

# Austrian Financial Intermediaries: Regaining Profitability to Increase Resilience of Crucial Importance

## One-Off Effects Erode Austrian Banks' Profits

The continued economic recovery and further strengthening of the regulatory and supervisory framework for the banking system marked economic and financial developments in Europe in 2013. Macroeconomic uncertainties were reduced and market participants' confidence in the financial system's stability improved, resulting in a benign market environment for financial intermediation.<sup>1</sup>

Nevertheless, Austrian banks faced noticeable headwinds due to continuously low interest margins as well as one-off effects related to legacy issues, such as goodwill write-downs and large losses at Hypo Alpe-Adria-Bank International AG. These challenges are a heavy burden on the profitability of the Austrian banking system, leading to the first system-wide loss in recent history. Without taking into account one-off effects, net profits would have been positive, but still considerably below precrisis levels.

The ongoing period of weak profitability is also the result of structural cost issues in a very competitive domestic market and banks' continued need to provision for credit risks. While in Austria loan quality remained comparatively favorable in 2013, Austrian banks' subsidiaries in CESEE – although operationally still profitable – are facing considerable loan quality issues in several countries. This trend can be explained by two factors, which are both linked to the weak economic environment: The inflow of new nonper-

forming loans (NPLs) has continued, and credit demand has remained sluggish overall. To promote transparency and dispel lingering concerns about loan quality and provisioning, the ECB, in cooperation with national authorities, is currently performing a comprehensive assessment of the balance sheets of systemically significant European banks. The ECB will publish the results of this exercise in October 2014 before it takes over its supervisory role within the Single Supervisory Mechanism (SSM).

In 2013, bank funding markets continued to strengthen, with further signs of receding fragmentation in both market and deposit funding, and Austrian banks further reduced their liquidity risk exposure. Retail deposits at Austrian banks grew steadily, but the low interest rate environment kept growth rates below their long-time average. Loan growth in Austria was also sluggish: Lending in foreign currency remained low, as intended by supervisory action, but the outstanding volume of such loans (including those linked to repayment vehicles) continues to pose a risk to Austrian banks. Euro loans to domestic customers, however, increased. Both trends continued in early 2014.

In the euro area, banks continued to strengthen their capital ratios by a combination of asset deleveraging and capital increases in 2013. Austrian banks also followed this trend, but the capitalization gap between them and their international peers has widened, and there is persistent market pressure for further improvements.

<sup>1</sup> The benign market environment is also reflected in the Austrian Financial Stress Index (AFSI), see chart 20.

The operating environment remained difficult for insurance undertakings as well, with financial results reflecting a modest, but stable performance. The low-yield environment is set to remain a particular concern for a large number of insurers over the medium term.

### Consolidated Profitability of Austrian Banks Negative in 2013

The challenging environment for Austrian banks since the onset of the financial crisis characterized by weak economic growth, higher credit risk provisioning and continuously low interest rate margins has been weighing on banks' profits. Furthermore, tighter regulation and bank levies, which have been introduced as a direct consequence of the crisis, are shifting public costs back to banks, investors and creditors.

Consequently, Austrian banks recorded a consolidated return on (average) assets (RoA) of close to zero, but slightly negative at  $-0.04\%$  for 2013 (chart 14). The net loss after tax and minority interests amounted to about EUR 1 billion, compared to a profit of EUR 3 billion in 2012. This result can be attributed to several factors: On the one hand, operations were characterized by ongoing low interest margins and reduced volumes, which led to a decline in consolidated net interest income by 3.4% to EUR 18.6 billion. On the other hand, the net result was affected by write-downs of goodwill linked to subsidiaries in CESEE as well as losses at Hypo Alpe-Adria-Bank International AG. Without taking into account these negative one-off effects, the net profit would have been positive, but still below precrisis levels. Moreover, in 2012, results had benefited from positive one-off effects from buybacks of supplementary and hybrid capital.

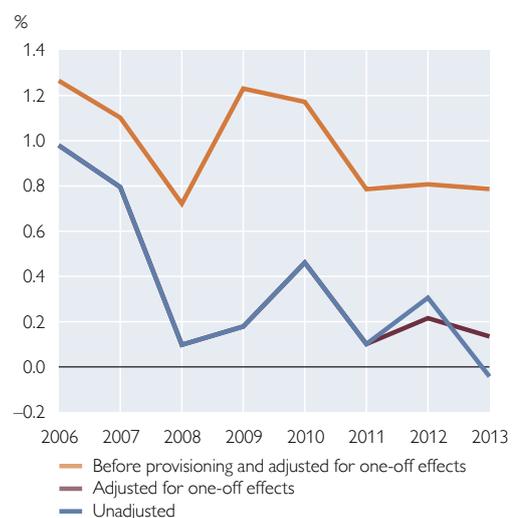
Austrian banks' profitability affected by several factors

CESEE operations, while continuing to be an important contributor to the (operating) profitability of Austrian banks, also come with higher risks: higher NPL ratios, goodwill write-downs and political uncertainty in some countries. These risks have translated into higher risk costs over the past few years. The increasing impact of higher risks on Austrian banks' overall profitability becomes evident in a widening gap between pre-provisioning and realized RoA. Over the past few years, persistently high risk costs – reflecting especially the difficult economic environment in some CESEE countries – have substantially eaten into banks' overall profitability (chart 14). Since 2008, Austrian banks have had to spend nearly EUR 44 billion, i.e. 65% of total operating profit in the respective period, on covering credit risks; in 2013, this share increased even further, reaching 88%.

Finally, an increase in income from fees and commissions (primarily owing to a recovery in the securities business)

Chart 14

### Consolidated Return on Assets of the Austrian Banking System



Source: OeNB.

was not able to offset the significant decrease in trading income (down compared to the previous year's profits driven by one-off effects) and lower other (remaining) income items.

In 2013, interest margins on European banks' new business increased further – to nearly 200 basis points – driven by more risk-adequate pricing in the euro area's southern peripheral countries. Despite increasing on a similar scale, the level of interest margins in Austria remained well below the European average (chart 15, left-hand panel). But this improvement had little impact on the margin on existing stock (chart 15, right-hand panel), as the volume of new business was rather low.<sup>2</sup>

As regards existing business, small Austrian banks (i.e. banks with total assets below EUR 2 billion) were affected by the steady decline in interest margins over the past few years, which put pressure on their profitability given their heavy reliance on net interest income (chart 15, right-hand panel).

