Austrian Subsidiaries' Profitability in the Czech Republic and Slovakia – CESEE Margins with an Austrian Risk Profile

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The Czech Republic and Slovakia belong to the small and increasingly concentrated group of countries in Central, Eastern and Southeastern Europe (CESEE) whose banking markets have continued to generate substantial profits for Austrian banks also after the outbreak of the financial crisis in 2008. This short study sheds light on why Austrian subsidiaries have been able to maintain their profitability in these two countries especially when compared to those in other CESEE countries. We find that the strong quality of their asset portfolios is the main contributing factor; also, the Czech and Slovak markets now offer net interest margins well above Austrian levels, while the credit risk level is close to that in Austria. By contrast, several other CESEE markets have recorded worsening credit quality and, consequently, dwindling returns. Despite some downside risks related to the low interest rate environment, the openness of the Czech and Slovak economies and a potential intensification in competition, it seems that, from a current perspective, Czech and Slovak subsidiaries can be considered the most stable earnings generators in Austrian banks' international portfolio.

JEL classification: G21, G28, P34
Keywords: Banking sector, Austrian banks, financial stability, profitability, risks, Czech Republic, Slovakia

After the recent financial and economic crisis, it is only a few markets in Central, Eastern and Southeastern Europe (CESEE) that continue to be substantial profit generators for Austrian banks, most of all Russia as well as the Czech Republic and Slovakia, where Austrian subsidiaries posted a return on assets (RoA) of 2.9% (Russia) and 1.2% (for each the Czech Republic and Slovakia) in 2013, which compares with an RoA of 0.8% for all CESEE subsidiaries of Austrian banks. As a result, Austria's financial stability has become vulnerable to a deterioration in financial and economic conditions in these countries.[2] This special topic study explores the reasons for Austrian subsidiaries' sustained profitability in the Czech Republic and Slovakia, especially when compared to other CESEE markets.[3] Our analysis starts out with a look at the competitive and cost situation of banks in both countries to better understand the operating environment; subsequently, we turn to the sources of income and funding and carry out a peer group comparison of net interest margins before risk costs. The last facets discussed in this study are asset quality and coverage level, before we conclude with the lessons learned.

1 Competitive Environment and Cost Structures

Austrian banks were among the first Western banks entering the Czech and Slovak markets in the early 1990s. In 2013, their subsidiaries had total assets of

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[2] *Please refer to the section on CESEE profitability in this Financial Stability Report.*

[3] *For more information on Austrian banks in Russia, please refer to Wittenberger et al. (2014). Unless indicated otherwise, the presented figures for the Czech Republic (CZ) and Slovakia (SK) are figures relating to Austrian subsidiaries. The peer group is composed of Austrian subsidiaries in 14 other CESEE countries: Albania (AL), Belarus (BY), Bosnia and Herzegovina (BA), Bulgaria (BG), Croatia (HR), Hungary (HU), Montenegro (ME), the former Yugoslav Republic of Macedonia (MK), Poland (PL), Romania (RO), Russia (RU), Serbia (RS), Slovenia (SI) and Ukraine (UA).*

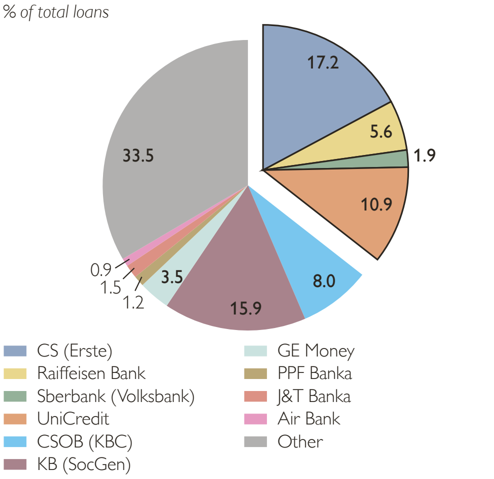
EUR 88.5 billion in these two countries. Both markets are dominated by foreign banks (see charts 1 and 2), with Austrian banks holding a share of more than one-third in the Czech Republic and close to one-half in Slovakia. For the purpose of this study, the figures of the Czech and Slovak banking sector are often aggregated, as both markets share similar characteristics and UniCredit's decision to turn its Slovak subsidiary into a branch of its Czech subsidiary at the end of 2013 disrupted the time series.

