

Austrian Financial Intermediaries: Further Strengthening of Financial System Is Needed for Sustainable Recovery

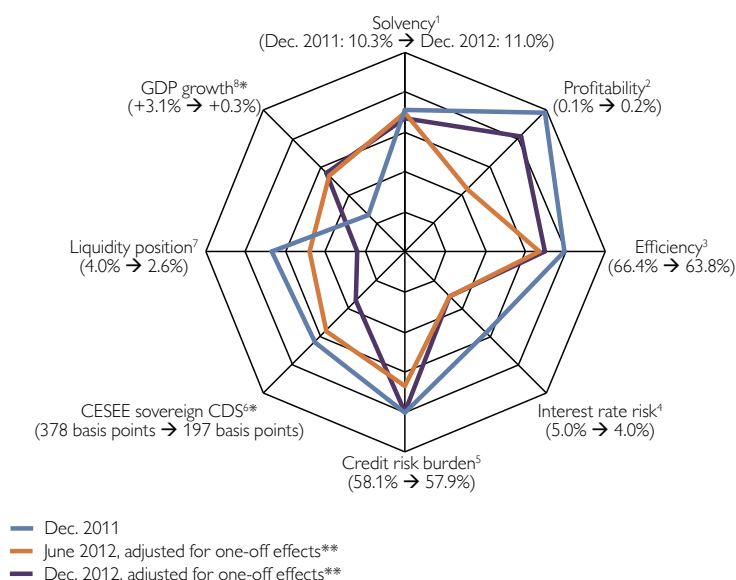
Financial conditions have improved since the publication of the previous Financial Stability Report in December 2012. Both financial stress and volatility on international markets declined thanks to further European policy commitments and renewed monetary stimulus, which helped drive down market and funding risks. Nevertheless, further efforts to strengthen financial institutions, and in particular banks, are central to ensure a sustainable recovery across Europe. This is all the more important as near-term economic prospects in the euro area remain weak.

The performance of the Austrian banking system reflects the recent up-trend amid an uncertain outlook. 2012 turned out to be better than the year before: many key indicators presented in the financial stability diagram (chart 13) have improved, but these developments may not be of a lasting nature. The increase in overall profitability, for example, was driven in large parts by one-off effects at several bigger institutions. In the remainder of 2013, the contracting economic activity and the low-yield environment might weigh on banks' profits, thus posing additional challenges to Austrian financial intermediaries. Low yields, in particular, could become an issue for life insurers, which have to meet long-term interest rate guarantees. Besides, historically low yields on government bonds have whetted the appetite for risk and have revived a more aggressive search for yield. Also, low interest rates and inflationary fears among investors are driving real estate markets in some countries, including Austria.

Much has been done to improve financial regulation in Europe, with initiatives generally strengthening the ability to deal with the ongoing crisis and offering further means and flexibility to act in the future. But there is still a long way to go. First, missing pillars of the European banking union have yet to be agreed, e.g. an effective European resolution regime that allows for the orderly exit of unviable banks. Such a regime should also include cross-border agreements for winding down internationally active banks. Second, the pillars that have already been agreed require speedy implementation to put the tools in the hands of regulators and supervisors as well as to prevent

Chart 13

Key Indicators for the Austrian Banking System



Source: OeNB.

¹ Tier 1 ratio.

² Return on assets after taxes.

³ Cost-to-income ratio.

⁴ 200 basis point interest rate shock (loss of eligible capital).

⁵ Credit risk provisions in % of operating result.

⁶ Exposure-weighted sovereign CDS spread.

⁷ Cumulative 12-month funding deficit in % of total assets.

⁸ Real GDP growth per annum.

* Most recent value available at the cutoff date. ** Effects related to capital measures of several banks.

Note: Consolidated figures, largely scaled on the basis of historical data. The closer the data points fall to the center, the better the ratios and the lower the risks are.

regulatory uncertainty for market participants. As a case in point, sustained operational progress toward an effective single supervisory mechanism (SSM) is essential.

In view of the current economic difficulties and new regulatory measures, there have been worries that banks might restrict lending to the real economy, in the case of Austrian banks most prominently with regard to the CESEE region. However, concerns about widespread deleveraging have not materialized. On the contrary, local funding has improved in line with supervisors' expectations, and with the exception of a few particularly stricken countries, total credit to the real economy has increased. Moreover, a gradual reduction in leverage is a welcome development from the perspective of financial stability. An important compo-

nent of adapting banks' balance sheets to a post-crisis environment, such a process should – provided it is undertaken carefully – result in positive externalities. Clearly, both its scale and pace require close monitoring, particularly given its potential impact on the supply of credit to the real economy.

Not least because of the importance of Austrian banks in the CESEE region, Austria has been included in the list of 25 globally systemic banking systems by the IMF. As a consequence, Austria was subject to a periodical Financial Sector Assessment Program (FSAP) at the beginning of 2013, an important external assessment of strengths and weaknesses of the Austrian financial system. The resulting recommendations will be discussed with all relevant authorities, and will contribute to making the Austrian financial market more resilient.

Box 1

Main Results of the IMF's Austrian Financial Sector Assessment Program 2013

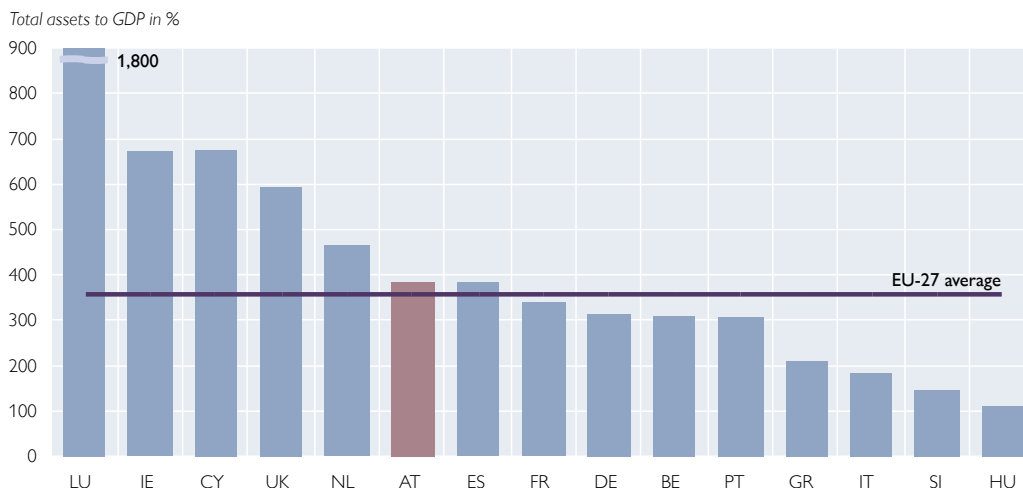
The preliminary financial stability assessment of Austria under the FSAP 2013¹ is broadly in line with the assessment of the OeNB as presented in this issue and previous issues of the Financial Stability Report. The IMF mission team recognized the following strengths of the Austrian financial system: Austrian banks' improving capital position and their diversified business models, limited reliance on wholesale funding, small sovereign exposures and stable domestic asset quality. In the short term, sources of concern are the low domestic profitability, bank asset quality in the CESEE region and the legacy foreign-currency loan portfolios. In the medium term, the risk of large outward cross-border spillovers to the CESEE region appears contained and Austrian banks should also be able to comply with the Basel III transitional arrangements without major difficulty. Nevertheless, Austrian banks should further strengthen their capital positions in light of higher market expectations, irrespective of the results of the FSAP stress tests (see section "Stress Tests Highlight the Downsides of the Challenging Environment").

The FSAP also identified several areas for improvement, in particular with regard to the legal framework for banking supervision and financial stability. A case in point is the institutional framework for macroprudential policy, which, according to both the IMF and the OeNB, needs to be strengthened, e.g. by establishing a full-fledged framework and considering a broad macroprudential toolkit. In addition, the IMF delegation also proposed to reform the Austrian deposit guarantee system with the aim of creating a single public ex ante funded system. Further areas for improvement concern the expansion of early intervention tools for troubled banks, the creation of a framework for orderly bank resolution and several issues related to effective banking and insurance supervision. The final results of the Austrian FSAP 2013 are scheduled to be published in the second half of 2013.

¹ The final report of the Austrian FSAP 2013 is scheduled to be published by the IMF in fall 2013 once the results have been integrated into Article IV surveillance and discussed by the IMF Executive Board.

Chart 14

Banking System Size



Source: ECB (data as at June 2012), Eurostat, Swiss National Bank.

Note: Not all countries are represented in the chart.