Another factor which explains the comparatively small interest margin is the competitive pressure that results from the high number of banks operating in Austria (790 registered banks as of end-2013; this high figure is mostly due to the prominent role of the decentralized sectors with their high density of branches). Together with a rigid cost structure, long-term structural problems have negative implications for profitability. Therefore, the current process of restructuring and re-dimensioning of cost structures is likely to continue.

In order to strengthen the structural profitability and capital generation capacity of banks, it is necessary that banks with an unsustainable business model that does not yield positive returns over the medium term may leave the market without jeopardizing its stability. This objective has also been at the center of recent legislative initiatives, such as the EU Bank Recovery and Resolution Directive (BRRD).

... including structural (cost) issues

Low interest margins on domestic business

Chart 15

### Interest Margins of Austrian Banks

#### Interest Margins on New Business with Households and Nonfinancial Corporations



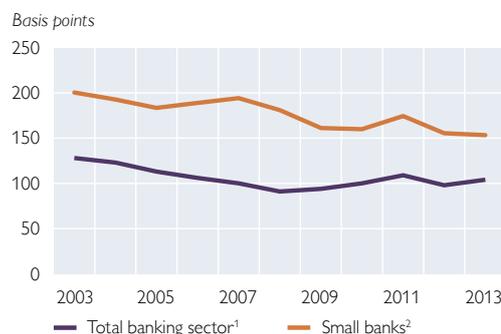
Source: OeNB, ECB.

<sup>1</sup> Total banking sector excl. nationalized banks.

<sup>2</sup> Total assets of less than EUR 2 billion.

Note: Unconsolidated data.

#### Net Interest Margins on Domestic (Existing) Business



<sup>2</sup> The definitions of interest margins in chart 15 (left-hand and right-hand panels) are not completely identical, therefore comparability is limited.

CESEE: profits increasingly concentrated in certain markets and eroded by goodwill write-downs

Net profits of Austrian subsidiaries in CESEE came to EUR 2.2 billion in 2013, up 5.8% on the previous year, amounting to an RoA of approximately 0.8%. However, on a consolidated level, this profit was almost entirely offset by write-downs of goodwill linked to CESEE subsidiaries. What is more, in the past, the profit sources of Austrian subsidiaries had been evenly distributed across CESEE, which also yielded risk diversification benefits; in recent years, by contrast, profits have increasingly come from just a few countries (chart 16), namely the Czech Republic, Slovakia, Russia and Turkey.<sup>3</sup> The relatively high profits in these few markets highlight

a concentration risk and the need for a sustainable growth strategy in the region. Recent turmoil in some of these markets has also underlined the fragility of the current earnings situation.

### Loan Quality: Benign Conditions in Austria, Deterioration in CESEE

While loan quality conditions in Austria remained fairly benign in 2013, Austrian banks' subsidiaries in CESEE are still facing noticeable headwinds. This ongoing weakness can be explained by two factors, both of which are linked to the fragile economic environment in several countries: The inflow of new nonperforming loans (NPLs) continued, and credit demand has remained sluggish overall. As a consequence, the consolidated share of NPLs in the Austrian banking system stabilized at a high 8.6%, while the consolidated loan loss provision ratio (LLPR) continued to rise to 4.8% at the end of 2013, resulting in an improved coverage ratio ahead of the asset quality review under the ECB's comprehensive assessment of significant banks (see chart 17 and box 1).

Loan quality in Austria remained largely unchanged in 2013, as highlighted by the unconsolidated LLPR (stock of specific loan loss provisions as a share of total nonbank loans), which has been range-bound between 3.0% and 3.5% since 2010. However, chart 18 illustrates substantial differences between banks: Small and locally active banks<sup>4</sup> had a relatively stable LLPR of approximately 4.2%, while significant

Chart 16

### Distribution of Profits of Austrian Subsidiaries in CESEE



Source: OeNB.

Quality of domestic loan portfolio broadly stable, especially at small locally active banks

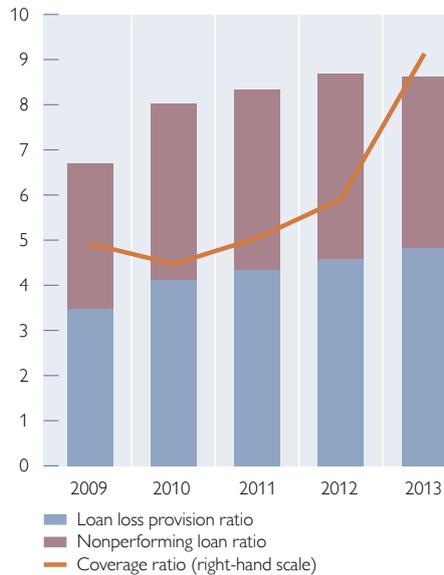
<sup>3</sup> As a significant joint venture in Turkey is not covered separately by the Austrian supervisory reporting framework, its results are not included in the analysis of subsidiaries. See also Wittenberger et al. 2014. *Macrofinancial Developments in Ukraine, Russia and Turkey from an Austrian Financial Stability Perspective*, in this issue.

<sup>4</sup> In this context, we define small and locally active banks as banks with total assets of less than EUR 2 billion on an unconsolidated basis.

Chart 17

### Loan Quality of the Austrian Banking System

Ratios for the consolidated nonbank loan portfolio in %

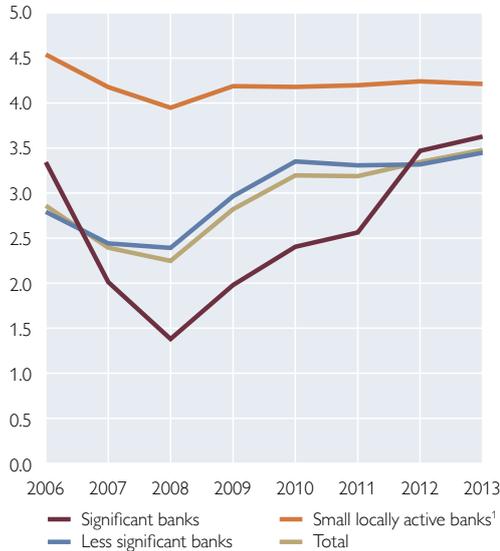


Source: OeNB.

