Austrian Financial Intermediaries: Operating under Elevated Risks to Financial Stability

After a grounding year for Austrian financial intermediaries in 2011, the short-term perspective improved markedly in early 2012. Banks increased their overall profitability and insurance companies benefited from their activities in the CESEE region. The equity base of the Austrian banking system strengthened and the liquidity situation improved. At first sight, these developments (as illustrated by key measures for the Austrian banking system, see chart 13) seem reassuring, but further consideration suggests caution.

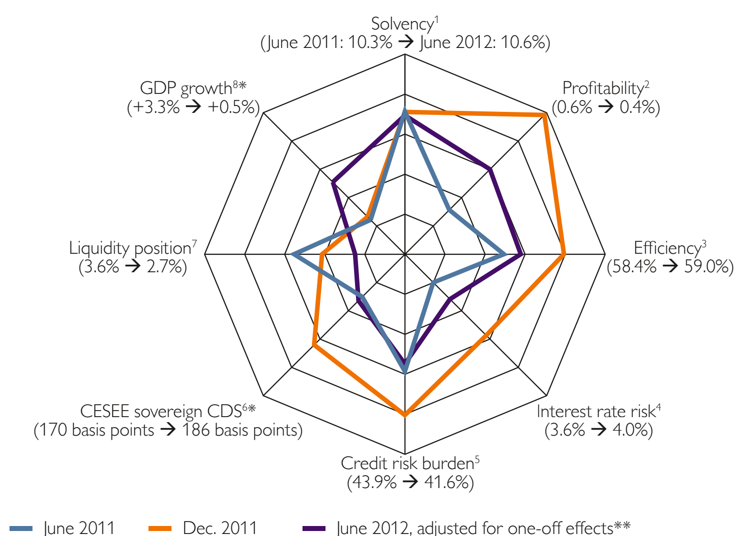
Net banking profits were upward-biased because of extraordinary revenue items related to capital measures. The CESEE business remains a net contributor to the overall profitability, but an ongoing deterioration of debtors' credit quality, as mirrored by the increase of the nonperforming loan ratio, has been persistently driving up credit risk costs. The increase in liquidity buffers was basically facilitated by the ECB's monetary policy but the more conservative liquidity risk profile also reflects sustained market uncertainty. At the same time, deposit growth at Austrian banks was above the European average over the past year and Austrian subsidiaries in the CESEE region increased their customer deposits as well. Reflecting this, the dependance of Austrian banks on ECB financing is still comparatively low.

Concerns about a credit crunch in Austria due to higher capital requirements, strained funding markets or a deteriorated asset quality have not materialized so far and the exposure of domestic banks to the CESEE region has even increased. New foreign currency lending in Austria has all but come to a halt; the outstanding amount will, however, pose a risk for many years because most foreign currency loans are bullet loans expiring in ten to twenty years.

In order to improve the stability of financial market infrastructures, new regulations like the one on over-the-counter derivatives, central counterparties and trade repositories are going to be transposed into Austrian law. The proposal for the establishment of a single supervisory mechanism (SSM) is an important step towards a genuine economic and monetary union in Europe. However, the SSM will have to be reinforced with an integrated crisis management framework and a common deposit guarantee scheme, as such tools constitute necessary pillars for a successful banking union.

Chart 13

Key Indicators for the Austrian Banking System



Source: OeNB.

[1] *Tier 1 ratio.*
[2] *Return on assets after taxes.*
[3] *Cost-to-income ratio.*
[4] *200 basis point interest rate shock (loss of eligible capital).*
[5] *Credit risk provisions in % of operating result.*
[6] *Exposure-weighted sovereign CDS spread.*
[7] *Cumulative 12-month funding deficit in % of total assets.*
[8] *Real GDP growth per annum.*

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

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

This section is structured as follows: It starts with a discussion of important developments in Austrian banks' balance sheets, including foreign activities and credit quality; goes on to review recent trends in profitability, current capitalization levels and regulatory improvements; and concludes with a brief note on nonbank financial intermediation.

Austrian Banks Faced with Legacy Assets and Challenging Market Conditions

Crisis-Related Focus on Customer Business Strengthens Resilience, but Structural Weaknesses Remain

Despite widespread concerns about asset reductions in the European banking sector since mid-2011, the consolidated total assets of Austrian banks actually increased by 4.5% in the past 12 months. Following a crisis-induced decrease of consolidated total assets between 2008 and 2009 and a second wave in 2010, Austrian banks expanded their balance sheets in the first half of 2012, to approximately EUR 1,189 billion (+4.5% year on year). Overall, the size of the Austrian banking sector in terms of total assets is large by international comparison, which also reflects the greater dependency of the Austrian economy on bank intermediation as opposed to other financial intermediaries or direct finance.

Austrian banks tended to reinforce their customer business in recent years, while gradually reducing interbank activities. Despite the reduction in overall interbank activities, the level of interconnectedness between Austrian banks on the domestic market remains relatively high, primarily as a result of the multi-tier structure of the decentralized sectors (Raiffeisen, Sparkassen and Volksbanken). To shed more light on this topic, this report also provides a detailed network analysis of the Austrian banking system (see the Special Topics section).

In their domestic business, Austrian banks are increasingly focusing on core business activities. Current regulatory reforms are likely to further encourage banks to concentrate resources on well-performing areas and divest in non-core business. Some banks have announced plans to sell leasing subsidiaries and scale back investment banking activities during 2012. In addition, the ongoing restructuring of three medium-sized Austrian banks which received government support should also increase the resilience of the banking system against future turmoil and therefore support financial stability.

Above-average bank branch and staff density

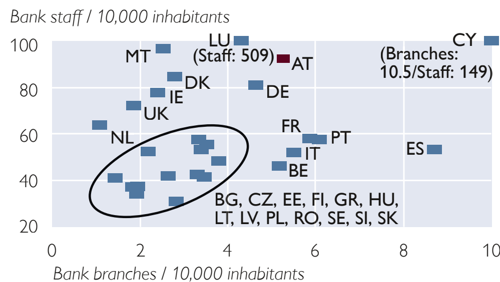
Structural weaknesses of the Austrian banking system remain essentially unchanged compared to the height of the global financial crisis. The Austrian banking sector is characterized by a large number of banks, local branches and staff compared to the size of the population. In mid-2012, a total of 822 banks were registered in Austria, which reflects the prominent role of the decentralized sectors of the banking system. On average, banks had 5.2 local branches with a staff of 92.5 for every 10,000 inhabitants (as of end-2011). Based on ECB data, the branch density within the European Union was only higher in Portugal, Spain, Italy, Cyprus and France, and the bank staff density only in Luxembourg, Malta and Cyprus (see chart 14).

High interconnectedness because of decentralized multi-tier structures

A new early intervention and bank resolution framework is needed to address structural weaknesses more proactively than in the past. The OeNB and the Austrian Financial Market Authority (FMA) have repeatedly pointed at the need for a legal framework for early intervention and the orderly resolution of troubled banks, and proposed cornerstones of such a framework in early 2012. The Austrian government has committed itself to present a legislative proposal focusing on early intervention by year-

Chart 14

EU-27 Comparison of Bank Branches and Staff Relative to Population Size



Source: ECB, Eurostat, OeNB.

end. In parallel there are plans to create a European resolution framework as one of the building blocks of the envisaged European banking union (see box on page 46) and the European Commission issued a draft directive on bank recovery and resolution in June 2012. In case the plans currently under discussion for a European resolution mechanism do not lead to an operational system in the foreseeable future, the current national proposal should be complemented with a bank resolution framework as soon as possible. Otherwise, public bailouts could remain as the only "feasible" resolution option in individual cases. This outcome is socially undesirable for several well-known reasons (violation of basic principles of a market economy, moral hazard, fiscal costs, etc.), including its implications for lasting financial stability.

Diverging Trends in the Foreign Exposure Development of Austrian Banks – CESEE Region Up, Euro Area Periphery Down

Recent foreign exposure developments of Austrian banks point at diverging trends, foremost between the CESEE region and euro area countries with high risk premiums. Totaling EUR 215.5 billion in June 2012 (see table 1), the exposure[1] of majority owned Austrian banks to the CESEE region has remained almost unchanged compared with end-2011 figures. While the exposure is broadly diversified, the lion's share of 57% was recorded vis-à-vis the countries that joined the EU in 2004 (NMS-2004). In comparison, economies in Southeastern Europe (SEE), the NMS-2007 states and the CIS economies accounted for 18%, 15% and 10%, respectively, of the overall exposure. The exposure to Poland stands out with a marked increase by about 50% over the first six months of 2012, resulting from the purchase of Polbank by Raiffeisen Bank International AG. As addressed later in more detail, this acquisition affects several key indicators such as foreign currency lending and credit quality.