Difficult Environment for Austrian Banks Persists

Size of Austrian Banking System Is Stagnating

Consolidation trends in the Austrian banking market remained muted in 2012. Income-based flexibility seems limited, so cost-side optimizations have to be continued. Austria has a fragmented banking market characterized by a large number of banks. High competition and traditionally low interest margins in the domestic market are forcing banks to cut down on costs, as revenue-side measures are limited. In 2012, the total number of banks was reduced by 15 to 809. The number of bank employees declined slightly to approximately 79,100. This trend is expected to continue in 2013 following the announcement of further branch closures.

The size of the Austrian banking system remained almost unchanged in 2012 at around 380% of GDP, slightly above

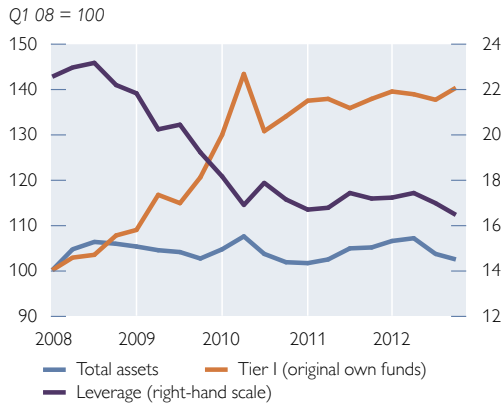
the weighted average for the EU-27 (illustrated in chart 14). Total assets of the consolidated Austrian banking system stagnated in the year 2012 at approximately EUR 1,164 billion (chart 15).

Austrian banks remain committed to the CESEE region. The exposure of majority Austrian-owned domestic banks remained largely flat at around EUR 210 billion as at year-end 2012.¹ The exposure to CESEE is relatively high, but broadly diversified, with more than half of it concerning investment-grade countries. Developments in the various CESEE countries have recently been diverging. Reductions in exposure in some countries are in essence outweighed by expansions in other countries. Nevertheless, the market share of Austrian banks in CESEE declined slightly in 2012 to around 11%, which was, among other things, due to a sale of operations in Kazakhstan and Kyrgyzstan.

¹ Austrian banks' total CESEE exposure ran to approximately EUR 320 billion.

Chart 15

Leverage of the Austrian Banking System



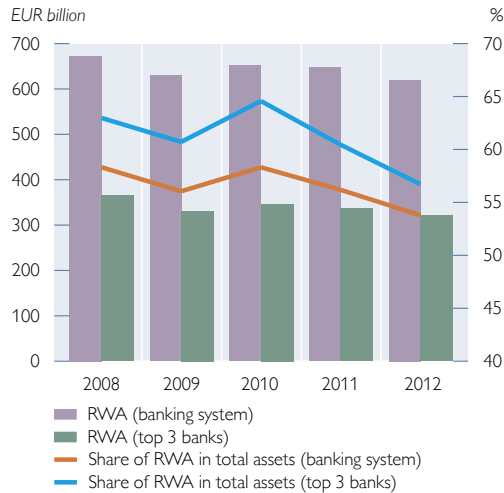
Source: OeNB, consolidated data.

Capital Ratios Continued to Increase in 2012

The tier 1 ratio of the Austrian banking system continued to improve in 2012, partly due to reductions in risk-weighted assets (RWA). After its low in the second quarter of 2008, the aggregate tier 1 capital ratio (capital adequacy ratio) of all Austrian banks rose steadily and reached 11.0% (14.2%) at end-2012. The increase of the aggregate tier 1 capital ratio can be mainly attributed to two effects. First, the volume of eligible tier 1 capital has risen by more than one-third since 2008, reflecting capital increases (private placements, capital injections from the parent group, retained earnings and other measures) as well as government measures under the bank stabilization package worth EUR 9.4 billion (or about half of the increase in eligible tier 1 capital). Second, in a direct response to the financial crisis, banks were reducing their RWA until the fourth quarter of 2009 (see chart 16), inter alia by streamlining their balance sheets and cutting off-balance sheet activities. While there

Chart 16

Risk-Weighted Assets (RWA) of Austrian Banks



Source: OeNB.

was a slight increase in RWA in 2010, the trend of RWA reductions has continued ever since: RWA shrank by 4.3% in 2012, with reductions being more pronounced for Austria's top 3 banks than for the rest of the banking sector.

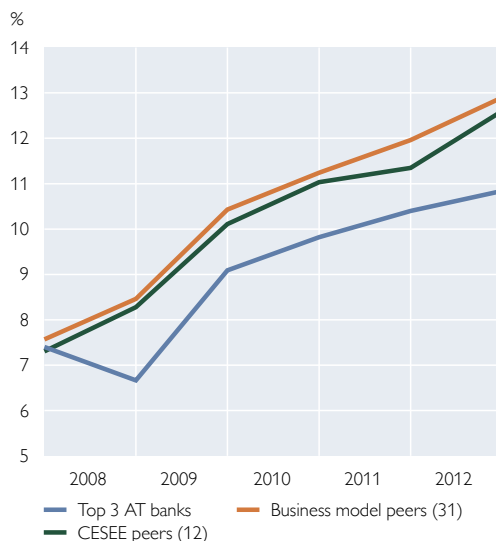
By international comparison, Austrian banks still have a rather high ratio of RWA to total assets, reflecting low leverage. The leverage of large Austrian banks is considerably lower than that of their peer groups (16.1 for the top 3 banks versus 22.8 for European peers and 28.6 for CESEE peers). As the leverage ratio is independent of banks' internal models and/or changes in external ratings and, therefore, of the credit cycle, it constitutes a stable (long-term), alternate indicator for financial stability. However, the aggregate tier 1 capital ratio of Austria's top 3 banks indicates that they are less adequately capitalized than their international peers.² Even though the top 3 banks have continually improved their tier 1

Leverage of large Austrian banks still have a rather high ratio of RWA to total assets, reflecting low leverage below European average

² The two peer groups analyzed here consist of, first, 12 European banks with relevant CESEE exposure and, second, of 31 European banks with similar business models.

Chart 17

Tier 1 Ratio of Large Austrian Banks Compared with European Peers



Source: OeNB, Bankscope.

capital ratios in recent years, chart 17 shows that the gap to their peer group's ratios widened from 1.0 percentage point in 2009 to 1.8 percentage points by end-2012.³ The three banks will therefore have to strengthen their capital base further, as a substantial amount of government participation capital subscribed under the bank support package will have to be replaced by private funds by 2017.

The distribution of capital ratios among Austrian banks highlights the fact that the capitalization of local and regional banks is more solid than that of large banks. At the end of the second quarter of 2012, the median tier 1 capital ratio

Chart 18

Aggregate Tier 1 Ratio of Austrian Banks



Source: OeNB.

of all Austrian banks stood at 14.1% and thus above the aggregate mean (see chart 18). The higher median ratio essentially reflects the high number of local and regional banks with above-average capitalization that operate in Austria alongside the few large banks which dominate the industry.

The allocation of banks' capital within the Austrian banking system mirrors the importance of their CESEE business. Roughly one-third of Austrian credit institutions' consolidated capital is located at CESEE subsidiaries. For the biggest banks, this relation is even more pronounced. This can of course also be explained by the fact that several countries concerned have higher capital requirements than Austria.

³ Figures relate to the 12 banks with relevant CESEE exposure.

Implications of Basel III for Austrian Banks

The Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRD IV), which transpose Basel III (mainly the new capital and liquidity framework) into European law will enter into force on January 1, 2014. The new capital framework will increase both the quantity and quality of banks' own funds. The new minimum capital requirements (which will be fully applicable as of January 1, 2015, following a phasing-in period) specify a common equity tier 1 capital ratio of 4.5% (for capital of the highest quality, e.g. shares); a tier 1 capital ratio of 6% (1.5% of which may be made up of additional tier 1 capital, e.g. hybrid capital); a total capital ratio of 8% (2% of which may be made up of tier 2 capital, e.g. subordinated bonds). On top of that, banks are required to hold a capital conservation buffer of 2.5% and may have to hold a (1) countercyclical buffer, (2) a systemic risk buffer and (3) a buffer for other systemically important credit institutions (capped at 2%). The CRD IV also introduces a buffer for globally systemically important credit institutions in accordance with the framework established by the Financial Stability Board (FSB). Currently, however, no banking group headquartered in Austria is defined as a globally systemically important institution. All these capital buffers have to be met with capital of the highest quality (common equity tier 1 capital). The full range of new capital requirements (stricter qualitative criteria for own funds instruments) will only enter into force after a transitional period for own funds instruments which will no longer be eligible after January 1, 2022, and after the phasing-in of new deduction requirements for own funds (until January 1, 2016).

