FOR INFORMATION

SM/20/51

February 24, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Austria—Publication of Financial Sector Assessment Program Documentation—Technical Note on Banking Oversight**

Board Action:	Executive Directors' **information**
Publication:	Yes, after Monday, March 2, 2020
Questions:	Ms. Melo, MCM (ext. 36485) Ms. Valderrama, MCM (ext. 37816)

INTERNATIONAL MONETARY FUND

AUSTRIA

FINANCIAL SECTOR ASSESSMENT PROGRAM

February 20, 2020

TECHNICAL NOTE

BANKING OVERSIGHT

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program (FSAP) in Austria. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary

ABBA	Austrian Banking Business Analysis
aGAAP	Austrian Generally Accepted Accounting Principles
BaSAG	Bank Recovery and Resolution Act
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles
BMF	Federal Ministry of Finance
BRRD	Bank Recovery and Resolution Directive (Directive 2014/59/EU)
BWG	Austrian Banking Act
CESEE	Central Eastern and Southeastern Europe
CET1	Common Equity Tier 1
CI	CRR Credit Institution
CRD IV	Capital Requirements Directive (Directive 2013/36/EU)
CRR	Capital Requirements Regulation (Regulation (EU) No. 575/2013)
EBA	European Banking Authority
ECB	European Central Bank
EU	European Union
FC	Financial Conglomerate
FICOD	Financial Conglomerate Directive (Directive 2002/87/EC, as amended by Directive 2011/89/EU)
FHC	Financial Holding Company
FMA	Financial Market Authority
FMABG	Financial Market Authority Act
FSAP	Financial Sector Assessment Program
FMSB	Financial Market Stability Board
FSMA	Financial Services and Markets Authority
FSB	Financial Stability Board
FTE	Full-Time-Equivalent
G-SIFI	Global Systemically Important Financial Institution
ILAAP	Internal Liquidity Adequacy Assessment Process
ITS	Implementing Technical Standards
LSI	Less Significant Institution
NCA	National Competent Authority
NPL	Nonperforming loan
OeNB	Austrian National Bank
SI	Significant Credit Institution
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
TN	Technical Note
UTP	Unlikely-to-pay

EXECUTIVE SUMMARY

This technical note[1] includes a targeted review of banking regulation and supervision, with a particular focus on topics related to the supervision of less significant institutions (LSIs). The review was based on the international standards for banking supervision—the Basel Committee on Banking Supervision's (BCBS) *Core Principles for Effective Banking Supervision* (BCP)—but did not conduct a compliance assessment. The mission considered the findings and recommendations of the 2018 euro area (EA) FSAP[2] and the authorities' BCP self-assessment, followed-up on recommendations of the 2013 Austria FSAP, and reviewed implementation of BCBS standards and guidance issued in the interim. Although the review was based on implemented legislation and regulation, the mission reviewed proposed draft legislation consolidating financial system supervision in the Financial Market Authority (FMA).

The national transposition and implementation of European Union (EU) directives and regulations has significantly closed some of the gaps identified in 2013. Fit-and-proper requirements for supervisory board members have been strengthened, the Bank Recovery and Resolution Directive (BRRD) was transposed into the Austrian Banking Act (BWG) effective January 2015, and banking supervision was integrated into the Single Supervisory Mechanism (SSM). However, the review of the regulatory and supervisory framework disclosed deficiencies in significant acquisitions (CP 7) and related party transactions (CP 20). Significant improvements were implemented to governance (CP 14) and corrective and sanctioning powers of supervisors (CP 11). Issues raised by the 2013 assessment regarding the FMA's operational independence were unchanged at the time of the mission. [3]

Although not legally binding, the FMA has issued circulars and minimum standards to communicate supervisory expectations. Lending in central, southeastern and eastern Europe (CESEE) is an important source of earnings for Austrian banks. A significant amount of that exposure had been foreign currency loans to local borrowers that did not have income sources in the foreign currency. In 2017, the FMA issued *Minimum Standards for The Risk Management and Granting of Foreign Currency Loans*. The standards emphasize the importance of ensuring that borrowers have sufficient income in the currency of exposure to service the debt. Other circulars, such as on internal audit and credit risk, were issued in 2005; the internal audit guidelines are being updated and the credit risk circular is under discussion for possible updating.

Oversight of bank loan portfolios was strengthened by guidance from the European Central Bank (ECB) and European Banking Authority (EBA) concerning nonperforming loans (NPLs) and forborne exposures, and by EU regulation. Regulation (EU) 2019/630 established Pillar 1

[1] This note was prepared by Jose Tuya and John Laker (external experts) in the context of the 2019 Austria FSAP.

[2] Euro Area - Detailed Assessment of Basel Core Principles for Effective Supervision (July 2019).

