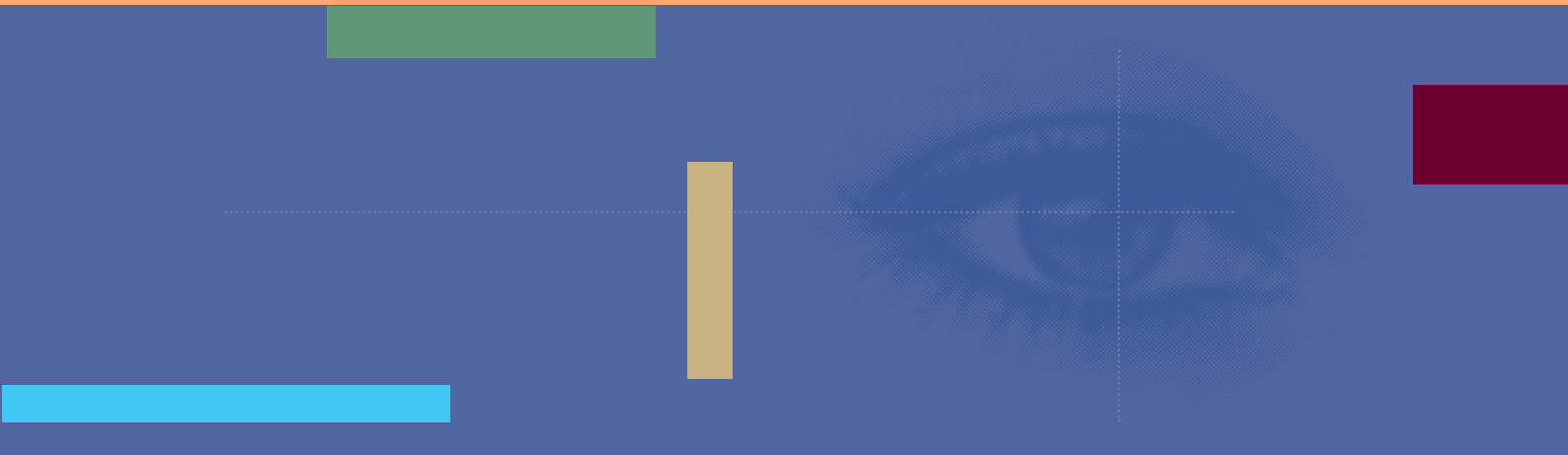


BANKING SUPERVISION IN AUSTRIA



Publisher and editor

Oesterreichische Nationalbank (OeNB)
Otto-Wagner-Platz 3, 1090 Vienna, Austria
Austrian Financial Market Authority (FMA)
Praterstrasse 23, Vienna 1020

Production

Oesterreichische Nationalbank

Editors-in-chief

Günther Thonabauer, Communications Division (OeNB)
Jürgen Bauer, Staff Department for Executive Board Affairs and Public Relations (FMA)

Contributions

Andreas Höger, Karin Hrdlicka, Wolfgang Messeritsch, Markus Schwaiger, Johannes Turner, Florian Weidenholzer (all OeNB)
Jürgen Bauer, Patrick Darlap, Doris Radl, Dagmar Urbanek, Alexander Veverka, Markus Waldherr, Thomas Wulf, Alexander Zimmermann (all FMA)

Translation:

OeNB Language Services

Design

Peter Buchegger, Communications Division (OeNB)
Birgit Vogt (layout, typesetting)
Typesetting, printing, and production
OeNB Printing Division

Published and produced at:

Otto-Wagner-Platz 3, 1090 Vienna, Austria

Inquiries

Oesterreichische Nationalbank, Communications Division
Postal address: PO Box 61, 1011 Vienna, Austria
Phone: (+43-1) 404 20-6666
Fax: (+43-1) 404 20-6698
E-mail: oenb.info@oenb.at
Austrian Financial Market Authority (FMA)
Staff Department for Executive Board Affairs and Public Relations
Postal address: Praterstrasse 23, 1020 Vienna, Austria
Phone: (+43-1) 249 59-5100
Fax: (+43-1) 249 59-5199
E-mail: fma@fma.gv.at

Orders/address management

Oesterreichische Nationalbank, Documentation Management and Communications Services
Postal address: PO Box 61, 1011 Vienna, Austria
Phone: (+43-1) 404 20-2345
Fax: (+43-1) 404 20-2398
E-mail: oenb.publikationen@oenb.at
© Oesterreichische Nationalbank, 2009. All rights reserved.

Internet

www.oenb.at
www.fma.gv.at

Paper:

Printed on environmentally friendly paper

DVR 0031577

Vienna, 2009



PREFACE

Efficient prudential supervision is instrumental for the stability of economic systems, as the turmoil on financial markets in the course of 2008 patently showed. In Austria, the reform of the supervisory framework in 2008 helped lay the foundation for keeping in step with the rapid evolution of financial markets.

One of the primary aims of the supervisory reform was to establish clear responsibilities and to optimize the communication interfaces between the Oesterreichische Nationalbank (OeNB) and the Financial Market Authority (FMA). The reform ensures that supervisory reviews are quick, effective and well-documented. The OeNB and the FMA are assured of having the same level of information at all times, which also reinforces both institutions' cooperative partnership in supervising the Austrian financial market.

The supervisory reform has resulted in further improvements in joint action and enabled closer supervisory collaboration, which has made it possible to take even more timely and efficient prudential measures to strengthen financial stability in Austria since January 1, 2008. Furthermore, the introduction of the single point of contact (SPOC) principle, by which one person at each of the two institutions is appointed as a contact for a given bank, has further reinforced regular exchanges with banks.

The OeNB and the FMA endeavor to pass the synergy and efficiency benefits of the supervisory reform on to banks. As a case in point, notifications of the supervisory authorities that must be filed with the FMA and the OeNB will only have to be submitted once to a dedicated "incoming platform" to which official documents can be sent electronically. This platform not only reduces submission time, it also lessens the operational burden for all parties involved.

This publication presents the new cooperative supervisory structure and gives an in-depth account of the respective tasks and responsibilities assigned to the FMA and OeNB. It is designed to allow supervised credit institutions, supervisory institutions in other countries and the general public to gain an immediate understanding of the newly developed processes and responsibilities.

We hope that this publication provides you with a useful and informative read.



Philip Reading
(Director, Financial Stability
and Bank Inspections Department, OeNB)



Michael Hysek
(Head of Department, Banking Supervision)

Table of Contents

PREFACE	3
TABLE OF CONTENTS	4
LIST OF CHARTS	5
ABBREVIATIONS	6
1 Introduction	7
1.1 Overview and Specific Characteristics of the Austrian Banking Sector	7
1.2 Reasons for the Reorganization of FMA and OeNB Responsibilities	10
1.3 Assignment of Banking Supervisory Responsibilities from January 1, 2008	11
2 THE SUPERVISORY ARCHITECTURE	14
2.1 Framework	14
2.2 Organizational Structure of the FMA	15
2.3 Organizational Structure of the OeNB	18
3 THE SUPERVISORY PROCESS	22
3.1 General Framework	22
3.2 Coordination between the OeNB, the FMA and Banks	23
3.3 Information Sources for Banking Supervision in Austria	25
3.4 Off-Site Analysis	27
3.5 Activities of the Authorities	29
3.5.1 Framework Conditions for Executing Regulatory Procedures	29
3.5.2 Interpretation and Further Development of Supervisory Law	30
3.5.3 Supervisory Procedures	31
3.5.4 Basel II Approval Procedures	32
3.5.5 Other Supervisory Areas Covered by the FMA	35
3.5.6 Supervisory Measures	35
3.6 Planning and Conduct of Audits	36
3.7 Inspection and Evaluation of the Internal Capital Adequacy and Assessment Process	37
3.8 Supervisory Cooperation and Exchange of Information	39
3.9 Structured Dialogue	40
4 FINANCIAL CONGLOMERATES	42
4.1 Organization and Implementation of the Supervision of Financial Conglomerates	42
4.1.1 Regulations and Financial Conglomerates Act Interpretation Issues	42
4.1.2 Organization of Operational Supervisory Activities	42
4.1.3 Supervisory Strategy	42
4.1.4 Supervisory and Official Measures	43
4.1.5 On-Site Inspections at the Financial Conglomerate Level	43
5 FINANCIAL STABILITY	44
5.1 Extension of the Financial Stability Mandate	44
5.2 CESEE Risk Assessment	44
5.3 Nonbank Financial Intermediaries	45
5.4 Risk Transfer	46
5.5 Liquidity Risk	46
6 OUTLOOK	47

LIST OF CHARTS

Chart 1: Size of the Austrian Banking Sector	7
Chart 2: Austrian Subsidiaries' Market Shares in CESEE	9
Chart 3: Return on Assets and Cost-to-Income Ratio	9
Chart 4: Assignment of Banking Supervision Responsibilities between the FMA and the OeNB: Old and New	12
Chart 5: Supervisory Architecture: Internal and External Control Layers	14
Chart 6: Organizational Structure of the FMA	17
Chart 7: Organizational Structure of the OeNB	19
Chart 8: Organizational Structure of the Financial Stability and Bank Inspections Department	20
Chart 9: Schematic Representation of Supervisory Responsibilities	22
Chart 10: Schematic Representation of the Link between On-Site Inspections and Off-Site Analysis	23
Chart 11: Interinstitutional Coordination	25
Chart 12: Key Models Used in Basic Analysis	28
Chart 13: Ongoing Supervision Process	29

Abbreviations

ABBA	Austrian Banking Business Analysis
AMA	Advanced Measurement Approach
Banking Act	Austrian Banking Act
BFS	bank financial strength
BSC	Banking Supervision Committee
CAMEL	capital, assets, management, earnings, liquidity
CCR	Central Credit Register
CEBS	Committee of European Banking Supervisors
CEO	Chief Executive Officer
CESEE	Central, Eastern and Southeastern Europe
CRD	Capital Requirements Directive (RL 2006/48/EG)
ECAI	External Credit Assessment Institution
ECB	European Central Bank
EEA	European Economic Area
ERP	European Recovery Programme
ESCB	European System of Central Banks
FMA	Financial Market Authority
Financial Market	Federal Act on the Institution and Organisation of the Financial Market Authority
ICAAP	Internal Capital Adequacy Assessment Process
ICS	internal control system
IRB Approach	Internal Ratings Based Approach
MoU	Memorandum of Understanding
Nationalbank Act	Federal Act on the Oesterreichische Nationalbank
OeNB	Oesterreichische Nationalbank
ROA	return on assets
SPOC	Single Point of Contact
SREP	Supervisory Review and Evaluation Process
VaR	Value at Risk

1 Introduction

The supervisory reform in Austria that went into force on January 1, 2008, placed the Austrian financial supervision framework on a new footing. While the supervisory system has remained a dual one, with responsibilities shared by the Financial Market Authority (FMA), Austria's independent, integrated financial supervisory authority, and the Oesterreichische Nationalbank (OeNB), Austria's central bank, the reform tightened the links between micro- and macroprudential supervision, that is, supervision of individual institutions and supervision at the systemic level. As a consequence, the OeNB was assigned additional operational tasks in this field. The reform has provided a new structure for cooperation between the FMA and the OeNB in banking supervisory activities since the beginning of 2008.

In this publication, readers will find an in-depth presentation of the new organizational framework for supervision, including descriptions of the organizational structure of the FMA and the OeNB, as well as a thorough account of the revamped supervisory review process. The cooperation between the FMA and the OeNB is discussed at length, and their respective areas of responsibility, procedures and methods, exchanges with banks and cooperation with supervisory authorities in other countries are presented in detail. The supervision of financial conglomerates is also explained, as are the greater responsibilities of the OeNB for financial stability following the reform. In order to provide background information and enhance the reader's understanding of the organizational and procedural modifications at these institutions, this introductory chapter also provides a brief overview of the features particular to the Austrian banking sector, the causes of and reasons for the recent reform, and the main elements of the legal framework for the updated banking supervisory system.

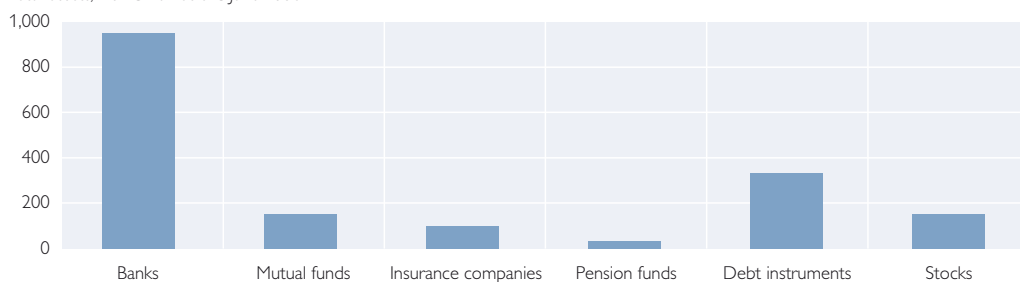
1.1 Overview and Specific Characteristics of the Austrian Banking Sector

Austria's banking sector is the prime determinant of the country's financial system. With borrowing practices in Austria starting to align with those in the euro area, capital markets have become more important as a source of corporate finance, and households have also begun to change their traditional investment behavior. But banks have remained far and away the predominant financial intermediaries in Austria. Measured in terms of Austrian banks' total assets as a share

Chart 1

Size of the Austrian Banking Sector

Total assets, EUR billion at end-June 2008



Sources: OeNB, ECB, Vienna Stock Exchange.

of GDP, banking intermediation stood at 332.1% in 2007, which is close to the EU average.

The Austrian banking system is an integrated system, meaning that banks that have taken out a comprehensive license are authorized to provide the entire range of financial services. Traditionally, banks that have an Austrian license or operate through a branch in Austria (total at end-December 2008: 870) are classified as belonging to one of eight sectors, depending on their legal form and the traditional focus of their business. But these distinctions have become increasingly blurred. The overall figure breaks down as follows: joint stock banks (51), state mortgage banks (11), building societies (4), special purpose banks (93), branches of credit institutions from Member States under Article 9 para. 1 of the Banking Act (28), savings banks (56), industrial credit cooperatives (69) and Raiffeisen, or agricultural, credit cooperatives (558); all data at end-2008. Savings banks and industrial credit cooperatives are organized in two tiers, Raiffeisen credit cooperatives in three tiers. As all three types of banks follow a decentralized approach in doing business, they may be referred to as belonging to “decentralized sectors.” The individual credit institutions in these sectors have their own legal personalities, but as a rule they are attached to a centralized institution whose tasks include providing services to the entire sector and performing coordination functions, such as refinancing; in the case of the agricultural credit cooperatives, regional cooperative banks act as intermediaries. Given the close business ties between the individual institutions and the very principle on which cooperatives are based, the sectors go so far as to offset risks internally.

