

Austrian financial intermediaries: adaptation process continues in the financial sector

Austrian banks' financial performance has improved, but its sustainability remains to be proven

Euro area banks' profitability improved moderately in 2015, while remaining at low levels. The annual increase in profits was mainly driven by higher non-interest income and lower loan loss provisions. Despite these improvements, impairments still account for more than half of pre-impairment operating profits. The current weak economic growth outlook, low interest rates and flat yield curves remain a key challenge to European banks' profitability.

This equally applies to Austrian banks, which are additionally undergoing an adaptation process. Reducing structural costs further is meant to pave the way for more sustainable business models, and some banks have already started to take action along those lines. Nevertheless, the competitive Austrian market calls for further efficiency enhancements, as technological change is in full swing and has a major impact on banks' traditional business and distribution channels.

Austrian banks' consolidated net profit amounted to EUR 5.2 billion in 2015, up significantly from the 2014 figure, which had been compressed by write-downs and losses from restructuring. The return on average assets increased to 0.6%. This was to a large extent attributable to lower credit risk provisions and one-off effects that reduced operating expenses. But even when adjusted for one-off effects, which occurred in both 2014 and 2015, the increase in profits in 2015 was slightly above 50% year on year.

Austrian banks' consolidated operating profit increased by 17.7% to EUR 10.5 billion, although their un-

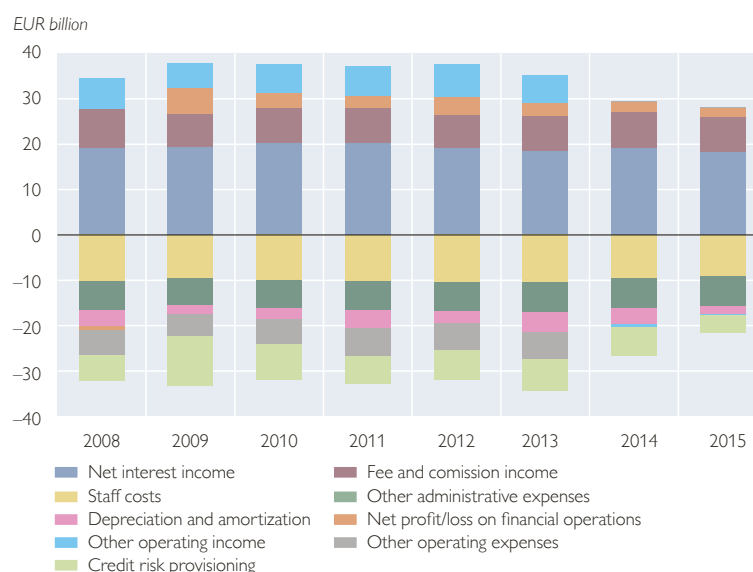
derlying operating income (before risk) in 2015 lagged behind the corresponding 2014 figure. The decrease in income was driven by net interest income dropping 5.2% year on year. In addition, dividend income went down by one-third, to run to EUR 0.6 billion at end-2015. Fee and commission income remained relatively stable, while trading income turned negative for the first time since 2008.

In terms of expenses, Austrian banks cut their costs by 11.2% in 2015, but mainly on account of a one-off effect in pension provisions, which was again partially offset in early 2016. Administrative costs grew by 4% year on year. Goodwill write-downs, which had proved material in 2014, more than halved in 2015. Having peaked in 2009 at EUR 11 billion, until 2014, Austrian banks' provisions to cover credit risks in the loan portfolios remained at levels between approximately EUR 6 billion

Reduction in personnel expenses based on one-off effects

Chart 16

Selected components of Austrian banks' consolidated profitability



Source: OeNB.

Note: As from end-2014, other operating income has been netted with other operating expenses.

and EUR 7 billion. In 2015, this figure plunged by more than one-third to EUR 4.0 billion.

Thanks to declining operating costs, the Austrian banking sector managed to slightly raise its operating efficiency. The cost-to-income ratio improved from 69% in 2014 to 63% at end-2015. However, as banks were not able to compensate for the drop in net interest income by considerably strengthening other sources of operating income, they need to take further efficiency-enhancing measures. In addition, the substantial costs banks incur on account of the still high branch density in the domestic market weigh on operational efficiency.

In 2015, European banks started to make regular contributions to new funds. The Single Resolution Mechanism (SRM) was established to facilitate the effective and efficient resolution of failing credit institutions or credit institutions that are likely to fail. In Austria, banks' initial contributions to a national resolution fund were esti-

mated to have amounted to approximately EUR 198 million in 2015. Starting with 2016, banks are also required to contribute to the Single Resolution Fund (SRF). The level of banks' individual contributions will depend on their size and risk profile in comparison with other euro area banks. Moreover, in 2015, Austrian banks also had to provide their share of initial funding (an estimated EUR 90 million) for the Deposit Guarantee Scheme.

Profitability in domestic business back in positive territory

After having registered a loss in the domestic market in 2014, which was mainly due to one-off effects (i.e. accounting and restructuring effects), Austrian banks improved their net result significantly in 2015. At EUR 3.7 billion, this figure was back in positive territory. Operating expenses came down slightly to EUR 13.8 billion. Likewise, administrative costs decreased by EUR 0.3 billion, which was mainly attributable to reduced staff costs.

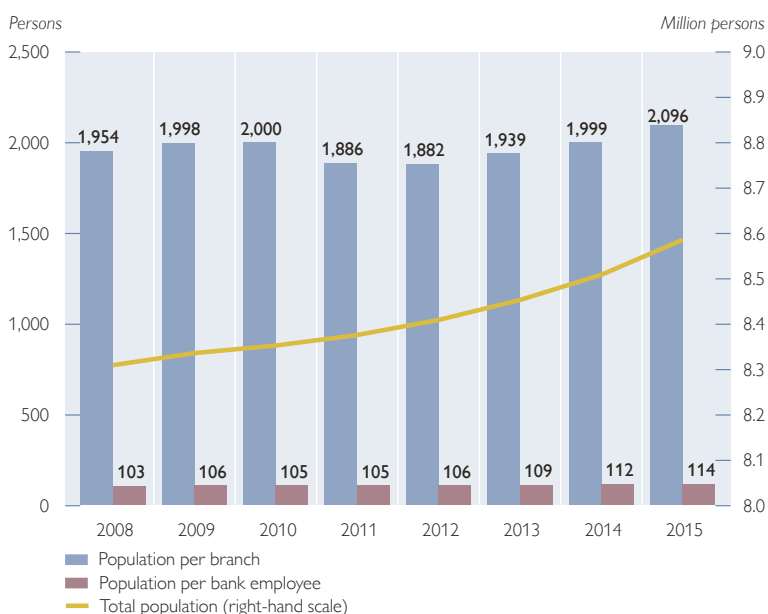
Even though net interest income as well as securities and investment income contracted, operating income rose by 4.4% against the previous year. Credit for this is due mainly to a EUR 1.0 billion improvement in other operating income and a slight increase in fee and commission income. Risk provisioning decreased by nearly two-thirds to EUR 2.1 billion in 2015. However, it should be noted in this context that restructuring within the Volksbanken sector had driven up net risk costs in 2014.