[3] Assessors made a number of findings where the operational independence of the FMA might be endangered, including the presence of industry representatives on the Supervisory Board, the BMF's role in approving FMA regulations, and the BMF's right to gather information from the FMA.

minimum provision coverage for exposures originated on or after April 26, 2019 that become nonperforming. ECB Pillar 2 supervisory expectations cover NPLs arising from the stock of loans originating before April 26, 2019. The pillar 2 guidance applies the minimum provisioning backstop to the stock starting on January 1, 2021. The FMA is not planning to extend the ECB Pillar 2 expectations to the LSI population. The FMA is implementing the EBA guidelines addressing the development of strategies for managing NPLs.

Transposition of the Capital Requirements Directive (CRD IV) and the BRRD provide the FMA with broad powers to require banks to address deficiencies regarding regulation or operations. The FMA has adopted the guidelines on triggers for the use of early intervention issued by the EBA. Additionally, internal procedures have been implemented for decision-making, coordination, and action when triggers are breached. Most triggers are based on quantitative factors. The FMA needs to enhance guidance and training for supervisory staff on employing qualitative information and applying supervisory judgment in the Supervisory Review and Evaluation Process (SREP) in the internal governance sub-module, as deficiencies in internal governance may become apparent long before impacting bank results.

There are some regulatory and supervisory areas requiring attention. As noted in the previous BCP assessment,[4] the BWG and regulations do not establish an adequate framework for monitoring and addressing transactions with related parties; and the BWG does not require ex-ante approval for acquiring qualifying holdings in undertakings outside the financial sector. Although the BWG amendments strengthened the duties and responsibilities of credit institutions' supervisory boards, operationally the role may be made more robust by increasing interaction between the supervisory board and banking supervisors.

The previous BCP assessment raised concerns about the operational independence of FMA. These concerns related to the presence of industry representatives on the FMA Supervisory Board, the right of the Federal Ministry of Finance (BMF) to commission the FMA to conduct onsite examinations, and the obligation on the FMA to consult the BMF before issuing regulations. As of the time of the mission, the governance structure of the FMA remains unchanged, although a proposed institutional reform may address some of these aspects (see Box).

Traditionally state commissioners have played a major role in banking supervision; however, considering the evolving role of the supervisory boards of credit institutions, the commissioners' role should be re-assessed. State commissioners are primarily BMF staff and in their role report directly to the FMA. The commissioners attend all supervisory board meetings and assist the FMA in their assessment of governance by reporting on supervisory board execution of their duties and responsibilities. The role of the supervisory board has evolved, reflecting enhanced fit-and-proper requirements and an expanded oversight role. Given the more active participation of the supervisory board in oversight of management in areas of governance and risk controls, the role

[4] Austria - Detailed Assessment of Basel Core Principles for Effective Banking Supervision (Jan 2014).

of the commissioners may no longer be appropriate as it brings the BMF into close interaction with banking supervision. The function may be more appropriately and less intrusively exercised by the supervisors' participation in selected board meetings.

Table 1. Austria: Summary of Key Recommendations

Recommendation	Authority	Time[1]
1. Review existing legislation to clarify and narrow the BMF's role in oversight of the FMA and remove industry participation in its Supervisory Board, as recommended in the 2013 FSAP.	BMF	MT
2. Establish an ex-ante approval or notification requirement for significant investments outside the financial sector.	BMF	MT
3. Increase frequency and substance of interaction between the FMA and the Austrian National Bank (OeNB) and credit institutions' supervisory boards.	FMA/OeNB	I
4. Strengthen the framework for identifying and monitoring related-party transactions and extend requirements to sister companies.	BMF/FMA	NT
5. Enhance guidelines and training to aid staff in developing support for risk scoring internal governance in the SREP based on qualitative factors when the quantitative triggers have not been met and the bank is operating profitably.	FMA	NT
6. Ensure that complex ownership structures are adequately considered in group-wide risks in the SREP.	FMA/ECB	NT
7. Substitute state commissioner function with an enhanced FMA and OeNB engagement with supervisory boards.	BMF/FMA	MT
8. Implement ECB Pillar 2 NPL Guidance on provisioning for LSIs.	FMA	I

[1]C–Continuous; I–Immediate: within 1 year; NT–near term: 1 to 3 years; MT–medium term: 3–5 years.

INTRODUCTION AND SCOPE

1. This technical note presents a review of selected topics related to the supervision of LSIs, as well as certain aspects of bank governance. The review was undertaken as part of the 2019 Austria Financial Sector Assessment Program (FSAP). The mission followed-up on recommendations of the 2013 Austria FSAP, considered the findings and recommendations of the 2018 euro area (EA) FSAP, and reviewed implementation of relevant guidance issued by the BCBS and the EBA in recent years. The assessment was based on the regulatory framework in place as of mid-2019; the mission also reviewed proposed reforms to the institutional framework that would, if enacted, result in broad-ranging changes in powers, responsibilities, and functions in the Austrian supervisory system. As a consequence of political developments in May 2019, which led to the collapse of the Austrian Government, the reform has been officially abandoned.