Decreasing exposure to euro area countries under market pressure, CESEE commitments maintained

At the same time, Austrian banks continued to reduce their exposure to euro area countries currently under market pressure. The exposure to euro area EU/IMF program countries (Greece, Ireland and Portugal) is limited and on a continued downward trend: after a reduction of about one-third within the first half of 2012 – partly related to the Greek private sector involvement scheme, write-downs and risk provisioning – foreign claims amounted to EUR 2.7 billion in June 2012. The exposure to Italy and Spain amounts to EUR 15.4 billion, down about EUR 2.1 billion since end-2011.

Concerns about widespread deleveraging by Austrian banks in the CESEE region

[1] *Here, exposure refers to the on-balance exposure of majority Austrian-owned banks to credit institutions and nonbanks in CESEE. Majority Austrian-owned banks exclude, for instance, UniCredit Bank Austria (majority-owned by Italy-based UniCredit group), Volksbank International (majority-owned by Russia-based Sberbank) and BAWAG (majority-owned by U.S.-based Cerberus).*

have not materialized so far, yet data indicate significant differences at the country level. In connection with the current economic difficulties and new regulatory measures, there have been worries that banks might restrict lending to the real economy, causing a credit crunch and thereby slowing down economic growth. Deleveraging fears are most prominent with regard to the CESEE region, where Austrian banks have high market shares in various countries. However, as far as available data show, the Austrian banking system[2] remains committed to the CESEE region and Austrian banks' business models are consistent with the spirit of the Vienna Initiative 2. Going forward, the OeNB continues to support the objectives and principles of the Vienna Initiative 2 and commends an ongoing intense dialog taking into account both home and host perspectives.

Since the height of the CESEE market turmoil in early 2009, Austrian banks' exposure to the region has increased by more than a cumulative 9% as reported or close to 14% when adjusted for exchange rate effects and provisions.[3] Even when excluding the recent acquisition of Polbank, the increase still amounts to 7% (11% when adjusted). This development is not uniform across the countries in which Austrian banks have substantial exposures, however. In sum, the exposure shrank by approximately 3% in countries with a difficult economic and/or regulatory environment (Ukraine, Kazakhstan and Hungary), but this decrease was more than compensated by an aggregate increase of 17% in

Table 1

Foreign Claims of Austrian Financial Intermediaries in June 2012 (on-balance sheet, immediate borrower basis)

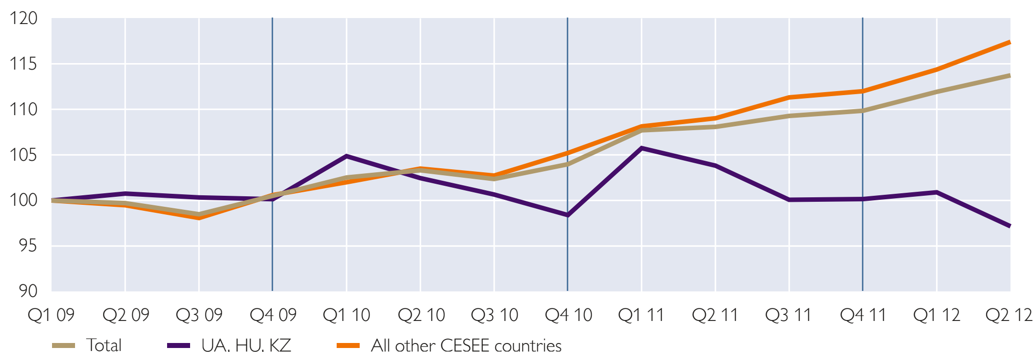
	CESEE	IT	ES	IE	PT	GR
	EUR billion					
Banks (domestically owned)	215.5	12.9	2.5	1.5	0.7	0.5
Banks (total)	326.1	22.8	3.6	3.2	1.3	0.6
Insurance companies[1]	4.5	2.1	1.3	1.4	0.2	0.0
Pension funds and severance funds[1]	0.5	0.7	0.3	0.0	0.0	0.0

Source: OeNB.

[1] *Securities held in Austria.*

Chart 15

Development of Austrian Banks' CESEE Exposures from Q1 2009 to Q2 2012



Source: OeNB.

[2] *All banks with an Austrian banking license, irrespective of whether they are majority Austrian or foreign owned, including their respective CESEE subsidiaries.*

[3] *Reported exposure is distorted by movements in exchange rate effects and loan loss provisions. Even if real loan volumes were constant, figures reported in euro would grow or shrink as exchange rates fluctuate. In order to monitor the development of exposures, those effects need to be neutralized, as it is done in chart 15.*

other CESEE countries,[4] as illustrated by chart 15.

A gradual reduction in leverage is a welcome development from the perspective of financial stability. Times of economic difficulty usually go hand in hand with lower demand for credit, as businesses and households scale back investment and consumption. As the current crisis was in part caused by misdirected investments into only seemingly profitable projects, this effect is more pronounced in the present environment. Over the past few years, those misled investments as well as credit-funded consumption led to the build-up of system-wide leverage. Both the nonbank private as well as the banking sector increased the use of debt relative to equity, which increased risk and reduced their capacity to absorb shocks and unexpected losses. Economic agents are now making efforts to repair their balance sheets, which is a necessary path to adjustment. With a view to financial stability in Europe, the observed gradual reduction in leverage is therefore foremost a welcome development, as lower leverage decreases both the potential for risks as well as the degree of financial interconnectedness, and thereby mitigates systemic risk.

Stable Credit Growth in Austria

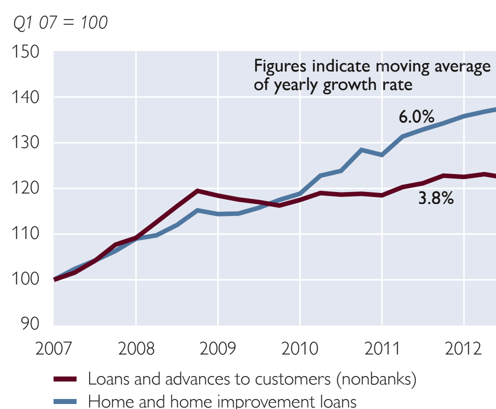
Concerns about a credit crunch in Austria due to higher capital requirements, strained funding markets or a deteriorated asset quality have not materialized so far. Though growth rates weakened, the supply of credit to the Austrian economy has remained virtually stable (see the section on Austria's real economy starting on page 19). By September 2012, the volume of loans to domestic nonbanks amounted to EUR 331.9 billion, almost 1.8% higher than the year before. With regard to the composition of domestic loan growth, it is notable that loans for home and home improvements have been outpacing the general development since 2010 (see chart 16). This development may be traced back to the growing demand for real estate in Austria as a perceived safe haven investment in times of heightened economic and financial uncertainties, which is reflected in the recent surge in property prices. Though still low by international comparison, the property price increases will have to be followed closely given their potential repercussions for financial stability. In particular it will be crucial to determine to which extent the recent property price increase has been related to bank lending and how loan-to-value

Strong demand for home improvement loans

Chart 16

Loan Growth in Austria

Q1 07 = 100



Source: OeNB.

[4] *Of the countries with a substantial exposure of Austrian banks, reductions in reported (i.e. unadjusted) exposure were largest in Ukraine, Kazakhstan (both –18% since Q1 2009) and Hungary (–11%), reflecting economic difficulties as well as elevated levels of political risk. In contrast, exposures to other countries grew substantially, with Poland (+65%), the Czech Republic (+29%), Slovakia (+14%) and Russia (+10% since Q1 2009) featuring prominently.*

(LTV) and debt/payment-to-income (DTI/PTI) ratios in this segment look like. Closing existing data gaps in this respect will be important.

Lending by Austrian subsidiaries in the CESEE region has increased slightly. As of mid-2012, the 70 fully consolidated CESEE subsidiaries of Austrian banks posted total assets of around EUR 281 billion, which corresponds to a semiannual increase of 1.8% without accounting for the acquisition of Polbank. At the same time, the loan volume increased to EUR 176 billion. On a net basis (i.e. after risk provisions) and adjusted for the stated acquisition, loan growth was essentially flat (+0.2% year on year).