As the business environment has changed in the past two decades, the Austrian banking system has had to adjust accordingly. Preparations for Austria’s membership in the EU from 1995 started as early as the 1980s, when Austria implemented prudential reforms and a broad range of measures to liberalize the Austrian financial sector, notably the complete deregulation of capital movements in a series of steps taken from 1989 to 1991. Moreover, formerly large government-owned shares in banks were reduced to nearly zero by the beginning of the 21st century. The newly privatized banks were exposed to fiercer competition, which was instrumental in triggering a process of consolidation and concentration despite favorable economic conditions that fostered high loan growth.

The second main influence on the development of Austria’s banks was the fall of the Iron Curtain and the resultant opening up of markets in Central, Eastern and Southeastern Europe (CESEE). Austrian banks have revived historical ties and taken advantage of the region’s geographical proximity to expand into CESEE markets over the past two decades and to help pioneer the development of banking markets there. In a first step, Austrian banks expanded by establishing subsidiaries in CESEE, and from the second half of the 1990s, they also acquired interests in local banks as governments sold off their stakes.

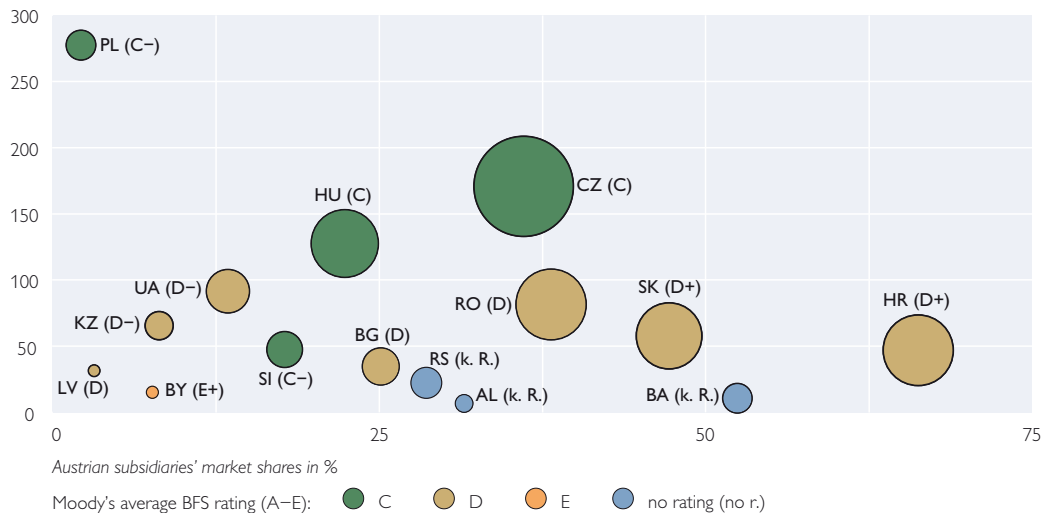
From the beginning, Austrian banks have steadily reinforced their foreign business focus on the CESEE region. At the end of 2007, 12 Austrian banks were operating 73 fully consolidated CESEE subsidiaries. As a result, Austrian banks have come to hold some 15% of the entire CESEE banking market, or even roughly 23% excluding Russia. Because Austrian banks hold around two-thirds of their foreign subsidiaries’ aggregated total assets in EU Member States, the risks arising from the legal and institutional framework are limited.

Chart 2

Austrian Subsidiaries' Market Shares in CESEE¹

As at June 30, 2008

Aggregated national total assets of banks, EUR billion

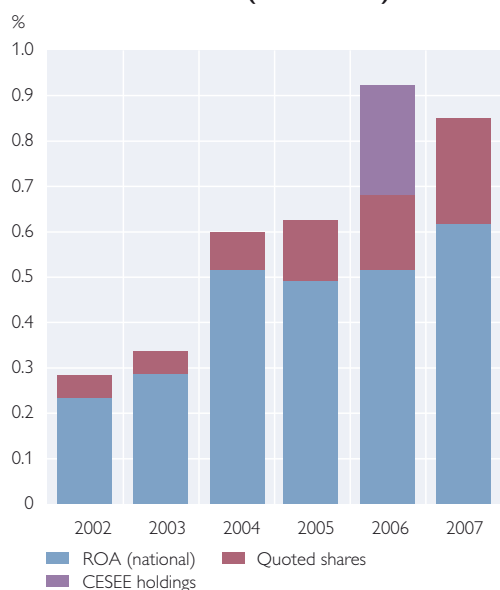


¹ The individual countries are shown according to the market shares of Austrian subsidiary banks (x-axis) and the aggregated total assets of the national banking industry (y-axis). The size of each circle corresponds to the total exposure of Austrian banks vis-à-vis the respective country. The countries' colors correspond to their average bank financial strength (BFS) ratings by Moody's. For technical reasons, the chart does not include Russia (4% market share, total assets of EUR 625 billion).

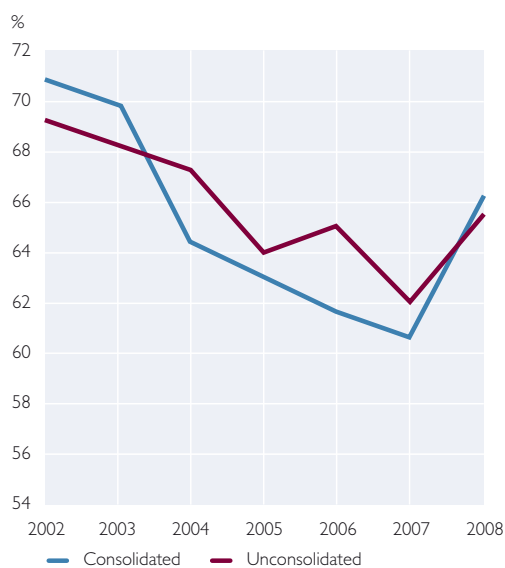
Chart 3

Return on Assets and Cost-to-Income Ratio

ROA of Austrian banks (consolidated)



Cost-to-income ratio of Austrian banks



2008 figures: As at Q3/08 for unconsolidated values, Q2/08 for consolidated values. Due to changes in reporting standards, consolidated values from 2008 are only partly comparable with earlier values.

Source: OeNB.

In the first half of 2008, the Austrian banking sector's unconsolidated total assets came to EUR 972 billion, the unconsolidated ROA (return on assets) stood at 0.36%, and the unconsolidated cost-to-income ratio was 65.8%; consolidated total assets amounted to EUR 1.161 trillion, the consolidated ROA was 0.62%, and the consolidated cost-to-income ratio ran to 66.6%. Operations in CESEE contributed as much as 42.6% of the pre-tax earnings of all Austrian banks in 2007. This focus on the CESEE region is one important reason the U.S. subprime mortgage crisis that started in mid-2007 had a comparatively low direct impact on the Austrian banking sector. However, the global financial turmoil in the wake of the U.S. crisis is a development of such proportions that it has not left the Austrian banking sector fully unscathed. Consequently, echoing the approach of other European countries, the Austrian parliament adopted a package of measures designed to mitigate the fallout of the crisis and to strengthen the Austrian financial market.

Austria is not only a home country, but also a host country for banking groups with cross-border operations. Since 2007, three of the six largest Austrian banks have been majority foreign owned. As home and host country supervisors, the FMA and the OeNB therefore consider it a top priority to cooperate closely with the respective supervisory authorities abroad.

1.2 Reasons for the Reorganization of FMA and OeNB Responsibilities

Financial market supervision, which was originally incumbent on the Austrian Federal Ministry of Finance, was reformed from the ground up at the turn of the millennium. One major milestone was that the newly established Financial Market Authority (FMA) began operating as an independent, integrated supervisory agency for the financial sector on April 1, 2002. Austria was now endowed with an independent statutory financial supervisory authority in line with international standards.

Upon the establishment of the FMA, the role of the OeNB in banking supervision was further strengthened in order to make use of the expertise at the central bank and to leverage synergies. In particular, the obligation to instruct the OeNB to conduct on-site inspections for the purpose of reviewing market and credit risk limitation was stipulated by law; the OeNB was accorded the right to be consulted and was obligated to provide expert opinions (especially about internal market risk models). Moreover, the OeNB has retained its responsibility for reporting and, like the FMA, it carries out off-site analyses of banks. In addition, the FMA and the OeNB are obligated to share observations about fundamental or significant developments in banking. When the Basel II requirements went into force on January 1, 2007, the OeNB was assigned additional competences to provide expert opinions, in particular on whether banks fulfilled the requirements for use of the Internal Ratings Based (IRB) Approach to assess credit risk.

Credit institutions constantly have to adjust their operations to market developments, and regulatory provisions need to be amended to account for new circumstances – by the same token, the organization of the supervisory framework also has to reflect supervisory experience and a changed environment.

In this vein, supervisory practice has shown that the reform implemented in 2001 and 2002 certainly represented an important step, but it turned out that the new prudential structure featured some systemic weaknesses that could not be

fully eliminated despite all cooperation efforts. For instance, there were overlaps and duplications in surveillance and analysis, and some gray areas regarding the scope of responsibilities. Also, the link between the micro- and the macrolevel – that is, the individual institution and the systemic level – has clearly become particularly important for the Austrian financial market due to Austrian banks' substantial exposure to CESEE. It became clear that the supervisory structure had to take advantage of synergies and had to reflect this link more effectively.

Therefore, the program presented by the Austrian government at the beginning of 2007 for the next legislative period announced an evaluation of financial market supervision in order to make it “more effective and efficient and to eliminate areas in which responsibilities are ambiguous, overlapping or duplicative.” At the outset, however, the actual means of attaining these objectives was a bone of political contention. As a result, a parliamentary inquiry committee was established first and foremost to investigate the political responsibilities involved in the guarantee the Republic of Austria granted to BAWAG P.S.K. in spring 2006, and an exhaustive discussion was launched. Additionally, the Austrian Court of Audit drew up a report addressing the criticism of overlapping responsibilities between the FMA and the OeNB and evaluated several models aimed at eliminating those overlaps. The report concluded with a recommendation for an organizational merger of the respective supervisory areas, in particular advocating a consolidation of on-site inspections and the concentration of off-site analysis in a single institution.

The primary aim of the government bill which was presented at the beginning of November 2007 and which incorporated the results of these discussions, the findings of the inquiry committee and the recommendations of the Court of Audit, was to optimize the architecture of banking supervision in Austria. The bill retained the integrated financial supervision model, keeping the FMA as the competent independent authority, but reassigning the FMA's and OeNB's responsibilities in the field of banking supervision along clearer lines in order to allow the expertise and experience of both institutions to be keyed to their respective strengths and to optimize the use of resources. The Austrian parliament passed the bill as early as December 2007, and the amendments of the relevant Acts (Banking Act, Financial Market Authority Act etc.) went into force on January 1, 2008.

To implement the reform in supervisory practice, the FMA and the OeNB initiated a project in parallel to the parliamentary process with the objective of optimizing the reassignment of responsibilities and of handling the related processes and resource requirements. Despite the extremely short run-up period, the authorities thus managed to put the reformed architecture into live operation on January 1, 2008, in line with the statutory provisions.

1.3 Assignment of Banking Supervisory Responsibilities from January 1, 2008

In essence, the new supervisory structure can be split up into a fact-finding function (overall risk assessment) and a decision-making function (official decisions). The OeNB is in charge of fact finding, while the FMA handles decision making. The main features of the new division of responsibilities are as follows:

- The FMA has retained its status as an independent and autonomous integrated financial supervisor and remains the authority in charge of banking supervision.

Assignment of Banking Supervision Responsibilities between the FMA and the OeNB: Old and New

	On-site inspection	Off-site analysis	Reporting	Administrative procedures
Old	FMA/OeNB	FMA/OeNB	OeNB	FMA
New	OeNB	OeNB	OeNB	FMA

- The OeNB is now in charge of conducting all on-site inspections.
- As a basis for these inspections, the FMA and the OeNB define an audit plan stating the priorities of the on-site inspections for each institution and the respective starting dates.
- In principle, the FMA continues to issue inspection mandates to the OeNB.
- The OeNB is responsible for all off-site analyses of banks. In this connection, it is obligated to perform regular comprehensive analyses of data reported and of other relevant information for banking supervision purposes and for preparing preliminary investigations by the financial supervisory authority. The OeNB is required to make all analysis results and any relevant information available to the FMA. These findings must contain a clear statement about whether there is a substantial change in the risk situation or any reason to suspect a violation of regulatory provisions. The OeNB is obligated to inform the FMA without delay if either of these two conditions applies. On request of the FMA, the OeNB must carry out specific off-site analyses or provide further explanations of analysis results.
- The OeNB operates a joint database with the FMA that ensures a high level of information at both institutions.
- Whenever possible, the FMA must draw on the OeNB's inspections, expert opinions and analyses and on the data available from the joint database. Unless it has reasons for justified doubts, the FMA may rely on the correctness or completeness of these data.
- Under the reformed framework, the OeNB also has to draw up expert opinions in approval procedures for all risk management models. Moreover, the OeNB has to assess the viability of banks' business models and has to present this assessment at a hearing before credit institutions are granted approval to merge or split.
- Finally, the new distribution of responsibilities is reflected by the fact that the adoption of memorandums of understanding (see section 3.8) – which under Austrian constitutional law is the responsibility of the Federal Minister of Finance – is now based on a joint proposal by the FMA and the OeNB.
- In addition to the reform, the OeNB's financial stability mandate was explicitly established in Article 44b of the Federal Act on the Oesterreichische Nationalbank (Nationalbank Act). Under this amendment, the OeNB must, in the public interest and based on extended data access rights, monitor all circumstances that may have an impact on safeguarding financial stability in Austria. These

enhanced competences entail the obligation that the OeNB inform the Federal Ministry of Finance and the FMA of any findings of a fundamental nature or of particular importance to financial stability. Upon request, the OeNB must produce the necessary technical explanations, make documents available and deliver expert opinions.

To sum it up, the reform has established a clear allocation of responsibilities. The measures taken to implement the reform guarantee an efficient and effective supervisory process and have tightened the overall supervisory framework. In formal terms, supervisory competences remain divided among two institutions, but from the perspective of credit institutions, there is a single, integrated supervisory process under reinforced joint responsibility.

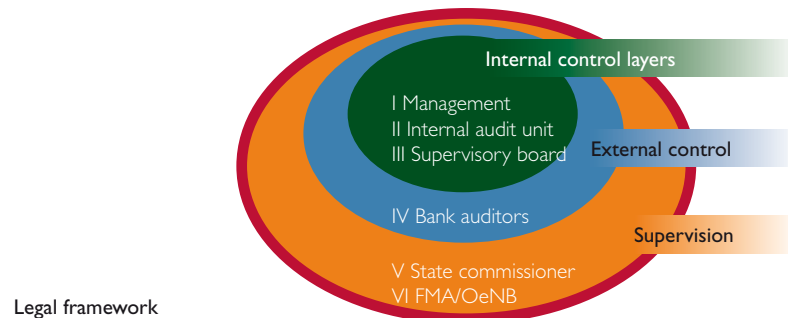
2 The Supervisory Architecture

2.1 Framework

The supervisory system is organized as a series of control layers, or checks and balances (see chart 5), with different responsibilities and obligations assigned to each layer.

