Austrian financial intermediaries: adapting to a changing environment

Austrian banks face additional headwind because of low interest rate environment

Profitability of Austrian banks rose as a result of lower credit risk provisioning

Banks across the globe have posted mixed results over the past years. While the profits of U.S. banks have been relatively high and robust, European banks remain under pressure in a situation that has come to be known as "the new normal" (low economic and credit growth, loose monetary policies and low inflation rates). Net interest income, the most important source of income for banks, has decreased slightly both in Europe as well as in the U.S.

Compared to the previous year, the profitability of Austrian banks improved significantly in the first half of 2015, supported by lower credit risk provisioning (nearly one-third lower) and reduced write-offs and impairments (approximately two-thirds lower).[1] This at the first glance positive development has to be seen against the background of relatively low macroeconomic growth prospects in Austrian banks' core markets (Austria and CESEE), which cast doubt on the longer-term sustainability of this recovery. Moreover, extensive branch networks, flat yield curves and still elevated loan loss provisions in CESEE will continue to put pressure on banks' profitability. In addition, contributions to stabilization funds (e.g. for resolution and deposit insurance) and bank levies affect profitability. Also, the growing threat of cybercrime has been increasing the costs of a secure IT infrastructure.

In their domestic business, banks registered an increase in operating profit of around 15% as at June 2015 compared to the corresponding pre-year figure due to stronger operating income and lower operating expenses.

Operating income inched up by 6% year on year and exceeded EUR 10 billion. Against the background of stagnating net interest income, security and investment earnings as well as fee and commission income rose by 8% each, indicating that Austrian banks managed – at least partly – to increase their non-interest income. The trend of a higher significance of non-interest income components continued. Reduced staff costs were the main driver for lower operating costs. As a result the cost-income ratio on the domestic market improved significantly to 59% compared to end-2014 (70%). This improvement, however, has to prove its sustainability, as the cost-income ratio in Austria has historically been at elevated levels above 60%. Based on June 2015 data, Austrian banks estimate an unconsolidated return on average assets of 0.4% for the overall year. However, it has to be noted that this figure incorporates an estimate on risk provisioning for the whole year and thus should be interpreted with the necessary caution.

Figures for the third quarter confirmed the development of the first half of 2015 for Austrian banks' domestic business, although the momentum in operating income weakened.

[1] *As Hypo Alpe-Adria-Bank International AG was wound down at end-2014, the year-on-year analysis was adjusted for this effect.*

Box 2

Impact of the low interest rate environment on Austrian banks' interest margins

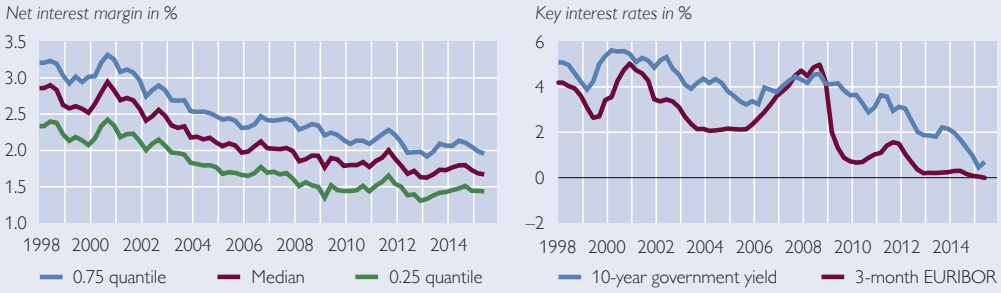
An econometric study conducted by the OeNB shows that banks' net interest margins have indeed been suffering from the low interest rate environment. Generally speaking, a decrease in key interest rates from around 1% to 0% is expected to result in a 25-basis point reduction in net interest margin. This effect is strongest if key interest rates are near zero and ebbs away at higher interest rate levels.

This is confirmed by recent international research.[1] The approach chosen by the OeNB is a panel regression that encompasses all Austrian banks and goes back to the late 1990s, which yields more than 30,000 observations. We control for various other explanatory variables like steepness of the yield curve, risk taking, liquidity, market power and main macroeconomic aggregates (for more details on the dataset and estimation details see: Gunter et al. 2013. Macroeconomic, Market and Bank-Specific Determinants of the Net Interest Margin in Austria. In: OeNB. Financial Stability Report 25.).

A further finding is that banks that rely on customer deposits and a large branch network are hit harder by the above-mentioned interest rate decrease. We estimate that the additional effect of a deposit-based funding structure on a bank's interest margin is about 4 basis points per 100-basis point reduction of the interest rate level. While the effect is statistically significant, it is small from an economic viewpoint. However, deposit-funded banks tend to have costly branch networks (and these costs are not part of the net interest income).

Also, we find strong evidence for reduced margins in an environment of a flat yield curve, which adds to the current margin squeeze. From year-end 2013 to the second quarter of 2015 the yield curve contributed to a further expected decline in net interest margins of 4 basis points according to the calculation. The chart below shows the ongoing decrease in net interest margins, which started close to 3% in 2000, dropping to 1.75% by end-2014.

Interest margins in Austria and reference rates



Source: Statistics Austria.

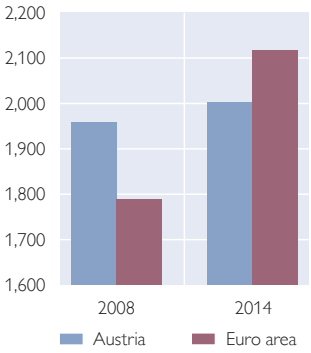
It must be emphasized that the interest rate level is one of many factors explaining the net interest margin. Market power, the asset side structure and risk taking are further important determinants in our econometric approach. Changes to these factors might compensate for the interest rate level effect.

More generally, net interest income is still clearly positive, and it depends on the level of other profit and loss positions, most importantly operating costs and risk costs, whether banks can remain profitable. Given the above results we expect banks to further curb costs and explore different profit sources like fees and commissions. Asset classes with a higher margin (and potentially higher risks and lower liquidity) might also be part of the reaction to the low interest environment and its pressure on banks' margins.

[1] *See for example: Busch, R. and C. Memmel. 2015. Banks' net interest margin and the level of interest rates. Discussion Papers 16/2015. Deutsche Bundesbank. Research Centre; or: Borio C., L. Gambacorta and B. Hofmann, 2015. The influence of monetary policy on bank profitability. BIS Working Papers 514. Bank for International Settlements.*

Chart 17

Population per bank branch



Source: OeNB, ECB, Eurostat.

Number of bank employees somewhat higher than at the start of monetary union

The relatively weak profitability of the Austrian banking system is a result of both structural and cyclical issues. Over the last few years, the profitability of the Austrian banking system has been driven by profits from foreign operations that were, however, associated with higher risks. As risks to profitability in CESEE materialized, banks stepped up their efforts to address structural issues, e.g. by reducing personnel costs via outsourcing or part-time employment models, the reduction of branch numbers or the adaption of distribution channels. But this trend is only slowly evolving. According to the recent ECB Report on financial structures,[2] for example, the reduction of bank branches (measured by population per branch) since 2008 has progressed much faster in other countries like the Netherlands, Spain, Greece or Belgium than in Austria. Moreover, the minor increase in population per branch in Austria has been driven by population growth and not by a reduction in branches.

Reduction of staff numbers in the Austrian banking sector has been moderate so far

According to OeNB data, Austrian banks employed 75,714 persons at the end of 2014. Since end-2008, this number had decreased by 5.7%, after an increase of 7.3% in the previous ten years (1998–2008). All in all, the number of bank employees was marginally higher at end-2014 (1.2%) than at the beginning of Stage Three of Economic and Monetary Union (EMU).

As in the Austrian economy at large, employment in banking has to a considerable degree reflected cyclical factors, although the momentum of this development has been markedly less pronounced in the banking sector. Only in the five years prior to the crisis (2003–2008) was the growth rate of bank employment similar to that in Austria as a whole. Then, the crisis left its mark on banking sector employment. The share of Austrian banking sector employment in total employment has been steadily declining since 1998. At the end of 2014, the banking sector accounted for 2.18% of all employed persons, 0.21 percentage points less than in 1998.