Chart 18

### Loan Loss Provisions in Austria (Domestic Business)

Provisions on customer loans in %



Source: OeNB.

<sup>1</sup> Subsector of less significant banks.

Austrian banks<sup>5</sup> experienced a very strong increase in provisioning in recent years.

Bank lending to nonbanks in Austria declined slightly in 2013 (–0.4% year on year). This decline was driven by reduced lending to nonbank financial intermediaries and the government, while the volume of loans to households and corporates was slightly higher than the corresponding prior-year figure. In the first quarter of 2014, the volume of loans to domestic customers declined by 0.2% (year on year), driven by an upswing in lending to households compared to end-2013.

Regarding lending to households, lending for housing and home improvement continued to outpace general

lending growth, but the share of housing loans to total loans is still below the European average. Nevertheless, the recent strong increase in residential property prices, particularly in Vienna, coupled with continued mortgage lending growth may entail a higher risk of credit losses for banks compared with previous periods. Therefore, what is called for is great vigilance and strict monitoring by the supervisory authorities to assess whether sufficiently conservative credit standards and adequate risk pricing are applied.

In 2013, the share of foreign currency loans (FCLs) in Austria declined further. By the end of the year, 12.3% of all loans to customers were denominated in a foreign currency. In the first

Positive loan growth in Austria in 2013 limited to lending to households and corporations

Share of foreign currency loans in total loans continues to fall

<sup>5</sup> The following Austrian banks are deemed “significant” according to the Single Supervisory Mechanism (SSM) regime and are participating in the comprehensive assessment and the stress test: BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG, Erste Group Bank AG, Raiffeisenlandesbank Oberösterreich AG, Raiffeisenlandesbank Niederösterreich-Wien AG, Raiffeisen Zentralbank Österreich AG and Österreichische Volksbanken-Aktiengesellschaft as well as Unicredit Bank Austria (which participates in the SSM as part of its Italian parent).

quarter of 2014, this share decreased further (12.1%). Despite the 2.2 percentage point drop in outstanding FCLs compared to end-2012 and limited new foreign currency lending to Austrian borrowers, legacy assets continue to be a relevant issue for the Austrian banking system. The maturity profile of FCLs shows that most of these loans will mature from 2017 onward; a particular challenge is related to the fact that 70% of FCLs to households are bullet loans, more than 90% of which are linked to repayment vehicles.

Therefore, strict compliance with the supervisory foreign currency minimum lending standards (as of January 2013) will be an important element in containing the various risks related to this type of lending (credit risk, currency risk, market risk).

The total loan volume of Austria's top six credit institutions' CESEE subsidiaries declined moderately in 2013, mainly due to the planned sale of a subsidiary of UniCredit Bank Austria in Ukraine,<sup>6</sup> resulting in a discontinuation of the reporting of the respective exposure. Without this planned sale, the overall exposure would have remained broadly stable. However, regional heterogeneity is on the rise: Banks have been increasingly focusing on their core markets, reducing their business in countries which are defined as non-core or display macroeconomic and/or political vulnerabilities. Declines in exposures were reported in Ukraine and Hungary, while growth was still strong in Russia, Belarus and Slovakia in the first half of 2013, but slowing down in the second half of the year. The share of loans to households in the overall loan portfolio amounted to

43.3% at end-2013, while loans to non-financial corporations accounted for the remaining 56.7%.

Supervisory initiatives that have been launched to restrict foreign currency lending in CESEE can be considered effective, as these loans declined by 7.1% year on year (amounting to EUR 74.2 billion at end-2013), taking into account exchange rate effects, and thus more strongly than the overall loan portfolio. As a result, the aggregate share of foreign currency loans – the bulk of which is denominated in euro – in total loans decreased from 45.7% to 43.2%.

Turning to nonperforming loans (NPLs), the NPL ratio of Austrian subsidiaries in CESEE remained broadly stable in 2013, standing at 14.9% at year-end (chart 19). The NPL ratio for foreign currency loans increased from 19.4% to 20.2%. Due to different definitions of NPLs and heterogeneous economic and foreign exchange developments in CESEE, cross-country differences in NPL ratios are still high. While the ratio remained below or close to 5% in some of the most important host countries of Austrian banks (e.g. the Czech Republic, Russia, Slovakia), the NPL ratios of subsidiaries in other countries (Hungary, Serbia, Bosnia and Herzegovina, Croatia) increased markedly in recent years, reaching levels of close to or more than 25%. Regarding other troubled loans, the share of restructured loans amounted to 6.5% of total loans at end-2013, which is a slight decline compared to end-2012, and renegotiated loans were only of minor importance (3.3% compared with 4.1% in 2012).

NPL coverage ratios I (ratio of loan loss provisions for NPLs to NPLs) in

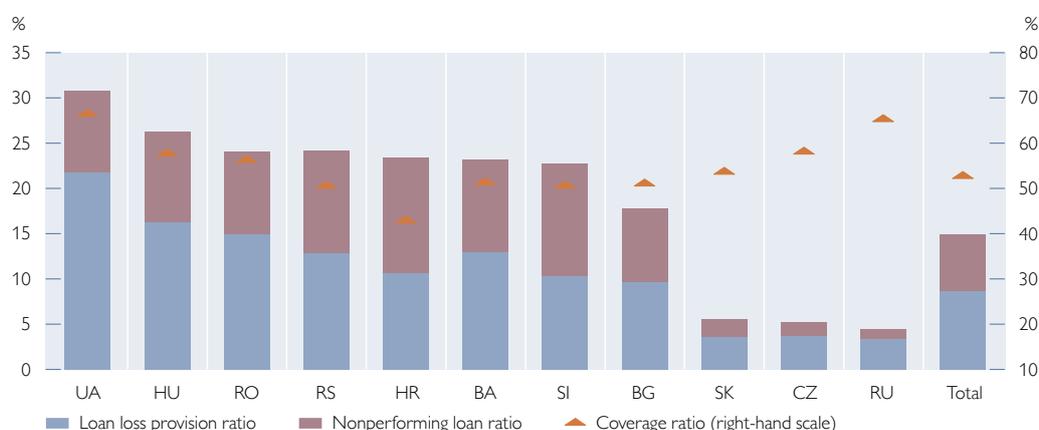
NPLs of Austrian subsidiaries in CESEE still rising in several countries

Coverage ratios of Austrian subsidiaries in CESEE improved in recent years

<sup>6</sup> This subsidiary was therefore classified as a disposal group held for sale in the 2013 financial statement; in the income statement, it was included in the item "Total profit or loss after tax from discontinued operations."