Chart 5

Supervisory Architecture: Internal and External Control Layers



The first layer of control is the banks' **management**, which is obligated to comply with prudential legislation. Under Article 39 Banking Act, the managers of a credit institution must exercise the diligence of a prudent and conscientious manager. In particular, they must obtain information on and control, monitor and limit the risks of banking transactions and banking operations using appropriate strategies and mechanisms (internal control system – ICS), and have in place plans and procedures for internal capital adequacy assessment. Wherever possible, the administrative, accounting and control procedures must also capture risks which might possibly arise. Moreover, the managers are subject to the specific responsibility of fulfilling supervisory notification and reporting duties.

In addition, under Article 42 Banking Act, credit institutions have to set up an **internal audit unit** which reports directly to management and which serves the exclusive purpose of ongoing and comprehensive reviews of the legal compliance, appropriateness and suitability of the entire undertaking. The duties of the internal audit unit include performing audits of the capital adequacy assessment process and of measures to suppress money laundering, as well as auditing internal rating systems and their procedures at least once a year.

The **supervisory board** oversees the management of the credit institution. Some transactions are subject to approval by the supervisory board. The supervisory board may demand reports from the management board, may demand to inspect the books, documents and assets, and may call a general meeting in the interest of the company (see Article 95 Stock Corporation Act).

Beyond these internal control mechanisms, **bank auditors**¹ (see Article 60 ff Banking Act) represent the first external control layer. Bank auditors audit the financial statements of every credit institution and the consolidated financial statements of every group of credit institutions on an annual basis. This audit includes

¹ Bank auditors are certified external auditors or external auditing companies appointed as external auditors of financial statements as well as auditors (auditors, auditing unit of the Savings Bank Auditing Association) from legally competent auditing organizations.

an assessment of the factual accuracy of valuation, including the necessary depreciation, value adjustments and provisions, as well as an explicit assessment of compliance with key legal provisions (e.g. capital, reporting and disclosure requirements). The result of the audit must be presented in an annex to the audit report (prudential report). If, in the course of their auditing activities, bank auditors identify facts which

- may jeopardize the existence of the undertaking or materially affect its development;
- may endanger the fulfillment of the obligations of the credit institution;
- indicate a substantial deterioration of the risk situation;
- represent a substantial infringement of the legal basis; or
- indicate that material balance sheet items or off balance sheet items are worthless; or if they
- find reason to doubt the accuracy of documents or the declaration of completeness provided by the management board, then the bank auditors must report these facts to the FMA and the OeNB in writing immediately (special reporting duty of bank auditors).

Unless otherwise specified by law, the Federal Minister of Finance must appoint a state commissioner and a deputy state commissioner for a maximum term of five years in the case of credit institutions whose total assets exceed EUR 1 billion. The state commissioner has veto as well as inspection rights. In addition to their duty to regularly report to the FMA, state commissioners must report immediately any facts which become known to them and on the basis of which the credit institution's fulfillment of its obligations are no longer ensured.

The supervisory activities of the FMA and OeNB, which are described in detail in section 3, are based on these upstream control layers.

2.2 Organizational Structure of the FMA

The Executive Board (*Vorstand*) and the Supervisory Board (*Aufsichtsrat*) are the decision-making bodies of the FMA.

The **Executive Board** is responsible for managing operations as well as the FMA's business transactions in line with legal provisions and the Rules of Procedure. It represents the FMA in courts of law and extrajudicially. In addition, it must, in particular, issue Rules of Procedure and a Compliance Code and must submit a quarterly report to the Supervisory Board. On the basis of the Rules of Procedure, the Executive Board must ensure that the FMA fulfills its tasks in accordance with legal provisions, effectively, efficiently and economically, and that its staff is deployed in line with professional standards. As a collegial body, the Executive Board takes its decisions unanimously. The members of the Executive Board are nominated by the federal government and appointed by the Federal President for a term of office of five years.

The **Supervisory Board** is responsible for monitoring the management and business conduct of the FMA. The Financial Market Authority Act details the Supervisory Board's tasks, which include approving the budget, the Rules of Procedure, the compliance provisions of the FMA and its annual report to the Federal Minister of Finance and to the Finance Committee of the Austrian *Nationalrat* (National Council, one of the chambers of the Austrian parliament). The FMA's Supervisory Board has six members with voting rights and two co-opted members

without voting rights. The chairperson, deputy chairperson and other ordinary members are appointed by the Federal Minister of Finance; the OeNB has the right to propose the deputy chairperson and two other members. The co-opted members are nominated by the Austrian Federal Economic Chamber; these members have the right to obtain information. Members of the Supervisory Board serve five-year terms.

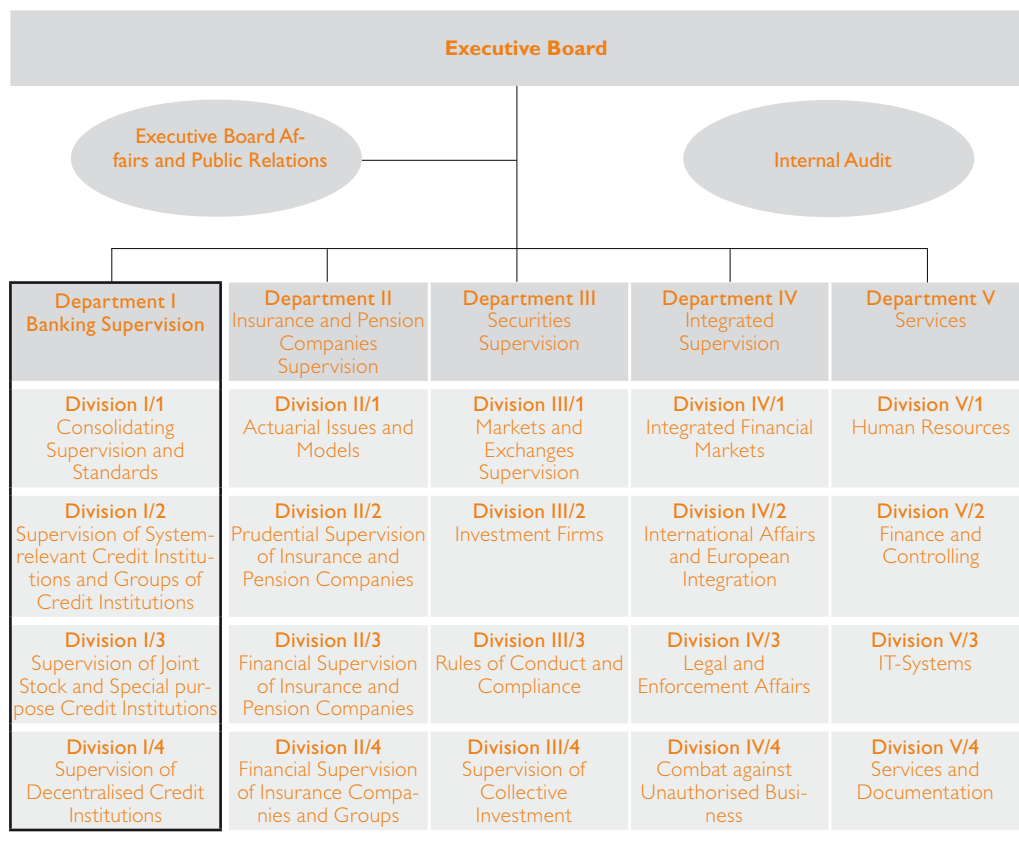
The Federal Ministry of Finance oversees the FMA in order to ensure that it fulfills its statutory tasks (statutory supervision under Article 16 Financial Market Authority Act). The FMA must submit a report on each calendar year to the Finance Committee of the *Nationalrat* and to the Federal Minister of Finance. In particular, this report has to include an overview of supervisory activities and the status of the financial sector.

As an integrated financial supervisory authority, the FMA is in charge of supervising banks, insurance companies, pension funds, and financial conglomerates as well as securities firms, investment service providers and investment companies. The organizational structure of the FMA reflects these responsibilities.

- **Banking Supervision Department:** The tasks of this department mainly include handling licensing, authorization and notification procedures, assessing whether the results of analyses necessitate official measures, performing administrative supervisory procedures, instructing the OeNB to conduct on-site inspections, handling supervisory issues pertaining to branches and representative offices of foreign banks and handling cross-border supervision under the consolidating supervision framework. Moreover, this department interprets supervisory law and participates in the drafting of supervisory legislation.
- **Insurance and Pension Companies Supervision Department:** This department is in charge of the ongoing prudential supervision of insurance companies' and pension funds overall operations, including on-site inspections, providing proposals for the further development of related legislation, handling licensing issues and exercising ongoing supervision.
- **Securities Supervision Department:** This department covers, in particular, the supervision of banks' compliance with reporting requirements with regard to instruments subject to these requirements, the supervision of markets and exchanges, issuer supervision, prospectus examination and approval, licensing and ongoing monitoring of securities firms, investment service providers and investment groups, investigations in the securities business and related cooperation with the penal authorities, supervision of adherence to rules of good conduct and compliance provisions, and proposals for the further development of related legislation.
- **Integrated Supervision Department:** This department is responsible for ensuring the homogeneity of financial market supervision, that is, for establishing a level playing field, and for preventing supervisory arbitrage. It exercises cross-sectoral supervisory responsibilities. The department's duties include supervising financial conglomerates, handling procedural and legislative issues, taking measures against illegal operations, coordinating the FMA's international activities, and collecting and distributing the knowledge required to gain a comprehensive assessment of market conditions for prudential supervision. Each department is represented in international bodies in the areas covering its remit.

Chart 6

Organizational Structure of the FMA



Four divisions handle the tasks of the **Banking Supervision Department**:

Division I/1, Consolidating Supervision and Standards, is responsible in particular for the observation of and contributions to international developments and for the further development of the strategy for home-host supervisory cooperation; it also participates in the establishment of (inter)national structures for crisis prevention and management. With regard to the further development of supervisory law, the division provides expert contributions to national and international review procedures and prepares bank-specific FMA regulations and minimum standards as well as guidelines. Another important task handled by this division is legal interpretation, which involves responding to external inquiries, compiling and reconciling the content of FMA circulars, and ensuring consistency in prudential administrative practice. Moreover, this division is in charge of fulfilling official disclosure requirements under pillar 3 of the Basel II framework. Together with the OeNB, this division sets up the annual audit plan for on-site inspections and issues the respective mandates to the OeNB. Additional responsibilities include handling issues related to the two FMA-OeNB coordination bodies that were established years ago, the heads of department forum and the senior management-level coordination forum; approving and supervising external credit assessment institutions under Article 21b Banking Act; imposing penalty interest under Article 97 Banking Act; managing various supervisory databases and delivering the division's contributions to FMA reports.

Each division in the Banking Supervision Department has representatives in the international bodies and working groups that correspond to their responsibilities.

Divisions I/2, I/3 and I/4 of the Department exercise all supervisory functions incumbent on a regulator. They are in charge of carrying out licensing, authorization and notification procedures, performing administrative supervisory procedures and handling official measures related to model supervision under the Banking Act as well as other relevant supervisory regulations. Further aspects of these divisions' activities comprise participating in management talks with banks and conducting company visits related to the provisions of the Banking Act on money laundering and terrorism financing. Furthermore, these divisions are in charge of collecting and processing information under Article 70 para. 4a Banking Act and evaluating analysis results in order to assess the need for official measures. Finally, Divisions I/2 through I/4 officially monitor the elimination of shortcomings found during on-site inspections and handle legal inquiries from supervised institutions. The divisions – especially Division I/2, which is responsible for cross-border banking groups – cooperate closely with foreign supervisory authorities. These divisions are also in charge of representing the FMA's international interests in connection with operational supervision. Each division is responsible for the FMA's international interests related to those banks that the division supervises. **Division I/2, Supervision of System-relevant Credit Institutions and Groups of Credit Institutions**, takes official action related to banks and banking groups whose size and cross-border investments render them highly systemically important for the Austrian financial market. **Division I/3, Supervision of Joint Stock and Special purpose Credit Institutions**, is in charge of supervising joint stock banks which are not systemically important as well as building and loan associations. Finally, **Division I/4, Supervision of Decentralised Credit Institutions**, is responsible for supervising industrial credit cooperatives and the primary banks of the agricultural credit cooperative sector.

2.3 Organizational Structure of the OeNB

The OeNB's decision-making bodies are the General Meeting (*Generalversammlung*), the General Council (*Generalrat*) and the Governing Board (*Direktorium*). The **General Meeting's** main responsibilities are to approve the annual accounts, to decide on profit appropriation and to fix the dividend to be distributed to shareholders. Moreover, the General Meeting is responsible for electing six members to the General Council and for appointing the OeNB's auditors.

The **General Council** is charged with the supervision of all business not falling within the remit of the ESCB. It is responsible for advising the Governing Board in the conduct of business and in matters of monetary policy; moreover, it has specific authorization rights. The General Council consists of the President, the Vice President and twelve other members. The President, the Vice President and six members are appointed by the federal government for a term of five years and may be reappointed. The other six members are elected by the General Meeting.

The **Governing Board** is responsible for the overall running of the OeNB and for conducting its business. In pursuing the objectives and tasks of the ESCB, the Governing Board undertakes to act in accordance with the guidelines and instructions of the ECB. The Governing Board consists of the Governor, the Vice Governor and two other members. The members of the Governing Board are appointed

by the Federal President of Austria acting on a proposal of the federal government. Each appointment is for a term of five years, and persons holding office may be reappointed. The Governor of the OeNB is a member of the Governing Council and of the General Council of the ECB. In performing these functions, the Governor and the Governor's deputy are not bound by the decisions of the Governing Board or by those of the General Council, nor are they subject to any other instructions.

