: OeNB-Barometer Q2/2018)



Chart 24: Austrian ownership of or interest in crypto assets (% of population; source: OeNB-Barometer Q2/2018)

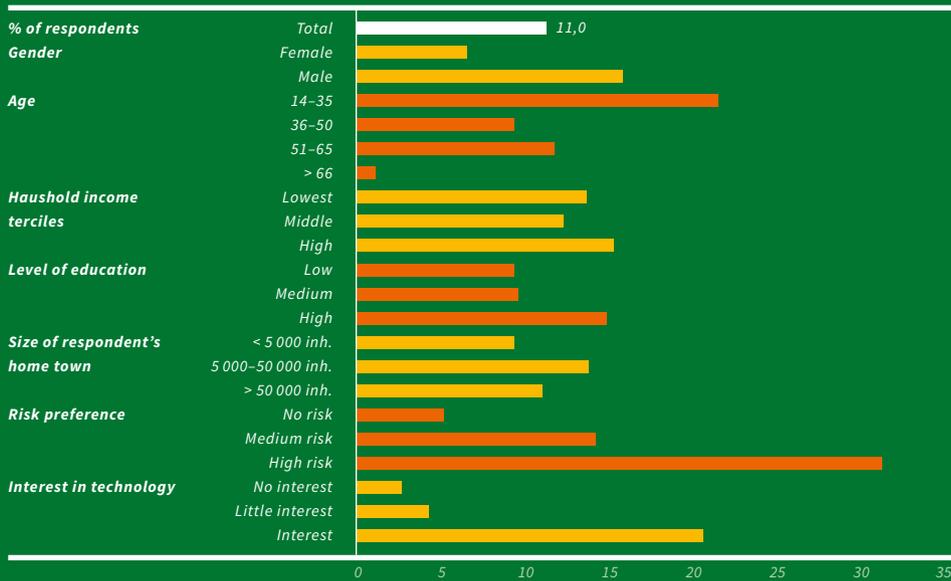


Chart 25: Interest in crypto assets (% of respondents; source: OeNB-Barometer Q2/2018)

As an integrated supervisory authority that unites regulation and supervision of the entire financial market under one roof, the FMA has an overview of all areas and is predestined to make appropriate regulatory proposals and subsequently ensure competition-neutral compliance.

It is also part of the FMA's mission to create transparency and clarity as quickly as possible where regulations are not yet in place or regulatory requirements are unclear or opaque. This helps create a clear and fair framework for financial innovation while allowing risks, especially for consumers, to be promptly addressed and limited.

In principle, an ICO can be an attractive, efficient and effective way of crowdfunding. As shown, however, there may be numerous regulatory implications and, depending on the specific nature of the business model, a licence from the FMA may be required or compliance necessary with other legal provisions, such as an obligation to publish a prospectus or anti-money laundering measures. In any case, the FMA recommends that an enquiry be addressed to the FinTech Point of Contact before commencement of planned business activities and placement of an ICO in order to clarify at an early stage all issues relating to licensing requirements, prospectus obligations, compliance or AML rules, FMA procedures and costs.





# NEW FMA ENFORCEMENT TOOLS

in administrative penal law using the example of AML

**T**he package of measures constituting the Supervisory Reform 2017, which entered into force on 3 January 2018, has successfully improved the transparency of supervision, simplified administrative processes, strengthened legal security and furthered development of the risk-based approach and proportionality of supervision. Of particular importance in this context are the new enforcement tools made available to the Austrian Financial Market Authority (FMA). These include:

- The option for “accelerated proceedings” (for administrative proceedings and administrative penal proceedings) in cases where the relevant party waives the right to appeal from the outset
- The expanded ability to target sanctions primarily against legal persons
- The replacement of the “principle of accumulation”, i.e. cumulative imposition of penalties for multiple breaches, with the “principle of absorption”, i.e. imposition of a single appropriate administrative penalty even for multiple breaches
- The requirement to publish all sanctions
- The expansion of the FMA’s discretion to refrain from imposing fines in less serious cases.

The new, expanded or enhanced enforcement tools improve the ability of the FMA to react appropriately, efficiently and in a risk-based manner to misconduct, and allow the Authority to further optimise its resource deployment.

How the FMA uses and applies these new tools in practice is illustrated here using the example of money laundering prevention.

## THE ROLE OF THE FMA IN THE FIGHT AGAINST MONEY LAUNDERING

For years, Austria has attached the highest priority to the fight against money laun-

dering and terrorist financing, pursuing a zero tolerance policy in this area. The legislature has defined money laundering and terrorist financing as criminal offences to be investigated by the police, publicly prosecuted and punished by the ordinary courts. At the same time, it has imposed special preventative due diligence obligations on industries and professions particularly exposed to the risk of abuse for the purpose of money laundering and terrorist financing.

The provisions to prevent the use of the financial system for the purpose of money laundering and terrorist financing have been brought together specifically in the Financial Markets Anti-Money Laundering Act (FM-GwG; *Finanzmarkt-Geldwäschegesetz*). Among other things, these include the obligation to establish the identity of every customer, conduct risk-based monitoring of accounts and transactions and report suspicious transactions to the Financial Intelligence Unit of the Austrian Federal Office of Criminal Investigation (BK). Compliance with detailed organisational requirements is necessary in order to fulfil these obligations properly.

Involvement in money laundering or terrorist financing also poses a considerable reputational, legal and, ultimately, prudential risk for financial service providers. Moreover, a lack of willingness to combat money laundering and a lack of due diligence in preventing it carries the risk of discrediting the financial market as a whole.

As the competent authority, the FMA therefore meticulously monitors compliance of the companies it supervises with all regulations for the prevention of money laundering. To this end, it conducts an open dialogue with the supervised persons and companies, explains new legal developments in this area, communicates the expectations of the Authority and clarifies any open questions. The FMA monitors compliance with due diligence obligations through regular management talks and company visits, as well as risk-oriented on-site inspections. Further sources of information include the annexes to the audit reports pursuant to the Austrian Banking Act (BWG, *Bankwesengesetz*), facts presented by the Financial Intelligence Unit and information from whistleblowers.

If, in the course of its audit, the FMA identifies shortcomings in the strategies, procedures and controls established to mitigate and manage risks, it classifies these as “systematic defects”. If the breach of standard or other regulatory finding relates to the business relationship with an individual customer, this is classified as an “individual defect”.