Chart 19

### Loan Quality of Austrian Subsidiaries in CESEE



Source: OeNB.

Europe have been increasingly diverging, with some European banks tending to show levels of below 25%. This does not hold true for Austrian banks, whose ratios were approximately 56% on a group level and nearly 53% at CESEE subsidiaries. For foreign currency loans in CESEE, the ratio improved from 42.5% to 49.6% in the course of the year 2013. The NPL coverage ratio II, which also includes eligible collateral according to Basel II for NPLs in the numerator and which is substantially higher due to a high share of mortgage loans, improved from 68.7% at end-2012 to 71.4% at end-2013 (again at CESEE subsidiaries); the respective figures for the foreign currency loan portfolio are 66.9% and 69.8%, respectively.

The leasing portfolio of large Austrian banks in CESEE declined significantly in 2013 (-11.3% to EUR 11.2 billion), mainly due to a decrease in the leasing volume of Hypo Alpe-Adria-Bank International AG. At the same time, the foreign currency leasing portfolio dropped by 12.5% year on year, amounting to EUR 4.8 billion at end-2013. The ratio of nonperforming leasing contracts fell from 24.8% to

22.6% for all contracts and from 35.1% to 24.7% for contracts denominated in foreign currency.

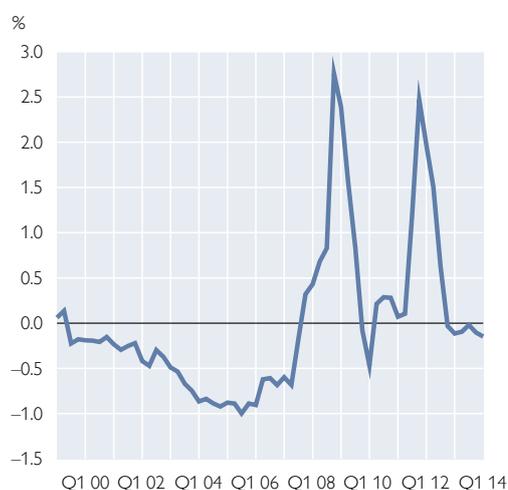
### Swiss Franc and U.S. Dollar Liquidity Situation Now Satisfactory

As macroeconomic uncertainties decreased in 2013 and market participants' confidence in the banking system's stability improved, funding markets became less volatile and funding costs generally decreased in Europe. In this

Liquidity situation has improved further

Chart 20

### Austrian Financial Stress Index (AFSI)



Source: OeNB.

### The European Asset Quality Review and Stress Test from an Austrian Perspective

**The ECB is currently performing a comprehensive assessment of 128 significant banks in the euro area**, which comprises an asset quality review (AQR) based on year-end 2013 data and a stress test covering the years 2014 to 2016. Six significant Austrian banking groups participate in this assessment. The comprehensive assessment is carried out by the ECB with close involvement of the national authorities, including in Austria the FMA and OeNB. The overall goal of the exercise is to achieve more transparency about banks' balance sheets and, where needed, to speed up balance sheet repair by demanding adequate corrective action.

**The AQR is currently in phase 2, which covers the on-site review.** Phase 1, the selection of portfolios, was completed in February 2014. Phase 2 consists of ten overlapping work blocks, which are currently executed in line with the project schedule. The central element is the review of credit files and collateral values based on samples that are drawn from the selected portfolios. Since these activities require an extensive workload that has to be conducted on site in line with ECB methodology, several international auditing firms were commissioned to perform these tasks in Austria. Furthermore, a wide-ranging quality assurance process has been established at the European and national levels to ensure the consistent application of the methodology across participating banks and geographies, and considerable staff resources of national authorities (including the OeNB) have been allocated to these tasks.

**As regards the EU-wide stress test, the scenarios and methodology were published at the end of April 2014 by the relevant European bodies (EBA, ECB).** The exercise will assess banks' resilience to an adverse scenario that was designed based on the current systemic risk assessment at the European level. It assumes, inter alia, a cumulative deviation of 7 percentage points from the baseline real GDP growth path for the entire EU from 2014 to 2016 (6.7 percentage points for Austria), a foreign exchange shock and a global reassessment of risks in equity and bond markets. The publication of the common methodology and scenarios in April 2014 marked the operative start of the bottom-up stress test calculation by the participating banks; national authorities and the ECB are closely involved in preparations, management and quality assurance.

**The results of the AQR and the stress test will be published jointly in fall 2014.** The current timeline foresees the publication of results before the ECB's assumption of supervisory tasks for significant banks in the countries participating in the SSM, which is scheduled for November 2014. Given the current stage of the comprehensive assessment and the agreed publication strategy among SSM countries, no indication on the likely results for participating Austrian banks can be given prior to the publication of the results.

benign environment, the Austrian Financial Stress Index – introduced in the previous Financial Stability Report – remained low (chart 20),<sup>7</sup> and capital market conditions are supportive of funding and capital raisings.

Since the end of September 2013 (the Financial Stability Report 26 cut-

off date), the liquidity situation of the Austrian banking system has improved from an already comfortable position. This macroprudential assessment is based on the weekly liquidity report, which is submitted by the 29 largest Austrian banks on a consolidated level (latest data as of May 30, 2014). It

<sup>7</sup> Details of the methodology of the Austrian Financial Stress Index (AFSI) can be found in Financial Stability Report 26 (December 2013). In general, an AFSI below zero is an indication of no current financial stress in Austria.

covers about 80% of total assets of the Austrian banking sector. The cumulated net funding gap (maturities up to 12 months without money market operations and foreign exchange swaps, aggregated across all currencies) amounts to about –EUR 34 billion and has been basically unchanged since the end of September 2013. The aggregate liquidity risk exposure is sufficiently covered by substantial liquidity risk-bearing capacity; the respective cumulated counterbalancing capacity stands at about EUR 109 billion (+10% since the end of September 2013).

