Favorable Financing Conditions for Real Economy

Financial Situation in Corporate Sector Stabilizes

Economic Upturn Gathers Momentum

As in the three preceding quarters, Austria's economy expanded at a vigorous rate during the first quarter of 2011, and seems poised to return to the level last seen before the financial and economic crisis over the course of the first half-year. The main driver behind this resurgence was the rebound of the world economy, which caused a marked increase in exports. Stimulated by dynamic export activity, which improved the order situation and pushed capacity utilization above average, the corporate sector began to boost its propensity to invest significantly since the second quarter of 2010. Construction investment, by contrast, was restrained. In fact, investments in both housing and civil engineering projects, for which public sector stimulus remained low overall, continued to decline toward the end of 2010.

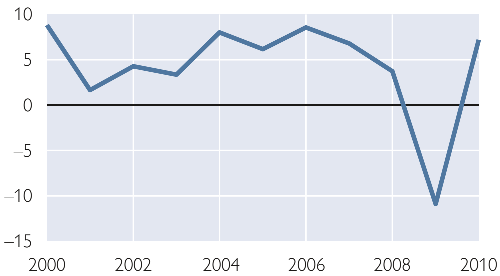
The economic upturn was also evident in the development of corporate profits. Corporate sales activities gained momentum while the cost burden remained slight as a result of moderate wage increases and low interest rates. At EUR 60.5 billion, the 2010 gross operating surplus gained 7.2% compared to the figure for 2009; however, it remained 4% below the precrisis high of EUR 63.3 billion in 2008.

Economy grows powerfully

Chart 15

Gross Operating Surplus of Nonfinancial Corporations

Annual change in %



Source: Statistics Austria.

Further Decline in External Corporate Financing

Gains in internal financing

The rebound in corporate earnings not only strengthened corporate stability and creditworthiness, but also increased the internal financing potential of Austrian companies. Measured as the sum of changes in net worth and depreciation, the corporate sector's internal financing increased by 21% in 2010 while external borrowing failed to even reach the low level posted in 2009. According to national financial accounts data, the volume of external financing came to EUR 9.1 billion, which is about 5% less than in 2009 and amounts to just a quarter of the 2007 figure.[1] As a result, the share of external financing in total corporate financing[2] declined for the third successive year and, at 15.6%, plummeted to its lowest level since 2004.

Corporate profits on the rebound

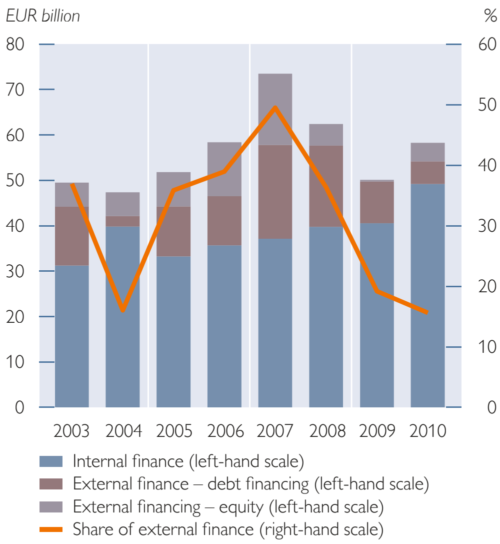
Debt financing, which had represented nearly the entire volume of external financing in the preceding year, dropped to 55%, so that for the first time in four years, equity instruments again provided the bulk of external financing. The total corporate financing volume, by contrast, experienced growth for the first time in two years.

[1] *Adjusted for foreign-controlled holdings in special purpose entities (SPEs).*

[2] *External financing plus internal financing.*

Chart 16

Internal and External Corporate Finance



Source: OeNB, Statistics Austria.

Favorable financing conditions for the corporate sector

Tentative Recovery in Bank Lending

Bank loans begin to show growth

Having made a negative contribution to growth in the previous year, bank loans (net new lending) accounted for one-sixth of total external financing in 2010.[3] Since fall 2010, bank lending has begun to show some signs of recovery. According to the MFI balance sheet statistics, the annual rate of change in Austrian bank lending (adjusted for reclassifications, changes in valuations and exchange rate effects) ceased its decline by October 2010 and stood at 1.2% in March 2011.[4] Companies continued to substitute short-term loans with longer-term financing even though the decline in short-term loans diminished considerably in recent months. Conversely, lending at maturities greater than five years recorded stable growth rates.