2. The review of LSIs supervision was based on the analysis of the authorities' self-assessment against the BCP, detailed discussions, and review of documentation. The Austrian authorities provided a partial self-assessment of compliance with the 2012 BCP and responses to a complementary questionnaire. The ECB has also provided responses to a dedicated questionnaire, and the authorities provided examples of actual supervisory practices and assessments. The FSAP review team benefitted greatly from the inputs received and exchanging of views during meetings with supervisors, banks, industry associations, and other market participants.

3. The mission focused on selected topics based on their macro-financial relevance, especially for LSIs, and on previously identified weaknesses in the Austrian regulatory and supervisory framework. Primary emphasis included key aspects of independence; major acquisitions; supervisory approaches and tools; enforcement and sanctioning framework; banks' governance; transactions with related parties; and internal control and audit. The terms "bank" and "credit institution" (CI) are used interchangeably in this note.

4. The national transposition and implementation of EU directives and regulations has helped to address some of the gaps identified in the 2013 Austria FSAP. Fit-and-proper requirements for supervisory board members have been strengthened, the BRRD was transposed into the BWG effective January 2015, and integration of banking supervision into the SSM has been completed. However, deficiencies in related party lending, major acquisitions, and governance remain.[5] Concerns about the independence of the FMA raised in 2013 also remain.

[5] In this note, as in the BCP, "board" refers to the management body in its oversight function (supervisory board) and senior management refers to the management body in its management function (executive board).

MARKET AND INSTITUTIONAL STRUCTURE—OVERVIEW

A. Market Structure

5. The Austrian financial system is dominated by a large, concentrated, and diverse banking sector. Total assets of the banking sector (EUR 986 billion) represent around 250 percent of GDP and about 75 percent of total financial system assets (EUR 1,314 billion). Mutual funds, insurance firms, and pension funds account for 14 percent, 10 percent, and 2 percent of financial system assets, respectively. There are almost 600 banks. Notwithstanding continued consolidation in the banking sector (see below), total assets grew by 3.9 percent in 2018. The banking sector is both highly concentrated—with the top three banks accounting for 50 percent of market share—and diverse, with two large internationally active banks, and numerous domestically focused institutions. The diversity of the banking system is valued by authorities, which are strongly supportive of the principle of proportionality in regulation and supervision to ensure that diversity can be sustained.

6. The structure of ownership, control, and financial linkages in the Austrian banking system is complex. There are three "decentralized banking segments" that comprise most of the banks in Austria.[6] The largest bank, Erste Group Bank AG (EGB), is the lead bank of the Sparkassen (savings bank) segment. Together with the other 48 Sparkassen they form a banking group, a cross-guarantee scheme, and an institutional protection scheme (IPS). EGB also owns banks in several other countries. Raiffeisen Bank International AG (RBI) is the lead bank of the three-tiered Raiffeisen cooperative segment with 386 local Raiffeisen banks in the country and eight regional Raiffeisen banks (Landesbanken or RBLs) at the provincial level. RBI is partly owned (at 58 percent) by the eight RBLs, which in turn are owned by the small cooperative Raiffeisen banks in their respective provinces. Six of the eight provincial RLBs along with the local Raiffeisen banks in each region form regional IPSs. The eight RLBs along with RBI form a separate IPS. RBI owns banks in several other countries. The third decentralized segment, the Volksbanken (VB) cooperative segment, comprises a VB in eight of the nine provinces, including the lead bank VB Vienna and a specialized bank. The VB segment has entered into an unlimited cross-guarantee scheme, which increasingly operates as a single centralized institution. All three (the Raiffeisen segment, EGB, and the VB segment) also form liquidity associations whereby members participate in a joint cash-clearing system.

7. The Austrian banking sector has undergone a continuous, albeit uneven, process of consolidation over recent years, mainly in the Raiffeisen and Volksbanken sectors. Consolidation through mergers has seen the total number of banks fall from 764 in 2014 to 597 in 2018. Major factors driving consolidation have been pressures on profitability due either to

[6] While banks operate as separate entities within these segments, they are part of liquidity associations and contractual explicit support mechanism to support each member in case of need. This requires consistent risk management within the segment.

heightened regulatory requirements, the low interest rate environment, and/or high cost-to-income ratios.

8. Austrian banks have improved their capital levels and credit quality but continue to have high exposure to CESEE countries. Capital levels have risen from 11.6 percent Common Equity Tier 1 (CET1) in 2013 to 15.4 percent in 2018, but the rate of increase has subsided in the last two years partly due to the payment of higher dividends. Credit quality has improved, with NPL ratios shrinking from 8.6 percent in 2013 to 2.6 percent in 2018. The increase in credit quality was especially pronounced among bank subsidiaries in CESEE countries, where NPL ratios declined from 14.0 percent in 2013 to 3.2 percent in 2018. Given cyclically favorable economic conditions, Austrian bank subsidiaries in CESEE saw improved profitability mainly due to reductions in loan loss provisions, but performance is likely to have peaked given late-cycle risks.