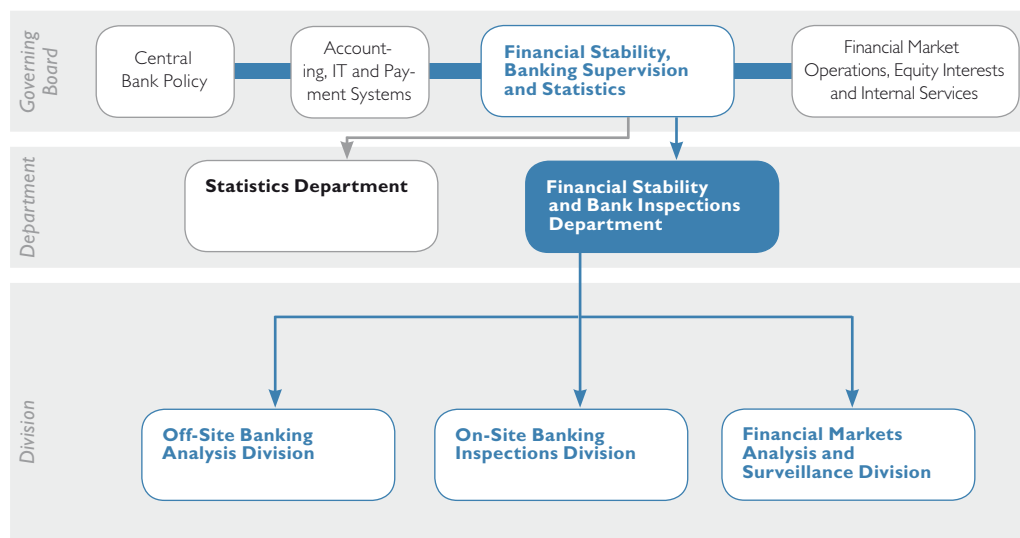
The organizational structure of the OeNB comprises four **Executive Directorates**. The Central Bank Policy Executive Directorate, which is headed by the Governor, is in charge of economic issues and has several staff-level positions. The Accounting, IT and Payment Systems Executive Directorate (assigned to the Vice Governor) also handles cash management. The Financial Market Operations, Equity Interest and Internal Services Executive Directorate is in charge of the Treasury Department and the Internal Services Department.

The Financial Stability, Banking Supervision and Statistics Executive Directorate handles supervisory issues; more precisely, these tasks are performed by the Financial Stability and Bank Inspections Department.

The Statistics Department, which is located within the same executive directorate, contributes substantially to the smooth operation of the banking supervisory process, as the data for supervisory statistics reported under Articles 74 and 75 Banking Act represent the decisive prerequisite for all types of supervisory analyses.

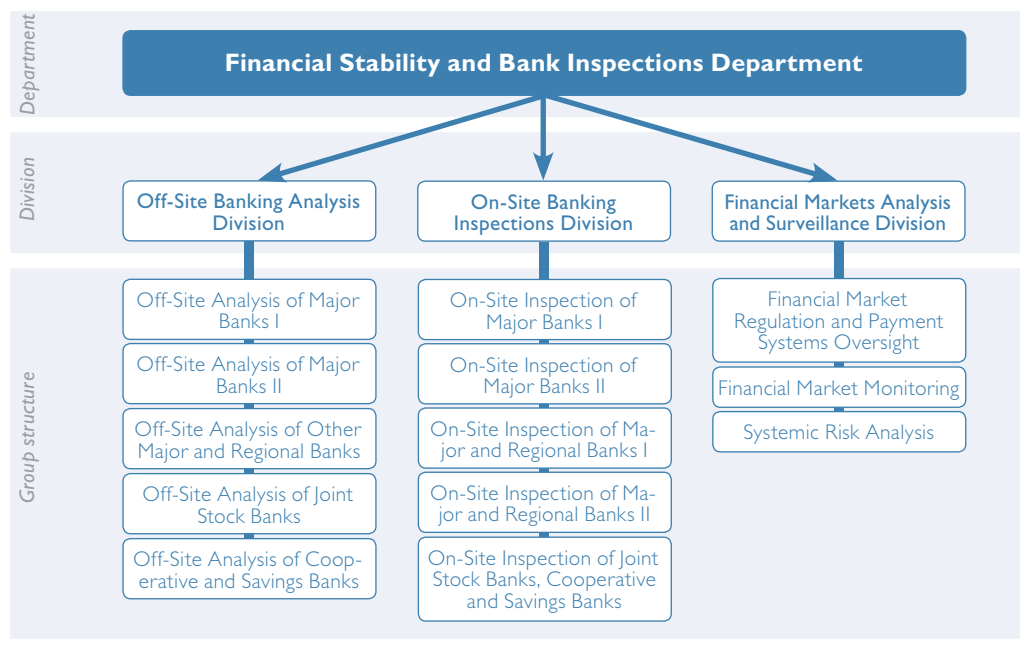
Chart 7

Organizational Structure of the OeNB



The organization and tasks of the Financial Stability and Bank Inspections Department with its three divisions are described in detail below.

Organizational Structure of the Financial Stability and Bank Inspections Department



Within the OeNB, microprudential supervision is handled primarily by

- the **Off-Site Banking Analysis Division** and by
- the **On-Site Banking Inspections Division**.

The two divisions' respective tasks are presented in sections 3.4 (Off-Site Banking Analysis Division) and 3.6 (On-Site Banking Inspections Division).

Under the new structure, the units established in each division are organized by banking sectors, with distinctions drawn between major banks, other major banks and regional banks, joint stock banks and cooperative and savings banks. The respective divisions (see section 3.1) handle the coordination with the FMA and any other supervisory authorities.

The **Financial Markets Analysis and Surveillance Division** analyzes the banking sector and other financial intermediaries primarily from the financial market stability perspective, focusing above all on systemic risk. Moreover, this division handles national and international regulatory and prudential issues and coordinates the preparation of contributions to bodies dealing with prudential topics (at the national level: for the Supervisory Board of the FMA and for the finance ministry's Financial Market Committee; at the EU level: e.g. for the ESCB's Banking Supervision Committee (BSC)). Moreover, the division is responsible for taking official action in connection with payment systems oversight in Austria. In view of the overarching goal of forging close links between micro- and macroprudential supervision, the division cooperates closely with the divisions responsible for microprudential supervision (on-site inspections and off-site analysis).

Prudential analysis is preceded by the collection and processing of data for prudential statistics. These tasks are handled by the Statistics Department, which is located within the same executive directorate and contributes substantially to the

smooth operation of the banking supervisory process. Two divisions located within the Statistics Department – the Supervisory and Monetary Statistics Division and the Credit Division – handle data reports for banking supervision purposes.

The Supervisory and Monetary Statistics Division collects a wide range of data for supervisory statistics, including the following reports:

- Report on compliance with regulatory standards under Article 74 Banking Act
- Asset, Income and Risk Statement under Article 74 Banking Act
- Large exposures report under Article 74 Banking Act
- Audited annual financial statements under Article 44 Banking Act
- Annex to the audit report on the annual financial statements (prudential report) under Article 63 para. 5 and disclosures regarding hidden reserves
- Report on loss data (loss database) under Article 74 Banking Act
- Payment systems statistics under the Nationalbank Act
- Statistics on severance funds under the Severance Fund Act
- Master data reports under Article 74 Banking Act

Within the framework of the OeNB's legal mandate, the Supervisory and Monetary Statistics Division is obligated to notify the FMA of violations of reporting requirements. Late, incorrect or incomplete reports constitute violations. Also, the division must notify the FMA of instances in which the reported data indicate noncompliance with the minimum requirements for banks established by law (e.g. the violation of large exposure limits for lending).

The Credit Division supports microprudential supervision especially by maintaining a database containing master data, by managing the Central Credit Register (CCR) and by analyzing the respective data. The division prepares a wide range of supervisory analyses based on CCR data for three main purposes: The first type, which involves the regular analysis of unusual CCR data, forms part of the Austrian Banking Business Analysis (ABBA) framework and as such is an integral part of off-site analysis. A second area of analysis supports experts' detailed analyses of large banks in the course of regular model examinations. Finally, the third type of analysis based on CCR data is used to prepare on-site inspections.

Above and beyond these tasks, the division is specifically responsible for the balance sheet analysis of Austrian nonbanks, for balance sheet statistics and for decisions to accept and handle credit claims as eligible collateral for Eurosystem credit operations. In addition, the division operates an extensive information database (e.g. primary data on companies, banks and participations) for various areas within the OeNB. Finally, the division assesses the financial soundness of European Recovery Programme (ERP) credits and handles such credits, and it is in charge of export promotion issues.

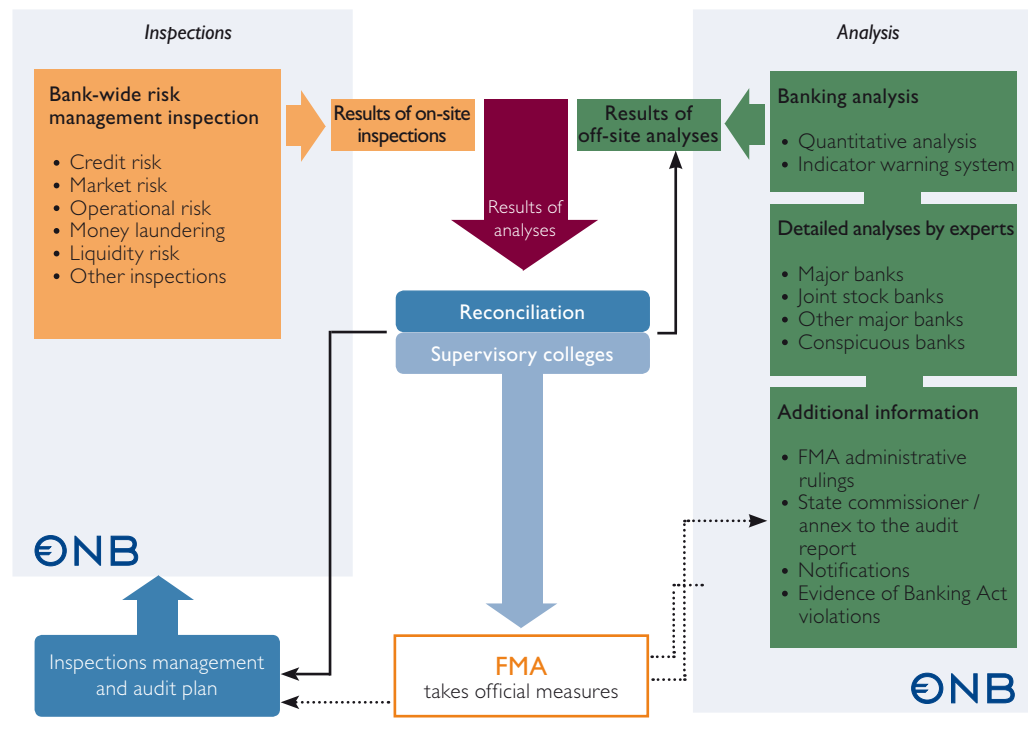
3 The Supervisory Process

3.1 General Framework

Based on the reassignment of responsibilities and on the recommendations for prudential supervision² of the Committee of European Banking Supervisors (CEBS),³ the supervisory review process in Austria was reformed along the following lines:

Chart 9

Schematic Representation of Supervisory Responsibilities



The supervisory process is organized so as to allow an efficient and risk-oriented use of the available supervisory resources – the greatest attention goes to the banks that bear the highest risk and to the systemically most important banks.

The right side of chart 9 shows the processes implemented (analyses) to determine which banks are exposed to particular risks. The first stage of analysis involves the automated processing and analysis of all banking data, known as basic analysis. Banks identified as conspicuous either during this first stage or because of an official procedure as well as major banks, major regional banks and joint stock banks are subjected to a comprehensive detailed analysis by an expert. In addition to the data reported, this analysis uses information from authorities, reports from state commissioners, reports from external auditors and other notifications. The structured dialogue (see section 3.9) plays an important role as a source of infor-

² All CEBS guidelines are available for downloading at www.c-ebbs.org (Publications > Standards & Guidelines).

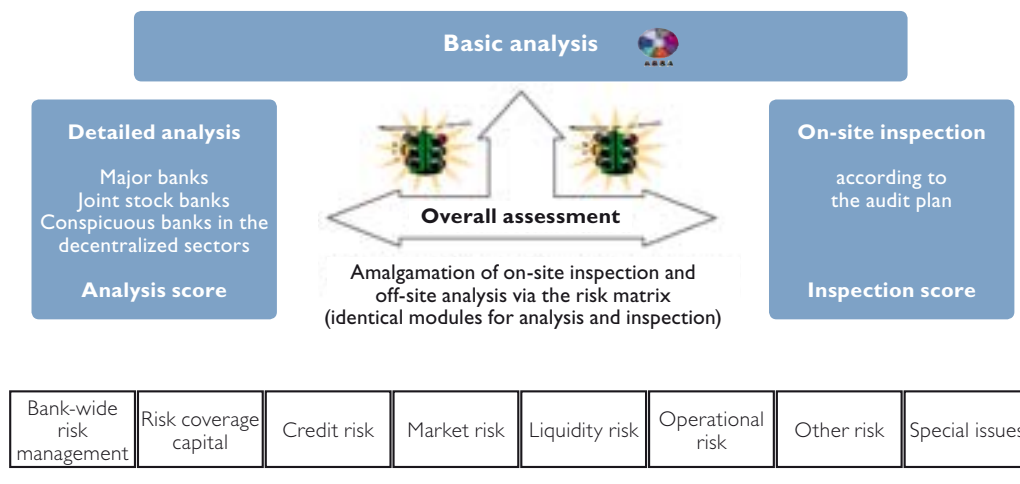
³ A London-based committee whose members are representatives of EU financial supervisory authorities and central banks and whose aim is to promote the convergence of national supervisory practice and to reinforce cooperation and the exchange of information.

mation. This practice refers to discussions with the banks' managers (management talks), risk managers (risk management talks) and CESEE business experts as well as bank auditors in order to obtain qualitative data on the basis of identified risks. In preparing analyses, staff experts may also draw on the macroeconomic analyses prepared by the Financial Markets Analysis and Surveillance Division and on information from the Central Credit Register administered by the Credit Division.

Once the analyses have been produced, the FMA launches an official procedure (if immediately required) or selects those banks which need to be examined more closely by means of on-site inspections. Such on-site inspections can be either bank-wide risk management inspections, covering all risk-related areas of a given bank, or they can focus on a specific aspect. Moreover, the analysis results also determine the focus of the inspection at a given bank. Uniform modules have been developed to examine and analyze specific areas, such as credit risk, market risk, money laundering or liquidity risk; this serves to better integrate the results of the inspection into the overall analysis of the respective bank.

Chart 10

Schematic Representation of the Link between On-Site Inspections and Off-Site Analysis



The process described above also includes tasks required in connection with the assessment and supervision of internal risk measurement models, specifically the Internal Ratings Based (IRB) Approach for credit risk, the Value at Risk (VaR) model for market risk and the Advanced Measurement Approach (AMA) for operational risk. The continuous supervision of models is handled by the division in charge of the off-site analysis of banks, while the assessment of these models is performed by the division in charge of on-site banking inspections; the related official activities are handled by the FMA.

3.2 Coordination between the OeNB, the FMA and Banks

In handling official activities related to supervision, the FMA must, as far as possible, draw on analysis and inspection results as well as the results of the expert opinions prepared by the OeNB during model approval procedures, in addition to

using information from third parties or from the respective bank. This collaborative setup calls for intensive, timely coordination between the two institutions. To this end, the FMA and the OeNB each appoint a **single point of contact (SPOC)** for every bank and for every banking sector. These SPOCs exchange information frequently and are thus a key communication bridge between the two authorities.

