OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

Conference

„Introducing counter-cyclicality into prudential regulation; its role in Basel II“

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Central and Eastern European perspectives on counter-cyclical regulation

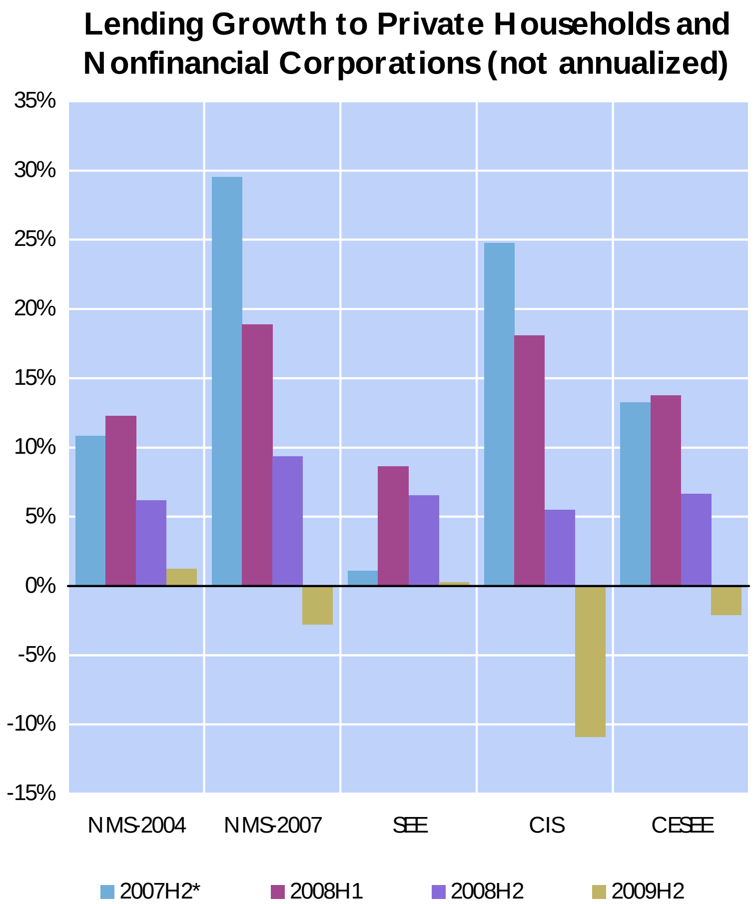
Background

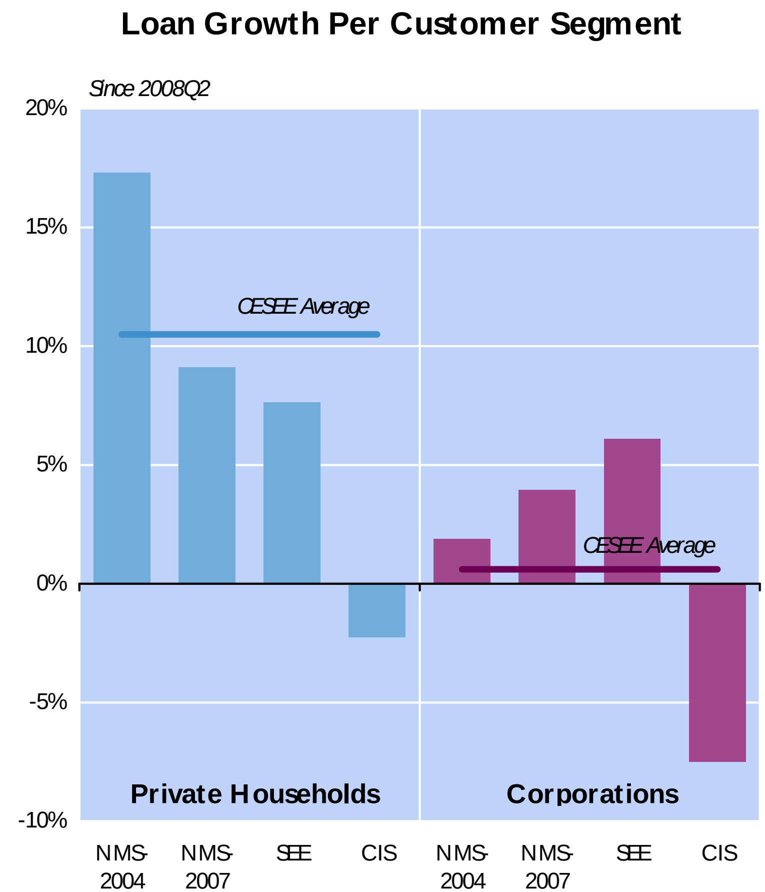
- **Basel II/CRD: primary goal = increasing risk sensitivity of capital requirements**
- **Therefore: Risk weighted assets and capital requirements move in tandem with economic conditions**

