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TECHNICAL NOTE

CRISIS PREPAREDNESS AND MANAGEMENT FRAMEWORK

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Austria. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations.

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Glossary

BCP	Basel Core Principles
BU	Banking Union
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DGS	Deposit Guarantee Scheme
EA	Euro Area
EC	European Commission
ECB	European Central Bank
ESRB	European Systemic Risk Board
EU	European Union
FSAP	Financial Sector Assessment Program
IMF	International Monetary Fund
MoU	Memorandum of Understanding

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EXECUTIVE SUMMARY

The global crisis revealed weaknesses in Austria's financial stability policy framework, and recent changes at the European levels provide an opportunity to address them. These would include setting up a macroprudential policy framework with a clear mandate and a range of instruments that would effectively address system risks, and establishing a full-fledged framework for bank resolution that would allow Austria to deal more efficiently with failing banks, while reducing the risk of future bank bailouts.[1]

Regarding macroprudential policy, priorities include setting up an authority with a clear policy mandate, with the OeNB playing a leading role in close coordination with the Ministry of Finance (MOF) and the FMA at the national level, and the European Systemic Risk Board (ESRB) and ECB at the European level. The need for macroprudential policy instruments that go beyond those included in forthcoming European Union (EU) Directives should be considered.

As highlighted by recent experience during the crisis, Austria needs to put in place a special bank resolution regime to resolve problem banks in a manner that does not endanger financial stability or fiscal sustainability. While the authorities prefer to await the formal adoption of the EU Directive on bank recovery and resolution, it would be in Austria's interest to swiftly introduce a full-fledged bank resolution framework, with a wide range of tools and powers—based on international best practices and consistent with the proposed EU directive—and strengthened resolution arrangements with non-EU countries. The FMA should become Austria's bank resolution authority.

While the current Deposit Guarantee Scheme (DGS) has certain benefits, the authorities should use the opportunity of the forthcoming EU DGS Directive to introduce a unified DGS. Specifically, an ex ante-funded and publicly-administered national DGS would improve risk pooling, transparency and DGS fund management, and prompt payout. A high-level working group should be tasked with designing the new DGS, taking the EU Directive as well as the Basel Committee on Banking Supervision (BCBS) Core Principles for Effective Deposit Insurance Schemes as minimum standards.

The existing systemic crisis management framework could be further strengthened. Further to strengthening early intervention powers, the framework governing the OeNB's finances in general and Emergency Liquidity Assistance (ELA) operations in particular could be improved, in line with recent EU developments, and complementary measures can be taken to decrease the possible adverse effects on OeNB's balance sheet and the country's fiscal position. The mandate of the Federal Corporation of Financial Market Participation (FIMBAG) and the conditions under which capital support is provided to distressed banks should also be strengthened.

[1]Three months after the FSAP mission, the authorities have adopted legislations covering the macroprudential policy framework (Federal Law Gazette I Nr 184/2013) and early intervention framework for banks (Federal Law Gazette I Nr 160/2013). Both laws will come into force on January 1, 2014.

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INTRODUCTION[2]

1. To ensure financial stability governments should have at their disposal a variety of policy tools. While these may range from effective supervision to prudential tools mitigating volatile capital flows, not all will be discussed in this technical note. In line with the FSAP mission's work this note focuses particularly on areas that are more directly related to dealing with failing banks and the fall-out within the financial system as a consequence of this failure.

2. The 2008 financial crisis has underlined the importance of familiar concepts and introduced relatively new ones, and this note covers both. For example, it has become more apparent that early intervention in banks that are showing financial weaknesses and are otherwise having trouble complying with regulatory requirements is of the utmost importance to increase the chances of preventing these banks from actual failure. Similarly, being confronted with failing banks, more jurisdictions were confronted with the need to introduce specific legal regimes to resolve these banks. Also, we have come to understand the need for a new form of prudential policy—that is, macroprudential policy—to complement convention prudential supervision and monetary policy. These are key aspects of any modern financial stability framework; for this reason Austria is considering changes in legislation and policy.

3. Crisis prevention and management are costly, so there is a need to discuss the funding of related actions as well. This crisis has shown a reemergence of emergency liquidity assistance operations by central banks. In particular in countries hit severely by the crisis central banks have been deeply involved in such operations. Therefore this note also discusses the consequences for the OeNB's balance sheet and the fiscal consequences for the Federal Government. Similarly, the note discusses in depth how a well-desigend deposit insurance scheme can effectively support bank resolution. The peculiar Austrian scheme for deposit insurance can be explained historically, but is not necessarily conducive to effective bank resolution.

4. The paper is organized as follows. Subsequent chapters discuss the key elements of any financial stability framework: (i) macroprudential policies (Chapter II); (ii) early intervention and orderly bank resolution (Chapter III); (iii) deposit insurance (Chapter IV); (iv) emergency liquidity assistance (Chapter V); and (v) systemic crisis management (Chapter VI). Each chapter starts with an introduction, discusses the framework in Austria, and concludes with recommendations; where needed, EU developments are referenced.

[2] Prepared by Atilla Arda (LEG), Paul Mathieu, David Parker, and Jianping Zhou (all MCM).

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MACROPRUDENTIAL POLICY[3]

A. Introduction

5. The 2008 crisis has shown that microprudential policies need to be complemented with macroprudential policy to achieve the stability of the financial system as a whole. Macroprudential policy has been defined as the use of primarily prudential tools to limit systemic risks arising from macro-financial linkages and interconnectedness among financial institutions.[4] Such policy does not replace, but complements microprudential policies, whose main focus is on the soundness of individual financial institutions.[5]

6. Many jurisdictions are now exploring how existing financial sector legislation should be modified to allow for implementation of macroprudential policy. With respect to the design of the substantive legal provisions, the underlying legislation should include adequate provisions pertaining to the macroprudential *mandate*, including: (i) *the objective* of macroprudential authorities to help guide the decision-making process and enhance accountability ; (ii) *the functions* of these authorities, which define the overall scope of responsibilities for the implementation of macroprudential policy (i.e., identifying systemic risks, formulating a policy response, and mitigating systemic risk through rule-making, supervision, and enforcement); and (iii) *the powers* of macroprudential authorities, which—consistent with other areas of financial sector policy—should include powers to make rules, to collect pertinent information, to supervise regulated entities, and to enforce compliance with applicable rules.[6]

7. Macroprudential policy will need to be supported by a strong institutional framework to ensure its effectiveness. This framework needs to foster the *ability to act* and assure the *willingness to act* in the face of evolving systemic risks; it will also need to provide an appropriate accountability mechanism to the public at large and political principals in particular, and effective communication to develop public awareness of systemic risks and the need to take mitigating action.

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[3] Macroprudential policy focuses on the financial system as a whole and uses prudential instruments to (i) limit the buildup of financial imbalances; (ii) address the market failures related to risk externalities and interconnectedness between financial institutions; and (iii) dampen the pro-cyclicality of the financial system.

[4] See IMF (2011) and FSB, IMF, and BIS (2011).

[5] IMF (2013a), "Key Aspects of Macroprudential Policy," SM/13/145, September 2013.

[6] IMF (2013b), "Implementing Macroprudential Policy—Selected Legal Issues" (SM/13/159), September 2013 gives guidance to IMF members on the key legal issues that will need to be addressed when designing frameworks to support macroprudential policies.

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B. Framework in Austria

8. Financial stability is a shared responsibility of the FMA, OeNB, and Ministry of Finance. Austria has a dual supervisory system involving the FMA and OeNB, while the Ministry of Finance is responsible for developing financial sector legislations. Specifically:

- The FMA, as the integrated supervisory agency, is responsible for supervising all significant providers of financial services and functions, including credit institutions, insurance and pension companies, investment funds, financial conglomerates and the stock exchange.

- The OeNB collaborates with the FMA in implementing bank supervision, and is also responsible for the oversight of payment systems. As regards bank supervision, it undertakes off-site analysis and on-site examinations based on inspection orders issued by the FMA, and can request audits or the expansion of inspection orders.

- The Federation has exclusive legislative and executive powers with respect to the monetary, credit, stock exchange and banking system. Within the Federal Government, these issues and other related policy areas, such as capital and payment systems, and insurance supervision fall within the jurisdiction of the MOF.

9. While there is no formal macroprudential framework in Austria certain important elements are in place:

- The Financial Market Committee (FMK) provides a useful platform to discuss financial stability-related issues. Established at the MOF, it comprises one representative from each of the MOF, the FMA, and the OeNB; the MOF appoints the FMK chair from among the FMK members, for a three-year, renewable term. The FMK is mandated "to promote inter-institutional cooperation and exchange of experiences" among its members, and to "adopt recommendations on financial market issues with a majority of votes."

- Macroprudential *measures were taken to mitigate potential systemic risks associated with large financial institutions*. For example, new supervisory guidance for the three large Austrian banks was issued in March 2012 (Box 1). However, in the absence of specific legal authority for macroprudential supervision, and of a general rule-making authority for the FMA or FMK, the measures taken to date are non-binding supervisory guidance or "comply or explain" instructions.

10. The authorities are in the process of implementing an ESRB recommendation on national macroprudential mandates. Appendix 1 describes EU developments with respect to

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macroprudential policies. A recently adopted law, which will enter into force on January 1, 2014, provides a framework for macroprudential policies in Austria: [7]

- The FMK will be renamed Financial Market Stability Committee (FMSG) and redesigned into a macroprudential committee authorized to issue recommendations to the FMA under the 'comply or explain' principle when its systemic risk assessments would show that macroprudential measures are called for.

- The FMSG will be chaired by its two MOF members; in addition, the FMSG will include one OeNB member, one FMA member, and two members from the Fiscal Council—one of which the chair of the Fiscal Council.

- The FMA's mandate will include macroprudential supervision with tools laid down in the so-called CRD IV package.[8] The FMA's existing rule-making power will include macroprudential measures. As is currently the case, FMA regulations will continue to require ex ante consent from the MOF. Also, the FMA is required to act after consultation with the OeNB.

- The OeNB's financial stability mandate will specify explicitly that it is responsible (i) to assess systemic risks and to advise the FMSG in this regard, (ii) to propose the FMSG recommendations for submission to the FMA, (iii) to assess the FMA's implementation of these recommendations and to advise the FMSG in this regard, and (iv) to prepare an annual financial stability report.[9]

[7] Federal Law Gazette I Nr 184/2013. Articles 13 and 22 through 24a of the Banking Act are particularly relevant in this respect.

[8] This package comprises a regulation and a directive: (i) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012; and (ii) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[9] New Article 44c of the OeNB Act.

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Box 1. Supervisory Guidance in Strengthening the Sustainability of the Business Models of Large Internationally Active Austrian Banks

- *On March 14, 2012, the Austrian supervisors issued new supervisory guidance for the largest three Austria-based banks after consultations with CESEE supervisors; the goal is to improve the sustainability of these banks' foreign operations (including those in CESEE) and secure financial stability both in Austria and in host countries. The guidance consists of three pillars:*

- *Higher capital buffers***.** Basel III capital rules regarding CET1 capital were fully implemented by January 1st, 2013 without transitional provisions (though private and government participation capital issued under the Austrian bank support act will initially be included in the Core Tier I capital base, and phased out according to CRR/CRD IV), as well as a CET1 capital surcharge of up to 3 percentage points from January 1st, 2016. The rules governing the exact amount of this surcharge remain to be determined.

