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	FHP 80/99 Mag. Erich Kühnelt	3739	29.07.2003

3rd Consultative Document on "Basel II"

Dear Sir/Madam,

The Austrian Federal Economic Chamber - Wirtschaftskammer Österreich - represents all businesses in Austria, the vast majority of them being SMEs, and also represents the Austrian financial services industry including banks.

We welcome the significant progress concerning the **treatment of loans to SMEs** that has been achieved in the negotiations in the Basel Committee in the last two years. The proposed treatment of loan exposures to SMEs of up 1 Mio € as **retail exposure** is an improvement for many loans to SMEs even compared to the existing capital regulations. We also acknowledge the QIS 3 results, which show a significant reduction in the banks' capital requirements for retail loans to SMEs, and in general a slight reduction of the capital requirements for loans to SMEs.

On the other hand we think that much of the advantages achieved for SMEs could be compensated by the implementation costs of Basel II in the banking sector. With regard to the fact that especially **small and medium-sized banks** are important financing partners for SMEs in many EU member states, we therefore think that further measures have to be taken that make a more pragmatic, unbureaucratic and cost efficient implementation in the banking system possible. **In the annex you find specific proposals by the Austrian banking industry which we fully support.**

From the point of view of Austrian businesses we think that there is still some work to do:

1. **Retail loans**

In our opinion a regulatory **preferential treatment for loans to SMEs is fully justified** since portfolio and diversification effects in a bank's loan portfolio reduce the bank's risk. This has been taken account through lower risk weights. Besides the default of a loan to a SME does not endanger the Committee's main priority, which is enhancing the stability of the banking systems.

The **granularity criterion** which was proposed for the standardised approach in the QIS 3 Technical Guidance (no aggregate exposure to one counterpart can exceed 0,2 % of the overall regulatory retail portfolio) would discriminate SME-retail customers of smaller banks and should therefore be deleted. The effect of the criterion would be a strong distortion in the competition in the banking sector. In the current proposal the "0,2 %-criterion" is foreseen as an example how granularity can be achieved in the retail loan segment; we would prefer a deletion in the final document; see also 3rd Consultation Paper by the Commission where the "0,2-criterion" has already been deleted by the Commission.

The required **use test** for retail loans (par 200) could be a hindrance for a wide application of the retail loan category to loans to SMEs. Also it is questionable that the retail segment requires an estimation of all parameters (not only PD, but also LGD and EAD) which means de facto that for the retail segment only the **advanced IRB approach** and not the foundation IRB approach is available. Since the justification for the preferential treatment of smaller loans to SMEs is the diversification and therefore lower risk in the bank's loan portfolio, we doubt whether these two restrictions to the application of the retail segment are really necessary. With respect to smaller loan amounts administrative costs in the bank are even more relevant than in the case of larger loans. We therefore think that instead of prescribing sophisticated rating systems for smaller loan amounts it would be necessary to enable banks to use **simplified rating systems** (e.g. credit scoring models, but not as a mere element of the rating procedure, but as the sole process in determining the probability of default, and without the necessity to estimate LGD and EAD.

The threshold for retail loans (1 Mio €) should be **adjusted to inflation** on a regular basis, otherwise it will decline in real terms. Already in the end of 2006 when Basel II finally gets into force, 1 Mio € will be less in real terms than now (summer 2003). See also 3rd Consultation Paper by the European Commission that foresees the possibility of adjustment.

In the standardised approach according to par 43, footnote 19, supervisors may determine higher risk weights for retail exposures. The **conditions for increasing risk weights** for retail loans by the authorities in the standardised approach should be described much more precisely. An increase in risk weights of retail loans by the authorities should happen only in exceptionally circumstances.

If the authority decides to increase the risk weights for retail loans in an economic downtrend, this could increase the pro-cyclical effects of the new framework.

Besides, if the supervisory authority is able to increase the risk weight, it should also be able to lower it, if there is a low risk and low default rate.

Taking into account the low risk of small loans to a bank's stability we would prefer a deletion of footnote 19.

2. firm size adjustment for SMEs in the corporate loan segment

We welcome the approach to prevent negative effects for SMEs whose loan volumes exceed the retail threshold by taking into account their revenues (**firm size adjustment in the corporate portfolio**; **SME-portfolio**) but we think that this firm size adjustment **should not be restricted to the IRB-approach.** We propose a special risk weight in the standardised approach for non-retail loans to SMEs with sales of up to 50 Mio €, which should be between the 75 % for retail loans, and 100 % for unrated corporates (the risk weight should be near the risk weight for retail loans; e.g. 80 %).