In early 2016, operating income decreased as net interest income continued to decline and fee and commission income was falling for the first time since 2012. Furthermore, financial market turmoil in the first quarter burdened Austrian banks' trading income.

Structural indicators of the Austrian banking sector improve

Chart 17

Structural indicators of the banking sector in Austria



Source: OeNB, Statistics Austria (population as at the beginning of the year).

Chart 18

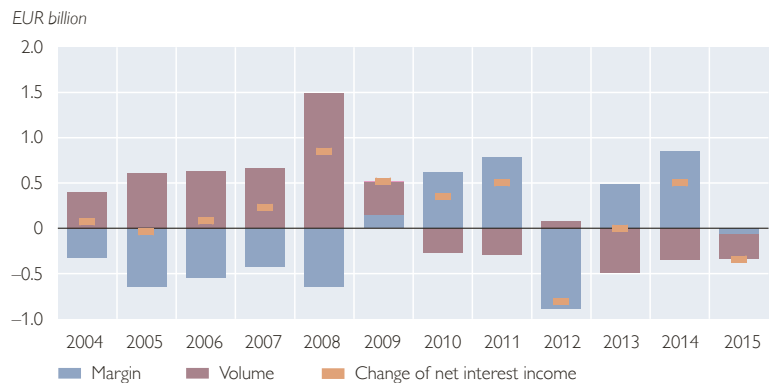
Structural indicators of the Austrian banking sector (“population per branch” and “population per bank employee) increased, which points to an improved utilization of resources over recent years. Since this development was influenced by a rise in the Austrian population, banks should continue their structural reforms to further improve their efficiency.

New competitors as well as financial technology start-ups are entering the market with innovative, technology-driven products and services that differ from the traditional banking model. Besides, customers are getting more confident in using the full range of digital services. Banks should therefore analyze what digitalization means for both their customers and processes and explore and pursue new service opportunities (see also box 3 in this report).

The negative impact of the low interest rate environment is manifesting itself only gradually (as higher-yielding assets and liabilities mature). In the Financial Stability Report 30, an econometric study examined the impact of the low interest rate environment on Austrian banks’ interest margin. Given that Austrian banks’ net interest income eroded by 3.6% in 2015, we took a closer look at the causes of this development. The reduction was mainly driven by contracted volumes rather than a slightly lower margin. This was true especially for banks with total assets of more than EUR 2 billion, while smaller banks experienced comparatively more pressure from lower margins.

Before the onset of the financial crisis, the increase in net interest income in Austria was basically driven by higher volumes, but burdened by compressed margins; a trend that was reversed after 2008.

Factors influencing banks’ net interest income in Austria



Source: OeNB.

Profitability of Austrian subsidiaries in CESEE improved

Austrian banks’ operations in CESEE remain a key source of profits and continue to compensate for the relatively weak performance in the domestic market. The profitability of Austrian banks’ subsidiaries in CESEE improved considerably in 2015, as the aggregated net profit almost tripled to EUR 2.0 billion from EUR 0.7 billion a year before.

Like in previous years, the Czech Republic and Slovakia provided stable and substantial profit contributions (EUR 0.8 billion and EUR 0.3 billion, respectively) in 2015. In Russia, which is still a crucial market for Austrian banks’ subsidiaries, profits continued to decline (–23%), though. In Croatia, Austrian subsidiaries reported a net loss of EUR 0.5 billion in 2015, after having recorded a steady string of profits also during the recession that had lasted from 2009 until 2014. In Romania, the latest net result turned positive again (EUR 0.4 billion), following a period marked by strong earnings volatility. Also on the upside, Austrian subsidiaries were profitable in Hungary for the first time since 2010. They had posted extraordinary high losses particularly

Asset reduction as the main driver for reduced net interest income in Austria in 2015

Credit risk provisions in CESEE decline

in 2011 (–EUR 1.0 billion) and 2014 (–EUR 0.7 billion) partly due to state interventions in banks' loan books. Losses in Ukraine decreased to EUR 0.2 billion in 2015, down from EUR 0.5 billion the year before.

Drivers behind the improved CESEE profits are manifold and confirm the heterogeneity of the developments in the region, including political risk and macrofinancial developments. In general, the profit and loss account of Austrian CESEE-based subsidiaries shows that changes were registered in income rather than in expenses. Net interest income, the main component of Austrian banking subsidiaries' profits, declined by EUR 0.6 billion in 2015. At 1.7% in 2015, the increase in average interest-earning assets was not high enough to compensate for a noticeable reduction in the total spread from 3.3% (2014) to 3.1% (2015). Fee and commission income, which likewise contracted (–EUR 0.1 billion) did not balance out the lower net interest income. Trading income, on the other hand, increased by EUR 0.9 billion, driven by operations in Russia and Turkey, after having plummeted in 2014.

Other operating expenses – which are part of the other operating result – shrank by EUR 0.7 billion. This improvement can be traced back to 2014 legislative measures in Hungary tackling particularly foreign currency loans and the sale of an Austrian subsidiary in Romania. In 2015, Austrian subsidiaries in Croatia were also confronted

with governmental measures related to foreign currency loans.

Risk provisions had a crucial impact on the aggregated net profit, as they shrank by EUR 1.0 billion, which was mostly attributable to subsidiaries in Romania and Hungary. In Romania, the reduction of nonperforming loans and the sale of an Austrian subsidiary led to a decrease in loan loss provisions. In Hungary, the need for credit risk provisioning declined in the wake of legal interventions to convert outstanding foreign currency loans into forint and loan loss provisions created earlier. In numerous CESEE countries, the macroeconomic environment also contributed to the reduction of loan loss provisions. At the same time, risk provisioning increased fairly strongly in Croatia and Russia, albeit from low levels (especially in Russia). In Croatia, the rise followed foreign currency loan conversions mandated by law, while in Russia it was due to the country's still ongoing recession.

Austrian banks' business models and activities in CESEE are also adapting to a changing environment. There is selective growth in markets that are perceived as being stable, such as the Czech Republic and Slovakia. By contrast, business is downsized, for instance, in Russia and Ukraine. The outlook for growth continues to be more favorable for CESEE than for Western Europe, with an expected GDP growth differential between CESEE EU countries and the euro area of about 1.5%.

The impact of fintech companies on banks and payment systems

Over the last decade, several industries (e.g. music, travel, taxi) have been disrupted by the advent of new Internet competitors. This has put incumbents in these sectors under serious pressure – the question is whether this will also happen in the financial sector. The term fintech (an acronym for financial technology) comprises both several thousand small Internet-based enterprises/start-ups and big Internet incumbents (e.g. Apple, Google and Amazon) that are aiming to enter the market for financial services. Fintechs focus in particular on those market segments that are prone to standardization: in terms of services, they have a strong focus on payments/transactions and to a lesser extent on (peer-to-peer) lending/investments. In terms of customer segments, they concentrate on retail customers (in particular young “digital natives”) and small and medium-sized enterprises. In terms of business processes, they try to eliminate the middleman by bridging the gap between providers and customers.