Foreign Currency Loans Remain a Financial Stability Concern

New lending in foreign currency very limited in Austria

New foreign currency lending in Austria has all but come to a halt, while the legacy of the period from the mid-1990s to 2008 remains a medium-term concern. The stock of foreign currency loans (FCL) in Austria has been on a steady decline since autumn 2008 and new foreign currency lending accounted for only around 4% of total new lending to households since end-2010. As of September 2012, foreign currency loans to domestic nonbanks in Austria summed up to EUR 50.7 billion, corresponding to 15.3% of all loans, of which EUR 34.6 billion were owed by households (FCL share of 25%) and EUR 10 billion by nonfinancial corporations (FCL share of 7%). The outstanding foreign currency loan stock of domestic nonbanks declined by 14.1% on a year-on-year basis (adjusted for foreign exchange rate effects) (households: –13.3%, nonfinancial corporations: –21%).[5] The Swiss franc continued to be the dominant currency for foreign currency loans (93% for households, and 72% for corporates), while the Japanese yen and the U.S. dollar play a minor role.

Foreign currency loans and repayment vehicle loans in Austria continue to be a challenge for borrowers and banks. In September 2012 roughly 72% of foreign currency loans to households were designed as repayment vehicle (RPV) loans, where regular loan installments are replaced with a regular savings plan (involving capital market-related products in three out of four cases). This framework serves to repay the outstanding debt in a lump sum at the maturity of the loan. As a result, the associated credit risk is linked not only to exchange rate movements but also to asset price fluctuations. In addition to foreign currency RPV loans, Austrian banks hold euro-denominated RPV loans in the amount of EUR 3.1 billion, which only exhibit asset price risk in addition to the ordinary credit risk. According to an OeNB/FMA survey, aggregate funding gaps of all RPV loans to households amounted to EUR 4.7 billion or 18% of the outstanding loan volumes in mid-2011. Given the maturity profile of foreign currency loans to retail customers (see chart 17), those gaps are a big issue for Austrian banks not necessarily in the short run but in the medium to long term. Therefore Austria is currently implementing the recent recommendations of the European Systemic Risk Board (ESRB) with respect to foreign currency lending.

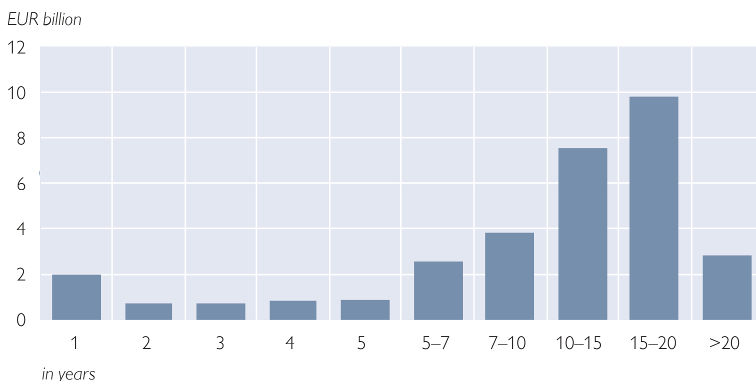
In the CESEE region, foreign currency loan developments were distorted by one-off effects in the first half of 2012. Among the CESEE subsidiaries of the top 6 Austrian banks, the share of foreign currency loans in total loans went down by 2 per-

[5] *The decline in the FCL volume of nonbank financial intermediaries and of the public sector was below the domestic nonbank average.*

centage points, to 46% or EUR 86 billion until June 2012 according to a semiannual OeNB survey. Adjusted for exchange rate effects and the acquisition of Polbank, this corresponds to a reduction by 2.9% since end-2011. Part of the reduction, however, was due to the migration of a number of nonperforming foreign currency loans to the foreign currency leasing portfolio, predominantly by one banking group. The acquisition of Polbank also affected the currency composition of the foreign currency loan portfolio of CESEE subsidiaries: The Swiss franc-denominated loan portfolio, which actually declined significantly during the first half of 2012, thus increased by 1.8 percentage points to 18.7%. The euro maintained its dominant position and accounted for more than half of the total foreign currency loan portfolio held by Austrian bank subsidiaries in the CESEE region in June 2012 (58%). Similarly, approximately 79% of direct cross-border foreign currency[6] loans granted by Austrian banks to borrowers in the CESEE region were denominated in euro, while the Swiss franc played only a minor role in that segment (4.2% as of June 2012).

Chart 17

Maturity of FX Bullet Loans to Retail Customers in Austria in September 2012



Source: OeNB.

Credit Quality Worsens Further in CESEE while Staying Stable in Austria

Persistently heightened credit risk costs are a consequence of an ongoing decline of debtors' credit quality mirrored by the increase of the nonperforming loan ratio (see chart 18). The increase in the consolidated nonperforming loan (NPL) ratio was almost exclusively driven by Austrian banks' exposure to CESEE countries which had to cope with a difficult economic environment during the previous crisis years and whose outlook is still moderate. While the development of the unconsolidated NPL ratio (i.e. domestic business in Austria) totaled approximately 4.6% in June 2012, having remained almost flat over the last quarters, the NPL ratio of Austrian subsidiaries in the CESEE area accumulated to 15.9%, inter alia driven by above-average ratios in the foreign currency loan segment (19.7%). The consolidated NPL ratio of the Austrian banking system stood at 9.1% in mid-2012. The worsening credit quality of CESEE portfolios can also be seen from the development of loan loss provision ratios (see chart 19).

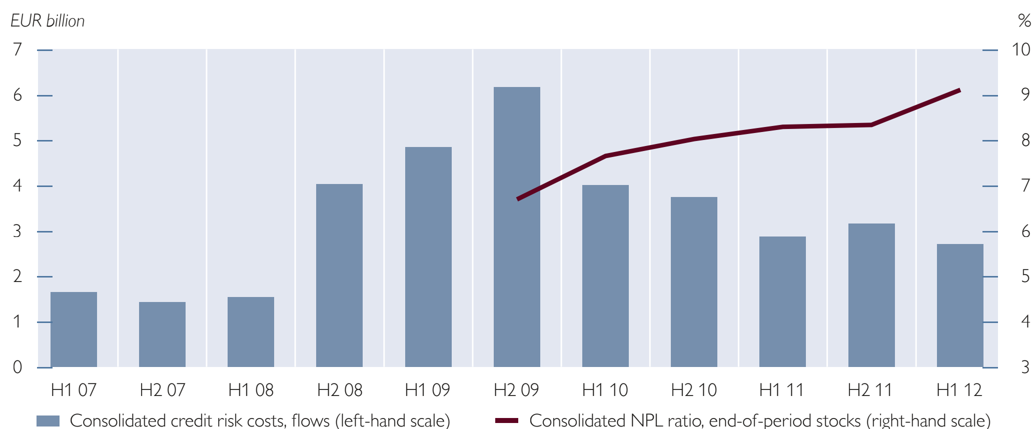
While having remained stable in the domestic market, loan loss provision ratios continue to rise at subsidiaries abroad. The unconsolidated loan loss provision ratio,[7] which primarily covers loans to domestic customers, broadly remained at the level recorded in mid-2011 (3.2% as at September 2012). In the CESEE region, loan loss provision ratios increased in most countries during the

[6] *Foreign currency from a borrower's perspective, i.e. loan denominated in a currency other than the local currency in the borrower's country of residence.*

[7] *Stock of specific loan loss provisions for claims on nonbanks as a share of total outstanding claims on nonbanks.*

Chart 18

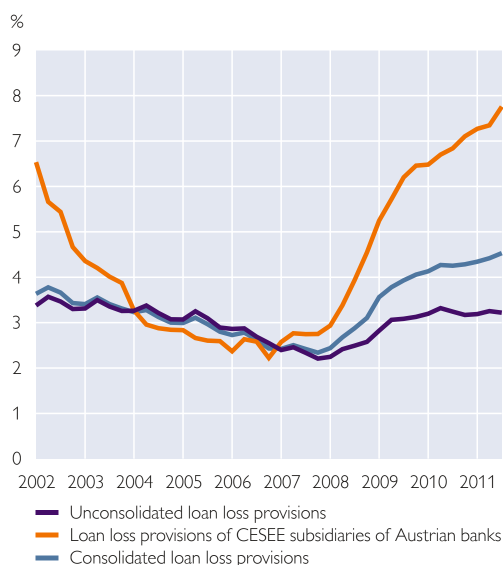
Consolidated Credit Risk Costs and NPL Ratio of Austrian Banks



Source: OeNB.

Chart 19

Loan Loss Provisions of Austrian Banks



Source: OeNB.