In an international perspective, the decline in bank employment in 2008–2014 was moderate; across the EU, the number of bank employees decreased by more than 10% according to data compiled by the ECB. This difference was all the more noticeable as the significant increase in bank employment that had been registered in Austria in the run-up to the crisis was not mirrored in many other countries. In contrast to the 7.3% increase in Austria, the number of employees in the euro area as a whole dropped by 0.5% between 1998 and 2008.

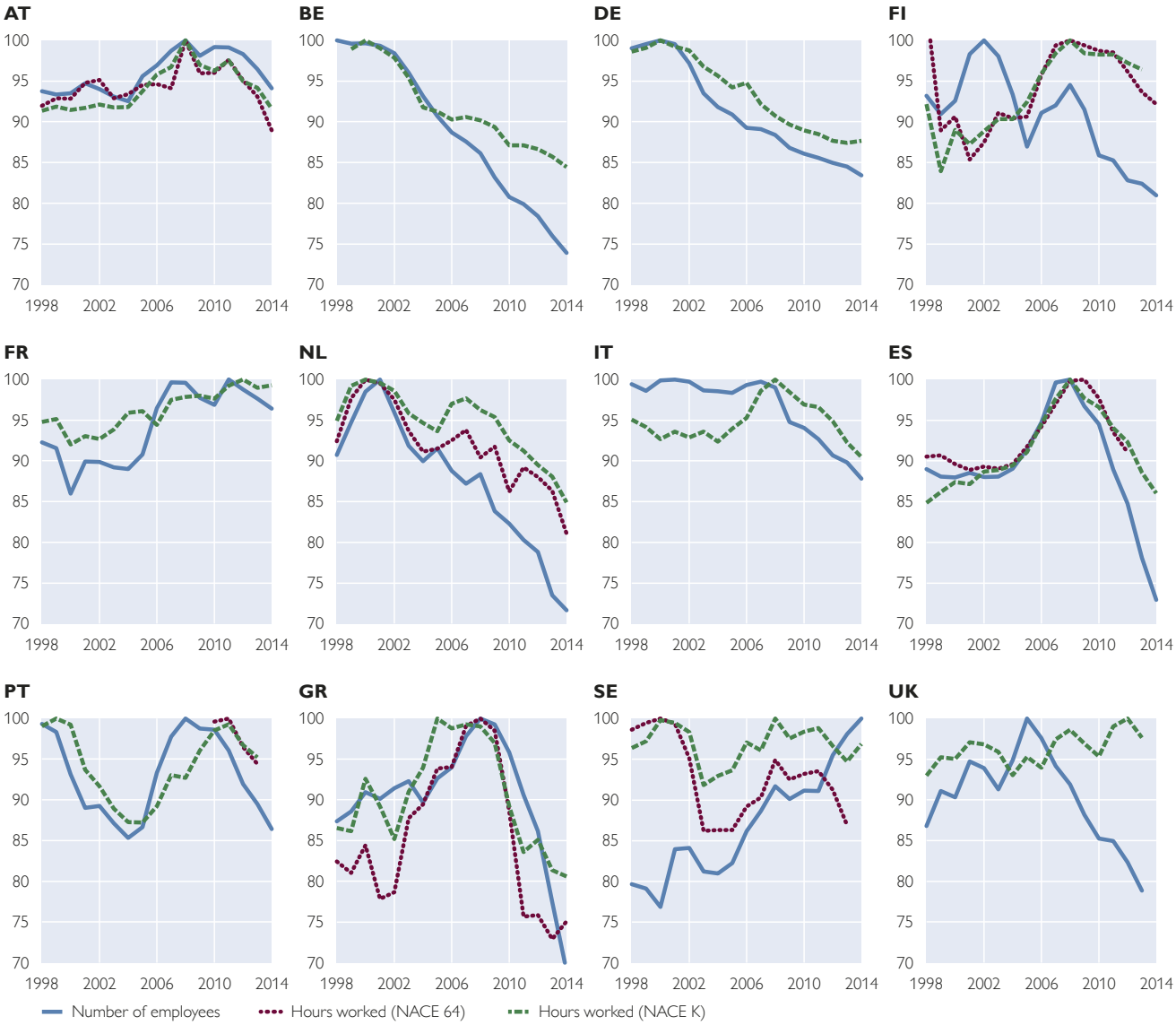
[2] *http://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201510.en.pdf.*

Chart 18 shows how far the reduction of bank employment has gone in European countries both in terms of headcount and the average number of hours worked.[3] In Germany, the Netherlands and Belgium the reduction in headcount already started at the turn of the millennium. In most countries in the euro area periphery, the number of employees has been reduced markedly

Chart 18

Number of employees and hours worked at credit institutions

Index (100 = max [1998, 2014])



Source: ECB, Eurostat, authors' calculations.

[3] *To make the data comparable they are presented in the form of an index. The index value is set at 100 for the year in which the relevant time series reached its maximum during the period 1998–2014. The data on the number of hours worked are obtained from national accounts data compiled by Eurostat. As for many countries there are no data available for the sector that comes closest to the banking sector, namely NACE 64 (financial service activities, except insurance and pension funding), data for NACE K (banking and insurance) are displayed in addition. In most cases where both time series are available they move very much in tandem.*

since the onset of the crisis. In contrast, the number of bank employees in Austria is still close to its historical peak. A development similar to that observed in Austria has occurred in France. The consolidation we now see in the Austrian banking sector is in line with what has happened in other countries.

Significant rise in the part-time ratio

The reduction in the number of hours worked was rather moderate by international comparison. In 2014, the Austrian banking sector recorded 121 million hours worked according to national accounts data (K64). After having risen by 8.7% in the period 1998–2008, hours worked fell by 11.1% in 2008–2014, which means that at the end of the observation period they were 3.3% lower than at the start of the third stage of EMU. To a large extent, this reflects the significant rise in part-time work. Whereas the number of full-time bank employees shrank by 14.4% between 1998 and 2014, the number of part-time employees almost doubled. Thus, the part-time ratio rose from 12.5% to 25.3%.

Austrian banks have stepped up their efforts to address structural weaknesses; several banks have announced or already started to implement consolidation plans in order to improve the efficiency of their activities. Adjustments in the structure of the Austrian banking system include a stronger focus on markets with a higher potential for generating sustainable returns and a reduction of risk-weighted assets to increase available capital.

Box 3

IT risk and the threat of cybercrime for banks

Over the last decades, the information and communication technology (ICT) used by banks has grown strongly both in size and complexity. With the growing dependence of business processes on ICT systems and the widespread use of new technologies, this area has become a major risk factor for the financial industry and a significant source of several kinds of operational risk, including IT security issues (with cybercrime, i.e. criminal activities that make use of or are directed against ICT, having become a hot topic recently), risks related to software quality and data quality, and infrastructure risks (e.g. loss of critical infrastructure such as data centers). In addition, it is common today to outsource ICT services, and technologies like cloud computing, though they offer new possibilities, also raise a whole new set of security issues.

Due to the importance of this topic, several activities have been launched at the European level to deal with IT risks. The proposed EU Network and Information Security (NIS) Directive is meant to protect critical infrastructure (such as energy and transport, but also banking). Also, the Basel Committee on Banking Supervision's (BCBS) principles for effective risk data aggregation and risk reporting (BCBS 239, January 2013) require that banks take efforts to increase data quality and data governance. Both the European Central Bank (ECB) and the European Banking Authority (EBA) have classified IT-related risks as a supervisory priority; a broad risk assessment is currently being carried out, and specific supervisory activities directed against cybercrime have been taking place throughout 2015 and will continue in 2016.

In Austria, the OeNB has performed several on-site inspections with a focus on operational risk and IT risk. Furthermore, the OeNB monitors these risks continuously as a part of its supervisory activities and takes part in the ECB's and EBA's efforts to strengthen the supervision of IT-related risks in Europe.

Recovery of CESEE profits after weak performance in 2014

The profitability of Austrian banks' subsidiaries in CESEE improved significantly to EUR 1.5 billion in the first half of 2015 after having hit a historical low in 2014 (EUR 1 billion), which was e.g. triggered by additional credit risk provisioning in Romania, the impact of foreign currency loan measures in Hungary and the tensions between Russia and Ukraine. The results for the first half of 2015 came close to the levels reported in June 2011, which marked a high in the post-crisis area. The main driver of the improvement was the significant reduction in risk provisioning.

