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Reference:

EBA CP on Draft Regulatory Technical Standards on the specification of the calculation of specific and general credit risk adjustments according to Article 105(4) of the draft Capital Requirements Regulation (CRR) (EBA/CP/2012/10))

Date

28.09.2012

Dear Mr. Farkas,

BAWAG PSK welcomes the opportunity to comment on the EBA's Consultation Paper on Draft Regulatory Technical Standards on the specification of the calculation of specific and general credit risk adjustments according to Article 105(4) of the draft Capital Requirements Regulation (CRR).

BAWAG P.S.K. is one of the largest banks in Austria, operating as a universal bank predominantly in Austria, but also in other countries. The Bank's business activities cover retail and corporate banking as well as the financial markets segment.

In general, we highly appreciate enhancing regulatory harmonization in Europe with the particular aim of specifying details on the calculation and treatment of general and specific credit risk adjustments. We have outlined below our comments we have in relation to the proposed guidelines.

#### **Recognized credit risk adjustments versus expected losses in the IRB approach**

Art. 155 CRR clarifies that specific risk adjustments on exposures in default shall not be used to cover expected loss amounts on other exposures. This clarification determines a very high implementation effort both on the technical as well as on the economical side, i. e. adaptation of all relevant IT systems as well as economic compliance challenges. A multiyear phase in approach would be required to implement the changes required by the above-mentioned article.

Generally, provisioning practices in Austria result in SCRA being higher than the expected loss estimate. The incentive to keep the current practice would be eliminated if the separation is put in place. In addition it has to be mentioned that provisions for non-defaulted exposures may only be recognized to a limited extent according to current rules in IAS 39. This will lead to a surplus of SCRAs regarding defaulted exposures which may not be considered in Tier 1 calculation although the corresponding provisions have been recognized in profit or loss and thereby reduced Tier 1. On the other hand, a shortfall (deduction on CET1) may arise when comparing SCRAs for non-defaulted exposures with expected losses for this portfolio. This shortfall partly arises due to the limitations of IAS 39 and other accounting rules to recognize provisions for non-defaulted exposures. This fact will only change after implementation of IFRS 9 which is not expected before January 2015.

One solution would be to amend the current text of article 155 of CRR in the following way:  
“Discounts on balance sheet exposures purchased when in default according to Article 162(1) shall be treated in the same manner as specific credit risk adjustments ~~Specific credit risk adjustments on exposures in default shall not be used to cover expected loss on other exposures.~~ Expected loss amounts for securitized exposures and general and specific credit risk adjustments related to these exposures shall not be included in this calculation.”

It has to be mentioned, that as currently different proposed versions (EP, EC, ECouncil) of the CRR exist, this regulatory technical standard is to be considered as extremely important, potentially anticipating or even circumventing the final CRR version.

### **Fair value losses**

According to Article 2.5(a), specific credit risk adjustments include losses recognized in profit or loss as credit risk impairment for instruments measured at fair value.

Currently it is not clear, if the provisions in this paragraph only refer to securities and receivables or if they also refer to derivatives. As detailed rulings exist on how to calculate and account for risks resulting from derivatives, we assume that fair value losses relating to derivatives are not included in the definitions of Article 2.5(a).

Further, we do not see a clear guideline on how to account for credit risk impairments recognized in other comprehensive income for securities classified as available for sale. According to CRR the available for sale reserve will only gradually influence Tier 1 during the phase in period. Should credit risk impairments recognized in the available for sale reserve therefore be included partially or in their entirety in the calculation of SCRAs?

When calculating a fair value, credit risk can have positive or negative effects. We assume that Article 2.5(a) only references to cumulative credit risk losses and does not refer to the individual movements in a month. Clear guidance would be helpful.

Fair value movements, in particular movements of prices of financial instruments traded in the market, depend on several risk factors, such as liquidity risk, market risk and credit risk as well as changing market preferences. This RTS only refers to credit risk which will be difficult to separate and therefore will always include elements of judgment.



It is not clear, if all credit risk losses included in a fair value calculation are identical to credit risk impairment as mentioned in article 2.5(a). Current requirements for IRB defined in CRR state, that any credit risk impairment recognized for an individual instrument will lead to the default of the relevant instrument. In case every credit risk loss results in a credit risk impairment, any increase in credit spreads would therefore lead to a default of the security if measured at fair value. This will lead to high volatility as a security may be in default in one period, whereas it may not be in default in the next period due to improving credit spreads.

In case any increase in credit spreads compared to the credit spread at the time of acquisition results in a credit risk impairment, the fact that a security is in default will depend on the spread at the time of acquisition. A security may therefore be in default if purchased on date X (e.g. in June 2011, spread on acquisition date: 50), whereas it may not be in default if purchased at date Y (e.g. in December 2012, spread on acquisition date: 100).

As an increase in credit spreads does not necessarily lead to permanent losses we do not think that all credit risk valuation losses should be regarded as credit risk impairment. We would rather propose that credit risk impairment should only be relevant if a certain deterioration of credit quality has occurred. Only credit risk valuation losses recognized for securities that show a significant deterioration of credit quality and which – in addition – exceed a certain threshold of e.g. 5.000 Euro should be regarded as credit risk impairments and consequently lead to the default of the relevant financial instrument.

In addition we would propose to include specific guidelines regarding the recognition of credit risk impairments for securities or loans recognized at fair value issued by member states of the European Union. To support financial stability in the EU, we would propose that credit risk valuation losses relating to securities or loans from member states do not give rise to credit risk impairments at all or at least define reasonable thresholds.

#### **Provision for losses incurred but not reported**

We assume that a provision for losses incurred but not reported recognized according to IAS 39.AG89 is included in the definition of article 2.5(c) and therefore a provision for losses incurred but not reported qualifies as SCRA. We understand, according to general section para 8 (page 11 of current draft RTS) that the existence of this portfolio provision does not result in the fact that for these obligors a default event has occurred for IRB calculations in contradiction to Art 5(3)

#### **Implementation date**

As banks need time to implement the new requirements, an implementation period of 20 days after publication is not feasible. To allow banks to adjust systems and processes, implementation date should not be earlier than 1<sup>st</sup> January, 2015.

We hope that you find our comments useful. If you wish to discuss we are at your disposal and we would be happy to explain our comments in more detail.

Yours sincerely,

BAWAG P.S.K. Bank für Arbeit und Wirtschaft und  
Österreichische Postsparkasse Aktiengesellschaft

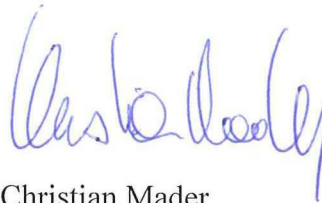
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