The central task of the FMA in the prevention of money laundering is to ensure that identified defects are rectified as quickly as possible through enforcement of measures to restore legal compliance. In addition, the FMA is required to impose sanctions for violations of the law which are predictable, proportionate and – in the sense of special and general prevention – effective and dissuasive. The new enforcement tools improve the effectiveness and efficiency of supervision, strengthen the principles of proportionality and risk-based supervision and increase transparency within the financial market.

#### **CONSENSUAL (ACCELERATED) CONCLUSION OF PROCEEDINGS (Article 22 para. 2b FMABG)**

Even in the past a party had the possibility in official proceedings to waive the right of appeal once an administrative decision had been issued. Since the reform it has also

been possible to accelerate the conclusion of proceedings by mutual agreement, if the party – natural persons as well as legal entities – declares a waiver of appeal before the FMA issues the decision. A mandatory prerequisite for the legal validity of the waiver declaration is that the FMA has demonstrably notified the party as to the content of the anticipated administrative decision before the declaration was issued.

This accelerated conclusion is possible both in administrative proceedings under the General Administrative Procedure Act 1991 (*AVG; Allgemeines Verwaltungsverfahrensgesetz*) and in administrative penal proceedings, with the exception of emergency administrative decisions.

Accelerated proceedings require intensive communication between the FMA and the addressee of the decision (party/person charged). The first step is to clarify whether they are familiar with the institution of accelerated proceedings and – if necessary after explanation of the procedure – whether there is actually a genuine interest in such an accelerated process. This clarification can also be carried out by telephone. If it is found that the process is of interest, the FMA then communicates in writing the main content of the anticipated decision in the case of a waiver of appeal (concrete allegation, violated provision and amount of the intended fine). A template of a written waiver of appeal in accordance with the law is attached to the letter. On the basis of this written information, the addressee of the decision must then decide whether to accept the offer of accelerated proceedings. If the addressee returns the signed waiver declaration within the specified period to the FMA, the proceedings will be concluded with an expedited decision. In this case, the decision is issued without a statement of reasons.

If the addressee of the decision does not submit a waiver of appeal or states opposition to such, the ordinary procedure continues.

The FMA considers a waiver of appeal in administrative penal proceedings to be an acknowledgement of responsibility for the violation, which means the person charged is treated as if a full admission of facts and guilt had been made and the penalty is calculated accordingly. The amount of the intended penalty will never be discussed during the proceedings. Likewise, an assessment of whether or not to publish sanctions can never be the subject of these proceedings, even in the case of an accelerated conclusion. Publication is to be assessed independently, as would be the case with a legally effective decision by the Federal Administrative Court.

It should be noted that there is no legal entitlement to accelerated proceedings (or prior notification of the expected decision). The party may, however, express interest in accelerated proceedings and in this way initiate proceedings pursuant to Article 22 para. 2b of the Financial Market Authority Act (*FMABG; Finanzmarktaufsichtsbehördengesetz*).

Consensual accelerated conclusion of proceedings provides the addressee of the decision with rapid legal certainty and minimises procedural costs. It also shortens official processes, saves resources and thus increases the efficiency of supervision.

#### **PRIORITY SANCTIONING OF THE LEGAL PERSON (Article 22 para. 6 no. 2 FMABG)**

In financial market law European lawmakers are increasingly moving towards making it possible not only to sanction the natural person responsible but also to sanction the relevant legal person for infringements of legal norms. Accordingly, this trend is also reflected in Austrian enforcement rules.

**Accelerated proceedings: it is possible to accelerate the conclusion of proceedings by mutual agreement. The assumption of responsibility is taken into account in the calculation of penalties.**

**If there are no special circumstances, the company will be held responsible instead of the natural person.**

The Supervisory Reform<sup>1</sup> now enables the FMA to refrain from punishing the responsible natural person<sup>2</sup> when an administrative penalty has already been imposed on the legal person for the same breach and no particular circumstances exist that prevent the possibility of refraining from imposing a fine. This possibility was already provided, e.g. in the FM-GwG, but now applies to all laws to be enforced by the FMA.

In the event of violations of due diligence obligations to combat money laundering and terrorist financing, the FMA generally makes use of this option and primarily prosecutes the legal person. In particular, the FMA does not make use of its discretion to also punish the natural person<sup>3</sup> if, absent gross misconduct or due to resignation of the person appointed to represent the company, the FMA finds no compelling specific and general preventive grounds.

However, the legal precedent on the part of the Federal Administrative Court (BVwG) with respect to the criminal liability of legal persons<sup>4</sup> is still inconsistent at the level of appeal. In four cases, the BVwG assumes a “two-stage process” with regard to sanctioning legal persons: The offence must have been committed unlawfully and culpably by an authorised representative (stage 1) in order to be attributed in a further step to the legal person, the organisation (stage 2; “two-stage assessment”). The BVwG concludes that a legal person can therefore only be sanctioned if the culpable conduct of the natural person has been established with final effect beforehand. In these cases, the BVwG declared the ordinary high-court appeal admissible because of the unresolved legal issue. Accordingly, the FMA submitted an official high-court appeal against the decisions of the BVwG to the Administrative Court (VwGH). These high-court appeals are still pending.

In another still pending case, however, the BVwG takes the opposite legal view: the legal person must first have been the subject of a final decision before the appeal proceedings can be continued against the natural person.

Until this question of attribution has been decided upon by the VwGH, the FMA will keep with its strategy of prioritising the sanctioning of the legal person, unless there are special grounds for not refraining from imposing a fine.

#### **ABSORPTION PRINCIPLE INSTEAD OF ACCUMULATION PRINCIPLE (Article 22 para. 8 FMABG)**

Previously, the principle of accumulation applied in administrative penal law: if several breaches were committed, each instance had to be sanctioned individually and the penalties had to be added together, i.e. cumulated. Even in the case of minor violations of the law, this could lead to high, even excessive, total penalties. In the course of the reform, the accumulation principle was replaced by the absorption principle for the FMA’s area of supervisory competence. This means that if multiple punishable breaches coincide, only one overall penalty is to be imposed. The penalty is to be determined according to the violation that carries the largest fine and is based on the principle of proportionality. Where several criminal offences have been committed, this constitutes an aggravating<sup>5</sup> factor.

<sup>1</sup> Article 22 para. 6 no. 2 FMABG.

<sup>2</sup> Article 9 VStG.

<sup>3</sup> Article 22 para. 6 no. 2 FMABG.

