

Austrian financial intermediaries: a financial system in structural transformation

Austria has a very large and highly interconnected banking sector

New macroprudential measures will improve systemic resilience of Austrian banking sector

On June 1, 2015, Austria's macroprudential policy body, the Financial Market Stability Board (FMSB),¹ issued a recommendation to the Austrian Financial Market Authority (FMA) to activate the systemic risk buffer (SRB) and the buffer for other systemically important institutions (O-SII) for selected banks. The SRB, ranging from 1% to 3%, will apply to 11 banks. The O-SII buffer will apply to seven banks but as these banks are also subject to the SRB only the latter applies. Both buffers will enter into force as of July 1, 2016. A phasing-in period is recommended for the four largest banks: From July 1, 2016, to June 30, 2017, they will have to hold an SRB of 2%. These macroprudential measures will improve the financial stability of the Austrian banking system by addressing long-standing structural systemic risks which have persisted for the past decade. The OeNB, international institutions and rating agencies have repeatedly highlighted these risks in their publications (including the Financial Stability Report) over the past few years.² The tools to finally address them have been made available only recently. They also provide for the implementation of a measure that was set out in the

Foreign exposure of Austrian banks is high and concentrated in emerging markets

Austrian Sustainability Package published in 2012.³

Austria has a very large banking sector with total assets equivalent to 328% of Austrian GDP as of end-2014. The dominant intermediation role of the Austrian banking sector may cause substantial negative external effects on the real economy. The Austrian bank support package adopted in 2008 was the largest in the EU relative to GDP. Meanwhile, most countries with similarly large banking sectors have taken macroprudential measures (see below), while the European Systemic Risk Board (ESRB) concluded in a recent study that a banking system that grows beyond a certain threshold exerts a negative influence on GDP growth.⁴ Also, the Austrian banking sector consists of a relatively large number of individual banks, and most of them are effectively part of only five large banking groups or sectors, which together account for more than 80% of the entire sector's total consolidated banking assets.

The Austrian banking sector's foreign exposure is high and concentrated in emerging markets. The total foreign exposure amounts to 160% of Austrian GDP, two-thirds of which are located in Central, Eastern and Southeastern Europe (CESEE). The Austrian banking sector has the largest share of emerging market exposure among ad-

¹ For more details on the Financial Market Stability Board see www.fmsg.at/en.

² See e.g.: IMF. 2014. *Austria: 2014 Article IV Consultation Staff Report*; Fitch. 2013. *Peer Review: Major Austrian Banks*. September 27, 2013; Moody's. 2014. *Banking System Outlook Austria*. May 21, 2014.

³ <http://www.oenb.at/en/Financial-Stability/Systemic-Risk-Analysis/Sustainability-of-Large-Austrian-Banks--Business-Models.html> (retrieved on June 15, 2015).

⁴ ESRB. 2014. *Is Europe Overbanked? Reports of the Advisory Scientific Committee No. 4*. June. https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_4_1406.pdf (retrieved on June 15, 2015). Similar results are obtained by Denk, O., S. Schich and B. Cournède. 2015. *Why implicit bank debt guarantees matter: Some empirical evidence*. In: *OECD Journal: Financial Market Trends Volume 2014/2*. 63–88; Arcand, J.-L., E. Berkes and U. Panizza. 2012. *Too much finance? IMF Working Paper No 12/161*.

vanced economies' banking sectors. It is therefore exposed to heightened geopolitical, credit and exchange rate risks in these countries. The size and concentration of the exposure has repeatedly been identified as a structural systemic risk to the Austrian banking sector.⁵ Risks materializing at individual subsidiaries in a particular CESEE country can cause adverse effects on Austrian parent banks, other Austrian banks, the Austrian financial system and, ultimately, even public finances as well as the real economy in Austria and in CESEE.

The Austrian banking system has yet to fully prepare for the ongoing withdrawal of implicit government guarantees in the EU, which will – most notably – be the consequence of the implementation of the European Bank Recovery and Resolution Directive (BRRD) in the Member States.⁶ According to the OeNB's calculations, Austrian banks' refinancing advantage resulting from the implicit government guarantee is estimated to have been in the range of 25% to 40% of consolidated bank profits over the past decade. For some banks, the removal of implicit government guarantees has already led to rating downgrades. Downgrades, in turn, may result in rising funding spreads unless banks increase their capitalization levels.

Austrian banks have relatively low common equity tier 1 (CET1) ratios compared to their international peers. Furthermore, the banking system's ownership structures could make private sector recapitalizations difficult in the event of stress, as many shareholders are highly leveraged themselves (e.g.

the decentralized sectors). At the same time, the ability to generate capital internally is hampered by banks' low profitability. In the case of banks directly owned by regional governments, such as some state mortgage banks, EU state aid rules have made recapitalization difficult. State aid proceedings hamper quick ex-post recapitalization in the event of a crisis, making it more costly until a decision by the European Commission is reached. This further increases the costs of recapitalizations which would have to be borne by the general public.

Over recent years, the structural, systemic risks the Austrian banking system has been exposed to have attracted international attention: In its 2014 Article IV Consultations Report, the International Monetary Fund (IMF) found that the high exposure to volatile CESEE markets makes the Austrian banking system susceptible to macroeconomic and political risks arising in this region. In addition, the IMF has repeatedly pointed out Austrian banks' below-average capitalization and low profitability levels. Although Austrian banks have strengthened their capital positions over recent years, the IMF still sees capital gaps vis-à-vis the levels of their international peers.

Since 2014, the vast majority of EU Member States have tackled systemic risks by activating macroprudential instruments. Structural systemic risks to the banking sector or the economy, including the issue of systemically important institutions, have been addressed by the implementation of SRBs and O-SII buffers,⁷ sometimes in combination with complementary pillar 2

Systemic risks attract international attention

Austrian banks are dependent on an implicit government guarantee, whose value is to be reduced

Several EU countries have started to tackle systemic risks

Austrian banks have relatively low capital ratios

⁵ See e.g.: IMF. 2014. *Global Financial Stability Report*. May.

⁶ In Austria, the BRRD was implemented by the adoption of the Federal Act on the Recovery and Resolution of Banks (*Bundesgesetz über die Sanierung und Abwicklung von Banken – BaSAG*), which came into force in 2015.

⁷ The Czech Republic, Croatia, Denmark, Estonia, the Netherlands, Norway and Sweden have introduced these buffers.

Growth effects of the systemic risk and O-SII buffers are positive

requirements. Some countries have brought forward the full application of the capital conservation buffer.⁸ The macroprudential responses to systemic risks emanating from the real estate sector are more diverse: They encompass tools based on the Capital Requirements Regulation regarding risk weights and values of losses-given-default,⁹ as well as policies based on national law such as loan-to-value or loan-to-income ratios.¹⁰ A number of countries¹¹ have also introduced the anti-cyclical capital buffer regime ahead of time.

O-SII buffer addresses risks that a bank poses to the financial system

The O-SII buffer was introduced to address risks that emanate from a specific bank. The European Banking Authority's (EBA) guideline on the identification of O-SIIs stipulates four characteristics for a bank to be identified as an O-SII: (1) size, (2) importance,¹² (3) complexity and cross-border activity and (4) interconnectedness. An O-SII may be required to hold an additional capital buffer of up to 2% of CET1 in relation to its risk-weighted assets.

Systemic risk buffer addresses systemic risks banks are exposed to

The OeNB considers the systemic risk buffer to be the most suitable instrument for strengthening the resilience of the Austrian banking system further. Its application has two objectives: first, increasing banks' resilience with respect to risks emanating from the large size of the banking system, i.e. banks hold more capital and therefore should be able to bear the costs of potential future banking crises instead of having to resort to taxpayers' money; and second, increasing the resilience of the Austrian banking system with respect to shocks emanating from CESEE.

Capital ratio increase of Austrian banks stalls

The OeNB has carried out a comprehensive cost-benefit analysis of the introduction of the systemic risk buffer and the O-SII buffer in Austria and found that there would be a minimal reduction in economic growth over the short term. In the long term, however, the reduction in the probability and costs of banking crises has in fact significant positive effects on economic growth. The risk-adequate pricing of loans should subsequently improve the allocation of capital and, as a result, lead to more sustainable economic growth. The OeNB also expects that the introduction of the systemic risk buffer and the O-SII buffer would have long-term positive economic effects on the CESEE host countries of Austrian banks' subsidiaries. A number of host authorities have already taken macroprudential measures; the OeNB considers the Austrian measures to be complementary to and supportive of these measures.

Overall the systemic risk buffer and the O-SII buffer constitute the least intrusive tools that combine high effectiveness and transparency with the lowest possible distortion of credit supply and the Single Market. These buffers will also improve the relation between Austrian banks' risk exposure and risk-bearing capacity, which is still weak.

The planned macroprudential buffers will help to align Austrian banks' capital levels with those of their peers. The increase in the capital ratios of Austrian banks that was observed in previous years came to a halt in 2014. The three largest Austrian banks even

⁸ Bulgaria, the Czech Republic, Estonia, Finland, Italy, Lithuania, Luxemburg, Latvia, Norway, Sweden and Slovakia.

