

# A year in review

## Peter Knobl of Cerha Hempel Spiegelfeld Hlawati tracks EU legislative developments and their impact on Austrian bank regulation

The development of Austrian laws on bank regulation during the last two years reflects the main banking regulatory issues that have occurred in the last decade and that will continue to play an important part in the future.

Most legislative developments have been implemented by amendments to the Austrian Banking Act 1993 (Bankwesengesetz).

### The role of the FMA

The legal basis for the Austrian FMA as a public law institution was passed as constitutional law in 2002, shortly after the Austrian Constitutional Court had repealed the provisions founding the competences of the FMA's predecessor authority, the Austrian Securities Authority, as being unconstitutional. Due to this structure it was discussed whether FMA qualifies as a legal entity independently liable for damages caused to third parties or whether the Republic of Austria is responsible for FMA's acts and omissions by way of official liability (*Amtshaftung*). As of July 1 2005, the Austrian legislator clarified that: (i) the Republic of Austria is officially liable for FMA's acts and omissions; (ii) FMA has considerable discretion in exercising its supervisory powers; and (iii) in case of damages caused by FMA's acts and omissions, the Republic of Austria is heavily restricted in taking recourse against FMA personnel in line with general recourse principles of Austrian law relating to official liability. In particular, taking recourse against FMA staff is excluded for the Republic in cases of non-grossly negligent conduct of staff members.

### Strengthening enforcement

As of January 1 2007, an amendment to the Austrian Banking Act and to the Austrian Act on the Financial Market Authority (Finanzmarktaufsichtsbehördengesetz) entered into force, increasing money fines for, among other things, unauthorized pursuit of banking and investment services to a maximum of €50,000. Almost all other money fines were also increased. In addition, FMA was conceded a new set of competences specifically targeted at prohibiting further business operation of legal entities acting without adequate licence on Austrian territory. However, FMA's additional competences have not adequately been integrated into the existing set of rules for prohibiting unauthorized activities to licensed Austrian entities by the legislator. FMA has also been provided with power to prescribe an administrative penalty (*Säumnisgebühr*) in

cases of violations of duties of disclosure and of submission through FMA. However, the legislator did not amend anything with regard to the total exclusion of rights of appeal against administrative measures taken by FMA (outside penal proceedings).

### Tightening bank audit rules

As of January 1 2006, a set of rules aimed at increasing the level of quality of annual audits for Austrian banks entered into force. The circle of reasons for preclusion of auditors from the annual audit was enlarged, now encompassing the incompatibility of audit on the one hand, and legal and expert services having more than negligible effect on the annual audit on the other hand. A requirement to effect an internal rotation of the bank auditor applying after five annual audits was enacted instead of an external rotation (which would have required a change of the auditing company). Statutory caps for the auditors and liability provisions applying irrespective of the auditors' slight or gross negligence were introduced as well as a mandatory system of quality control in line with international standards. In mid-summer 2005 the Austrian legislator was compelled to react on a Supreme Court judgment stating that defective bank supervisory reports may cause the Austrian Republic's official liability. The Austrian legislator specified that bank auditors usually exclusively act on behalf of and within the mandate of the appointing bank so that their acts cannot be qualified to be "execution of laws" within the meaning of the Austrian Act on official liability (*Amtshaftungsgesetz*). So providing services relating to the annual audit of banks will usually not trigger official liability, whereas auditors' services rendered upon explicit instruction by FMA will.

### Mortgage bonds and debentures

With effect from June 1 2005, the Austrian legislator has improved the legal framework for Austrian (public) mortgage bonds

((*öffentlicher*) *Pfandbrief*), Austrian public-sector debentures (*Kommunalschuldverschreibungen*) and Austrian funded bank debentures (*fundierte Bankschuldverschreibungen*)

Mortgage banks and mortgage-bond issuing companies, as well as issuers of funded bank debentures, will be able not only to hedge interest rate and currency risks relating to the coverage portfolio by entering into derivative instruments, but also to hedge credit risks by entering into credit derivatives.