<sup>4</sup> Article 35 FM-GwG or Article 99d BWG.

<sup>5</sup> Article 22 para. 10 FMABG.

In cases where an administrative penalty has already been imposed and a further administrative penalty is pending which could have been imposed in the earlier proceedings after commission of the breach, the FMA will impose an additional fine<sup>6</sup>. However, this fine must not exceed the maximum fine threatened for the breach to be punished. Additionally, the sum of the penalty and the additional fine must not exceed the penalty that would have been permissible if the two breaches had originally been penalised jointly<sup>7</sup>. An additional fine<sup>8</sup> will not be imposed if the joint punishment would not result in a higher penalty than that imposed in the earlier proceedings. The transition from the accumulation principle to the absorption principle has brought administrative practice in Austria into line with that of the other supervisory authorities in the EU.

The principle of absorption is also to be applied to the calculation of fines pursuant to the FM-GwG. However, this law expressly obliges the FMA to take all relevant circumstances into account when calculating the single fine for the purpose of “effective punishment of breaches of obligations”<sup>9</sup>.

#### **MORE TRANSPARENCY: THE “NAME AND BLAME” PRINCIPLE (Article 37 FM-GwG)**

In accordance with the FM-GwG<sup>10</sup>, the FMA must publish severe, repeated and systematic breaches of due diligence and the resulting sanctions on its website at least after they have become legally effective. However, it can also publish imposed sanctions before these have become legally effective. The publication is meant to generally avert threats, have a general preventive effect and thus strengthen confidence in the financial and capital markets. It also serves to protect investors and creditors and contributes to financial market stability.

Before each publication, the FMA conducts a case-by-case proportionality review and assesses whether the stability of the financial market would be threatened by publication. In accordance with the result of the review, the FMA must also decide on the time and form of publication. Under certain circumstances, the publication of the breach and its sanctioning can be anonymised.

The publication itself is a simple administrative act; there is no requirement to issue an administrative decision in which the making of the publication is discussed. Nevertheless, the person affected by the publication may oppose the publication by submitting an application<sup>11</sup> for a review of the lawfulness of the publication. The FMA must then initiate a procedure to arrive at an administrative decision on the legality of the publication. The FMA must also publicise the initiation of such a procedure by updating its original publication, likewise if an appeal has been lodged against the underlying decision. If, in the course of this review, it is found that the publication was unlawful, or if an appeal against the decision underlying the publication is granted, the person concerned may decide whether the publication should be revoked or removed from the FMA’s website.

If a publication is not to be revoked or removed from the website for the above reasons, it remains published for a period of five years.

**The public shall be informed, in accordance with the principle of proportionality, of any sanctions imposed, in particular severe, repeated and systematic breaches.**

<sup>6</sup> Article 22 para. 9 FMABG.

<sup>7</sup> Article 22 para. 8 FMABG.

<sup>8</sup> Article 22 para. 9 FMABG.

<sup>9</sup> Article 38 FM-GwG.

<sup>10</sup> Article 37 FM-GwG.

<sup>11</sup> Article 37 para. 4 FM-GwG.

### **WAIVER OF PENALTIES FOR NON-SIGNIFICANT BREACHES (Article 22 para. 6 no. 1 FMABG)**

Individual supervisory laws (e.g. BWG, BörseG, FM-GwG) already provided for the possibility of refraining from imposing a fine if the breach was not significant. The Supervisory Reform has now extended this possibility to all laws assigned to the FMA for enforcement. The FMA is thus given expanded discretion – in the sense of an opportunity principle – to refrain from punishing minor violations<sup>12</sup>. Significant infringements, on the other hand, must be severely sanctioned in accordance with the particularly high penalties<sup>13</sup> under EU law as compared to other administrative penal law.

In the opinion of the FMA, the framework for the scope of application of this provision<sup>14</sup> is set in such a way that a breach that “is not significant“ may be more serious than a “minor offence” pursuant to the Administrative Penal Act (VStG; *Verwaltungsstrafgesetz*)<sup>15</sup>; to this extent, the new provision expands the discretionary scope of the FMA. But one thing is beyond dispute: a “severe, repeated or systematic breach” under the FM-GwG<sup>16</sup> does not fall within the scope of this procedural simplification.

Within this framework, it is up to the FMA to define the limits within which it makes use of its expanded discretion and refrains from imposing a fine. Since entry into force of the FM-GwG in 2017, the FMA has already refrained from imposing a fine in several cases though application of the opportunity principle.

However, there is no individual legal entitlement<sup>17</sup> to a waiver of penalties. The FMA decides in individual cases whether and how it will make use of its expanded discretionary scope. The most efficient possible approach to the imposition of sanctions – in particular with regard to individual breaches – must also take account of the effects of the absorption principle.

### **IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF SUPERVISION**

The new enforcement tools that the Supervisory Reform has put in the hands of the FMA this year make a significant contribution to improving administrative penal proceedings by making them more uniform, efficient and transparent. They enable a more risk-oriented sanctioning of misconduct and at the same time improve legal certainty for the supervised entities. In addition, they contribute to reducing the Authority’s administrative burden. This applies in particular to the expansion of the FMA’s discretion to refrain from initiating proceedings and/or from sanctioning breaches under certain conditions. Within the scope of accelerated proceedings, however, the supervised entities themselves can also actively influence the duration of the proceedings more strongly than before through cooperation with the FMA, thus also making a significant contribution to reducing the administrative burden. In this way, the reform frees up resources and supports the FMA in its efforts to concentrate in the most risk-based manner possible on serious negative developments within the financial market.

<sup>12</sup> See explanatory notes on the government bill in annex 1661 to the shorthand verbatim records of the National Council, 25th legislative period, p. 54.

<sup>13</sup> Cf. VfGH 13 December 2017, G 408/2016, G 412/2016, G 2/2017, G 21/2017, G 54/2017.

<sup>14</sup> Article 22 para. 6 no. 1 FMABG.

<sup>15</sup> Article 45 para. 1 no. 4 VStG.

<sup>16</sup> Article 34 para. 2 FM-GwG.

<sup>17</sup> Explanatory notes on the government bill in annex 1661 to the shorthand verbatim records of the National Council, 25th legislative period, p. 54.

# LEGAL DEVELOPMENTS

Major changes in national, European and international laws

**S**ince the onset of the global financial crisis, triggered by the insolvency of US investment bank Lehman Brothers in 2008, Austrian and European financial market legislation has changed markedly. While efforts to set global standards<sup>1</sup> as regulatory guidance were initially strong, some of the early momentum has been lost as the markets have recovered again.