In the IRB approach risk weights for SMEs above the retail threshold should be lower and nearer the retail risk weights. This would also prevent a "cliff effect" (large difference in risk weights for loans of up to 1 Mio € and slightly above 1 Mio €); The lowering of risk weights for loans to SMEs above the retail loan threshold has also been demanded by the Committee on Economic and Monetary Affairs of the European Parliament (July 9th, A5-0258/2003).

It will be important that all the thresholds (for retail loans and the SME-segment) will be **adjusted to economic growth and inflation** on a regular basis.

3. Corporate loans in the standardised approach

According to par 41 supervisory authorities can increase the risk weight for unrated claims to corporates "when they judge that a higher risk weight is warranted by the overall default experience in their jurisdiction"; they can also increase risk weights for corporates in the case of individual banks.

The **conditions for increasing risk weights** for corporate loans by the authorities in the standardised approach should be described much more precisely. An increase in risk weights of corporate loans by the authorities should happen only in exceptionally circumstances.

E.g. if the authority decides to increase the risk weights for corporate loans in an economic downtrend, this could increase the pro-cyclical effects of the new framework.

Besides, if the supervisory authority is able to increase the risk weight, it should also be able to lower it.

4. Procyclical effects

We still think that the stronger focus on the creditworthiness of companies could **enforce cyclical downtrends in an economy**, but we appreciate that both the Basel Committee and the Commission have addressed these concerns (e.g. requirement of stress tests); But see also various Working Papers published by the BIS.

Work by the Basel Committee, the European Commission, by supervisory and monetary authorities on this question **has to be continued**.

5. Collateral, business creation

A wide-ranging recognition of SME-typical collateral is necessary:

Progress has been made, but the rules are still too restrictive (e.g. in the case of "commercial real estate" the term "multi-purpose" excludes many kinds of real estate that is used by businesses, e.g. factories). It is necessary that physical collateral is also recognized in the standardized approach.

The requirement of periodic inspection by the bank of inventories that are collateral (par 485, bullet point 5) could be a dis-incentive for banks to accept this kind of collateral.

6. Business Start-ups

Since **newly created enterprises** can demonstrate no rating history when applying for a loan, we think that there should be special rules for this companies, because otherwise their financing condition could worsen under Basel II:

Start-ups are crucial for the dynamic, innovation and change in an economy.

Because of the significant economic importance of business creations we therefore propose a general risk weight of 75 % for newly created enterprises (risk weight for retail loans in the standardised approach can be applied by banks to newly created enterprises irrespective whether the bank chooses the IRB or the standardised approach = *partial use*). This special "partial use" could also be applied for **entrepreneurs taking over a small enterprise**, and should be possible in the first two years after the business creation / transfer.

7. High-volatility Commercial Real Estate (HVCRE; par 195, 196)

We ask the Committee to define more clearly what HVCRE is, since this term causes some concern among our members. HVCRE should be restricted to very large <u>and</u> very risky commercial real estate projects.

(In the current proposal it is in the discretion of supervisory authorities to decide what commercial real estate exposures are qualified as HVCRE, par 196)

8. Default definition

According to the proposed default definition, a default takes place when the obligor is past due more than 90 days on any credit obligation. The default definition could be to the disadvantage of certain businesses since this could heighten the PD for them. We therefore welcome the more flexible approach in par 414, footnote 80 (for the retail segment supervisors can substitute a figure of up to 180 days), but think such a flexibility is also necessary for non-retail exposures to SMEs. A preferential treatment for one member country of the Basel Committee is not an ideal solution (par 414, footnote 80).

9. Equity

The proposed treatment of equity has to be improved. For instance concerning loans the proposals differ between retail and corporate loans, depending on the size of the loan exposure of the bank (1 Mio € threshold). We propose to create a **retail segment** also **for equity investments** (with more favourable risk-weights for smaller equity investments compared to larger investments) – both in the standardised approach and in the IRB approach, and to allow a **firm-size adjustment** (in analogy to the corporate loan segment)

The proposed risk weights for equity investments seem to be much too high (e.g. IRB, simple risk weight method: 300 % for publicly traded companies, 400 % for all other equity holdings, par 315)

Yours sincerely

Dr. Christoph Leitl
President

Dr. Reinhold Mitterlehner
Deputy Secretary General

Annex: comments by the Austrian banking industry