The Austrian banking sector has already started to enhance its capital structure. However, banks still have additional capital needs. The Austrian banking sector is estimated to need additional own funds of between EUR 3 billion and EUR 8 billion until January 1, 2022, to be compliant with the new minimum capital ratios. This figure is made up of EUR 1 billion of common equity tier 1 capital, EUR 2 billion of additional tier 1 capital and a maximum of EUR 5 billion of tier 2 capital.¹ The amount of additional tier 2 capital needed depends on the individual features of the tier 2 capital instruments. Especially the frequent incentives to redeem capital instruments (e.g. step-up clauses stipulating an increase of coupon payments if the instruments are not called on a specified date) impair the eligibility of these instruments as tier 2 capital.

The main challenge for the Austrian banking sector remains the replacement of state aid instruments (i.e. participation capital) to the amount of EUR 5.15 billion by 2017, when state aid instruments other than common equity tier 1 capital will no longer be eligible under the CRR. Although the common equity tier 1 capital necessary to fulfill minimum requirements has meanwhile gone down to about EUR 1 billion, the Austrian supervisory authority as well as markets will expect large and internationally active Austrian banks to hold buffers well above these minimum requirements.

Another important innovation under Basel III is the introduction of a harmonized quantitative liquidity regulation. Its core component is the Liquidity Coverage Ratio (LCR).² Compliance with this minimum ratio will improve the risk-bearing capacity of Austrian banks, thereby decreasing the frequency and severity of banking crises and enhancing the stability of credit supply to the real economy (especially to SMEs). Harmonized liquidity regulation enables the competent authorities to more effectively supervise the adequacy of cross-border banking groups' liquidity risk management. The LCR will be phased in from 2015 onward; in the first year, banks will have to cover only 60% of their net cash outflows over 30 days by high-quality liquid assets. By 2018, at the latest, banks will have to reach 100% coverage. From a financial stability perspective, an accelerated adjustment process is advisable. Also, the market expects banks to cover 100% of their stressed net cash outflows by assets of (extremely) high credit quality and (extremely) high liquidity.

¹ The calculation is based on data as at the fourth quarter of 2012 under the following assumption: minimum capital plus capital conservation buffer required for the common equity tier 1 ratio of 7%, additional tier 1 capital ratio of 1.5% and tier 2 capital ratio of 2%; no retained earnings or capital increases for the period until 2022 have been taken into account.

² The LCR is defined as the ratio of high-quality liquid assets (HQLA) over stressed net cash outflows over 30 days. See Basel Committee of Banking Supervision. 2013. Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools. Basel. <http://www.bis.org/publ/bcbs238.pdf>.

Liquidity Situation Shows Signs of Further Improvement

At the EU level, banks' liquidity situation has remained stable yet fragile during the past six months. The first quarter of 2013 showed weak debt issuances throughout the EU-27. In the first three months they accumulated to EUR 97 billion, which is far below the seven-

year average of EUR 187 billion for the first quarter.⁴ Nevertheless, funding pressure has not become an imminent problem yet. Banks, especially in the euro area periphery, benefit from the provision of extensive central bank liquidity. Moreover, banks have increased their deposit base during the last couple of months. Partial deleveraging for certain asset categories and an increasing tendency of nonfinancial corporates with market access to tap debt markets also reduce structural refinancing pressures.

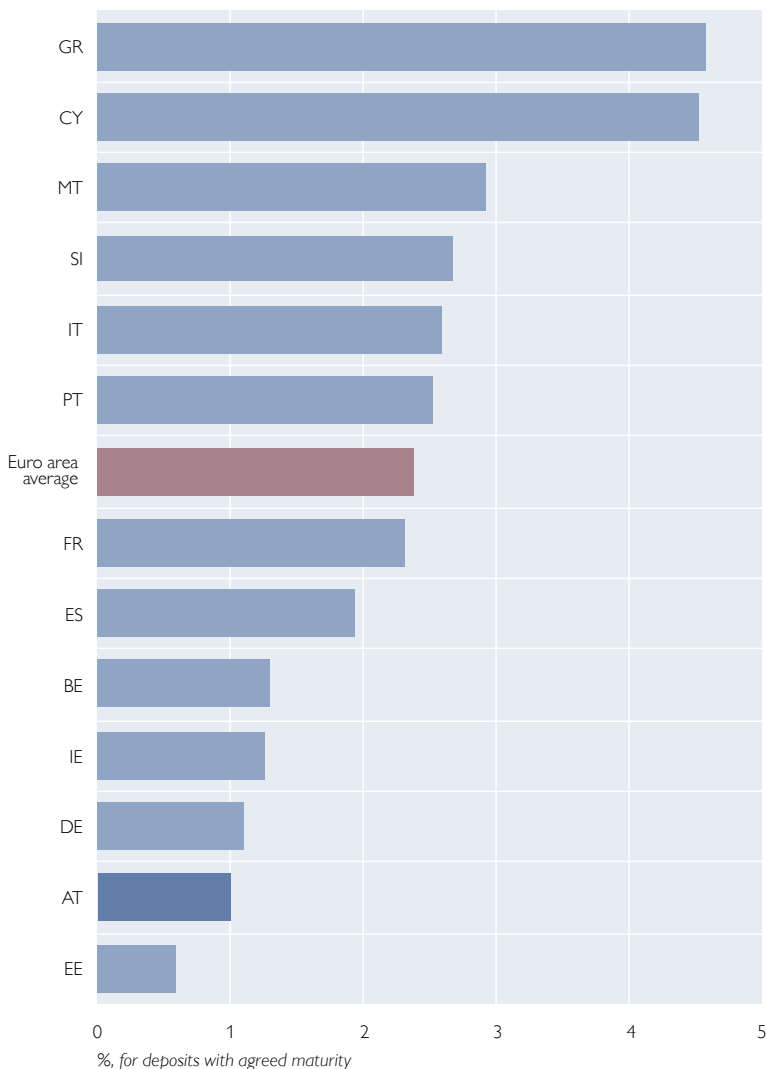
The use of early repayment signals a relaxation of the refinancing situation. A number of EU banks – mainly from euro area core countries – made use of the early repayment option for the two longer-term refinancing operations (LTROs) two years ahead of the original three-year maturity. Nevertheless, the ongoing bail-in discussion and events like the crisis in Cyprus will most likely affect the pricing and availability of bank funding in the medium term.

Austrian banks reduced their participation in the ECB's open market operations by more than 56% in the first quarter of 2013. The total volume of allotments to Austrian banks equals 0.7% of the ECB's total allotted volume, well below the proportionate share of Austrian banks in the European banking system⁵ (3.8%). The cumulated net funding gap of the 30 largest Austrian banks (12 months without money market operations) increased from EUR 34 billion in September 2012 to EUR 41 billion by mid-April 2013. This figure, however, is in line with the long-term average. The net position of planned debt issuances in relation to repayable debt has improved slightly. It remains

Robust liquidity situation of Austrian banks

Chart 19

Annualized Interest Rate on Household Deposits



Source: ECB.

⁴ Figures are based on a recent study of April 2013, conducted by Bank of America Merrill Lynch; source: Bloomberg.

⁵ As measured by consolidated total assets.

positive for instruments with maturities of up to one month but remains clearly negative over a 12-month horizon. The counterbalancing capacity (12 months without unsecured money market operations and foreign exchange swaps) remained stable at EUR 100 billion (April 2013).

As regards foreign currency funding, banks narrowed their liquidity gaps in U.S. dollar- and Swiss franc-denominated funding. However, some banks lag in the adjustment process and still rely excessively on short-term foreign exchange swaps. As some legacy positions in U.S. dollar and Swiss franc are difficult to unwind, some banks should increase the levels of their liquidity buffers, lengthen funding tenors and diversify funding instruments and counterparties.

Austrian Banks Show Higher Resilience in Their Funding

A low-interest environment fosters a deposit shift in Austria. Domestic deposit rates are well below the euro area average. As to deposit rates for new business in Europe (chart 19), strong heterogeneity in early 2013 indicates that banks in euro area periphery countries have to offer far higher interest rates to acquire new business than, for example, Austrian banks, which were able to reduce their funding costs. At the same time, expectations of persistently low interest rates reduced the momentum of deposit growth in Austria in 2012. While growth in 2011 was nearly 5%, the figure went down to some 1.6% in 2012, and this downward trend continued in early 2013. At end-2012, Austrian banks held EUR 354 billion in customer deposits, of which approximately 16% came from foreign depositors – mostly from Germany.