In a regional comparison, the high degree of concentration in the Czech and Slovak banking sectors is evidenced by the comparatively large shares of the top five credit institutions in their banking system's aggregate total assets (see chart 3). This can have a positive

Chart 1

Czech Republic: Bank Market Shares at End-2013

% of total loans

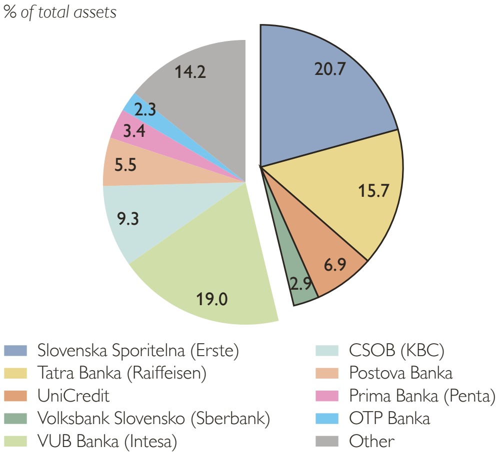


Source: RBI (2014), OeNB.

Chart 2

Slovakia: Bank Market Shares at End-2013

% of total assets



Source: RBI (2014), OeNB.

Chart 3

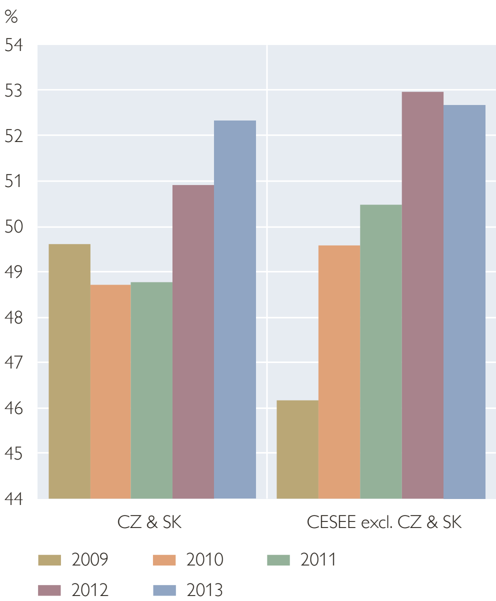
Market Concentration and Staff Levels

Source: ECB.

effect on cost efficiency via economies of scale and tame competitive pressures, but may also be a barrier for new entrants. Also, staff levels seem relatively low, as the ratio of inhabitants to employees shows. Despite these favorable structural indicators, the cost-income ratio of Czech and Slovak banks stood at 52% in 2013 and was range-bound over the last few years (48% to 52%), more or less on par with the ratio of their peers in other CESEE countries (see chart 4). Therefore, the operational cost structure of Austrian subsidiaries in the Czech Republic and Slovakia can be discarded in the search for the main determining factors of higher profitability.

Chart 4

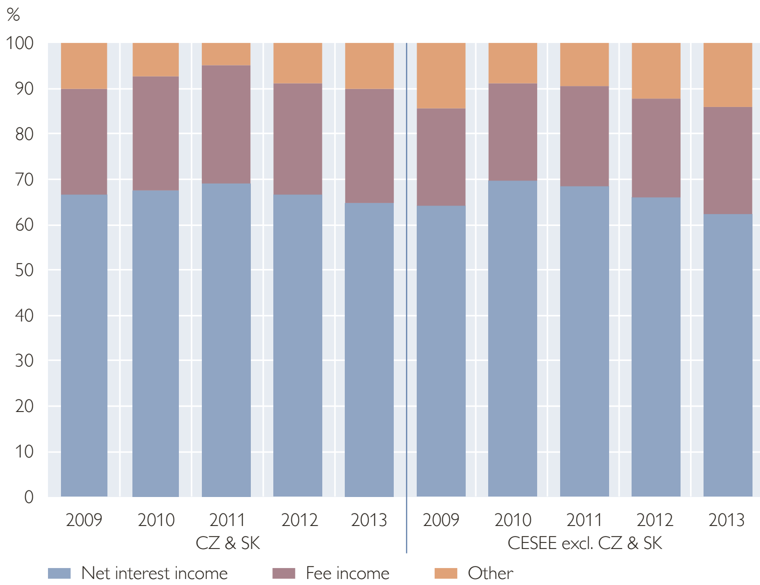
Cost-Income Ratio of Austrian Subsidiaries



Source: OeNB.