The operating profits of Austrian subsidiaries in CESEE remained unchanged at EUR 3.2 billion in the first half of 2015 compared to the previous year.[4] Yet the most important sources of operating income – net interest income and fee and commission income – declined as lower net interest income came hand in hand with compressed interest rate margins. Operating expenses also fell on the basis of lower personnel expenses and shrinking administrative costs.

The profitability analysis at country level (for the most significant banking operations) can be built around three groups: the Czech Republic, Slovakia and Turkey, where profits grew; Russia and Croatia, where they decreased but stayed distinctly positive; and Romania and Hungary, where results turned positive as of mid-2015, after losses in the previous year. Net profits earned in the Czech Republic grew by 3% year on year and have remained the by far largest contributor to the aggregated net profit of Austrian banks in CESEE. Profits in the Czech Republic were mainly driven by a reduction in risk provisioning and to a lower extent by higher operating income. In Slovakia, net results increased by 13%, also on the back of growing operating income and shrinking provisions. As for Turkey, the pro rata net profit from a Turkish joint venture increased by 16%, with all types of income on the rise. Provisioning increased markedly but is still at a low level compared to other countries.

Profitability in Russia decreased by 30% year on year in the first half of 2015. Despite this strong decline, which was due to a slowdown in credit growth, higher funding costs, compression in interest margins and weaker credit quality as well as the depreciation of the Russian ruble, Russia remained the second largest contributor to the overall profitability of Austrian banks' subsidiaries in CESEE, although the share of profits from other CESEE countries (i.e. Romania, Slovakia and Turkey) rose markedly.[5] The operating income of Austrian subsidiaries in Russia declined by 6% year on year. The decline in income was alleviated by a decline in expenses. Both developments were attributable to the currency depreciation. Loan loss provisions doubled in the first half of 2015 year on year due to the recessionary environment in Russia. In Croatia, Austrian subsidiaries faced lower net results than the year before on the back of lower operating income (–9%), which was mitigated by reduced risk provisions, however (–8%).

Diverse profit development for CESEE subsidiaries

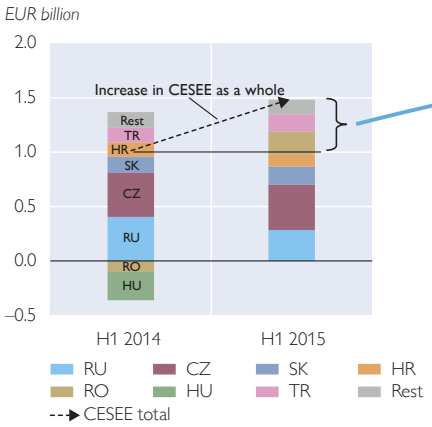
[4] *As Volksbank Romania was sold in the course of 2015, year-on-year comparisons were adjusted for this effect.*

[5] *For more details on the Russian banking sector and Austrian subsidiaries in Russia please see the special topics section in this issue.*

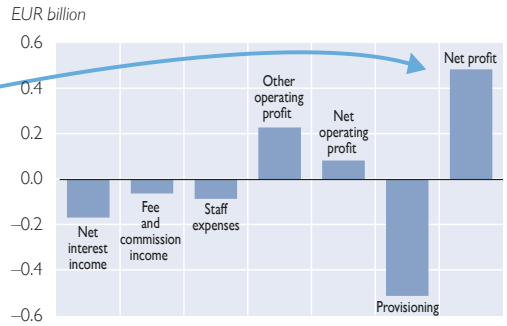
Chart 19

Profitability of Austrian banks in CESEE

Net profit of Austrian subsidiaries in CESEE



Drivers of net profit of Austrian subsidiaries in CESEE between mid-2014 and mid-2015



Source: OeNB.

Increase in consolidated profits due to improvement in domestic and foreign business

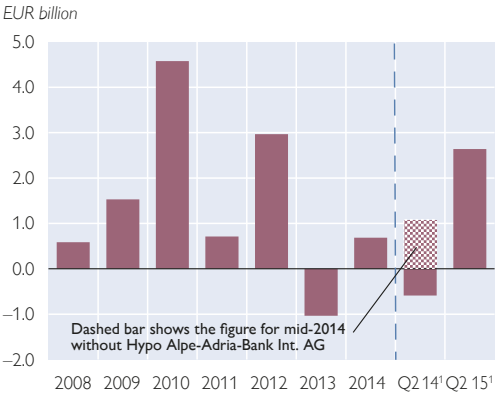
In Romania and Hungary, Austrian subsidiaries experienced a turnaround in their aggregated net results. In Romania, losses of –EUR 0.5 billion at end-2014 turned into profits of EUR 0.2 billion as at June 2015, which was almost exclusively due to a drop in credit risk provisions. In Hungary, where banks have been confronted with several legal interventions over the past five years (e.g. conversion of foreign currency mortgage loans and settlement act on overpayments), Austrian subsidiaries were able to make positive contributions to the profitability of their respective groups for the first time since 2010. Profitability developments at an individual bank level have been very diverse as some Austrian subsidiaries in Hungary are still producing losses.

The outlook for Austrian banks' profitability in CESEE remains weak. Legal interventions concerning foreign currency loans in Croatia and Poland as well as the tension between Russia and Ukraine add to the uncertainty. Risks concerning the concentration of profits in a few countries persist. In this regard, profits from Russia and Turkey are more volatile and vulnerable as they are tied to higher macrofinancial risks than in the Czech Republic and Slovakia.

The consolidated net result of Austrian banks (i.e. including foreign subsidiaries) totaled EUR 2.6 billion in the first half of 2015. On an annualized basis, this would translate into a return on average assets of 0.6% for 2015 as a whole. This improvement can mainly be traced back to reduced credit risk

Chart 20

Consolidated net profit of Austrian banks



Source: OeNB

[1] Data for the second quarter are not comparable with end-of-year data.

costs and an increase in operating profits, both in domestic and foreign business.

Austrian banks' consolidated operating profit increased from EUR 4.3 billion to EUR 5.5 billion even though the underlying operating income (before risk) was below the corresponding 2014 figure.[6] This decrease was attributable to lower trading income and a decrease in other operating income. The most important components of revenues – net interest and fee-based income – exceeded 2014 results slightly but could not offset the decline in the remaining sources of operating income. Regarding operating costs, staff costs decreased in the first half of 2015 compared to the year before. A strong decrease in depreciation and amortization costs had a positive impact on operating profit as well. Credit risk provisions declined to EUR 1.9 billion, the lowest level since 2008. Austrian banks improved their operating efficiency as the cost-to-income ratio strengthened, reaching 61% in June 2015 (June 2014: 76%).

Apart from the bank levy set up already in 2011, banks need to make regular contributions to new funds: On the one hand, the harmonized deposit guarantee schemes, the third pillar of the banking union, require banks to build up funds in advance ("ex ante") to finance resolution measures. On the other hand, the Single Resolution Fund (SRF) – the funding element of the Single Resolution Mechanism (SRM) – is also financed by contributions from the banking industry, a fact which already affected the operating profit of Austrian banks in the first half of 2015. In total, contributions to these funds will be about EUR 350 million a year for Austrian banks.

Growth rates in bank lending differ markedly across Europe

In an environment of very low interest rates, loan growth continued to recover in Europe in the first half of 2015. The ECB's targeted longer-term refinancing operations and its expanded asset purchase programme contributed to improvements in money and credit indicators. Moreover, European banks' funding costs stabilized at historical lows. More favorable lending conditions continued to support a gradual recovery in loan growth for European banks. Nevertheless, growth rates still differ markedly across countries.

Austrian banks' exposure to CESEE increased in the first half of 2015

On a group level, the total assets of the Austrian banking system remained more or less unchanged against end-2014, with EUR 1,079 billion as at June 2015. While interbank activities and securities have been further reduced, cash holdings and lending to the nonfinancial sector have been extended. However, the dynamics have been mixed.

Austrian banks' exposure to countries in the CESEE region increased by 3% compared to end-2014, coming to EUR 329 billion in June 2015, but growth rates varied markedly. While business in Poland, the Czech Republic and Turkey was expanded, banks cut back on their activities in Romania[7] and Ukraine.