Note: Loans to nonbanks in all cases.

first half of 2012, most notably in the NMS-2007 economies. In June 2012 the ratio stood slightly above 10% in the NMS-2007 and CIS subregions (10.6% and 10.4%, respectively), while it averaged 6.1% in the NMS-2004 countries and 6.9% in SEE economies. Over the past four years, the loan loss provision ratio of foreign subsidiaries of Austrian banks has risen by a total of 5 percentage points. Despite that increase and given the fact that restructuring in the loan portfolio of banks quite naturally plays a role during economically difficult times, an adequate coverage of NPLs by loan loss provisions is an important element of financial stability.

Together, domestic and foreign credit quality developments resulted in a slightly increased consolidated loan loss provision ratio in the first half of 2012 (4.5% as of mid-2012). The moderate increase of the ratio in the first half of 2012 is mainly due to the fact that the unconsolidated loan loss provision ratio still covers more than 70% of all nonbank exposures of Austrian banks. In international fora, loan forbearance gained attention. In line with their peers, Austrian authorities contribute to work ongoing in this field.

Increased Funding Resilience of Austrian Banks

Customer deposits have traditionally played an important role in funding for Austrian banks. Austrian households hold roughly 50% of their financial wealth in bank deposits, much more than their peers in

the U.S.A., the U.K. and the euro area, which contributes to a stable refinancing situation. Customer deposits by households and nonfinancial corporations accounted for approximately 80% of total loans to nonbank customers in the domestic market, corresponding to an unconsolidated customer loan-to-deposit ratio of 124% as of mid-2012 (–3.8 percentage points year on year).

Deposit growth rates of Austrian banks exceeded the European average over the past year (see chart 20). In an environment of tightened funding conditions, European banks have come to rely more strongly on customer deposits to ensure a stable funding base. While several European banking systems managed to increase their local deposit base in recent quarters, a few countries at the center of the European sovereign debt crisis have faced deposit outflows in the course of 2012.[8] With an average growth rate of almost 5% in Austria, domestic banks were able to increase customer deposits at a rate above the EU-27 average (approximately 3% in June 2012) and in the average range of those EU countries which registered positive domestic growth rates (5.5%, fostered by strong growth rates in some EU Member States outside the euro area such as Sweden or the United Kingdom). There is growing evidence that banks in Austria experienced a net increase in foreign deposits. The strong deposit growth may be seen as evidence of the higher confidence in the Austrian banking system as compared to the confidence in some troubled banking systems, and it may also reflect the lack of alternative safe and liquid assets.

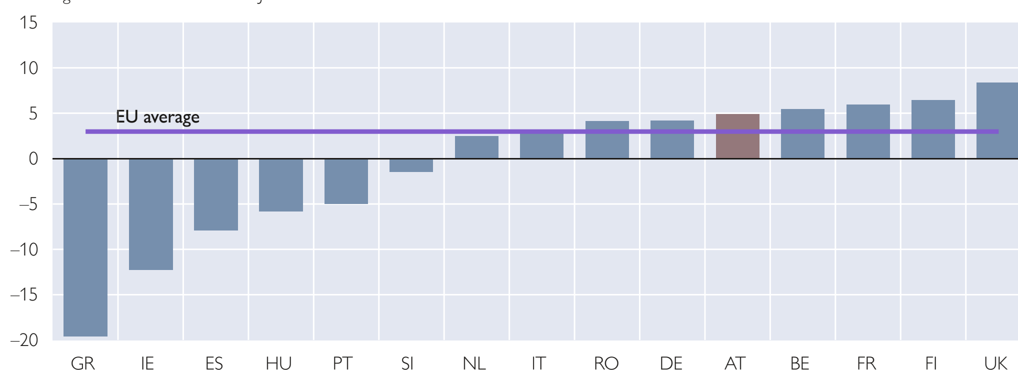
CESEE subsidiaries improved their deposit base

Austrian banks' subsidiaries in CESEE increased their customer deposits by 5.3% over the past year, driven by strong growth in a few countries. Customer deposits expanded at a strong pace in Russia, Slovakia and Bulgaria, while declining at Hungarian subsidiaries.[9] The increase in local customer deposits and the associated improvement in the loan-to-deposit ratio of the CESEE subsidiaries of Austrian banks (which shrank to 104% by June 2012) are favorable developments from an Austrian supervisory perspective and correspond with

Chart 20

Deposit Growth in the EU

Annual growth rate as measured in June 2012 in %



Source: OeNB.

[8] *See the IMF's Global Financial Stability Report of October 2012, chapter 2.*

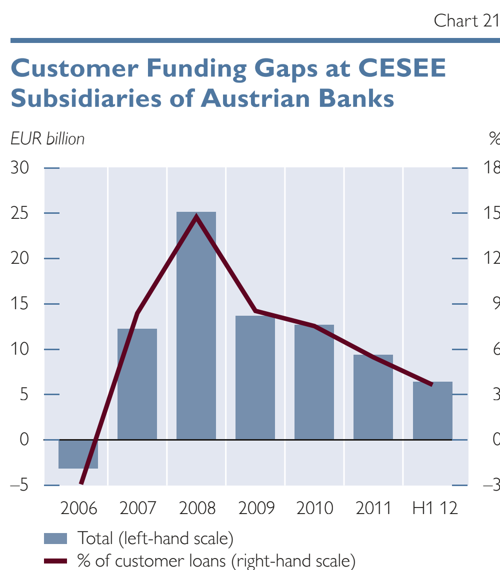
[9] *Partly related to the early repayment scheme for foreign currency loans in Hungary.*

the objective of a stronger local stable funding base as stated in the "sustainability package" developed by the OeNB and the FMA (see chart 21). In general, a greater reliance on local funding sources should also be in the interest of host supervisors, since it may dampen the susceptibility of CESEE banking systems to international spillover effects going forward. As regards the currency denomination of customer deposits at Austrian banks' CESEE subsidiaries, approximately 30% of those customer deposits were denominated in a foreign currency at the end of the second quarter of 2012, especially in euro (72%) and Swiss francs (25%).[10]

Lower state subsidies take their toll on deposits made with building and loan associations. With a market share of 6.5% in June 2012,[11] savings plans with building and loan associations are popular savings instruments in Austria. However, the fiscal austerity package agreed by the government in March 2012 also includes the halving of state subsidies on deposits accumulated under such savings plans. Conjointly with the current unfavorable interest environment, this has already led to a moderate decline in new business.

Chart 21

Customer Funding Gaps at CESEE Subsidiaries of Austrian Banks



Source: OeNB.

Liquidity Situation Shows Signs of Improvement

On a European level the liquidity pressure for banks has eased substantially since its peak levels in late autumn 2011. In late 2011 funding markets tightened up almost entirely due to the high level of market uncertainty caused by the European sovereign debt crisis. The ECB has since introduced several monetary policy measures that were instrumental in improving the liquidity and funding conditions of the European banks. Above all, the ECB allotted a total volume of EUR 1.02 trillion in two supplementary longer-term refinancing operations with a 3-year maturity, conducted in December 2011 and February 2012. In addition, the substitution of TARGET2 balances for market funding has shielded banking systems which had relied on fragile funding sources (such as unsecured interbank markets) against rollover risks. Furthermore, the ECB lowered minimum reserve requirements from 2% to 1% of credit institutions' reserve base, since minimum reserves were no longer needed to enlarge the demand for central bank reserves, which used to be one of their roles in the operational framework for monetary policy implementation.