This slight improvement in corporate lending appears to be rooted in both the supply and demand sides. On the one hand, demand for loans strengthened on the back of growth in investments. On the other hand, the results of the Eurosystem Bank Lending Survey for Austria indicate that as of the first quarter of 2011, banks have not tightened their credit standards any further for two years. Overall, however, corporate lending conditions can still be considered restrictive by historical comparison, since they were tightened steadily over a two-year period until mid-2009.

Until the first quarter of 2011, financing costs continued to ease the burden on loan financing. In March 2011, interest rates for corporate loans stood at 2.36%, thus posting a moderate gain of around ½ percentage point over their April 2010 low while still hovering 3.3 percentage points below October 2008 levels. As evidenced by the Bank Lending Survey, the noninterest components of loan conditions, which were tightened during the crisis, have also remained mostly unchanged since mid-2010.

Sustained Expansion in Bond Financing

Bonds account for sizeable portion of corporate financing

In the previous year, Austrian companies had obtained almost two-thirds of their external financing by issuing bonds, and this trend continued into 2010, where bond financing, at 43%, again accounted for a sizeable portion of corporate financing. While corporate bond issues have lost some momentum in recent quarters, statistics on securities issues indicate that they still posted an annual growth rate of 6.6% in 2010. As a result, their expansion rate

[3] *As national financial accounts data were available through the fourth quarter of 2010 at the editorial close, the figures on growth contribution refer to the year 2010. The more recent development of financing flows is shown by data from the MFI balance sheet statistics/securities issue statistics.*

[4] *For more information on the development of bank loans, see the OeNB's lending report (www.oenb.at).*

in March 2011 still markedly exceeded that of other financing instruments. In line with the downward movement in interest rate levels, the share of variable rate bonds, which had been in decline since fall 2008, had dropped to 11.8% by March 2011. Likewise, the proportion of foreign bond issues saw a decrease as of mid-2010 and equaled roughly 10% at the beginning of 2011.

Until recently, bond yields continued to hover near low levels, thus mirroring the development of credit interest rates. The spread between corporate bond yields and yields of top-rated euro area government bonds showed only slight movement in 2010 and during the first few months of 2011. In April 2011, at 5.0%, yields on BBB-rated[5] bonds were still more than 3 percentage points below the peak levels recorded at the height of the financial market turmoil in the fall of 2008.

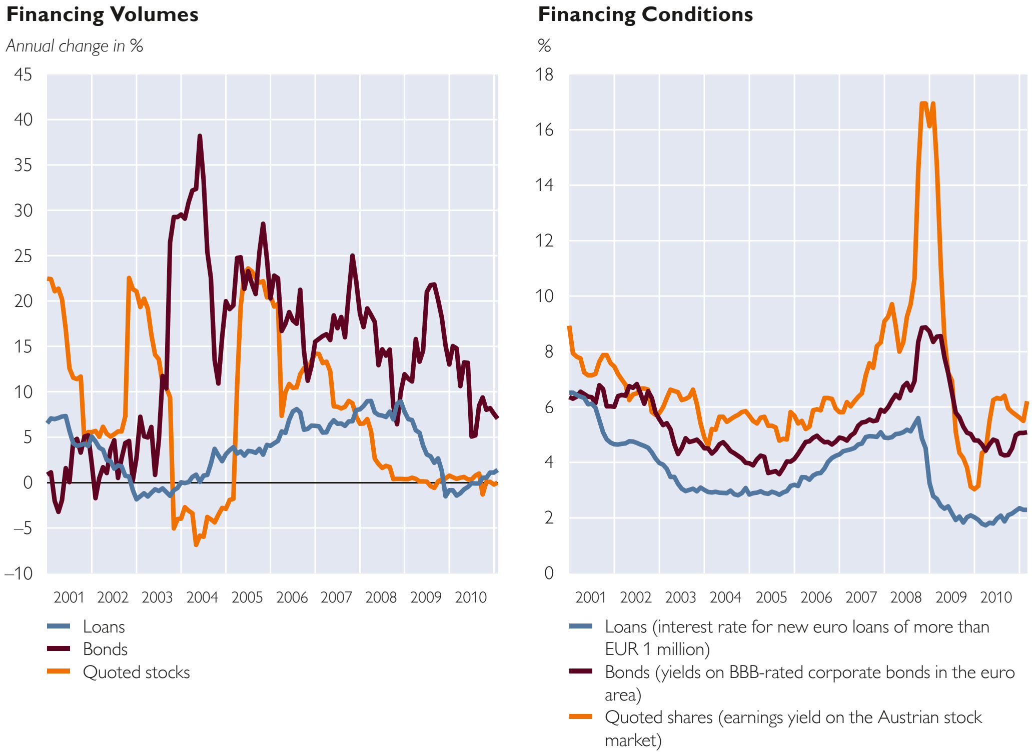
Slight Recovery in Financing via the Stock Market