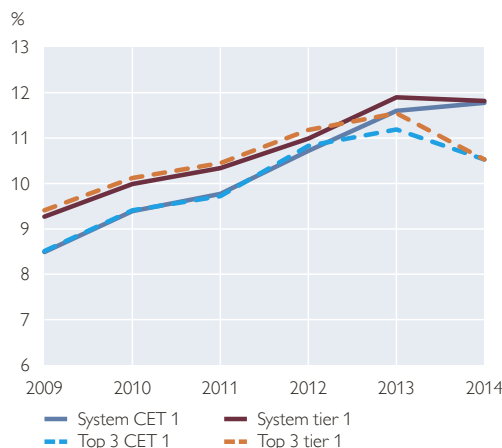
⁹ E.g. In Belgium, Croatia, Ireland, Norway and Sweden.

¹⁰ E.g. In Cyprus, Hungary, the Netherlands and Slovakia.

¹¹ The Czech Republic, Norway, Slovakia, Sweden and the United Kingdom.

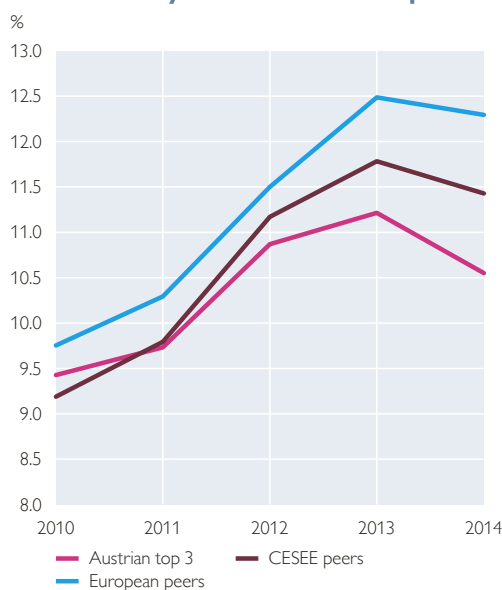
¹² E.g. share in payment transactions, share in deposits, share in loans.

Chart 13

Capital ratios of Austrian banks

Source: OeNB, SNL Financial.

Chart 14

CET1 ratio by international comparison

Source: SNL Financial.

saw a reduction in their capital ratios (chart 13). These developments can largely be ascribed to a reduction in share premiums and Basel III transitional adjustments. Strategies to im-

prove capital ratios differed somewhat across banks, but the general pattern – except for the top 3 banks – was a shift away from reducing risk-weighted assets toward retaining profits. Low bank profitability, however, limits organic capital generation at Austrian banks and shareholders' capacity to recapitalize banks at reasonable costs during a crisis is often weak.

At the end of 2014, Austrian banks continued to lag behind their European and CESEE peer groups; the difference between the average CET 1 ratio of Austria's top three banks (10.6%) and that of their European¹³ (12.3%) and CESEE peers¹⁴ (11.4%) remained significant. Consequently, Austrian banks should continue to aim at closing this widening gap (chart 14), especially since market participants are expecting banks to hold significantly more capital than minimum requirements stipulated by the Basel III rules.

While the capital ratios of Austrian banks remained broadly unchanged, the leverage ratio increased to 5.7% in the course of 2014. This figure is well above the European average. The median fully-loaded Basel III leverage ratio for European large and complex banking groups stood at 3.7% at end-2014, although it showed some variation across institutions and countries.

Austrian banks' profitability still under pressure

Continuing the trend of recent years, 2014 was characterized by high credit risk provisions and low interest rates. Therefore, the profitability of European banks was still under pressure. While banks have made further progress in addressing legacy issues from

¹³ The European peer group consists of 29 European banks with similar business models.

¹⁴ The CESEE peer group consists of 12 European banks with relevant CESEE exposure.

the financial crisis, the outlook for growth remains subject to downside risks both for the euro area and CESEE. Geopolitical tensions resulting from the Russia-Ukraine conflict had repercussions in CESEE markets and hence for the activities of Austrian banks as well.

Austrian banks' consolidated net profit back in positive territory in 2014

The Austrian banking sector generated a net profit of EUR 1.4 billion in 2014 after a net loss in the preceding year. This profit was equivalent to a consolidated return on average assets of 0.1%. The 2014 result does not reflect the losses of Hypo Alpe-Adria-Bank International AG (HAA), however, as the bank was put into resolution in the course of the year. For the second year in a row the Austrian banks deemed significant under the Single Supervisory Mechanism (SSM) faced a loss in 2014, while the less significant banks generated stable profits in both years.

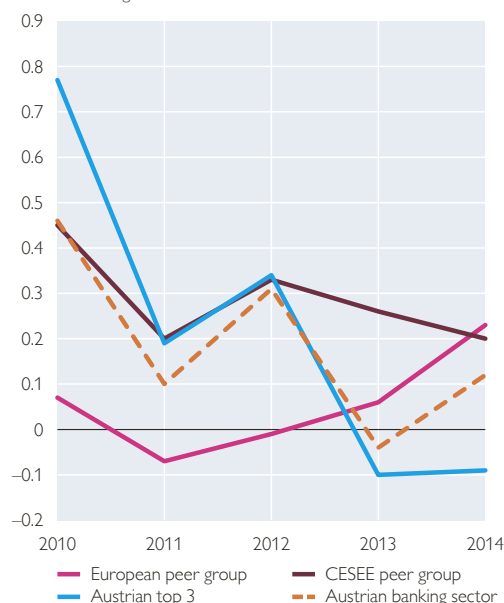
Due to sustained goodwill write-downs in CESEE, the net result of the top 3 Austrian banking groups continued to be negative in 2014. Compared to banks in their peer group, Austrian banks are therefore still lacking internal capital-generating capacity (see chart 15).

Provisioning remains at elevated level

Austrian banks' consolidated operating profit (before risk) improved by 16.8% in 2014. In the low interest rate environment banks were able to increase their net interest income. Fee and commission income was up as well. However, the downward trend in trading income continued in 2014. On the other hand, operating expenses were positively influenced by a reduction in staff costs. Compared to previous years, depreciations were also significantly reduced and administrative costs remained near the level of 2013 (see chart 16). This resulted in an overall improvement in the operating efficiency of Austrian banks, as the cost-in-

Austrian banks' profitability by international comparison

Return on average assets in %



Source: SNL Financial.

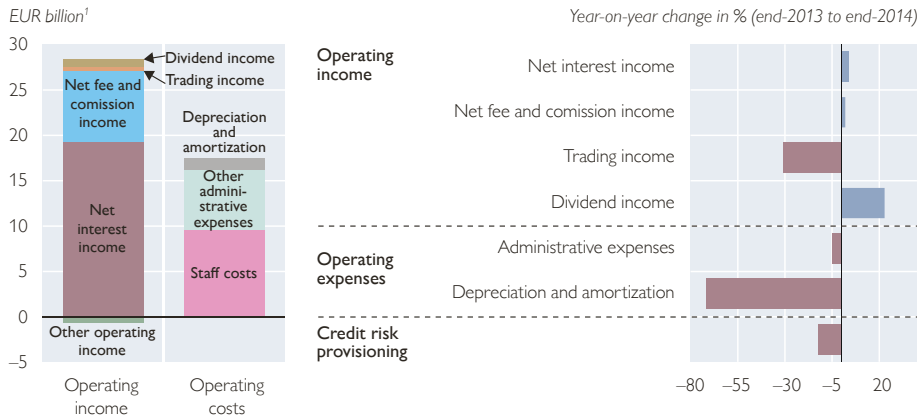
come ratio decreased slightly to 67.6% in 2014 (compared to 73.0% in 2013). However, efficiency-enhancing programs should be pursued further as this figure is still above historical values and the latest available EU average figures.

Provisions to cover credit risks in the loan portfolios continued to remain at elevated levels in 2014 (EUR 6.2 billion or two-thirds of total operating profit), but had decreased compared to the year before. However, this decline was caused by the adjustment of credit risk provisions after the restructuring of HAA. Also, two large banks had to increase their credit risk provisions due to developments in Russia and Ukraine. Hence, asset quality continues to be weak and remains a substantial drag on overall profitability.

The results of Austrian banks on an unconsolidated basis were affected by one-off effects in 2014. These (accounting and restructuring) effects led to a

Chart 16

Main drivers of Austrian banks' operating profit (consolidated level)



Source: OeNB.

¹ Figures as at end-2014.

net loss of EUR 6.7 billion. Without these effects the result would have been slightly positive, but still weak in comparison to banks in other countries. Tight competition in the domestic market, structural weaknesses and continuously low interest margins are set to remain a particular concern for a large number of Austrian banks.