Chart 5

Breakdown of Austrian Subsidiaries' Operating Income



Source: OeNB.

2 Operating Income and the Importance of Net Interest Income

Net interest income accounted for around two-thirds of operating income of Austrian subsidiaries in the Czech Republic and Slovakia in 2013, while the share of fee income was around 25%. These two dominating sources of income remained fairly stable throughout the crisis (at around EUR 2.5 billion and EUR 1 billion, respectively) and their shares in operating income are similar at other Austrian CESEE subsidiaries (see chart 5). This is indicative of a traditional business model with deposit taking and lending at its core but cannot explain the differences in profitability compared with other CESEE countries.

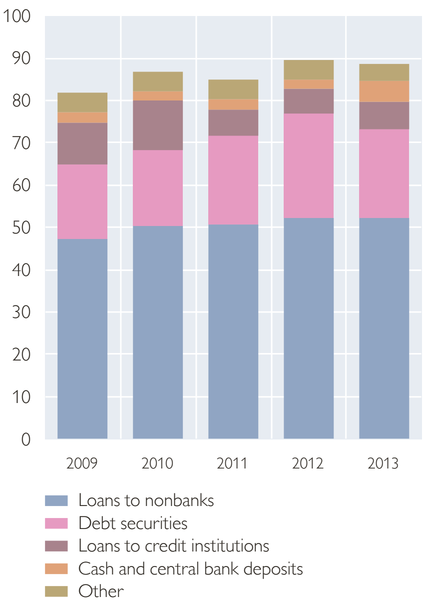
For a closer analysis of profitability, we decompose net interest income into interest-earning assets (for size and growth effects) and net interest margins earned before risk (relative profitability of these assets). Lastly, we look at the risk costs incurred (via provisioning).

2.1 Interest-Earning Assets

The growth of interest-earning assets can affect profitability in two ways: First, it raises the base on which to earn

Chart 6

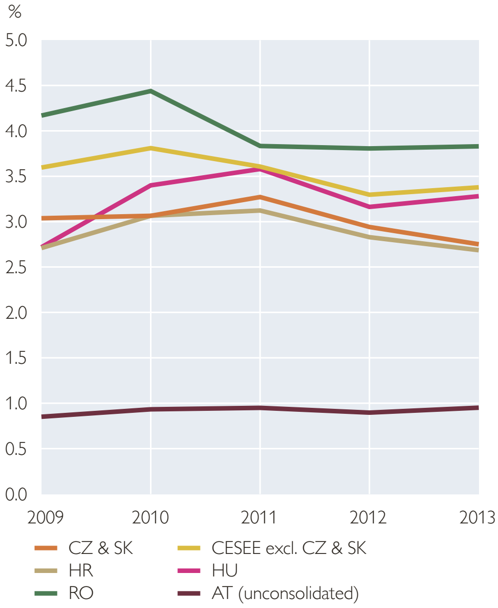
Breakdown of Assets of Austrian Subsidiaries in the Czech Republic and Slovakia



Source: OeNB.

Chart 7

Net Interest Margins of Austrian Subsidiaries



Source: OeNB.

Note: The net interest margin is calculated as net interest income over total assets.

income, and second, it may (temporarily) improve asset quality by adding new nondefaulted assets to the existing stock. Both of these effects seem to have played a minor role for Austrian subsidiaries in the Czech Republic and Slovakia. Loans to nonbanks (59%) and debt (including government) securities (24%) dominate the balance sheet; their respective compound annual growth rates were moderate at 2% and 6% between end-2008 and end-2013 (see chart 6). Also, the apparent switch from loans to credit institutions to (government) debt securities should not have affected asset quality in any substantial way, given that both categories are generally assumed to have very low default probabilities.[4]

2.2 Net Interest Margin before Risk

In order to gain a regional perspective of the net interest margin (NIM) before risk of Austrian banks' subsidiaries in the Czech Republic and Slovakia, we conduct a peer group analysis with Austrian subsidiaries in other countries (Croatia, Hungary and Romania; see chart 7). It shows that the pre-risk NIM developed heterogeneously over recent years; in the Czech Republic and Slovakia it was broadly comparable to that in Croatia, while Austrian subsidiaries in Romania and Hungary earned substantially higher pre-risk NIMs. Moreover, the pre-risk NIM for the Czech Republic and Slovakia is below the average for all other Austrian CESEE subsidiaries. Again, this factor does not explain the