Global investments in fintechs grew exponentially over the last couple of years, to reach more than EUR 10 billion in 2014. This increase has accelerated further recently. In January 2016 alone, EUR 7 billion were invested in fintechs. In Germany, Austria and Switzerland, such investments stood at around EUR 125 million in 2014, which suggests that the development of fintechs in this region lags somewhat behind compared with the United States and that a “big wave” of fintech market entries is yet to come. Until 2025, selected bank segments are estimated to shrink by up to 40% due to the market entry of new fintech players; among the most commonly known are Kickstarter (crowd investment), Lending Club (peer-to-peer lending), Apple Pay and Google Wallet (payments) or Number 26 (free current account with a strong focus on user experience). Besides being a threat to established banks, fintechs might also act as a catalyst for the former to improve their profitability, e.g. by cooperating with and/or taking over new players to increase efficiency, improve (segment-specific) customer services or generate new business.

With the rise of fintechs, supervisors will also need to integrate them into their scope and ensure a level playing field between new and established financial service providers. Besides its responsibilities in banking supervision, the OeNB is responsible for the smooth functioning as well as the oversight of payment and securities settlement systems. The payments market, traditionally dominated by banks, is particularly driven by (technological) innovations. Fintechs, which are able to react more quickly to market developments given their size and structure, are increasingly challenging the existent market players by promoting fast and convenient payment methods. This trend is facilitated by decreasing customer loyalty and an increasing affinity for technical gadgets. In this area, currently favored fintech activities relate for example to mobile payments, near field communication, customer authentication, blockchain technology or cryptocurrencies. Payment system overseers closely monitor these new trends and face the challenge of managing the balancing act between fostering innovation and ensuring a level playing field. While the current supervisory regime is focused on traditional payment system operators (which often hold a banking license), new market players also have to be adequately overseen. This necessitates harmonized regulatory efforts. Here, the new Payment Services Directive (PSD2) may be considered to be one piece of the puzzle: it enables new market players to enter the regulated payments market, while at the same time ensuring basic requirements in the area of consumer and data protection, authentication and safeguarding.

Cleanup of nonperforming loan (NPL) portfolios remains sluggish in Europe

Euro area banks’ weak profitability and their subsequent reduced ability to build capital buffers hinder the resolu-

tion of NPLs in several national banking systems, where elevated NPL volumes have become a major structural weakness. At end-June 2015, euro area banks still had EUR 900 billion of NPLs on their books.

NPL ratios of Austrian banks improve in 2015

The asset quality of Austrian banks' domestic loan portfolio remained stable in 2015 due to improvements especially in the second half of the year. The quality of retail loans increased continuously, while the quality of domestic corporate loans deteriorated only slightly. Asset quality on a consolidated level improved due to a modest reduction of NPLs at Austrian subsidiaries in CESEE.

Chart 19

Nonperforming loan ratios of the Austrian banking sector



Source: OeNB.

NPL ratios of CESEE subsidiaries still elevated, but coverage improves

Nevertheless, elevated NPL levels need to be tackled urgently, especially in some CESEE markets, by using a comprehensive strategy combining assertive supervision, reforms of insolvency regimes, the development of distressed debt markets and the involvement of asset management companies.

The NPL ratio of Austrian banking subsidiaries in CESEE improved slightly, dropping to 11.5% at end-2015 (end-2014: 11.8%), while the NPL ratio for foreign currency (FX) loans increased marginally to 16% at end-2015 (end-2014: 15.7%). However, based on heterogeneous economic and foreign exchange rate developments, the cross-

country differences in Austrian subsidiaries' NPL ratios remain substantial: while the ratio remained below or close to 5% in Slovakia and the Czech Republic, other countries like Romania, Croatia, Hungary and Serbia – although having recorded (slight) declines in their NPL ratios in recent years – still attained levels between 16.5% and 19.5%.

The NPL coverage ratio of Austrian subsidiaries in CESEE improved further: the NPL coverage ratio I (ratio of loan loss provisions on NPLs to NPLs) improved from 56.7% at end-2014 to 59.0% at end-2015, while the respective figure for FX loans increased from 55.6% to 58.2% over the same period.

Foreign currency loan volumes continue to decline

Stepped-up supervisory efforts aimed at curbing FX lending have proven to be effective – outstanding FX loan volumes in Austria continued their year-long downward trend. Between October 2008 and March 2016, FX loans to domestic nonfinancial borrowers declined by almost 43.5%. The associated exchange rate-adjusted reduction amounted to 56%. Last year alone, the volume shrank by 12% on an exchange rate-adjusted basis. In March 2016, FX loans to domestic nonfinancial borrowers equaled EUR 32.8 billion, of which around EUR 23.5 billion corresponded to FX loans to households and EUR 5 billion to FX loans to nonfinancial corporations.

The share of FX loans to households in total loans to households came to 16%, which is markedly below the all-time high of 31.7% registered in May 2006. Loans to households in Swiss franc are by far the most common, accounting for more than 96% of all FX loans to households.

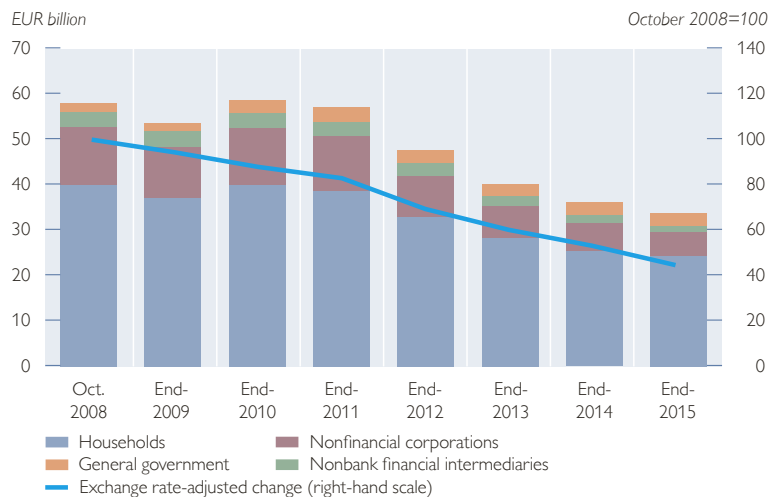
While the volume of domestic FX loans has been declining steadily, legacy issues continue to be relevant for the Austrian banking system. As at March 2016, nearly 80% of outstanding FX loans to households were set to mature from 2021 onward, which entails significant redemption risks to Austrian banks, as three out of four FX loans to households are bullet loans linked to a repayment vehicle. Besides exchange rate risks, these loans and their borrowers are also vulnerable to adverse capital market developments reducing the value of the repayment vehicle. In order to assess borrowers' funding gaps, the OeNB together with the FMA will conduct a survey in 2016, along the lines of surveys that had been carried out in 2009, 2011 and 2015.

Loan loss provision ratios in Austria improved steadily in the course of 2015, driven by lower provisioning for euro-denominated loans to nonbank retail customers and cross-border loans. At the same time, provisioning for FX loans has been increasing. This trend continued into early 2016, which is especially important as most domestic FX loans are bullet loans approaching maturity.

Austrian banks also continued to reduce their FX exposure in CESEE. At year-end 2015, the total FX exposure (including direct and indirect lending via subsidiaries as well as leasing) of Austrian banks in CESEE had decreased by 7.6% year on year to EUR 106.8 billion. This reduction was largely driven by the conversion of FX loans in Hungary and Croatia, where Austrian subsidiaries saw their FX loan volumes drop by 9.7% to EUR 69.3 billion (see chart 22). As a result, the aggregate share of FX loans – the bulk (62%) of which is denominated in euro – in total loans declined from 41.9% at end-2014 to 38.2% at end-2015.