Despite solid operating income, additional provisions made for future staff pensions¹⁵ triggered a strong increase in

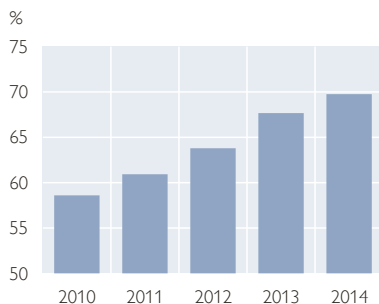
operating (i.e. staff) costs. Interest margins in Austria continued to be below the European average, even though the margins on existing business have risen slightly, especially at bigger institutions. Yet the effects of the low interest rate environment on banks' profitability have so far been smaller in Austria, as variable rate loans play a big role in the asset structure of Austrian banks. Nevertheless, high liquidity in the market paired with long-lasting low interest rates might be a burden on bank profitability. For a more detailed analysis of the effects of low and negative interest rates on Austria's banks, see box 2.

Net risk costs in Austria decreased by approximately 8% in 2014 due to the restructuring of HAA, but – as in 2013 – nearly offset operating profit.

Continued efforts by banks and supervisory authorities to foster the consolidation of the Austrian banking sector should ideally lead to more risk-adequate pricing in the future. This is important because the efficiency

Chart 17

Unconsolidated cost-income ratio of Austrian banks



Source: OeNB.

¹⁵ Due to lower discounting rates, some banks had to endow their pension schemes with additional funds.

Recovery of Austrian banks' profitability depends on structural factors and sustainable growth strategy

of the domestic business weakened in recent years (see the increase in the unconsolidated cost-income ratio shown in chart 17).

The recovery of Austrian banks' profitability, which is important for supporting organic capital growth, depends on the resolution of legacy credit quality issues in CESEE but also, and more importantly, on structural factors in the domestic market. As the profitability pressures on the Austrian banking sector described above persist, so does the need for further consolidation efforts.

The total assets of the Austrian banking sector amounted to EUR 896 billion at the end of 2014 on an unconsolidated level, mirroring a decline by 16.2% compared with 2008 and a reduction by 3.4% compared to 2013. Since 2008, the number of credit institutions in Austria has been reduced from 867 to 764 (end-2014). The two key banking system capacity indicators "inhabitants per local branch" and "inhabitants per bank employee" increased both by 3% in 2014 compared to the previous year. Nevertheless, the decentralized sectors with their large number of local branches and staff – compared to the latest euro area averages – still dominate the system.

The need for adjustments in the structure of the Austrian banking system has also been reflected in recent resolution and restructuring processes at several Austrian banks. Also, regulatory initiatives, such as the adoption of the Federal Act on the Recovery and Resolution of Banks (BaSAG), the act transposing the new EU bank resolution regime into national law, play an important role.

Given the low earnings-generating capacity and structural weaknesses of the Austrian banking sector, the CESEE business of Austrian banks has become

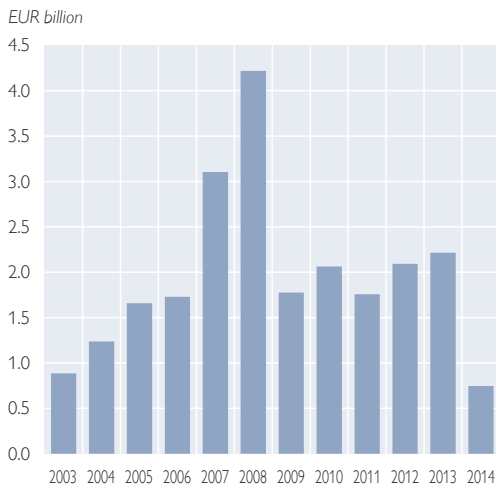
an ever more important contributor to profits. However, as banks are facing domestic and external risks in the CESEE region, Austrian banks are well advised to strengthen their domestic activities and their profitability. Market observers see a certain likelihood that changes in regulations and prolonged weak economic conditions in certain CESEE countries may prompt Western banks to become more selective about their foreign operations. Some banks have already announced that they will focus on core markets that are in a strong position to generate sustainable returns. This strategy includes, among other things, a reduction of risk-weighted assets in selected markets, a lower cost base as well as higher capital buffers. These efforts to adjust business models to new realities and regulatory requirements should be continued.

Austrian banks' subsidiaries in CESEE continued to make a positive contribution to the sector's consolidated net profit in 2014. However, net profits decreased significantly compared to 2013 – from EUR 2.2 billion to EUR 0.7 billion – despite the first time inclusion of profits from banking operations in Turkey in 2014. The sharp decline in net profits was mostly due to increased risk provisioning in Romania, new measures to reduce foreign currency loans in Hungary and the tensions surrounding Russia and Ukraine.

As in the years before, Austrian banks' subsidiaries in the Czech Republic, Russia, Turkey and the Slovak Republic accounted for the largest profit shares. However, net profits posted in Russia went down by 28% year on year. This was mainly due to increased risk costs, which had been on a relatively low level so far. Further negative factors included the sharp depreciation of the ruble and the deterioration of the overall operating environ-

Chart 18

Profits of Austrian subsidiaries in CESEE



Source: OeNB.

ment (i.e. slower lending growth, higher funding costs). The outlook for banking activities in Russia remains weak in 2015, marked by high funding costs, low credit and GDP growth,

pressure on credit quality, profitability and capitalization.

In a longer term comparison, Austrian subsidiaries' net profit registered a historical low in 2014. In general, the outlook for Austrian banks' profitability in the region remains weak on account of the following factors: ongoing uncertainties surrounding Russia and Ukraine; measures aimed at foreign currency loans that have already been or are set to be implemented in several CESEE countries, such as Hungary, Croatia and Poland; and banks' exposure to volatile emerging economies (such as Turkey), particularly in view of a potential monetary normalization in the U.S.A. In the first quarter of 2015, Austrian subsidiaries in CESEE recorded a net profit of EUR 0.6 billion, which is slightly below the figure of 2014. The reduction was driven by lower net interest income and lower fee and commission income, while provisioning and staff costs were also lower.

Box 2

Implications of the low – and partly even negative – interest rate environment for Austrian banks

The currently observed low and nearly flat yield curve is expected to have a negative impact on banks' net interest income, as it reduces the profitability of maturity transformation. Furthermore, the high level of banks' liquid assets in Austria in combination with the ECB's asset purchase program (APP) puts bank profitability under further pressure, exemplified by the yield of 25-year Austrian government bonds dropping by about 2 percentage points to 0.5% between April 2014 and April 2015. So far, there have been few signs that the low interest rates have negatively impacted the net interest income of European banks; margins have even profited from falling funding costs. Over the medium term though, adverse profitability pressures are likely to intensify and risks may accumulate in the financial system when money flows out of deposits into higher-yielding instruments and banks themselves start a hunt for yield by investing in riskier assets.

A more complex question is the impact of negative interest rates. The decision of the Swiss National Bank to lower the target for the Swiss franc three-month LIBOR to a range between -0.25% and -1.25% could have profound implications for Austrian foreign currency loans denominated in Swiss francs and referenced to this rate. The currently clearly negative reference interest rate would for some borrowers result in negative interest payments on their loans. In practice, however, the legal structure of credit contracts makes such reversely

oriented payments difficult. For banks, a zero percent floor on interest payments would widen their margins as they can refinance themselves with negative rates without passing them on to their customers. Depending on how open legal questions are resolved, several scenarios are possible:

- If banks were to be obliged to fully pass on negative rates to their customers, their margins would effectively be left unchanged. They could, however, even decrease, if banks would not be able to actually fund themselves at these negative rates.
- If banks were allowed to limit the nominal interest rate on loans at zero, banks' margins would depend on the negativity of the reference rate. Given that the average margin of Swiss franc loans is 1%, banks would earn the same margins, if the reference rate were between 0% and -1% and higher margins at reference rates below -1%.
- If banks were allowed to introduce a zero percent floor for the reference interest rate, banks would earn their contractual margin (of 1%) plus whatever they receive by financing themselves at negative rates.

Final legal decisions on these issues have yet to be made, but in any case, the effect on profitability remains dependent on the extent to which banks can actually refinance themselves at negative rates.

For more information regarding potential effects of the low interest rate environment on other market participants, such as life insurance companies as well as bond and equity markets, please refer to the dedicated sections at the end of this report.

Credit growth remains positive in 2014 both in Austria and CESEE

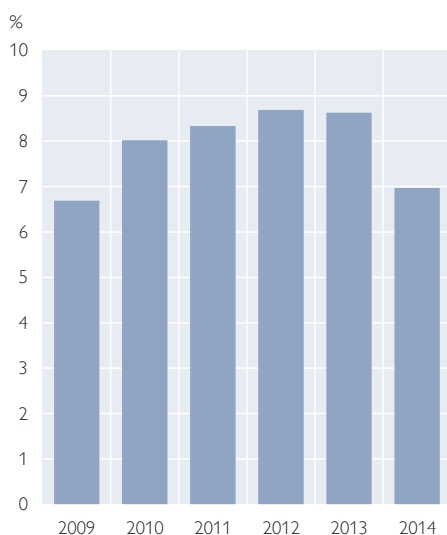
Following a small reduction in the previous year, loans to nonbanks in Austria increased in total by 0.7% year

on year in 2014, with lending having gained momentum especially in the second half of the year. Nevertheless, the overall growth rate was still well below the historical average, also into the first four months of 2015. In absolute terms, Austrian banks granted new loans¹⁶ to domestic customers amounting to EUR 94.1 billion in 2014. Loans for housing purposes remained the main driver of lending to households, whereas new loans for other purposes have declined since 2012. The rise was driven by a strong increase in euro-denominated loans.