Due to tightened supervision by the Austrian authorities and lessons learned from the crisis, Austrian banks have substantially improved their liquidity situation in Swiss francs and U.S. dollars compared to 2009. After years of gradual adjustment, Austrian banks' liquidity situation is sound in both currencies. Since the end of September 2013, domestic banks have managed to turn a U.S. dollar cumulated net funding gap into a surplus. This improvement was driven by a reduction of assets in foreign currency through the sale of subsidiaries and successful supervisory action in the area of foreign currency lending, while banks also improved the funding structure and counterbalancing capacity for their remaining foreign currency assets. The Swiss franc cumulated net funding gap continued to improve as well (–25% since the end of September 2013). In addition, liquidity buffers increased, so that the cumulated counterbalancing capacity improved by 60% to –EUR 3.2 billion compared with the end of September 2013.

Despite these encouraging developments, pockets of vulnerability remain.

Especially smaller banks are faced with substantial concentration risk regarding their high quality liquid assets (HQLA). They need to diversify across counterparties and funding instruments and also ensure sufficient diversification across assets, asset classes and issuers in their counterbalancing capacity. In addition, it remains banks' responsibility to ensure that their HQLA composition reflects changes in market liquidity. Adapting liquidity risk management to properly reflect the market-based indicators of HQLA is highly recommended.<sup>8</sup>

Market pressure to reduce liquidity risk and improve liquidity risk disclosure will increase with the European Commission's delegated act pursuant to Article 460 of the Capital Requirements Regulation (CRR) entering into force and the publication of the final requirements for disclosure related to the Liquidity Coverage Ratio (LCR). The delegated act is scheduled to enter into force by end-2014; it will be based on the results of the EBA report on the LCR impact assessment. This report showed that the average LCR of EU banks was 115% at the end of 2012 (five years ahead of the envisaged 100% LCR requirement). Two-thirds of the bank sample already had an LCR above 100% and only one-sixth an LCR below 60%. The report also included unweighted data of net cash outflows and liquidity buffers and revealed that for Austrian banks in the sample, contractual net outflows over the following 30 days are six times higher than their HQLA, while for other banks the ratio is above eight.

The recalibration of the LCR in January 2013 increased the average LCR in the sample by 15 percentage points and reduced the liquidity short-

Market pressure for  
LCR disclosure  
expected

<sup>8</sup> See also *Guidance for Supervisors on Market-Based Indicators of Liquidity* published by the Basel Committee on Banking Supervision in January 2014.

fall by about EUR 550 billion to EUR 264 billion (or 0.8% of total assets in the sample). The lowering of the bar increases the role of disclosure and market discipline. In January 2014, the Basel Committee on Banking Supervision (BCBS) published its final require-

ments for LCR-related disclosures, which have to be implemented by national authorities no later than January 1, 2015. The BCBS compromise focuses on the quarterly disclosure of simple averages for a number of LCR components based on 90 daily observations.

Box 2

### Deposit Guarantee Schemes and Bank Recovery and Resolution Directives Adopted

*On April 15, 2014, the European Parliament adopted the Directive on Deposit Guarantee Schemes (DGSD). The DGSD, designed to further strengthen depositor confidence, recasts Directive 94/19/EC and its subsequent amendments and will enter into force at the beginning of July 2014 at the latest. Within one year after entry into force, the DGSD needs to be transposed into national law. Harmonized deposit guarantee schemes are complements to the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), both key pillars of the future banking union.*

*However, the DGSD does not represent a system change toward a common DGS, as in some aspects it maintains the diversity in national systems; rather, it is a further harmonization of existing rules. The aim of the DGSD is to ensure sufficient financial means in DGSs by introducing ex-ante financing arrangements with a minimum target level of 0.8% of covered deposits to be reached within a ten-year period and collected from banks' contributions. In the event of bank deposits becoming unavailable, DGSs under the new regime are to ensure faster payouts to depositors: by 2024 within 7 working days compared with currently 20 working days. Moreover, according to the directive, DGSs must be supervised on an ongoing basis and regular stress tests of the systems must be performed. Depositors will no longer have to submit an application for repayment if their deposits become unavailable. The determination of their eligibility for repayment will be further simplified and harmonized. The coverage level will remain at EUR 100,000 per depositor and per institution.*

*In Austria, the DGSD requires a change from the current ex-post funded system to an ex-ante funded system. The estimated Austrian target level will amount to around EUR 1.5 billion, requiring annual contributions of EUR 150 million. Contributions will be calculated on the basis of covered deposits and the risk profiles of individual banks.*

*The Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (Bank Recovery and Resolution Directive – BRRD) was adopted by the EU Council on May 6, 2014.<sup>1</sup> It provides capabilities to tackle potential bank problems at three stages: preparatory and preventative, early intervention, and resolution. Early intervention in unsound or failing institutions should ensure the continuity of the institution's critical functions, while minimizing the impact of an institution's failure on the economy and financial system.*

*As a further key element, the BRRD requires credit institutions to set up recovery plans. National resolution authorities will be set up and draft resolution plans for institutions. Credible resolution instruments, including the write-down of shareholders' capital and bail-in of creditors,<sup>2</sup> complete the toolbox. Certain liabilities, including deposits covered by the DGS, will be excluded from write-downs.*

*While one aim of the BRRD is to minimize the need for public support for failing banks, the application of government financial stabilization tools, including temporary public owner-*

<sup>1</sup> See also OeNB. 2013. Box 3 – Preparations for a European Banking Union. Financial Stability Report 26.

<sup>2</sup> The bail-in tool shall be available from January 1, 2016, at the latest.

ship of an institution as a last resort, is not precluded, if financial stability would otherwise be jeopardized. However, such public support may only be provided under strict conditions.

The BRRD requires Member States to set up national ex-ante resolution financing arrangements (funds) to support the application of resolution tools. Banks will have to make annual contributions to enable the financing arrangement to reach within ten years a target level of at least 1% of covered deposits of all the credit institutions authorized in the respective country. According to current estimates, annual ex-ante contributions of credit institutions authorized in Austria will amount to about EUR 180 million, with the target level being EUR 1.8 billion.<sup>3</sup>

Banks' capacity to absorb losses will be further strengthened by new minimum requirements for own funds and eligible liabilities, which authorities will set for each institution based on size, risk and business model.

In Austria, the Banking Intervention and Restructuring Act<sup>4</sup> currently provides for preventive and early intervention measures. The transposition of the BRRD into Austrian law requires certain amendments, including the establishment of a resolution authority<sup>5</sup> and a resolution fund. Also, the new resolution tools have to be incorporated into national law.