Moreover, a shift in deposits became evident. While demand deposits were still growing strongly in terms of volume, savings deposits and term deposits stagnated or declined.

The customer funding gap at Austrian banks' subsidiaries in CESEE was closed on aggregate as loans stagnated and deposits continued to grow strongly.

In 2012, deposits at Austrian subsidiaries in CESEE increased by 6.2% to EUR 172.1 billion. Deposit growth was driven by subsidiaries in Poland⁶, the Czech Republic and also Hungary. On aggregate, all CESEE subsidiaries were able to close their funding gap for the first time since 2006 (chart 20). The increase in local customer deposits and the associated improvement in the loan-to-deposit ratio of Austrian banks' CESEE subsidiaries (which shrank to 99.4% by December 2012) are favorable developments from a supervisory perspective and correspond with the objective of strengthening the local stable funding base as laid down in the sustainability package developed by the

Customer funding gap closed

Chart 20

Customer Funding Gaps at CESEE Subsidiaries of Austrian Banks



Source: OeNB.

⁶ Deposit growth in Poland was, inter alia, attributable to the acquisition of a Polish subsidiary.

OeNB and the FMA. Subsidiaries that continue to show imbalances in this area should therefore actively seek to

improve their local funding. In the first quarter of 2013, deposit growth somewhat lost momentum.

Box 3

Findings of the Monitoring Exercise with Regard to the Sustainability Package

The sustainability package¹ (released in March 2012) stipulates that the stock and flow loan-to-local stable funding ratios (LLSFRs) at the subsidiaries of Austria's three largest banks² and the risk-adequate pricing of intragroup liquidity transfers to subsidiaries be monitored. These measures are based on the Austrian supervisors' experience that banking subsidiaries that entered the recent financial crisis with high (i.e. above 110% stock) LLSFRs were significantly more likely to exhibit higher loan loss provisioning rates than other banking subsidiaries that had been following a more conservative and balanced business and growth model. Therefore, banking subsidiaries with stock LLSFRs of above 110% are considered to be "exposed," and starting with data from end-2011, the sustainability of their new business has been monitored closely. The latest available data are of end-2012, which means that first conclusions can be drawn with regard to the sustainability of the monitored subsidiaries' business models over the year 2012.

At end-2012, most monitored subsidiaries (28 out of 39) were not considered to be exposed, since their stock LLSFRs were below 110%, and all but one subsidiary found to be above the early warning threshold exhibited welcome trends in their new business. These findings are updated quarterly and shared and discussed with the banks concerned and their host and home supervisors. Besides these results, the sustainability monitoring also focuses on intragroup liquidity transfer volumes and the fund transfer pricing (FTP) models applied to them. Analyzing these data is an ongoing supervisory task and helps assess the adequacy of banks' internal risk and pricing models.

¹ FMA and OeNB. 2012. Supervisory guidance on the strengthening of the sustainability of the business models of large internationally active Austrian banks.

² Erste Group Bank, Raiffeisen Zentralbank and UniCredit Bank Austria.

Slight Credit Growth in Austria, Increased Local Funding in CESEE

Loan growth in Austria is leveling off, but there are no signs of a credit crunch. Housing and home improvement loans are outpacing the general trend. Credit growth in Austria weakened as the year 2012 progressed. This trend also continued in early 2013. However, a credit crunch did not materialize. The decline in loan growth rates was mainly driven by a decline in demand as corporations, for example, are well capitalized and are holding back on investments. By March 2013, the volume of loans to domestic nonbanks amounted to EUR 329 billion, up 0.2% against the previous year.

Loans for housing and home improvements continued to outpace the general development by increasing by 4.9% in 2012. In contrast, foreign currency loans dwindled.

The supervisory measures targeting foreign currency loans (FCLs) and repayment vehicle (RPV) loans to households in Austria continued to be successful. Supervisory efforts, stepped up since October 2008, have proved effective. The outstanding amounts of FCLs to households have declined steadily. The total FCL volume amounted to EUR 31 billion in March 2013, down by 37% or EUR 15 billion against October 2008 on a foreign currency-adjusted basis⁷;

Share of foreign currency loans in total loans decreasing rapidly

⁷ Not adjusted for foreign exchange effects, the volume of outstanding foreign currency loans decreased by just EUR 8 billion or 21% as a consequence of the strong appreciation of the Swiss franc.

FCLs accounted for a share of 23% in total loans to households. The decline of FCLs was compensated for by developments in euro-denominated loans. The total amount of FCLs to domestic nonbank borrowers added up to EUR 46 billion in March 2013, equaling 14% of total loans.

New lending standards for FCLs address ESRB recommendations and Austrian supervisory experience. At the beginning of 2013, the FMA issued new “Minimum Standards for the Risk Management and Granting of Foreign Currency Loans and Loans with Repayment Vehicles,” integrating the 2003 Minimum Standards and the 2010 Extension of the Minimum Standards and reflecting the ESRB’s 2011 recommendations on foreign currency lending as well as the additional experience Austrian supervisory authorities had gathered over the past years. The new FMA Minimum Standards target both domestic and foreign exposures and introduce the principle of reciprocity, which means that rules targeting foreign currency lending abroad have to be adhered to not only by Austrian banks’ subsidiaries in CESEE but also in Austrian banks’ cross-border activities as such.

The legacy of past exuberances will remain a challenge for financial stability in Austria for the coming years. While domestic FCLs declined rapidly over the past years, the legacy of the boom observed in the last decade will continue to be a challenge. This is most importantly due to the fact that the majority of FCLs are designed as bullet loans with an RPV as repayment instrument. This exposes such loans not only to foreign exchange risks but also to asset price risks. As per 2012, 73% of outstanding FCLs to Austrian households were RPV loans. Another 7% were bullet loans without an attached RPV. Accordingly, FCLs had a longer term to

maturity than euro-denominated loans: 84% of FCLs to households had a maturity of more than five years, while this was the case for only 51% of euro-denominated loans.

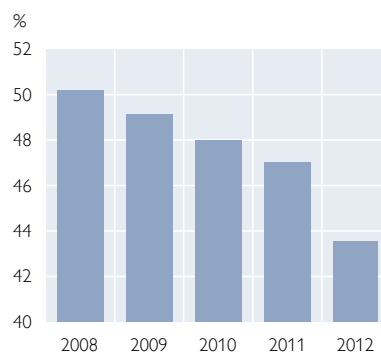
The overall credit volume of Austrian banks’ CESEE subsidiaries has remained rather stable throughout the past year. The 66 fully consolidated CESEE subsidiaries of Austrian banks reported EUR 276 billion of total assets as at end-2012, which corresponds to an annual decrease of 0.5%. The drop is mainly due to the sale of subsidiaries in Kazakhstan and Kyrgyzstan. The loan volume remained essentially unchanged year on year, totaling EUR 171 billion (–0.1%). The total volume of direct cross-border lending of all Austrian banks to CESEE decreased slightly by 0.5% over the same period and amounted to EUR 51 billion in December 2012.

Significant decrease in foreign currency-denominated loans in direct and cross-border lending in CESEE. The total loan volume of the CESEE subsidiaries of the Austrian top 6 credit institutions increased by 1.6% year on year at end-2012. At the same time, loans denominated in foreign currency decreased by 5.8% to EUR 79 billion (taking

Austrian banks’
CESEE subsidiaries
report currently flat
loan growth

Chart 21

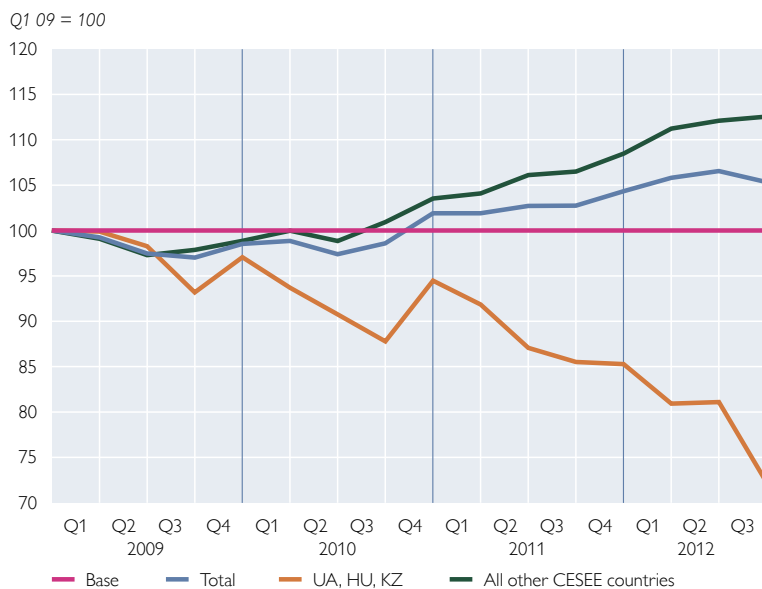
Share of Foreign Currency Loans at Austrian Subsidiaries in CESEE



Source: OeNB.