B. Supervisory Environment

9. Austria's supervisory environment is characterized by a dual supervisory system, operating within the framework of the SSM. Responsibilities for banking sector oversight are shared between the FMA, Austria's integrated financial supervisory authority, and the OeNB. The FMA is the National Competent Authority (NCA) for banking supervision; for convenience, however, the FMA and the OeNB are jointly referred to as "supervisors" in this note. However, the FMA is solely responsible for the supervision of the insurance and securities markets sectors and all other significant providers of financial services and functions,[7] while the OeNB is solely responsible for the oversight of payment systems in Austria. The BMF is responsible for the development and implementation of the legislative framework, as adopted by the Austrian Parliament.

10. The tasks of the supervisory system are governed by a range of separate laws. The most relevant laws are the Financial Market Authority Act, the National Bank Act, the Banking Act, the Insurance Supervision Act, the Pension Funds Act, the Stock Exchange Act, the Investment Fund Act, the Provision of Payment Act, and the Capital Market Act. In 2014 the FMA issued the Regulation on Credit Institution Risk Management (KI-RMV). The FMA has also issued circulars and standards addressing fit-and-proper, internal auditing, guidance on credits in foreign currency, and credit risk. Although not legally enforceable, these instruments are key in communicating supervisory expectations.

11. Within the SSM, the ECB is responsible for the supervision of CIs established in the participating EU Member States, in cooperation with NCAs. Significant credit institutions (SIs) or groups are under the direct supervision of the ECB, which also has full responsibility with respect to all CIs for certain common procedures related to the granting and withdrawal of CI licenses and the acquisition of qualifying holdings in a CI. There are seven Austrian SIs, representing 60 percent of

[7] These include payments institutions, e-money institutions, pension companies, corporate provision funds, investment firms and investment service providers, investment funds, financial conglomerates and stock exchanges.

total banking system assets.[8] The FMA continues to directly supervise LSIs in Austria, but subject to the oversight of the ECB. Currently, those LSIs considered to have medium or high intrinsic risk with high or medium impact (i.e., their failure may damage the domestic financial system) are classified as high priority LSIs, and their supervision involves more regular and in-depth feedback from the FMA to the ECB. Given the unusual ownership structures involving LSIs and SIs, coordination between ECB supervision and the FMA is key so that risks in the wider group in both directions are adequately considered in the respective SREP processes

12. The dual supervisory system is built on extensive collaboration and cooperation between the FMA and the OeNB, aimed at achieving a single, integrated supervisory process. As the NCA, the FMA is the decision-making authority; it issues all the necessary rulings and considers all legal questions in the field of banking supervision. The OeNB is responsible for the execution of all onsite inspections based on inspection mandates issued by the FMA (except for anti-money laundering and combating the financing of terrorism); the OeNB has the right to request audits or the expansion of inspection orders. The OeNB is also responsible for all offsite analysis and risk assessments, based on data reported by credit institutions, and for preparing preliminary investigations by the FMA. All supervisory-related data held by both institutions is shared in a common database, maintained by the OeNB. Reflecting the dual system, there is a (single) point of contact for day-to-day supervision for each CI at both the FMA and the OeNB. The OeNB also provides expert opinion on risk management models and assesses the viability of business models, amongst a range of other operational roles.[9]

13. The dual supervisory system is also reflected in current governance arrangements for the FMA. The Supervisory Board of the FMA currently consists of ten members: the chairperson, the deputy chairperson, six additional members and two co-opted members. Except for those co-opted, members are appointed by the BMF. The BMF also provides the chairperson and three additional members, while the OeNB provides the deputy chairperson and the other three additional members. The Supervisory Board co-opts two members named by the Austrian Federal Economic Chamber, who do not have voting rights. Hence, 50 percent of the voting members of the Supervisory Board are from the BMF and 50 percent from the OeNB. The Supervisory Board does not involve itself in the execution of supervision but rather with the business organization and operations of the FMA. The Executive Board consists of two persons appointed by the BMF after a tender process, with the Minister and the OeNB naming one person each from the tender results. Appointments to positions immediately below the Executive Board need to be confirmed by the Supervisory Board.

[8] As of January 1, 2019, there were six Austria-headquartered SIs—Erste Group Bank AG, Raiffeisen Bank International AG, BAWAG Group AG, Raiffeisenbankengruppe OÖ Verbund eGen, Volksbank Wien AG, and Sberbank Europe AG. The other Austrian SI—the third largest bank, Bank Austria UniCredit—is supervised as a systemic subsidiary of UniCredit.

[9] Providing prior opinions on the licensing of new CIs or the merger or division of existing institutions, and on the issuing of regulations by the FMA or BMF; participation in audits of CIs (wherever located) and preparation of annual audit plans; verification of prudential information to external supervisory agencies and consultation on cooperation arrangements with such agencies; participation in supervisory colleges; providing prior opinions on the licensing of e-money institutions and on the recognition of IPSs; and providing prior opinions on measures to be undertaken on the resolution authority.