Capital increases in the fourth quarter of 2010

During the fourth quarter of 2010, financing via the stock exchange, which the crisis had severely constrained for a long time, showed some upward momentum, triggered by a number of large-volume capital increase measures. Coming to EUR 2.4 billion, almost all of which was recorded during the last quarter of the year, quoted stocks accounted for approximately 25% of nonfinancial corporations' external financing volume in 2010. In the

Chart 17

Volumes and Conditions for Key Elements of Corporate Financing



Source: OeNB, Thomson Reuters, Wiener Börse AG.

[5] *As no time series is available for yields on Austrian corporate bonds, figures for the euro area are used here.*

first months of 2011, however, the level of corporate funds raised via the stock exchange returned to a very low value. To date, there has only been one new listing on the Vienna Stock Exchange (in April 2011) since the onset of the crisis.

Measured in terms of earnings yields (i.e. the inverse of the price-to-earnings ratio), the cost of raising capital on the Austrian stock market has remained relatively stable since mid-2010. Between July 2010 and April 2011, the earnings yield fluctuated in a relatively narrow range of between 5.5% and 6.6%.

Slow growth in corporate debt

Corporate equity position rises

At EUR 1.7 billion, over-the-counter equities account for almost one-fifth of Austrian companies' external financing volume. In total, corporations obtained 45% of their external financing – which, at 32%, is more than the average for 2005 through 2009 – in the form of equity. Relative to its total liabilities, the corporate sector's equity position (i.e. the proportion of stocks in total liabilities and shareholders' equity) increased by just under 1 percentage point to 46.5% in 2010.

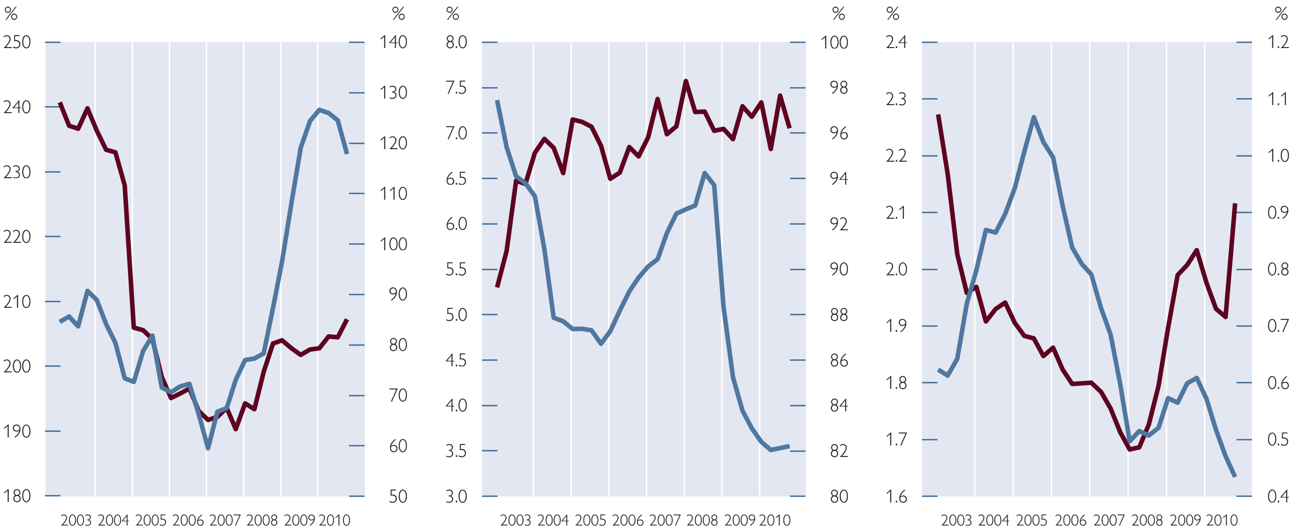
Corporate Strength Indicators Continue to Improve