The further development of European and national financial market law was based on learning the lessons from the global financial crisis, but change was also needed, and is still needed, to keep pace with the technological changes in the financial sector. Additionally, investor and consumer protection featured highly on the legal agenda, while strict transparency requirements contributed to the development of modern and efficient markets. In Europe there is a clear trend towards directly applicable EU law. This avoids a situation in which the options accorded to Member States and authorities when the regulations are transposed into national law undermine the harmonisation aim of European regulations. Another trend is that European lawmakers are increasingly adopting framework principles at level 1 of the regulatory process, which the European supervisory authorities (EBA, ESMA, EIOPA) subsequently convert into regulatory standards to be used by market participants. Enforcement continues to be determined nationally to a large extent, with an observable trend of penalties increasingly being aligned throughout Europe, particularly by stipulating low maximum penalties.

As the Austrian economy is predominantly based on small and medium-sized companies, the Austrian Financial Market Authority (FMA) has advocated the principles of subsidiarity and proportionality in developing the European framework for regulation

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<sup>1</sup> [www.g20.utoronto.ca/2009/2009communique0925.html](http://www.g20.utoronto.ca/2009/2009communique0925.html).

and supervision in order to ensure that the proven diversity on the Austrian market, with a structure that has evolved historically and is appropriate to the country's real economy, can be maintained.

The following section provides a summary of major changes to the legislation relevant to the FMA's remit.

## NATIONAL LEGISLATION

### AMENDMENTS TO EXISTING LAWS DURING THE REPORTING PERIOD

#### **PRIIPs Enforcement Act (*PRIIP-Vollzugsgesetz*), Federal Law Gazette I No. 15/2018**

The PRIIPs Enforcement Act lays down the necessary provisions to make Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) applicable in Austria. The Act specifies, among other things, that state-sponsored retirement provision and supplementary pension insurance schemes are excluded from the scope of the PRIIPs Regulation. However, as of 30 September 2018 contracts may still only be concluded after information about the customer's wishes and needs has been obtained. The FMA is the competent authority in relation to credit institutions, insurance undertakings, investment firms, investment fund management companies and alternative investment fund managers, and has been granted the necessary powers. This includes product intervention powers in relation to insurance undertakings and credit institutions acting as insurance intermediaries for insurance-based investment products. Furthermore, the Act regulates penalties, publications, reporting to the European supervisory authorities (EBA, ESMA, EIOPA), whistleblowing and the allocation of any supervisory costs incurred.

#### **Amendment to the Insurance Supervision Act 2016 (VAG 2016; *Versicherungsaufsichtsgesetz*), the Insurance Policy Act (VersVG; *Versicherungsvertragsgesetz*) and the Income Tax Act 1988 (EStG 1988; *Einkommensteuergesetz*) (VersVertrRÄG; *Versicherungsvertriebsrechts-Änderungsgesetz – Insurance Distribution Law Amendment Act 2018*), Federal Law Gazette I No. 16/2018**

This Amendment Act transposes Directive (EU) 2016/97 on insurance distribution (IDD) into Austrian law. The IDD's main objective is to create a level playing field and to ensure a uniform level of consumer protection for policyholders irrespective of the distribution channel. With regard to insurance distribution, the VAG 2016 includes provisions on governance, on its organisation, on information requirements and rules of conduct including special provisions relating to insurance-based investment products and on market supervision. In addition, it contains penal provisions and rules on publications, communications to EIOPA and on whistleblowing. The VersVG in turn regulates insurance distribution law in general and serves to protect policyholders. It facilitates electronic communication with customers via websites, introduces changes as required in view of Regulation (EU) 2016/679, the General Data Protection Regulation, and contains new rules for insurance agents and adaptations in accordance with the 2nd Adult Protection Act (ErwSchG 2; 2. *Erwachsenenschutz-Gesetz – Federal Law Gazette I No. 59/2017*) The amendments entered into force on 1 October 2018.

**Payment Services Act 2018 (ZaDiG 2018; Zahlungsdienstegesetz),  
Federal Law Gazette I No. 17/2018**

The ZaDiG 2018 implements Directive (EU) 2015/2366 on payment services in the internal market (PSD2), revising the former ZaDiG. Taking account of changes in e-commerce, payment initiation and account information services have been added to the list of payment services. With payment initiation services a customer commissions a provider to initiate a payment order with their account-servicing payment service provider, for example to pay for purchases made from a retailer's online shop. Account information services enable customers to receive specifically prepared information about their payment accounts held at one or several payment service providers. Account-servicing payment service providers are obliged to provide the technical interfaces for payment initiation and account information services. Another focus of ZaDiG 2018 is the security of electronic payment transactions. In this context, strong customer authentication (SCA) is required for any online payments, with at least two elements being used in the categories of "knowledge" (something only the user knows), "possession" (something only the user possesses) and "inherence" (something that can only be attributed to the user). Consequently, the customer's identity is verified by way of several characteristics (e.g. password and finger print). Finally, the ZaDiG 2018 also brought some amendments with regard to consumer protection. The payer's liability for misappropriation of their payment instrument by a third party (e.g. credit card theft) has been lowered from € 150 to € 50.

The Act entered into force on 1 July 2018. The PSD2 specifies a transitional period of 18 months from the date of entry into force of the European Commission's related delegated acts for both payment initiation and account information services as well as for SCA.

**Amendment to the Austrian Banking Act (BWG; Bankwesengesetz)  
and the Investment Fund Act (InvFG 2011; Investmentfondsgesetz),  
Federal Law Gazette I No. 36/2018**

The BWG was amended to comply with the Joint EBA and ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12), as well as the EBA Guidelines on internal governance (EBA/GL/2017/11).

Supervisory boards must now have at least one independent member. Supervisory boards of credit institutions of significant relevance or of credit institutions that have issued transferable securities that are admitted to trading on a regulated market pursuant to Article 1 no. 2 of the Stock Exchange Act 2018 (BörseG 2018; Börsegesetz) must have at least two independent members. Members are deemed independent where they are not closely associated with the institution in question or its group, with association being defined by law. In addition, with regard to systemically important institutions, the majority of the members of their risk committees must be independent. The requirements for holders of key functions (risk management, compliance, internal audit) regarding governance and personal suitability have been raised.