Chart 20

Foreign currency loans to Austrian nonbank borrowers



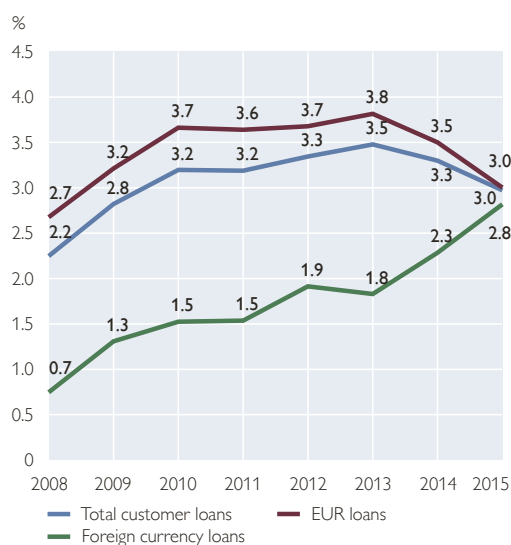
Source: OeNB.

The strong appreciation of the Swiss franc in recent years triggered a series of legislative action in several CESEE countries forcing FX loan conversions. All known measures, whether already implemented or still under discussion, are expected to increase the financial burden on Austrian banks operating in these countries.

Provisioning for foreign currency loans in Austria has been increasing

Chart 21

Loan loss provision ratios in Austria

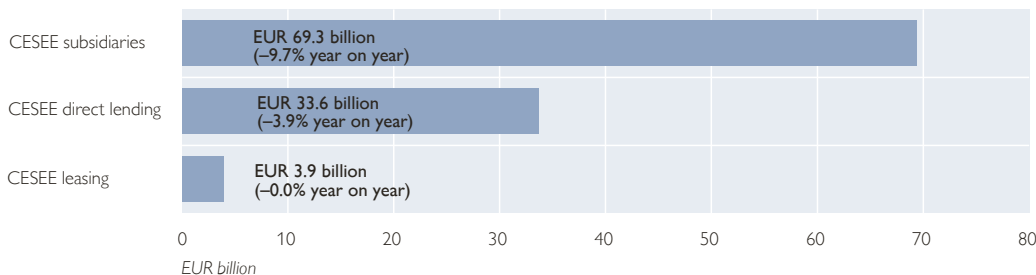


Source: OeNB.

Chart 22

Foreign currency loans of Austrian banks in CESEE

Growth rates from Q4 14 to Q4 15



Source: OeNB (growth rates are exchange rate unadjusted).

Austrian banks further strengthened their capital position

The recovery process of the EU banking system continues to go hand in hand with a major strengthening of banks' capital position. During the first half of 2015, the amount of CET1 capital grew by 6.1%, while risk-weighted assets (RWAs) increased by approximately 2.5%. This goes to show that EU banks' strengthening capital position continues to be driven by increases in capital rather than by reduced RWAs.¹

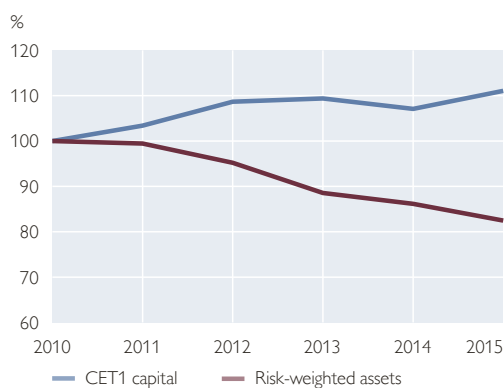
This EU trend does not fully correspond with that of Austrian banks, however. Although CET1 capital increased by 3.3% against 2014, RWAs have been falling as well. As a consequence, the capital ratio of the Austrian banking system improved to 12.7% (CET1 ratio as well as tier 1 ratio). An adjustment of capital ratios driven by RWAs is often seen as particularly critical, because – rather than sustainably increasing their capital base – banks could have been “optimizing” their risk weights and/or could have reduced lending to customers with higher capital charges while total lending increased.

Austrian banks have increased their capital ratios ...

... but still lag behind the level of their peer groups

Chart 23

Components of Austrian banks' CET1 ratio



Source: OeNB.

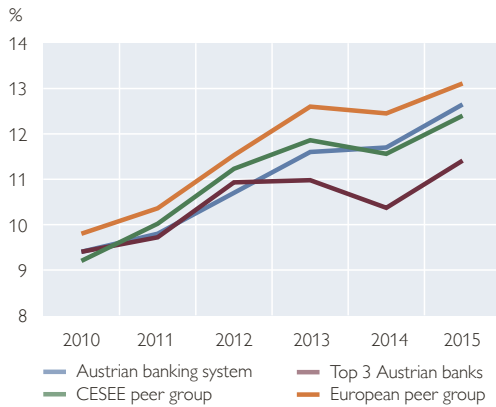
The regulatory overhaul of the banking sector is nearing its completion, as the outstanding elements of the Basel III framework related to the reduction of the variability in risk-weighted assets and the calibration of the leverage ratio are about to be finalized in 2016. Under the current definition, the leverage ratio of Austrian banks further increased to 6.3% in the year 2015.

In the same vein, both the CESEE and European peer groups² of Austrian banks increased their capital ratios in

¹ Source: EBA Risk Assessment of the European Banking Sector, December 2015.

² The CESEE peer group consists of 12 European banks with relevant CESEE exposure, while the European peer group consists of 29 European banks with similar business models.

Chart 24

CET1 ratios in an international comparison

Source: OeNB, SNL Financial.

the course of 2015. And even though the CET1 ratios of the top 3 Austrian banks have been growing faster than the respective figures of their peer groups, banks in both peer groups still display a noticeably higher capitalization.

In May 2016, the Austrian Financial Market Authority, after having duly notified the EBA, the ESRB and the ECB, published the decision on the implementation of a capital buffer for other systemically important institutions in Austria (O-SII buffer). The O-SII buffer aims to raise the risk-bearing capacity of these banks and mitigate the too-

big-to-fail issue. The decision followed a recommendation of the Austrian Financial Market Stability Board from June 2015. To identify the affected banks, the Austrian authorities applied the respective EBA Guideline (EBA/GL/2014/10). As can be seen from table 1, there is a gradual phase-in of the buffer requirement, which cumulates to 2% for Erste Group Bank, Raiffeisen Zentralbank, Raiffeisen Bank International and UniCredit Bank Austria and 1% for other banks by 2019. The decision on the O-SII buffer levels is scheduled to be reviewed in November 2016.

It is worth noting though that a systemic risk buffer was implemented in Austria at the beginning of 2016 and only the higher of a bank's systemic risk buffer and O-SII buffer shall be applied (in line with Article 131 paragraph 14 CRD). Since the O-SII capital buffer decision lists neither additional banks nor higher requirements, there is no additional capital effect due to the O-SII buffer.