<sup>3</sup> These funds will be transferred to the Single Resolution Fund within the SRM once the SRM becomes operational and the Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund enters into force (by January 1, 2016, as currently envisaged; the target level is to be reached by January 1, 2024). Under the SRM, the time span to reach the target level may decrease by one year compared to the BRRD regime. In that case, the respective annual contributions would increase accordingly.

<sup>4</sup> Bankeninterventions- und Restrukturierungsgesetz (BGBl. I Nr. 160/2013).

<sup>5</sup> This authority will also set up resolution plans, which, according to the current law, are drafted by the institutions themselves.

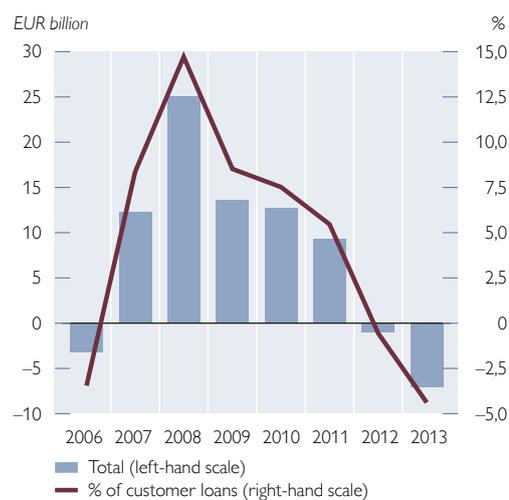
Despite financial market conditions improving and customers' risk appetite starting to increase, retail deposits at Austrian banks grew steadily in 2013 on an unconsolidated basis (+2.5% year on year). Nevertheless, the low interest rate environment kept growth rates below precrisis levels, and figures for the first quarter of 2014 show a reduction in deposit growth, especially in savings deposit growth. The loan-to-deposit ratio improved to 119% in 2013, also driven by sluggish credit growth. A similar path was observed for funding by Austrian banks' subsidiaries in CESEE, where the aggregate funding gap closed in 2012, and the deposit surplus increased in 2013, continuing the positive trend of recent years. However, there are differences across the region as subsidiaries in some countries are still dependent on intra-group liquidity transfers.

The Austrian "sustainability package"<sup>9</sup> adopted by the OeNB and the

Vast majority of Austrian subsidiaries in CESEE has sustainable business model

Chart 21

### Customer Funding Gaps at CESEE Subsidiaries of Austrian Banks



Source: OeNB.

<sup>9</sup> FMA and OeNB. 2012. Supervisory guidance on the strengthening of the sustainability of the business models of large internationally active Austrian banks. <http://www.oenb.at/en/Financial-Stability/Systemic-Risk-Analysis/Sustainability-of-large-Austrian-banks-Business-Models.html>

Small and locally active Austrian banks have above-average capital ratios

FMA in 2012 stipulates that the stock and flow loan-to-local stable funding ratios (LLSFRs) at the CESEE subsidiaries of Austria's three largest banks and the risk-adequate pricing of intra-group liquidity transfers to subsidiaries be monitored. These measures are based on the Austrian supervisors' experience that banking subsidiaries which 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 subsidiaries that had been following a more conservative and balanced business and growth model. Therefore, banking subsidiaries with stock LLSFRs above 110% are considered to be "exposed," and the sustainability of their new business is monitored more closely. All supervisory findings are regularly shared and discussed with the respective banks as well as their host and home supervisors.

By end-2013, more than 80% of monitored subsidiaries were considered not to be exposed since their stock LLSFRs were below 110%. Only one exposed subsidiary was also found to exhibit an unsustainable trend in its new (year-on-year) business. Besides these results, monitoring also focuses on intragroup liquidity transfer volumes and the fund transfer pricing (FTP) models applied, which helps assess the dependency of foreign subsidiaries on parent bank funding and the adequacy of banks' internal risk and pricing models.

### Higher Capitalization Remains Priority

In the euro area, banks strengthened their capital positions amid ongoing deleveraging in 2013. In Austria, improvements have been achieved through a combination of capital increases, e.g. via rights issues and retained earnings,

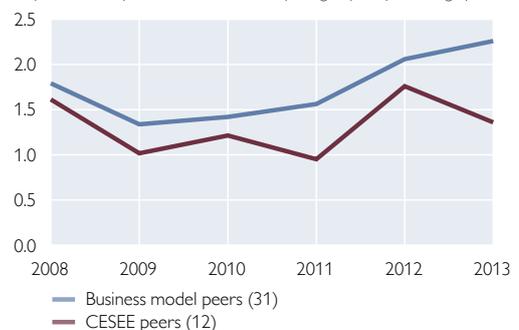
and reductions in risk-weighted assets. Though recent external capital raisings have been successful and helped repay state participation capital at some banks, there is still market pressure for higher capital ratios. However, weak profitability makes internal capital generation more difficult.

After their low in the second quarter of 2008, the aggregate tier 1 capital ratio and the capital adequacy ratio of all Austrian banks continued to improve, reaching 11.9% and 15.4%, respectively, by end-2013. The OeNB acknowledges banks' positive progress to date, but there is more to be done, since the capitalization of Austrian banks remains below that of their European peer group. In particular, the gap between the capitalization of Austria's top three banks (11.4%) and their European peers (13.6%) and CESEE peers (12.7%) is still significant. At the same time, however, the top three Austrian banks have a higher (better) leverage ratio<sup>10</sup> than their European peers. This can be attributed to the fact that in contrast to the tier 1 capital ratio, the leverage ratio does not take into account the risk weighting of assets.

Chart 22

### Peer Group Comparison of Tier I Ratios

Gap between top 3 Austrian banks and peer groups in percentage points



Source: OeNB.

<sup>10</sup> Leverage ratio defined as tier 1 capital to total assets.

The distribution of capital ratios among Austrian banks highlights the solid capitalization of small and locally active banks compared to larger banks. At the end of 2013, the median tier 1 capital ratio of all Austrian banks stood at 14.9%, 3.4 percentage points above the aggregate mean (chart 23). The higher median ratio essentially reflects the large number of locally active banks

with above-average capitalization: Half of all Austrian banks around the median (i.e. the second and third quartiles) post tier 1 capital ratios between 11.4% and 19.7%. But the chart also shows that the total range of ratios has increased over time, indicating a growing heterogeneity among those small banks.