- *Promotion of stable local funding of subsidiaries*. Supervisors will monitor the funding of subsidiaries to encourage more reliance on local funding.

- *Recovery and resolution plans*. Parent banks submitted these plans by end-2012.

- The promotion of stable local funding of subsidiaries will be through the monitoring of Loan-to-Local-Stable-Funding-Ratios (LLSFR), defined as loans to non-banks divided by local stable funding (i.e., the sum of deposits from non-banks; supranational funding; capital from third parties; and total outstanding debt securities with original maturities of one year or more issued by the subsidiary to investors outside their consolidated group. The "LLSFR flow ratio" is defined using the year-on-year changes in the numerator and the denominator of the LLSFR. Subsidiaries with a stock-LLSFR above 110 percent shall achieve a sustainable flow-LLSFR so as to reduce their LLSFR over time to below 110 percent, unless home and host supervisors agree that (i) there are no impediments to liquidity transfers between parent and subsidiary and there would not be any in a stress situation either; and (ii) a burden sharing agreement is in place between the supervisory and fiscal authorities of the countries concerned. In addition, parent banks are expected to price intragroup liquidity transfers taking into account adequate risk, in line with the relevant EBA guidelines.

C. Recommendations

11. The new framework as described above could be further improved in several respects. Building on the comparative advantages of the FMA ('prudential supervision') and the OeNB ('systemic risk monitoring'), the following measures are recommended:

- *The FMSG should be designated as the macroprudential regulator*. This would ensure that macroprudential measures are implemented, while respecting the constitutionally protected autonomy of the FMA. The FMSG would formulate macroprudential policies and set related rules, either on its own initiative, or to implement ESRB or ECB decisions; the FMA would continue to be the sole supervisor enforcing both microprudential and macroprudential rules.

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- *The OeNB should chair the FMSG.* OeNB chairmanship of the FMSG would be in line with the ESRB Recommendation to give a leading role to central banks.[10]

- *A broader macroprudential toolkit should be considered.* While the macroprudential tools enshrined in the CRDIV package are a welcome expansion of existing prudential measures, *more tools could usefully* be considered, such as structural measures, and LTV and DTI ratios; this would be in line with the ESRB Recommendation on macroprudential tools.[11]

12. A set of principles should be adopted to ensure the 'will-to-act' and trigger the use of macroprudential instruments during upswings. The ability to identify and measure systemic risks and vulnerabilities is a key factor for successful implementation of macroprudential tools, and there must be clear criteria for activation.[12] Decision to trigger activation is likely to be complex as there is no easy measurement of systemic risk being by nature multi-dimensional. Assessing success is also difficult, as the counterfactual may not be known. Costs of a mistimed activation could be asymmetric as delayed action may be more costly than intervention taking place too early. Delayed activation may imply that instruments are less effective as there may not be enough time for them to have an impact, but too early activation may incur un-necessary side effects. Having rules in place would be important to reduce uncertainty and anchor expectations, but, given the limited experience with macroprudential policies, a large element of discretion and judgment is likely to be necessary to decide the timing and extent of tightening.[13]

13. Finding a set of early warning indicators to trigger the use and release of instruments is key to the successful implementation of macroprudential policies. The indictors could include: (i) the credit to GDP ratio or its deviation from a trend level (the Gap measures), at aggregated or sectoral level; (ii) indicators for market volatility (CDS spread) or other price-based measures of default or distress; (iii) indicators measuring bank vulnerability and potential funding stress, such as non-core bank liabilities. Sectoral measures (such as measures of household or corporate indebtedness) would more easily identify the build-up of sectoral vulnerabilities that may not be well captured by the private credit to GDP ratio. The rule-based triggers should be transparent, thus avoid surprises to markets. They would help constrain the incentives for risk taking, and prevent forbearance. The triggers based on market prices need to be carefully designed to minimize the risk of triggering a downward spiral, which could undermine financial stability.

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[10] Recommendation on the macroprudential mandate of national authorities (ESRB/2011/3). This is also advocated in IMF (2013a).

[11] Recommendation on intermediate objectives and instruments of macroprudential policy (ESRB/2013/1).

[12] "Operationalising the selection and application of macroprudential instruments," CGFS Publications No.48. December 2012.

[13] Borio, C., 2009, "Implementing the macroprudential approach to financial regulation and supervision," Banque de France, Financial Stability Review 13, the Future of Financial Regulation, September.

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EARLY INTERVENTION AND ORDERLY BANK RESOLUTION

A. Introduction

14. Early identification of problem institutions and prompt remedial action is essential to reduce moral hazard and to prevent more intrusive resolution measures. Such early intervention is the supervisory authority's general enforcement power authorizing it to require supervised financial institutions to address any violation of law or regulation or unsafe and unsound practices.[14] Typically, use of this power does not require a finding that the financial institution is in danger of failure and the institution remains under the control of its shareholders and management.

15. Where early intervention fails or time-constraints do not allow for early intervention, it may be necessary to resolve a problem bank. In light of the special nature of banks—compared to non-financial companies—more and more jurisdictions, also in the EU, introduce special bank resolution regimes instead of relying on regular bankruptcy procedures. Such special regime allows so-called resolution authorities to quickly intervene through private sector solution and to resolve a bank against minimum costs for the taxpayer.

B. Framework in Austria

Early intervention

16. The FMA has several corrective and remedial measures at its disposal under its supervisory enforcement framework:[15]

- *Government Commissioner*—When there is a risk that a credit institution may not be able to fulfill its obligations, the FMA can appoint a government commissioner, prohibit capital withdrawals, restrict distribution of capital and earnings, or discontinue the institution's operations.

- *Compliance Measures*—For breach of licensing or other legal requirements, the FMA can impose penalties and compliance, remove Directors in cases of repeated or continuous violation, and/or revoke a license.

[14] Some jurisdictions bolster the enforcement powers by requiring various corrective measures that are automatically triggered at declining levels of capital adequacy, a framework referred to as prompt corrective action (PCA). The endpoint of the PCA is typically a requirement to initiate formal bank resolution proceedings when the capital adequacy levels fall below a certain critical point.

[15] See also the findings of the BCP assessment conducted for Austria as part of this FSAP.

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- *Financial Measures*—In specified circumstances, the FMA can require additional capital, restrict the payment of interest and dividends, and order the conversion of hybrid capital if the solvency of a credit institution is at risk.

17. Complementing these functions of the FMA, the private DGS of the bank associations may also intervene banks within each association (section C)—although this has often involved large supervisory discretion and regulatory forbearance.

18. A recently adopted law is going to introduce a more comprehensive early intervention framework starting on January 1, 2014.[16] Building on the above measures, new Articles 71a and 71b of the Banking Act will include more specific intervention triggers and tools:

- *Triggers* will include (i) non-compliance with capital and liquidity requirements, or a risk that these requirements may not be met;[17] or (ii) failure to take recovery measures when a recovery indicator has been met, or failure to perform a measure requested by the FMA to make corrections in a recovery or resolution plan or to remove obstacles to recovery or resolution.

- *Early intervention measures* will include (i) the implementation of one or more recovery measures from the recovery plan; (ii) carrying out specific improvements to risk management practices; (iii) convening a General Meeting, for instance to decide about capital increases; and (iv) preparing a negotiation plan for a voluntary restructuring of liabilities with creditors.

Bank resolution

19. Austria does not have a special bank resolution framework in place. In the absence of such a framework, two main alternative options are currently available to deal with problem banks: an Austrian-specific receivership regime, and bankruptcy. Both options lack adequate tools to ensure orderly resolution and to limit potential risks to financial stability. The authorities do not intend to introduce a national bank resolution framework before the adoption of the RRD.

20. An Austrian-specific receivership under going concern basis is available for banks only.[18] This procedure is aimed at reorganizing the problem bank while satisfying existing claims. Receivership can be ordered in case of over-indebtedness or inability to pay debts, and it appears likely that the insolvency can be remedied. Both the FMA and the problem bank—but not creditors—can request an insolvency court to order receivership. If the court decides to do so, this

[16] Federal Law Gazette I Nr 160/2013.

[17] Proposed new Article 71a clarifies that "A risk of violation exists where there is a substantive deterioration in a credit institution's assets, earnings, liquidity or refinance situation and if, in light of the negative development, there is a justified assumption that the credit institution may be at risk of failing to fulfill its obligations. A risk of violation shall be assumed in any event if the credit institution's equity is less than the threshold of 8.625 percent own funds or less than 5 percent CET1, unless the credit institution demonstrates that due to other measures already taken early intervention measures are not required."

[18] Under Austrian legislation the term 'receivership' is used in a non-typical way.

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must be published; the court would also appoint and oversee a receiver. The FMA is party to the proceedings—also in case it has not requested receivership—and can appeal the court's decision not to order receivership; the FMA must also be heard before appointment of the Receiver. Unless the court decides otherwise at the request of the Receiver, a problem bank may continue its business while under receivership. The Receiver supervises the bank's management and may prohibit execution of resolutions adopted by the bank's bodies; for non-core business activities the problem bank requires the consent of the receiver. Receivership cannot last more than twelve months and must be terminated earlier where the bank's financial problems have been remedied or bankruptcy proceedings have been initiated.

21. Bankruptcy under gone concern basis is available for banks except for the possibility of a 'reorganization plan'; consequently, every bankruptcy case results in winding-down of the problem bank. Bankruptcy can be ordered in case of over-indebtedness or inability to pay debts. Both the FMA and the Receiver—but not the problem bank and its creditors—can request an insolvency court to order bankruptcy. If the court decides to do so, this must be published; the court would also appoint and oversee a Trustee. The FMA is party to the proceedings—also in case it has not requested bankruptcy—and can appeal the court's decision; the FMA must also be heard before appointment of the Trustee. When bankruptcy proceedings have been initiated, the FMA must revoke the problem bank's license. The Trustee may sell the problem bank's assets either through public auctions or through privately negotiated contracts; the Trustee can choose to sell all assets to one buyer or strip assets and sell these individually. Distribution of proceeds takes place as often as reasonable; all insolvency claims have equal rank.

22. Recent experience with the three nationalized banks confirms the importance for Austria to be better prepared to resolve banks going forward. Cross-country experience suggests that losses at troubled banks are almost always greater than supervisors estimate, and in the absence of adequate resolution framework, may more likely give rise to pressures for open-ended financial support. In the current situation of the three nationalized Austrian banks, restructuring plans remain uncertain and cannot provide for the needed mechanisms to resolve these institutions in a least-cost manner. This introduces significant risks as to their eventual cost even though such a cost appears manageable from a fiscal standpoint. Going forward, these risks would be greatly reduced if the recommended early intervention and special bank resolution frameworks were in place (Box 2), to deal effectively with both banks currently under restructuring and with future bank failures.

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Box 2. EU Developments on Early Intervention and Bank Resolution

The EU is considering a legal framework for early intervention and bank resolution. Mid-2012 the European Commission proposed a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (RRD). End-June 2013 the EU Council agreed on a position regarding this draft Directive. /1 The European Parliament has scheduled its plenary debate on this matter for November 2013.