Austrian banks' subsidiaries operating in CESEE did not markedly step up lending to customers over 2014. Adjusted for exchange rate effects, the total amount of outstanding customer loans stood at EUR 183 billion, up only 0.3% on an annual basis. It must be noted, however, that 2014 was also marked by significant one-off effects, most notably triggered by the restruc-

Chart 19

Nonperforming loan ratio of Austrian banks¹



Source: OeNB.

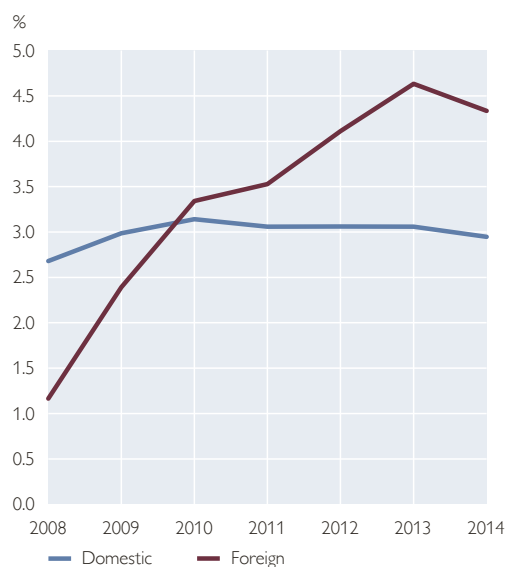
¹ Consolidated nonbank loan portfolio.

¹⁶ Contains all new business loans that are denominated in Euro.

turing of HAA's business in Southeastern Europe. Corrected for these one-off effects, the growth of customer loans was markedly higher at 2.6%. As in previous years, loan growth was heterogeneous across the region: In most countries, banks continued to reduce their gross exposures in 2014, most notably in Hungary and Romania,¹⁷ where customer loans dropped by about 10%.¹⁸ Yet the ongoing expansion of Austrian banks in markets like the Czech Republic, Slovakia, Russia and Turkey more than offset these deleveraging tendencies. Austrian banks' exposure to the latter two are monitored closely, given the Russia–Ukraine conflict and Russia's recessionary economic situation as well as Turkey's rapid credit growth over the past few years.

Although external financing by Austrian nonfinancial corporations via debt instruments was muted in 2014, the amount of outstanding bonds issued by Austrian nonfinancial corporations tripled in absolute terms in the decade between the second quarter of 2004 and the second quarter of 2014. The share of bond issuances as a percentage of external financing increased from 15% to 30%. Despite this strong disintermediation process, banks have posted positive rates of growth of credit to nonfinancial corporations of 8% since the onset of the crisis. This implies that an increasing share of the loan portfolio consists of loans to small and medium-sized enterprises (SMEs). In order to achieve higher market penetration in SME financing, banks might be tempted to decrease interest margins below the costs of capital, liquidity and risk. This in turn could lead to a systemic misallocation of capital and pose

Chart 20
Loan loss provision ratio in Austria by nationality of borrower



Source: OeNB.

a danger to financial stability. Thus, supervisors need to monitor carefully whether banks maintain reasonable interest margins throughout the economic cycle, even when loan demand and quantitative easing put profitability under pressure.

Against the background of weak macroeconomic conditions, Austrian banks have increased their consolidated loan-loss provisions since 2008, especially on account of their CESEE exposure. In 2014, restructuring at Austrian banks whose asset quality is weak picked up speed and led to an improvement in the relevant ratios: At end-2014, Austrian banks reported a consolidated nonperforming loan (NPL) ratio of nearly 7% and a consolidated loan loss provision (LLP) ratio of 4.5%; both ratios are well below 2013 figures (see chart 19 for the reduction in the

Bank restructuring triggers improvement in consolidated asset quality

¹⁷ In Romania, the sale of Volksbank Romania is not yet reflected in the data.

¹⁸ A significant reduction of loan volumes was seen also in Croatia, although mainly caused by HAA's restructuring.

Driven by Hypo Alpe-Adria-Bank's restructuring, credit quality at CESEE subsidiaries is improving

NPL ratio). This improvement mostly reflects the restructuring of HAA, as group-level credit quality at other Austrian banks was stable in 2014. It is still not clear how banks have to handle provisioning needs that have been identified during the ECBs' asset quality review in 2014, because the assessment was to some extent based on valuation rules different from those required by common accounting standards.

The asset quality in banks' domestic (unconsolidated) business was stable in 2014, with the NPL ratio and the LLP ratio standing at 4.4% and 3.3%, respectively. Nevertheless, there are differences in the quality of domestic loans, as provisioning for loans to foreign customers has by far outpaced that for loans to Austrian citizens over the last years (chart 20). As in previous years, the domestic asset quality at Austrian banks reflects a low ratio of problem loans, as banks' domestic assets have proven relatively resilient to the lackluster economic situation and consolidated trends have predominantly been driven by foreign exposures.

Credit quality in Russia is still good, but starting to deteriorate

The aggregate NPL ratio of Austrian banking subsidiaries in CESEE decreased by 2½ percentage points to 11.8% in 2014. Similarly, the NPL ratio for loans denominated in foreign currency fell to 15.7% compared to almost 19% at the end of 2013. Even though this reduction to a large extent stems from the restructuring of HAA, the underlying fundamental development was encouraging, too, as NPL ratios in core markets like Croatia and Romania, which used to be in the mid-twenties, are now below 20%. As indicated above, risks to credit quality in fast growing banking markets like Turkey and Russia – where NPL ratios are still very low – require close monitoring.

Austrian banks' direct exposure to Greece is negligible

The coverage of NPLs has improved significantly over recent years, but even

more so since HAA has shifted the majority of its NPL portfolio to its bad bank (HETA Asset Resolution AG). By the end of 2014, Austrian CESEE subsidiaries reported an aggregated NPL coverage ratio I (provisions relative to NPLs) of 65% and the respective ratio for foreign currency loans was almost similar (64%). The NPL coverage ratio II, which also includes eligible collateral, was substantially higher, mainly due to the high share of mortgage loans. It also improved significantly to 86% for all nonfinancial customer loans and stood at 80% for foreign currency loans.

The year 2014 also saw the leasing portfolio of major Austrian banks operating in CESEE decreasing strongly – to EUR 10 billion – and the share of nonperforming leasing loan volumes fell to 13%, compared with 23% one year ago. Again, this improvement was largely due to the restructuring of HAA.

In the Russian banking sector, in which state-related banks hold a dominant market share of close to 60%, Austrian banking subsidiaries have a market share of about 3%. The volume of outstanding loans of these subsidiaries was about EUR 20 billion at end-2014, 75% thereof were loans to corporates and 25% to households. Due to the strong ruble depreciation, the share of foreign currency loans in total loans increased to 51% (from 36% in the previous year) and they had been extended almost exclusively to corporates. Credit growth registered by Austrian subsidiaries was 7.7% in 2014, mainly driven by corporate loans, but also by consumer loans. While the NPL ratio was still moderate at 4.6%, the volume of NPLs started to rise, although from very low levels.

The prolonged negotiations on the Greek government's financial situation

have sparked a debate on potential spillovers to the European banking sector. Austrian banks reduced their exposure to Greece significantly between 2009 and 2012. At the end of 2014, Austrian banks' ultimate risk exposure to Greece amounted to EUR 116 million, EUR 7 million thereof were claims on

the Greek government. Direct contagion risks from a renewed flare-up of the Greek debt crisis are therefore limited for the Austrian banking sector, but second-round (including confidence) effects are difficult to assess at the current juncture.

Box 3

Implementing an effective framework for NPL resolution in CESEE

The recent boom-bust cycle in several CESEE countries has left local banking systems with a legacy of high volumes of nonperforming loans (NPLs). These NPLs remain a serious burden on balance sheets and often hinder a recovery of banks' profitability and new lending activities. Due to the high market share of foreign banks in the region, this also has negative implications for cross-border banking groups and for entire banking sectors. Besides the direct burden on banks, protracted NPL resolution is a drag on economic growth. Despite previous efforts by banks and the public sector, tackling the issue has proceeded at too slow a pace. Therefore, the European Bank Coordination ("Vienna") Initiative decided to act¹ and coordinate solutions for effective national frameworks for NPL restructuring and resolution.