Chart 22

Development of Austrian Banks' CESEE Exposures, 2009–2012¹



Sustained commitment of Austrian banks to CESEE

exchange rate effects into account). Thus, the aggregated share of foreign currency loans in the overall loan portfolio of said CESEE subsidiaries decreased to 43.6% in December 2012. The euro is still the most important foreign currency in their loan portfolios, accounting for more than half of all FCLs, while Swiss franc- and U.S. dollar-denominated loans decreased to 18.1%. The U.S. dollar continues to play a significant role especially in the CIS region, where it takes up a share of approximately 90% of all foreign currency loans. The total volume of direct cross-border foreign currency loans granted by Austrian banks to borrowers in the CESEE region further decreased by 2.1% to EUR 37.7 billion in December 2012.

Austrian banks reduced their leasing portfolio in CESEE in total, but foreign currency leasing increased owing to one-off effects. The overall volume of leasing to households and nonfinancial corporations by the top 6 Austrian banks in CESEE decreased by 2.4% year on year, to EUR 12.7 billion, the vast majority of which was contracted with nonfinancial corporations. Foreign currency-denominated leasing contracts recorded an increase mainly in the first half of 2012 as the portfolio of a major Austrian bank was restructured. Their total volume came to EUR 5.4 billion in December 2012.

In 2012, Austrian banks took further steps to restructure their balance sheets, but concerns about widespread deleveraging – most prominently with regard to the CESEE region – were not confirmed. The figures presented in the sections above show that Austrian banks' subsidiaries in CESEE continued to support growth while safeguarding against rising local vulnerabilities. Austrian banking groups⁸ remained committed to the CESEE region, and Austrian banks' business models are consistent with the spirit of the Vienna Initiative 2. Going forward, the OeNB continues to support the objectives and principles of the Vienna Initiative 2 and commends an ongoing dialogue, taking into account both home and host country perspectives.

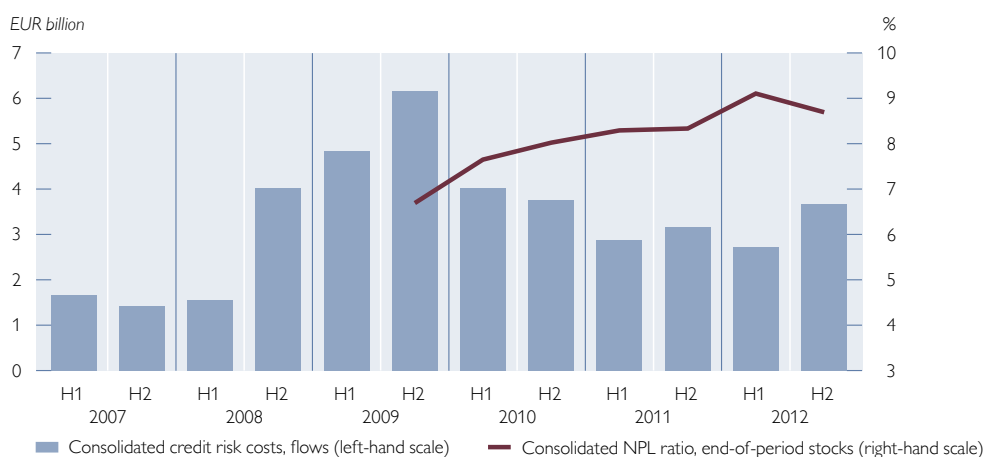
Since the height of the CESEE market turmoil in early 2009, Austrian banks' exposure to the region has increased. When taking exchange rate effects into account, the increase amounted to approximately 5%.⁹ However, this development is not uniform across the countries in which Austrian banks have

⁸ All banks with an Austrian banking license, irrespective of whether they are majority Austrian- or foreign-owned, including their respective CESEE subsidiaries.

⁹ Reported exposure is distorted by movements in exchange rate effects. Even if real loan volumes were constant, figures reported in euro would grow or shrink as exchange rates fluctuate. In order to monitor the development of exposures, such effects need to be neutralized, as shown in chart 22.

Chart 23

Consolidated Credit Risk Costs and NPL Ratios of Austrian Banks



Source: OeNB.

substantial exposures, as chart 22 illustrates.

While total exposure is on a long-term upward trend, it went down in late 2012, which was mainly attributable to the sale of subsidiaries in Kazakhstan and Kyrgyzstan. This also explains the sharp decline in Austrian banks' exposure to the country aggregate of Ukraine, Kazakhstan and Hungary. In total, Austrian banks' exposure shrank by approximately 28% in countries with a difficult economic (policy) and/or regulatory environment. Exposure reductions in those countries were more than offset by an aggregate increase of exposure by 13% in other CESEE countries¹⁰.

Deterioration of Credit Quality in CESEE Slowed Down

The asset quality of Austrian banks remains an issue of concern. While credit quality remained fairly benign in the domestic

market, it continued to deteriorate at Austrian banks' CESEE subsidiaries. On a consolidated basis, net provisioning by Austrian banks increased during 2012 by around EUR 400 million against the preceding year. This development was mainly driven by banks that had already experienced problems in the past but to a certain extent also by some medium-sized Austrian banks. The decline in the share of nonperforming loans (NPLs) to total loans observed in late 2012 was triggered by the above-mentioned sale of subsidiaries. Overall, however, the share of NPLs in total loans increased to 8.7% year on year by end-2012.

The credit quality of foreign currency loans in CESEE continued to be lower than that of local currency loans. According to an OeNB survey¹¹, the overall NPL ratio of Austrian banks' CESEE subsidiaries decreased slightly from 15.8% in June 2012, to 14.7% in December 2012,

Sustained high level of nonperforming loans in CESEE

¹⁰ Of the countries in which Austrian banks record a substantial exposure, reductions in reported (i.e. unadjusted) exposure were largest in Kazakhstan (–94% since Q1 09 due to the sale of operations), Ukraine (–25%) and Hungary (–16%), reflecting economic difficulties as well as elevated levels of political risk. Exposures to other countries, by contrast, grew substantially, with Poland (+47%), the Czech Republic (+29%), Slovakia (+16%) and Russia (+24% since Q1 09) featuring most prominently.

¹¹ The survey is conducted semiannually and includes the top 6 Austrian banking groups.

Stable provisioning
in banks' domestic
business

while the NPL ratio of foreign currency loans decreased from 19.7% to 19.0% over the same period. The decline, however, can again be attributed to the sale of subsidiaries in Kazakhstan and Kyrgyzstan. Moreover, country-specific differences remained high, reflecting the heterogeneous economic development of the CESEE region as well as different definitions of nonperforming loans. The NPL ratio remained below 10% and even decreased in some of the most important host countries of Austrian banks (e.g. the Czech Republic, Russia and Slovakia), while it reached levels close to or above 20% in many southern European countries (e.g. Bosnia and Herzegovina, Croatia, Romania and Serbia). The NPL ratio exceeded 40% in two CESEE countries where the exposure of Austrian banks, however, is of rather minor importance.

Even though Austrian banks experienced an ongoing deterioration in their loan portfolios, they managed to increase their coverage ratios. The coverage of NPLs by loan loss provisions and collateral improved over the recent years, with the NPL coverage ratio I¹² increasing to 47.6% in December 2012, up from 44.3% in June 2012. Due to the high share of mortgage loans in total loans in the CESEE region, the NPL coverage ratio II¹³ was significantly higher, amounting to 67.4% in December 2012 (68.2% in June 2012). In December 2012, the coverage ratios for foreign currency loans in CESEE stood at 42.9% and 68.4%, respectively, compared to 40.4% and 68.5% in the previous period. In light of the uncertain

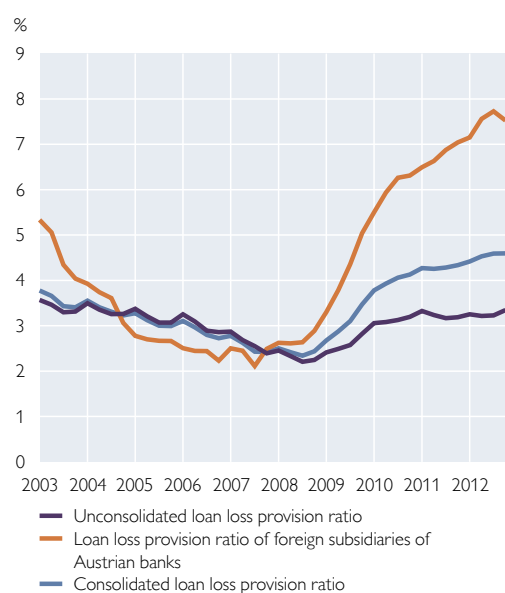
economic prospects discussed before, Austrian banks' subsidiaries are called upon to further increase coverage ratios.