Early intervention. Title III of the draft RRD prescribes that member states ensure that competent authorities have the power to take in particular the following measures: (i) require the management of the problem institution to take action in accordance with its recovery plan or a new action program, to convene a shareholders meeting to adopt certain decisions, to remove and replace board members, to negotiate a debt restructuring plan with its creditors; (ii) to convene itself—instead of the management—a shareholders meeting; (iii) to collect pertinent information to prepare for resolution of the institution, including an evaluation of its assets and liabilities; (iv) to contact potential purchasers in order to prepare for the resolution of the institution; and (v) when certain conditions are met, to appoint a 'special manager' to replace the institution's management. /2

Orderly resolution. The remainder of the draft RRD concerns mainly the resolution of troubled financial institutions./3 In this respect the draft RRD requires the following:

- *Resolution authority.* All member states would need to vest resolution powers in a 'public administrative authority.'
- *Recovery plans*. All relevant financial institutions would need to submit plans setting out arrangements and measures to enable a financial institution to take early action to restore its long term viability in the event of a material deterioration of its financial situation. Groups would be required to develop plans at both group level and for the individual institutions within the group. Supervisors would assess and approve recovery plans.
- *Resolution plans.* Resolution authorities would have to prepare in cooperation with supervisors in good times plans allowing an institution to be resolved with minimal taxpayer exposure to loss from solvency support while protecting vital economic functions. A resolution plan would have to set out options for resolving the institution in a range of scenarios, including systemic crisis. Such plans would have to include details on the application of resolution tools and ways to ensure the continuity of critical functions. Group resolution plans will include a plan for the group as well as plans for each institution within the group.
- *Resolvability*. If resolution authorities, based on resolution plans, would identify significant impediments to the resolvability of an institution or group, they would be authorized to require the institution or group to take measures in order to facilitate its resolvability./4
- *Intra-group financial support*. Institutions that operate in a group structure would be able to enter into agreements to provide financial support to other entities within the group that experience financial difficulties. /5 Such early financial help can address developing financial problems within individual group members. The RRD would allow that these agreements be submitted for approval in advance by the shareholders' meetings of all participating entities in accordance with national law and would authorize the management bodies to provide financial support if needed within the terms of the agreement./6 As a safeguard, the supervisor of the transferor will have the power to prohibit or restrict financial support pursuant to the agreement when that transfer threatens the liquidity or solvency of the transferor or financial stability.
- *Resolution tools and powers.* Resolution authorities would have at their disposal the following tools: (i) sale of business (also known as purchase and assumption); (ii) bridge banks; (iii) asset separation; and (iv) bail-in./7

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Box 2. EU Developments on Early Intervention and Bank Resolution (Concluded)

/1 Press Release 11228/13 of June 27, 2013.

/2 These conditions are: (i) a significant deterioration in the financial situation of an institution; or (ii) where there are serious violations of law, regulations or bylaws or serious administrative irregularities; and (iii) other measures listed above are not sufficient to reverse the financial deterioration.

/3 The draft RRD also covers briefly the stage before early intervention; in the words of the draft, 'preparation.'

/4 Such measures could include inter alia: reducing complexity through changes to legal or operational structures in order to ensure that critical functions can be legally and economically separated from other functions; drawing up service agreements to cover the provision of critical functions; limiting maximum individual and aggregate exposures; imposing reporting requirements; limiting or ceasing existing or proposed activities; restricting or preventing the development of new business lines or products; and issuing additional convertible capital instruments.

/5 Such support could be in the form of a loan, the provision of guarantees, or the provision of assets for use as collateral in transaction.

/6 This would increase legal certainty as it will be clear when and how such financial support can be provided.

/7 On the bail-in resolution tool, see Jianping Zhou, et al., 'From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions,' IMF SDN/12/03, April 24, 2012.

C. Recommendations

23. The new framework for early intervention is a step in the right direction, but should have a clear objective of limiting supervisor discretion and regulatory forbearance. Also, the framework should of course be fully consistent with the RRD.

- *Early Triggers*—The set of measures that may be taken by the FMA could be increased and better linked to specific triggers, ranging from early triggers, when banks' capital ratios have declined but solvency is not an immediate concern, to late triggers, where viability is at risk.
- *Loss Absorbance*—The FMA should have the power to require an increase in bank loss absorbency (such as through a capital increase or surcharges, the issuance of convertible bonds, or unsecured long-term debt that could be bailed-in) and restrict dividend payments.
- *Special Administrator*—The FMA should also have the power to appoint a special administrator and to replace management.
- *Banking Groups*—Furthermore, the law should also provide for specific measures related to banking groups, such as regarding ring-fencing the institution from the actions of parent companies, subsidiaries or other related entities.

24. Within the current framework, there are some steps that can already be taken to reduce the potential cost of resolving the three nationalized banks. While swift action is essential to put a limit on such a cost, the authorities also need to adopt a flexible approach in order to maximize recoveries and minimize losses, and some key steps are to be followed. In particular, full

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due diligence is necessary to assess and monitor on a continuous basis the operations and asset quality of troubled banks. Also, procedures to collect loans and sell assets as soon as possible should be pursued aggressively. Finally, financial institutions that are not viable must be wound down in an orderly fashion, coordinated among other public entities as necessary.

25. More broadly, the authorities should start preparing a full-fledged bank resolution regime. This regime should be introduced as soon as the RRD is adopted This regime should ensure that out-of-court bank resolution is possible by the resolution authority; and the latter should have at its disposal the full range of resolution tools based on leading practices in many jurisdictions, including the EU. The mandate of the resolution authority should be clearly cast in terms of promoting financial stability through depositor protection and continuation of systemic financial functions, if any. The authority's toolkit should include powers to deal efficiently and expeditiously with distressed assets to maintain business value.

26. Under a bank resolution framework, DGS staff should be involved very early in the problem bank resolution process. Whether via a Purchase and Assumption (P&A) transaction, using a paying agent bank, or implementing a direct insured deposit payout, advance preparation is necessary in order to ensure prompt payment and reduce the risks of contagion.[19] The DGS should be permitted to use its funds to facilitate a P&A transactions without exceeding the amount that would have been expended to compensate insured depositors in a straight liquidation. Relatedly, the new legal framework should include depositor preference, either to depositors directly or—by way of subrogation—to the DGS. Many jurisdictions consider two-tiered depositor preference, where insured deposits enjoy a higher priority than uninsured deposits, which, in turn, have a higher priority than general creditors. This is also recommended for Austria.

27. The authorities should also further strengthen cross-border bank resolution arrangements with non-EU/EEA countries. The RRD, when in force, will cover cross-border bank resolution within the EU and EEA, albeit without a burden-sharing mechanism. In light of Austrian banks' very large cross-border exposures, the authorities will need to take initiatives to strengthen the current MoU-based cross-border arrangements for inter-agency supervisory cooperation. This could be done through bilateral or multilateral international agreements—for example between the CESEE cross-border stability group—and complementary changes in national law—for example, to ensure that adequate information can be shared; also, the authorities will need to put in place burden-sharing mechanisms conducive to effective cross-border resolution.[20]

[19] A P&A transaction is a bank resolution mechanism whereby, with the benefit of a special resolution regime and advance preparation, certain "good" assets and (usually insured) deposit liabilities are transferred to a stronger bank so that insured depositors have virtually immediate access to their funds (a P&A usually requires an assuming bank to continue some of the failed banks business, such as safe deposit boxes, etc).

[20] Should these mechanisms be based on non-binding legal instruments, the authorities would need to develop contingency plans in case of non-compliance.

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28. The FMA should become Austria's bank resolution authority. While other options are available, such as the OeNB or the DGSs, the complementarities between corrective measures and early intervention under the FMA's supervisory mandate on the one hand, and a future bank resolution mandate on the other hand are important considerations. To address conflicts of interest between supervisory and resolution powers, appropriate governance measures would need to be put in place within the FMA. In particular, functional separation of supervision and resolution could be established through different decision-making and reporting lines within the FMA.

29. Consistent with the BCP Assessment, the legal protection of FMA's bodies and staff should be strengthened in preparation for its role as a resolution authority. While the current arrangements provide a relatively high level of legal protection to FMA staff and that of the OeNB (Box 3), such protection should be strengthened since resolution activities are more intrusive and publicly scrutinized than regular supervisory decisions and involve large sums of public money. Specifically, it is recommended to:

- set a monetary cap on the liability of the FMA's bodies and staff vis–a-vis the Federation, and align the liability insurance for FMA's bodies and staff with this cap;
- put in place adequate safeguards, such as immunity, for FMA bodies and staff, to protect them against self-incrimination while assisting the Bundes Finanzprokuratur;[21]
- exclude from the Federation's power to seek reimbursement from FMA bodies and staff for those cases in which courts judged that supervised financial institutions were non-compliant with prudential rules; and
- ensure that strengthened legal protection for FMA's bodies and staff is not weakened after the introduction of the SSM, in particular when they act on behalf of the SSM.[22]

[21] The Bundes Finanzprokuratur is the Attorney who represents the Federation in court, amongst others, in liability cases. FMA bodies and staff are under a legal obligation to provide the Bundes Finanzprokuratur all pertinent information regarding the decisions they have taken.

[22] The ECB Executive Board and Staff enjoy broad legal protection under an elaborate set of legal instruments. This framework applies to NCB staff when they are seconded to the ECB. For members of the ECB Governing Council a limited form of legal protection applies; for the members of the ECB Supervisory Board envisaged under the SSM there is no specific legal protection framework. In light of the foregoing, there is uncertainty about the legal protection of NCB officials and staff involved in supervisory activities under the SSM.

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Box 3. Legal Protection of Supervisors

The liability of the Federation and, among others, bodies and institutions established under public law is enshrined in the Federal Constitutional Law. Article 23 thereof provides that (i) the Federation and said bodies and institutions are "liable for the injury which persons acting on their behalf in execution of the laws have by illegal behavior culpably inflicted on whomsoever," (ii) such persons are "liable to [these legal entities] in so far as intent or gross negligence for which the legal entity has indemnified the injured party," and such persons "are liable for the injury…they have by illegal behavior inflicted directly on the legal entity." The Constitutions allows Federal laws to detail these "principles."

While the FMA as well as its bodies and staff cannot be held liable towards an injured party, the FMA's bodies and staff can be held liable towards the Federal Government.

- **The Federal Government assumes liability towards injured parties**. This is stated in Article 3.1 of the FMABG. Pursuant to this provision, the Federal Government is liable for "for damage caused by the FMA's bodies and employees in the enforcement of [Federal prudential supervision laws." To leave no uncertainty on this matter, Article 3.1 also provides that "The FMA as well as its employees and bodies shall not be liable towards the injured party."
- **The Federal Government may demand reimbursement from the FMA's bodies and employees**. This is stated in Article 3.3 of the FMABG. Pursuant to this provision, "If the Federal Government made good the damage to the injured party pursuant to article 1, it shall be entitled to demand reimbursement from the FMA's bodies or employees." The Federal Government cannot seek reimbursement from the FMA.

Reimbursement by FMA bodies to the Federal Government is possible in case it has paid damages to injured parties caused by: (i) gross negligence ('grobfahrlässig') or intentional ('vorsätzlich') actions (Article 3.1, AHG)—in case of gross negligence, the Court can mitigate reimbursement on grounds of fairness; and (ii) anything other than excusable failures ("entschuldbaren Fehlleistung"); (Article 2.2, Organhaftpflichtgesetz—OrgHG) Similarly, the staff of the FMA is liable to the FMA pursuant to the Liability of Employees Act (Dienstnehmerhaftpflichtgesetz—DNHG).