For their part, banks are also required to appoint a SPOC as a first contact and communication partner for the FMA and the OeNB and as a hub for prudential issues. Every supervised bank was requested to provide the supervisory authorities with the name of a SPOC and of a deputy SPOC for the SPOC's absence.

The SPOC's tasks include harmonizing internal positions and obtaining authorizations, clearing relevant documentation for release, scheduling appointments, naming contacts for special issues, and coordinating investigations and national as well as international research. Moreover, the SPOC serves as the first contact for urgent matters related to supervision.

To fulfill his or her responsibilities effectively, a bank's SPOC must exhibit a basic knowledge of supervisory matters (risk management, accounting, supervisory law) and must be authorized to provide information about supervisory issues. If the SPOC is not a management executive, he or she should nevertheless be authorized to consult senior management and if necessary the supervisory board to agree on a joint course of action on important issues. As a rule, the bank's SPOC should be available during business hours.

Also, the established forums in which basic prudential issues are harmonized between the FMA and the OeNB, namely the middle management-level forum and the senior management-level coordination forum, were supplemented by a **bank forum** (*Einzelbankforum – EBF*) which is in charge of handling issues at the individual bank level and ensuring that all relevant facts and perspectives will be taken care of in the decision making process. The new forum also ensures that broad agreement is reached on the approach chosen (at the middle or senior management level, depending on the issue). This reconciliation process is supported by a database, the **joint information system**. Various reporting data, relevant information available from the FMA's supervisory activities as well as data and results of OeNB analyses are filed in this database.

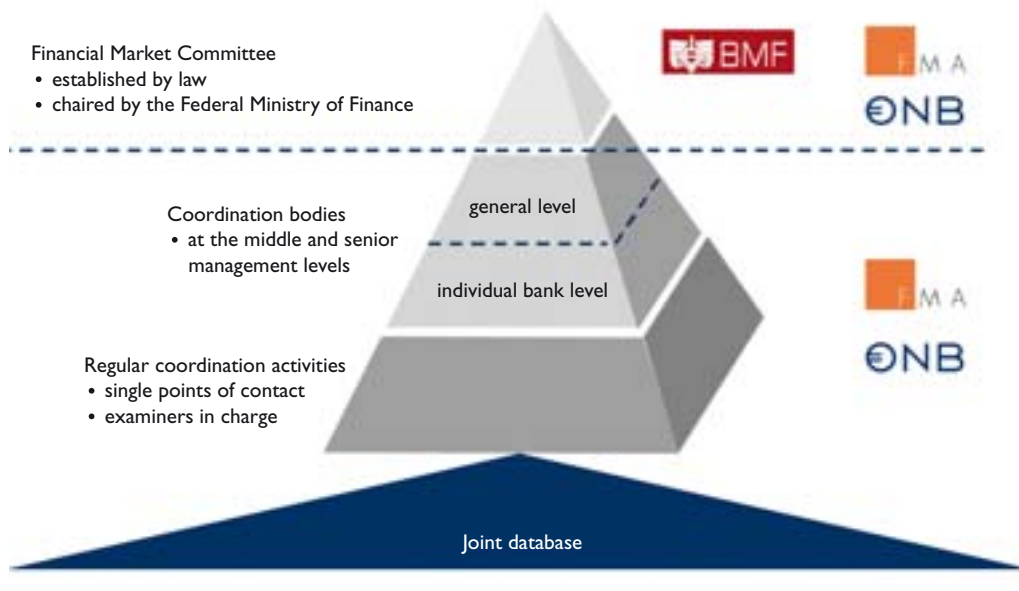
A **Financial Market Committee** was established at the Federal Ministry of Finance to foster cooperation and the exchange of views, and to provide advice on financial market and financial stability issues. The committee has one member each from the FMA, the OeNB and the Federal Ministry of Finance and meets at least once every quarter. The committee discusses national legal and overall financial market policy issues, and discusses the Austrian position on drafts of European legislation. Moreover, the Financial Market Committee also coordinates action during financial crises; in this function, it acts as the domestic standing group established in line with the 2008 Memorandum of Understanding.⁴

The assessment of risk and supervisory measures for banks which operate internationally requires cooperation with the competent financial supervisory bodies abroad. This cooperation is coordinated within supervisory colleges. All

⁴ *Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability agreed in April 2008 (entry into force: June 1, 2008).*

Chart 11

Interinstitutional Coordination



relevant cross-border information from every country in which the respective bank does business is discussed in such **supervisory colleges**, which are chaired by the home country's financial supervisory authority. The information is aggregated into an overall risk assessment and joint action is agreed if necessary.

3.3 Information Sources for Banking Supervision in Austria

Under Article 79 para. 4a Banking Act, the OeNB must subject the data reported and other supervisory information to ongoing comprehensive evaluation for the purposes of banking supervision and for the purpose of preparing supervisory investigations. The OeNB must inform the FMA without delay if there is a material change in the risk situation or if there is reason to suspect a violation of regulatory provisions. In general, the OeNB's analysis activity in the course of ongoing supervision is based on the following:

- reporting
- supervisory statistics
- reports to the Central Credit Register
- facts in notifications
- information requested in particular cases
- the structured dialogue framework
- banks' disclosure requirements

Regarding **reporting requirements**, under Article 44 para. 1 Banking Act credit institutions and the branches of foreign credit institutions must submit audited annual financial statements, annual reports, consolidated financial statements and consolidated annual reports, including the annex to the audit report on the annual financial statements (prudential report) indicated in Article 63 para. 5, to the FMA and the OeNB at the latest within six months after the close of the business year. The OeNB accounts for the relevant aspects of these reports in its overall

analysis within its risk-oriented approach. Its responsibility also includes monitoring adherence to deadlines. The OeNB notifies the FMA of any violations of law detected by the bank auditor.

Reports of bank auditors under Article 63 para. 3 Banking Act (ad hoc reporting obligation of bank auditors) represent an important source of supervisory information. In view of the inherent danger of a violation of the law in such cases, officials generally need to take immediate action. Consequently, the primary responsibility for these reports lies with the FMA. Such reports are submitted to the FMA and the OeNB; the FMA handles the related procedure, in the course of which it also assesses whether the OeNB is to be charged with a special analysis.

Annual and case-related reports by the state commissioners and deputy state commissioners about their activities (Article 76 para. 8 Austrian Banking Act) and reports of the auditing associations and deposit guarantee schemes serve as additional sources of information for the OeNB and the FMA.

The FMA is notified when the Federal Ministry of Finance appoints a state commissioner. The **reports of the state commissioner** are forwarded to the FMA, which evaluates whether the reports warrant any official action. The FMA shares these reports with the OeNB by filing them in the joint database. The FMA also handles requests for additional meeting documentation from state commissioners, which may also prove useful for official or analysis purposes.

As supervisory capacities are not sufficient to perform on-site inspections at every bank every year, Austria's supervisory authorities must rely on a sophisticated reporting system to procure information for off-site analyses (Article 74 Banking Act). At the end of 2006, several regulations⁵ designed to implement the uniform European reporting requirements (common reporting – COREP; financial reporting – FINREP) were announced in Austria.

The **Central Credit Register (CCR)**, to which exposures are reported under Article 75 Banking Act, is also a key source of information for analysis activities. The OeNB uses this information in its overall analyses. Within the framework of international cooperation on exchanges of large exposure reports, the FMA is principally in charge of forwarding information. However, this task has been entrusted to the OeNB by means of an FMA regulation.⁶

With information to be forwarded to both institutions under the provisions of the Banking Act being filed in the database by the OeNB, the two authorities have shared the responsibility for processing **notifications** under Article 73 Banking Act since January 1, 2008. In practice, the OeNB bears formal responsibility. As a matter of principle, though, all notifications are followed by a substantive review of their compliance with the provisions of the Banking Act, and this review is an activity carried out by the FMA. A special analysis may be required in individual cases.

The OeNB regularly reviews supervisory statistics data, which form the basis for OeNB analyses at the level of individual banks and banking groups as well as

⁵ The announcements may be downloaded in German from the FMA's website (www.fma.gv.at; Anbieter > Banken > Verordnungen).

⁶ See *FMA Regulation on the International Exchange of Data from the Central Credit Register*, Federal Law Gazette II No. 299/2005.

the systemic level. In turn, the FMA is provided with the results of these comprehensive analyses.

For the purpose of monitoring credit institutions and groups of credit institutions on an ongoing basis, the FMA has the statutory power to demand that bank bodies provide **ad hoc information** about all business matters and to inspect bookkeeping records, documents and data media (Article 70 para. 1 no. 1 Banking Act). In 2007, this right to demand information was invoked in some 150 cases; as a rule, the bank auditor was also involved.

In addition to such ad hoc formal requests for information, standardized talks under the **structured dialogue** framework are held with the management of numerous banks; these are known as **management talks** and **risk management talks** at major banks (see section 3.9). Moreover, the OeNB and the FMA maintain contact and regularly confer with all bank auditors of Austrian banks. The regular talks held with the auditing associations of the decentralized sectors and with bank auditors are especially noteworthy in this context. This exchange of information has proved invaluable over time and is just as important a component of official supervisory activities as the talks with the bodies running deposit guarantee schemes, which are required under the Banking Act to issue early warnings for their respective sectors.

Finally, bank disclosures under the Basel II requirements represent an additional source of information for supervisors. Within the framework of ongoing risk-based analysis, the OeNB monitors compliance with the disclosure requirements for credit institutions under Articles 26 and 26a Banking Act in conjunction with the Disclosure Regulation. If there is reason to suspect a breach of the law, the OeNB informs the FMA in an ad hoc report.

The classification of a credit institution as a significant subsidiary pursuant to Article 26a para. 5 Banking Act by means of an administrative ruling issued by the FMA is to be viewed separately (this classification results in limited disclosure requirements); in such cases, the OeNB makes a timely classification recommendation.

3.4 Off-Site Analysis

The OeNB's analysis concept is based on three pillars: economic analysis, continuous model supervision⁷ and official findings.

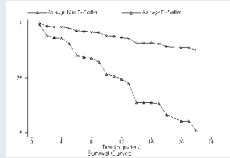
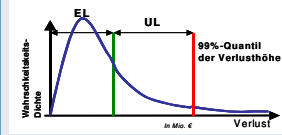

The purpose of the economic analysis is to capture a bank's economic risk. Economic analysis is subdivided into automated basic analysis⁸ of all banking data and detailed economic analysis.

For cost efficiency reasons, detailed economic analysis is not performed for each of Austria's 870 banks. Hence, a two-stage risk-based analysis process is needed. In the first step of this process, all banks are subjected to largely automated screening under the basic analysis framework. Then, in the second step, all banks identified as high-risk institutions during the basic analysis and on principle all major and joint stock banks undergo detailed economic analysis. The starting

⁷ Continuous model supervision applies to those banks that use advanced measurement approaches to assess.

⁸ For details on basic analysis, see the guideline "New Quantitative Models of Banking Supervision", which is available at www.oenb.at and www.fma.gv.at.

Key Models Used in Basic Analysis

Model	Peer group analysis	CAMEL approach	Logit model
Methodology	Deviation analyses (15 indicators, 9 groups)	Weighted assessment of key risk areas	Statistically optimized model to predict one-year default probabilities
Result	Number of outliers $\varepsilon = \frac{x - \mu}{\sigma}$	Total ranking C...capital A...assets M...management E...earnings L...liquidity	Default probability $PD_i = \frac{\exp(\beta_0 + \sum_{i=1}^k \beta_i x_i)}{1 + \exp(\beta_0 + \sum_{i=1}^k \beta_i x_i)}$
Model	Cox model	Structural model	Aggregation
Methodology	Statistically optimized model to predict time to default	Calculation of the expected maximum loss (relative to coverage capital) (Market, credit, operational and overall) value at risk	Statistical aggregation of various model results into a general assessment
Result	Time to default 		Score between 1 (excellent) and 6 (insolvent) 

point for the detailed economic analysis of major banks is invariably a group analysis (consolidated top-down approach).

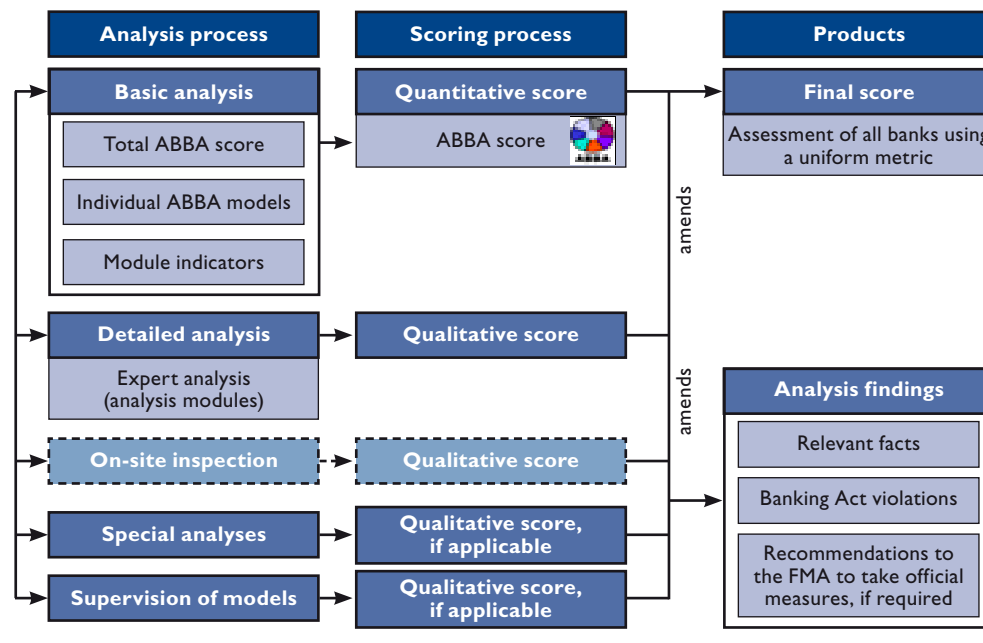
Whereas off-site analysis models rely exclusively on reported quantitative data, the detailed economic analysis uses additional qualitative information. Reports by external auditors, data from supervisory reports, information from talks under the structured dialogue framework (direct contacts with banks), market information, findings from the annex to the audit report (prudential report) and the reports of the state commissioners serve as the primary information sources for the detailed economic analysis. Unlike the basic analysis, where a model calculates bank scores automatically, the detailed economic analysis framework calls for expert assessments of those scores. Chart 13 illustrates how the analysis products are combined.

In addition to carrying out the economic analysis, the OeNB also conducts special analyses, which refer to a distinct type of analysis commissioned by the FMA as a **source of information for official procedures**.

Ongoing model supervision – the regular analysis of models subject to approval and of their use – includes all measures pertaining to the use of models subject to approval requirements under Article 21a ff Banking Act once they have been approved (see also section 3.5.4). This task is primarily incumbent on the OeNB. Ongoing model supervision involves assessing the functionality and adequacy of models on the basis of the relevant data reports and notifications as well as information from third parties, such as validation reports of banks as well as report and evaluation data, and analyzing compliance with the approval procedures specified in Articles 21 ff Banking Act. The findings derived from ongoing model supervision are transmitted directly to the FMA; they are also used in scoring for the OeNB’s overall assessment of banks.