The allocation of bank capital within the Austrian banking system mirrors banks' sustained commitment to foreign business. Roughly 40% of Austrian credit institutions' consolidated tier 1 capital was located abroad in 2013, mainly at CESEE subsidiaries. At large banks, this share was even higher. At the end of 2013, Austrian subsidiaries had an aggregate tier 1 ratio of 15.5%, well above their individual group ratios. The higher capitalization is also due to the fact that higher minimum requirements apply to these banks; Austrian subsidiaries also surpass these higher requirements. Recent developments in the field of macroprudential supervision in Europe suggest that a lot of countries are going to use macroprudential supervision to increase the capitalization of their banks.

Nearly 40% of capital is allocated abroad

Chart 23

### Change in Aggregate Tier 1 Capital Ratio of Austrian Banks



Source: OeNB.

Box 3

### Overview of Macroprudential Measures in the EU

The new European banking legislation<sup>1</sup> (Capital Requirements Regulation and Capital Requirements Directive – CRR/CRD) has established a legal framework for macroprudential supervision. Based on this new framework, since the beginning of 2014 a number of supervisory authorities in EU Member States have notified the European Systemic Risk Board (ESRB) of macroprudential policy measures to address specific risks to financial stability in their jurisdictions or have announced their intention to do so in the near future.

**Belgium:** The Belgian central bank (NBB) notified the ESRB and the European Banking Authority (EBA) of a measure based on Article 458 CRR to increase risk weights for retail exposures secured by Belgian residential immovable property by a linear add-on of 5 percentage points for all banks using an internal ratings-based approach for this type of credit risk. The macroprudential measure is intended to increase the resilience of the banking system against potential adverse developments in parts of the Belgian real estate market and is scheduled to apply as of July 1, 2014. This measure is subject to a “European safeguard procedure” involving

<sup>1</sup> Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms of 26 June 2013 (CRR) and Directive No. 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms of 26 June 2013 (CRD).

assessments and opinions by the EBA and the ESRB and the option for the European Commission to propose to the EU Council an implementing act rejecting the measure.

**Croatia:** The Croatian central bank (HNB) notified the ESRB and the EBA of the application of a systemic risk buffer of additional common equity tier (CET) 1 capital of 1.5% for all banks and of 3% for large banks in Croatia in accordance with Article 133 CRD. Based on Article 124 CRR, the HNB also sets stricter criteria for the application of the 35% risk weight to exposures secured by mortgages on residential property in the standardized approach regarding credit risk. These measures are to address structural systemic risks prevailing in the real economy and the financial sector in Croatia.

**Netherlands:** The Dutch central bank (DNB) notified the ESRB and the EBA of its decision to impose an additional CET 1 capital requirement of 3% on the three largest Dutch banks and of 1% on another bank that is also deemed systemically relevant. The measure is based on the CRD capital buffer framework regarding systemically important banks and long-term structural risks to financial stability. This policy complements macroprudential measures previously adopted by the DNB to address systemic risks emanating from the real estate sector.

**Sweden:** The Swedish Financial Supervisory Authority (FI) decided that the four largest banks must hold additional CET 1 capital of 3% in the form of a systemic risk buffer (Article 133 CRD) as of 2015 and a further 2% within the framework of pillar 2. In order to strengthen the resilience of the banking system, the FI also increased the risk weight floor for Swedish mortgages from 15% to 25%. Furthermore, FI has announced its intention to activate the counter-cyclical capital buffer, which is part of the CRD buffer framework. A decision about the level of this tool, which is designed to address the procyclical dimension of risks to financial stability, is expected to be made in fall 2014.

### Low Interest Rate Environment Remains Main Risk to Austrian Insurance Sector

Better market conditions in 2013 led to a stable investment performance of Austrian mutual funds, pension funds and insurance undertakings, but there are still uncertainties regarding a potential resurgence of the sovereign debt crisis or an increase in risk appetite given the intensified search for yield in a prolonged period of low interest rates.

Generating adequate investment earnings remains the main challenge for the Austrian insurance sector. Given that only new premiums and expired investments are reinvested at current market interest rates, the effects of the low interest rate environment materialize rather slowly. Still, insurers need to adjust to this challenging environment and reconsider their investment strategies. From a macroprudential perspective, it is crucial to monitor investment portfolios of insur-

ance undertakings to detect a potential shift to riskier assets early.

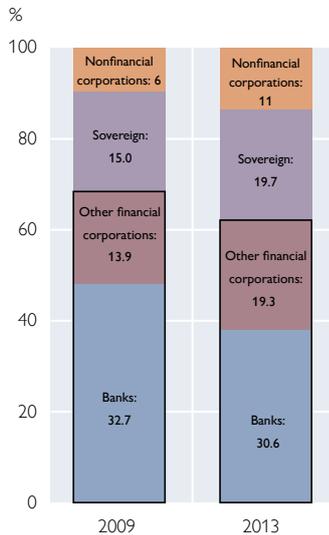
The asset allocation of Austrian insurers has already changed noticeably over the past five years: Whereas in 2009, almost 50% of all assets were invested in bank securities, the share came down to 38% in 2013. The strongest growth in this time period was recorded for securities of nonfinancial corporations. Although the importance of investments in banks decreased, insurers' exposure to the financial sector is still substantial (60% of total securities holdings). Therefore, the contagion risks between Austrian financial intermediaries also remain high. Although direct lending by insurance undertakings is permitted, the exposure through loans to corporates remained at a low level.

The profitability (measured as the return on investment) of Austrian life insurance undertakings in 2013 was well above the guaranteed interest rate

Profitability is the main challenge for insurance undertakings

Chart 24

### Securities Held by Austrian Insurance Undertakings

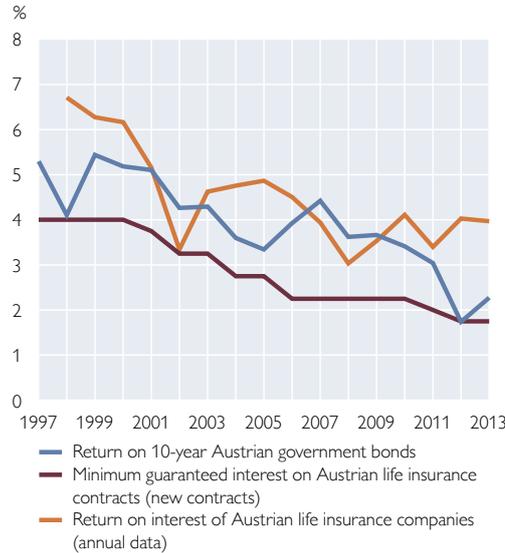


Source: OeNB.