Two working groups were established in 2011 that focused on the implications of selected regulations and the management of NPL portfolios. The results were then presented and discussed in several fora. To bring new momentum to NPL resolution, a regional NPL action plan was launched in early 2015. Under this plan, country-specific groups – comprising local authorities, local banks, advisors and other insolvency professionals as well as representatives from international financial institution – are asked to work on tailor-made solutions for individual countries. The tasks of these groups are (1) to conduct a stocktaking of obstacles to NPL resolution, (2) to recommend and endorse measures in the areas of regulatory as well as tax and legal changes and (3) to act as a single provider of legal and advisory support. The overall objective is to improve the environment for banks' internal NPL workouts as well as to set up a foundation for outright sales.

The action plan's roll-out started in Croatia and Hungary; some initial meetings have already taken place. Serbia and Albania will be the next focus countries. To ensure continuous progress, the Vienna Initiative will regularly review and discuss the results of national projects.

¹ Vienna Initiative. 2014. Vienna Initiative pushes for action plan to deal with NPLs in central and south-eastern Europe. Press release. September 26, 2014. <http://vienna-initiative.com/wp-content/uploads/2014/10/NPL-Press-Release.pdf> (retrieved on June 15, 2015).

Foreign currency loans decline further despite Swiss franc appreciation

Outstanding foreign currency (FX) loan volumes in Austria continued their downtrend in 2014. However, the recent appreciation of the Swiss franc in mid-January 2015 has both increased the outstanding volume in nominal terms and the funding gap between re-

payment vehicles and redemption amounts.

The stepped-up supervisory efforts aimed at curbing FX lending have proven effective. FX loans to domestic nonbank borrowers have steadily declined since October 2008. In April 2015, the volume of outstanding FX loans amounted to EUR 38.6 billion, which means a drop of 58% since

October 2008 on an exchange rate-adjusted basis.

In April 2015, FX loans to households made up 70% or EUR 27.1 billion of FX loans to domestic borrowers and EUR 6.8 billion were FX loans outstanding to nonfinancial corporations. Three out of four FX loans to domestic households were bullet loans linked with a repayment vehicle, i.e. an investment – e.g. a life insurance policy – which is used to repay the principal of the loan at the end of the term.

In order to get a read on the funding gaps of repayment vehicle loans the FMA and the OeNB conducted a survey in early 2015 – an update of the surveys of 2009 and 2011. The survey covered 35 banks that account for more than 85% of outstanding FX loans which have to be repaid (fully or in part) via repayment vehicles. The results revealed that the aggregate funding gap of FX repayment vehicle loans amounted to 14% of the outstanding amount – or EUR 3.3 billion – at end 2014. This would constitute a reduction from the June 2011 numbers both in relative terms (2011: 20%) and in absolute terms (2011: EUR 5.8 billion). However, if the appreciation of the Swiss franc vis-à-vis the euro by 15% between December 31, 2014, and April 30, 2015, is factored in, the funding gap will widen to an estimated 23% or approximately EUR 6 billion.

The distribution of systemic risks arising from FX lending to domestic borrowers has changed over the past few years: The outstanding volumes of FX loans as well as the number of FX borrowers have declined strongly. At the same time, the funding gaps – taking into account the recent Swiss franc appreciations – have increased in relative and absolute terms. Another source

of risk is the asset valuation in repayment vehicles, the majority of which has benefitted from the asset price surges in financial markets spurred by low interest rates in major world economies over recent years. These asset valuations might erode, however, when financial markets turn, which would widen funding gaps even further. And although the majority of FX bullet loans will mature only after 2019, hoping for FX markets to turn for the better is a risky strategy and issues should be proactively addressed by borrowers and their banks.

In line with the ongoing downward trend of FX lending in Austria, Austrian banks have continued to reduce their FX loan exposure in CESEE. The total FX exposure (including direct and indirect lending as well as leasing) of Austrian banks in CESEE had decreased to EUR 116 billion by the end of 2014, supported by the restructuring of HAA (see chart 21). The associated FX loan share was 49% for the Austrian banks and their subsidiaries taken together and 42% for their CESEE subsidiaries.

The biggest contribution to this notable decline came from cross-border direct lending, which dropped by almost 15% year on year. FX lending via subsidiaries decreased further to EUR 77 billion (–2.9% year on year or –5.4% year on year adjusted for exchange rate effects). FX leasing in CESEE amounted to EUR 3.9 billion at the end of 2014.

Although these figures seem quite encouraging it should be pointed out that more than half of the reduction in FX lending of Austrian subsidiaries and basically the entire reduction in the FX leasing exposure was due to the restructuring of HAA.

Swiss franc appreciation widens funding gaps of FX bullet loans

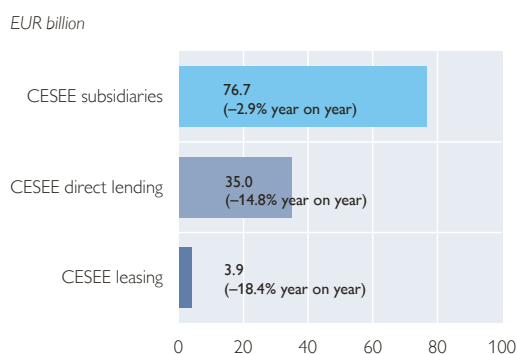
FX exposure in CESEE declines markedly but FX share in total loans remains close to 50%

Chart 21

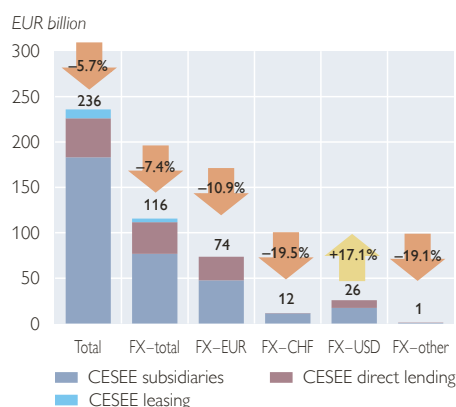
CESEE credit and leasing exposure denominated in foreign currency at the end of 2014

Foreign currency exposure of Austrian banks in CESEE

(growth rates from Q4 2013 to Q4 2014)



CESEE credit and leasing exposure by type and currency



Source: OeNB (all figures are not exchange rate adjusted).

The reduction in the overall credit exposure toward CESEE was driven particularly by a significant reduction in FX loans denominated in euro and Swiss francs. However, growing U.S. dollar lending, especially in Russia and Turkey, in connection with the appreciation of the U.S. dollar in 2014 has partly offset this development. To date it seems unlikely that borrowers are able to significantly mitigate the risk associated with an increasing U.S. dollar exchange rate by either natural or financial hedges, as most corporate customers do not seem to have enough income in U.S. dollars.

The decision of the Swiss National Bank (SNB) to remove the EUR/CHF peg in January 2015 did not only directly increase the notional amounts denominated in Swiss francs, it also fueled a wave of regulatory action concerning FX loans in several CESEE countries. Both new regulatory measures and those taken in the past pose a

challenge to Austrian banks. While a forced conversion of households' FX mortgages took place in Hungary, the Croatian parliament passed a temporary exchange rate fixing for Swiss franc-denominated mortgage loans, which is set to last one year. Despite actively discussing various approaches, Polish regulators have not yet taken specific action.

Liquidity levels at Austrian banks reach record high

Continuous inflows of deposits and low credit demand have pushed up Austrian banks' liquidity levels to a record high. On April 17, 2015, the aggregate counterbalancing capacity of the Austrian banking system (maturities of up to three months without money market operations) stood at EUR 143 billion, up from EUR 131 billion a year ago.¹⁹ At the same time the corresponding cumulated net funding gap decreased to EUR 6.9 billion from EUR 8.8 billion.

Regulatory measures to reduce burden for FX borrowers in CESEE

¹⁹ Based on the weekly liquidity reports submitted by the largest 30 banks in the system, which account for about 85% of total assets.

Banks have addressed excess liquidity by reducing own issuances. Over the past year the stock of outstanding short-term and long-term bank issuances decreased by more than 7% to EUR 200 billion. This leaves banks with sufficient room to adjust to a more challenging issuing environment, as spreads have widened in the aftermath of the Heta moratorium adopted on March 1, 2015.²⁰

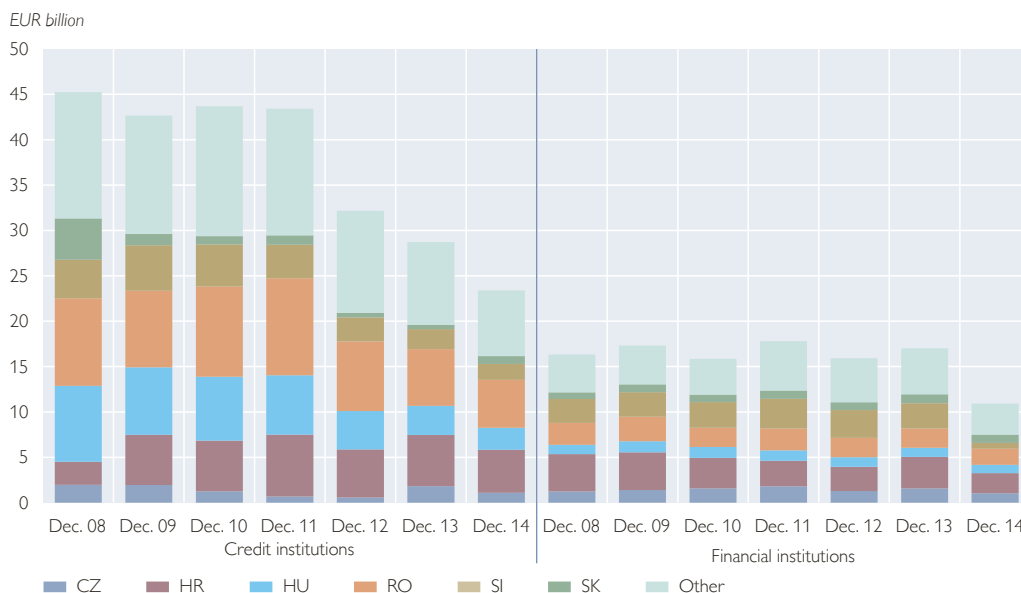
Local funding position of foreign subsidiaries improves further