Chart 13

Ongoing Supervision Process



Broken down by areas, ongoing model supervision covers the analysis of model approval and validation reports (credit risk, market risk, operational risk), the administration of model changes (Articles 21 ff Banking Act), the analysis of disclosure requirements (Articles 26 and 26a Banking Act) and the assessment of whether the requirements for permanent partial use are still fulfilled (Article 22b para. 9 Banking Act). For example, a qualitative and quantitative analysis of the validation results of the model is performed (e.g. back-testing; the results of stress tests for market risk as well as the discriminatory power, stability and calibration of internal rating procedures are also analyzed). Finally, an overall analysis is performed (Article 21 ff and Article 79 para. 4a Banking Act). This model-specific analysis is performed every year to obtain an overall assessment of the scope and quality of the models used, which is also useful for other supervisory institutions involved in the model approval procedure. The analysis includes the results of the above-mentioned reports from the respective preceding year, in particular the model approval and validation report. In drawing up this analysis, the OeNB also accounts for reporting data, in particular CCR data, when assessing credit risk. If in the course of the analyses the OeNB comes to the conclusion that the conditions for model approval no longer apply, it issues an ad hoc report to the FMA.

3.5 Activities of the Authorities

3.5.1 Framework Conditions for Executing Regulatory Procedures

As the authority responsible for banking supervision, the FMA is entrusted with the enforcement of the Banking Act, the laws cited in Article 2 para. 1 Financial Market Authority Act and the regulations issued on their basis.

Regulatory banking supervision activity by the FMA implies the existence of a sufficiently specific circumstance as grounds for action (see also section 3.5.6). As

a rule, it is up to the OeNB to ascertain the existence of such a circumstance, which is based either on analyses generated automatically (e.g. the Banking Act violation table) or on specific expert analyses.

As a result, specific facts are represented such that they are accessible for a final legal assessment by the FMA and an evaluation of required official measures (in particular, official requests for reports and information under Article 70 para. 1 no. 1 Banking Act, imposition of reporting obligations, issuance of administrative rulings under Article 70 para. 4 Banking Act, talks with management and the like). Unlike special analyses, which result from official requirements, ongoing analysis is risk based. For high-risk banks and banks of high systemic significance, a detailed analysis by experts is performed in addition to the automated quantitative analysis performed for all banks.

The recently established SPOC principle (see section 3.2) ensures that the respective responsibilities are clearly assigned and that communication is efficient.

The OeNB continually informs the FMA about all findings of its risk-based analyses, in particular about any deterioration of a bank's risk situation or any other arising need for official action. If the analysis shows no need for action, the FMA will rely on this result as long as it has no information to the contrary.

If during the course of its ongoing off-site analysis the OeNB determines that there is a need for official action, the OeNB forwards a report containing the conclusions of the analysis and a specific description of the facts to the FMA for further official activities. The report explicitly specifies the legal provisions (Banking Act, regulations, ancillary laws) that the OeNB suspects have been violated. Wherever specific remedial measures suggest themselves (e.g. imposition of a reporting obligation, an administrative ruling regarding measures and the like), these are also proposed. Principally, though, the choice of and responsibility for the measure to be applied in each specific case is up to the FMA.

In practice, the OeNB provides the FMA with all analysis results via the **joint database**. By the same token, the FMA also informs the OeNB about all official measures via this database. Ad hoc reports are dealt with in the newly established bank forum. A joint presentation by the FMA's SPOC for official issues and the OeNB's SPOC for analyses, with each SPOC covering topics within their remit, serves as the basis for decision making in the bank forum.

The structure of the interface between analysis and official tasks is described in the next section using specific examples of the FMA's enforcement competences.

3.5.2 Interpretation and Further Development of Supervisory Law

The interpretation of the Banking Act as well as ancillary laws and regulations is centralized and is incumbent solely on the supervisory authority. Legal inquiries are to be addressed to the FMA and are also answered by the FMA. The FMA informs the OeNB of any significant interpretations of supervisory law so that the OeNB can take them into account when drawing up expert opinions. In cases where legal inquiries from supervised entities have an economic background, the FMA may instruct the OeNB to prepare a special analysis for the legal issue in question.

Moreover, the FMA participates in the further development of supervisory law at the European level. Depending on the issues and the area of activity concerned, the Federal Ministry of Finance, the FMA and the OeNB send delegates to the

relevant bodies. In any event, the Austrian position is agreed in advance. The Federal Ministry of Finance supports the legislative process and the FMA issues regulations to implement European regulations; the OeNB is involved under the hearing procedure provided for by law.

3.5.3 Supervisory Procedures

In Austria, banks may carry out transactions if they have taken out a license with the FMA or under the freedom to provide services and the freedom of establishment. Numerous procedures at banks require prior authorization by the FMA. The main supervisory activities of the FMA are listed below:

- **Granting and expansion of licenses (Articles 1 through 5 Banking Act):** Applications for licenses and applications for the expansion of an existing license, including all enclosures to the application, must be addressed to the FMA. The FMA conducts any preliminary talks required for the submission of an application. The FMA examines the application documents from an economic and a legal perspective and then forwards them to the Federal Ministry of Finance and the OeNB as well as the competent deposit guarantee scheme for consultation. The FMA receives and examines the comments of these institutions and then takes a final decision. If a license is granted, the FMA informs the above-mentioned institutions by forwarding the relevant administrative ruling. After granting or expanding a license, the FMA files the license or expansion ruling in the license database.⁹
- **Revocation and lapse of licenses (Articles 6 and 7 Banking Act):** The FMA must issue an administrative ruling indicating that a license has been revoked or has lapsed. If the FMA gains knowledge of facts which constitute grounds for the revocation or lapse of a license, it must take the appropriate official steps, also involving supervisory authorities abroad if necessary. If such facts come to the attention of the OeNB in the course of its analysis activities, the OeNB notifies the FMA on an ad hoc basis.
- **Notification procedures (Articles 9 through 19 Banking Act):** Under the freedom of establishment and the freedom to provide cross-border services, banks from European Economic Area (EEA) Member States may carry out banking activities, provided they have notified the FMA accordingly. These procedures are handled without involving the OeNB; immediately thereafter, the information is forwarded to the OeNB (and the Austrian Federal Economic Chamber) and published on the FMA's website.¹⁰ The Banking Act applies to a restricted degree, and the OeNB performs continuous risk-based supervision in the course of its analysis activities. The FMA takes supervisory measures and handles contacts with the competent Member State authorities (Articles 15 through 17 Banking Act).
- **Qualifying participations in banks (Article 20 Banking Act):** Within the framework of ownership monitoring, Article 20 Banking Act serves to provide the FMA with information about current ownership structures and the reli-

⁹ The German website of the FMA provides access to the license database at www.fma.gv.at (Anbieter > Banken > Übersicht).

¹⁰ See www.fma.gv.at (Anbieter > Banken > Übersicht) for a list of the banks which have taken up activities in Austria on the basis of the freedom of establishment or the freedom to provide cross-border services.

ability of owners; this information is also required at the international level. In addition, the FMA is responsible for applying the fit and proper assessment procedure to a new potentially qualified participant in a bank. Notifications of the intended purchase of a qualifying participation in a bank are submitted to the FMA, which takes the procedure (including any contacts with other supervisory authorities and the like) all the way to a decision to authorize or prohibit the participation. The OeNB is involved if a special analysis is required for the procedure.

Annual notifications under Article 20 para. 3 Banking Act are submitted to the FMA and to the OeNB. The OeNB files this information in the joint database. If the analysis reveals violations of the Banking Act, the OeNB informs the FMA in an ad hoc report.

The FMA is responsible for imposing supervisory measures under Article 20 para. 5 Banking Act and for notifying the competent authorities under Article 20a para. 5 Banking Act.

– **Approvals under Article 21 Banking Act:** A variety of heterogeneous items are included among the activities subject to approval under Article 21 Banking Act. All applications for approval are to be submitted to the FMA. The FMA handles procedures and the contacts required for this purpose (including contacts with the competent supervisory authorities abroad).

The involvement of the OeNB in the individual procedures varies, resulting partly from legal provisions and partly from the need for more in-depth economic analysis:

a. Bank mergers or amalgamations (no. 1), bank demergers (no. 6) and mergers or amalgamations of banks with nonbanks (no. 7): Consulting the OeNB is obligatory in such cases. Applications are submitted to the FMA; after an examination of the legal and economic aspects of these documents, they are forwarded to the OeNB for consultation. The FMA takes the comments of the OeNB into account in decision making.

b. Transactions in which the limits of 10% (qualifying participation), 20%, 33% or 50% of the voting rights or capital of a credit institution (no. 2) are reached, exceeded or underrun: The Banking Act does not provide for OeNB involvement in the approval procedure. A special analysis by the OeNB may be required as a result of the transaction (type, volume, complexity) or the parties involved (applicant bank or bank to be acquired). The OeNB automatically monitors compliance with this approval requirement.

c. Change in the legal form of a bank (no.3), establishment of branches in a third country (no. 5) and expansion of the purpose of business to include activities related to insurance mediation (no. 8): As a rule, the OeNB need not be involved. The FMA provides information about the conclusion of these procedures by way of the joint database.

3.5.4 Basel II Approval Procedures

To calculate minimum capital requirements for credit, market or operational risk, banks may use their own refined calculation methods, also known as internal models. This requires authorization by the FMA, which is preceded by an expert opinion from the OeNB. Articles 21a para. 1, 21c paras. 1 and 2, 21d para. 1, 21e para. 1 and 21f para. 3 Banking Act specify the respective conditions under which

the FMA grants special approval for the use of the following internal models by banks or by a superordinate bank for its banking group:

- Calculation of the assessment base for **credit risk** pursuant to Article 22 para. 2 Banking Act using the Internal Ratings Based (IRB) Approach pursuant to Article 22b Banking Act (Article 21a para. 1 Banking Act);
- Use of own volatility estimates under the **financial collateral comprehensive method** pursuant to Article 22g para. 3 no. 2 lit. b Banking act (Article 21c para. 1 Banking Act);
- Calculation of the **exposure value adjusted for the effect of collateral** using an internal model in the case of master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transactions, or other capital market-driven transactions which do not involve derivative instruments in accordance with Annex 2 to Article 22 Banking Act, or margin lending transactions (Article 21c para. 2 Banking Act);
- Calculation of minimum capital requirements for **operational risk** using the Advanced Measurement Approach under Article 22l Banking Act (Article 21d para. 1 Banking Act);
- Calculation of minimum capital requirements for **market risk** using an internal model (value at risk model) under Article 22p Banking Act (Article 21e para. 1 Banking Act);
- Use of an **internal model** to calculate the exposure value for (1) the derivative instruments listed in Annex 2 to Article 22 Banking Act, (2) repurchase transactions, (3) securities or commodities lending or borrowing transactions, (4) margin lending transactions, and (5) long settlement transactions (Article 21f para. 3 Banking Act).

In each case, the FMA's approval is subject to the existence of conditions specified under the Banking Act or to the fulfillment of the related requirements (see Articles 21a para. 1, 21c para. 1, 21c para. 2, 21d para 1, 21e para. 1 and 21f para. 3 Banking Act). The actual design of the internal model in the respective area to which it is applied is up to the bank or the superordinate bank for its banking group.

The FMA must obtain an expert opinion from the OeNB on the existence of the conditions or fulfillment of the requirements in each case (see Articles 21a para. 2, 21c para. 1, 21c para. 2, 21d para. 1a, 21e para. 2 and 21f para. 5 Banking Act).

In an exclusively national (i.e. Austrian) approval procedure, the FMA as the competent authority issues administrative rulings by which it approves applications for the use of an internal model, taking into account all facts presented, the documents made known to it and the expert opinion provided by the OeNB.

If a superordinate bank established in Austria and its subordinate institutions established in Austria and in another Member State apply jointly for approvals under Article 21a or Article 21d to Article 21f Banking Act, then this joint application is to be submitted to the FMA (as the central competent supervisory authority) by the superordinate bank on behalf of the entire banking group (see Article 21g para. 1 Banking Act). As the central competent supervisory authority, the FMA must under Article 21g para. 2 Banking Act immediately forward the complete application to the remaining competent authorities and decide on the application after consultation with those authorities in accordance with Article 129 (2) of Directive 2006/48/EC within a period of six months.

As the central competent supervisory authority, the FMA in turn is obligated to obtain an expert opinion from the OeNB on the fulfillment of the requirements for approval. However, in a cross-border procedure, those areas which must be examined by the remaining competent authorities are to be excluded from the scope of the expert opinion with which the OeNB is charged. As the central competent authority, the FMA sends a structured request to the remaining competent authorities for a statement on the fulfillment of the requirements for approval in the respective area of national supervisory competence.

In such a cross-border approval procedure, the FMA as the central competent authority comes to an agreement with the remaining competent authorities about the application for approval of the use of an internal model, taking into account all facts presented, the documents made known to it and the expert opinions provided by the OeNB and the other competent authorities, in the form of a joint decision under Article 21g para. 2 Banking Act.

Finally, the FMA as the central competent authority issues an administrative ruling to implement the joint decision reached with the remaining competent authorities.

The principal competence for handling procedures related to **model changes** also lies with the FMA. Here, a distinction must be made between nonessential changes, which are simply acknowledged, and essential changes, which result in a new approval procedure.

A further task assigned to the FMA in the implementation of the Basel II requirements is the recognition and supervision of **external rating agencies (External Credit Assessment Institutions – ECAI)** under Article 21b Banking Act. Banks may rely on ratings prepared by external rating agencies for ratings under the Standardized Approach to Credit Risk or for calculating exposure amounts for securitizations, provided the FMA has recognized the respective external credit assessment institution for these purposes. If an external credit assessment institution has already been recognized by the competent authority in another Member State, the FMA may recognize that external credit assessment institution in a fast-track procedure without further review. Where such a fast-track procedure does not apply, the FMA must conduct a comprehensive approval procedure. In this context, the FMA may commission the OeNB with drawing up an expert opinion on the fulfillment of the conditions for approval. In addition to recognizing external rating agencies, the FMA must assign the assessments of the respective rating agency to the credit quality steps defined for supervisory purposes by way of a (mapping) regulation. The OeNB has the right to be consulted in the process of issuing such regulations.

Finally, the FMA is in charge of monitoring external credit assessment institutions on a regular basis. This applies especially to notifications of the FMA by rating agencies under Article 21b para. 3 Banking Act. As in the approval procedure itself, the FMA may instruct the OeNB to prepare special analyses in individual cases. The OeNB informs the FMA of facts that come to its attention in the course of its activity and that justify doubts as to the ongoing fulfillment of the conditions for approval under Article 21b Banking Act.