Just as NPLs were reduced, the loan loss provision (LLP) ratio of Austrian banks' foreign subsidiaries declined, albeit not by the same extent. Within CESEE, the NMS-2007 posted the largest increase in the LLP ratio during the second half of 2012 (+1.7 percentage points) as well as the highest LLP ratio level (12.3% at year-end). The CIS countries experienced the opposite development: their LLP ratio dropped by 2.7 percentage points to a slightly above-average level of 7.7%.

In Austria, loan loss provision ratios were stable in 2012. In the domestic market, the LLP ratio¹⁴ increased

Chart 24

Loan Loss Provisions of Austrian Banks



Source: OeNB.

Note: All ratios refer to nonbank loans (end-of-period stocks).

¹² Coverage ratio I is defined as the ratio of loan loss provisions on NPLs to NPLs.

¹³ In addition to the loan loss provisions, coverage ratio II includes eligible collateral on NPLs according to Basel II in the numerator.

¹⁴ Stock of specific loan loss provisions for claims on nonbanks as a share of total outstanding claims on nonbanks (unconsolidated data).

slightly to 3.3% at end-2012. Despite having recorded the highest starting level so far in 2011, the Volksbanken credit cooperatives also registered the largest increase in LLP ratios of 5.4% in total. At the same time, building societies and state mortgage banks were able to reduce their respective ratios slightly. Combining domestic and foreign provisioning data yields a consolidated loan loss provision ratio for non-bank lending that stayed almost flat over the second half of 2012 (and came to 6.6% at year-end).

Asset quality assessment remains one of the most important issues for Austrian supervisors. Work toward a harmonized EU approach is welcome, as it fosters comparability. In the wake of the financial crisis triggered by the default of Lehman Brothers, international regulatory bodies have focused their interest on asset quality assessment in general and on loan forbearance in particular. Austrian authorities contribute to this work at the European level. A crucial element of these efforts will be to assess whether banks have been overly lenient with respect to doubtful loans by classifying them as renegotiated or restructured instead of nonperforming, thus understating the need for risk provisioning. Overall, there are still inconsistencies and uncertainties, especially with respect to the definition of NPLs across various countries as well as to the valuation of collateral. The OeNB therefore supports the EBA recommendation to national supervisory authorities to conduct asset quality reviews¹⁵ and related work on the introduction of the SSM.

Rebound in Profitability of Austrian Banks

Risk costs continue to weigh on the profitability of the Austrian banking system. Uncertainties about the sustainability of public indebtedness in some euro area countries, regulatory developments at the EU level, low interest rates, blurred economic growth prospects as well as the implementation of different economic policy measures in individual CESEE countries affected the profitability of Austrian banks.

Austrian banks' profitability rose in 2012, mainly on account of one-off effects and banks' activities in CESEE. The consolidated profitability of Austrian banks increased in 2012. Net profits after taxes rebounded to EUR 3 billion, which is more than three times higher than in 2011. The return on assets (RoA) was 0.2 percentage points higher and amounted to 0.3% (chart 25). However, the 2012 results should be interpreted with caution, as they were driven by hybrid capital repurchases and similar one-off measures. Without taking into account these extraordinary effects, the RoA would have stood at 0.2% – still an improvement, albeit less significant.

Austrian banks' operating results were rather weak in 2012, and risk costs constitute a burden on net profits. Banks' net interest income, which has traditionally accounted for more than half of total operating income, as well as income on fees and commissions decreased by 5.7% and 4.3% year on year, respectively. By contrast, trading income and other operating income grew relatively strongly. Provisions for covering credit risk in Austrian banks' loan portfolios

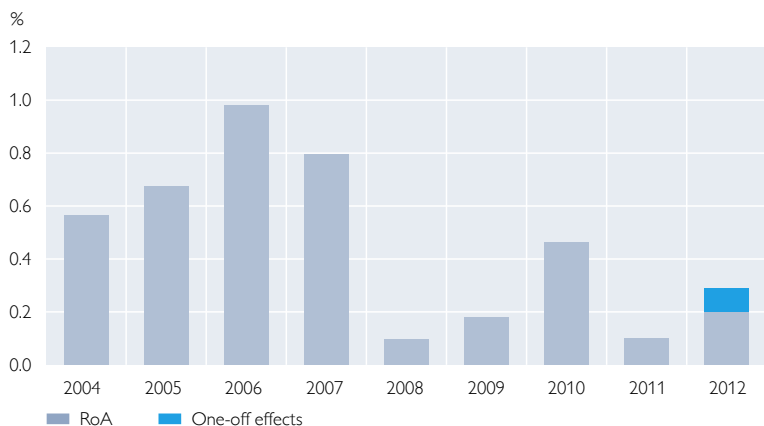
Forbearance risks and asset quality need to be monitored closely

Weak operating results outweighed by repurchases in hybrid capital instruments

¹⁵ See EBA press release dated May 16, 2013.

Chart 25

Consolidated Return on Assets of Austrian Banks



Source: OeNB.

More profitable
CESEE subsidiaries
tend to have lower
LLP ratios

increased by 6.0% in 2012 and depressed results by EUR 6.4 billion. These provisions still remain a substantial factor that drags on banks' overall profitability, although they tend to be lower than in previous years.

Austrian banks' subsidiaries in CESEE contributed substantially to the consolidated profitability of the Austrian banking sector. Their respective contributions were increasingly heterogeneous across countries,

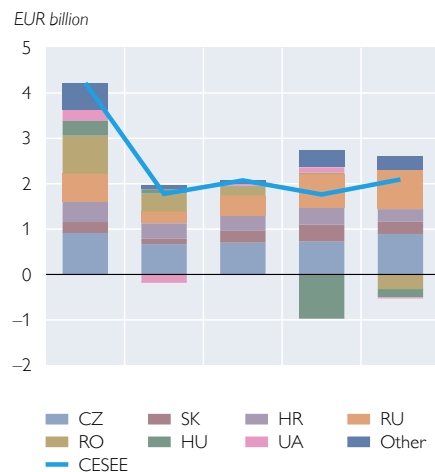
however. Net profit after taxes increased by nearly 19% to EUR 2.1 billion. Compared to 2011, the average RoA of Austrian banks' subsidiaries in CESEE increased to 0.8%. However, their higher profitability needs to be interpreted with some caution, as banks' business in CESEE is generally associated with higher risks, which imply higher expected returns for banks' operations. Moreover, developments have become increasingly heterogeneous across countries – a fact that is mirrored in the performance of Austrian banks' CESEE subsidiaries (chart 26).

While operations remained profitable in the Czech Republic, Slovakia or Russia over the past couple of years, banks' profitability in other CESEE countries (e.g. Hungary or Romania) decreased or even turned negative. The key drivers behind this development were mainly the deterioration in credit quality but also reduced net interest income and policy measures in certain CESEE countries. While the diversification effect across the region has paid off for the top 3 Austrian banks so far, any unexpected problems e.g. in the Czech Republic or Russia would expose Austrian banks to substantial pressure on their consolidated profitability.

Profitability on Austrian business remains low. As a first line of defense, banks should seek further cost-cutting measures and look at ways to achieve higher margins as their margins are currently among the lowest in the euro area. Austrian banks' domestic profitability is still suffering from structural weaknesses. Operating profits slipped by nearly 8% in 2012, driven by weaker net interest income and stagnating income from fees and commissions. At the same time, operating expenses climbed by more than 4%. Due to lower provisioning, net profits went up to EUR 3.2 billion, resulting in an unconsolidated RoA of

Chart 26

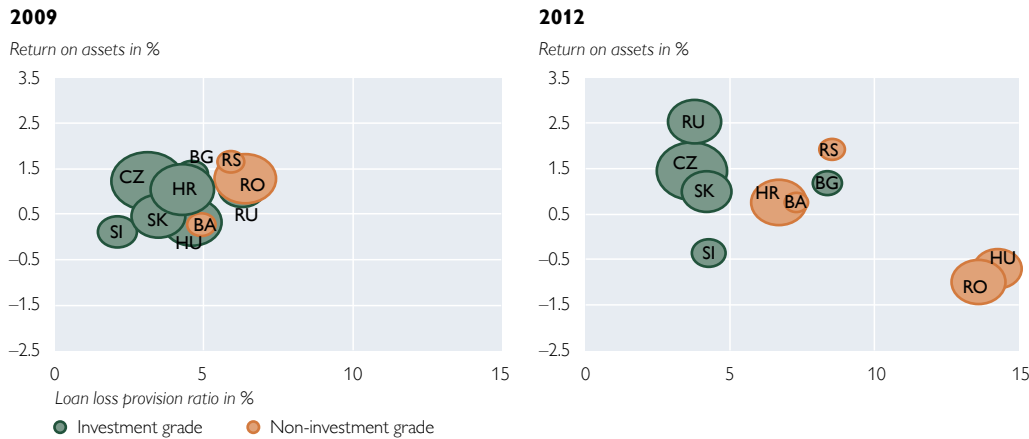
Net Profit of Austrian Subsidiaries in CESEE



Source: OeNB.