What do we want to avoid:

- **Sudden additional capital requirements for banks in times of stress**
- **Excessive up- and downswings in capital requirements**
- **Unstable lending conditions for the economy**

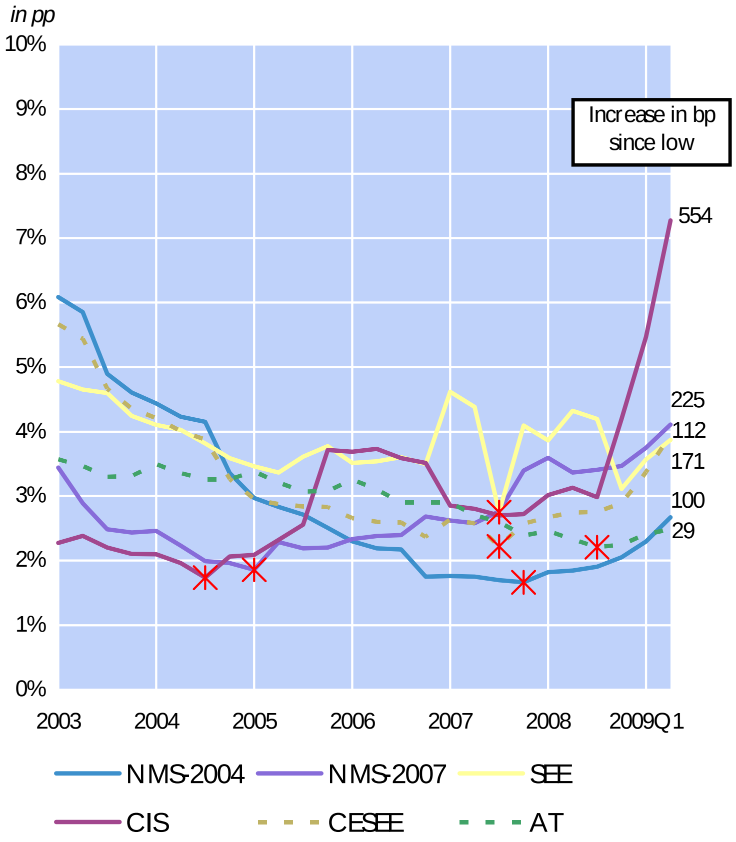
Lending Slows amid Difficult Economic Environment