New lending to Austrian nonfinancial corporations subdued

In the first nine months of 2015, Austrian banks granted new EUR-denominated loans to domestic households and nonfinancial corporations (NFCs) in the amount of EUR 63 billion. This was noticeably less than in

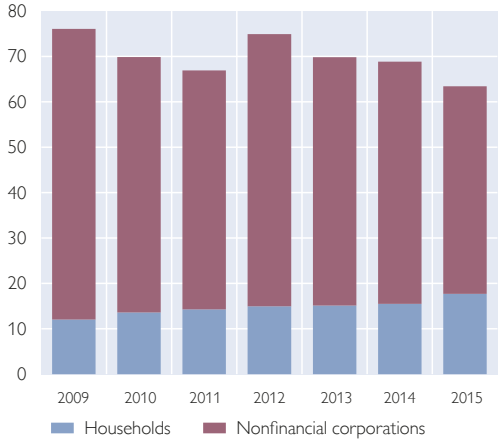
[6] *The year-on-year analysis has been adjusted for the effects of the wind-down of Hypo Alpe-Adria-Bank International AG at end-2014.*

[7] *The reduction in Romania was driven by the sale of a subsidiary.*

Chart 21

New lending[1] in Austria between January and September

EUR billion



Source: OeNB.

[1] New loans denominated in euro.

Borrowers' funding gaps widen

previous years. The reduction was driven by subdued dynamics in lending to NFCs, which are increasingly making use of internal financing. Apart from this, the investment activity of Austrian businesses has been subdued. Lending to households has increased over the previous years because of higher lending for house purchases, while lending for consumption has been stagnating.

In the first nine months of 2015, Austrian banks increased their claims on domestic nonbanks by 0.6% year on year to EUR 333 billion. The highest growth rates were recorded by savings banks and joint stock and private banks. Direct banks also increased their activities on the Austrian market further. In contrast, lending by building societies came under pressure due to the low interest rate environment, in which other banks can provide more favorable mortgage lending rates.

Domestic foreign currency exposure continues to decline

Systemic risks arising from foreign currency lending to domestic borrowers have declined over the last years but are still significant. The outstanding volumes as well as the number of foreign currency (FX) borrowers have declined strongly.

Foreign currency loans to domestic borrowers continued their year-long trend of constantly declining outstanding volumes, although there was a temporary increase in the total volume of outstanding CHF-denominated loans caused by the discontinuation of the EUR/CHF minimum exchange rate by the Swiss National Bank in January. At the end of the third quarter of 2015 total FX loans to Austrian nonfinancial customers amounted to EUR 35 billion. Although this constitutes only a minor annual change in nominal terms, the associated annual exchange rate-adjusted reduction amounts to 17%. By September 2015 FX loans to households and nonfinancial corporations made up EUR 25 billion and EUR 6 billion, respectively. About 75% of FX loans to domestic households are designed as repayment vehicle loans (i.e. bullet loans that are redeemed only at maturity by life insurance policies and/or other capital market products; until then, regular financial contributions are only made toward the repayment vehicle).

Austria's Financial Market Authority (FMA) and the OeNB launched a survey at the beginning of 2015 to gain an overview of borrowers' funding gaps affecting such repayment vehicle loans. Similar surveys were carried out already in 2009 and 2011. The survey was conducted among 35 Austrian banks covering more than 85% of outstanding repayment vehicle loans. The conclusion of the survey was that the aggregate borrowers' funding gap affecting repayment vehicle loans amounted to an estimated 23% of the total amount or EUR 6 billion in nomi-

nal terms. Compared with 2011, the gap has remained almost unchanged, especially due to the appreciation of the Swiss franc in early 2015.

As the majority of FX bullet loans do not mature before 2020 there is still some time to close borrowers' funding gaps. Nevertheless downside risks must not be underestimated as financial markets could turn for the worse and the Swiss franc might remain at current levels or even appreciate further. Consequently, the OeNB and the FMA have stepped up their efforts to encourage banks and debtors to timely engage in bilateral negotiations aimed at sustainable tailor-made solutions.

Foreign currency loans in CESEE significantly reduced

The first half of 2015 was marked by reductions in the foreign currency credit and leasing exposures of Austrian banks operating in the CESEE region. Driven by the conversion of foreign currency loans in Hungary and the sale of Volksbank Romania S.A., Austrian banks' foreign currency loan exposure fell by EUR 5.5 billion to EUR 110.1 billion during the first six months of 2015. Consequently the associated foreign currency loan share continued to decline to 46% in total nonbank loan exposure (including cross-border lending) and to 39% for Austrian subsidiaries alone.

As there were no material changes in the amount of cross-border lending or leasing activities, the reduction is entirely attributable to Austrian CESEE subsidiaries, which reported a decrease of their foreign currency credit portfolio by 7.3% since the beginning of 2015. If it were not for the significant appreciation of the Swiss franc, the decline would have been even more pronounced, as the exchange rate-adjusted change of –11% indicates.

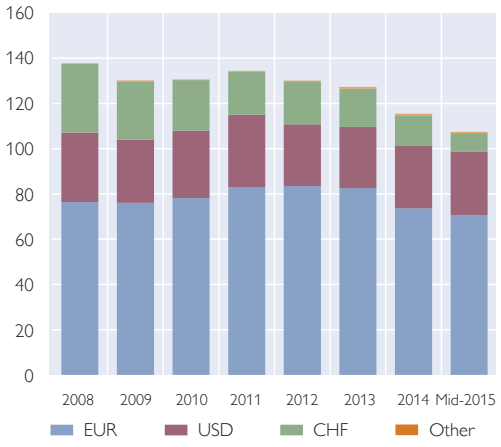
OeNB and FMA are encouraging banks and debtors to timely engage in bilateral negotiations

The strong appreciation of the Swiss franc in recent years also triggered a wave of legislative action in several CESEE countries. Hungary has already legally prescribed the conversion of foreign-currency mortgage loans in the first half of 2015. Consequently, the foreign currency exposure of Austrian banks' Hungarian subsidiaries dropped by 50% or EUR 3.7 billion. While Croatia enacted legislation imposing related measures in September 2015, discussions in Poland are ongoing. The OeNB sees the need for a cooperative and coordinated approach in the interest of sustainable financial stability in home and host countries.

CESEE subsidiaries reduced overall FX credit exposure

Chart 22

Foreign currency loans of Austrian banks in CESEE



Source: OeNB.

Note: Figures include lending via subsidiaries and cross-border lending to customers and are adjusted for foreign exchange developments.

Box 4

Austrian banks hit by Eastern European legislators' intervention in foreign currency loans

To reduce the burden for foreign currency borrowers, some Eastern European countries have already introduced (or are discussing) measures to force the conversion of foreign currency consumer loans to into local currency, mainly at banks' cost. Due to their material foreign currency loan portfolio, subsidiaries of Austrian banks operating in these countries are particularly affected by these interventions.

***Hungary:** In November 2014 the Hungarian Parliament passed a law on the mandatory conversion of foreign currency mortgage loans previously granted to households into HUF. Although the law stipulated the applicable exchange rates for EUR, CHF, and JYP, these rates were close enough to the then prevailing market rates that banks only suffered minor losses from the conversion. In order to minimize effects on the HUF, Magyar Nemzeti Bank (MNB) provided the necessary liquidity out of its reserves. In October 2015, the Hungarian Parliament passed an additional law on the conversion of foreign currency consumer loans whereby the decision to convert was to be taken by borrowers within 30 days. Again, the exchange rates were stipulated in the law, only this time they were out of market, since the same rates as in November 2014 were applied to ensure an equal treatment of borrowers. The resulting losses are to be equally divided between the banks and the state; the state's half will first be borne by the affected banks; in turn, the state will reduce banks' tax bill in 2016 and 2017. Initial losses in EUR million for subsidiaries of Austrian banks are estimated in the low two-digit range. As already in 2014, the MNB has provided the necessary liquidity out of its reserves.*

***Croatia:** In September 2015 amendments to the Croatian consumer credit legislation were made in order to enable the conversion of CHF loans into EUR loans. The aim of these amendments is to reduce the debt-servicing burden for natural persons with loans denominated in CHF as well as loans denominated in Croatian kuna with a currency clause linking payments to CHF. Based on the new legal provisions, these borrowers are given the possibility to use a conversion mechanism that places them in the same position they would have been in if their loans had been denominated in euro at drawdown. The conversion is expected to cost Austrian banks approximately EUR 0.7 billion in total. The effect may vary depending on the individual bank's composition of its loan portfolio. However, banks are still in the process of appealing against the law to avert possible losses.*