The Austrian ‘Sustainability Package’ adopted by the OeNB and the FMA in 2012²¹ stipulates that the stock and flow loan-to-local stable funding ratios (LLSFRs) of foreign subsidiaries of Austria’s three largest banks be monitored. This measure was introduced based on Austrian supervisors’ experience that banking subsidiaries which had entered the recent financial crisis

with high LLSFRs were significantly more likely to exhibit higher loan loss provisioning rates than other subsidiaries that followed a more conservative business and growth model. Therefore, banking subsidiaries with stock LLSFRs above 110% are considered to be “exposed” and the sustainability of their loan growth has to be monitored more closely. The stock LLSFRs of the monitored subsidiaries have shown a welcome trend in 2014. Most subsidiaries saw their stock LLSFR declining or stabilizing, which points to an improved local stable funding position. At the end of 2014, only one out of 35 subsidiaries was both exposed in terms of its elevated stock LLSFR and had an unsustainable flow LLSFR over the past twelve months, which qualifies this subsidiary’s business model as un-

Chart 22

Intragroup liquidity transfers of Austrian banks to their CESEE subsidiaries



Source: OeNB.

Note: Financial institutions also cover leasing activities, for example.

²⁰ http://www.heta-asset-resolution.com/sites/hypo-alpe-adria.com/files/content/announcement/file_download/k3505-heta_brief-zahlungsstop_beilage_bescheid-eng.pdf (retrieved on June 15, 2015).

²¹ For more details, please see <http://www.oenb.at/en/Financial-Stability/Systemic-Risk-Analysis/Sustainability-of-Large-Austrian-Banks--Business-Models.html> (retrieved on June 15, 2015).

sustainable (according to the relevant supervisory guidance). Another three subsidiaries exhibited an elevated stock LLSFR, but a positive trend in their new business.

Data also show that the volume of intragroup liquidity transfers to CESEE was substantially reduced in the course of the financial crisis (see chart 22), which reflects the increased importance of local funding sources. This re-

duction of subsidiaries' dependence on intragroup liquidity was particularly pronounced for credit institutions (as gross liquidity recipients), where volumes fell by close to one-half between end-2008 and end-2014. At the same time liquidity transfers to financial institutions (e.g. leasing companies) were reduced by one-third. Again, the restructuring of HAA contributed markedly to this development.

Intragroup funding continues to decline in importance

Box 4

The new legal framework for deposit guarantee schemes (DGS)¹

The new Austrian law on deposit guarantees and investor compensation (*Einlagensicherungs- und Anlegerentschädigungsgesetz, ESAEG*) will transpose the EU Directive on Deposit Guarantee Schemes (DGSD) into national law.² Together with the Single Supervisory Mechanism (SSM) and the Bank Recovery and Resolution Directive (BRRD), the DGSD is the third pillar of the European banking union.

Under the current framework, there are five different deposit guarantee schemes in Austria. The total amount of covered deposits under these schemes was EUR 192 billion at the end of 2014 (table 1).

Table 1

Deposit guarantee scheme	Covered deposits	Covered investment services	Total assets
	EUR billion		
Joint stock banks	43.4	4.7	197.5
Savings banks	61.7	8.6	284.3
State mortgage banks	6.2	0.5	63.2
Raiffeisen	65.7	4.5	271.3
Volksbanken	15.1	1.3	45.4
Total	192.1	19.6	861.7

Source: OeNB.

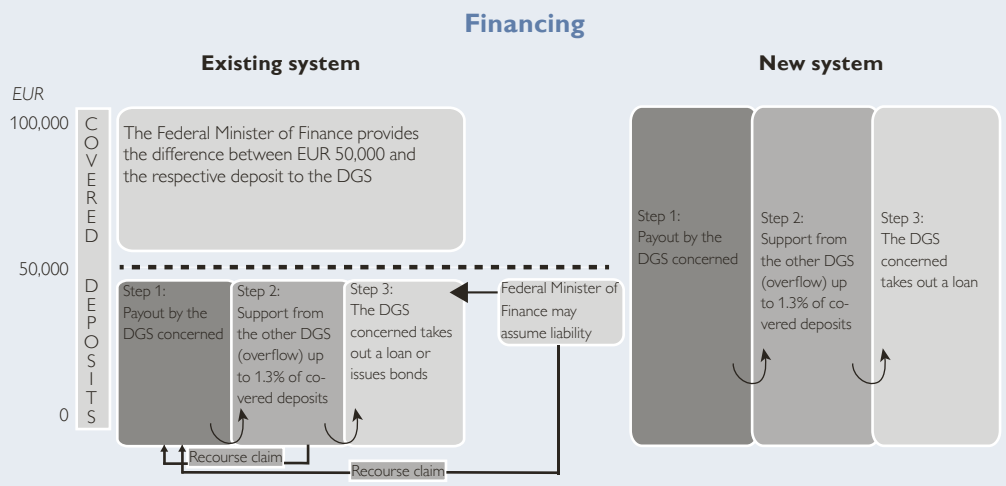
The ESAEG provides for substantial amendments to the current framework that will strengthen the protection of deposits in Austria. While the coverage level remains EUR 100,000 per depositor and credit institution, the group of covered depositors will be extended (to include, e.g., large nonfinancial companies); also, deposits in foreign currencies will be included. To ensure a timely payout and reduce procyclical effects, credit institutions will be required to pay annual risk-based contributions to build up ex-ante funds of at least 0.8% of covered deposits by mid-2024 (part of which can be payment commitments). If the ex-ante fund of a DGS is not sufficient to finance a payout, ex-post contributions of up to 0.5% of covered deposits may be raised within the DGS concerned. It is only then that other national DGS are required to provide their financial means (overflow from one national scheme to the others). Finally, as a last resort, the deposit guarantee scheme concerned may take out a loan.

¹ Editorial close: June 15, 2015. The draft ESAEG will be finalized with the Austrian parliament adopting the act in July 2015.

² Investor compensation provisions remain unchanged (including the coverage level at EUR 20,000).

Funding will be exclusively provided by credit institutions. Government involvement in financing a payout is no longer part of the legal framework (chart 1). This set-up will reduce negative incentives for the banking sector (“moral hazard”) and remove the contingent liability from the federal budget.

Chart 1



To strengthen depositor confidence, the payout period will be gradually reduced from 20 to 7 working days by 2024. In addition, the existing complex structure comprising five national deposit guarantee schemes will be changed, as only one common scheme is foreseen to be in place as of 2019. Additionally, institutional protection schemes (IPS) may be recognized as DGS.

The financial means of DGS will be used not only to repay depositors but also in the context of a credit institution’s resolution, provided that depositors have continuous access to their deposits during resolution. According to the Austrian legal act to implement the BRRD, the liability of a DGS in connection with a bank in resolution is limited to 0.4% of covered deposits (50% of the target level of the ex-ante funds). An IPS that has been recognized as a DGS may use the available financial means for alternative (e.g. recovery) measures as well. The FMA is designated to supervise DGS in cooperation with the OeNB to ensure compliance with the new rules.

The new legal framework for DGS improves financial stability in Austria, as funds for deposit payouts are now collected in advance, the coverage level will be maintained and credit institutions are required to take full responsibility for the financing of deposit payouts without having recourse to public funds.