Indemnification of FMA staff is regulated by law and assured by insurance. Article 14.3 of the FMA Act prescribes that the FMA provide "appropriate legal protection of its employees entrusted with supervisory activities in the event that claims for damages are made against them as a consequence of their supervisory activities." To this end the FMA has concluded (i) a liability insurance contract (Haftpflichtversicherung) on behalf of the FMA, the Executive Board, the staff and other persons who are deemed bodies of the FMA,[23] and (ii) a defense and recovery insurance contract (Rechtsschutzversicherung).[24] These contracts became effective on 1 July 2008; these are permanent contracts, with the possibility of contracting out annually. The insurance protection is applicable upon the insured risk independently from the time when the cause for the insurance case incurred (claims-made).

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[23] The FMA does not bear any retained amount upon own risk (Selbstbehalt). The FMA is insured against risk concerning all duties it has to perform concerning enforcement of the supervisory acts. The insurance covers the satisfaction of rightful claims as well as the defense against unrightful claims of third parties. It does not cover claims arising out of knowing violations of the law insofar the knowing violation of law was ascertained by judgment, administrative ruling, acknowledgment or settlement. The insurance further covers damages incurring out of public liability claims as well as costs of defense (for in or out of court-proceedings) against such claims. The insured amount encompasses a maximum of EUR 7.5 million yearly.

[24] Maximum amount of EUR 225,000 yearly. Again no retained amount upon own risk is foreseen in this contract. This insurance contract covers the ensuring of legal interests of the FMA as well as the recovery of costs for damage claims the FMA intents. The insurance also covers costs for defense in penal proceedings in front of judicial or administrative bodies for criminal acts and omissions as well as in disciplinary proceedings. In case of a claim based upon an intentional crime, the insurance covers costs provisionally. In case of a final condemnation for intentional crime the insurance protection is retroactively inapplicable.

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DEPOSIT INSURANCE[25, 26]

30. Austria has five private guarantee schemes (DGS), organized by sub-sectors and supplemented by a government guarantee that was introduced after the 2008 global financial crisis (Box 4). This complex two-tranche system provides that private schemes cover deposits up to €50,000 while the government guarantee covers deposits that exceed €50,000 and up to €100,000 (both per depositor per bank).[27] Each private scheme is administered by the respective bank association in the sector, and funded ex post; member banks from the affected sector are required to contribute only when a payout event occurs. The government guarantee is also ex post funded.

31. For the private schemes, repaying the first tranche of insured depositors is accomplished via a three stage process. First, funding will be provided by the contribution of banks in the affected sector (to which the failed bank belonged) based on the share of their covered deposits in the sector. The contribution is capped at 1.5 percent of their risk-weighted assets (adjusted upward for the size of their trading book). A payout in excess of this ceiling triggers the second stage, with individual banks' contribution from the other sectors calculated by the same formula. If a shortfall persists, then the third stage permits the originally affected DGS to take up a loan or issue bonds in order to raise external funds, which may be guaranteed by the government. The cost of repaying the second tranche of insured deposits (€50,000 – €100,000) is borne solely by the government.

32. Payouts by the private schemes are rare; there has been no payout since 2001. The last payouts by private schemes were for small failed banks in the late 1990s and 2001. There has never been a payout in the three cooperative sectors, possibly because their individual intra-sector Institutional Protection Schemes (IPS)—which vary in terms of scope and legal strength[28]—provide financial as well as managerial assistance to the distressed banks and favor intra-sector mergers to bank bankruptcy. To mitigate moral hazard, all sectors have early warning and intervention systems in place, with financial assistance accompanied by conditions, including (in some sectors) intervention in business policy and changing management.

[25] Appendix II includes a more detailed discussion of the DGS system, including simulations of potential payout events.

[26] An informal assessment of the characteristics of the Austrian DGS system rated against the IADI core principles is found in Appendix III.

[27] Before the 2008 financial crisis the maximum amount of insured deposits per bank and per customer by the private DGS was set at the EU minimum of €20.000. During the crisis, unlimited coverage of deposits of natural persons was introduced, which expired at end 2009, when the new EU-wide minimum was raised to €100.000.

[28] In the Raiffeisen sector, the intervention is not legally binding.

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Box 4. Deposit Guarantee Schemes

Austria has five Deposit Guarantee Schemes (DGS) representing each of the five sectors in the banking system (the latter three dating from the 19th century):

1. **Austrian Bankers Association** represents the limited liability public stock commercial banks. It has 56 members that accept deposits. Its largest member is BAWAG PSK with about a 4 percent share of the industry at end 2011. Newly licensed banks or banks that leave a cooperative association are assigned to this DGS.

2. **Hypo** Regional Mortgage Banks Association represents the Hypo group of 8 regional mortgage banks, and two that have associated international banks, bringing membership to 10. Historically, the Hypos are owned by regional state governments, which they serve with treasury operations; they generally fund social infrastructure (schools, hospitals, etc.), SMEs, and mortgages. Members may move out of their home state to follow customers and for syndication, otherwise there is little competition between members. Some Hypos have seen large or majority ownership stakes taken by the Raiffeisen group. (Hypo Alpe Adria was taken over by the Austrian Government in 2009).

3. **Raiffeisen** Credit Cooperatives Association represents the Raiffeisen group of cooperative banks. 527 local banks own 8 regional banks that provide back-up (e.g.: treasury, liquidity) and fee based services and engage in their own larger scale banking, including taking deposits. The group operates an institutional protection scheme (IPS), which is basically an early warning and risk assessment system and is empowered to assist individual members that face problems. Before engaging the DGS, the cooperative group will provide aid through a regional solidarity fund, owned by associates and funded by fees that individual Raiffeisen banks are obliged to pay, on ex ante or ex post basis. Such financial aid can be provided with conditions, including management changes, capital increases, and takeover. When the group assistance fails, the DGS will be engaged.

4. **Sparkassen** Savings Banks Association represents the Sparkassen group of 48 savings banks, created by municipalities and associations as cooperative ventures for the urban poor. The Sparkassen have an unusual legal governance structure with no defined proprietor, which necessitated a national Sparkassen Act (1979) to regulate the sector. In recent years members have moved away from this special structure (and municipal control) to a joint stock structure control by association foundations. Only 15 members are still in the traditional set-up. The Sparkassen group is also characterized by a special auditing system and a contractually defined system of enhanced oversight and intervention among its members. Confidentiality clauses allow the DGS to receive the confidential OeNB and FMA examination reports. Erste Bank is the largest members of the group with 18 percent market share. (Bank Austria, with 20 percent market share, left the Sparkassen IPS upon its joining with Unicredito in 2010).

5. **Volksbanken** Credit Cooperatives' Association represents the credit cooperatives group of 64 member banks. This group was reorganized in September 2012 under a new Article 30a of the Austrian Banking Act adopted in spring 2012. Its international unit was sold off (except for one subsidiary), following large losses. The Austrian Government now holds 43 percent of the central domestic unit (VBAG), while 50.1 percent is individually owned by the regional Volksbanks. With the reorganization, corporate governance has been significantly strengthened and the Volksbanks are treated as a single group for prudential purposes. The Volksbank group has an independent audit regime on a regional banks' level and joint audit approach on the level of association, an extensive and sophisticated early warning and intervention system for member banks, as well as an ex post funded institutional protection scheme. The Volksbank DGS has also devised a detailed and comprehensive payout plan.

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33. While the Austrian DGS system has certain advantages, it falls short of best practice, primarily on account of its private, fragmented, and ex post funded nature (see Appendix III). Although the private schemes may perform a valuable oversight and intervention function to reinforce and complement the FMA's, they lack explicit policy objectives/mandates and mostly have powers granted by their member institutions. A public scheme, with explicit objectives to protect small depositors and promote financial stability by making prompt reimbursement to insured depositors, would have more formally specified powers and more transparent internal procedures. During the times of economic distress, the ability of the ex post funded private schemes to meet full obligations under the mutual protection could be limited when it requires large borrowing from the market and may ultimately have to resort to extensive public support.

A. Recommendations

34. The authorities should use the forthcoming EU DGS Directive as an opportunity to move to a unified and prefunded national DGS in order to safeguard depositor confidence. It should meet the international best practice that banks should bear the cost of bank failures and help safeguard financial stability, by allowing for a higher degree of risk pooling, greater transparency, prompt payout, and simpler management of the funds. The national DGS should be aligned with the EU Directive not only in terms of quantities (through minimum coverage limits), but also in terms of prices, with premiums adjusted for risk as far as practicable, and a shortened length of time to payout. Additional recommendations include:

- *The formation, as soon as feasible, of a high-level working group* including officials from the MOF, OeNB, FMA, and the various DGSs, to decide how to transition to a simple, public ex-ante funded scheme, taking the EU Directive as well as the BCBS Core Principles for Effective Deposit Insurance Schemes (DICP) as minimum standards.

- *The creation of a single DGS scheme which should immediately start collecting premiums on a flat rate basis to begin building an ex ante fund.* Collecting even a nominal amount will give the DGS valuable operational experience, and will facilitate a smooth transition to the more complex Risk Based Premiums (RBP) which would be introduced later, in conjunction with the EU directive.

- *The working group needs to determine the appropriate target DGS fund size for the Austrian banking system*, regarding the target reserve level that is currently proposed in the draft EU Directive (1.5 percent of eligible deposits) as a minimum.[29] Inadequate reserves can lead to costly delays in problem bank resolution as well as loss of confidence in the DGS and the banking sector.

[29] Deposit insurance coverage regards two aspects: scope and level. Eligible deposits refers to the scope of coverage and represent those types of deposits that qualify for coverage. The level of coverage determines the insured amount of coverage, in case of the EU, € 100,000. An eligible deposit could be in excess of the coverage amount; hence the distinction between "eligible" and "insured."

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- *Establishing an appropriate liquidity back-up arrangement* with the MoF. This could also be addressed by the working group.

- *The single DGS should be an integral part of an effective bank resolution framework.* Specifically, DGS personnel should be involved in the advance preparation of bank resolution. Whether via a Purchase and Assumption (P&A) arrangement, using a paying agent bank, or implementing a direct insured deposit payout, advance preparation is necessary in order to ensure prompt payment, and lessening the potential for contagion. The DGS should be specifically permitted to use its funds to facilitate a P&A transaction, capped at the amount of compensation to insured depositors in a straight liquidation. Moreover, the trigger for insured deposit reimbursement should be license revocation when a problem bank enters the special bank resolution process.

OENB LIQUIDITY SUPPORT

35. Central bank liquidity support is a key component of the financial safety net, and the ongoing financial crisis has triggered important changes in the Eurosystem. The crisis has revived the discussion on central bank lending, and a move away from 'constructive ambiguity' and toward a more 'rule-based and transparent' ELA framework is underway, aiming to better balance financial stability and central bank's financial autonomy considerations. Box 5 gives an overview of leading international practices.

36. Due to ELA operations during the crisis conditions for such operations have developed within the EU. This was necessary to ensure consistency of ELA operations with EU prohibitions on state aid and monetary financing.[30] Also, following NCBs' increased ELA operations, complementary rules that would apply throughout the Eurosystem are being developed, so the mission was informed by the authorities.

37. While the OeNB Act does not provide for an explicit legal basis for ELA, the OeNB has in place operational policies that are broadly aligned with international best practices. The OeNB's ELA operations are based on a provision in the OeNB Act that authorizes the OeNB "to effect transactions" other than its ESCB tasks.[31] These national transactions are executed on the responsibility and liability of the OeNB.[32] In 2006, the OeNB adopted a policy to better guide its ELA operations, which prescribes that ELA should be provided: (i) in exceptional cases when refinancing through Eurosystem monetary policy operations is not possible due to lack of eligible collateral for such operations; (ii) to solvent banks; (iii) against adequate collateral and with appropriate haircuts; and (iv) only in the short term (with a possibility of renewal). The OeNB is awaiting a Eurosystem-

[30] Articles 107 and 123 of the Treaty on the Functioning of the European Union.