[4] *Please note that growth figures for the Czech Republic and Slovakia are distorted by several effects in 2013, which include, inter alia, the forced devaluation of the Czech crown (through an intervention by the Czech central bank in November 2013). In general, it can be said that there was no credit crunch in these countries during the financial crisis, but loan growth remained moderate due to weak domestic demand and a slow economic recovery.*

relatively good profitability levels after risk in the Czech Republic and Slovakia. It does, however, provide a good explanation for the attractiveness of CESEE markets, when comparing their pre-risk NIMs to those in the domestic Austrian market.

Given its crucial importance for the Czech and Slovak banks' business model and their profitability, we analyze the NIM in more detail, with the rate paid on customer deposits and the rate earned on lending to nonbanks and the local government as the main drivers.

2.2.1 Rates Paid on Customer Deposits

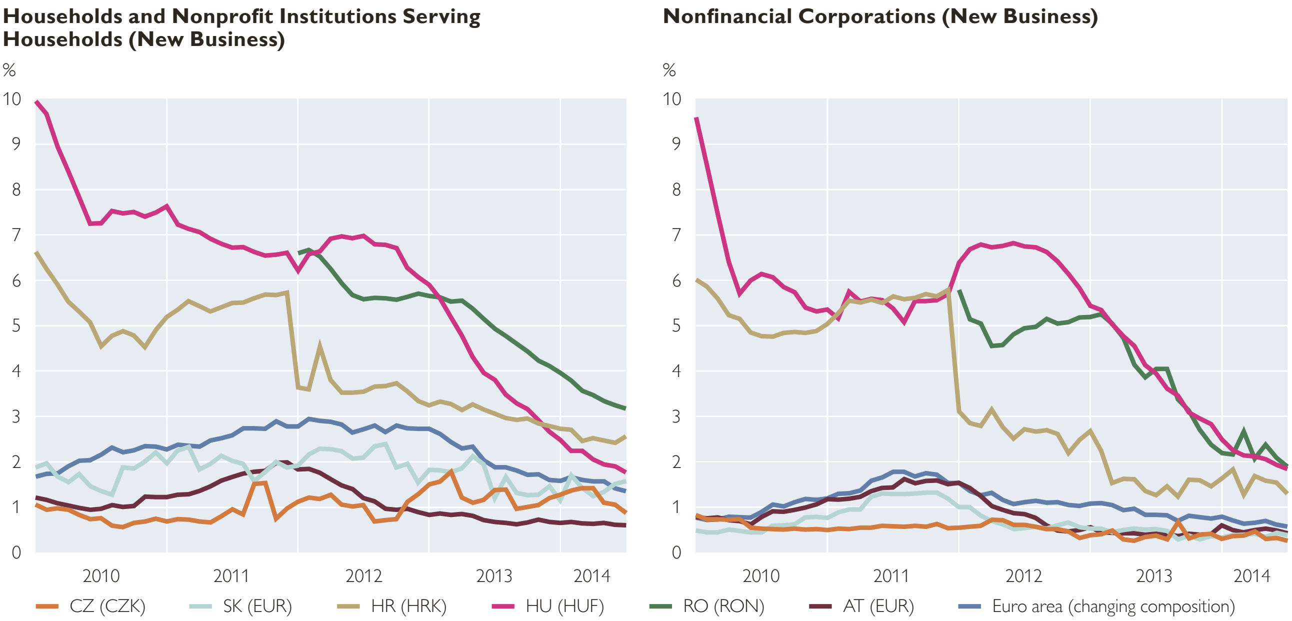
The funding base[5] of the Austrian subsidiaries in the Czech Republic and Slovakia is characterized by a high share of nonbank deposits (87% of total funding volume, compared with 70% for the rest of CESEE), while bank deposits account for only 6% of the total funding base (compared with 25% for other CESEE subsidiaries). Hence, Czech and Slovak banking subsidiaries' reliance on more volatile interbank (and often intragroup) funding is very low, while customer deposits are generally considered to be "sticky," contributing to a more stable and locally funded refinancing structure. Concerning the pricing of customer deposits, Czech and Slovak banks have offered low rates over recent years in comparison to banks in Croatia, Hungary and Romania (see chart 8), influenced by the ECB's and Česká národní banka's very accommodating monetary stance.