***Poland:** At the end of October 2015 the Polish president signed a bill designed to help consumers struggling with the repayment of their loans due to external factors. This group includes i.a. foreign currency debtors who are affected by unfavorable foreign currency developments. The law stipulates that banks have to offer non-interest bearing supporting measures in the form of contributions which have to be paid by the banks into a fund at the state-owned Gospodarstwa Krajowego bank. The total volume of the fund is expected to reach EUR 142 million.*

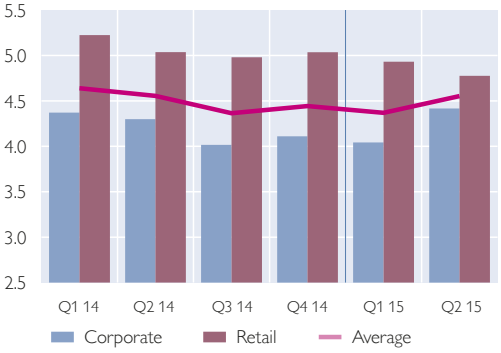
Nonperforming loan resolution has high priority for banks

European banks face significant challenges arising from their high levels of impaired assets, asset quality being quite uneven across European countries, with banks from financially stressed countries reporting the highest NPL ratios. The level of impairments depends not only on the level of financial distress endured by the country but also on the degree of progress achieved in restructuring legacy asset portfolios. Deleveraging via asset sales can contribute to improved asset quality. Over the last quarters, material volumes of loan portfolio transactions took place, assisted by the search for yield by investors.

Chart 23

Nonperforming loan ratio in Austrian banks' domestic business

% of total loans to corporates and households



Source: OeNB.

The asset quality of Austrian banks' domestic loan portfolio somewhat deteriorated in the first half of 2015, as the NPL ratio increased to 4.6%, up 0.1 percentage points compared to the end of 2014. Nevertheless, the ratio has been quite stable over the last years, moving in a range between 4.1% und 4.7% since 2009, with NPL ratios for loans to households slightly higher than the overall average. The increase was especially driven by a deterioration in asset quality at state mortgage banks. In the first six month of 2015, the coverage ratio of Austrian banks' domestic business declined slightly to 72% due to stalling provisioning; viewed against the comparable ratios of their CESEE subsidiaries and banking systems in other countries, however, this ratio is still high.

The average NPL ratio of Austrian subsidiaries in the CESEE region increased slightly to 12.0% for the total loan portfolio and 16.3% for foreign currency loans. This deterioration was the result of a comparatively strong increase in NPLs in Ukraine and Russia (see also the special topics section). On the other hand, Hungarian and Romanian subsidiaries reported material reductions in NPLs due to the sale of assets and other resolution measures. Nevertheless, the NPL ratios of Austrian subsidiaries in these countries are still elevated.

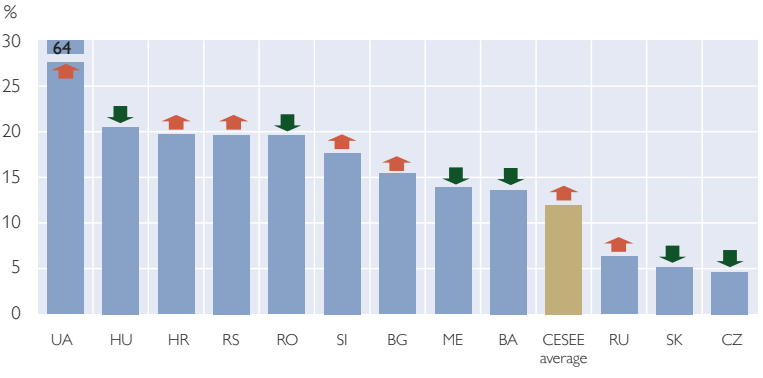
The coverage of NPLs has improved significantly over recent years, even more so since Hypo Alpe Adria shifted the majority of its NPL portfolio to its bad bank (HETA Asset Resolution AG). By the end of the first half of 2015, Austrian CESEE subsidiaries reported an NPL coverage ratio of 57% (Austrian banking system at group level: 64%).

In the first half of 2015, the leasing portfolio of major Austrian banks operating in CESEE remained constant at EUR 10 billion and the share of nonperforming leasing volumes fell to 12.1%, compared to 13% at end-2014.

A country-by-country analysis by the European Banking Authority[8] has shown that Austrian banks have an

Chart 24

Nonperforming loan ratio of Austrian subsidiaries in CESEE (June 2015)



Source: OeNB.

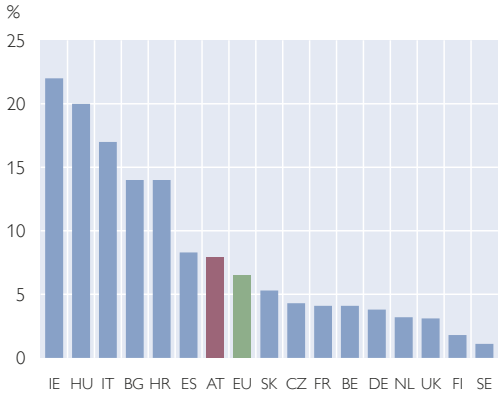
Note: Arrows indicate changes compared to end-2014. The CESEE average includes more countries than those shown in this chart.

[8] *EBA Risk Assessment of the European Banking System, June 2015.*

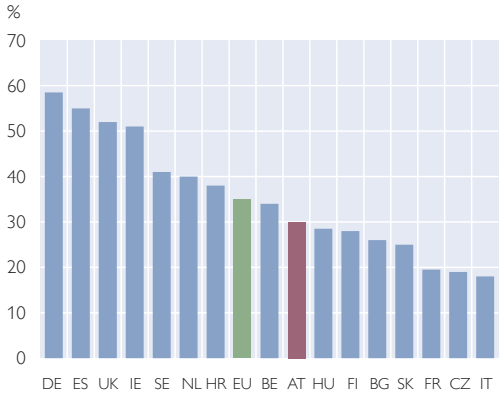
Chart 25

Loan quality in European banking sectors

Nonperforming loan ratios



Forbearance ratios for nonperforming loans



Source: EBA.

Note: Data as at end-2014.

above-average NPL ratio which is driven by the relatively weak loan quality of their CESEE exposure. At the same time, the forbearance[9] ratio of Austrian banks' NPLs is rather low. This has to be seen against the background of the relatively high coverage ratio of Austrian banks.

Persistently high NPLs are a burden for credit growth and economic activity as weak asset quality ties up bank capital and reduces profitability via write-downs and higher funding costs for the affected institutions. In Austria, banks have recorded costs for credit risk provisioning to the amount of nearly EUR 52 billion since 2008, which corresponds to approximately 60% of banks' current regulatory capital.

A recent study of the International Monetary Fund underlines that stronger momentum in NPL resolution would "unclog" the bank lending channel and enhance the transmission of monetary policy to the real economy.

Austrian banks' consolidated corporate loan portfolio is characterized by a below-average credit quality (NPL ratio: 7.2%) compared to the quality of loans to households (NPL ratio: 6.2%) and material differences across industries. Loans to the sectors "accommodation, food service" and "construction" recorded the lowest credit quality in mid-2015. These sectors account for approximately 30% of the corporate loan portfolio.[10] The overall NPL ratio of the Austrian banking sector was 6.9% in June 2015, down 10 basis points compared to end-2014.

Capitalization of banks improved

The repair process of the European banking system initiated in 2011 has led to a major strengthening of banks' capital position. Overall, EU banks increased their weighted average core equity tier 1 (CET1) ratio from 9.2% to 12.1% between 2011 and 2014.