[31] Pursuant to Article 14.4 of the ESCB/ECB Statute, the OeNB can exercise national tasks unless a majority of two-thirds of the ECB Governing Council finds that these interfere with the objectives and tasks of the ESCB.

[32] Contrary to losses stemming from monetary policy operations, for which the Eurosystem has put in place a loss-sharing mechanism, losses stemming from ELA operations are fully carried by NCBs. In accordance with ESCB procedures, the OeNB has to inform the ECB if ELA is above certain thresholds.

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wide rule-based arrangement for ELA by NCBs, and does not intend to update its policy prior to the conclusion of this arrangement.

Box 5. Key Elements of an Emergency Liquidity Assistance (ELA) Framework

ELA policies vary among countries. However, many central banks indicate—in central bank legislation, regulations, or public speeches—that ELA would be granted with adequate collateral, only in exceptional circumstances, to a temporary illiquid but solvent institution with central bank holding discretionary power. The solvency requirement implies that the term 'ELA' does not include capital support.

ELA arrangements should be part of a safety net, be supported by strong supervision and resolution frameworks, and ensure that private sector solutions are explored first. Furthermore, central banks should closely coordinate with the bank supervisor and the MOF, because the former is in charge of bank supervision and the latter represents tax payers who ultimately will pay for any costs of ELA.

Key principles on ELA to be considered—which should be agreed among relevant government agencies and publicly disclosed—are:

- **Solvency requirements**. For banks, ELA should only be given to institutions judged to be technically solvent but temporary illiquid, to the best knowledge of the central bank and bank supervisor. For non-bank financial institutions, the relevant supervisor should have principal responsibility for solvency assessments. In judging solvency, the viability of the troubled instution should be take into account.
- **Eligible institutions**. For banks, all licensed deposit taking financial institutions would be eligible for ELA. For NBFIs, the authorities need to decide to what extent they might trigger a systemic event.
- **Adequate collateral**. ELA should be granted with adequate collateral to protect the central bank's balance sheet. Moreover, the use of collateral could impose more discipline on institutions requesting ELA.
- **Collateral policies**. For ELA operations, a broad range of assets that meet the central bank's criteria for adequate collateral could be accepted. Collateral should have sufficient credit-worthiness and be relatively easily handled (e.g., transfer of collateral). The haircuts for the collateral must be established, taking account of credit, legal, and other operational risks. A schedule of eligible collateral should be developed and published.
- **Limits**. The total amount of eligible collateral (with value adjusted for haircuts), that is at the borrower's disposal constitutes a natural upper limit on access to ELA resources in additional to any other limits established by the central bank (possibly in consultation with the MOF due to possible fiscal consequences).
- **Interest rates**. Interest rates should normally be no less than the standing credit facility rate, and designed to avoid mispricing or subsidizing liquidity assistance. Nevertheless, in a system-wide emergency situation, the rate could be set below the standing credit facility rate.
- **Loss coverage**. To protect the central bank's balance sheet, the government should promptly indemnify the central bank for any ELA losses. This could be contractly agreed upon or enshrined in law.
- **Maturity**. The maturity of ELA usually should be short term but enough to address underlying liquidity problems. ELA can be renewable with appropriate supervisory conditions to prevent undue recurrent ELA.
- **Supervisory follow up**. A financial institution that accesses ELA should subsequently be subject to intensified monitoring, and its management should be requested to prepare and implement a plan to reduce the likelihood of future ELA use.
- **Disclosure**. The central banks should report, at least ex post, on actions to demonstrate consistency with principles and account for any use of public funds. The timing of the disclosure of ELA operations should take into account the fact that some information may be market sensitive.

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A. Recommendations

38. The current ELA framework should be strengthened to better protect the OeNB's balance sheet. Key steps in this regard include:

- While maintaining the discretionary nature of ELA and preserving the autonomy of OeNB's decisions, formalize the above-discussed ELA policies, possibly together with a cap on total outstanding ELA to prevent adverse fiscal consequences;[33]
- Ensure that the OeNB's unconditional preferential right also applies to minimal reserves held with the OeNB, by deleting paragraph 4 of Article 77 of the OeNB Act;[34]
- Prescribe in the OeNB Act that a shortfall of capital should be promptly covered by the Federation with either a transfer of cash or marketable government securities,[35] or alternatively, provide that in case of losses that cannot be covered by the OeNB's reserves and its statutory capital, future profits will not be transferred to the State until the OeNB's statutory capital and the OeNB's reserves have been replenished;[36]
- Conclude an agreement between the Federation and the OeNB to promptly indemnify the latter for losses stemming from ELA operations; alternatively, the OeNB should be given an ongoing statutory government guarantee for ELA operations.[37]

SYSTEMIC CRISIS MANAGEMENT

39. In addition to individual bank resolution mechanisms, specific legal and operational frameworks should be in place to address systemic crises swiftly. Such crises may be caused by an ineffective financial safety net (e.g., delays in depositor repayment leading to contagion), the failure of a systemic bank or function, or the simultaneous failures of multiple banks that

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[33] See ECB Opinion CON/2008/42 concerning legislation in Luxembourg introducing an explicit mandate for the Banque Central du Luxembourg to provide ELA, which the ECB welcomed. In this context the MOF and OeNB could also consider an agreement on instance where the OeNB needs to inform the MOF before providing ELA above a certain amount. This would facilitate an early dialogue to take into consideration the fiscal consequences of ELA.

[34] Article 77(4) of the OeNB Act provides that "The preferential right accorded to the Oesterreichische Nationalbank shall not apply to deposits held with the Bank as minimum reserves."

[35] State coverage of national central banks' capital shortfall is expected by the ECB as expressed in its Convergence Reports, for example in 2012: "Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence."

[36] Similar arrangements can be found in, for example, the Netherlands, Slovakia, Finland, and Denmark.

[37] As an example of a statutory ELA loss indemnification arrangement see Article 9 of the Organic Law of the National Bank of Belgium, which was welcomed by the ECB (see Opinion CON/2008/46). See also the above-mentioned ECB Opinion CON/2008/42 concerning legislation in Luxembourg that also introduced a State guarantee for losses stemming from ELA operations, which the ECB welcomed.

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fundamentally weaken the financial system. In order to enable the government to act swiftly in such cases, Parliament should adopt—before a crisis erupts—legislation authorizing the government to act promptly and under strict conditions, in cooperation with the FMA and OeNB, and with ex post accountability to Parliament (instead of having to go through regular legislative and budgetary procedures during a crisis).

40. In recent years, the Austrian authorities have taken several measures that strengthen their preparedness for a systemic banking crisis. These include:

- *Role of the FMK*. With respect to crisis management, a Crisis Team has been established under the FMK consisting of experts from the MOF, FMA, and OeNB. As such, the FMK acts as the Austrian standing group established in line with the MoU of 2008 on co-operation between the financial supervisory authorities, central banks, and finance ministries of the EU.

- *Cross-Border Stability Group (CBSG)*. The CBSG was established in 2011 to strengthen crisis management with Bulgaria, Czech Republic, Hungary, Slovakia, and Slovenia,[38] and a crisis simulation exercise was conducted with these countries in 2012. The FMK organizes regular meetings of the CBSG in order to identify emerging systemic risks.

- *FinStaG framework*. The FinStaG is a legal framework for the provision of government financial support, and makes available several instruments for recapitalization purposes. For example, in November 2008, FIMBAG was established to hold the government financial interests stemming from recapitalization operations. The financial contracts including restructuring plans consistent with EU law were negotiated by the MOF with the troubled financial institutions. Then, these contracts were transferred to FIMBAG that acts as the Federation's trustee.[39]

A. Recommendations

41. In order to further strengthen the above crisis management arrangements, the following steps could be considered:

- Increase the financial envelope under the FinStaG, and introduce in the Federal Organic Budget Act an explicit escape clause for financial crises.[40]

[38] The participating countries were selected based on the share (>5%) of the four largest Austrian banking groups in their markets.

[39] FIMBAG was established as a subsidiary of ÖIAG, the Austrian holding company for state-owned enterprises, which owns the share capital of FIMBAG in full. Members of FIMBAG's supervisory board and management are appointed by the ÖIAG upon proposal from the Federal Government.

[40] Similar to natural disasters, which are already recognized under this Act.

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- Give the Federal Government standing statutory authorization to take appropriate action—in cooperation with the FMA and OeNB—to deal with financial crises, including solvency and liquidity support, and nationalization powers, with prompt, ex post accountability to parliament.

- Clarify in the law the FMK's responsibilities with respect to the Federal Government's actions—financial and otherwise—to address financial crises.

- Increase the frequency of CBSG meetings (to more than once a year) and mandate it with the preparation of a multilateral binding framework to ensure effective information exchange, crisis cooperation, and burden-sharing.

- Create a cooperation mechanism with non-EU/EEA countries similar to the CBSG.

42. In parallel, FIMBAG's mandate and the conditions under which public capital support is provided should be strengthened. While the government has provided substantial public support to troubled financial institutions, FIMBAG has limited powers to ensure that the implementation of restructuring plans is effective.[41] Specifically:

- *In the short term*, FIMBAG should be made responsible for overseeing the implementation of restructuring plans, and where necessary negotiating changes in these plans; this responsibility would include, for example, the power to replace management.[42] Moreover, the Ordinance detailing the FinStaG recapitalizations could be strengthened along the lines of good principles for so-called 'open bank assistance' (Box 6).

- *For future recapitalization operations*. FIMBAG should be given a more prominent role in negotiating financial contracts and restructuring plans. Such an expanded mandate could require that the FIMBAG be put further at arm's length from the MOF. As a subsidiary of ÖIAG, FIMBAG could be made accountable to it parent company, ÖIAG, which in turn is accountable to the Federal Government.

[41] FIMBAG can only attend shareholders meetings without a vote and has no powers otherwise.

[42] This does not prejudice the powers of the FMA as supervisor (and in the future as resolution authority).

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Box 6. Open Bank Assistance

In most circumstances, Open Bank Assistance (OBA) is strongly discouraged. OBA can take the form of direct capital injections, purchases of financial institutions' stocks, direct loans or placement of deposits from the government or the DGS. Experience indicates that OBA:

- Can virtually never pass the "least cost" test as it is by definition open-ended and losses of problem banks are generally underestimated;
- Increases moral hazard as ailing banks may use OBA to engage in ever more risky activities in an effort to restore profitability;
- Is susceptible to political pressures that could hamper good business decisions; and
- Could lead to psychological entrapment, as the authorities' desire to protect the investment could give rise to further support if the bank's conditions continue to deteriorate, driving up the total resolution costs.