3.5.5 Other Supervisory Areas Covered by the FMA

Other supervisory areas covered by the FMA include the following:

- **Special Requirements for Bodies of Credit Institutions (Article 28a Banking Act):** The FMA is responsible for enforcing the special provisions governing chairpersons of supervisory boards (“fit and proper tests”). The OeNB’s involvement in the approval procedure is not provided for; within the framework of its ongoing analysis activities, the OeNB among other things takes account of compliance with Article 28a Banking Act, and if there is any evidence of a violation of the law, the OeNB notifies the FMA ad hoc. The FMA then undertakes the further official procedural steps.
- **Risk classification organizations (Article 39 para. 2a Banking Act):** The FMA is to be notified of and has to take into account the intention to use joint risk classifications (data pooling in preparation for the IRB). However, a related special analysis by the OeNB may prove useful with regard to the actual preparation for IRB use.
- **Appointment of bank auditors (Article 60 ff Banking Act):** The FMA is to be notified of the appointment of bank auditors, and the bank must certify the absence of reasons for exclusion. The FMA examines the existence of any reasons for exclusion, takes the related measures and informs the OeNB by way of the joint database.
- **Unauthorized conduct of banking business (Articles 22b ff Financial Market Authority Act):** The FMA officially prosecutes institutions which conduct banking business without the required authorization. Within the scope of its supervisory activities, the FMA conducts preliminary investigations until sufficiently specific facts have been determined. If facts which raise suspicions of the unauthorized conduct of banking business come to the attention of the OeNB in the course of its analysis activities, the OeNB notifies the FMA for further action.

3.5.6 Supervisory Measures

- **Official investigations (Article 70 para. 1 Banking Act):** In order to take supervisory measures, the FMA must have sufficiently specific facts at its disposal. Article 70 para. 1 Banking Act provides the FMA with a comprehensive range of instruments that serve the purpose of ascertaining such facts. Within the framework of its official activities, the FMA may at any time obtain information from banks or bank auditors (imposition of reporting obligations), it may have experts conduct audits, or it may instruct the OeNB to conduct on-site inspections. It must be noted that these sources of information are seen as a complement to the OeNB’s analysis activities (see section 3.5.1).
- **Official measures (Article 70 paras. 2, 4 and 4a Banking Act):** In cases of danger to the fulfillment of a bank’s obligations to its creditors, the FMA may issue an administrative ruling ordering measures for a limited period (Article 70 para. 2 Banking Act). In cases where a violation of the law but no danger to the fulfillment of obligations to creditors is identified, the FMA first has to instruct the bank to restore legal compliance within an appropriate period, and in cases of repeated or continued violations, to completely or partly prohibit the directors from managing the bank, or, if other measures cannot ensure the proper functioning of the bank, to revoke the license (see section 3.7

for violations of pillar 2 provisions). In line with the principle of proportionality inherent in its actions, the FMA must employ the most moderate instrument to reach the respective target, namely the reestablishment of a status in conformity with legal provisions. All measures presuppose that a bank has violated standards or are contingent on the existence of a danger to the fulfillment of obligations to creditors (without the occurrence of insolvency or overindebtedness). As the competent authority, only the FMA may take supervisory measures, which require official procedures to be carried out under the provisions of the General Law on Administrative Procedure.

- If reports of bank auditors drawn up under Article 63 para. 3 Banking Act or information to be evaluated by the FMA contains facts that are sufficiently specific to warrant further official action, the FMA will immediately institute proceedings. Where such facts become apparent only in combination with the analysis by the OeNB, the OeNB informs the FMA of these facts in an ad hoc report.
- With reference to measures under Article 70 para. 2 Banking Act (danger to the fulfillment of obligations to creditors), rapid communication and agreement on the further procedure ensues between the FMA and the OeNB. The established communication channels and bodies ensure that the special urgency of such cases is properly taken into account.
- **Reorganization measures (receivership and insolvency proceedings under Article 81 ff Banking Act):** The FMA is the competent authority for such measures. The facts in each case are determined through various channels: On the one hand, the OeNB pays attention to such facts in the course of its ongoing analysis activities and informs the FMA ad hoc. However, the FMA may also ascertain facts that trigger reorganization measures, especially in reports under Article 63 para. 3 Banking Act or notifications under Article 73 para. 1 nos. 5 and 6 Banking Act. Such cases warrant and require immediate action by the FMA already on the basis of this information, and the FMA may commission the OeNB with a special analysis if necessary. The FMA handles the exchange of information and cooperation with the competent supervisory authorities of other Member States.
- **Penalty interest (Article 97 Banking Act):** The FMA must charge penalty interest to banks that fall short of or exceed statutory limits (on capital requirements, liquidity, open term positions and large exposures). The interest is to be paid to the federal government.
- **Administrative penal proceedings (Articles 98 and 99 Banking Act):** In its capacity as an authority, the FMA conducts administrative penal proceedings in the first instance. In order to initiate such proceedings the FMA must have sufficiently specific facts at its disposal; this information may stem from the OeNB's analysis activities or from the FMA's own investigations.

3.6 Planning and Conduct of Audits

The reform of financial supervision included the adoption of more specific legal framework conditions for determining which banks are to be inspected. Under Article 70 para. 1b Banking Act, the OeNB and the FMA must jointly define an audit plan for each upcoming calendar year that takes into account the following criteria:

- audits of system-relevant banks
- an appropriate frequency of audits of banks which are not system-relevant
- resources for ad hoc audits
- thematic focuses of audits
- the review of measures taken to remedy the defects identified (follow-up audits)

The audit plan determines the focus of inspections for each bank and the time at which they are to be conducted. This plan is adopted jointly by both institutions.

The audit plan also lists all inspections needed for model approval procedures or other official purposes. Moreover, on the basis of the analysis results, those institutions and audit areas are chosen which appear relevant for an inspection either because of their size or because of their risk level.

Additionally, whenever necessary, the OeNB is entitled or obligated to request that the FMA extend ongoing inspections or initiate inspections not envisaged in the audit plan. The FMA must decide on such requests from the OeNB without delay, at the latest, however, within one week. Moreover, the OeNB may carry out on-site inspections on its own initiative, that is, without an inspection mandate from the FMA, if “macroeconomic reasons” warrant such inspections (e.g. the inspection of systemically relevant institutions).

For on-site inspections under the audit plan, the FMA issues an inspection mandate specifying the area to be inspected by the OeNB. Where advance notice is not expected to frustrate the objective of the inspection, the FMA notifies the bank of the planned inspection and the OeNB’s examiner in charge contacts the bank to arrange organizational details. The inspection itself is conducted in close cooperation with the FMA and OeNB SPOCs. Once the inspection has been completed, the bank is usually informed of the preliminary inspection results in a concluding meeting.

The OeNB simultaneously provides both the bank and the FMA with the audit report, and the bank has the right to comment on the report. The bank’s comments are also made available to the FMA. The FMA is immediately informed in an ad hoc report under Article 79 Banking Act of facts that become known to the OeNB in the course of its inspections and that trigger immediate official measures.

The compilation of expert opinions for model approvals under Article 21a ff Banking Act are drawn up according to a similar procedure. On account of the legal framework, however, these opinions are sent to the FMA first, and then the FMA grants the bank the right to comment.

On-site inspection reports and opinions on models are an important source of information for analysis. Consequently, the OeNB must relate them to the other analysis results available and the comments made by the bank and then must evaluate them to determine any violations of laws and the resulting need for official measures.

3.7 Inspection and Evaluation of the Internal Capital Adequacy and Assessment Process

Under pillar 2 of Basel II, banks need to implement sound processes and systems to ensure that they are adequately capitalized at all times in view of all material risks. In international forums of debate, the relevant methods are described as the **Internal Capital Adequacy Assessment Process (ICAAP)**. The specific design of the processes under pillar 2 takes due account of the type, scope and complexity

of the banking transactions conducted and is therefore left to the individual discretion of each bank.

ICAAP evaluation is generally considered an additional task under the OeNB's established analysis activities and has been integrated into existing processes and responsibilities. In terms of the scope and depth of evaluation, the approach used follows the principle of dual proportionality.¹¹

In analyzing the ICAAP, the OeNB reviews the banks' own procedures and methods to evaluate capital adequacy and compares the quantitative data compiled internally by banks with the data it has compiled. In reviewing the individual banks' procedures and methods, the OeNB is guided by the proportionality principle when addressing various topics, such as strategies to ensure capital adequacy, the integration of the ICAAP into the internal control system, methods to determine risks and coverage capital, the adequacy of methods to quantify and aggregate risks, the allocation of risk capital and a comparison with solvency ratios (plausibility of the risk level), among others.¹²

In addition, risk management talks were introduced as an additional communication channel in order to directly address the units in charge of risk management processes (operational implementation of the risk strategy and second level of management) at banks (see section 3.9).

Within the ongoing supervisory process, the ICAAP is evaluated annually at all Austrian banks with due attention to the proportionality principle. The annual evaluation focuses on selected issues and relies on all sources of information available to the supervisory authority, including the bank auditor's report for the purpose of initial assessment (see section 3.3). The facts established during the analysis of the data in the audit reports from bank auditors, the reports of the state commissioners, public information as well as the facts ascertained in regular exchanges with banks are continuously entered into the OeNB's integrated analysis system.

In addition, more detailed information is gathered, either by means of standardized questionnaires or by means of full-scope evaluations or on-site inspections. The information collected depends on the systemic relevance of the bank and the type, scope and risk level of its transactions.

The FMA's overall assessment of the appropriateness of the ICAAP at individual banks is based on all findings of on-site inspections and off-site analyses. On this basis, the FMA decides whether supervisory measures are required.

Under Article 69 para. 2 Banking Act, the FMA must, in the course of its ongoing monitoring activities, monitor the adequacy of the capital available for the quantitative and qualitative coverage of all material risks from banking transactions and banking operations as well as the adequacy of procedures pursuant to Article 39 paras. 1 and 2 and Article 39a, with special regard to the risks indicated in Article 39 para. 2b. Where a bank or banking group has not provided for adequate limitation of risks (and the proper capture and limitation of risks cannot be expected in the short term), the FMA must impose a minimum capital requirement which is sufficient to limit the risks arising from the banking transactions

¹¹ "Dual proportionality" means that both the banks' internal capital adequacy assessment process (ICAAP) and the supervisory review and evaluation process (SREP) take due account of the type, scope and complexity of the banking transactions conducted.

¹² See OeNB/FMA, *Guidelines on Bank-Wide Risk Management (Internal Capital Adequacy Assessment Process)*

and banking operations and which exceeds the minimum capital requirement specified under Article 22 para. 1.

Such additional capital requirements may be imposed immediately if, given the circumstances involved, other measures cannot be expected to reestablish the adequate coverage and limitation of risks and to restore statutory compliance within a reasonable period of time.

Since mid-2008, the FMA has been publishing aggregated statistical data on the supervisory measures taken under pillar 2 with regard to banks and investment firms each year.¹³ In the course of work on the CEBS disclosure scheme, it was agreed to publish data on supervisory activities (number of on-site inspections, number of supervisory measures) on the one hand and data on the supervisory measures implemented (number of banks against which measures under Article 136(3) of Directive 2006/48/EC¹⁴ have been taken) on the other. However, it must be pointed out that in view of the discrepancies between supervisory approaches and instruments in the individual Member States, a direct comparison of pillar 2 implementation is possible only to a limited degree and should in any case account for national circumstances.

3.8 Supervisory Cooperation and Exchange of Information

The FMA and the OeNB have made an explicit commitment to reinforcing international supervisory cooperation. To this end, they rely on formal instruments such as international agreements (Article 77a Banking Act) on the one hand and on the reinforced exchange of information between the competent supervisory authorities within the framework of ongoing supervisory activities on the other hand.

Bilateral and multilateral cooperation agreements (memorandums of understanding – MoU) with foreign banking, insurance and securities supervisory authorities contribute to the establishment of effective and efficient supervisory processes. These agreements, which do not change the respective legal frameworks for supervisory activities, make it possible to simplify and speed up practical supervision activities in cross-border cases. Especially in dealings with non-EEA Member States, they are a confidence-building measure and an important instrument in the efforts of the FMA and the OeNB to continuously strengthen cross-border operational cooperation, above all in CESEE countries. For example, between 1994 and 2007, a total of 25 MoUs on banking, insurance and securities supervision were concluded with 17 countries. In essence, these MoUs define the respective rights and duties of contacting and informing the other supervisory authority in a practical way, and they form the basis for regular meetings between the authorities involved.

Supervisory colleges play a central role in the cooperation among supervisors of cross-border financial groups. Depending on the issue at hand, these colleges are made up of representatives of the home country supervisor and representatives of either all or a selected group of host country supervisors. The objective of these colleges is first, to coordinate the process of supervising banking groups (see in particular the coordination function under Article 129(1) of Directive 2006/48/

¹³ See www.fma.gv.at (FMA > Supervisory Disclosure).

¹⁴ Implemented in Article 70 Banking Act.

EC). Second, the colleges also work to define a common understanding of pillar 2 issues at the group level or at the individual bank level. This comprises a uniform risk assessment on the issues of concentration risk, liquidity and interest rate risk, ICAAP and stress testing. Non-EU countries are involved to the extent possible under the MoUs concluded and under the existing legal framework.

The framework conditions for cooperation in colleges are laid down in **multi-lateral agreements**, whose form and content are determined by the specifications of the CEBS Subgroup on Operational Networks. The tasks envisaged in this area comprise:

- establishment of effective cooperation agreements with the supervisory authorities involved
- risk identification and assessment
- planning of supervisory measures
- implementation of supervisory measures
- joint ICAAP assessment
- definition of official measures
- monitoring of measures taken
- cooperation in cases of crisis

In the event of a cross-border model approval procedure under Article 21g Banking Act or within the framework of the supervisory process, the FMA assumes the role of a home or host country supervisor in line with international standards. In order to reinforce cooperation between the competent authorities, the FMA, together with the OeNB, has established cooperation meetings in its function as the consolidating supervisor in the supervisory colleges. Representatives of the respective competent authorities, in some cases the supervisory authorities of non-EU member countries (e.g. candidate countries) and the respective bank (for specific items on the agenda) are invited to such meetings, which serve the purpose of exchanging information and agreeing on the next preparatory steps or the specific procedure. In line with its statutory mandate, the OeNB covers the issues of analysis and on-site inspections in these colleges.

Another important instrument for the exchange of information is the FMA's "Restricted Area", an Internet-based, password-protected platform on which information on approval procedures and on the Supervisory Review and Evaluation Process (SREP) is provided to other supervisory authorities safely, efficiently and in a structured fashion.

3.9 Structured Dialogue

Under pillar 2, the intensification of the dialogue with banks is considered especially important, among other things because analysis now includes ongoing model supervision. The management talks have now been supplemented by more formalized and structured contacts with banks. The approach is keyed to the partner in each case: The dialogue with large, complex banking groups is intensive and communication is close, whereas in the case of the smaller banks belonging to the cooperative and savings banks sectors, contacts with the respective auditing association are the main source of information.