The amendment enters into force on a staggered basis between 1 September 2018 and 1 January 2019, with the provisions on the independence of supervisory board members not taking effect until 2019.

**Second Data Protection Amendment Act (2. Materien-Datenschutz-Anpassungsgesetz), Federal Law Gazette I No. 37/2018**

With this Amendment Act a large number of federal acts, including financial market laws, has been amended to comply with Regulation (EU) 2016/679, the General Data Protection Regulation (GDPR). Apart from adjustments to data protection rules, the amendment also changes a number of other provisions in financial market legislation with no bearing on data protection. For example, the Bank Recovery and Resolution Act (BaSAG; *Bankensanierungs- und Abwicklungsgesetz*) created a separate insolvency creditor rank for senior unsecured bonds, positioned in the hierarchy between pari passu obligations and subordinated liabilities. Additionally, the FMA is now no longer responsible for the prosecution of unauthorised business operations at commodity exchanges. Finally, with regard to the Financial Markets Anti-Money Laundering Act (FM-GwG; *Finanzmarkt-Geldwäschegesetz*), the transitional period during which prepaid cards with a value of up to € 250 are exempt from due diligence obligations pursuant to Article 6 paras. 1 to 3 and Article 5 nos. 1, 2 and 5 is extended until the end of 2019.

**Amendment to the Capital Market Act (KMG; *Kapitalmarktgesetz*) and the Alternative Financing Act (AltFG; *Alternativfinanzierungsgesetz*), Federal Law Gazette I No. 48/2018**

The amendment basically refers to information requirements as defined in the KMG or AltFG that issuers have to meet regarding interested retail investors. The new rules are as follows:

- In accordance with the AltFG, an information sheet must be prepared if the total equivalent value of the issue exceeds € 250 000.
- If the total equivalent value of the public offering is in excess of € 2 million or if more than € 5 million is raised from securities or capital investment issues within seven years, a simplified prospectus must be drawn up.
- Lastly, a regular (not simplified) prospectus must be published if the securities or capital investment issues exceed € 5 million.

Apart from these thresholds, any other distinction between the KMG and AltFG is abolished, which means that even non-SMEs may become issuers within the scope of the AltFG (change of personal scope of application) and may issue all types of securities and investments (change of pertinent scope of application). The amendment of the KMG partly also serves to implement Regulation (EU) 2017/1129, the Prospectus Regulation, which is why it became effective retroactively as at 21 July 2018. The amended AltFG entered into force on 1 September 2018.

**Amendment to the Alternative Investment Fund Managers Act (AIFMG; *Alternatives Investmentfonds Manager-Gesetz*), the Real Estate Investment Fund Act (ImmoInvFG; *Immobilien-Investmentfondsgesetz*) and the Investment Fund Act 2011 (InvFG 2011; *Investmentfondsgesetz*), Federal Law Gazette I No. 67/2018**

These amendments were made as a consequence of Regulation (EU) 2017/1131 on money market funds. Non-registered alternative investment fund managers (AIFMs) are now obliged to report any changes of managing director as well as any transfers of their head offices to the FMA. Where an EU AIFM intends to distribute units in a non-EU AIF in Austria, it must send a notification letter for each non-EU AIF to the FMA. In accordance with Article 38 para. 2 AIFMG, an auditor or other expert must confirm that

the respective non-EU AIF complies with the AIFMG as well as other applicable EU rules. Furthermore, new offences were included under Article 60 para. 2 no. 20c lit. a to f AIFMG sanctioning infringements of Regulation (EU) 2017/1131. These sanctions pertain to infringements of requirements, specifically with regard to the portfolio, asset composition, valuation, governance, documentation, transparency and reporting. Regulations specifying a notification obligation in the form of a summary statement on issued and closed special real estate funds pursuant to Article 34 para. 5 ImmoInvFG or special funds pursuant to Article 165 InvFG 2011 are no longer applicable as they are now covered by Article 22 AIFMG. The FMA's power to issue regulations pursuant to Article 70 para. 5 no. 3 InvFG 2011, allowing it to define criteria for money market funds, is repealed following an amendment to Regulation (EU) 2017/1131, which already defines those criteria. The amendment also defines that the FMA must be notified of any change of depositary bank pursuant to Article 164 para. 3 no. 6 InvFG 2011 as well as the merger of a special fund pursuant to para. 6 of the same Article in InvFG 2011. Pursuant to Article 144 para. 1 InvFG 2011, the FMA's costs arising from the accounting group of Securities Supervision must be borne by the management companies licensed pursuant to Article 5 para. 1 InvFG 2011 or by the management companies pursuant to Article 36 InvFG 2011 which operate in Austria through a branch.

**Amendment to the Introductory Act to the Administrative Procedure Acts 2008 (EGVG; *Einführungsgesetz zu den Verwaltungsverfahrensgesetzen*), the General Administrative Procedure Act 1991 (AVG; *Allgemeines Verwaltungsverfahrensgesetz*), the Administrative Penal Act 1991 (VStG; *Verwaltungsstrafgesetz*) and the Administrative Court Procedure Act (VwGVG; *Verwaltungsgerichtsverfahrensgesetz*), Federal Law Gazette I No. 57/2018**

The aim of the amendments to the AVG is to make procedures more efficient. The request to institute proceedings pursuant to Article 13 para. 8 AVG may now only be modified for as long as the investigation procedures have not been completed. New evidence can now only be submitted during the investigation procedures. Where those have been closed, now by means of a procedural order, they may be continued upon application. This is a possibility where a party can credibly demonstrate that it was not their fault that facts and evidence could not be put forward, and that it is likely that another decision, differing from the main content of the ruling, would be reached on the basis of the new facts and evidence alone or in conjunction with other findings from the investigation procedure. These prerequisites are in line with a re-opening of proceedings pursuant to Article 69 para. 1 no. 2 AVG and are intended to prevent proceedings from being delayed.

In administrative proceedings it is now possible to conduct questionings using technical equipment for audio and video transmission, with this option also intended to boost efficiency. Article 51a AVG states that this form of questioning is allowed where a personal appearance is not necessary and questioning with audiovisual aids appears appropriate considering the particularities of the case.

The changes in administrative penal proceedings were effected in order to make them more efficient, transparent and uniform. Article 5 para. 1a VStG now provides for an exemption from the assumption of negligence for penalties in excess of € 50 000. The texts also stipulate that no fault is to be assumed with representatives of legal entities

if they can prove that they have established and managed an organisation subject to regular controlling and quality assurance.