OBA should only be used during systemic crises when the need for immediate action does not permit a more orderly resolution process. But even under such circumstances, international best practice dictates that OBA should, at a minimum, meet the following strict conditions:

- *Injection of private capital*. New or existing shareholders must be required to inject significant matching funds into the institution, to assure that the risk of the bank's potential failure is not borne entirely by public entities.
- *Burden sharing*. The authorities must ensure that the ailing bank's ownership interest is significantly diluted, or eliminated, to ensure that shareholders of failing institutions do not benefit from public support.
- *Management competence*. In virtually all cases, the authorities should require management changes, particularly where management's action or inaction have contributed to the deterioration of the bank's condition. New management should be competent, cooperative, and free from any indications of insider dealings, speculative practices, or other abusive activity.
- *Strict oversight*. Financial assistance to an ailing bank must be properly monitored and conditioned by the authorities. The recipient bank should remain under special supervision, ideally with one (or more) examiner(s) permanently on site to ensure safe and sound practices. The supervisors must have the authority to monitor and approve all transactions above a certain threshold, particularly intra-group transactions or those involving insiders.
- *Limits on compensation and dividends*. Executive compensation should be limited and dividend payments should be suspended until the financial support is repaid.

An exit strategy is always necessary. OBA must coincide with the preparation of a legitimate business plan that will facilitate the restoration of the bank's profitability and allow for the full repayment, including a satisfactory rate of return, within a reasonable timeframe. The exit strategy should incorporate all the elements of a Resolution Plan—or Living Will—that details how the bank can be resolved without causing disruption to the financial sector. This would include identifying and segregating different business units for sale, including not only subsidiary operations, but potentially breaking the bank up into branch clusters, thus downsizing the institution and enlarging the universe of potential acquirers.

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Appendix I. EU Developments on Macroprudential Policies

The EU has established the European Systemic Risk Board. This was done in January 2011 following the 2009 De Larosiere Report, which resulted in the establishment of the European System of Financial Supervision (ESFS)—a network of national supervisors working in tandem with new European Supervisory Authorities (ESAs) and the ESRB. The ESRB is responsible for the macroprudential oversight of the financial systems and institutions within the EU in order to prevent or mitigate systemic risks, to avoid episodes of widespread financial distress, contribute to a smooth functioning of the internal market and ensure a sustainable contribution of the financial sector to economic growth.[43] The ESRB does so through systemic risk assessments and by submitting warning and policy recommendations to competent national authorities; for this purpose the ESRB depends on the ECB for analytical, statistical, logistical and administrative support.[44] IMF (2013c) discusses the responsibilities—and constraints—of the ESRB.

The EU is considering a macroprudential mandate for the ECB. The primary objective of the ESCB, of which the ECB is the center, is to maintain price stability.[45] While the ESCB and the ECB have supporting and advisory tasks with respect to financial policies and stability, it has no macroprudential mandate.[46] The EU legislature is working on legislation to introduce a Single Supervisory Mechanism, which would give the ECB supervisory responsibilities; these responsibilities would include a macroprudential mandate over banks—but not financial and mixed holding companies.[47] Specifically, and in accordance with the EU banking directives, the responsibility for macroprudential policy would in principle remain in the realm of national competent or designated authorities, while the ECB would be authorized (i) to impose capital buffers, including countercyclical buffers, higher than those established by competent national authorities and in addition to the regular capital requirements, and (ii) to apply more stringent measures than those established by competent or designated national authorities aimed at addressing systemic risks—EU member states would also retain authority over macroprudential measures not provided for by EU law. Mutual consultation requirements would apply to the ECB and competent or designated national authorities.

[43] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

[44] Council Regulation (EU) 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.

[45] Article 2 of the Statute of the European System of Central Banks and the European Central Bank (ESCB/ECB Statute)

[46] Articles 3.3, 4, and 25.1 of the ESCB/ECB Statute.

[47] Article 4a of the draft Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

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The EU has adopted legislation on macroprudential measures. This is done in the so-called 'CRD IV package', comprising a regulation and a directive:[48]

- the *Capital Requirements Regulation (CRR)* lays down prudential requirements for capital, liquidity and the credit risk for investment firms and credit institutions; and
- the *Capital Requirements Directive (CRD)* lays down rules on bankers' remuneration and bonuses, prudential supervision, corporate governance and capital buffers.

The ESRB has adopted two recommendations with respect to EU member states' macroprudential framework:

- *Recommendation on the macroprudential mandate of national authorities* (ESRB/2011/3). The ESRB noted that the effectiveness of EU macroprudential policy also depends on the national macroprudential frameworks because the responsibility for the adoption of measures necessary to maintain financial stability lies first within national frameworks. Recognizing that legislative initiatives are being discussed in some EU member states to implement macroprudential policies, the Recommendation requires member states to designate an authority entrusted with the conduct of macroprudential policy and provides guiding principles on core elements of national macroprudential mandates.[49] The Recommendation advocates clear objectives, tasks, and powers to overcome the bias towards inaction; and recommends giving a leading role to central banks because of their expertise and their existing responsibilities in the area of financial stability. Member states are also required to ensure that macroprudential authorities be given at a minimum operational independence—in particular form political bodies and from the financial industry—and that organizational and financial arrangements do not jeopardize the conduct of macroprudential policy. Recommended measures should be in force no later than July 1, 2013.
- *Recommendation on intermediate objectives and instruments of macroprudential policy* (ESRB/2013/1). The objective of this Recommendation is to take a necessary next step towards an operational macroprudential oversight. The Recommendation suggests an indicative list of instruments, including but not limited to those envisaged in the CRD IV package, which EU member states could assign to macroprudential authorities in order to pursue the identified intermediate objectives, while not restricting jurisdictions in applying further instruments (see Table A1). Moreover, it is recommended that macroprudential authorities develop an overall policy strategy on the application of macroprudential instruments to foster decision making, communication and accountability of macroprudential policy. Recommended intermediate

[48] This package comprises a regulation and a directive: (i) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012; and (ii) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[49] A similar requirement is also laid down in the CRD IV package.

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objectives and instruments need to be in place no later than end-2014; the recommended policy strategy end-2015.

Table A1. ESRB Macroprudential Instruments

Intermediate Policy Objectives	ESRB recommendations
To mitigate prevent excessive credit growth and leverage	• Counter-cyclical capital buffer • Sectoral capital requirements (including intra-financial system) • Macro-prudential leverage ratio • Loan-to-value requirements (LTV) • Loan-to-income/debt (service)-to-income requirements (LTI)
To mitigate and prevent excessive maturity mismatch and market illiquidity	• Macro-prudential adjustment to liquidity ratio (e.g. liquidity coverage ratio) • Macro-prudential restrictions on funding sources (e.g. net stable funding ratio) • Macro-prudential unweighted limit to less stable funding (e.g. loan-to-deposit ratio) • Margin and haircut requirements
To limit direct and indirect exposure concentration	• Large exposure restrictions • CCP clearing requirement
To limit the systemic impact of misaligned incentives with a view to reducing moral hazard	• SIFI capital surcharges
To strengthen the resilience of financial infrastructures	• Margin and haircut requirements on CCP clearing • Increased disclosure • Structural systemic risk buffer

Source: ESRB Recommendation on intermediate objectives and instruments of macroprudential policy (ESRB/2013/1).

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Appendix II. Deposit Insurance Scheme

A. Key Features

Austria has a complex, multi-sector, private/public, ex-post funded, deposit guarantee scheme (DGS). The DGSs are private schemes, independent from the government, created and controlled by trade associations, with minimal staff and assets. The DGSs lack explicit public policy objectives. They are primarily narrow mandate "paybox" schemes; however, given their trade association affiliations and ex-post funding nature, other considerations, such as the protection of group branding, come into play. The DGSs in cooperative sectors have supervisory and intervention powers, secured by agreement with their members; information is shared with the supervisory authorities.

Article 93 of the Banking Act requires all credit institutions in Austria that accept deposits subject to guarantee obligations pursuant to paragraph 2 of Article 93 to be members of a DGS. The arrangement is reciprocal: a credit institution cannot be a member of a DGS unless it is licensed by the FMA.

Austria's deposit insurance coverage is consistent with the pending EU DGS Directive. Five DGSs, representing the individual sectors of the banking system cover individual and SME[50] deposits up to €50,000, with the federal government insuring the remainder to €100,000. The new scheme must cover all individual depositors and non-financial companies up to €100,000 per depositor per bank.[51] An analysis of the impact of this change to all non-financial companies should be undertaken.

The DGSs are all private, ex post funded schemes, which leads to pro-cyclicality, an exacerbating effect for banks' contributions during times of economic distress. As ex post funded schemes, the DGSs have no reserve fund, collect no premiums or fees, and have no assets to invest.

[50] Small and medium enterprises (SMEs) are defined as those firms that do not exceed more than one of the following ceilings: (1) €19.25 million of total assets; (2) €38.5 million of annual sales; and (3) 250 employees.

[51] Insiders and related parties (and their families) will also continue to be excluded from coverage.

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Box 7. Potential Downsides of Privately Operated Deposit Guarantee Schemes

Funding. Private systems generally do not have adequate emergency back-up funding if the fund gets depleted (e.g., line of credit with MOF).

Governance. A DGS needs adequate and advance information on problem banks for prompt pay out. Because of the apparent conflict of interest, supervisors generally will not and should not share information with private DGSs about which banks are in distress.

Coordination. A DGS has a financial stability role and should be included in government crisis committees, access which should not be granted to private schemes.

Public awareness. In general, public schemes are perceived as more credible.

Legal liability. Private DGS employees may not be granted legal protection for actions taken in good faith in the course of their assigned duties.

The sharing of supervisory information with the individual DGSs could give rise to potential conflicts of interest, especially for the Banks and Bankiers group, since active bankers comprise the supervisory boards of the DGSs and have access to confidential FMA or OeNB information regarding problem banks. Although, reportedly, the trade associations act in the best interests of their particular sector and do not abuse access to confidential information, there seems a lack of safeguards to prevent such abuse. The cooperative sectors have explicit confidentiality and information sharing agreements and protocols in place, especially for the Volksbanken group under Article 30a of the Banking act, but the issue of active bankers or members of bank associations having access to confidential supervisory information remains.

Although FMA provides deposit insurance information on its website and the various DGSs maintain websites, the information is quite limited. With the creation of a future single, public DGS, the DGS should develop and maintain a comprehensive website (see next section).

B. Funding of Payout events

When an insured event occurs, insured deposit repayment up to €50,000[52] is accomplished via a three stage process: (i) banks in the sector to which the failed bank belonged contribute to an amount in proportion to their covered deposits, but not to exceed 1.5 percent of their risk-weighted assets (RWA) plus an upward adjustment for trading book positions; (ii) if that amount is insufficient, then the banks from four other DGSs will be required to contribute proportionally using the same formula;[53] and, (iii) if these amounts are still inadequate, then the DGS to which the failed bank belonged must take up a loan or float debt to fund any remaining deficient amount. The law

[52] The federal government insures the amounts from €50,000 to €100,000 per depositor per bank.

[53] *New entrant banks are covered directly by the second stage for the first 10 years before being absorbed by their home sector DGS.*

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provides for the possibility that the federal government may guarantee amounts owed under stage 3.

There has not been a DGS payout event in the last decade. The last payouts, in the "Bank & Bankiers" sector were for a few small failed banks in the late 1990s, the last being in 2001. There has never been a payout in the three cooperative sectors.