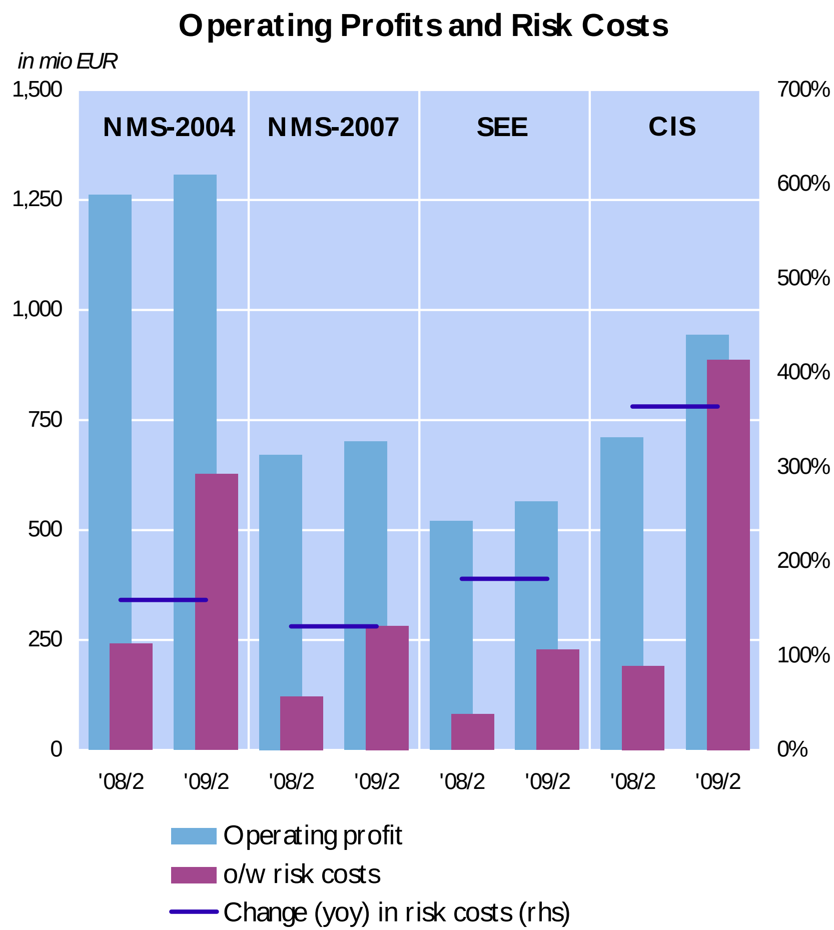


*Source: OeNB, preliminary data as of 2009Q2; *...adjusted for acquisitions and foreign exchange rate changes.*

Rising Risk Costs Constrain Banks' Risk Taking Capacity



Source: OeNB, as of 2009Q2: * … denotes lows.



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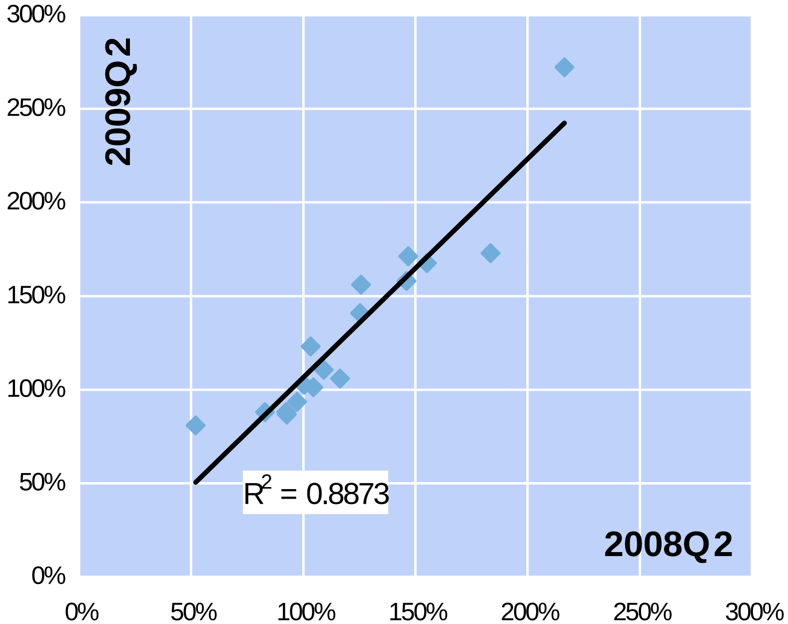
Cyclical Effects Bind Additional Capital

Credit Risk of AT Subsidiaries - Risk Weighted Assets vs. Outstanding Amount of Loans to Nonbanks