14. The EBA's Implementing Technical Standards (ITS) provide a set of regulatory reporting standards for CIs. The ITS on supervisory reporting is aimed at monitoring compliance with requirements established by the Capital Requirements Regulation (CRR) (mostly Pillar 1 requirements); it represents the sole EU-wide legal framework for supervisory reporting in several areas and is a "maximum harmonization" instrument. This means that "with regard to the scope of application of the ITS, competent authorities cannot add nor delete data to be reported, nor can they require the reporting of that data in a different format nor in a different (less or more granular) breakdown, nor in a combination, other than in accordance with the CRR and with [CRD]," as explained by the EBA.

15. In Austria, ITS information is supplemented by credit registry data and information generated through ongoing supervision and macroprudential analysis. Analysts at the OeNB supplement FINREP and COREP regulatory reports with credit information drawn from the credit registry. On a bilateral basis, analysts also collect bank-specific information required to conduct ongoing monitoring of their CI. While each analyst may be able to develop a full risk profile for their bank, the ad hoc collection of the information may not make it suitable to include in the automated banking analysis tool (ABBA) and to produce standard reports on banking trends or to draw peer comparisons for banking system oversight.

Box 1. Institutional Reforms in Banking Oversight

In November 2018, authorities announced broad-ranging reforms to the institutional framework for banking supervision, which would see the current shared responsibilities consolidated within the FMA. The stated aims of the reforms were to improve the efficiency of the supervisory system, reduce duplication, speed up decision making, establish clear points of contact for financial market participants, and strengthen "service orientation". Draft legislation released for public consultation in April 2019 varied some elements but not the main thrust of reforms. These would involve changes to the powers and responsibilities of three bodies, as well as to the governance and funding of the FMA.

The reforms were intended to come into effect from January 1,2020. However, political developments in May 2019 resulted in the reforms being officially abandoned, and no draft legal texts were presented to the Council of Ministers and Parliament.

Powers and Responsibilities

Banking supervision would be fully consolidated within the FMA, which would assume responsibility for onsite inspections and offsite analysis from the OeNB. The FMA would become the sole point of contact on day-to-day supervision and would normally be the sole representative in supervisory colleges. In the case of regular supervisory reporting, the FMA would have sole "ownership" of content but the OeNB would retain responsibility for data collection, processing and quality assurance.

Box 1. Institutional Reforms in Banking Oversight (continued)

Although losing all operational roles in banking supervision (including the provision of expert opinions), the OeNB would retain an involvement in this area since the governor of the OeNB would continue as a member of the Governing Council of the ECB, the highest decision-making body of the SSM, and an OeNB representative would remain as a non-voting member on the ECB's Supervisory Board. The OeNB's responsibilities for financial market stability would be unchanged. It would retain its tasks of analyzing macroprudential risks and developing draft recommendations and risk warnings for the Financial Market Stability Board (FMSB) and would continue to provide the FMSB secretariat. These responsibilities would be underpinned by an increase in the number of OeNB representatives on the FMSB from one to two, and by new powers to issue inspection orders to the FMA for financial market stability purposes as well as in crisis situations.

The reforms would also concentrate regulatory powers in an enlarged BMF. The FMA would remain subject to the oversight of the BMF, with the stated objective of ensuring that the FMA fulfils its statutory tasks, does not violate laws and regulations, and does not overstep its scope of duties. The BMF would continue to be entitled to gather information from the FMA on all matters relating to financial supervision.

FMA Governance

The reforms would reduce the FMA's Supervisory Board from the current ten members to six, including the removal of two members co-opted from industry. The two-person Executive Board would be reduced to one member, with termination of the OeNB appointee. Beyond its current administration focus, the Supervisory Board would take on responsibilities in strategic planning and in establishing priorities for supervision. The OeNB would be able to nominate two of the six members while the BMF would appoint the other four, two of whom are to be independent experts with no current affiliation with regulated entities. The OeNB's current right to nominate the Deputy Chairman would disappear.

The FMA would also establish a Financial Market Advisory Board, composed of experts from relevant ministries, industry, academia, the stock exchange, and the OeNB. Its mandate would be to advise on matters related to financial markets, monitor and analyze international financial market developments, and draw up proposals on supervisory topics. The Board would be able to seek opinions and make its proposals public, including on priorities for regulation. The draft legislation is silent on how the FMA would respond to such proposals.

FMA Funding

The reforms would substantially increase the dependence of the FMA on Federal budget funding. Under current arrangements, the OeNB's costs for prudential supervision are borne by the OeNB itself, after a partial refund from the FMA; the FMA's costs, after a small and fixed contribution from the Austrian Federation, are passed to CIs through supervisory levies. Since there is no intention under the reforms to increase supervisory levies, the increased costs incurred by the FMA from the absorption of OeNB staff would need to be funded by the Federal budget.

Box 1. Institutional Reforms in Banking Oversight (concluded)

The authorities have indicated that the FMA and the OeNB would be required to implement cost-efficiency programs intended to capture the benefits from the consolidation of supervisory tasks. The authorities have also proposed an increase in the OeNB's profit distribution to the Austrian Federation from 90 to 95 percent to capture the reduction in the OeNB's staffing numbers. In its published opinion on the reforms, the ECB has requested that, with a view to ensuring financial independence, any intended amendment to the profit distribution rules of the OeNB be taken only in cooperation with the OeNB.