Similar to Article 371c of the Trade Act (*GewO; Gewerbeordnung*), Article 33a VStG stipulates that the provision of advice in writing must always precede the imposition of a penalty (principle of advising instead of punishing), provided that the legal interest, the extent of the impairment of that interest and the offender's fault are all insignificant. The offender is to be advised of the administrative offence and requested to restore compliance with the legal requirements, with the setting of an appropriate period of time to do so.

Moreover, the newly added Article 34a VStG, implementing Article 4 of Directive 2016/343/EU, specifies at what time during an investigation procedure an authority is allowed to provide information to the media. According to Article 46 para. 1a VStG, accused persons who do not understand the German language must be provided with a written translation of the penal decision in a language they understand. This addition transposes Article 3(1) of Directive 2010/64/EU.

### **Second Federal Law Consolidating Act (BRBG 2; *Zweites Bundesrechtsbereinigungsgesetz*), Federal Law Gazette I No. 61/2018**

The BRBG 2 repeals all simple federal acts and federal government regulations that were promulgated before 1 January 2000 and are still valid. Only the acts and regulations listed in the 248-page annex have been exempted. With regard to financial market law, the following acts and regulations are repealed (listed according to their original versions):

- Ship Mortgage Banks Act (*Schiffsbankgesetz*), Reich Law Gazette I S 241/1943
- Various regulations on hail storm insurance promotion from between 1955 and 1994 that were issued on the basis of the Hail Insurance Promotion Act (*Hagelversicherungs-Förderungsgesetz*), Federal Law Gazette No. 64/1955
- Endowment Insurance Promotion Act (*Kapitalversicherungs-Förderungsgesetz*), Federal Law Gazette No. 163/1982
- Bank Pensions Regulation (*Bankpensionsverordnung*), Federal Law Gazette No. 377/1933
- Regulation of the Federal Ministry of Finance on Units in Pension Investment Funds (*Verordnung des BMF über Anteile an Pensionsinvestmentfonds*), Federal Law Gazette II No. 447/1999

The repealed provisions still apply to those facts of a case that occur or have occurred before 1 January 2019. The InvFG 1993 is also formally repealed. Furthermore, Article 5 of BRBG 2 lays down that a legal statute that is not listed in the annex will still continue to be applicable where its applicability results from another legal statute. Any referred statute therefore does not need to be listed in the annex to continue to be applicable by way of reference. Those parts of the InvFG 1993 that are still valid are referred to in Article 198 InvFG 2011, meaning that they remain applicable and unchanged.

### **European Investigation Order in Administrative Penal Matters (EAO-VStS; *Europäische Ermittlungsanordnung Verwaltungsstrafsachen*), Federal Law Gazette I No. 50/2018**

A separate federal act was issued to transpose Directive 2014/41/EU into Austrian law. The new rules are to facilitate and accelerate the gathering of evidence in cross-

border administrative penal proceedings within the EU. The European Investigation Order (EIO) establishes a single regime for obtaining evidence, with time limits being set and the decision by the administrative authority ordering an investigative measure having to be validated by the competent administrative courts. Where an EIO is submitted, the competent authority in the executing state is obliged to recognise and execute it, within certain time limits and by complying with the formalities and procedures indicated by the issuing authority, unless grounds for non-recognition exist. Execution must be in the same way and under the same modalities as if the investigative measure had been ordered by an authority of the executing state.

## FMA REGULATIONS DURING THE REPORTING PERIOD

### **Disclosure Requirements Regulation 2018 (VeröffentlichungsV 2018; Veröffentlichungsverordnung), Federal Law Gazette II No. 13/2018**

The VeröffentlichungsV 2018 replaces the version from 2002. The Federal Minister of Finance was responsible for securities supervision back in 2002, which is why he also issued the VeröffentlichungsV 2002. In accordance with Article 119 para. 9 BörseG 2018, it is now within the FMA's remit to issue the revised regulation, subject to approval by the Federal Ministry of Constitutional Affairs, Reforms, Deregulation and Justice. Corporations listed on the Vienna Stock Exchange are required to publish a report when granting stock options and buying back shares and to inform the FMA. The Regulation specifies the form and content of this report. References to Regulation (EU) No 596/2014, the Market Abuse Regulation, and with regard to the BörseG 2018 were also adapted in the course of the revision. Moreover, the FMA is now named as the competent authority replacing the former Austrian Securities Authority.

### **Consumer Payment Account Services Regulation (VZKDV; Verbraucherzahlungskonto-Diensteverordnung), Federal Law Gazette II No. 60/2018**

This Regulation determines the most representative services linked to a payment account, and lists standardised terminology including definitions. The list comprises "General services linked to an account" (account management, online banking and specific account statements), "Card-less payments" (e.g. transfers and credits), "Cards and cash" (provision of a debit card, i.e. ATM card, cash deposits and withdrawals), as well as "Overdraft and related services". Customers must be informed of the fees under those specific terms, both before setting up an account in the form of a fee information document and then at least annually by way of a statement of fees. The Regulation transposes Directive 2014/92/EU, the Payment Accounts Directive, also taking account of the related EBA-RTS, Commission Delegated Regulation (EU) 2018/32.

### **Amendment to the Regulation on Asset, Income and Risk Statements (VERA-V; Vermögens-, Erfolgs- und Risikoausweis-Verordnung), Federal Law Gazette II No. 111/2018**

The VERA-V details the data that the FMA collates, including data on the so-called high earners of credit institutions. High earners are those employees whose annual remuneration amounts to at least € 1 million. The amendment allows for more flexibility with regard to the number of remuneration brackets: it will now be possible to

use additional remuneration brackets for remuneration exceeding € 5 million, using consecutive numbers for the € 500 000 brackets.

**Regulation on the Collection of Granular Credit Data 2018 (GKE-V 2018; *Granulare Kreditdatenerhebungs-Verordnung*), Federal Law Gazette II No. 170/2018**

The GKE-V 2018 replaces the Regulation on Reports to the Central Credit Register (ZKRM-V; *Zentralkreditregistermeldungs-Verordnung*), which previously regulated the reporting of receivables by BWG credit institutions and insurance undertakings exceeding € 350 000. The replacement comes as a result of Regulation (EU) 2016/867, the AnaCredit Regulation. The AnaCredit Regulation harmonises the collection of credit and credit risk data from CRR credit institutions with regard to legal entities as debtors with a commitment amount equal to or larger than € 25 000. In contrast to the ZKRM-V, the GKE-V 2018 limits reporting agents to CRR credit institutions and CRR financial institutions with their head offices or branches within Austria. The requisite reporting is very similar, regarding content and structure, to reports made in accordance with the AnaCredit Regulation, allowing data to be collected within the data model of the Oesterreichische Nationalbank (OeNB) in a non-redundant and integrated manner.