More conservative liquidity risk profile also reflects heightened market uncertainty

Austrian banks participated in the ECB's supplementary longer-term refinancing operations with a total volume of EUR 15.7 billion, which corresponds to 1.5% of the total allotted volume, well below the

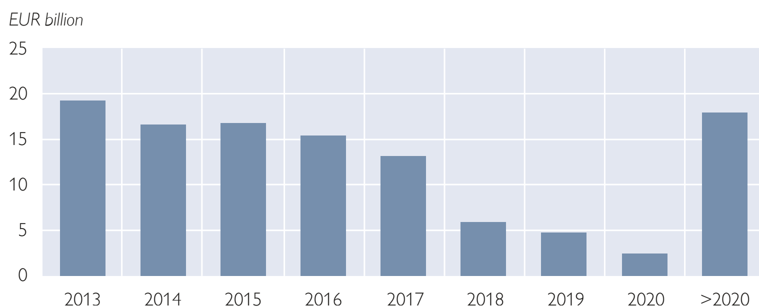
[10] *Data on the currency distribution of deposits are based only on subsidiaries of the top 3 Austrian banking groups.*

[11] *Market share measured by the outstanding amount of deposits by domestic customers (nonbanks) in euro and foreign currency.*

proportionate share of Austria in the Eurosystem (3.8%[12]*).* Banks reported that the additional liquidity was mainly used to increase the liquidity buffers as a precautionary measure. In addition, they achieved a price advantage by replacing other more expensive refinancing instruments and tender allotments with shorter maturities, thus reducing the demand for main refinancing operations. Several banks reported that they intended to redeem parts of the ECB's supplementary funding after the first year. Since May 2012 the cumulated net funding gap of the 30 largest Austrian banks, 12 months ahead before money market operations, has increased from a historically low level of EUR 26 billion to EUR 34 billion, which is still below the long-term average, mainly due to an increase in financial investments planned for the next 12 months. In the unsecured money markets, the aggregated net position of Austrian banks is positive three months ahead. The net position of issuances 12 months ahead narrowed slightly but remains clearly negative. The additional liquidity that can be realized within the next 12 months after deduction of funding gaps (counterbalancing capacity) increased to roughly EUR 100 billion (May 2012) since the beginning of 2012 and has been stable ever since (October 2012). This buffer level exceeds the long-term average and can be mostly attributed to an increase in liquid assets (cash and unencumbered securities of higher quality).

Chart 22

Refinancing Needs of the Top 6 Austrian Banks



Source: OeNB.

As regards the funding situation in foreign currencies, banks narrowed their liquidity gaps in U.S. dollar and Swiss franc funding. Nevertheless, banks ought to continue their efforts to reduce their U.S. dollar and Swiss franc legacy positions, lengthen funding tenors and diversify funding instruments and counterparties.

Debt issuance activity remained at relatively low levels, which can be partly explained by the use of ECB funding. Nevertheless, existing rollover needs remain. Within new issuances a structural shift towards secured issuances (covered bonds, *Pfandbriefe*) can be observed at the expense of senior unsecured bond issuances. Although asset encumbrance levels for Austrian banks are relatively low compared to their European peers, the favorable treatment of covered bonds in the new proposed liquidity regulation and the increased market demand for covered bonds might lead to higher levels in the future. As shown in chart 22, the top 6 Austrian banks will have to refinance a material amount of outstanding debt within the next years, in competition with the rollover needs of other banking systems.

Profitability Indicators Distorted by One-Off Effects

Lower net interest income and risk provisioning burdened the aggregate profitability of the Austrian banking system during the first half of 2012. Provisions set aside by Austrian banks to cover credit risks in their loan portfolios amounted to EUR 2.7 billion on a consolidated level in the first six months of 2012 (see chart 23).

[12] *Measured in terms of consolidated total assets.*

Chart 23

Operating Income (before risk) and Credit Risk Cost of Austrian Banks (consolidated)

Source: OeNB

This is approximately 5.5% lower than in the first half of the preceding year and thus helped improve profitability in relative term, but remains a substantial factor that drags on overall profitability. At the same time, net interest income, which has traditionally accounted for more than half of total operating income (51.5% in H1 2012), deteriorated slightly (–3.9% in H1 2012 compared to H1 2011), in line with commission and fee income, which also decreased by 2.8% compared to the first half of 2011. It remains to be seen how a long lasting low interest environment will affect interest margins.

Net profits after taxes were upward-biased because of extraordinary revenue items related to capital measures of several large Austrian banks. The stable operating profit (+1% in H1 2011 year on year) and net profit after taxes of roughly EUR 3 billion (+4.6%) for the banking system should therefore be interpreted with caution. After adjusting for the stated one-off effects, which are related to hybrid capital buy-backs and similar one-off measures, the banking system generated a consolidated return on assets after taxes of nearly 0.4% during the first three quarters of 2012. Given the more difficult macroeconomic conditions and the challenging international environment toward the end of 2012, as well as seasonal effects, the return on assets for the entire year is likely to be lower than this level, though.

Slightly weaker adjusted profitability than in the first half of 2011

The CESEE business was again a substantial net contributor to the overall profitability of the Austrian banking system in the first half of 2012. Similar to previous years, the after-tax return on assets of Austrian banks' CESEE subsidiaries (1.0%) was significantly above that recorded by Austrian banks on an unconsolidated basis (0.4%). However, the higher profitability of CESEE subsidiaries needs to be qualified by pointing at three caveats that may apply: First, the CESEE business is in general associated with higher risks, which imply higher expected returns for the CESEE operations on average. Second, the comparison of the two return figures is influenced by the pricing of intragroup liquidity transfers. Lastly, some admin-

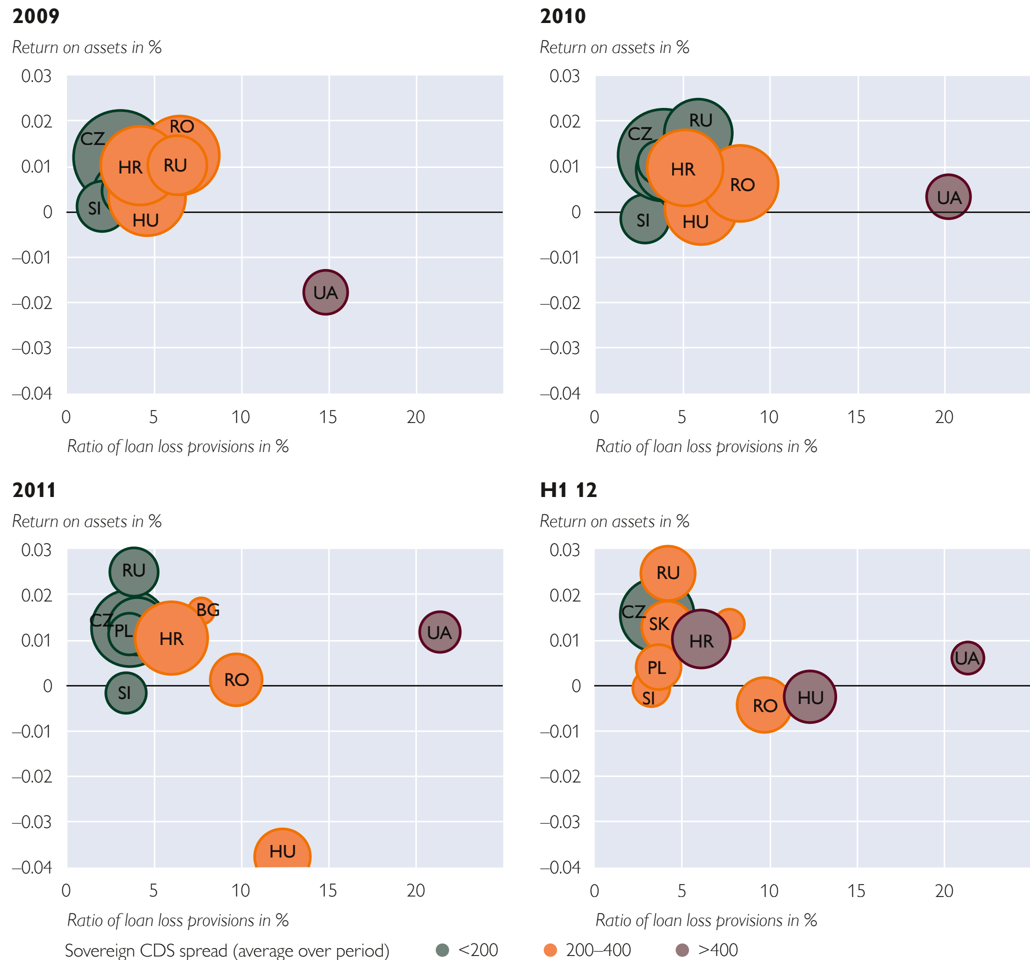
istrative expenses that are related to the CESEE subsidiaries are covered by headquarters in Vienna. Compared to 2011, the average return on assets of CESEE subsidiaries was higher than for the entire year 2011 (0.7%) but lower than the level recorded during the first half of 2011 (1.2%) when macroeconomic conditions in the CESEE region were still more favorable on average.

Increasingly heterogeneous performance of CESEE subsidiaries

On a country level, the performance of Austrian CESEE subsidiaries has become more heterogeneous in recent years. While it is important to highlight the remarkably resilient aggregate profitability of Austrian banks' CESEE subsidiaries as a whole over the past few years, the aggregate numbers mask country differences that have become clearer over time. As chart 24 shows, business operations in some countries (most notably the Czech Republic, Slovakia, Croatia and Russia) have yielded relatively stable net returns ever since 2009, while the performance in other countries has been more uneven, in particular in the case of countries with elevated country risks, as proxied by their sovereign CDS spreads in chart 24.