The amendment also introduces a highly practicable insolvency law provision requiring that a special receiver for a segregated mass (*Sondermasse*) in the insolvency of a mortgage bank, a mortgage-bond issuing bank or an issuer of funded bank debentures must first try to realize the proceeds from the coverage portfolio by selling the whole portfolio entirely to another bank. If so, the pertaining assets need not be terminated early and redeemed in the bank's insolvency proceedings. At the same time, interest payments on Austrian (public) mortgage bonds, public sector-debentures and funded bank debentures are secured also after initiation of insolvency proceedings against the issuing bank.

Lastly, by permitting coverage for funded bank debentures consisting of assets held in fiduciary trust by other credit institutions, the Austrian legislator enabled some Austrian banks to issue funded bank debentures in a larger volume than before or even for the first time. The first Austrian bank making use of the new provision was BAWAG PSK in June 2005, placing €1 billion-worth of covered bonds with five years' maturity on a pan-European basis.

### The Basel II Capital Accord

Austria has implemented the Basel II capital accord by transposing EC directives 2006/48/EC and 2006/49/EC into Austrian law in 2006. A large part of the pertaining provisions entered into force on January 1 2007. The set of implementation instruments consisted, apart from a heavy amendment to the Austrian Banking Act, of two implementing regulations enacted by FMA and a Minimum Standard on Loan Business issued by FMA (which contained recommendations and duties of diligence). The Minimum Standard for Loan Business provides for a strict functional separation of front office and back office departments within

**"The concept of economic supervision has been shifted to a concept of prudential regulation"**

## Author biography



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Peter Knobl works in the banking and debt capital markets field and has been a partner at Cerha Hempel Spiegelfeld Hlawati (CHSH) since 2006. Knobl graduated from the University of Vienna as Mag iur in 1986 and Dr iur in 1987. He was admitted to the Austrian Bar in 2001 and has been with Cerha Hempel Spiegelfeld Hlawati since 1998.

He has regularly rendered advice to Austrian and non-Austrian banks and investment firms relating to all banking and securities regulatory laws questions, including questions of

licence requirements, conduct-of-business rules and cross-border provision of banking and investment services. He continues to be involved in questions of drafting and passporting prospectuses.

He has prepared issues and Austrian offers of more than 100 securitized derivative products and performance-linked structured investment products. He permanently advises Luxembourg domiciled undertakings for collective investment in transferable securities (funds) as to their Austrian offer and represents foreign fund managers as to their agreements with Austrian KAGs. He also advised an Austrian listed corporate issuer in setting up its EMTN programme and in the offering of its inaugural bonds issue. In 2006 and 2007, he was involved in a European Investment Bank project financing for a terminal at Vienna airport and in the issuance of two convertible bonds of Austrian listed share corporations.

Before joining CHSH, Knobl worked for more than seven years as in-house counsel in the securities and international departments of Erste Bank.

CHSH is one of Austria's largest law firms, with strong international links and offices in Vienna, Bratislava, Brussels, Budapest, Bucharest, Warsaw, Gdansk, Katowice, Poznan and Wroclaw. The firm has a banking and capital markets group that focuses on the permanent representation of Austrian commercial banks, international investment banks and their clients and investment funds. CHSH has been involved in most of the big Austrian international equity offerings of the last few years, including privatizations, IPOs, second placements and rights offerings.

The firm represents Austrian and international companies and is regarded as one of Austria's leading law firms in mergers and acquisitions, banking and capital markets, real estate, litigation and arbitration. The firm was awarded Austrian law firm of the year in 2004 as well as 2005 by the *International Financial Law Review*.

a bank linked to the principle of granting credits and loans by double vote from both the front and the back offices. The two FMA regulations transpose the regulatory capital provisions and the disclosure requirements of Basel II pillars one and two and of Directive 2006/48/EC into Austrian law.