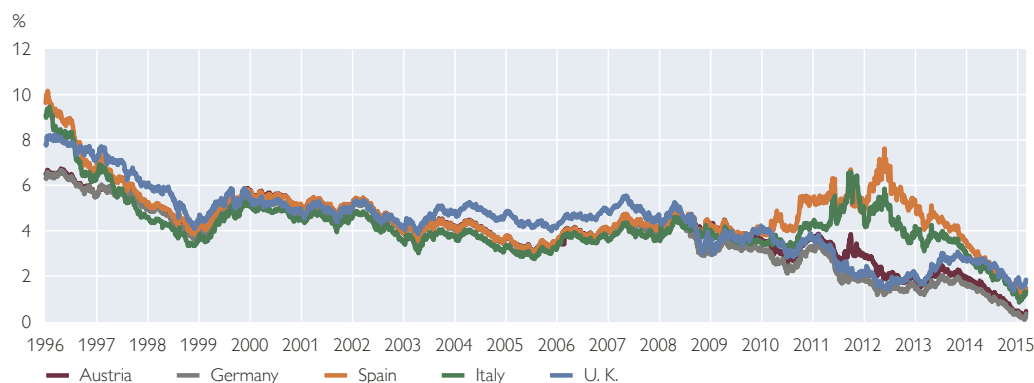
Ultra-low interest rate environment – no clear-cut evidence of acute cyclical risks

What are the financial stability implications of monetary policy rates close to or even below zero and the balance sheet expansion of central banks around the world by a total of about EUR 10

trillion? There is no clear-cut answer to this question. On the one hand, higher growth could reduce defaults and reduce losses given default. On the other hand, the search for yield might lead to excessive risk taking and the mispricing of risk across the financial system. This in turn would lead to the

Chart 23

Selected European 10-year sovereign bond yields



Source: Bloomberg.

misallocation of capital, lower medium- to long-term growth and increasing systemic risk.²²

Since the sovereign debt crisis in 2012, European sovereign bond spreads have contracted. Chart 23 shows the alignment of sovereign bond yields of Austria, Germany, Spain and Italy with the introduction of the euro; the U.K. is shown as an example of a non-euro area EU country. From 2000 until the collapse of the investment bank Lehman Brothers (in September 2008), sovereign bond yield spreads (the difference between a country's sovereign bond yield and the German sovereign bond yield) remained low. For Italy, it was negative (average -0.31 basis points), for Austria and Spain, it amounted to 12 basis points. These low spreads were unlikely to reflect the actual credit quality of the sovereigns. With the onset of the financial crisis, bond yields started to diverge. The spreads for Austria remained relatively small, at an average of 51 basis points, while those of Italy and Spain spiked to 456 basis points (in December 2011)

and 552 basis points (in August 2012), respectively. By April 2015 (after the ECB's public sector purchase programme started in March), these spreads had fallen back to 11 basis points for Austria, 113 basis points for Spain, and 97 basis points for Italy. Despite this significant spread compression, the levels are now well above their pre-crisis minimum levels.

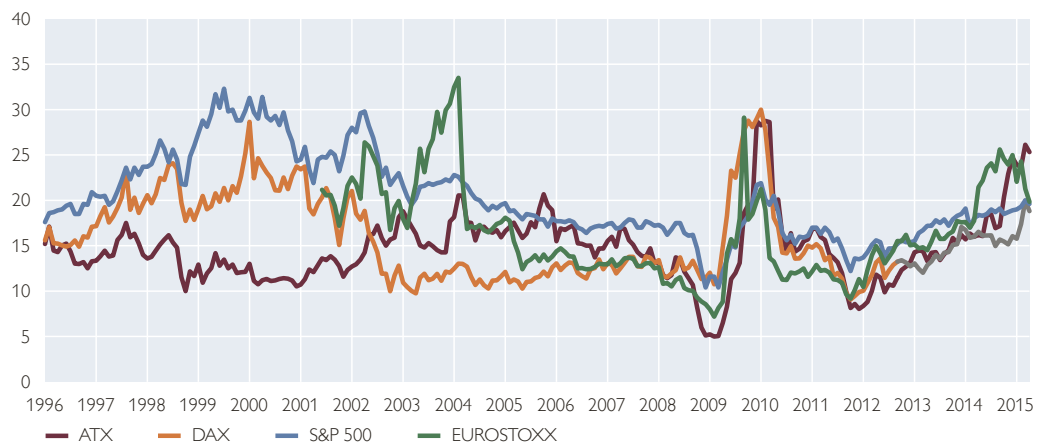
Similar dynamics were observable in the corporate bond market. Like sovereign bond yield spreads, high-yield bond spreads remained²³ narrow during the pre-crisis period 2002 to 2007 (at an average of 500 basis points). With the onset of the financial crisis and previously mispriced risks materializing, high-yield bond spreads suddenly and dramatically increased (a maximum spread of 1,950 basis points was reached in the first quarter of 2009). By mid-2014, the spread was almost as low as at its minimum in the third quarter of 2007 (261 basis points versus 234 basis points). Over the past few months, this trend has reversed slightly: The spread increased continuously and reached

Initial signs of a potential build-up of asset price bubbles

²² The risks of a misallocation of funds due to a search for yield were also recently highlighted by the IMF (see global financial stability report, April 2015) and the ECB (see financial stability review, May 2015).

²³ The high yield bond spread is defined as the difference between the Pan-European High Yield Index of the least creditworthy borrowers and Thomson Reuters AAA rating corporates' 10 years benchmark yield.

Price-to-earnings ratios of selected equity indices



Source: Thomson Reuters.

380 basis points in the first quarter of 2015, pointing to slightly higher risk aversion.

Overall, stock markets showed an upward trend over the past few years. In order to assess the cyclical dynamics of equity markets, we look at the price-earnings ratio (P/E ratio) as a useful indicator of the potential build-up of an overvaluation of equity prices (“equity bubble”). In chart 24, the P/E ratio for several equity indices shows a (slight) tendency of overvaluation since the beginning of 2014, especially for the ATX and the EUROSTOXX. Before the recent financial crisis, the average P/E ratio of the ATX was 16;²⁴ it increased almost up to 29 in 2010, declined strongly to 8 in 2012 and has continuously been increasing since then, reaching a level of 25 in April 2015.

In sum, there are initial signs of a potential build-up of asset price bubbles in bond and equity markets. Macroprudential policy can complement monetary policy by addressing its unintended consequences for financial stability. However, macroprudential instruments (e.g. the countercyclical capital buffer²⁵) only address cyclical systemic risks arising from the banking sector and there is still a lack of instruments for the nonbank financial sector.²⁶ These instruments would need to be well designed to capture risks arising from financial markets.

Low interest rates remain the key risk for life insurers offering guaranteed interest rates

A prolongation of the low yield environment and weak macroeconomic

²⁴ A P/E ratio of 16 means the price of a share is equivalent to 16 times its past yearly earnings. As the multiple is based on past earnings (not expected), the P/E ratio has a cyclical component: In an upward phase, expected earnings are reflected in the price but not yet shown in the past earnings.

²⁵ This buffer focuses on excessive bank credit growth and cannot address the systemic mispricing of risks in financial markets.

²⁶ See the speech by ECB Vice-President Vítor Constâncio “Is financial regulation holding back finance for the global recovery?” Washington, D.C. April 16, 2015. <http://www.ecb.europa.eu/press/key/date/2015/html/sp150416.en.html> (retrieved on June 15, 2015).

conditions remain the key risks for the insurance sector. Low profitability inducing a risky search for yield and a potential re-emergence of the sovereign debt crisis are further sources of risks for the sector. Even so changes in the asset allocation of Austrian insurance companies (chart 25) suggest derisking rather than an increase in credit risk.

The European Insurance and Occupational Pensions Authority (EIOPA) ran a stress test, including a low-yield scenario, in 2014. The results have shown that the key vulnerability of the European insurance sector is the so-called “double hit:” first, insurers are particularly vulnerable to an abrupt fall in global asset prices as a result of a reassessment of risk premiums and/or a new sovereign debt crisis; second, an extended period of low risk-free interest rates poses a challenge to insurers. Low risk-free rates increase the value of insurers’ long-term liabilities but

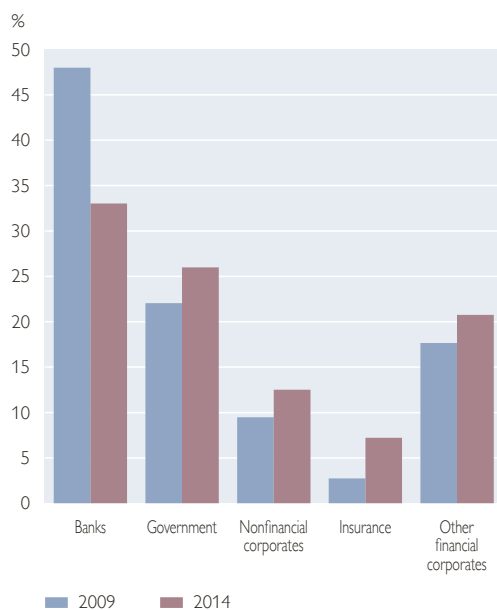
also that of their investments, but compress the margins between guaranteed returns in life policies and newly bought low-risk assets. The insurers affected most by the low interest rate scenario in the stress test were those with a significant mismatch in duration and returns between assets and liabilities (i.e. liabilities are “longer” than assets and/or guarantee rates are above the return rates of assets) and life insurance businesses with long-term guarantees. On the country level, Austria, Germany, Sweden and Malta are the countries that were found to be most exposed to the risks of the current low interest rate environment in the stress test.