Chart 24

Profitability and Loan Loss Provisions of Austrian Banks' CESEE Subsidaries



Source: OeNB.

Note: The size of the data points represents the total exposure of Austrian banks to the respective country (ultimate risk basis).

Profitability in the domestic banking market remains rather subdued. Local smaller banks[13] saw their after-tax return on assets decrease from 0.4% in the first half of 2011 to 0.3% in the first half of 2012. This reduction was mainly due to lower net interest income, which plays a greater role for smaller banks than for large and regional banks. Similarly, return on equity was lower in the first half of 2012 for domestic banking operations (4.8%) than for operations at CESEE subsidiaries (8.7%). Profitability remained restrained in the third quarter of 2012. Unconsolidated operating profit was about 8.8% lower than a year ago in September 2012. However, because risk costs declined as well, expectations on the unconsolidated return on assets remain unchanged at the level of June 2012 (0.4% for the total banking sector).

Capital Ratios Continue to Increase in 2012

The tier 1 ratio of the Austrian banking system continued to improve in early 2012, partly due to reductions in risk-weighted assets (RWA). After its low in the second quarter of 2008, the aggregate tier 1 capital ratio (capital adequacy ratio) of all Austrian banks rose steadily and reached 10.6% (13.7%) in the second quarter of 2012. The increase of the aggregate tier 1 capital ratio can be mainly attributed to two effects. First, the volume of eligible tier 1 capital has risen by more than a third since the third quarter of 2008, reflecting internal capital increases (private placements, capital injections from the parent group, retained earnings and other measures) as well as government measures under the bank stabilization package worth EUR 8.7 billion (or about half of the increase in eligible tier 1 capital). Second, in a direct response to the financial crisis, banks were reducing their risk-weighted assets until the fourth quarter of 2009 (see chart 25), inter alia by streamlining their balance sheets and cutting off-balance sheet activities. While there was a slight increase in RWA in 2010, the trend of RWA reductions has continued ever since: RWA shrank by 1.7% in the first half of 2012, with the aggregate rate masking divergent developments of the top 6 banks on the one hand (–4.4%) and the rest of the banking sector on the other hand (+3.0%). By international comparison Austrian banks still have a rather high ratio of risk-weighted assets to total assets, reflecting a low leverage.

Despite improvement, further capital increases required

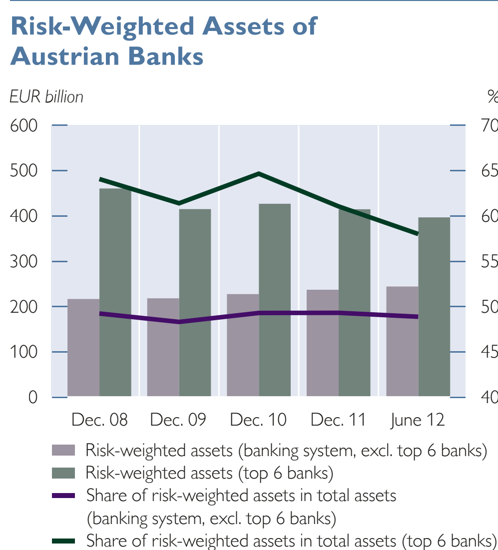
The Austrian banking sector's aggregate tier 1 capital ratio is dominated by the country's top 6 banks, which are less adequately capitalized than their international peers.[14] Even though the top 6 banks have continually improved their tier 1 capital ratios in recent years, the gap between them and their peers has remained, as the latter also strengthened their capital positions considerably. In the case of the top 6 banks and their peers with a relevant CESEE exposure, the gap widened from 1.2 percentage points in 2009 to 1.8 percentage points by mid-2012 (10.2% versus 12.1% on average; see chart 26). The top 3 banks, which had managed to narrow their gap somewhat in the second half of 2011, fell behind again, mainly resulting from a marked increase in the peer group's

[13] *The sector of local smaller banks includes certain joint stock companies, the savings banks without Erste Group and Erste Bank, the Raiffeisen credit cooperatives without Raiffeisen Zentralbank (RZB), the regional Raiffeisen-landesbank cooperatives and holdings, as well as Volksbank credit cooperatives without Volksbanken AG (VBAG).*

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

Chart 25

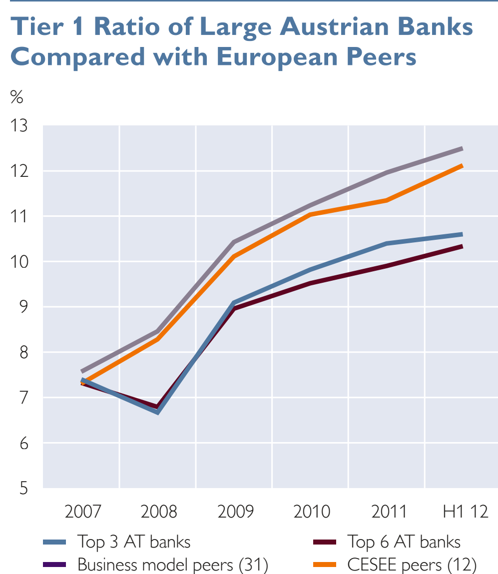
Risk-Weighted Assets of Austrian Banks



Source: OeNB.

Chart 26

Tier 1 Ratio of Large Austrian Banks Compared with European Peers



Source: OeNB, Bankscope.

aggregate tier 1 ratio in the first half of 2012 (+0.8 percentage points). The top 3 banks' aggregate tier 1 ratio is now 1.5 percentage points below the CESEE-related peer ratio, compared with 1.0 percentage points at the end of 2009. Nevertheless, the two large majority Austrian-owned banks that participated in the recapitalization exercise of the European Banking Authority (EBA) were able to meet the core tier 1 capital requirements as of end-June 2012. It is also worth noting that the leverage of large Austrian banks (i.e. based on total assets instead of risk-weighted assets) is significantly lower than that of their peer groups (15.9 for the top 3 banks compared to 26.1 for CESEE peers and 28.0 for European peers). A low(er) leverage is an important indicator of financial stability as it is independent from banks' internal models and/or changes in external rating.

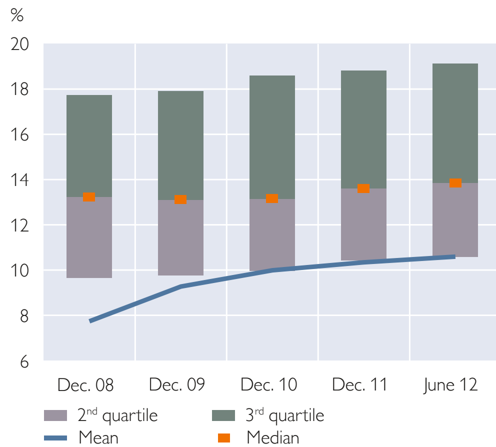
Smaller local banks with above-average capitalization

The distribution of capital ratios among Austrian banks highlights the more solid capitalization of local and regional banks compared to large banks. At the end of the second quarter of 2012, the median tier 1 capital ratio of all Austrian banks stood at 13.9% and thus above the aggregate mean (see chart 27). The higher median ratio essentially reflects the high number of local and regional banks with above-average capitalization that operate in Austria alongside the few large banks which dominate the industry. Half of all Austrian banks (i.e. the second and third quartile) post tier 1 capital ratios between 10.6% and 19.1%.

At the level of CESEE subsidiaries, capital ratios were for the most part well above the regulatory minimum requirements set by host countries. The RWA-weighted average tier 1 ratio (capital adequacy ratio) of CESEE subsidiaries increased to 14.2% (16.4%) during the first half of 2012, reflecting a continuously improving capital base of Austrian subsidiaries. Both ratios were significantly higher in the NMS-2007 and SEE subregions (tier 1 ratios of 16.4% and 18.0%) than in NMS-2004 and CIS subsidiaries, partly due to stricter regulatory minimum capital requirements and elevated country risks.

Chart 27

Aggregate Tier 1 Ratio of Austrian Banks



Source: OeNB.

Given their overall risk profile, tighter regulatory requirements in the future and the eventual repayment of government support measures, large Austrian banks ought to increase their capital ratios in the short to medium term. In particular, large Austrian banking groups that are among the key market players in the CESEE region should strive to close the gap with their international peers. The repayment of government support measures over the next few years is likely to be challenging and may require additional capital from external sources.