RWAs to Outstanding Amount per Country

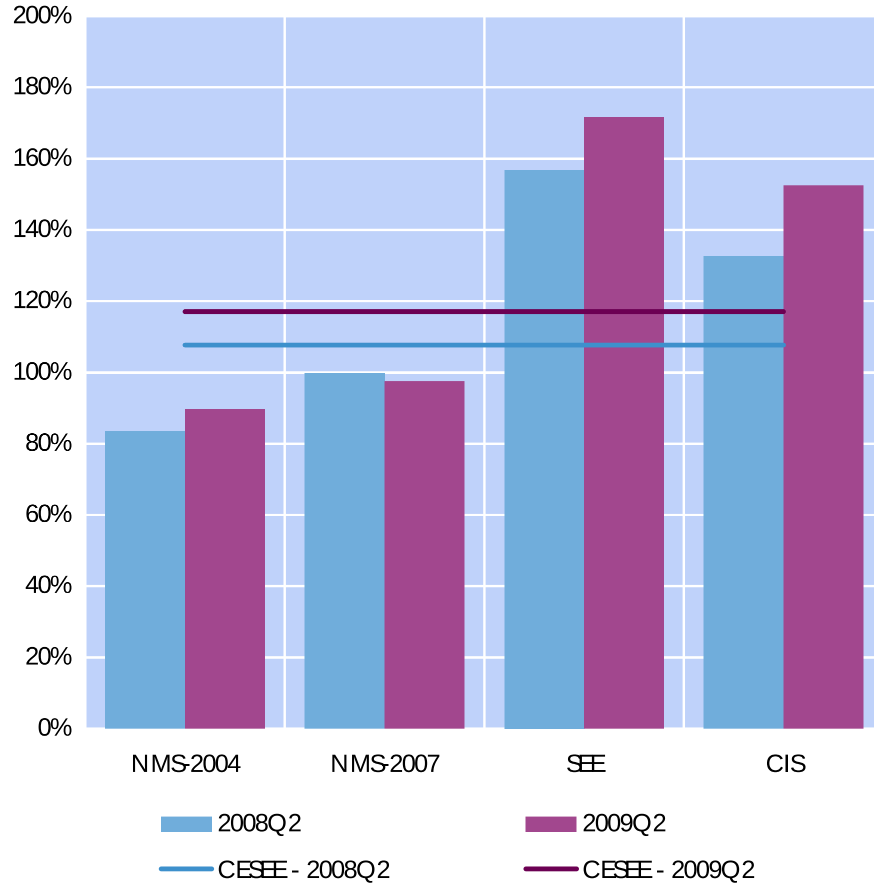


$$\left(\frac{RWA_{2009Q2,i}}{Loans_{2009Q2,i}}\right) = 1.17\left(\frac{RWA_{2008Q2,i}}{Loans_{2008Q2,i}}\right) - 0.1$$

i= index of CESEE countries

Source: OeNB, as of 2009Q2; Note: Regression adjusted for an outlier (AL not included).

RWAs to Outstanding Amount per Region



Mitigation of Pro-Cyclicality – current proposals in EU

Dynamic provisioning

- **Proposal by European Commission**
- **Addresses accounting (provision) issues, not capital (requirements)**
- **Build up a provision for credit risks during good times**
- **Run down provision in bad times, use it to cover (expected) losses**

Advantages:

- **Presumably high quantitative effects**
- **For standardised and IRB approach**
- **Once the scaling factor is set it is easy to implement for banks (see Spain)**

Disadvantages:

- **Determination of scaling factor is difficult**

Austrian position: positive

Mitigation of Pro-Cyclicality – current proposals in EU

Counter Cyclical Capital Buffers

- **Ongoing discussion in Commission and Basel Committee but yet no consultation**
- **Build up a capital buffer for credit risks during good times**
- **Run down capital buffer in bad times**
- **Based on systemic not idiosyncratic risks**

Advantages:

- **High quantitative effects are possible**
- **Smoothing of capital requirements over time**
- **In principle: for standardised and IRB approaches**

Disadvantages:

- **Determination of scaling factor is difficult**

Austrian position: positive, if it is an automatic buffer in Pillar 1 based on a macro economic variable. Re-scaling of input parameters should be avoided!

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Mitigation of Pro-Cyclicality – further proposals

<u>Realisable in the short run and low complexity:</u>

- **Re-rating of problem customers: more frequent re-rating stabilizes PDs for good rating classes and thus stabilizes capital requirements**
- **Tighter monitoring of customers: Avoid technical defaults by more effective controls of limits and reminders**

Austrian position: recommended as these measures need no change of laws and can be implemented in the short run.

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Mitigation of Pro-Cyclicality – further proposals

Realisable without change of laws but with higher complexity:

- **Through-the-cycle (TTC) ratings: use of long term data series on defaults will smooth capital requirements**
- **"English model": Using artificial long time data on bank level**

Austrian position: in favor of TTC but against artificial time series.

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Mitigation of Pro-Cyclicality – further proposals

With reservation:

- **Definition of default 90 → 180 days: less defaults will lead to lower capital requirements**
- **Definition of threshold for past due exposure: increasing the threshold for past due exposure will reduce risk weighted assets as less assets will be qualified as defaulted.**

Austrian position: objecting changes in definition of past due exposure

Conclusion

- **Current crises shows effects of worsening economic conditions on lending conditions in Central and Eastern Europe.**
- **As Austrian banks have a high exposure in Central and Eastern Europe their capital requirements increase with a deterioration of economic conditions.**
- **Austrian authorities therefore welcome measures for mitigating cyclical fluctuations of capital requirements.**
- **Austrian authorities support current Commission proposals: dynamic provisioning, anti-cyclical capital buffers**
- **Furthermore we especially encourage banks to refine their rating methodologies in several ways (TTC, re-rating, …) in order to cope with cyclicality**

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