In line with Basel II, Austrian credit institutions will not be entitled to apply the advanced IRB approach for credit risk and the advanced measurement approach for operational risks before year-end 2007. They are already entitled to use the standardized approach and the IRB foundation approach to calculate capital requirements for credit risk, and the basic indicator approach and the standardized approach to calculate operational risk capital requirements. In line with Directive 2006/48/EC, Austrian credit institutions will be permitted to apply the Basel I regulatory capital requirements until year-end 2007. Transitional provisions effective from 2007 through 2009 provide for floor minimum capital requirements calculated on the basis of Basel I for Austrian credit institutions that make use of an IRB-based approach in this period. For Austrian credit institutions that have decided to apply for supervisory approval to use an IRB-based

approach before December 31 2007, an Austrian specific transitional provision has been enacted enabling the use of the IRB approach before and without supervisory approval provided that: (i) the credit institution confirms by way of self-assessment that the pertaining requirements have been fulfilled; and (ii) a short opinion issued by the Austrian National Bank confirms that the requirements are complied with. This transitional approval for using the IRB approach elapses upon issuance of formal FMA approval, but at year-end 2009 at the latest. In line with Basel II and Directive 2006/48/EC, Austrian credit institutions will also be permitted to make "partial use" of the IRB approach and the standardized approach.

Austrian implementation peculiarities for the Basel II framework focused on the enactment of a special zero weighting as opposed to a 20% weighting for "intra-group exposures". Austria has decided to implement an option granted by Directive 2006/48/EC by enabling the option to apply a risk weighting of 20% to exposures to counterparties belonging to the same group of credit institutions. Moreover an option to apply the zero weighting was implemented for exposures to counterparties that are members

of the same institutional protection scheme as the lending credit institution where there is no group relationship between borrower and lender apart from such membership. In all cases, however, there must be a suitable and uniformly applied risk-management system for the scheme in place. This provision enables in particular Austrian credit institutions belonging to the cooperative banking sector (such as Raiffeisenbanken and Volksbanken) to attain the zero weighting for exposures to other members of the protection scheme and was challenged fiercely but without success by other Austrian banking sectors.

However, the Austrian legislator has decided not to make use of the option to waive the solo level application of capital requirements and apply the rules on a consolidated level within the Austrian borders only.

The Austrian legislator has opted to permit a calculation of regulatory capital requirements on a consolidated basis if internationally accepted accounting principles (IFRS) are used.

In practice, apart from Raiffeisen Zentralbank Österreich, the standardized approach will be used within the Raiffeisen banking sector, whereas the member institutions within the Austrian saving banks group will be obliged to use the IRB approach in line with Erste Bank's decisions.

The EC Directive's provisions on "consolidating supervisors" issuing approvals for using advanced models to calculate regulatory capital requirements and internal models to calculate the value of specified derivatives and other financial instruments have fully been implemented into Austrian law, enabling a joint decision by all affected supervisory authorities of multinational bank groups. A pertaining decree issued by FMA will have to be served to the group's superordinate credit institution in Austria, by which it will be deemed served to all subordinate credit institutions within the group.

In line with Basel II and the EC Directive's provisions on minimum capital requirements, the core Austrian banking capital requirements were amended as follows: Within the standardized approach, the composition of eligible regulatory capital resources (the numerator) remains unchanged, whereas the denominator was supplemented by the risk requirements for the operational risk in addition to the credit risk, and the market risk requirements now being calculated in a more risk-sensitive manner. The result of the fraction expressing the solvency ratio must, similarly to what was ruled under Basel I, be equal to or bigger than 8%.

In contrast, within the IRB approach, not only the denominator has been changed, but also the numerator. This is mainly due to the fact that loss provisions may in certain

circumstances be added to the eligible regulatory capital resources which, in turn, is due to only the risk weighted assets corresponding to unexpected losses from loans being calculated. As to the denominator's supplementation and the solvency ratio, see the above relating to the standardized approach.

The second pillar of Basel II will be reflected by Sections 39 and 39a of the Austrian Banking Act (supervisory review evaluation process and internal capital adequacy assessment process – Icaap and SREP) establishing new duties of diligence for members of a bank's management board, but also some new duties for the Austrian banking supervisory authority. The third pillar will be reflected in Sections 26 and 26a of the Austrian Banking Act and the FMA's Regulation on Disclosure Requirements for Credit Institutions. The Icaap requires that the management of a credit institution procure enough "economic capital" in relation to the risk situation of the credit institution. These provisions are supplemented by organizational requirements, which are internal governance rules for Austrian credit institutions. The rules are determined by internal governance guidelines issued by the Committee of European Banking Supervisors.