Note: Figures in EUR billion.

Chart 25

### Return on Investment and Minimum Guaranteed Interest Rate for New Contracts



Source: FMA, OeNB.

on new business and also still above the guaranteed rate on the stock of 2.7%. Austrian and European supervisors already responded to the risk of a prolonged period of low interest rates: At the national level, the FMA introduced additional provisioning requirements, which will have to be built up over the next ten years, depending on the individual company's (stock) guaranteed interest rate and a benchmark interest rate. At the European level, the European Insurance and Occupational Pensions Authority (EIOPA) will include scenarios of a prolonged period of low interest rates in its 2014 insurance stress test. The participation of Austrian insurance undertakings in this exercise is rather high: More companies than required by EIOPA are set to take part.

The amendment of the Austrian Insurance Contract Act, which is expected for mid-2014, will mark the implementation of the first phase of Solvency II. It will define the systems of

governance and prescribe a forward-looking assessment of undertakings' own risk, the submission of additional information to the supervisor and the pre-application of internal models.

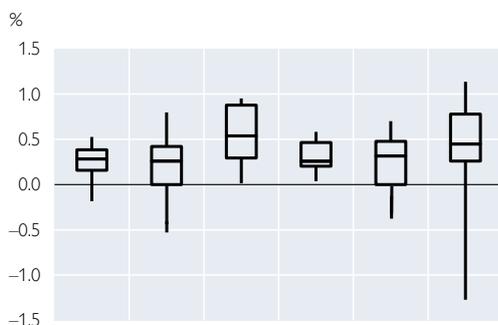
The net asset value of mutual funds reached EUR 150 billion in 2013 (+1.1% year on year), but was still below its precrisis level (EUR 170 billion in early 2007). The main challenge of mutual funds is to regain the confidence of (retail) investors; at the same time, the share of specialized funds (institutional investors) continued to grow, accounting for about 44% of total net asset value at end-2013. The overall investment performance of funds was moderate in 2013 (2.7% return on investment) and heterogeneous across asset classes: While the performance of equity funds was the main positive driver (accounting for more than 10%), bond funds only yielded 0.2%.

The fund industry is preparing for the implementation of the Alternative

Fund industry only slowly regains confidence of retail investors

Chart 26

### Return on Assets of Austrian Severance Funds



Source: OeNB.

Investment Fund Managers (AIFM) Directive, which puts institutional funds, hedge funds, real estate funds and private equity funds for the first time under a common European regulatory framework. Most of the licensing and registrations of AIFMs in Austria was completed in the first half of 2014.

Since their establishment in 2006, Austrian severance funds have built up funds by an average 20% p.a. At the end of 2013, the sum of accrued severance benefits came to EUR 6.2 billion, and asset volumes will continue to grow for the next five to ten years. After that, outflows due to claims will gain in importance relative to inflows and volume growth will be restricted, requiring adequate liquidity management. Severance funds' historical returns on assets were rather heterogeneous both within the sector and over time (chart 26).

### The Market's View – Geopolitical Risks Related to Ukraine Contrast Generally Benign Financial Market Developments

International financial market conditions have remained generally positive. Austrian listed banks performed very

well into the first months of 2014, and Raiffeisen Bank International has taken the opportunity to issue new equity to increase capitalization. However, increased tensions in Ukraine, economic risks in Russia and potential spillover effects have had a negative impact on Austrian banks' equity prices thereafter. In this environment, the lagging performance of Austrian bank equities in 2014 so far (compared to that of other European banks) can also be attributed to a renewed interest in bank equities from weaker euro area countries; more generally, the subdued profitability outlook for Austrian banks as a result of the weak business environment, elevated credit risk costs, adverse economic policy decisions and (in some cases) expectations that highly profitable markets such as Russia are prone to a turn in their benign credit cycle may also have played a role.

Research analysts and credit rating agencies point to the improvements in Austrian banks' capitalization since 2007. However, they also note that internationally active Austrian banks still have below-average capitalization levels and consider it as one of their key weaknesses. Further, the prevailing low interest rate margins are considered as a factor leaving little room for maneuver. Developments in Ukraine, Russia and Turkey are increasingly seen as challenges for Austrian banks.<sup>11</sup> On a positive note, Austrian banks' generally sound business model (retail banking) and their solid liquidity position are seen as strengths. As a consequence of the recent adoption of the EU Bank Recovery and Resolution Directive (BRRD), rating agencies are about to review government support for banks, which may, in turn, lead to lower

<sup>11</sup> See also Wittenberger et al. 2014. *Macrofinancial Developments in Ukraine, Russia and Turkey from an Austrian Financial Stability Perspective*, in this issue.

Liquidity management crucial for severance funds

ratings, in particular for Austrian banks, which benefit from an average uplift by 3 to 4 notches due to the implicit assumption of government support.

### **OeNB Assessment and Recommendations**

The reverberations of the recent financial, economic and sovereign debt crisis, including loan quality issues and the low interest rate environment, are still challenging the earnings potential of the Austrian financial sector. While the OeNB acknowledges the Austrian financial sector's progress toward improving financial stability at home and in host markets, it recommends further strengthening the sustainability of business models by taking the following actions:

- Banks should continue strengthening their capital levels – by retaining earnings and/or tapping capital markets – to close the capitalization gap between them and their international peers.
- Given persistent pressure on profitability, banks should strive to address structural issues and improve their cost efficiency.
- Risk-adequate provisioning and coverage policies should be further pursued to deal with loan quality issues.
- Banks should continue fulfilling supervisory minimum standards relating to foreign currency loans and loans with repayment vehicles.
- Banks should strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for risk-adequate pricing of liquidity transfers.
- Banks should prepare for increased market pressure for disclosure of LCR data; both investor communications and liquidity risk management, especially at smaller banks, need to be adapted.
- Banks and insurance undertakings should ensure high standards of risk management so that risks are properly addressed and effectively controlled; they should also proactively prepare for contingency situations.
- Insurance undertakings should proactively prepare for Solvency II.