Chart 27

Profitability and Loan Loss Provisions of Austrian Banks' CESEE Subsidiaries



Source: OeNB, S&P.

Note: The size of the data points reflects the total exposure of Austrian banks to the respective country.

0.3%. As revenue-side measures are limited in the current environment, Austrian banks should seek to reduce costs in order to increase profitability. Higher profitability is of utmost importance not least for internal capital generation, as particularly the largest Austrian banks still lag behind their peers in terms of capital position.¹⁶

Stress Tests Highlight the Downsides of the Challenging Environment

The heterogeneous results of recent OeNB stress tests persist in an exercise conducted for the Financial Sector Assessment Program in line with international best practice.¹⁷ The most extensive stress testing exercise in years yielded similar results as previous risk assessments. Aggregate figures – mainly driven by improving risk-bearing capacity, particularly at the first-tier banks – continue to improve, while known problem banks and a number of smaller institutions struggle under scenarios based on severe assumptions.

While the next Financial Stability Report will specifically cover the depth of the stress test, the focus in this issue remains on the baseline scenario and the most severe scenario of the macroeconomic stress test. As usual, the baseline scenario draws on the current macroeconomic outlook. The current adverse scenario, however, was broadly based on statistical criteria common in recent European FSAPs. Despite substantial progress in solving the European debt crisis, this scenario assumes major drawbacks paired with a sudden drop in confidence in the U.S.A. due to protracted fiscal problems, which hurts both consumption and investment globally. Contrary to other recent OeNB stress tests, both the baseline and the adverse scenario are based on a three-year horizon; in the adverse scenario growth resumes during the third year. While this leads to greater cumulated GDP growth (but also higher cumulated credit risk losses for banks) under both scenarios, shocks to GDP under

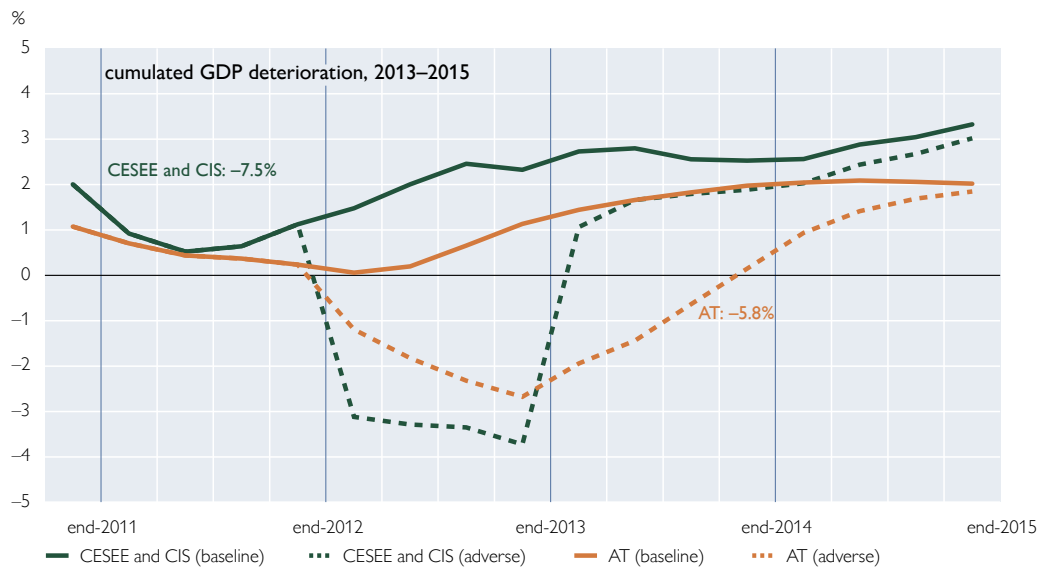
Current stress tests conducted jointly with the IMF

¹⁶ See chart 17 for a comparison with international peer groups and section “Rating Agencies Believe in Further Capital Increases” for an assessment of rating agencies.

¹⁷ See box 1 for further details on the IMF FSAP 2013.

Chart 28

GDP Growth under the Baseline and the Adverse Scenario, 2013–2015



the current adverse scenario are comparable to the adverse scenario published last year (see chart 28).

Until the introduction of Basel III via the CRR/CRD IV¹⁸, the core tier 1 (CT1) ratio, which was also used in the EU-wide stress test, remains the risk-bearing capacity measure of choice. Chart 29 shows that in the current OeNB stress test, the aggregate Austrian banking system started into 2013 with a CT1 ratio of 10.6% (whereas the starting point for the spring 2012 stress test was 9.9%) and, in the baseline scenario, managed to improve this ratio to 11.7% by end-2015 (10.5% according to the spring 2012 stress test, which had a two-year horizon). In the adverse scenario, the CT1 ratio went down to 8.9% (8.5%) by end-2015. This rather benign aggregate outcome masks the

significant dispersion of results the OeNB observes among the approximately 600 consolidated Austrian banks. Besides the known problem banks, banks with low initial capitalization ratios and low historical profitability perform poorly. In light of the continued struggle to generate operating income¹⁹, this phenomenon increased compared with previous years.

The top 3 banks²⁰ CT1 also stood at 10.5% at end-2012. Under the baseline scenario, they outperform the banking system as a whole by improving to an aggregate CT1 ratio of 13.2% at end-2015, which reflects mainly the higher earnings potential of their cross-border portfolios and the reduced risk weighting under the IRB approach. At the same time, the riskiness of these profitable portfolios hits the top 3 under

Top 3 results reflect higher earnings potential as well as higher risk

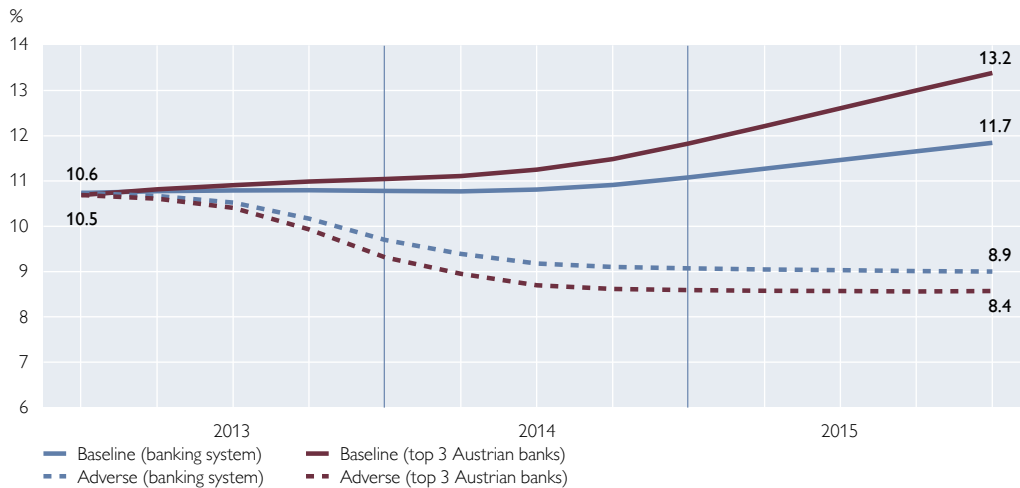
¹⁸ See box 2 for further details on the new Capital Requirements Regulation/Directive.

¹⁹ See section “Rebound in Profitability of Austrian Banks” for an analysis of recent developments of operating income.

²⁰ UniCredit Bank Austria, Erste Bank Group, and Raiffeisen Zentralbank. The OeNB switched from the top 5 aggregate in 2012 to the top 3 to reflect the difference in risk – in particular with regard to the CESEE and CIS portfolios – of Austria’s largest banks.