The financial position of the corporate sector, which in some cases deteriorated sharply in 2009 as a result of the crisis, stabilized or even improved slightly over the course of 2010. Due to the low level of external financing and the increase in equity financing, corporate borrowing saw its smallest expansion in almost four years during the fourth quarter of 2010. Owing to the recovery

Chart 18

Indicators of Corporate Financial Strength

Debt[1] | **Interest Expense** | **Corporate Insolvencies**



Debt: % of gross operating surplus[2] (left-hand scale); % of equity capital[3] (right-hand scale)

Interest Expense: % of gross operating surplus[2] (left-hand scale); Share of variable rate loans in % (right-hand scale)

Corporate Insolvencies: Default frequency (number of insolvencies as a percentage of companies; left-hand scale); Insolvency liabilities as a percentage of corporate liabilities (right-hand scale)

Source: OeNB, ECB, Eurostat.

[1] *Short-term and long-term loans, money market and capital market instruments.*

[2] *Including mixed income of the self-employed.*

[3] *Quoted stocks and other equity.*

in earnings, the ratio of corporate debt to profits fell slightly in 2010, while the debt-to-equity ratio remained relatively stable over the past two years.

Interest expense remains low

The persistently subdued pace of borrowing, coupled with continued low interest rates, kept interest expenses down in the corporate sector in 2010, which provided significant relief on the cost side. However, even though the corporate sector's debt-to-equity ratio remained relatively steady throughout the crisis and its exposure to interest rate risk did not climb overall, rising interest rates could create a noticeable burden for highly indebted companies. This risk factor is all the more salient since the Austrian corporate sector exhibits an above-average share of variable rate loans, making it vulnerable to interest rate risk to a substantial extent.

Number of insolvencies down

Relatively modest debt-to-equity ratios and low interest rates are probably also among the reasons why the number of corporate insolvencies has risen comparatively slightly in the course of the crisis, although it is important to note that insolvency figures generally constitute a lagging economic indicator. Based on moving four-quarter averages to rule out seasonal fluctuations, the number of insolvencies in the first quarter of 2011 was 6.1% below the figure for the previous year. Conversely, default liabilities saw a 22% hike during the same period, caused mainly by a number of large-scale insolvencies. Relative to total corporate sector liabilities (according to national financial accounts), the four-quarter moving average of insolvency liabilities increased from 0.78% in the first quarter of 2010 to 0.90% in the first quarter of 2011.

Still No Improvement in Households' Risk Situation

Sluggish Growth in Income and Spending

While favorable labor market conditions provided a positive stimulus to the income situation, above-average price hikes and public sector consolidation measures in early 2011 placed a burden on households' disposable income. Overall, real household income even declined slightly in the first quarter of 2011. Against this backdrop, the economic upturn has not yet spread to consumer spending, which, in addition, has been impacted by sharply rising prices for energy and raw materials.

Reduced propensity to save

The saving ratio, which had already slumped considerably from 11.1% to 9.1% in 2010, slipped again in the first quarter of 2011. This decline suggests that households viewed the reduction in income as temporary in nature. Moreover, the effects of two factors that had already suppressed household saving ratios in 2009 may have persisted: For one thing, ongoing low interest rates reduced the attractiveness of saving, and for another, the economic crisis affected the property income, that portion of disposable income that might exhibit a high saving rate. Property income, which had already plummeted by almost one-third in 2009, dropped by a further 19% in 2010. In general, low interest rates weakened net interest income, and the distributed income of corporations clearly reflected the poor corporate profit situation evident in 2009.