2.2.2 Rates Earned on Loans to Nonbanks

The portfolio of loans to the real economy of Austrian banks' Czech and

Chart 8

MFI Interest Rates on Deposits of …



Source: ECB.

Note: MFI interest rate data type: annualized agreed rate (AAR) / narrowly defined effective rate (NDER); deposits with agreed maturity of up to one year at credit and other institutions (MFI except MMFs and central banks).

[5] *This includes customer deposits, bank deposits, liabilities evidenced by paper and subordinated debt.*

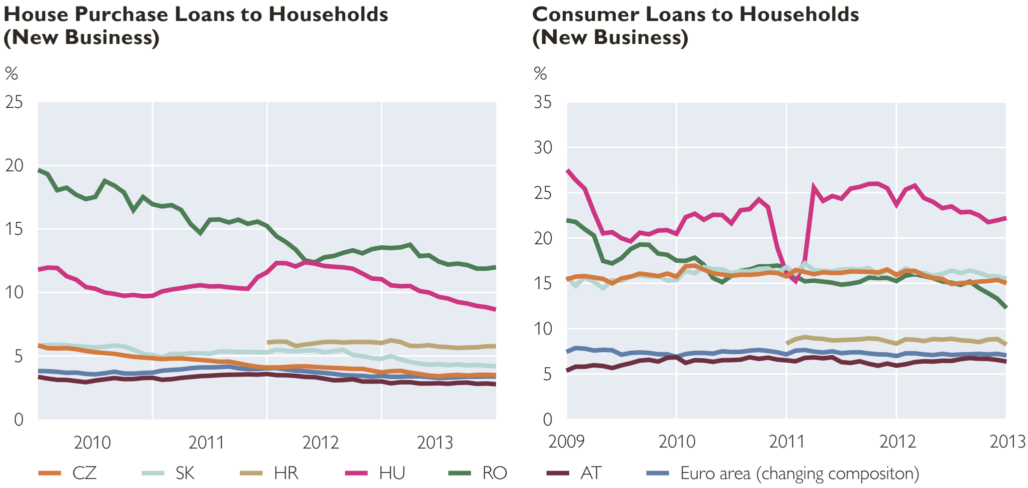
Slovak subsidiaries is evenly distributed between loans to households (49%) and corporate loans (51%), compared with the respective shares of 41% and 59% recorded for other CESEE countries. As regards lending to households, mortgage loans accounted for a share of 70%, whereas (riskier) consumer credit amounted to 27% at the end of 2013 (other CESEE countries: 58% and 38%, respectively). In 2013, total loans to nonbanks by Austrian subsidiaries in the Czech Republic and Slovakia expanded by 4% and 5%, respectively. The pace of growth differs by borrower segment, however: On the one hand, corporate loans registered weak growth of 3.1% in the Czech Republic, and the corresponding figure for Slovakia was even negative (–2.4%). On the other hand, loans to households showed a strong increase in both countries, expanding by 5.4% in the Czech Republic and even 12.6% in Slovakia. We focus on the more dynamic segment and find that Czech and Slovak banks strongly differentiate their pricing of household loans by loan purpose: While new house purchase loans display an annual rate of charge more or less in line with the (comparatively low) euro area and Austrian averages, new consumer loans in the Czech Republic and Slovakia are much more costly than in the euro area and Austria and more in line with those in Romania (see chart 9).

2.2.3 Yield Earned on (Domestic) Government Bond Holdings

As Czech and Slovak banks are characterized by large liquidity buffers, they invest heavily in domestic government bonds (see chart 10). This has ambiguous implications for profitability and financial stability. On the one hand, Czech and Slovak sovereign bonds' long-term yields are the lowest in CESEE (see chart 11), and large holdings (also in terms of the outstanding amount of such bonds[6]) may create concentration and

Chart 9

Annual Percentage Rate of Charge for...