Insurance companies are also faced with regulatory challenges, as they have to prepare for compliance with the legal provisions of Solvency II and its new capital requirements that enter into force in 2016. Chart 25 shows how Austrian insurance companies modified

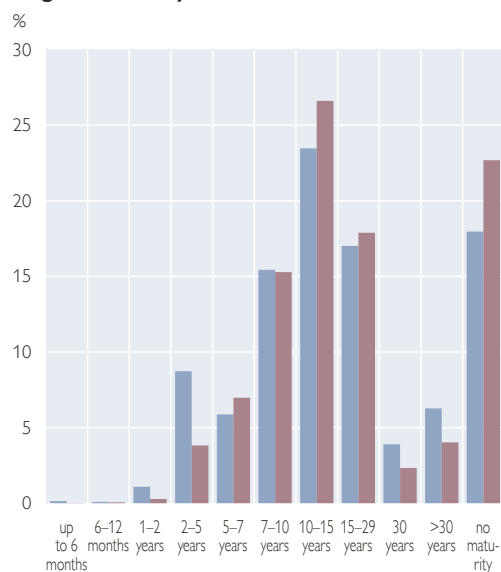
Chart 25

Considerable changes in investment behavior of Austrian insurance companies

Asset allocation of insurers’ investments in securities



Insurers’ investments in securities by original maturity



Source: OeNB.

EMIR license for
CCP Austria
granted in 2014

their investment behavior in the post-crisis and pre-Solvency II environment.²⁷

From end-2009 to end-2014, the securities investments of Austrian insurance companies show a notable shift away from investments in bank securities (–15 percentage points) toward government bonds²⁸ (+4 percentage points), nonfinancial corporations (+3 percentage points) and other financial corporations, including insurers (+8 percentage points). Overall, the share of investments in the financial sector (banks, insurance and other financial corporates taken together) in insurers' total investments decreased from 68% to 61%; in other words, the portfolio's dependence on the financial sector has decreased, but is still high.

Insurers also adjusted their investments' maturities, moving away from short (2–5 years) and very long maturities (30 years, more than 30 years) toward the 10–15 years maturities band, as the low yield environment makes short-term securities particularly unattractive and investing in very long running assets holds the risk of missing potential interest rate rises.

Summing up, the low interest rate environment has been identified as a crucial risk for the insurance sector over the medium term. Even though the FMA has already introduced additional provisioning requirements that will have to be built up over the next years (depending on an individual company's (stock) guaranteed interest rate and a benchmark interest rate), close monitoring remains essential and further regulatory action on a European and domestic level should be considered to avoid negative effects on financial stability in due time.

²⁷ However, these data have been subject to several inconsistencies so that sound conclusions have to be based on further investigation.

²⁸ Including regional and local governments.

A new legal framework for financial market infrastructures

Payment and securities settlement systems have also been subjected to numerous new legal requirements adopted at the European level, especially regarding financial market infrastructures, i.e. central counterparties (CCPs) and central securities depositories (CSDs). In Austria, the CCP Enforcement Act (Zentrale Gegenparteien Vollzugsgesetz – ZGVG) transposes the European Market Infrastructure Regulation (EMIR) into national legislation. The ZGVG, which was enacted in 2013, establishes the FMA and the OeNB as supervisors of CCPs with shared responsibilities. On this basis, the sole Austrian CCP – CCP Austria Abwicklungsstelle für Börsengeschäfte GmbH – was granted a CCP license in mid-2014.

The CSD Enforcement Act (Zentralverwahrer Vollzugsgesetz – ZvVG), which implements the CSD Regulation in Austria, is expected to enter into force in 2015 and takes the idea of the above mentioned ZGVG further. Against this background, Central Securities Depository Austria, the sole national CSD, will have to apply for a CSD license, which will be required under the new law.

Furthermore, the going live of TARGET2-Securities (T2S) in mid-2015 is closely monitored by the ECB – in its capacity as lead overseer of T2S – in cooperation with the competent national supervisors and overseers of the participating CSDs. The migration of Central Securities Depository Austria to T2S is scheduled for the third migration wave in September 2016.

New Austrian bond yield index UDRB introduced on April 1, 2015

For more than three decades, the indices for secondary market yields (SMR) had been published broken down by groups of issuers. Government bonds were the most important group as the SMR indices were weighted by the volume outstanding. Hence, the government bond SMR (“SMR Bund”) also dominated the overall SMR (“SMR Emittenten gesamt”). Trading in government bonds at the Vienna stock exchange has decreased over time and therefore the data base for the SMR calculation has shrunk over the years. The Oesterreichische Kontrollbank AG (OeKB) stopped calculating and publishing the SMR at end-March 2015. However, discontinuing the publication of secondary market yields was deemed undesirable as references to the SMR exist in many financial contracts, like bank loan agreements, often as a requirement under federal or provincial law.

Although it has been under no legal obligation to calculate or publish the SMR up to now, the OeNB offered to calculate and publish the “average government bond yields weighted by outstanding amounts” (Umlaufgewichtete Durchschnittsrendite für Bundesanleihen, UDRB) replacing the SMR from April 2015.

The transition from SMR to UDRB is set out in the federal law on the determination of weighted average yields on government bonds. According to the underlying law, the UDRB will succeed the SMR indices “central government,” “domestic issuers” and “domestic nonbanks” as well as “issuers total.”

SMR indices can no longer be used as reference interest rates in new contracts. In contracts concluded up to the end of March 2015 that use SMR indices as reference interest rates, the SMR must be replaced by the UDRB unless the contracting partners have agreed or agree otherwise. The SMR index for “domestic banks” issuances is exempt from this change; the OeKB will continue to make it available until the end of June 2015. A replacement for the SMR index for domestic banks’ issuances has not been provided for by law. As a consequence, any succeeding indicators must be agreed upon individually by the contracting partners.

The average government bond yields weighted by outstanding amounts reflects an average of the secondary market yields of individual government bonds, weighted by the volume outstanding according to the applicable redemption schedule. The individual yields are based on transaction data reported to European supervisory authorities according to the MiFID. These data are then provided by the FMA to the OeNB on a transaction level. Instead of solely reflecting the illiquid official market at the Wiener Börse including Europe, however, MiFID data ensure broader market coverage. Instruments must fulfill the following criteria in order to be included in the calculation of UDRB: They must be denominated in euro, have a fixed yield and a residual maturity of more than one year.

While the SMR was published daily, the UDRB will be published once a week (for every business day of the preceding week). The monthly, quarterly and annual figures are based on the arithmetic mean of the calculated trading-day figures. The OeNB publishes every Friday the UDRB trading day figures of the previous week. For additional information, please refer to <http://www.oenb.at/en/Statistics/Standardized-Tables/interest-rates-and-exchange-rates/austrian-government-bond-yields.html>.

OeNB assessment and recommendations

The Austrian banking system returned to profitability in 2014, albeit aided by the restructuring of HAA, but several of its structural issues prevail and need to be resolved in order to sustainably increase the system’s stability. The per-

sistently weak earnings situation in Austria and substantially reduced profits of CESEE subsidiaries have hindered internal capital generation, which came to a halt in 2014, with the largest banks’ capital ratios still well below their peers’. And while asset quality indicators show first signs of improvement, as

several banks started overdue restructuring processes, new challenges have emerged over the past few months: Ultra-low interest rates in Europe – that are linked to extraordinary monetary policy measures, including the ECB’s quantitative easing – may adversely impact banks’ operating profits over the medium term, and the sudden appreciation of the Swiss franc could have negative effects on foreign borrowers’ creditworthiness. On the regulatory front, the Federal Act on the Recovery and Resolution of Banks (BaSAG) and the proposed new legal framework for deposit guarantee schemes (ESAEG) are important milestones in the completion of the European banking union, while recommendations by the Financial Market Stability Board (FMSB) underpin purposeful macroprudential policies in Austria. Although this welcome paradigm shift creates short-term uncertainties in financial markets, it will ultimately improve financial stability in the long run by providing adequate tools when dealing with troubled banks. Regarding other financial intermediaries, low interest rates remain the key risk to life insurers offering guaranteed interest rates. With all these issues in mind, the OeNB recommends that the following action be taken:

- Banks should continue to strive for capital levels that are commensurate with their risk exposures. Systemic risks caused by a bank’s size,

interconnectedness and emerging market exposure should be addressed by means of the systemic risk buffer (SRB) and the buffer for other systemically important institutions (O-SII) as proposed by the FMSB.

- The still difficult profitability situation requires active cost management and risk-adequate pricing.
- The close monitoring of risks related to foreign currency loans and loans with repayment vehicles remains important. Against the background of increased funding gaps and risks regarding repayment vehicle values, banks and customers should assess the latter’s risk-bearing capacity and take risk-reducing measures if deemed necessary.
- At to CESEE subsidiaries, the resolution of nonperforming assets is crucial and ongoing initiatives to deal with legacy issues should be proactively pursued. Banks should also continue to strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for risk-adequate pricing of intragroup liquidity transfers.
- The effects of the ultra-low interest rate environment are still difficult to assess, but banks and insurance companies may need to adapt their business models to this challenging environment.
- Insurance undertakings should continue to prepare for Solvency II.