C. Payout Simulations

The mission requested payout event scenario simulations be undertaken to demonstrate the extent of risk transfer among the five sectors. In the first scenario, a mid size bank in the "Bank & Bankiers" group is assumed to fail in period one, with eligible deposits of €2 billion (not necessarily all covered), with a second period failure of the same size in the Hypo sector. A second scenario assumes the same sized serial failures in periods one and two in the Raiffeisen and Sparkassen groups. The OeNB had to use proxy data on covered deposits as its database did not have the granularity needed. This suggests that further work to collect data of sufficient granularity to fully estimate payouts would be extremely useful. Notwithstanding the data limitation, a few useful observations emerged:

- The eligible deposit assumption of €2 billion (a mid-sized bank in the Austrian context) is at the threshold of what the private sector will bear in a failure, larger amounts of which may impact on the fiscal accounts under the scheme's structure that stage 3 liabilities may attract a federal government guarantee. This potential fiscal cost is apart from the direct liability for deposits between €50,000 and €100,000.

- The asset and liability structures of the member banks of five sectors are quite heterogeneous, and together with the ex-post funding distribution formulas, yields a quite skewed sharing of DGS funding risks.

- The ex-post funding scheme represents not only a potential pro-cyclical problem for the banking system, but together with the sharing of deposit guarantee liabilities between the sectors under stage 2, represents a small but definite contagion mechanism.

D. Analysis and Recommendations

The authorities are encouraged to use the opportunity of the forthcoming DGS Directive to create a single, independent,[54] public, ex ante funded DGS, with clear public policy objectives to protect small depositors and help maintain financial stability. Ex ante funded models underpin the best international practice that the banking industry should bear the cost of bank

[54] The new, public DGS can be an independent public agency or an autonomous unit of OeNB or FMA. If the latter, it is paramount that finances, operations and staffing be separate from the host.

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failures.[55] Conflicts of interest can be reduced by prohibiting active bankers or members of bankers associations from serving on the DGS' Board, thus restricting access to confidential information that may result in competitive advantage.

The authorities should immediately set up a high-level working group, including officials from the MOF, OeNB, FMA, and the various DGSs, to decide how to transition the existing fragmented ex post funded DGS system into a public, ex-ante funded scheme, taking the EU Directive as well as the BCBS Core Principles for Effective Deposit Insurance Schemes (DICP) as minimum standards. This will help rationalize the present DGS topography, capture efficiency gains and introduce greater simplicity, rapidity of response, and transparency.

However, the Austria financial system has certain specificities with advantages that should not be lost or de-incentivized under a new unified approach. The three cooperative sectors have more-or-less elaborate internal governance structures that have value for financial stability. These intra-group cooperative schemes, while variable in quality, legal strength, and extent, have early warning, intervention, and mutual financial and managerial assistance in place.[56] These systems are close to the operational level and perform a valuable oversight and intervention function that reinforces and complements that of the central financial supervision authorities. The current set-up argues for a so-called "paybox plus" type of DGS, in that it is primarily concerned with repayment of insured deposits in case of bank failure, but also provides some risk minimization via the oversight and intervention functions.

Although the draft EU Directive has proposed a target reserve fund level (1.5 percent of eligible deposits), it would be prudent to regard this baseline as a minimum and task the working group to develop some method to determine the appropriate target reserve fund for the Austrian banking system (Table A2). Obviously, just as with ex post funding, inadequate reserves can lead to costly delays in problem bank resolution as well as loss of confidence in the DGS and the banking sector. The Working Group should address periodic premiums, along with entrance fees for new institutions entering the system. Emergency funding, including increased premiums and an appropriate liquidity back-up arrangement with the MOF are other essential features. Finally, ex ante schemes must have official, prudent investment policies that emphasize safety and liquidity over return.

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[55] See Basel Committee on Banking Supervision (BCBS)-International Association of Deposit Insurers (IADI) Core Principles for Effective Deposit Insurance Systems - A Methodology for Compliance Assessment (BCBSIADI Methodology), December 2010, Core Principle 11, Essential Criterion 3; as well as the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.

[56] The internal early warning and intervention scheme in the Volksbanken appears to be the strongest, and is a statutory mandate under Article 30a of the Banking Act.

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Table A2. Austria: Defining the Target Fund Size

		Impact on Target level of funding
Factors related with the banking system	Probability of banking failures	↑
	Amount of insured deposits	↑
	Degree of banking concentration	↑
Factors related with the deposit insurance mechanism	Risk aversion of the insurer	↑
	Alternative financial resources available in case of losses	↓
	Riskiness of investments	↓
Other factors	Effectiveness of supervision and intervention	↓
	Effectiveness of market discipline	↓
	Macro economic and financial market stability	↓

Source: IMF Staff analysis.

The EU draft directive also requires risk-based premiums (RBP), which may be difficult to implement (Box 8). Fund advice to jurisdictions considering RBPs is to not rush the process; therefore, the mission recommends that existing DGSs in Austria immediately begin collecting premiums on a flat rate basis to begin building an ex ante fund. This will acclimate them to the machinations of building a fund and enhance RBP adoption, as they calculate the base for the assessment, begin collecting, and investing the proceeds. When implementing RBPs, it is important to adhere to the Occam's razor adage and keep it simple.[57] Developing and implementing a risk-based system can be very problematic, because: (i) it is technically difficult to legitimately assign risk to the member banks, and (ii) it requires greater resource and information sharing between the DGS and the Supervisory Authority. So, the DGS and the authority should take the time to develop a model, get stakeholder buy-in, test the model, implement the system, analyze the results and modify as necessary (keeping in mind that there is no such thing as the "perfect" risk model). Moreover, when implementing RBPs it is just as important to assign risk categories appropriately. Many DGSs labor over the model design and then establish risk categories that do not properly motivate banks to improve their risk profile in order to reduce operating expenses. Risk-based premiums should be distributed over categories which are distinguishable enough as to incentivize banks to improve their risk profile and move into a more favorable (less expensive) risk category.

[57] The theory of Occam's razor can be paraphrased such that, all things being equal, the simplest solution is preferable to the more complex.

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The working group should include this topic in their strategic planning and begin thinking about the model for risk-based premiums; keeping in mind the advantages of simplicity.

Box 8. Risk-based Premiums

Under a unified, national, ex-ante funded DGS plan there are at least two options to preserve incentives for intensive cooperative intra-sectoral governance:

1. Provide a discount on the DGS contribution premiums specifically for banks under cooperative structures, in the form of proposed lower risk premium. The question would then be at what level to set that discount to fairly compensate for intra-sectoral governance and what would be the minimum elements, strength, and scope of intra-sectoral governance.[58]

2. Do not provide any cooperative discount *per se,* but allow supervisory risk scoring to determine the risk premium and assess whether strongly linked sectors (e.g.: the Volksbanken, Raiffeisen and Sparkassen sectors) demonstrate lower risk scores than other banks on a stand-alone basis.

The second option would have the merit of allowing a case-by-case discount – in case of a lower risk assessment—resulting in a lower risk premium. Heightened consolidated sector supervision would also suggest potential savings for the national financial regulator in reducing the number of small individual units under supervision, which is presently very large (700+).[59]

An important feature of the proposed single, public DGS regards public awareness and communications. The DGS should plan to develop and maintain a comprehensive website that provides information regarding the conditions and coverage of deposit insurance (including prominent identification of instruments that are not covered), progress on any payouts in process, other industry information, including links to other appropriate websites. The DGS should require member financial institutions to display membership certificates at all offices of operation, with compliance periodically audited. Furthermore, member financial institutions must openly make readily available material provided by DGS explaining the terms and conditions of deposit insurance. In an insured event, the DGS must publish information explaining the reimbursement process in one or more newspapers of general circulation.

Another important aspect of the draft EU Directive is the reduction in the payout time to seven days. DGSs in Austria have objected that this is too short a time frame; however, with the adoption of single customer view (SCV) that most banks are adopting, adequate advance preparation and the proper legal framework, the time frame is perfectly reasonable.[60] This

[58] For example, the Volksbank sector has strong legally-enforceable mutual internal supervision and intervention powers under Article 30a, while the Raiffeisen group's intervention has a more voluntary, but perhaps just as strong, moral suasion quality. For the Erste-Sparkassen sector, a joint-stock outright ownership structure is emerging.

[59] This is the case for Volksbanken, where, following an 18 month transition period, individual members will no longer be directly supervised for prudential norms.

[60] For example, in the US a bank is usually closed on a Friday, the FDIC executes a Purchase and Assumption (P&A) transaction with another bank, and the failed bank depositors' funds are available on the following Monday. Even in cases where there is no acquirer, FDIC can usually make payout within 3 or 4 days.

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requirement illustrates that an effective deposit insurance scheme is reliant on advance preparation and an amenable legal framework, as recommended elsewhere in this note.

The mission recommends that personnel from the proposed DGS be involved very early in the problem bank resolution process to make advance preparation for a Purchase and Assumption (P&A) transaction (Box 9) or payout. Advance preparation along with a special bank insolvency regime, is paramount for effective bank resolution. Whether via a P&A, using a paying agent bank, or implementing a direct insured deposit payout, advance preparation is necessary in order to ensure prompt payment, lessening the potential for contagion. As the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions recommend, both the Banking Act and the new deposit insurance law should provide for the DGS to make funds available to insured depositors via a P&A transaction, but not to exceed the amount that would have been expended to compensate insured depositors in a straight liquidation.[61]

Box 9. Brief Explanation of a Purchase and Assumption (P&A) Transaction

A P&A transaction provides that a financially healthier bank will purchase certain "good" assets and assume insured deposit liabilities of a failed bank. This approach represents an expedient method of resolving a failed bank because, with the proper legal framework and advance preparation, it can be accomplished quickly (usually over a weekend) A P&A has the potential to maintain banking services in under-served communities, and is virtually always less costly than liquidation, because any assets passed at book value to an assuming banks (generally performing mortgage and/or other consumer loans) represent 100 percent recovery for the liquidation estate, as well s keeping at least some assets in the private sector. Additionally, when there are several potential bidders, the failed bank's franchise value can be captured, to the benefit of the creditors, reducing the final cost of the failure.

Under the P&A concept, certain assets and insured deposits of the failed bank are transferred to an assuming bank at book value. In this way, the assets of the failed bank help offset the deposit liabilities transferred to the assuming bank, thus reducing the impact on the deposit insurance fund (if there are not enough "good" assets to balance the amount of insured deposits, the DPF must advance the cash to balance the transaction--assets must equal liabilities).The real cost of not employing a P&A transaction can be costly and distressing to a deposit insurance reserve fund.

A P&A does not end with the transfer of assets and liabilities, however. There are technical and operational details that should be contained in the contract, including, *inter alia*:

- Assuming Bank (AB) must pay contract rate of interest on deposits for a specified time (FDIC requires 14 days), after which it may adjust the interest rate.

[61] To facilitate a P&A, the proposed legislation should provide that the book value of some assets (e.g., seasoned, performing consumer or mortgage loans) can be considered fair market value; as well as providing for ex post asset valuation when necessary.

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Box 9. Brief Explanation of a Purchase and Assumption (P&A) Transaction (Concluded)

- Depositors have the right to withdraw their deposits without penalty
- Assets purchased at book value (usually performing consumer and mortgage loans)
- Fixed assets (bank premises, furniture, fixtures and equipment) can be purchased at book value, but shall be adjusted to fair market value ex post, following legitimate appraisals.
- Any bid amount (premium) that AB agrees to pay is stipulated in the P&A

Adjustments for errors and omissions in constructing the pro forma balance sheet, asset purchases (e.g., adjustment for fixed assets from book value to fair market value) shall be paid by either party during a Settlement period (not to exceed 180 days).