Slump in Financial Investment

In step with the declining saving ratio, household[6] financial investment contracted for the third successive year in

[6] *Not including nonprofit institutions serving households.*

2010 and, at EUR 12.0 billion, was 17% below the 2010 figure and 38% below the peak recorded in 2007 before the crisis took hold.

Bank deposits' share in financial investment diminishes

The decline in financial investment was primarily evidenced by a sharp contraction in bank deposits, which, at EUR 1.1 billion, contributed only around 10% to financial investment. Since the growth rates for deposits had already been in decline since mid-2009, this downturn is only in part a reflection of investors' shift to securities, which may have been triggered by the announcement of the new tax on capital gains accruing on securities.

Moreover, not all types of bank deposits were affected equally. For instance, the volume of overnight deposits went up while time deposits declined, even though deposits made under building loan contracts – as in 2009 – posted a dynamic growth rate and increased by 3.4% year on year. This development suggests that the strong preference for liquidity that had already shaped households' investment behavior in the previous year continued to exercise significant influence over their investment decisions in 2010. By extension, investor uncertainty also appears to have eased somewhat in the meantime.

Frontloading stimulates capital market investment

Reflecting the historically low share of deposits, the contribution of capital market investment to overall financial asset accumulation was extremely high at around 40%. For the first time in three years, the decline in households' securities investments was reversed in 2010, with investments in quoted stocks (+10.3%) and mutual fund shares (+6.5%) recording particularly strong gains. While this development is attributable in part to frontloaded investments triggered by tax considerations, the uptick in capital market investment can also, to some extent, be interpreted as an expression of greater investor confidence. Investment in foreign funds was especially pronounced throughout the year, and foreign securities represented a significantly larger share of direct investment in stocks and bonds than during the preceding years.

Investments in life insurance have a stabilizing effect

As in the preceding year, investments in life insurance and pension funds, which accounted for around one-third of households' financial assets, had a stabilizing effect on financial investment in 2010. A large proportion of the capital inflows attributable to these investment instruments is not, however, the result of current investment decisions, but – given the extended maturities and commitment periods and the predominantly long-term objectives associated with these instruments – rather reflects decisions that were made at an earlier time. A key underlying force in this trend is the growing demand for funded pension instruments. Moreover, life insurance policies are frequently used as repayment vehicles for foreign currency bullet loans.