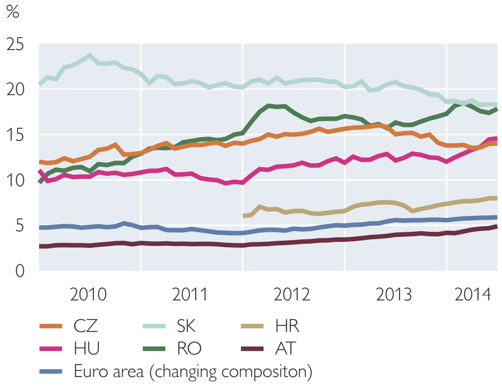


Source: ECB.

[6] *According to Národná banka Slovenska (2014a), the Czech (>40%) and Slovak (>30%) banking sector's holdings of domestic government bonds as a share of the total outstanding amount of such bonds is considerably above the euro area average (<20%). Only few EU banking sectors show larger relative holdings.*

Chart 10

Domestic Government Bonds as a Share of MFIs' Total Assets



Source: ECB, OeNB calculations.

Note: Data type: outstanding amounts at the end of period (stocks); MFIs excluding ESCB; balance sheet items: "securities other than shares" (counterpart area: domestic; counterpart sector: general government).

Chart 11

Long-Term Government Bond Yields

Source: OeNB.

liquidity risks. On the other hand, low yields also positively reflect on the stability and creditworthiness of the Czech and Slovak sovereign,[7] which favorably influences the stability of these assets and the stability of the financial sector overall.

3 The (All Important) Risk Perspective and Lessons Learned

The (falling) nonperforming loans (NPL) ratio of Austrian banks' Czech and Slovak subsidiaries remains substantially below the (still increasing) average NPL ratio of other Austrian CESEE subsidiaries (5% compared with 19% at the end of 2013; see chart 12). Also, the risks from NPLs were comparatively well provisioned for in the Czech Republic and Slovakia, given that the coverage ratio had substantially improved and remains above the CESEE average. Therefore, this strong credit quality can be seen as the most important contributor to the good profitability levels of Austrian subsidiaries in the Czech Republic and Slovakia.

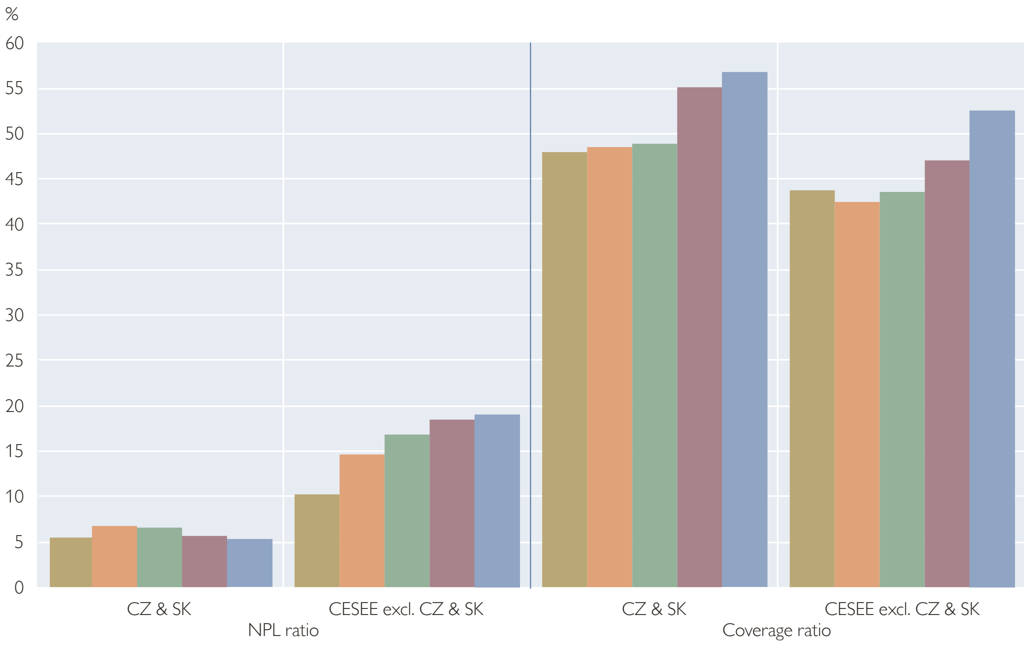
From a macroprudential perspective, this can be attributed both to exogenous and endogenous factors. Regarding the former, both countries are characterized by a stable and open economic environment that benefits from its export dependency on Germany and a rather predictable legal, political and regulatory framework. Regarding the endogenous factors – i.e. those related to banks' own business decisions – banks in the Czech Republic and in Slovakia avoided several risks in the run-up to the financial crisis that materialized in other CESEE countries:

- Although the growth of the loan exposure to nonbanks was strong – at 50% overall – from end-2006 to end-2008, it was underpinned by a parallel increase in deposits, resulting in a sustainable loan-to-deposit ratio

[7] *The Standard & Poor's long-term foreign currency rating (as of December 5, 2014) is AA– for the Czech Republic and A for Slovakia.*

Chart 12

NPL and Coverage Ratios



Source: OeNB.

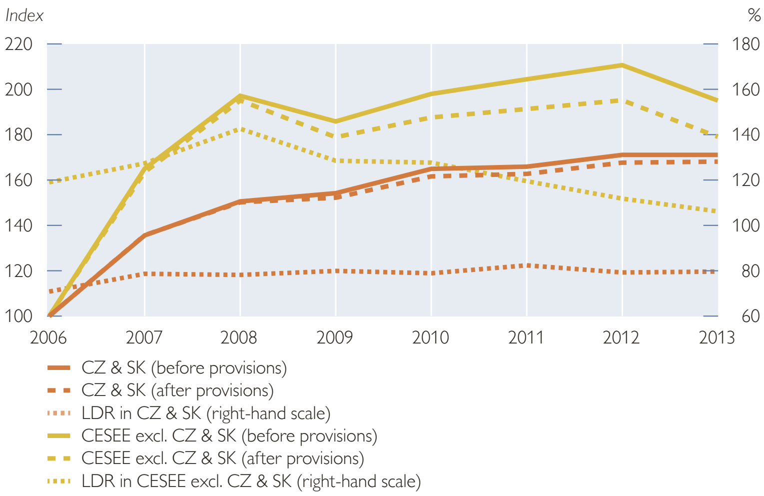
Note: Limited sample of banks.

that stayed at a healthy 80%. This strong local liquidity position also translates into a funding autonomy with very low levels of liquidity transfers from their Austrian parent banks (see charts 13 and 14). In the remaining CESEE region, Austrian subsidiaries' loan growth was much stronger, as the loan exposure nearly doubled, the loan-to-deposit ratio went up from 119% to 143% and intragroup liquidity transfers exceeded 20% of the subsidiaries' total assets. These very high precrisis growth rates in many CESEE countries often resulted in heightened provisioning levels, write-downs and (sometimes) costly market exits later on.

- Foreign currency lending is almost nonexistent in Slovakia (a member of the euro area) and to Czech households; the share of loans to corporates denominated in foreign currency was 27% in the Czech Republic at the end of 2013 (94% of which are denominated in euro). As many of these

Chart 13

Loan Exposure Growth and Loan-to-Deposit Ratios

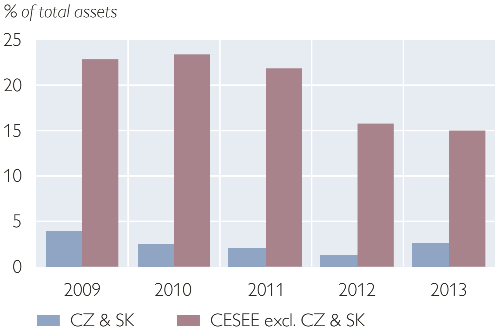


Source: OeNB.

Note: Loan exposure indexed to 100 at the start and not adjusted for bought or sold subsidiaries (i.e. changing sample composition).

Chart 14

Intragroup Liquidity Transfers to CESEE Subsidiaries



Source: OeNB.

Note: Liquidity transfers to credit institutions only and on a gross basis.

borrowers are (presumably) hedged exporters, the NPL ratio for the Czech corporate segment is very low compared to the average for other CESEE subsidiaries (4% versus 24%).

- Also, riskier consumer loans play a smaller role in the Czech and Slovak subsidiaries' loan portfolios (see also section 2.2.2).