Further amendments to the Banking Act and the anticipated new DGS must ensure harmonization, regarding bank resolution (i.e., there should be one and only one trigger for insured deposit reimbursement—license revocation). Additionally, such legislative changes should establish a two-tiered depositor preference in the claims priority (as currently being discussed at the European level): (i). eligible deposits up to and including €100,000; and, (ii) eligible deposits over €100,000). Implementing depositor preference will help curtail the problems inherent in the "no creditor worse off" quandary and ease the implementation of a P&A as the preferred bank resolution tool. The second tier—those deposits in excess of €100,000—can provide an opportunity for clients to offset uninsured deposits against outstanding loans.[62] This will also ensure the best practice that the DGS, as subrogee to repaid insured depositors, should enjoy a higher priority in the liquidation proceeding than uninsured depositors, unsecured creditors, subordinated debt holders and shareholders.

Finally, a major weakness of the draft EU DGS Directive lies with the possibility for a DGS to expend funds to save a bank before failure. This violates the principle that bank resolutions should meet a least cost test, since open bank assistance (OBA) is open-ended and virtually impossible to quantify. If a DGS does provide OBA, it is likely to feel trapped to provide ever more funding in order to "protect its investment." OBA is virtually never a good idea except in systemic circumstances when time constraints prevent design of a less costly resolution.

[62] The EU Directive proposes to end the practice of netting depositors' liabilities. In the staff's view, an effective DGS should not pay insured deposits to a client who has matured past-due or other non-performing loans. It is illogical to pay such a client, especially since it is unlikely that the liquidator will make recovery on the bad loan. On the other hand, permitting voluntary offsets of uninsured deposits to loans since it is hardly fair to expect a debtor to continue paying on his loan when a portion (or all) of his deposit has not been repaid.

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Appendix III. Core Principles for Effective Deposit Insurance Systems: An Informal Overview

Principle	Comments – Existing DGSs/Proposed New DGS
Principle 1—Public policy objectives The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.	The current DGSs lack specific public policy objectives. Objectives to (i) protect small depositors; and, (ii) help promote financial stability by making prompt reimbursement to insured depositors in the event of a bank failure should be included in any new scheme(s)
Principle 2—Mitigating Moral Hazard Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.	Moral hazard in the present context is primarily mitigated by monitoring by other banks in the scheme. Strong and effective supervision, along with risk-based premiums can help mitigate moral hazard in a new ex ante funded scheme.
Principle 3—Mandate It is critical that the mandate selected for a deposit insurer be clearly and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.	Mandates are unclear in the current context. Some schemes have effective early warning systems (EWS) and intervention actions often found in broad mandate schemes A new scheme could be a hybrid mandate scheme. Since FMA should be the resolution authority going forward, the new scheme should primarily be a paybox; however the effective early warning systems can aid FMA's supervisory and resolution functions.
Principle 4—Powers A deposit insurer should have all powers necessary to fulfill its mandate and these should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures,	The current schemes mostly have powers granted to them by their member institutions, while some are stated in law. A public scheme could have more formal powers to demand information of members,

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Principle	Comments – Existing DGSs/Proposed New DGS
and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.	enter into contracts, set budgets and investment policy, etc.
Principle 5—Governance The deposit insurer should be operationally independent, transparent, accountable, and insulated from undue political and industry influence.	The five DGS are independent of government agencies, but captive to their membership. A public scheme, whether an independent agency or a unit within the OeNB or FMA should be operationally autonomous, have separate finances and financial statements, dedicated staffing, etc.
Principle 6—Relationships with other safety-net participants A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized.	The current DGSs enjoy some of cooperation and information sharing with OeNB and FMA (subject to confidentiality agreement). They are also to be the conduit of MOF payments of insured deposits from €50,000 - €100,000. A new scheme should enjoy an adequate level of information sharing and participation in on-site inspections in order to make advance preparation for resolution and insured depositor repayment.
Principle 7—Cross-border issues Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognized in the determination of levies and premiums.	The DGSs have little to no interaction with foreign DISs or supervisory authorities. A public scheme could act from an official governmental capacity in establishing such valuable relationships.
Principle 8—Compulsory membership Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits	Membership is compulsory for all financial institutions in the particular DGS of its sector. Compulsory membership should continue

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Principle	Comments – Existing DGSs/Proposed New DGS
from those deemed most in need of protection (e.g., retail and small business depositors) to avoid adverse selection.	under any new scheme.
Principle 9—Coverage Policymakers should define clearly in law, prudential regulations or by-laws what is an insurable deposit. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.	Currently, the DGSs provide coverage for individuals and SMEs up to €50,000. The MOF covers the same types of deposits from €50,000 - €100,000. A new scheme following the EU Directive, would cover all non-financial institution deposits up to €100,000 (excluding insider and related deposits).
Principle 10—Transitioning from a blanket guarantee to a limited coverage deposit insurance system When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.	During the crisis, Austria had blanket coverage from late 2008 to end 2009. The country has transitioned back to the explicit limited protection (albeit with an increase from €20,000 - €100,000), with little ill effect. A blanket guarantee is expected to be inapplicable under a new scheme.
Principle 11—Funding A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilizing risk-adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all	The current DGSs are all ex post funded, with member banks' contributions capped at 1.5 percent of their risk weighted assets (adjusted upwards for trading book positions). Ex post funded schemes are procyclical, by their very nature weaken the capital position of remaining member institutions in periods of distress, and often shift the burden to the public purse (i.e., note MOF coverage as described above). Ex post schemes violate both DICPs and Key Attributes for Effective Resolution, both of which state that the banking industry should bear the cost of bank failures.

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Principle	Comments – Existing DGSs/Proposed New DGS
necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.	A new ex ante funded scheme will deal with (at least in part) the deficiency noted above. The Austrian authorities should carefully analyze the optimal target reserve fund level. Since the draft EU Directive calls for risk-based premiums, a difficult system to implement, it would be advisable for the current DGSs to either begin imposing flat rate premiums or at least simulating such assessments to get some experience with the process, which will only be more difficult with risk based premiums. DGS ex ante funding should specifically be permitted to facilitate a P&A transaction (not to exceed what would have been expended in a payout); and prohibited from being used for open bank assistance.
Principle 12—Public awareness In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.	Austria's Banking Act requires the DGSs to provide depositors with basic information regarding deposit protection. The DGSs maintain limited websites, on which information regarding where and how to claim a deposit would be posted in the event of a bank failure. A new scheme would have the same requirements that banks provide depositors with the terms and conditions of the depositor protection, particularly regarding the instruments that are not covered. A comprehensive website could be created that has more financial industry and consumer protection information (links), as well as FAQs. In the event of a bank failure, simple, specific, yet comprehensive information should be provided regarding deposit access.

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Principle	Comments – Existing DGSs/Proposed New DGS
Principle 13—Legal protection The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in "good faith" while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.	It is unknown, but highly doubtful, whether current DGS employees enjoy legal protected against lawsuits for decisions and actions taken in "good faith" while discharging their job responsibilities. A new scheme should provide such protection and also cover the legal costs in such cases.
Principle 14—Dealing with parties at fault in a bank failure A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.	It is unknown, but highly doubtful, whether current DGSs have the ability to pursue those at fault in a bank failure, other than civil lawsuits and perhaps cooperation with law enforcement authorities. A new DGS should be able to aggressively pursue such individuals or firms in order to recover restitution, if possible. Criminal activities should be pursued when possible and the DGS should aggressively cooperate with law enforcement agencies.
Principle 15—Early detection and timely intervention and resolution The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.	The current DGSs all have EWSs (some more sophisticated and effective than others); and some have intervention powers (which stop short of license revocation). it seems a dubious practice, however, for the supervisory authorities to share confidential, market sensitive information with private DGSs. The FMA, as the probable resolution authority, in cooperation with OeNB should bear responsibility for the early detection and timely intervention in problem banks when the new Banking Intervention and Restructuring Act comes into force. The new

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Principle	Comments – Existing DGSs/Proposed New DGS
	DGS should be involved early and given access to information in advance in order to effect timely insured deposit repayment.
Principle 16—Effective resolution processes Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimize resolution costs and disruption of markets; maximize recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (e.g., providing depositors with continuous access to their funds and maintaining clearing and settlement activities).	In Austria, the court-based bankruptcy framework makes bank resolution cumbersome (there is no special bank resolution regime yet). To their credit, some of the DGSs are quite effective with their EWS and intervention powers in preventing bank failures; however, effective bank resolution in Austria would require putting in place a special bank resolution regime. In order for a new DGS to be effective, it must be accompanied by changes to or new legislation establishing a special bank resolution regime (SRR), which provides, at a minimum, that courts cannot reverse FMA's decision to revoke a bank's license. These amendments to the BA must be harmonized with the anticipated new EU legislation, particularly regarding the trigger for insured deposit reimbursement (i.e., there should be one and only one—license revocation). The legislation should also enshrine depositor preference (preferably two-tiered as currently under the discussion at the EU level) so that the "no creditor worse off" issue does not inhibit using a P&A as a resolution tool. Such a resolution framework enables a DGS to promptly make insured deposits available to depositors (preferably via a P&A transaction). Open bank assistance should be prohibited except in systemic situations and even then, the government should take the lead, not the DGS. If DGS funds are used, it should only be at government direction and with a government guarantee.

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Principle	Comments – Existing DGSs/Proposed New DGS
Principle 17—Reimbursing depositors The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.	Currently, there are four triggers for insured deposit repayment: (i) when bankruptcy proceedings are initiated; (ii) the bank is put into receivership; (iii) when the supervisory authorities order a payment stoppage; and, (iv) when the home authorities have declared deposit unavailability at the parent level. When an insured event occurs, insured deposit repayment is accomplished via a three stage process: (i) banks in the sector to which the failed bank are required to contribute in an amount not to exceed 1.5 percent of their risk-weighted assets (adjusted for trading book positions); (ii) if that amount is insufficient to fully reimburse depositors (to the € 50,000 level), then the banks in the other sectors are required to contribute based on the similar formula; and, (iii) if these amounts are still not enough to reimburse the insured depositors to the € 50,000 level, then the DGS representing the sector to which the failed bank belonged are required to take up a loan or float debt to comprise the deficit amount. The DGSs also are to administer payment of deposits that are guaranteed by MOF (from €50,000 - €100,000). The Banking Act provides for reimbursement within twenty working days. No DGS has contingency plans for advance preparation for prompt payment of insured depositors, instead relying on an ex post application process which will severely delay payment. All consider the 7 day repayment requirement, currently under discussion at the EU level, as too short. The new DGS should work in partnership with the supervisory authorities and be involved

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Principle	Comments – Existing DGSs/Proposed New DGS
	early in the resolution process. They should stress advance preparation, and, with single customer view (SCV), frequently test computations of insured deposits (sorting and aggregating accounts held in the same ownership capacity, as well as coding excluded deposits). The DGS should, in coordination with the supervisory authorities, issue a press release and post on their website, information regarding how and where deposits will be repaid, as well as other related questions.
Principle 18—Recoveries The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.	Although the DGSs seem to enjoy a subrogation status for claims in bank bankruptcies the DGSs are in the same priority class as general creditors, since, in Austria bank liquidations are conducted under company insolvency law. With recommended changes to the resolution legislation, depositor preference should be introduced. This would give the new DGS, as subrogee to repaid insured depositors, a higher priority in the liquidation proceeding than uninsured depositors (who, under a two-tiered depositor preference system, would have a higher priority than other creditors), unsecured creditors, subordinated debt holders and shareholders.

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