In that period, the amount of CET1 capital grew by approximately 37%,

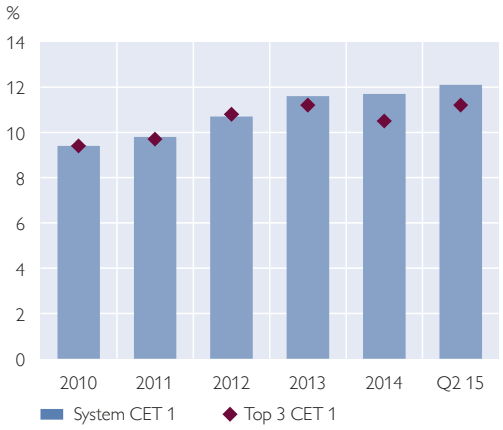
[9] *Forbearance measures are understood as modifications of the terms and conditions of loan contracts.*

[10] *Figures for the analysis of credit quality across branches only include Austrian banks that report under the FINREP framework and are therefore only a proxy for the Austrian banking system.*

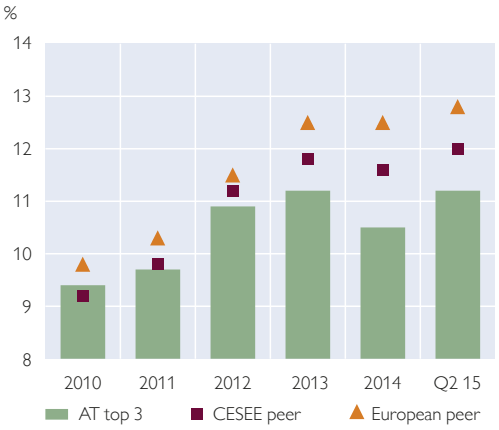
Chart 26

CET1 ratios of banks

Austrian banks



International comparison

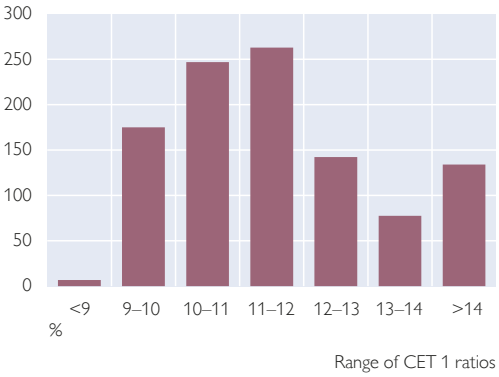


Source: OeNB, SNL Financial.

Chart 27

Distribution of Austrian banks' total assets by CET1 levels

Total assets in EUR billion (June 2015)



Source: OeNB.

while risk-weighted assets slightly increased by approximately 1 %. This means that in the EU the strengthening of banks' capital position has been driven more strongly by real capital issuances than by reductions in the denominator. The currently weak profitability of European banks might limit their ability to strengthen their equity through internal funds.[11]

Austrian banks improved capitalization but still lag behind their peers

The capitalization of the Austrian banking sector improved in the first half of 2015 through a combination of higher capital and reduced risk-weighted assets. Banks achieved this increase in capital by enlarging reserves and reducing excess of deduction from additional tier 1 items over additional tier 1 capital. This resulted in an increase of capital in the first half of 2015 of EUR 2 billion to EUR 89.5 billion. In mid-2015, Austrian banks registered an average CET1 ratio of 12.1% and a total capital ratio of 15.9%.

The capitalization ratios of Austrian banks differ markedly between different institutions. A categorization of banks (based on total assets) on the basis of their CET1 shows that the relative majority of assets of the Austrian banking systems is in the range of 10% to 12%, whereas the weighted average CET1 ratio came to 12.1% in June 2015. This is confirmed by chart 26, where the CET1 ratio of the top 3 Austrian banks is below the system average.

[11] *European Banking Authority, Risk Assessment of the European Banking System, June 2015.*

Micro- and macroprudential measures will also contribute to improving Austrian banks' capitalization. However, compared to their peers, bigger Austrian banks have a relatively low capitalization and therefore need to build up capital further.

Box 5

Making bail-in a feasible option: the minimum requirement for own funds and eligible liabilities (MREL)

The EU Bank Recovery and Resolution Directive (transposed into Austrian law by the Federal Act on the Recovery and Resolution of Banks – Bundesgesetz über die Sanierung und Abwicklung von Banken, BaSAG) established a framework for the recovery and resolution of credit institutions and investment firms in the European Union to deal with failing institutions. The directive ("BRRD" in short) introduced a number of new resolution tools to internalize the burden of bank failures and minimize moral hazard. Next to (1) the sale of business tool, (2) the bridge institution tool and (3) the asset separation tool, the BRRD also provides for a bail-in tool. Bail-in means that once an institution fulfills the conditions for resolution (e.g. an institution no longer meets the minimum own funds requirements) the resolution authority has the power to write down equity and subsequently convert liabilities into equity or to reduce an institution's principal amount of liabilities up to the extent necessary for restoring the own funds of this institution.

However, the bail-in tool can only be a feasible option for resolution authorities if enough own funds and liabilities are available to adequately recapitalize the institution under resolution. Therefore, the BRRD requires that all institutions at all times meet, on an individual and consolidated basis, a minimum requirement for own funds and eligible liabilities (MREL). The MREL is calculated as own funds and eligible liabilities expressed as a percentage of total liabilities and own funds of the institution.

All liabilities that should be counted toward MREL (i.e. eligible liabilities) have to fulfill a number of conditions (e.g. the liability must not be a derivate, nor a deposit benefiting from preference in the national insolvency hierarchy, and the liability must have a remaining maturity of at least one year).

Neither the BRRD nor the Austrian BaSAG provide for a common minimum requirement applicable to all institutions. In fact, after consulting the supervisory authority, the resolution authority (in Austria: the Financial Market Authority) determines the minimum requirement for each institution individually. However, the EU has established a Single Resolution Board within the banking union recently. In consultation with the national authorities and the ECB, this board will set the MREL for all significant institutions (i.e. institutions directly supervised by the ECB within the Single Supervisory Mechanism) and banking groups with cross-border business.

However, when setting the MREL the competent authority has to take six criteria into account: (1) resolvability, (2) recapitalization needs after resolution, (3) extent of possible exclusions of eligible liabilities listed in the resolution plan, (4) size, business model, funding model and risk profile, (5) extent to which the deposit guarantee scheme could contribute to the financing of resolution, and (6) systemic importance.

On the basis of these criteria, the European Banking Authority has further specified how to set a MREL to ensure that all Member States apply the requirements in a similar way. The competent authorities are required to assess the level of MREL needed to absorb losses. If necessary, institutions have to hold additional amounts required for recapitalization after resolution. These assessments should be linked to institutions' going concern capital requirements as determined by the Capital Requirements Regulation and the Capital Requirements Directive.

Given the current state of play, the Austrian banking sector has liabilities that are eligible under the MREL. However, the minimum still has to be set for each bank individually.

Recent activities of macroprudential supervision in Austria

One building block in strengthening Austrian banks' capitalization will come from macroprudential oversight. In its fifth meeting of September 7, 2015, the Financial Market Stability Board (FMSB) decided to adjust its recommendations to the FMA regarding the activation of the systemic risk buffer (SRB) and the buffer for other systemically important institutions (O-SII buffer) in the light of developments at European level.[12]

The SRB needs to be activated to address the specific combination of systemic risks in the Austrian banking system. These risks arise from the relatively large size of the Austrian banking sector as compared to the domestic economy, its high exposure to emerging markets, its below-average capitalization in relation to its European peers and its high share of non-listed banks and leveraged owners. A detailed analysis of systemic risks for the Austrian banking system was published in the OeNB's Financial Stability Report of June 2015.[13]

In its fourth meeting on June 1, 2015 the FMSB had decided upon the recommendation to activate macroprudential capital buffers of up to a total of 3% to strengthen the Austrian banking sector. These buffers are to be applied in addition to the applicable supervisory SREP[14] ratio.

Since the FMSB's fourth meeting, the Supervisory Board of the ECB has preliminarily determined the SREP ratios to be applied in 2016. These are markedly higher than the CET1 ratios on which the recommendation had been originally based. In light of this development, the FMSB has adjusted its recommendation of June 2015 and proposed that the FMA limit the systemic risk buffer to 2% of risk-weighted assets. To ensure a smooth implementation of the cumulated capital require-

Table 1

List of Austrian banks subject to a systemic risk buffer

	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 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	0.25	0.50	1.00	1.00
Raiffeisen-Holding Niederösterreich-Wien	0.25	0.50	1.00	1.00
BAWAG P.S.K.	0.25	0.50	1.00	1.00
HYPO NOE Gruppe Bank	1.00	1.00	1.00	1.00
Vorarlberger Landes- und Hypothekenbank	1.00	1.00	1.00	1.00
Hypo Tirol Bank	1.00	1.00	1.00	1.00
Oberösterreichische Landesbank	1.00	1.00	1.00	1.00
Sberbank	0.25	0.50	1.00	1.00

Source: Financial Market Stability Board.