In general, the Fund is agnostic about supervisory structures, and there is no one institutional format that has performed better than others during crisis situations. There are key principles and pre-requisites that underpin effective supervision and these elements can work in a variety of institutional settings. Wherever located, the supervisory agency needs to have a high degree of independence, strong accountability, a clear mandate, adequate resourcing, and strong regulatory capacity. Drawing on crisis lessons, institutional arrangements also need to support an enhanced focus on macroprudential supervision of systemic risk. Changes in supervisory models need to be based on a careful assessment of the most effective and efficient means of achieving desired supervisory outcomes, taking into consideration the potentially significant costs of reorganization. Major reorganizations inevitably divert the attention of senior management and staff from core activities for a time.

STRENGTHENING SUPERVISION

A. Supervisory Approach, Techniques, and Tools

16. A well-developed supervisory approach supported by established supervisory techniques and tools is in place. The SREP is based on four elements; (1) business model and profitability assessment, (2) governance and risk management assessment, (3) risk-by-risk assessment of risks to capital, and (4) risk-by-risk assessment of risks to liquidity and funding. The FMA is responsible for assessing governance and risk management strategies/policies, and the OeNB performs the assessment of the business model and profitability, and the assessment of risks to capital and liquidity.

17. The SREP results provide a comprehensive assessment of the LSI and an overall score that aids in determining the level of supervisory engagement. The SSM prioritization methodology classifies the LSI population in High, Medium, and Low categories. The classification is the starting point for the FMA and the OeNB to decide the level of intensity for the SREP assessment (frequency, scope, and granularity). Additionally, an overall SREP score of '3' with '4' for individual elements or an overall score of '4' are considered triggers for possible application of corrective supervisory measures.

18. An automated base-assessment is performed quarterly for each LSI. Based on reported quantitative data, an automated basic analysis is performed through the ABBA system and a risk score is assigned to the LSI. Based on FINREP and COREP data financial ratios are computed, peer analysis is performed, and outliers are identified. Loan data provides detailed information on NPLs and forborne debt but lacks granularity for segmentation of loan portfolio and monitoring delinquency rates, risk ratings (i.e., PD rates), and loan growth by segment. Analysts supplement reported information through the credit registry,[10] public information, external audit reports, and bilateral discussions with LSIs.

19. Problem asset and credit risk monitoring are in focus as a result of IFRS 9[11] and new NPL guidelines. NPL levels have declined since the global financial crisis and provisioning expenses have also declined. During onsite inspections a sample of loans may be selected and analyzed to ensure proper risk grading and adequate provisioning. The credit registry provides information on bank risk-grading of individual and connected borrowers that enables supervisors to monitor system-wide exposure.

B. Developments in Banking Regulation and Supervision

20. Significant enhancements to the regulatory and supervisory framework have accrued from implementation of EU regulations, EBA guidelines, and transposition of directives that increasingly converge with BCBS standards. The Banking Act (BWG) was amended to incorporate EBA Guidelines on Internal Governance (EBA/GL/2017/11) and Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12). The FMA also issued a regulation on credit risk management (KI-RMV) in 2013 and amended it in 2014. KI-RMV transposes Directives 2013/36/EU (CRD IV) and 2002/87/EC (FICOD). Passage of the Bank Recovery and Resolution Act (BaSAG) and the Deposit Guarantee Schemes and Investor Compensation Act (ESAEG) also resulted in enhancements to the enforcement powers of the FMA. Also incorporated into supervision are the EBA Guidelines on triggers for use of corrective and preventive measures (EBA/GL/2015/03).

21. Although not legally binding, FMA issues circulars and minimum standards to communicate supervisory expectations. Lending in CESEE is an important source of earnings for Austrian banks. A significant amount of the exposure was in foreign currency to local borrowers that did not have income sources in the foreign currency. In 2017 the FMA issued updated minimum standards for the risk management and granting of foreign currency loans. The standards emphasize the importance of ensuring that borrowers have sufficient income in the exposure's currency of denomination to service the debt. Other issuances, such as on internal audit and credit risk were issued in 2005 and are being updated or are under consideration for updating.

22. Oversight of bank loan portfolios was strengthened by issuances from the ECB and EBA concerning NPL and forborne exposures, and by EU regulation. Regulation (EU) 2019/630 established Pillar 1 minimum provision coverage for exposures originating on or after April 26, 2019 that become nonperforming. In addition, the ECB Pillar 2 supervisory expectations cover NPLs

[10] The credit registry covers instruments with a volume of more than 350,000; therefore, retail credits (e.g., mortgage loans, consumer loans) are excluded. Equity exposures are also excluded.