The minimum requirement for own funds and eligible liabilities (MREL) is one of the key elements in resolution planning. It is a major tool to remove impediments to the effective resolution of banks, as its purpose is to ensure that

Capital buffer for other systemically important institutions (O-SIIs) implemented in Austria

Table 1

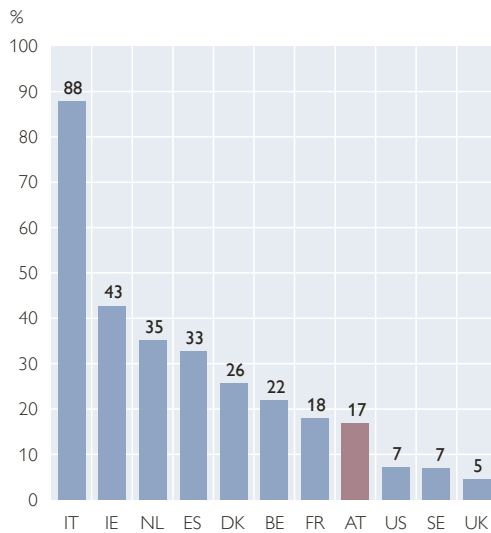
List of Austrian banks subject to the O-SII buffer

	Applicable O-SII buffer			
	June 2016	Jan. 2017	Jan. 2018	Jan. 2019
	% of risk-weighted assets			
Erste Group Bank	0.25	0.50	1.00	2.00
Raiffeisen Zentralbank	0.25	0.50	1.00	2.00
Raiffeisen Bank International	0.25	0.50	1.00	2.00
UniCredit Bank Austria	0.25	0.50	1.00	2.00
Raiffeisenlandesbank Oberösterreich	0.125	0.25	0.50	1.00
Raiffeisenlandesbank Niederösterreich Wien	0.125	0.25	0.50	1.00
BAWAG P.S.K.	0.125	0.25	0.50	1.00

Source: OeNB.

Chart 25

Consolidated Texas ratios (nonperforming loans net of provisions to capital)

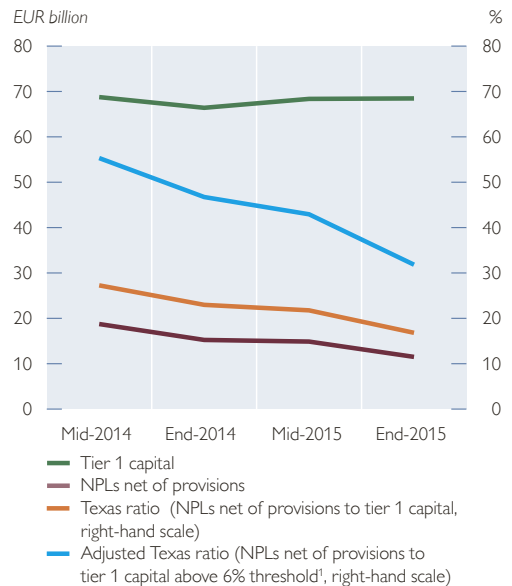


Source: IMF (Financial Soundness Indicators, consolidation basis: CBCSD) or DCCBS) and OeNB (authors' calculations).

Note: Q4 15 or more recent data. The lower the ratio, the better.

Chart 26

Consolidated Texas ratios of Austrian banks



Source: OeNB.

¹ The 6% threshold helps define "excess" tier 1 capital above the minimum tier 1 capital requirement.

Note: The lower the ratio, the better.

banks have an adequate loss absorption and recapitalization capacity in case of resolution. Additionally, it can have direct effects on the going concern situation of banks, since banks may need to adjust their funding structure to some extent to comply with this new requirement.

A first survey indicates that there is great uncertainty about the potential impact, which is amplified by the current international discussion of harmonizing MREL and total loss-absorbing capacity (TLAC). Challenges might occur in some cases in CESEE EU Member States, where funding is predominantly based on customer deposits. For a more detailed analysis of the impact of MREL on Austrian banks, see the special topics section in this issue.

The Texas ratio is a measure to assess banks' credit risk-bearing capacity by comparing the volume of (gross) nonperforming loans to the stock of built-up provisions and capital. In this context, the IMF's financial soundness

indicator "nonperforming loans net of provisions to [tier 1] capital" is used in order to compare international figures (on a consolidated basis, as at end-2015 or latest available data). The lower this ratio, the better the bank should be able to absorb credit losses it has not yet provisioned for. In this international perspective, Austrian banks' Texas ratio of 17% compares favorably with that of peers (e.g. 22% for Belgium or 35% for the Netherlands), while Italy displays a very high ratio of close to 90%.

Austrian banks' Texas ratio improved markedly (from 27% to 17%) from mid-2014 to end-2015, as the volume of tier 1 capital remained stable and the volume of nonperforming loans net of provisions dropped substantially, driven by a drop in nonperforming loans and an improving coverage ratio. Assuming that tier 1 capital can only be used up to the regulatory minimum of

High NPL coverage drives strong Texas ratio of Austrian banks

6% of risk-weighted assets in a going concern scenario, an adjusted Texas ratio³ was calculated: it improves from 55% to 32% over the same period. This implies that if all nonperforming loans were to default at once, banks would still keep 68% of their current “excess” tier 1 capital after absorbing all losses (the impact on the volume of risk-weighted assets was ignored).

Deposits gain importance in the context of bank funding

The unconsolidated loan-to-deposit ratio in Austria stood at 112% at end-2015. Compared with 2008, this represents a significant decline of more than 20 percentage points. As a direct consequence of the economic downturn, credit growth dwindled while deposits rose, although at a slower pace in 2015 than in previous years. Reduced or even negative cross-border lending to countries in the CESEE region also contributed to the decline in the unconsolidated loan-to-deposit ratio of Austrian banks between 2008 and 2015. On the other hand, provisioning had a minor impact as the loan quality in Austria was quite stable during those years.

The Austrian supervisory Sustainability Package adopted by the OeNB and the FMA in 2012⁴ stipulates that the stock and flow loan-to-local stable funding ratios (LLSFRs) of the foreign subsidiaries of Austria’s three largest banks be monitored.

In 2015, most monitored subsidiaries’ stock LLSFR remained stable or it

declined, which points to an improved local stable funding position. At the end of 2015, all 35 subsidiaries in the sample had a sustainable business model (compliant with the supervisory guidance). Only one smaller subsidiary exhibited an elevated stock LLSFR, albeit with a positive trend in its new business (driven by strongly increased local stable funding). In a year-on-year comparison, the aggregate stock LLSFR of all 35 banking subsidiaries fell from 87% (end-2014) to 81% (end-2015), as the local stable funding base rose substantially, while the volume of loans (after provisioning) increased only slightly.

When analyzing changes in the balance sheet composition of those subsidiaries that have been continuously monitored since end-2011, major developments improving the LLSFR occurred on the funding side, where a marked reduction in deposits from credit institutions (often intra-group liquidity transfers by the parent bank) was (more than) balanced out by a strong rise in deposits from nonbanks.

Bank funding markets in Europe have been adversely affected by the heightened volatility in financial markets in early 2016. But funding conditions improved following the ECB’s announcement of additional measures. The three-month EURIBOR continued to move deeper into negative territory. This will allow banks with high creditworthiness to refinance themselves at cheaper rates than banks mainly relying on deposit taking.