**Repeal of the Regulation on the International Exchange of Data from the Central Credit Register (ZKR-AustauschV; *Zentralkreditregister-Austauschverordnung*), Federal Law Gazette II No. 168/2018**

The ZKR-AustauschV regulated the cross-border exchange of data from the Central Credit Register. It was repealed as the OeNB is now legally entitled to exchange credit and credit risk data with its international counterparts and no longer requires authorisation by way of an FMA regulation.

**Repeal of the Money Market Funds Regulation (GMF-V; *Geldmarktfondsverordnung*), Federal Law Gazette II No. 169/2018**

The GMF-V contained provisions for funds that are referred to or marketed as money market funds or short-term money market funds. MMFs have been governed by Regulation (EU) 2017/1131 on money market funds since 21 July 2018. Since the Regulation lays down fully harmonised rules, national provisions have become obsolete and the GMF-V was therefore repealed.

**Amendment to the Regulation on (Consolidated) Financial Statements (JKAB-V; *Jahres- und Konzernabschluss-Verordnung*), Federal Law Gazette II No. 194/2018**

By way of JKAB-V, the FMA collects the audited (consolidated) financial statements of credit institutions. The double consolidation requirement for groups of credit institutions with a superordinate financial holding company has been dropped. In addition, the JKAB-V adapts the current forms for the financial statements pursuant to Article 40 of the Company Employee and Self-Employment Provisions Act (BMSVG; *Betriebliches Mitarbeiter- und Selbstständigenvorsorgegesetz*) for reports to be made by corporate provision funds. The changes are to be applied for the first time to reports made for the 2018 business year.

**Amendment to the Regulation on Qualifying Holdings 2016 (EKV 2016; Eigentümerkontrollverordnung), Federal Law Gazette II No. 195/2018**

The EKV 2016 specifies the information required to be submitted to the FMA in notifications of a proposed acquisition of a qualifying holding in financial market companies. The amendment generally excludes notifications of holdings in investment firms and investment service providers from the scope of EKV 2016, with the information to be submitted being based on Commission Delegated Regulation (EU) 2017/1946 instead.

**Amendment to the Regulation on the Annex to the Audit Report (AP-VO; Verordnung über die Anlage zum Prüfungsbericht), Federal Law Gazette II No. 196/2018, to the Regulation on the Annex to the Audit Report for Electronic Money Institutions (EGAPV; Verordnung über die Anlage zum Prüfungsbericht für E-Geld-Institute), Federal Law Gazette II No. 197/2018 and to the Regulation on the Annex to the Audit Report for Payment Institutions (ZAPV; Verordnung über die Anlage zum Prüfungsbericht für Zahlungsinstitute), Federal Law Gazette II No. 198/2018**

AP-VO, EGAPV and ZAPV specify rules regarding the form and structure of the annex to the audit report for credit, payment and electronic money institutions. References in the annexes to these Regulations to current legislation are also adapted. In the annex to the audit report for credit institutions, new audit modules are created for outsourcing and (concerning other observations by the bank auditor) in relation to compliance with Regulation (EU) 2016/1011, the Benchmarks Regulation, and Regulation (EU) No 1286/2014, the PRIIPs Regulation. The changes are to be applied for the first time to all annexes to the audit report made for the 2018 business year.

**Amendment to the Online Identification Regulation (Online-IDV; Online-Identifikationsverordnung), Federal Law Gazette II No. 199/2018**

Based on the FM-GwG, the Online-IDV determines the security measures to mitigate the potentially increased risk of money laundering and terrorist financing where customers are identified online via a video-based electronic procedure instead of requiring physical presence. The new rules also touch on data protection issues, which means that some changes were necessary to comply with the provisions according to Regulation (EU) 2016/679 (GDPR) without changing the Online-IDV as such.

## **EUROPEAN LEGISLATION**

### **REGULATIONS AND DIRECTIVES ADOPTED IN 2018**

As part of regular lawmaking procedures, the European Union adopted the following laws of particular relevance to the FMA's scope of enforcement during the reporting period:

**Directive (EU) 2018/843 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AMLD5)**

The revision of the Fourth Anti-Money Laundering Directive includes these new provisions, among others:

- Virtual currency exchange platforms and wallet providers are brought under the scope of the Directive.
- Facilitation of public access to information on beneficial owners of companies and foundations. Data on beneficial owners of companies and of trusts similar to companies become publicly available. Information on all other types of trusts are included in the national register and access is provided to third parties demonstrating a legitimate interest in that information.
- Interconnection of national registers to facilitate cooperation among Member States.
- Existing thresholds for prepaid cards are lowered from € 250 to € 150.
- National Financial Intelligence Units (FIUs) are given increased supervision and inspection powers.
- Harmonised procedures in relation to high-risk third countries.

Publication in the Official Journal of the European Union: 19 June 2018, implementation deadline: 10 January 2020.

#### **Directive (EU) 2018/411 amending Directive (EU) 2016/97 as regards the date of application of Member States' transposition measures**

The entry into force of Regulation (EU) 2016/97, the Insurance Distribution Directive (IDD), has been postponed by seven months to 1 October 2018. Publication in the Official Journal of the European Union: 19 March 2018, implementation deadline: 1 October 2018.

### **INTERNATIONAL STANDARD SETTERS**

Apart from European and Austrian legislation, other publications by standard setting bodies are also relevant to the financial market. Although these publications are not legally binding as such, they are frequently used as standards, guidelines or benchmarks when binding legislation is adapted at a national or EU level. Their aim is to harmonise supervisory practice at a global level. The publications most relevant to the FMA are outlined below.