Each year, the dialogue cycle sketched out below (with various focus areas) is carried out with banks selected according to risk considerations:

- **Talks with external auditors** represent the first step. These talks center especially on (group and individual) financial statements. Talks are held annually with the external auditors of major banks and more frequently as needed with the auditing associations of the cooperative and savings bank sectors.
- The **management talks** are the second step in the cycle. These annual talks concentrate on the significant risk potentials of a bank. A scoring table is drawn up on the basis of the detailed analysis to evaluate the bank's risk potential. Additionally, CESEE talks are held with banks that conduct substantial business in that region. The talks involve holding a meeting with the board member in charge of CESEE operations (at the group level) and with the managers of the main CESEE subsidiaries. The CESEE talks aim primarily at providing better insight into the structure, business and risk of the CESEE subsidiaries.
- The third step of the supervisory dialogue consists of so-called **risk management talks**. These are held specifically with the managers in charge of operational risk management (at the second management level) and serve to enrich the supervisor's insight into the bank's risk management. These talks deal with the business plans presented by management and the bank's liquidity plans, the amount of risk provisions and ongoing model supervision issues.

Within the framework of the risk management talks, an annual sample of banks undergoes a detailed examination with regard to ICAAP design (see section 3.7). This examination provides an opportunity to analyze any conspicuous issues and differences in detail and to point out necessary adjustments to the analysis tools or the ICAAP. The respective bank is informed of supervisory statements and recommendations on the ICAAP through the existing communication channels.

Prior to the risk management talks, a checklist with questions is forwarded to the bank for self-assessment. The answers are evaluated during the risk management talks, which conclude with an overall assessment of the bank.

The results of the talks are documented by the OeNB and made accessible to the FMA; they form the basis for any additional supervisory measures taken by the FMA. The information collected is available at any time for further communication with the bank and also serves as a basis for on-site inspections.

4 Financial Conglomerates

In view of the importance of such financial conglomerates in Austria (market share in the Austrian financial market: roughly 20% calculated according to Article 3 para. 2 no. 2 Financial Conglomerates Act), these enterprises in their entirety may also be systemically relevant.

4.1 Organization and Implementation of the Supervision of Financial Conglomerates

4.1.1 Regulations and Financial Conglomerates Act Interpretation Issues

The FMA determines whether a financial group constitutes, or no longer constitutes, a financial conglomerate under the Financial Conglomerates Act. The OeNB is informed before the FMA issues an administrative ruling to this effect. On the basis of the relevant data, the FMA continuously monitors whether the prerequisites for additional supervision under the Financial Conglomerates Act are met. The administrative rulings of the FMA are filed in the joint database under Article 79 para. 3 Banking Act. The FMA is responsible for issuing administrative rulings and for interpreting and clarifying the provisions of the Financial Conglomerates Act. All parties involved ensure that the interpretations are consistent with the relevant provisions and interpretations regarding financial conglomerates, banking groups and insurance groups.

4.1.2 Organization of Operational Supervisory Activities

A supervisory team has been set up for each financial conglomerate. To this end, the FMA and the OeNB appoint staff in charge of supervising groups and individual institutions to each supervisory team. The FMA is ultimately responsible for additional supervision under the provisions of the Financial Conglomerates Act pertaining to capital adequacy, intragroup transactions, risk concentration and risk management at the financial conglomerate level; the OeNB conducts plausibility checks of the reports to be made under the Financial Conglomerates Act. Individual institutional and group supervision under the Banking Act or the Insurance Supervision Act within a financial conglomerate is handled by the units in charge of banking or insurance supervision at the FMA and at the OeNB, so that the respective organizational structure suitably reflects the concept of additional supervision at the (group and) financial conglomerate level, which substantially supplements individual institution supervision.

The members of the supervisory team for each financial conglomerate exchange information on a regular basis (as a rule, every quarter). Whenever necessary, the OeNB is informed about any systemically relevant events or findings.

The results of the stress tests that the OeNB conducts at the individual institutional level or at the group level for banks in financial conglomerates are made available to the FMA by way of the joint database.

4.1.3 Supervisory Strategy

Supervisory strategy is coordinated by the FMA and implemented through cooperation between the respective SPOCs (see section 3.2) for institutions and groups at the FMA and at the OeNB. To this end:

- Special requirements are determined during analysis;
- The necessary on site inspections are specified and aligned with the annual audit plan that the FMA and the OeNB draw up jointly; the agreed scope of

the inspections should, if possible, be covered during regular on-site inspections. If special audit fields under the Financial Conglomerates Act so require, the FMA also appoints auditors.

4.1.4 Supervisory and Official Measures

Official measures to restore legal compliance are taken by the respective divisions in charge of each industry at the FMA on the basis of the findings of the audit team. This arrangement reflects the fact that supervisory measures are always directed at the enterprise subject to supplementary supervision and are thus taken under the laws applicable to the industry in question. The OeNB is immediately informed of any findings relevant to stability in order to enable the OeNB to fulfill its stability mandate.

4.1.5 On-Site Inspections at the Financial Conglomerate Level

The FMA may audit the areas stipulated in the Financial Conglomerates Act (see Articles 11, 12 para. 3 and 15 Financial Conglomerates Act) on site at any time according to the provisions applicable to the industry to which the supervised enterprise belongs. Where possible, this audit is conducted in parallel to the audits under the Banking Act, the Insurance Supervision Act and, if applicable, the Austrian Securities Supervision Act in order to benefit from synergies as much as possible and to prevent duplications. Under Article 70 Banking Act, the FMA is to instruct the OeNB to conduct on-site inspections of banks or banking groups in financial conglomerates. In order to ensure a coordinated approach, the audit team schedules the assignment of audit mandates to the OeNB, taking into account the audit plan drawn up jointly with the OeNB under Article 70 para. 1 Banking Act and scheduled insurance supervisory audits, and integrates these assignments into the annual audit schedule.

Audits of financial conglomerates comprise a review of capital adequacy and of the existence and proper functioning of an adequate risk management system that covers not just “typical” banking risks (see also Article 2 nos. 57 through 57e Banking Act), but also insurance risks. Banks are not exposed to such types of risks, as the risks do not arise from banking transactions and banking operations. Therefore, based on the analysis of these risks at the individual institution and at the group level, the FMA must conduct a comprehensive (on- and off-site) audit of financial conglomerates to review whether all relevant risks are suitably aggregated and controlled at the financial conglomerate level.

5 Financial Stability

5.1 Extension of the Financial Stability Mandate

Safeguarding financial stability is a core central bank responsibility which is also laid down in Article 105(5) of the Treaty establishing the European Community. In addition, since January 1, 2008, the OeNB's financial stability mandate has been specified explicitly in the Nationalbank Act (Article 44b Nationalbank Act). Under this provision, the OeNB must, "in the public interest ... monitor all circumstances that may have an impact on safeguarding financial stability in Austria." To this end, the OeNB now also has access to data on financial sector enterprises, among others.¹⁵ In this way, the OeNB has been accorded a new role especially with respect to nonbank financial intermediaries: To help ensure the stability of the Austrian financial market, more in-depth analyses of such firms must now be performed using additional data sources. If such financial market stability analyses produce any fundamental or significant findings, the FMA and the Federal Ministry of Finance must be informed accordingly.

Within the framework of this mandate, the OeNB is now able to carry out more intensive stability-related analyses of **nonbank financial intermediaries**, and now also puts a special focus on issues such as **CESEE risk assessment, risk transfer, liquidity** and the further development of **stress tests**. These issues reflect the geographical scope of Austrian banks' business activities as well as relevant developments in financial markets.

Reinforcing the links between micro- and macroprudential analysis is a key goal in this connection. Such links will complement the individual bank perspective with a systemic perspective and, conversely, will also make it possible to use relevant off-site analysis findings in financial stability analyses. As the competent supervisory authority, the FMA is informed accordingly of the results of analyses so that the FMA as well as the OeNB can react to critical macroprudential developments in a timely fashion.

5.2 CESEE Risk Assessment

The Austrian banking system's CESEE exposure has augmented substantially in recent years. Consequently, the OeNB started to analyze CESEE developments early. Whereas the analysis used to focus heavily on specific areas, it is currently being extended so that the OeNB can provide a comprehensive semiannual assessment of the risk arising from individual CESEE markets for the Austrian banking system and for individual banks operating in the region. The extension of the CESEE region analysis focuses above all on the immediate implications of developments in this region for Austrian financial stability and conversely on the impact of Austrian banks' activities on the host countries.

Based on the analysis of individual CESEE markets and the activities of the Austrian banks there, the individual countries are ranked in terms of their systemic risk potential for the Austrian banking system. In order to provide a largely consistent and uniform analysis of the individual countries, a weighting system is established for the indicators used in this step of the analysis, thus ensuring that the analysis process is transparent. This weighting system must possess a sufficient degree of

¹⁵ In particular, the OeNB has access to data on insurance companies, financial conglomerates, investment groups, mutual funds, pension funds, severance funds, securities firms and investment service providers.

flexibility to allow changes in the ranking justified on the basis of qualitative information.

The risk map drawn up in this way provides not only a weighting of priorities, but also an overview of the main risks to the Austrian banking system. Based on this risk map, a feedback loop is established for the countries ranked at the top of the priority list. This mechanism includes the experts at the respective national central banks, the SPOCs responsible for the off-site analysis of the respective banks and, in the case of actual problems, the bank itself. This makes it possible to maintain an objective view of problems and to clarify the need for any additional supervisory measures.

For the purpose of management information, the results of this process are summarized in a very concise semiannual internal CESEE highlight report that depicts concrete risk potentials and any need or options for action on CESEE-related risk for Austrian banks.

In parallel to the established analysis process, a regular stability monitoring process will be introduced for selected countries or regions in order to ensure that the authorities can react appropriately even to short-term changes that have an impact on the stability of the Austrian banking system. The close networking contacts planned with financial stability experts in the respective CESEE countries are an important aspect of this monitoring process.

Another key element of the further development of the OeNB's CESEE analysis is the expansion of the OeNB's systemic risk monitoring scheme. This scheme is used to measure the systemic risk of the Austrian banking sector in quantitative terms, especially for the purpose of stress testing. The scheme will now be enlarged to include CESEE subsidiaries.

5.3 Nonbank Financial Intermediaries

While nonbank financial intermediaries are far less important than the banking sector in Austria's financial system, all in all, they play a significant role nevertheless. For instance, there are about eight companies in the insurance sector whose total assets are high enough under the usual standards for banking to define them as systemically relevant institutions. In addition to the analysis of each category of financial intermediaries, such as insurance companies or mutual funds, the issue of contagion – even if “only” through reputation risk – between these categories plays a role, for example on account of cross-ownership or cooperation agreements. Given the size of nonbank financial intermediaries, the focus should be placed first on insurance companies and second on mutual funds.

In view of the OeNB's expanded financial stability mandate, the FMA and the OeNB have thus agreed which data the FMA will provide regularly for stability analyses. Based on the data delivered by the FMA, a set of indicators similar to that existing for the banking sector is being developed. This indicator set will be broken down by nonbank financial intermediary categories and will provide an overview of the key indicators¹⁶ used in the assessment of financial stability. The indicator set will be an intrinsic part of the analyses as well as internal and external reports

¹⁶ These indicators include, for example, data on business developments, profitability, risk exposure, regulatory capital requirements as well as comparative international data or information on cross-ownership.

of the OeNB.¹⁷ A crucial objective of the extended financial stability analysis of nonbank financial intermediaries is also to assess links to the banking sector.

As in the other areas analyzed, close cooperation between the FMA and the OeNB will make it possible to establish links between micro- and macroprudential findings and to identify potentially negative developments in a timely manner.

5.4 Risk Transfer

Ideally, the development of risk transfer markets should contribute to a more efficient allocation of capital and risks, which in turn promotes the stability of the international financial system. Yet the developments in international financial markets since mid-2007 have shown very clearly that while risk transfer undoubtedly has positive effects, it is very important to deal properly with the challenges to the financial system raised by the burgeoning use of risk transfer instruments.

Thus, in fulfillment of its stability mandate, the OeNB plans to approach the issue of risk transfer in a more systematic way in order to enable a comprehensive understanding and timely monitoring of the risk transfer market's underlying products, functioning and dynamics, of the financial intermediaries involved and of the management of the risks transferred. A more systematic approach should make it possible to identify current market developments as well as risk concentration within specific market segments and individual financial intermediaries (also at the systemic level), and to show whether there is any need to act and what the options for action are.

The issue of risk transfer is dealt with on the basis of a definition of relevant risk categories which mirrors the main categories defined under the Basel II capital requirements for banks: credit, market and operational risk. A matrix structure is used that takes into account the various types of risk and at the same time addresses the question of marketability and which financial intermediaries are involved. Financial intermediaries' use of risk transfer products is analyzed in a semiannual internal risk transfer report that is broken down according to the risk categories mentioned above. The report includes observations on the risk concentration of financial intermediaries and a review of risk-bearing capacity. The aim of this analysis is again to identify potential dangers as well as any need for or options for action as a basis for further measures.

5.5 Liquidity Risk

Above all, the current turbulence in international financial markets has shown that at times, not enough attention was paid to banks' liquidity risk. As liquidity risk is an element of each of the various types of risk described above, albeit to different degrees, it must be analyzed separately. In the future, the OeNB will monitor liquidity more systematically as part of its reinforced analysis of liquidity risk from the financial stability perspective. This more systematic approach includes regular monitoring of relevant market indicators as well as the further development and observation of liquidity indicators for financial intermediaries, especially banks. Stress tests for banks' liquidity risk will also be developed further. The indicators and tests will be taken into account in off-site analyses and systemic analyses.

¹⁷ For example, such analyses are provided in the OeNB's semiannual Financial Stability Report.

6 Outlook

The reform of Austria's financial market supervision framework in 2008 represented another stepping stone in the steady improvement of supervisory cooperation. These measures have made it possible to make full use of the available efficiency and effectiveness potential. The most recent dynamic developments in the markets patently show that effective supervisory management is indispensable for financial stability.

Both institutions – the FMA and the OeNB – have thus developed an ever closer cooperation relationship, with each institution focusing on its respective strengths. Market participants benefit from optimized processes, with two developments being of particular interest to them: On the one hand, partly on the basis of the joint database, the reform ensures that the supervised institutions are monitored more closely and according to risk-oriented aspects, and it contributes effectively to preserving the efficient operation of the banking system. On the other hand, the introduction of the central “incoming platform,” to which reports are submitted electronically, will substantially reduce the reporting burden on banks.

Clear decision-making structures and processes without duplications serve to strengthen the supervisory architecture in Austria. In the interest of the Austrian financial market, the FMA and the OeNB are in an excellent position to cope with current and future challenges in a sustainable and effective fashion.