Loan-to-deposit ratio in Austria has been declining since 2008

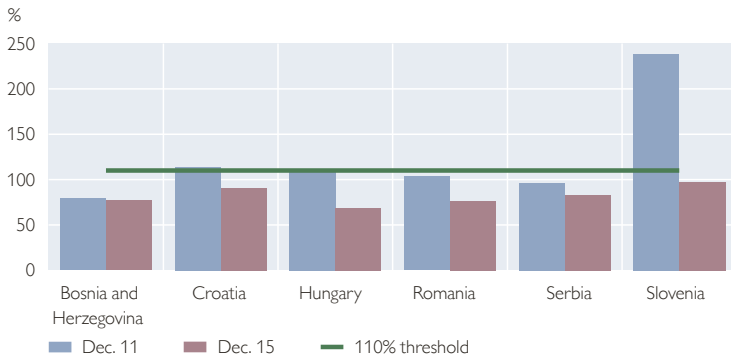
Austrian banks’ foreign subsidiaries continue to improve the sustainability of their funding position

³ The adjusted Texas ratio was calculated as NPLs net of provisions to tier 1 capital above the minimum 6% threshold.

⁴ For more details, see <http://www.oenb.at/en/Financial-Stability/Systemic-Risk-Analysis/Sustainability-of-Large-Austrian-Banks--Business-Models.html>.

Chart 27

Stock LLSFR of Austria's three largest banks' subsidiaries in selected host countries¹

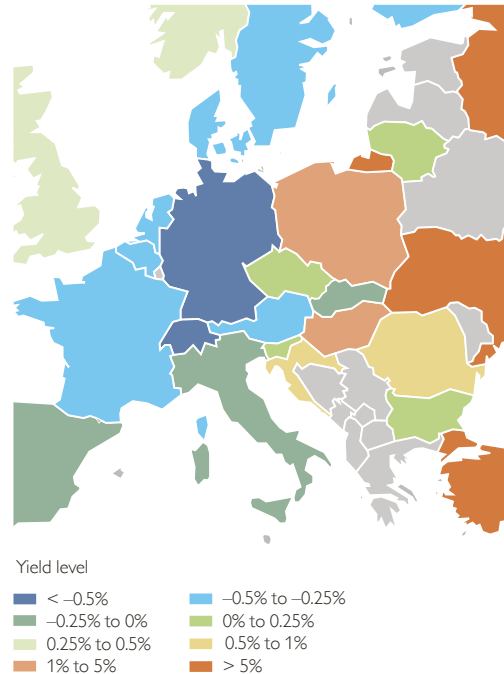


Source: OeNB.

¹ The country sample is based on the continued presence of all three parent institutions in the host country. End-2011 serves as the starting point for the comparison given that the Sustainability Package was adopted in March 2012.

Chart 29

Government bond yields in Europe

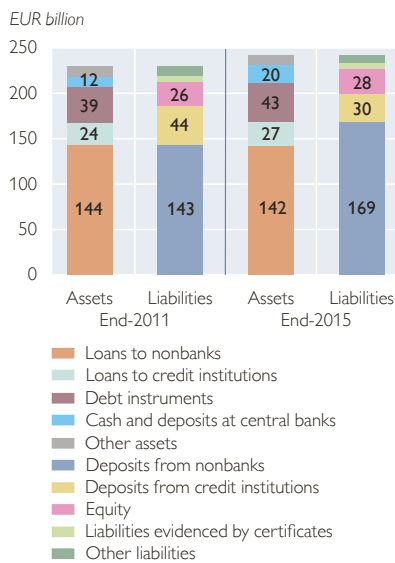


Source: OeNB.

Also, an increasing number of government bonds are trading at negative yields. Looking back one year, the yields of bonds with negative yields decreased further, while those of bonds

Chart 28

Balance sheet of Austria's three largest banks' foreign subsidiaries¹



Source: OeNB.

¹ The sample is based on subsidiaries that were active throughout the observation period. End-2011 serves as the starting point for the comparison given that the Sustainability Package was adopted in March 2012.

Growth in mortgage loans is picking up against the backdrop of buoyant property prices

with positive yields approached zero. At the one-year maturity, Spain, Italy and Slovakia now entered the list of countries with negative yields, while bonds of the Czech Republic, Slovenia and the Baltic countries are very close to zero. In the CESEE region, we observe countries with still relatively high yields like Hungary and Poland, while negative yields are spreading especially to the euro area countries in Central and Eastern Europe.

Given that Austrian banks and their subsidiaries have large holdings of Czech government bonds, the latter's approaching zero yields (0.05% for a maturity of one year) is of particular interest from Austria's financial market perspective, as this puts pressure on interest income.

Box 4

Have Austrian CESEE subsidiaries' loan-to-deposit ratios at the onset of the financial crisis affected subsequent lending and deposit gathering?

After the aggregate loan-to-deposit ratio (LDR) of Austrian CESEE subsidiaries peaked at the beginning of 2009, it experienced a sharp and continuous fall. This trend, however, masks major variations in the subsidiaries' underlying lending to and deposit gathering from customers. This box examines whether a subsidiary's initial LDR helps explain these variations. Moreover, it looks at the loan and deposit developments at the host country level at the height of the crisis and during a transition phase, when intra-group liquidity transfers were substituted by local deposits (as envisaged by the Austrian supervisory Sustainability Package).

First, the change in each subsidiary's gross loan volume since the start of the financial crisis (Q4/2008) is plotted against its initial LDR (chart 1).¹ The line of best fit shows a negative relationship between these two variables. In addition, the unweighted average change in loans among subsidiaries with LDRs below 150% was +48% (Q4/2008–Q4/2015), while it was negative for subsidiaries with LDRs above 150% (–11%). This is of particular interest for high-LDR subsidiaries, as many of them reined in their lending (or reduced their NPL portfolios). They did so partly to adjust their business models and reduce large local funding gaps, which were seen as a vulnerability following the outbreak of the crisis. Meanwhile, subsidiaries with low LDRs and sustainable funding levels seem to have been more willing and able to lend.

Second, banks can also lower their LDR by strengthening their deposit base, but this additional lever is less directly controlled by financial intermediaries. In analogy to the above, chart 2 shows a positive relationship between subsidiaries' initial LDR and their subsequent deposit growth. Again, high-LDR subsidiaries made a particular effort to close their local funding gap and reduce their often high dependence on parent funding, while low-LDR subsidiaries seem to have felt less pressure to collect further deposits. The unweighted average growth in deposits (over the entire period under review) was 90% for high-LDR versus 51% for low-LDR subsidiaries.

Chart 1

Change in gross loans versus initial loan-to-deposit ratio

Change in gross loans in % (2009–2015)



Source: OeNB.

Note: The regression coefficient is significant at the 0.01 level.

¹ The sample of 53 Austrian CESEE banking subsidiaries in this box comprises only those that operated continuously from 2009 to 2015. In order to estimate lending behavior, changes in gross retail loans are analyzed (i.e. before provisioning, which is considered to be exogenously driven).