Note: If both the systemic risk buffer and the buffer for other systemically important institutions are applicable, the higher of the two shall apply.

[12] *See also the FMSB's website at http://fmsg.at/en/.*

[13] *See https://www.oenb.at/dms/oenb/Publikationen/Finanzmarkt/Financial-Stability-Report/2015/financial-stability-report-29/fullversion/fsr_29_gesamt.pdf.*

[14] *Supervisory Review and Evaluation Process.*

FMSB discusses need for legal basis for additional instruments

ments, the FMSB has additionally recommended a gradual implementation horizon for banks that are directly supervised by the ECB. The scheduled initial application of the SRB has been brought forward to January 1, 2016, to facilitate operational implementation and to avoid further delays.

The O-SII buffer will enter into force on January 1, 2017. The list of O-SIIs and the levels of the applicable O-SII buffers will be published by the FMA in the course of 2016. As the higher of the two types of buffer (SRB, O-SII buffer) will apply and as the SRB is expected to be higher or equal to the O-SII buffer, the O-SII buffer is not expected to induce additional buffer requirements for Austrian banks.

Based on the currently available data, the FMSB recommended that the FMA set the countercyclical capital buffer at 0% of risk-weighted assets with effect from January 1, 2016. The countercyclical capital buffer is supposed to shield the banking system from the effects of cyclical systemic risks, which may in particular arise from unsustainable lending on an aggregated level. The growth of outstanding credit volume as compared to GDP growth currently does not indicate the need to recommend such a buffer. Further indicators support this assessment: Austrian banks continue to record sound balance sheets in terms of their unconsolidated aggregate debt ratios (tier 1 capital relative to total assets). Furthermore, the current account does not point to any major macroeconomic imbalances in terms of economic growth.

In its fifth meeting, the FMSB also discussed the need for establishing a legal basis which will enable the supervisory authority to closely monitor the real estate market and mortgage lending to prevent the buildup of risks, especially given the low interest rate environment. Rising real estate prices accompanied by expanding debt levels may increase borrowers' and lenders' vulnerability to crises. Past experience has shown that overvaluation in the real estate market is often a trigger for systemic financial crises if it is coupled with a strong rise in real estate lending. Caps on loan-to-value (LTV) ratios, debt-to-income (DTI) ratios and debt service-to-income (DSTI) ratios are deemed effective and adequate instruments[15] for addressing systemic risks associated with real estate financing. By mid-2015, 19 EU countries (and Norway) had implemented a combination of LTV, DTI and DSTI ratios and other measures in order to limit unsustainable mortgage lending booms. These measures are also aimed at reducing the expected costs for the overall economy in associated busts.

So far, the price increases on the Austrian housing market have not been accompanied by excessive mortgage lending growth. Over the medium or long term, however, macroprudential risks could arise in the wake of a real estate price boom. As a first precautionary step, the FMSB has started discussing how additional instruments might be applied, should the need arise. The FMSB concluded that it sees no need for their application at this point. In any case, the OeNB sees the need to

[15] *See e.g.: Jácome, L. I. and S. Mitra. 2015. LTV and DTI Limits – Going Granular. IMF Working Paper 15/154; Cerutti, E., S. Claessens and L. Laeven. 2015. The Use and Effectiveness of Macroprudential Policies: New Evidence. IMF Working Paper 15/61; McDonald, C. 2015. When is macroprudential policy effective? BIS Working Papers No. 496.*

prepare the legal framework for such instruments in order to be in a position to take adequate steps should they become necessary.

Based on current data, the FMSB also recommended that the FMA set the countercyclical capital buffer at 0% of risk-weighted assets with effect from January 1, 2016, as the growth of outstanding credit volume as compared to GDP growth currently does not indicate the need to recommend such a buffer.

Market observers see subdued outlook for Austrian banks

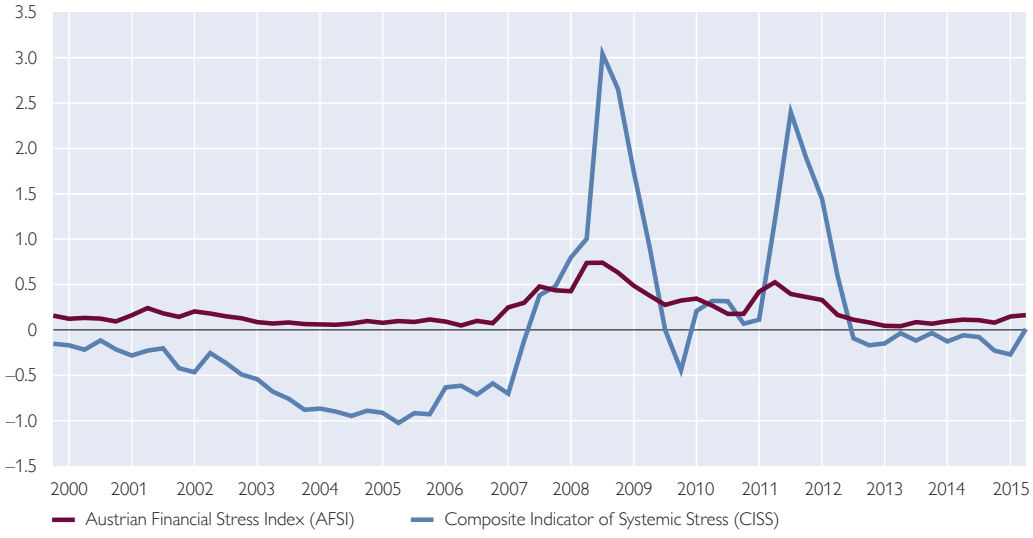
Market surveillance by and large confirms the weaknesses identified in this Financial Stability Report. The negative outlook of market observers reflects their expectation that Austrian banks' financial fundamentals will remain weak. Profitability will remain under pressure, as asset quality concerns in some key CESEE markets, including Croatia, Russia and Ukraine, are rising. So far the CESEE region is widely seen as not directly affected by the major slowdown in China or other key emerging market economies. The profitability of domestic business operations will remain low, given the pressure from low interest margins and strong competition. Some observers are questioning the profit diversification in CESEE, as major profit contributions have come from more volatile countries like Russia and Turkey. Further, politically motivated measures related to foreign-currency loans have led to increased uncertainty regarding the outlook for profits.

One of the most prominent potential vulnerabilities of Austrian banks is their fairly limited capitalization level, which still lags behind European peers. In this regard the FMSB's recommendation to introduce a systemic risk buffer was widely seen as a positive step.

The prospect of extraordinary government support for the Austrian banking sector is assessed as uncertain by rating agencies, following the full implementation of the European Bank Recovery and Resolution Directive, including bail-in powers. Therefore,

Chart 28

Austrian Financial Stress Index (AFSI)



Source: OeNB.

ratings of privately owned Austrian banks incorporate zero government support uplift.

Market intelligence shows that investor demand has weakened and funding costs have risen for Austrian bank debt instruments and capital instruments like additional tier 1 capital instruments due to events surrounding the HETA moratorium. Some banks have even lost market access according to some market participants. Austrian banks' pronounced risk profiles as well as HETA-related developments have been cited as explanations. If this negative sentiment persists for a longer period, it may put further pressure on banks' profitability and limit their room for maneuver.

Since the end of the double crisis period (2008–2012) the Austrian Financial Stress Index has settled just below zero. However, a recent increase in financial market volatility has led to an increase in the index. The closely related Composite Indicator of Systemic Stress (CISS) by the ECB, which measures euro area-wide financial stress, shows a similar movement.