[11] Most LSIs report under local GAAP, which does not offer a forward-looking approach to provisioning as IFRS 9.

arising from loans originating before April 26, 2019 by requiring the application of the minimum provisioning backstop starting on January 1, 2021. The FMA has not applied the ECB Pillar 2 provisioning expectations to the LSI population. The FMA is applying the EBA guidelines requiring the development of strategies for managing the stock of NPLs in CIs with gross NPL levels exceeding five percent.

23. Amendments to the BWG have expanded and made the role of the supervisory board more robust in its oversight of executive board and bank policies. The duties and responsibilities of the supervisory board's oversight role have been augmented since the last FSAP as have been fit-and-proper requirements. Article 28a defines supervisory board responsibilities to include discussing strategic goals, risk strategy, and internal principles of proper business management with bank management and to monitor implementation by executive directors. Article 39 specifies that managers must have the information necessary to exercise their oversight functions (regular risk and control reports). The internal auditor is required to report quarterly to the chairperson of the supervisory board. For CIs required to establish risk and audit committees, these must be established within the supervisory board.

C. Areas for Improvement

Independence, Accountability and Legal Protection for Supervisors

24. The FMA's operational independence is enshrined in legislation but the 2013 FSAP raised areas of concern. Under the FMA Act, the FMA is not to be bound by any instructions in the performance of its duties; the Federal Minister of Finance is authorized to commission the FMA to undertake onsite inspections, but this right has only been used once. The activities of the FMA are subject to the oversight of the Minister of Finance (through the BMF). This is intended to ensure that the FMA fulfils its statutory tasks, does not violate laws and regulations when doing so, and does not overstep its scope of duties. To support this supervision, the BMF is entitled to gather information from the FMA on all matters relating to financial market supervision (although specific information requests for this purpose have been uncommon). The 2013 FSAP assessed these arrangements as a typical accountability framework. At the same time, assessors made a number of findings where the operational independence of the FMA might be endangered, including the presence of industry representatives on the Supervisory Board, the BMF's role in approving FMA regulations, and the BMF's right to gather information from the FMA. The FSAP recommended amendments to the FMA Act to clarify and narrow the BMF's role, but these have not been implemented. The FSAP also found that legal protections for the FMA and its staff acting in good faith were adequate but would need to be revisited if the FMA were to be granted resolution powers; some specific weaknesses in protections were also identified. Since then, regulations have extended legal protections to cover actions taken by the FMA, its staff, and the resolution authority within the framework of the single resolution mechanism. However, specific weaknesses identified in the 2013 FSAP have not been addressed (the reform proposals included changes in the FMA governance, see Box 1).

Major Acquisitions

25. There is no requirement for ex-ante approval or notification of investment by LSIs in nonfinancial undertakings. If the investment outside the financial sector does not exceed 15 percent of the CI's capital or the total amount of such investments does not exceed 60 percent of the CI capital, there is no approval or pre-notification required. If those limits are exceeded CI must apply a 1,250 percent risk weight, alternatively, the FMA may prohibit the CI from having such investments. If supervisors determine that the investment is not prudential or presents obstacles for consolidated supervision, the FMA can take corrective action to restrict activities or require disposal of the investment. However, ex-ante review and approval or denial is more effective and would avoid costly and possibly complex unwinding of undertakings. The BCP standards require that laws or regulation state the types and amounts (absolute or in relation to a bank's capital) of acquisitions and investments needing prior supervisory approval.

Transactions with Related Parties

26. Transactions with related parties are defined in the BWG. The law has a broad definition of related parties and requires unanimous approval by the Executive Board and consent of the supervisory board for related party transactions. However, the law does not establish the requirement that transactions with related parties not be undertaken on more favorable terms than those offered on transactions with nonrelated counterparties. Additionally, the FMA does not have the power to set on a general or case-by-case basis limits for exposures to individual related parties, aggregate limits for exposures to all related parties or to require collateralization of such exposures, including intragroup transactions. Analysts monitor LSI exposure to related parties, but a uniform process for testing and monitoring the accuracy of information maintained by LSIs on related parties, reviewing terms of transactions and informing CIs on the detail of recordkeeping to maintain for monitoring and informing supervisors on the extent of related party transactions has not been implemented.

27. Standards and monitoring of intra-group transactions. Standards or regulations for intra-group transactions have not been adopted. Similar to related party[12] requirements, transactions with sister banks, affiliated nonfinancial companies, and group members should be monitored to ensure they are required to accomplish normal operations, are priced based on market values, performed in a safe and sound manner, and avoid shifting of problem assets between CIs without documented purpose. As required by the international standards, risks from other entities in the wider group, foreign or domestic, and including nonfinancial entities, need to be considered.

---

[12] The BCBS definition of related parties is broader than existing laws. Related parties "can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates and special purpose entities) that the bank exerts control over or that exerts control over the bank, the bank's major shareholders, Board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies."