Chart 2

Change in deposits versus initial loan-to-deposit ratio

Change in deposits in % (2009–2015)



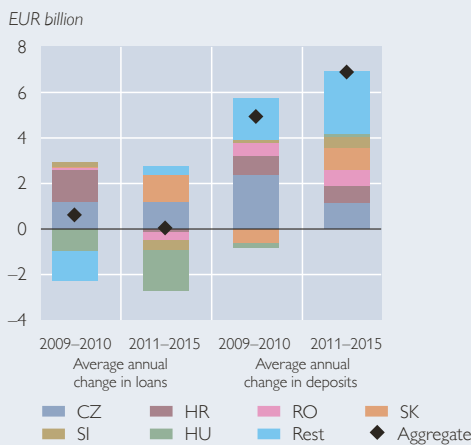
Source: OeNB.

Note: The regression coefficient is significant at the 0.05 level.

These two findings are mutually reinforcing, since a subsidiary's initial LDR bears similar impact strength on its lending as well as on its deposit gathering: high LDRs at the outbreak of the financial crisis made affected subsidiaries proactively close local funding gaps by both limiting lending and strengthening the deposit base. Lower LDR levels, in contrast, allowed subsidiaries to meet re-emerging credit demand more freely and hence to support nascent economic recoveries.

Chart 3

Net loan and deposit growth periods of Austrian subsidiaries in CESEE



Source: OeNB.

Finally, the drop of the aggregate LDR of Austrian CESEE subsidiaries can be analyzed over two distinct periods: the height of the crisis in 2009/2010 and the subsequent transition to a new post-crisis equilibrium with lower LDRs and higher local funding (chart 3). At first glance, aggregate net loan growth² was low and almost zero for the latter years, but aggregate deposit growth was strong and gained in momentum. The regional rebalancing of business models therefore occurred mostly on the funding side, while disorderly deleveraging was avoided. A more granular analysis at the CESEE country level reveals that while deposit growth was broad based, growth in net loans was more heterogeneous. This was caused by diverging macroeconomic developments affecting loan demand and provisioning needs, as well as idiosyncratic shocks (e.g. national policy actions).

² This analysis looks at net loans (after provisioning) given that it is not so much the lending behavior, as the factors affecting the LDR (which is calculated as net loans to deposits from customers) that are in focus.

Risks in mortgage lending need to be monitored

The financing of residential real estate exhibits increasing risks in the face of rising property prices, housing demand and mortgage lending, while the level of risks remains by and large muted. As mentioned in the previous section, growth rates of property prices picked up again in the second half of 2015. The acceleration was more pronounced in the rest of Austria than in Vienna. Such buoyant property prices should however be seen against the backdrop of anemic property markets before the financial crisis.

Demand for real estate as a form of saving and investment has remained strong compared to demand for other products, such as bank deposits and life insurance policies, particularly in light of low and constantly decreasing interest rates. Debt financing has become more important, too, as indicated by increasing mortgage growth rates. While yearly growth of housing loans averaged 3.0% from 2009 to 2015, housing loans expanded by 4.9% year on year in April 2016. This is the strongest growth rate since the end of 2008. Nominal pre-crisis growth rates of housing loans were considerably higher than recent ones; average yearly growth amounted to 8.1% from 2005 to 2008.⁵

All in all, the recent developments of key indicators warrant heightened caution. Against this backdrop, the Financial Market Stability Board has, upon the OeNB's initiative, issued the advice to the Minister of Finance to initiate the extension of the macro-

prudential toolkit by providing for the possibility of imposing limits on the LTV ratio, the DTI ratio and the DSTI ratio in new real estate lending.

External assessments confirm banks' resilience, but further enhancements are needed

The most recent international reviews (the IMF's 2015 Article IV consultation and an in-depth review under the European Commission's Macroeconomic Imbalance Procedure in 2016) broadly coincide in their assessment of the Austrian banking system regarding its comparatively low capitalization by international standards, its subdued profit outlook and the risks related to its CESEE exposure and foreign currency lending. Besides, it is noted that the low interest rate environment is putting pressure on banks' interest margins. Moreover, market intelligence reveals that developments around HETA have led to investor uncertainty, in particular about some Austrian banks. This contributed to elevated funding spreads, which are detrimental to banks' profitability and capital generation capacity.

In early 2016, Austria was subject to its first ever in-depth review under the Macroeconomic Imbalance Procedure of the European Commission. The review focused inter alia on the risks emanating from the Austrian financial sector's large foreign exposure and the potential impact on credit supply. The results of the country report⁶ were published as a Commission staff working document. Based on this report, the Commission concluded that

⁵ However, if the upward bias due to the strong growth of (foreign currency) bullet loans and inflation rates are taken into account, pre-crisis growth rates are at the level of current growth rates.

⁶ See http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_austria_en.pdf.

Single Resolution Board fully operational since January 1, 2016

In response to the financial crisis that had started in 2008, the European Commission called for a European banking union to improve the soundness of and confidence in the banking sector. One of its three pillars is the Single Resolution Mechanism, which divides tasks and responsibilities between the competent institutions at the European and at the national level.

At the European level, the Single Resolution Board (SRB) is responsible for those banks that are directly supervised by the ECB, operate as cross-border banking groups within the euro area or draw funds from the Single Resolution Fund (SRF). On January 1, 2016, the SRB took direct responsibility for resolution matters related to ten Austrian banks: Erste Group Bank AG, Raiffeisen Zentralbank Österreich AG, Raiffeisenlandesbank Niederösterreich-Wien AG, Raiffeisenlandesbank Oberösterreich AG, Volksbank Wien AG, BAWAG P.S.K., Sberbank Europe AG, VTB Bank (Austria) AG, HYPO Group Alpe Adria AG and Bausparkasse Wüstenrot AG. In addition, UniCredit Bank Austria AG is covered by the SRB via its Italian parent company. The new resolution regime has a strong precautionary character, as it includes the preparation of resolution plans, the definition of common rules designed to prepare banks for their potential resolution and the provision of a common framework to manage the process of winding down banks. To be precise, resolution plans will be prepared by internal resolution teams that include representatives of the SRB and the competent national resolution authority (NRA). In Austria, the Financial Market Authority (FMA) fulfills the role of NRA, and all Austrian non-SRB banks will remain under its full responsibility.

The purpose of the SRB is to ensure the orderly resolution of failing banks, while minimizing the impact on public finances and on the real economy. The SRB's key tasks include the establishment of a credible and feasible resolution regime, the adoption and implementation of resolution schemes and the management of the SRF. Importantly, the SRB triggers the resolution of a failing bank in its direct responsibility, i.e. it decides whether and when to place a bank into resolution, decides about restructuring measures and sets out the resolution scheme. The latter is a framework for the use of resolution tools and the SRF, when a failing bank is being wound down. Under the supervision of the SRB, the FMA will be in charge of executing the resolution scheme. The SRB will monitor the execution at the national level and – should an NRA not comply with its decision – directly address executive orders to the troubled bank.

Finally, the SRF, which has been set up under the control of the SRB, can make funding support available during a bank's resolution on the condition that at least 8% of that bank's total liabilities have been bailed in. The resolution of banks which are not under the SRB's direct responsibility, but have requested funding from the SRF will be transferred from the national to the European level. Starting in 2016, the SRF will be built up over an eight-year period with contributions from the banking sector. At the end of this transition period, the total target size of the SRF will be at least 1% of the amount of covered deposits of all credit institutions in the Member States participating in banking union (the target is currently estimated at EUR 55 billion).