Against the background of the discussed strengths that helped Austrian subsidiaries in the Czech Republic and Slovakia to weather the financial crisis well, it is also worth considering potential downside risks to future profitability:

- Margins: Czech and Slovak banks' net interest margins are affected by the low interest rate environment, with both Česká národní banka's two-week repo rate and the ECB's main refinancing rate at 0.05% (as of December 5, 2014). Given that deposit rates have a zero lower bound, banks' net interest margins may experience a further compression. Weak demand for higher-yielding consumer loans, a trend toward less profitable mortgages[8] and low yields on government bond holdings may exacerbate this effect and create pressures for a risky "hunt for yield." Risks in retail lending have recently been addressed in Slovakia,[9] while Česká národní banka (2014) cautioned that "the coverage of NPLs by provisions may not be sufficiently prudent from the aggregate perspective."
- Macroeconomic vulnerabilities: The Czech and Slovak economies are small, concentrated and very open, which makes their growth outlook as well as the creditworthiness and liquidity of exposed bank customers vulnerable in case cross-border spillover effects were to arise (e.g. via the trade channel).
- Market structure: The future intensity of competition in these profitable banking markets remains an open question. Given the low earnings potential international banks face in other markets, it is surprising that there is not much more competition for creditworthy Czech and Slovak customers – either from new market entrants or established banks trying to increase their market share. If competition intensified significantly, there would be increased pressure on local profitability levels.

4 Conclusions

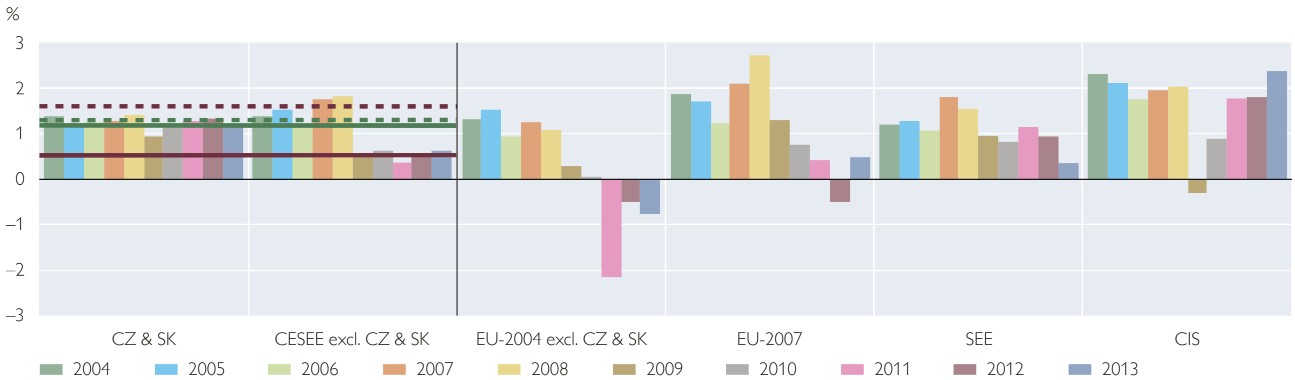
The Czech Republic and Slovakia might have seemed less promising than the rest of CESEE in terms of profitability before the crisis, but they now provide net interest margins well above Aus-

[8] *According to Moody's (2014), in the Czech Republic "[t]he growth in total loans was mostly driven by mortgage lending (up 5.2% year-on-year in 2013) [...] while consumer lending grew by a modest 0.4% during the same period."*

[9] *In October 2014, Národná banka Slovenska (2014b) published the macroprudential Recommendation No1/2014 on risks related to market developments in retail lending.*

Chart 15

Long-Term History of Returns on Average Assets in CESEE



Source: OeNB

Note: Dotted lines represent average ROAAs 2004–2008 (full lines 2009–2013), while red lines are for CESEE without the Czech Republic and Slovakia (green lines are for the Czech Republic and Slovakia). EU-2004 and EU-2007 = new EU Member States as of 2004 and 2007, respectively; SEE = Southeastern Europe; CIS = Commonwealth of Independent States.

trian levels while the credit risk is close to Austrian levels. By contrast, several other CESEE markets saw their NPL ratios rise strongly and their returns dwindle during the crisis (see chart 15). The strong asset quality of Austrian subsidiaries in the Czech Republic and Slovakia is the most obvious reason for their good profitability in the past. While there are also downside risks to the sustainability of profits, from a current perspective, it seems that Czech and Slovak subsidiaries can be considered the most stable foreign earnings generators in Austrian banks' international portfolio.

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