Current Market Assessment of Austrian Banks Should Not Lead to Complacency

The market assessment for euro area sovereigns and financial institutions showed signs of improvement after the ECB announced further measures to mitigate a systemic crisis. The intensification of the sovereign debt crisis in several euro area countries in the first half of 2012, the implementation risk of policy measures on a European and national level, the deteriorated economic outlook, as well as the challenging market environment for financial institutions had contributed to a sustained period of negative market assessment. An overall improvement in market sentiment was notable only after ECB announcements of further action, including Outright Monetary Transactions. However, the overall level of confidence remains relatively low, given the still fragile situation and heightened uncertainty.

ECB announcement as a "tranquilizer" for markets

The market valuation of listed Austrian financial institutions remains volatile at relatively low levels. The price-to-book ratios of listed Austrian banks continued to be subdued but exceeded those of European peers. Above all, the market assessment incorporates the comparatively limited exposure of Austrian banks to euro area EU/IMF program countries and their exposure to the CESEE region, where GDP is still expected to grow at a faster pace than in Western European economies.

Market participants and ratings agencies continued to voice concerns about the relatively low capitalization of large Austrian banks and the dependence of their CESEE subsidiaries on parent funding. These two concerns were addressed by the supervisory measures to strengthen the sustainability of the business models of large internationally active Austrian banks. A resilient banking system as well as solid public finances are necessary conditions for financial stability and help to contain a vicious circle between banks and the sovereigns. Therefore, the current market assessment should not lead to complacency and be rather seen as a window of opportunity to strengthen resilience further.

In the 2012 Article IV consultation, the IMF welcomed the introduction of the "OeNB/FMA sustainability package" and pointed at the need to strengthen early intervention powers. The Article IV staff report highlights the still deteriorating asset quality and subdued profit-

ability[15] of Austrian banks, while taking note of recent improvements in their capitalization and liquidity position. With regard to financial sector policies, the IMF recommends to proceed swiftly with the strengthening of early intervention powers and to revamp plans to restructure medium-sized banks that received public support to allow more efficient asset disposals. In addition, Austrian authorities were advised to strengthen the institutional framework regarding financial sector policies, in particular with respect to macroprudential policy.

Box 1

Banking Union: Great Leap Forward for Banking Supervision in Europe?

The ongoing financial crisis in Europe has shown that further steps are needed to address the specific risks within the euro area. Closer economic and financial integration due to the common currency have also increased the possibility of cross-border spillover effects in the event of bank crises. Moreover, recent developments point to an increasing risk of fragmentation of banking markets within the EU, with the potential of undermining the single market for financial services. In the area of banking supervision the crisis has shown that coordination between supervisory authorities is not enough to tackle these issues and that there is a need for more common decision-making. Last but not least, developments in the EU in recent years make it necessary to break the link between sovereign debt and bank debt, and the vicious circle of interdependence and contagion between them.

Consequently, following the euro area summit of June 29, 2012, the European Commission was asked to present proposals on the basis of Article 127(6) Treaty on the Functioning of the European Union (TFEU) for a single supervisory mechanism. Given an effective single supervisory mechanism, involving the ECB, for banks in the euro area, the European Stability Mechanism (ESM) would have the possibility to recapitalize banks directly. Accordingly, the European Commission issued on September 12, 2012, a communication on the establishment of a "banking union" consisting of a single supervisory mechanism (SSM), a common system for deposit guarantees and an integrated crisis management framework. The communication was accompanied by two legislative proposals, one for the setting up of a SSM and one for adaptations to the Regulation setting up the European Banking Authority (EBA).

As a first step towards a banking union, the proposal creates a SSM by conferring certain key supervisory tasks for the prudential supervision of credit institutions in the euro area to the ECB. In order to provide strong and consistent supervision the ECB will cooperate closely with national supervisors and the EBA. All tasks not conferred in the regulation on the ECB, such as consumer protection and the fight against money laundering for example, will remain the competence of national supervisors. Furthermore, for non-euro area Member States that wish to participate in the SSM there will be the possibility to enter into a close supervisory cooperation with the ECB subject to meeting specific conditions.

The proposal for the establishment of the SSM is an important step towards a genuine economic and monetary union in Europe. However, the SSM will have to be reinforced with a common deposit guarantee scheme and an integrated crisis management framework, as such tools constitute necessary pillars for a successful banking union. Thus, a roadmap, supported by clear political commitment towards putting in place all three pillars within a clearly defined timeframe, needs to be developed. Additionally, a realistic timetable is needed regarding the transfer of supervisory powers over all banks to the ECB in order to ascertain the maintenance of high supervisory standards. As regards the operational setup of the SSM, it will be

[15] *Source: IMF. 2012. Austria: 2012 Article IV Consultation Staff Report, www.imf.org/external/pubs/ft/scr/2012/cr12251.pdf (retrieved on November 27, 2012).*

crucial to avoid overly bureaucratic structures and to provide for an effective and efficient cooperation framework between the ECB and national competent authorities as close cooperation will be the key for success of the new European supervisory mechanism, whose establishment in such a short timeframe constitutes an eminent challenge.

Sound Financial Market Infrastructure and Improvement of Regulation

The OeNB is closely monitoring new developments regarding retail payment systems in Austria. For instance, an increasing number of market participants are offering contactless payment services based on cards or mobile phones. No payment system disturbances of systemic importance were recorded in the Austrian financial market in the first three quarters of 2012.

In order to improve the stability of financial market infrastructures, a new regulation has been implemented in Austrian law. The regulation on over-the-counter (OTC) derivatives, central counterparties and trade repositories[16] (also known as EMIR), which introduces a harmonized framework for central counterparties as well as reporting and clearing obligations for OTC derivatives, was transposed into Austrian law in October 2012 through an enforcement act. The FMA is designated as the competent authority for licensing central counterparties in Austria; however, the enforcement act provides for a close cooperation between the FMA and the OeNB in this context. Furthermore, the SEPA regulation[17] was implemented in Austrian law in November 2012 by an amendment of the Payment Services Act. In this context, the FMA was designated as the competent authority and the OeNB is expected to fulfill an expert function.

EMIR finds its way into Austrian law

Even though financial intermediation in Austria is dominated by the banking sector (see chart 28), nonbank financial

Chart 28

Distribution of Financial Intermediation in Austria

Source: OeNB.

[16] *Regulation (EU) No 648/2012.*

[17] *Regulation (EU) No 260/2012.*

Banks dominate the financial sector but nonbank financial institutions fulfill important additional functions

institutions fulfill an irreplaceable function within the financial system. Approximately 80% of financial market intermediation in Austria is performed by banks. Nonbank financial intermediation via insurance companies, pension funds, etc. represented just under EUR 240 billion in terms of total assets as of end-2011. Shadow banking, an increasingly important financial stability concern at the global stage, plays a below-average role in Austria,[18] but close monitoring of future developments seems warranted nonetheless.

Other Financial Intermediaries Face Crisis-Induced Challenges

Sovereign Debt Crisis Weighs on Insurance Companies and Mutual Funds

Sustained low interest environment as a challenge for insurance companies

Market conditions and cautious private investors create a challenging environment for the Austrian nonbank financial intermediaries. Life insurers and pension funds have started to feel the impact of the low interest rate environment, especially when it comes to product portfolios with interest rate guarantees for long periods. Insurers and pension funds as the largest group of institutional investors have been affected by low interest rates and the resulting reduction of investment earnings. Even though the negative effects appear rather slowly, given that only new premiums and expired investments are invested under current market interest rates, institutions are required to adjust to the changed environment and reconsider their investment strategies. The FMA reacted to the low interest rate environment with a reduction of the maximum guaranteed interest rate from 2% to 1.75% for new business of classical life insurances to be underwritten after December 20, 2012.

Life insurance business is stressed by several other factors. In addition to the potential problems resulting from the low interest rate environment, shrinking investment earnings and the weakened economic environment, life insurance business faced a continuous decrease in premium income over the last quarters (Q1 and Q2 2012: –8% compared to last year's period). This development was evident from the decrease of single and current premiums in mixed life insurance as well as in equity/index-linked insurance. Lower guaranteed interest rates and the commitment period of at least 15 years for products with single premiums as well as expensive lapse conditions discourage new business.