Austria was not experiencing macro-economic imbalances.⁷ While finding the domestic banking sector to be resilient, the report highlighted some key challenges, in particular the below-average capitalization, the low prof-

itability and the weak loan portfolio quality of the subsidiaries in CESEE. In addition, foreign currency lending in Austria and CESEE continues to be a risk factor. According to the report, credit demand rather than supply has

⁷ See http://europa.eu/rapid/press-release_IP-16-591_en.htm.

been the major driver of low credit growth in Austria. Another key finding was that the restructuring of the Austrian banking sector has reached a point where it can advance without additional public support. Regulatory and macroprudential requirements at the EU and national level have reduced the risk of negative spillovers to public finances. In this respect, the macroprudential measures – the systemic risk buffer, the Sustainability Package as well as several measures addressing foreign currency lending in Austria and CESEE – have strengthened the risk-bearing capacity and resilience of the Austrian banking sector and improved the local funding base and asset quality of operations in CESEE.

The IMF acknowledged in its 2015 Article IV consultation⁸ the progress made by Austria in revamping the regulatory and supervisory framework in line with the implementation of the EU banking union. Furthermore, the considerable progress which has been made in the resolution of nationalized banks was noted. While large Austrian banks are changing their business model by focusing more on core markets and improving efficiency, the IMF nevertheless underlined the need for additional measures. A case in point are banks' capital cushions, which have been strengthened but remain low relative to their peers. Furthermore, cross-border exposures to CESEE and loans denominated in Swiss franc remain a source of risks for Austrian banks. This means that the supervisory authorities will have to monitor and reassess large banks' capitalization and

to stand ready to implement additional measures if needed. Moreover, extending the macroeconomic toolkit by real estate-specific instruments would limit risks to banks' asset portfolios if real estate price bubbles were to emerge.

Investment performance poses a challenge to the insurance sector in a prolonged period of low interest rates

Low interest rates and weak macroeconomic growth remain the key risks for the insurance sector: while in 2015 the aggregate return on investment of Austrian insurance companies was 3.7%, today an increased reinvestment risk can be observed, as assets with a long duration are now generating much lower returns than in the past. The introduction of Solvency II, which entered into force this year, and the related higher capital requirement for long-term guarantees are a further challenge for the insurance sector and will also influence its investment allocation. There is a high incentive for insurance companies to switch new business away from "classical" life insurance policies to unit-linked⁹ and fee-based products; a move some Austrian companies have already made. But given the transition period of up to 16 years under Solvency II, it will take some time to observe the full impact of such a shift.

Chart 30 displays investment returns at the (solo) life insurance level, which are rather heterogeneous. A remarkable overall decrease can be observed since 2004, although the median rate of return in 2014 was still

⁸ The IMF carries out bilateral consultations with member countries regarding economic and financial developments as required under Article IV of its Articles of Agreement, usually on an annual basis. See <http://www.imf.org/external/np/sec/pr/2016/pr1658.htm>.

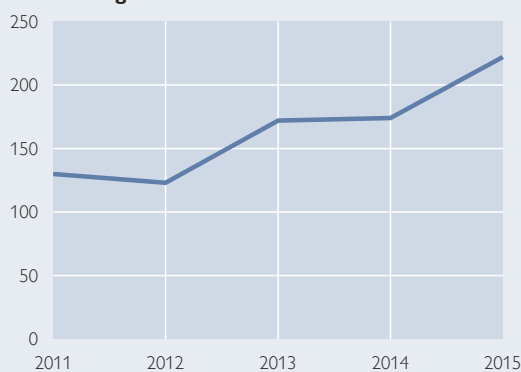
⁹ A unit-linked insurance plan combines insurance with investment. A part of the premium paid is utilized to provide insurance coverage to the policyholder, while the remaining portion is invested in mutual funds; typically no interest rate guarantee is given by the insurance company.

Prevention of money laundering and terror financing in Austria

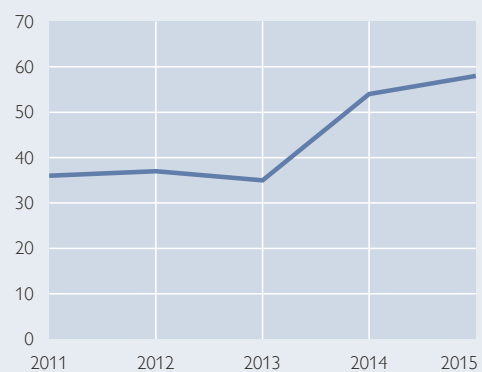
In Austria, the Financial Market Authority (FMA) is responsible for the (micro)prudential and conduct supervision of financial institutions and their compliance with the relevant regulatory laws and regulations. These include provisions for the prevention of money laundering (i.e. anti-money laundering – AML) and combating the financing of terrorism (CFT). As a follow-up to the Financial Action Task Force's (FATF) mutual evaluation of Austria in 2008, a comprehensive package of measures was agreed in 2010. Among other things, a specialist AML/CFT division was established at the FMA with effect from January 1, 2011. Austria thus strengthened its commitment to effectively monitoring and enforcing financial institutions' AML/CFT efforts and to helping enhance the Austrian financial market's capacity to ward off money laundering and the financing of terrorism.

FMA activities on anti-money laundering and combating the financing of terrorism (AML/CFT)

Proceedings



On-site measures



Source: FMA.

The AML/CFT division's core tasks include implementing on-site measures, conducting investigation proceedings and administrative proceedings to restore legal compliance as well as processing legal requests. The division is involved in policy formulation at the national and European level and represents Austria in various international bodies.

In its AML/CFT supervision, the FMA applies a risk-based approach to account for the money laundering and terrorist financing risks present in individual sectors and firms. In the past two years, the AML/CFT division has extended its on-site measures to include foreign subsidiaries and branches of Austrian financial institutions. On-site supervision entails testing and assessing the quality of the AML/CFT systems in place as well as their adequate application and efficiency in light of the institution's money laundering and terrorist financing risks. In the event of violations, the FMA instructs the institution to remedy the deficiencies. It may subsequently impose sanctions, which in the past ranged from the reorganization of banks' executive boards to the imposition of fines against directors.

In April 2016, the leak of the so-called Panama Papers triggered immediate on-site measures. In addition, off-site investigation proceedings were initiated to increase market transparency and thus contribute to further strengthening financial stability in Austria.

Chart 30

Rate of return of Austrian life insurance companies compared with the average guaranteed rate



Source: FMA (insurance statistics).

slightly above the average guaranteed interest rate for the stock of life insurance policies. Nevertheless, insurance companies need to further adjust to this challenging environment and reconsider their investment strategies. From a macroprudential perspective, it is crucial to closely monitor investment portfolios to detect a potential shift to riskier assets at an early stage.

The net asset value of Austrian mutual funds reached EUR 168 billion at the end of 2015, which is as high as the value recorded at the end of 2006. The Austrian mutual fund industry has developed in line with the European

market, where considerable growth was observable over the last years. Risks related to mutual funds may arise from their combined leverage and liquidity risk; leverage amplifies potential vulnerabilities that may surface when many investors simultaneously attempt to withdraw their money. Funds would then be forced to sell their assets, which may lead to a deterioration in prices and start a downward spiral. To address such risks, additional macroprudential instruments could be considered and become part of the macroprudential toolbox.

Austrian mutual funds have reached their pre-crisis volume