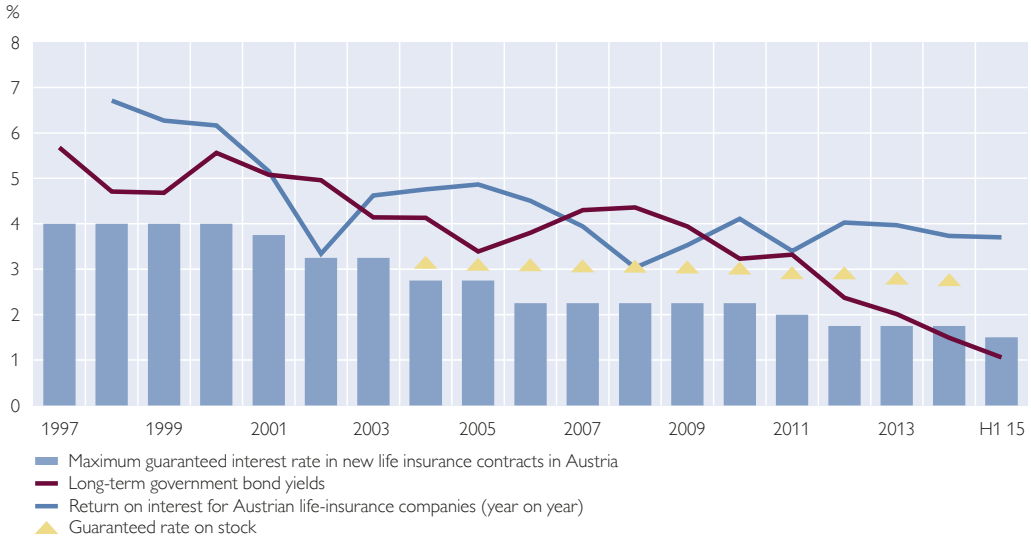
Prolonged period of low interest rates as a challenge for the insurance sector

Ultra-low interest rates and weak macroeconomic growth remain the key risks for the insurance sector. Low profitability and volatile financial markets also are challenges. In the first half of 2015, Austrian insurance companies still generated investment earnings of about 3.8%, but an increased reinvestment risk can be observed, as assets with a duration that is similar to that of the related liabilities are typically not available in the current market environment. The introduction of Solvency II and its new capital requirements, which will enter into force in 2016, are a further demanding task for the insurance sector and may have an influence on the allocation of investments, too.

The low interest rate environment most strongly affects insurers that face significant maturity mismatches in

Chart 29

Austrian insurance sector: return on investment and guaranted interest rates



Source: FMA, OeNB.

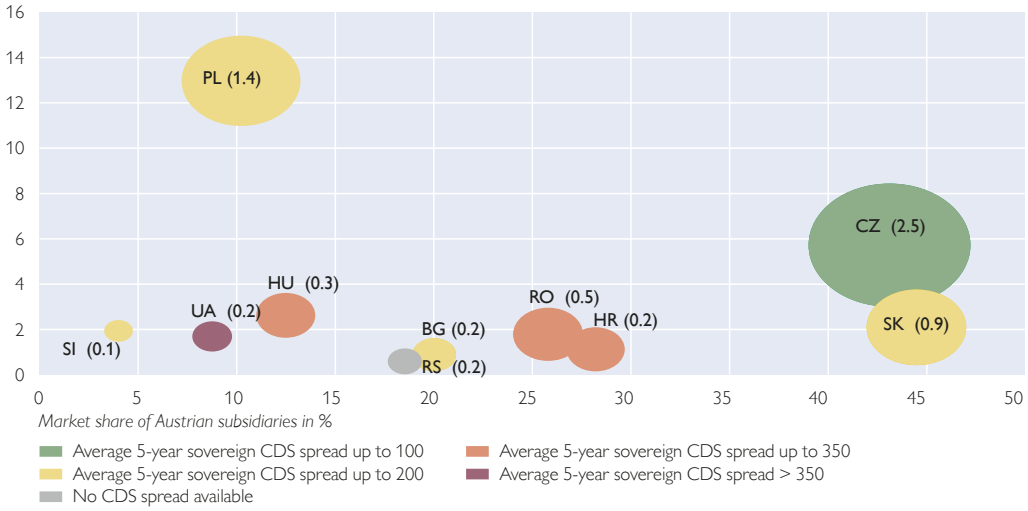
their assets and liabilities (i.e. liabilities have longer maturity periods than assets and/or guarantee rates are above the return rates of assets) and a gap between actual and long-term guaranteed returns in life insurance business. The funds of the Austrian insurance sector are primarily invested in the bond market, while the remaining assets are invested in participations, real estate and shares. Because of this strong dependency on bond yields, the low interest environment is extremely challenging for insurance undertakings. Chart 29 shows that the investment returns of life insurance companies are still about 1 percentage point higher than the average guaranteed rate on stock. The returns have been benefiting significantly from increased bond prices and thus valuation effects. The Austrian long-term government bond yield was at an all-time low at the end of the first half of 2015 and even below the maximum guaranteed rate for new life insurance contracts. In view of persistently low interest rates, the FMA will lower the maximum guaranteed rate in life insurance contracts to 1% with effect from January 1, 2016.

From a geographical perspective, CESEE has been the key growth market not only for Austrian banks but also for Austrian insurance companies because these markets offer higher margins and catching-up potential, as growth in developed economies has been subdued. Currently, Austrian insurance companies are active in 21 countries of the CESEE region, which accounted for about EUR 6.8 billion in premium income in 2014. The most important markets are the Czech Republic and Slovakia, where Austrian insurance companies hold market shares of more than 40%.

Business in emerging markets exposes Austrian insurers to higher legal, political and market risks. The financial crisis has slowed down the process of insurance penetration in the region, as growth perspectives are limited in the current macroeconomic environment.

Chart 30

Austrian insurance groups' exposure to CESEE



Source: SwissRe, FMA, Datastream.

Note: Premium income of Austrian subsidiaries in parentheses.

Chart 30 gives an overview of Austrian insurance companies' CESEE exposure; the x-axis shows the market share of Austrian subsidiaries, the y-axis the local market size; the size of the bubbles indicates the premium income of the Austrian subsidiary/subsidiaries per country. Finally, the color of the bubble signals the risk of the country measured by an average 5-year sovereign CDS spread.

Final assessment and recommendations

In the "new normal," Austrian banks have been facing a subdued operating environment in their core markets – Austria and CESEE – over the last years. What is encouraging is that Austrian banks have improved their risk-bearing capacity in an orderly way. However, the still uneven und fragile economic growth is putting a strain on banks' new business and makes it hard for them to resolve legacy issues of the past credit boom (high stock of NPLs in CESEE). This environment underlines the need for adapting the current business models, which hinge upon extensive branch networks. Therefore, there is no room for complacency, as the low interest rate environment puts further pressure on already low interest rate margins and on profitability.

The global environment of ultra-low interest rates affects Austrian banks in a critical phase, as they transition from a high- to a low-growth environment. In this regard, Austrian banks are vulnerable to shocks, as their risk profile and their risk-bearing capacity still need to be enhanced. Austrian banks are particularly vulnerable due to their significant CESEE exposure, which could be perceived in an undifferentiated way by market participants in times of turbulence. Given the higher uncertainty of future economic developments in key emerging markets (like China) and fragile conditions in important markets like Russia and Turkey, the exposure to CESEE could again take center stage. In these "risk off" times, Austrian banks' high stock of foreign-currency loans in Austria and CESEE increases their vulnerability further.

Against this background, the OeNB recommends that the following measures be taken:

- Banks should continue to strive for capital levels that are commensurate with their risk exposures. The OeNB notes that the trend of improving capitalization has slowed down. The OeNB thus welcomes the recommendation by the Financial Market Stability Board (FMSB) to activate the systemic risk buffer (SRB) and calls on banks to start preparations proactively.
- Banks and insurance undertakings should thoroughly review their business models, internal structures, branch networks and processes in order to increase their profitability and to be prepared for the possibility of a prolonged low growth and low interest rate environment. The OeNB positively notes ongoing efforts in this direction.
- Banks should refrain from trying to gain short-term growth at the cost of risk-inadequate pricing, as profit margins in Austria are narrow and margins in CESEE have come under pressure.
- Banks should further de-risk their loan portfolios by continuing to clean up their balance sheets and to pursue risk-adequate provisioning.
- Banks should adhere to the FMA minimum standards on foreign currency lending in their business in Austria and to the FMA's "Guiding

Principles" in their CESEE business. This also includes working proactively with borrowers on tailor-made solutions to reduce the risks for both sides. Such an approach also encompasses reducing the risk related to the underperformance of repayment vehicles.

– The OeNB recognizes that major improvements in local funding have taken place since 2011. Nevertheless, banks should further continue to strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for risk-adequate pricing of intragroup liquidity transfers.