Non-life and health insurers were less affected by the weaker macroeconomic environment. Property and casualty insurance as well as health insurance remained stable in Austria. Both non-life segments were able to increase their premium income compared to the preceding year (Q1 and Q2 2012, property and casualty insurers: +5%; health insurers: +3%). The combined ratio[19] for property and casualty insurance stayed steadily at around 90% and increased slightly by 2 percentage points compared to the previous year, due to an increase in the loss ratio.[20]

Higher profitability in CESEE insurance activities

Foreign operations of Austrian insurance companies faced a very similar business environment as the banking sector. Austrian insurance groups are prominent investors in CESEE, but their future growth in Austria and CESEE is cur-

[18] *Source: ECB survey including data from other regions as of end 2010.*

[19] *The combined ratio, defined as insurance expenses to earned premiums, should be less than 100% for efficient companies.*

[20] *The loss ratio is defined as incurred losses divided by earned premiums.*

rently overshadowed by financial market uncertainty. In 2011 the CESEE subsidiaries of Austrian insurance companies increased their premium income by 5.7% and their net result (profit on ordinary activities) by 46% (both year on year). However, as in the banking sector, higher profitability is accompanied by heightened risks such as macroeconomic or legal risk. Moreover, growth prospects were revised downward in the course of 2012.

Pension funds in Austria continued to grow and generated a slightly positive return. In June 2012 Austrian pension funds had total assets under management of EUR 15.5 billion, almost 4% more than a year ago. With a yearly performance of 1.2% business operations turned out to be positive but below average compared to institutional mutual funds (2.1%). Austrian pension funds are mainly invested in bonds (52%) and thereof 51% in government securities, which makes them vulnerable to the low interest rates of core government securities in general and even more so in case of a further intensification of the European sovereign debt crisis (see table 1).

Private pension plans are becoming less attractive as subsidies have been cut by half. The premium income of state-subsidized personal pension plans – part of the third pillar of the Austrian pension system – stagnated in 2011 with a yearly growth rate of 0.5%. Furthermore in 2012, subsidies were halved, making private retirement provisions less attractive.

Austrian mutual funds experienced divergent developments in different asset classes. Overall, assets under management by mutual funds declined by 3.5% year on year, to EUR 140 billion at the end of the second quarter of 2012. The decline was mainly driven by retail funds because private investors seemed to remain cautious and invested more in tangible assets or financial products that offer a deposit guarantee. The overall annual investment performance of mutual funds in Austria in the first half of 2012 was positive at 1.8% supported by a handsome return of bond funds (+5.1%) and a negative performance of equity funds (–8.4%).

Bond funds on the upswing

A new regulation for exchange-traded funds (ETFs) and undertakings for collective investments in transferable securities (UCITS) aims at improving investor protection and cross-border harmonization. In July 2012, the European Securities and Markets Authority (ESMA) published guidelines on ETFs and other UCITS issues. These guidelines will apply to national securities markets regulators and UCITS management companies and include a strengthening of investor protection as well as greater harmonization of regulatory practices within Europe. Besides improving the content of the information communicated to investors, the guidelines contain quantitative and qualitative criteria for collateralized transactions such as securities lending arrangements, repo and reverse repo transactions and OTC financial derivative transactions.

Vienna Stock Exchange – Lower Prices and Volume in the Wake of the Global Financial Crisis

The global financial crisis and the subsequent sovereign debt crisis had a severe impact on global stock markets, and the Vienna stock exchange was hit particularly hard. Heightened market uncertainty and volatility has led to increased risk aversion of market participants over the last few years, which is reflected in a broad reduction of market capitalization around the globe (see chart 29). Especially countries in the focus of the sovereign debt crisis were affected. The Vienna stock exchange also suf-

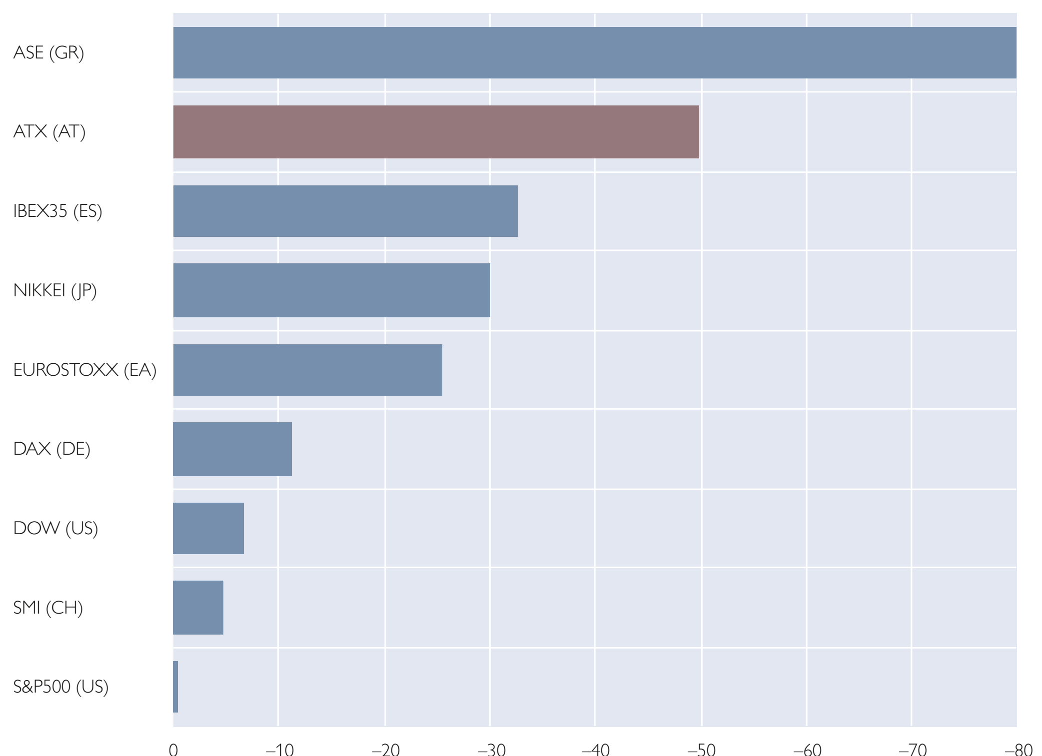
fered material losses, mainly for two reasons: First, the domestic market index is dominated by stocks of financial institutions which underperformed since the beginning of the financial crisis. Second, the attractiveness of stock market investments was reduced by the introduction of a capital gains tax in Austria that is not linked to the holding period of the security.

Lower turnover at Vienna stock exchange

Issuance activity on the Vienna stock exchange was rather limited in recent quarters and market turnover tumbled. The turnover of the Austrian Traded Index (ATX) went down markedly over the past years, reflecting a relative loss of importance in an international context (see chart 30). As a gateway towards the CESEE region, the domestic stock exchange also faces active competition within the CEE Stock Exchange Group and from the Warsaw stock exchange. Market transactions such as initial public offerings or capital increases virtually came to a standstill. At the same time, the bond market, in particular for nonfinancial corporate bonds, developed positively as investors were attracted by comparatively high interest rates as opposed to seemingly safer investment alternatives.

Chart 29

Stock Exchange Market Capitalization

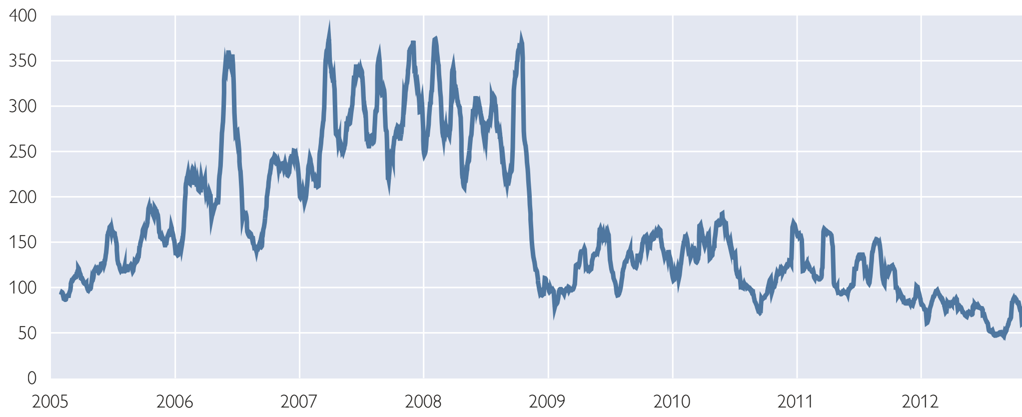


Source: Bloomberg.

Chart 30

Average Daily Turnover of the Austrian Traded Index

30-day moving average in EUR million



Source: Bloomberg.