Chart 29

EBA Core Tier 1 Ratio under the Baseline and the Adverse Scenario, 2013–2015



Source: OeNB.

the adverse scenario, reducing their CT1 ratio to 8.4%. On the one hand, this result shows material improvements over previous years, not least because of the higher capital ratios that serve as the starting point for the stress test. On the other hand, the top 3 banks operate in testing markets in testing times with significant downside risks beyond the scope of the macro-economic stress test. Given that international peers with similar portfolios hold more capital and move more swiftly to improve their risk-bearing capacity,²¹ the top 3 will need to continue to improve their capital position as well.

Overall, the stress test results calculated by the OeNB as part of the FSAP reflect the current juncture at which the Austrian banking system finds itself. Headline figures improve in line with international trends, but pockets of vulnerabilities in individual institutions as well as significant downside risks for the aggregate system persist. Amid the challenging European

economic environment and the associated risks, Austrian banks should respond to the outside pressure emanating from regulators, supervisors, investors and rating agencies alike to improve their risk-bearing capacity.

Rating Agencies Believe in Further Capital Increases

Given the positive financial market conditions, the prices of listed Austrian financial institutions went up further. The price-to-book ratios of quoted Austrian banks continued to be subdued but still exceeded those of their European peers. Market surveillance points to the fragile operating environment for Austrian banks in Austria and in CESEE, although the CESEE economies are expected to grow at a faster pace than the economies in western Europe. The profitability outlook for Austrian banks is deemed subdued as a result of low domestic (interest) margins and the expectation that loan loss provisions will remain elevated in CESEE for some time to come.

²¹ See section “Capital Ratios Continued to Increase in 2012” for details on recent European trends in banks’ capitalization.

The below-average capitalization of internationally active Austrian banks is seen as one of their key weaknesses although improvements in capitalization have been noted since 2007. Higher capitalization of Austrian banks is warranted as banks' ratings benefit from high government support. Therefore, current market surveillance still comes to a positive market assessment and finds evidence for the need and the opportunity to strengthen capitalization. If the market environment is indeed favorable, banks should – in the OeNB's view – make the necessary moves and step up their capitalization.

ESRB Recommendations Gain Importance as Macroprudential Policy Tools

The European Systemic Risk Board (ESRB) has so far issued six recommendations on financial stability issues. These recommendations and the underlying analyses are important in fostering a common understanding of major risks in EU financial markets and appropriate means to tackle

them. The ESRB recommendations are governed by an “act or explain” mechanism, i.e. addressees (either national supervisors, governments of EU Member States, the European Commission and the European System of Financial Supervision) are required to either implement the recommendations or give an adequate justification in case of inaction. Four recommendations addressing systemic risks have been issued so far: Recommendations on foreign currency lending, U.S. dollar-denominated funding, money market funds and the funding of banks. The first two recommendations were due to be implemented in 2012, the last two will have to be implemented in the course of 2014 and 2015.

Besides addressing systemic risks, the ESRB also aimed to improve the macroprudential oversight framework in the EU by issuing a recommendation on the macroprudential mandate of national authorities in 2011 and a recommendation on intermediate objectives and instruments of macroprudential policy in 2013.

Box 4

Macroprudential Tools – An Overview

Enhancing the framework for supervision at the macro level, including macroprudential tools, remained at the top of the European supervisory agenda in 2012. The purpose of macroprudential supervision is to address risks that result from the interplay between different forces in financial markets (systemic risks) in contrast to risks at individual financial institutions.

Macroprudential tools were an important issue in the negotiations about the new banking legislation at the European level (Capital Requirements Directive IV, CRD IV, and Capital Requirements Regulation, CRR). The new framework for banking supervision will provide competent national authorities across the EU with adequate instruments to mitigate risks to financial stability. The macroprudential toolkit comprises e.g. countercyclical capital buffers, a systemic risk buffer, sector-specific capital requirements, an additional capital buffer for systemically important financial institutions, enhanced disclosure requirements but also instruments to limit concentration risk and the application of higher sectorial risk weights for certain assets.

The European Systemic Risk Board (ESRB) has contributed to these effects by taking a broader perspective that goes beyond the banking sector. Its recent recommendation on macroprudential instruments includes not only tools addressed to the banking sector such as loan-to-value ratios, leverage ratios, and loan-to-deposit ratios but also tools applicable to other financial market segments, e.g. minimum requirements for asset-backed securities transactions. Given banks' eminent role in the EU financial market, the banking sector remains the main focus of these tools.

Challenging Environment for Insurers and Pension Funds

Performance of Austrian Financial Intermediaries Received a Noticeable Boost

Better market conditions in the second half of 2012 and at the beginning of 2013 substantially improved the performance of Austrian mutual and pension funds as well as insurance companies. Positive returns were partly generated by the appreciation of selected government bonds resulting from declining risk premiums. However, risks remain regarding the performance of Austrian mutual and pension funds in light of a potential resurgence of the sovereign debt crisis and, more generally, with regard to the uncertainty prevailing in financial markets and an expected prolonged period of low interest rates.

Especially traditional life insurers' products with long-term guaranteed interest rates are challenged by the low-yield environment, particularly through low interest rates at the long end of the yield curve. Even though the negative effects materialize rather slowly, given that only new premiums and expired investments are invested at current market interest rates, insurers need to adjust to the changed environment and reconsider their investment strategies. However, financial intermediaries should be careful not to revive the overly aggressive search for yield strategies that lead to riskier investments, which, in turn, might backfire in the future.

Both the insurance industry and supervisors are reacting to the challenges of a low-interest-rate environment. The European Insurance and Occupational Pensions Authority (EIOPA) had already included a potential low-interest-rate environment ("low-yield satellite scenario") in its 2011 insurance stress test.

The FMA cut the minimum guaranteed rate for classical life insurers

from 2.25% to 2% in April 2011 and to 1.75% in December 2013 (valid only for new contracts) and conducted further analyses with respect to the stress resilience of Austrian life insurers. The average guaranteed interest rate of Austrian life insurers' investment stock actually comes to slightly below 3% and is decreasing. The return on investment of Austrian life insurance business was stable at around 4% during 2012 and still decidedly covers the aggregate guaranteed interest rate. In addition to the potential problems resulting from low interest rates, the life insurance business faces a continuous decrease in premium income, which has now lasted for eight consecutive quarters. Lower guaranteed interest rates, changes in taxation and expensive lapse conditions have discouraged new business.

Property and casualty insurers as well as health insurers were less affected by the weaker environment, and premium growth remained stable. Both nonlife segments could increase their premium income in 2012 (property and casualty insurers: +2.7%; health insurers: +3.4%). The combined ratio for property and casualty insurance was about 93% and increased slightly by 2 percentage points year on year due to an increase in the loss ratio. The underwriting results remained at a low level owing to high competition especially in the motor vehicle insurance sector.

A further challenge for the insurance sector is preparing for Solvency II. An interim regime, which should include parts of Solvency II – systems of governance, a forward-looking assessment of undertakings' own risk, submission of information and pre-application for internal models – is discussed at the EU level. In the first months of 2013, with participation of Austrian insurers, EIOPA ran a "long-term guarantees assessment,"

Environment of sustained low interest rates as a challenge for insurance companies

which will help answer some open questions regarding in particular the valuation of insurers' liabilities under Solvency II.

Pension funds in Austria continued to grow (to EUR 16.3 billion, up 10% year on year) and generated year-on-year returns of 8.4% in the fourth quarter of 2012. It should be noted, though, that this good performance was largely driven by their investment in bonds (52% of total assets, of which approximately 50% were invested in government bonds). This positive performance was partly due to the declining interest rates for Austrian and German government bonds. With interest rates at historical lows, the currently high returns for existing bonds may thus be followed by low returns for new issuances.

Positive
development
in mutual funds

Austrian mutual funds experienced a very positive second half of 2012 and a good start into 2013. The performance of all asset classes improved, and over-

all returns stood at 8.5% in 2012 (13.5% for equity funds, 8.4% for bond funds). Assets under management increased by 7.5% year on year to EUR 148 billion. This increase was driven both by institutional and retail funds. The trend toward investment in institutional funds continues, with about 43% of the total fund volume now belonging into this category. Institutional funds will be subject to the Alternative Investment Fund Managers Directive (AIFM Directive) as of July 2013, which will, for the first time, provide regulations applicable to fund managers in charge of institutional funds, hedge funds, real estate funds and private equity funds under a common European regulatory framework. The AIFM Directive constitutes a welcome instrument counteracting the previous lack of regulation in this area, which had played a non-negligible role in the global financial crisis.