#### **BASEL COMMITTEE ON BANKING SUPERVISION (BCBS) OF THE BANK FOR INTERNATIONAL SETTLEMENTS (BIS)**

The Basel Committee produced the following publications in 2018:

##### **Pillar 3 disclosure requirements – updated framework (February 2018) and Pillar 3 disclosure requirements: regulatory treatment of accounting provisions (March 2018)**

The proposed disclosure requirements (Pillar 3) published in these two consultative documents are related to the finalisation of the Basel III post-crisis regulatory reforms. The publication issued in February concludes the fundamental revision of the regulatory disclosure requirements. The technical amendment published in March 2018 focuses on disclosures relating to the impact of expected credit loss accounting on regulatory capital, as well as on how to treat the general and specific provisions for standardised exposures during the interim period provided for under the Basel framework.

### **Revisions to the minimum capital requirements for market risk (March 2018)**

This consultative document proposes changes to some aspects of the standard relating to minimum capital requirements for credit institutions, addressing issues that the Basel Committee has identified in the course of monitoring the implementation and impact of the previous standard.

### **Criteria for identifying simple, transparent and comparable short-term securitisations and Capital treatment for simple, transparent and comparable short-term securitisations (May 2018)**

The first document, sound practices jointly published by the BCBS and IOSCO, lists 17 criteria with which the final criteria for identifying simple, transparent and comparable (STC) short-term securitisations, issued by BCBS-IOSCO in 2015 and revised in 2016, are again revised in order to allow them to also take account of the characteristics of asset-backed commercial paper (ABCP) conduits. The criteria are to assist in the financial industry's development of STC securitisation structures. The second standard issued by BCBS alone supplements the criteria document and sets out requirements for the purpose of applying preferential regulatory capital treatment for banks acting as investors in or as sponsors of STC short-term securitisations.

### **Treatment of extraordinary monetary policy operations in the Net Stable Funding Ratio (June 2018)**

This standard amends the treatment of extraordinary monetary policy operations in the Net Stable Funding Ratio (NSFR). The amendment aims to provide greater flexibility in the treatment of extraordinary central bank liquidity-absorbing monetary policy operations.

### **Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement (July 2018)**

With this standard, the Committee has reconfirmed the fundamental structure of the global systemically important bank (G-SIB) framework and made some enhancements to it (calculation of indicators, consolidation of insurance subsidiaries, disclosure, bucket migration), maintaining the core elements of the framework (to be applied from 2021). Among other things, G-SIBs are required to hold higher capital buffers and incentives are provided for such firms to reduce their systemic importance.

## **FINANCIAL ACTION TASK FORCE (FATF)**

The FATF produced the following publications in 2018:

### **Financing of Recruitment for Terrorist Purposes (January 2018)**

This report shows how terrorist organisations fund the recruitment of new members and supporters.

### **FATF Guidance on Counter Proliferation Financing (February 2018)**

With this guidance paper, the FATF has published recommendations on how to effectively implement the United Nations Security Council Resolutions with respect to preventing the proliferation of weapons of mass destruction.

**Concealment of Beneficial Ownership (July 2018)**

This joint FATF-Egmont Group report uses over 100 case studies provided by various different jurisdictions to illustrate the methods that criminals use to hide beneficial ownership of legal persons and trusts. The report shows and analyses vulnerabilities associated with beneficial ownership to support further risk analysis by authorities and other professional service providers.

**FATF President's Paper: Anti-money laundering and counter terrorist financing for judges and prosecutors (July 2018)**

This paper identifies the specific challenges that judges and prosecutors face in investigating and prosecuting money laundering and terrorist financing.

**Professional Money Laundering (July 2018)**

This report looks at the techniques and tools used by professional money launderers for their criminal activities. This should help countries identify and dismantle such activities.

**Financial Flows from Human Trafficking (August 2018)**

This FATF and Asia/Pacific Group on Money Laundering (APG) report aims to raise awareness about – certain types of – financial information that can identify human trafficking. The report also highlights potential links between human trafficking and terrorist financing.

**INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)**

These public reports adopted by IOSCO during 2018 constitute non-binding standards which can be used as benchmarks.

**FR01/2018 Recommendations for Liquidity Risk Management for Collective Investment Schemes, Report of the Board of IOSCO**

This final report replaces the liquidity risk management framework contained in the 2013 Liquidity Report and includes 17 recommendations. These recommendations set out an approach under which responsible entities are expected to monitor and evaluate the underlying portfolios of their CIS in light of stressed market conditions and other relevant circumstances in order to determine whether or not to activate additional liquidity tools and, when activated, the manner and timing of implementation.

**FR06/2018 Harmonisation of critical OTC derivatives data elements (other than UTI and UPI), Report of the Committee on Payments and Market Infrastructures and the Board of IOSCO**

This report addresses supervisory authorities and provides technical guidance regarding the definition, format and usage of key OTC derivatives data elements reported to trade repositories. Two separate guidance documents regarding the Unique Transaction Identifier (UTI) and the Unique Product Identifier (UPI) were published already in 2017.

**FR07/2018 Framework for supervisory stress testing of central counterparties (CCPs), Report of the Committee on Payments and Market Infrastructures and the Board of IOSCO**

This framework sets out six components that describe the steps authorities should follow when designing and running a multi-CCP SST (setting the purpose and exercise specifications, establishing governance arrangements, developing stress scenarios, data collection and protection, aggregating results and developing analytical metrics, determining the use of results and disclosure).

**INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS (IOPS)**

The IOPS produced the following publications in 2018:

**IOPS Good Practices on the Role of Pension Supervisory Authorities in Consumer Protection Related to Private Pensions (February 2018)**

This set of Good Practices aims to help pension supervision authorities provide effective consumer protection in the area of private pensions. The Good Practices focus on five of the G20 High Level Principles (HLP) and related Effective Approaches which are considered most relevant from the pension supervisory perspective: HLP 2: Role of Oversight Bodies; HLP 4: Disclosure and Transparency; HLP 5: Financial Education and Awareness; HLP 6: Responsible Business Conduct of Financial Services Providers and Authorised Agents; and HLP 9: Complaints Handling and Redress.

**FINANCIAL STABILITY BOARD (FSB)**

The FSB produced the following publications in 2018:

**Crypto-assets: Report to the G20 on the work of the FSB and standard-setting bodies**

This report sets out the metrics that the FSB will use to monitor developments in crypto-asset markets.

**Funding Strategy Elements of an Implementable Resolution Plan**

This guidance covers the development of a resolution funding plan for G-SIBs.

**Principles on Bail-in Execution**

This guidance sets out principles to assist authorities as they make bail-in resolution strategies for G-SIBs operational.

**Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices**

These Principles and Standards were developed to address misaligned incentives that could be created by compensation practices.