Corrective Action

28. The BWG grants FMA broad corrective action and sanctioning powers that have been further enhanced by BaSAG. EBA issued early intervention guidelines (GL/2015/03) establishing intervention triggers, Article 44 of BaSAG addresses early intervention powers and Process No. 67 issued by FMA includes the EBA guideline triggers. Article 70 of BWG covers FMA corrective action and sanctioning powers. Corrective and preventive measures may be initiated when a bank infringes legal requirements or when in the view of the supervisor the bank is likely to infringe, in the near future, legal requirements. Triggers for initiating supervisory measures are primarily quantitative based on SREP ratings, or breaches of legal requirements.

29. A detailed framework for early intervention and application of supervisory measures has been established. The framework refers to standards for identifying problem banks, has well-defined processes that include a crisis management tool that considers the source of the problem (business model, governance, capital, etc.) and indicates what supervisory measures may be appropriate. Additionally, the OeNB maintains a financial deterioration dashboard that signals soft and hard triggers of deterioration for reporting to the FMA for possible action.

30. Nevertheless, most triggers are quantitative and based on observed financial deterioration or legal breaches. Article 70 (4) of BWG establishes that FMA may impose supervisory measures when in the FMA's view there is evidence for assuming that a CI will breach the CRR or the CRD provisions within twelve months. To facilitate this determination, a review of available triggers or internal guidance to aid supervisory staff in making decisions to score SREP internal governance modules 3 or 4 based on qualitative factors for such areas as "doubts about the appropriateness of the corporate culture" , "the remuneration policy conflicts with the institution's risk strategy and long-term interests", or "wider-group oversight of anti-money laundering and combating the financing of terrorism risk is inadequate"[13]may be appropriate. The guidance would help staff support conclusions that there are weaknesses that may lead to problems, when there is no current evidential impact on bank performance.

Corporate Governance

31. As mentioned above, the BWG has expanded the responsibilities of the supervisory board and the role of the board has evolved significantly since the last FSAP; increasing interaction with the supervisors would contribute the continued evolution. Communications between the FMA/OeNB and the supervisory board following and during the SREP and after onsite inspections should increase and become broader and substantive at times of SREP and after onsite inspections to enhance evaluation of the board's effectiveness and knowledge of banking operations. Currently, the FMA places significant reliance on input from state commissioners concerning supervisory board performance and review of board meeting minutes.

[13] EBA: Relevance of AML/CFT concerns from a prudential perspective (July 2019).

32. State commissioners provide an inside view of the CI to the supervisors. State commissioners are appointed to CIs with total assets exceeding € one billion and participate in the general assembly, attend supervisory board meetings and other supervisory board committee meetings, and report to FMA on relevant activities of the CIs (profitability, change in risk profile, and high-level staff changes). They must report immediately if they become aware of facts that may threaten the ability of the CI to meet its creditor obligations. Although not voting members, the commissioners may object to supervisory board actions that breach regulations. The commissioners are BMF staff, are appointed by the BMF to serve five-year terms, and are salaried by the BMF. In their commissioner function, they report to the FMA.

D. Recommendations:

- **Review existing legislation to clarify and narrow the BMF's role in oversight of the FMA and remove industry participation in its Supervisory Board, as recommended in the 2013 FSAP.**

- **Consider legislation granting FMA power to review ex-ante major acquisitions outside the financial sector.** Although the FMA has authority to ex-post limit the activities or require disposal of a major acquisition, if it considers it detrimental to the bank, having ex-ante review authority would minimize the disruption of reversing the acquisition or imposing corrective action measures.

- **Enhance the related party transaction regulatory and supervisory approach.** Consider amending the BWG or issuing guidance addressing: (1) content and format in which banks must document their organizational structure, including related parties and beneficial owners and monitoring transactions with related parties, (2) tracking intra-group transactions between the CI and its affiliates, (3) establishing onsite and offsite processes for regular reviews of related party exposures, (4) requiring that transactions be at arms' length, and (5) consider establishing aggregate limits for related party transactions.

- **Enhance the framework for implementation and escalation of preventive and corrective action with additional guidance for use of qualitative factors**. In 2015 EBA issued guidelines for triggers of early intervention measures and in 2018 the Basel Committee published Frameworks for early supervisory intervention. Pre-emptive and proactive supervisory measures are largely based on supervisory judgment. A supervisor must assess the quality of risk management or governance to identify areas that may be profitable in the short-term but have risks the CI may not be able to properly manage. This always involves supervisory judgment and is different from ensuring regulatory compliance. To aid in decisions based on supervisory judgment and the analysis of qualitative factors, the FMA should review and determine the needs to enhance additional internal guidelines or provide training.

- **Review the state commissioner function.** State commissioners have added significant value to the FMA in their contributions to the monitoring of the supervisory board performance. However, the role of the supervisory board has evolved, and requirements placed on the members have become more technical and related to monitoring the safety and soundness of the CI and internal controls and closer engagement with the executive board over operating policies and risk appetite statements. Although the FMA is providing some training to commissioners to help them with the changing roles and technical issues, the new BCBS standards require more direct interaction between the supervisor and the supervisory board. Therefore, the state commissioner function should be supplanted by increased interaction between the supervisors and the supervisory board.