As to Basel II's third pillar, an Austrian credit institution may elect to publish in its annual report or otherwise in a way accessible for the public fundamental information on the organizational and risk structure of the credit institution (market discipline).

The new supervision on minimum capital requirements and risk assessment, as well as on adequate endowment with economic capital and on enhanced disclosure, has fundamentally changed the character of banking supervision exercised by the Austrian supervisory authority FMA. In traditional terms, the concept of economic supervision has been shifted to a concept of prudential regulation including systemic supervision and preventing increases in risks and distortion of competition.

#### Mifid and internal governance

The new set of rules on internal governance for credit institutions included in Basel II pillar two will be extended by organizational and compliance requirements under Mifid to enter into force as Austrian law by November 1 2007.

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## “Mifid implementation will severely affect the value chain in the Austrian securities business and will also amend the Austrian capital markets and banking laws”

Securities Supervision Act 1996, as amended, will totally be repealed by October 31 2007 and replaced by a new Securities Supervision Act 2007. The Austrian Banking Act and the Austrian Stock Exchange Act will be amended to reflect the newly enacted licensing provisions within the Securities Supervision Act, the "regulated markets"-concept, the licensing requirements for companies operating regulated markets, the new rules on pre-trade and post-trade transparency, facilitated listing requirements for transferable securities without the issuer's consent subject to prior listing on a regulated market or a comparable securities exchange outside the EU, and the amended rules for removal or suspension of financial instruments from trading on regulated markets.

The organizational requirements prescribed by Mifid and relating to general structural requirements, specific organizational and procedural minimum requirements for compliance functions within entities rendering investment services, equivalent provisions on risk management, internal audit, the management's responsibility, record-keeping requirements and personal transactions will form part of an exhaustive and separate chapter within the Austrian Securities Supervision Act 2007 headed "Organization". A new part of the Act will for the first time provide limits and conditions for the outsourcing of services and the use of tied agents by investment firms, investment services providers, credit institutions and Austrian branches of EEA member state firms and credit institutions.

Under the existing Securities Supervision Act 1996: (i) the rendering of investment advice; (ii) the provision of discretionary portfolio management services on a client-by-client basis; and (iii) the brokering of securities business require a special licence from FMA, which will not be changed in the draft new Securities Supervision Act 2007 (the Act). However, the Act now also requires an investment firm's licence for: (iv) the operation of a multilateral trading facility. These four core investment services will form

the elements of a newly introduced category of Austrian market participants called licensed Austrian *investment firms* (replacing the category of licensed Austrian *investment services providers* as previously authorized under the Securities Supervision Act 1996). Grandfathering provisions relating to existing Austrian licences will provide coverage until December 31 2008. Only entities providing investment advice or brokering activities relating to financial instruments solely to authorized investment firms, credit institutions, branches of investment firms or of credit institutions authorized in a third state, and EU collective investment undertakings and investment companies with fixed capital will be entitled to be licensed as investment service providers by FMA. But they will not be able to benefit from the European passport. On the other hand, the licensing criteria for such investment service providers will be substantially lower than for licensed investment firms. Apart from these two categories, Austrian licensed credit institutions (with the exclusion of operating multilateral trading facilities) will be authorized by law to provide those investment services that may be rendered by investment firms. The provisions relating to cross-border services by non-Austrian EU and EEA investment firms will be transferred from the Austrian Banking Act into the new Securities Supervision Act 2007, but remain essentially unchanged.

An informal ministerial bill for the Securities Supervision Act 2007 was issued by the Austrian Federal Ministry of Finance on February 26 2007 and was open for assessment and comments until April 25 2007. If the Austrian government reaches an agreement on the bill in time, the parliamentary procedure might start in June and the effective date November 1 2007 for Austrian implementing legislation could be achieved. Despite this, the EU Commission in April 2007 announced it had initiated infringing proceedings against Austria and 23 other EU member states for having missed the January 31 2007 implementation date for Mifid.