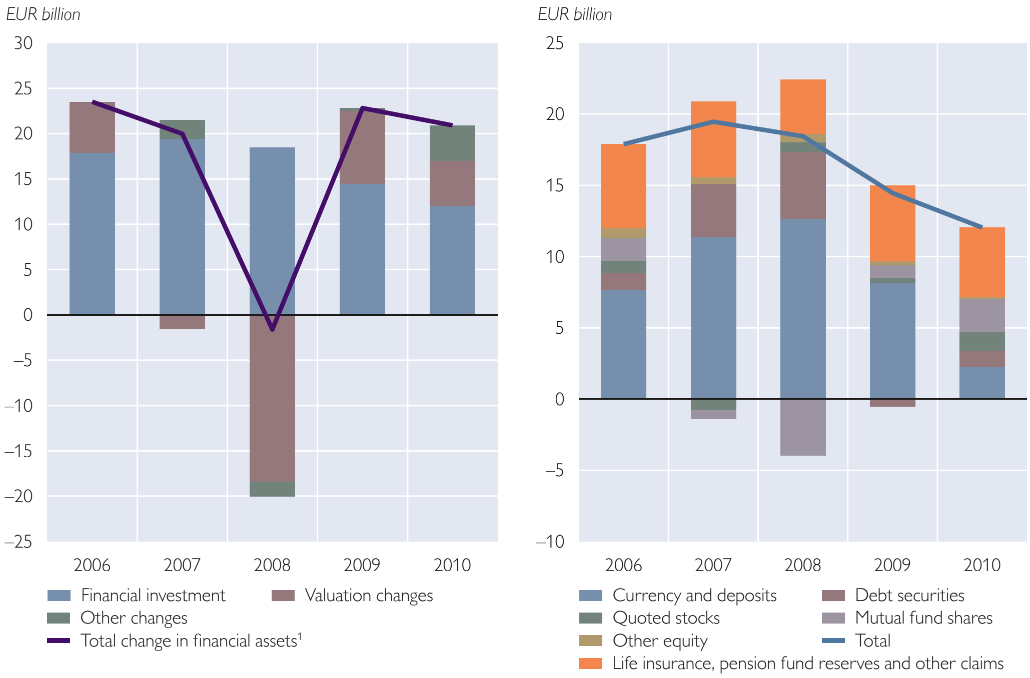
Financial assets post valuation gains

At the end of 2010, the financial assets of Austrian households amounted to EUR 461 billion, a plus of EUR 20.9 billion over the preceding year. Financial investment was responsible for around three-fifths of this growth; (unrealized) valuation changes accounted for about one-quarter, while the remainder can be explained by statistical reclassifications (the bulk were due to changed estimations of households' foreign security portfolios). Even though gains were recorded for the second successive year, the massive price losses of 2008 were still not fully recouped. Relative to the volume of financial assets at the close of 2009, these valuation gains came to 1.1% in 2010. At approximately one-fifth of the level recorded at year-end 2009, the price gains in equity portfolios were particularly pronounced.

Chart 19

Change in Households' Financial Assets

Determinants of Change in Financial Assets | **Components of Households' Financial Investment**



Source: OeNB.

[1] *2006: financial investment and valuation changes only.*

Subdued Lending Growth

According to Austria's financial accounts, bank loans accounted for about 85% of households' financial liabilities at the end of 2010. Overall, bank lending exhibited only very moderate growth over the past two years. In March 2011, the net increase in household loans extended by Austrian banks (adjusted to account for reclassifications, changes in valuation and exchange rate effects) came to 1.2%.

The volume of outstanding loans was 3.4% above the previous year's level, primarily due to changes in foreign currency loans caused by exchange rate fluctuations. The measures instituted by the Austrian Financial Market Authority to limit foreign currency loans already showed significant results in the past year. Adjusted for exchange rate effects, foreign currency loans to households fell by 8.4% in 2010 (2009: –4.9%). However, owing to the strong appreciation of the Swiss Franc against the euro, the foreign currency loan volume of households – translated into euro – still rose from EUR 36.7 billion to EUR 39.7 billion. While a fall to EUR 37.6 billion was recorded during the first quarter of 2011, foreign currency loans still constituted 28% of borrowing in the household sector.

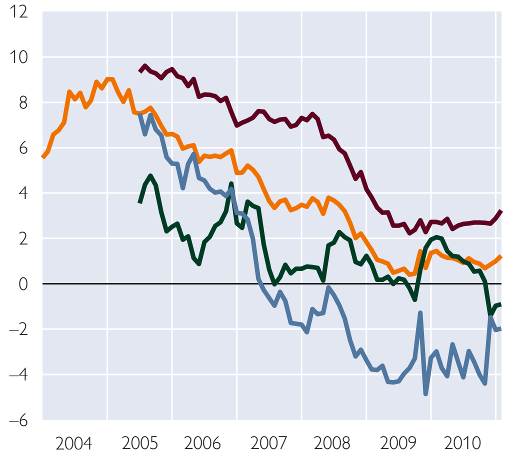
Exchange rate-adjusted decline in foreign currency loans

Categorized by purpose, housing loans saw gains (3.2% year on year) while declines were observed in consumer loans (–2.4%) and other loans (–0.7%). According to the Bank Lending Survey, the credit supply from banks has remained stable since mid-2010, so that the current growth in lending appears to be fundamentally rooted in demand-side factors. In the housing loan segment, some indicators

Chart 20

MFI Loans to Households

Annual change in %



Source: ECB, OeNB.

Note: Due to breaks in the time series, there is no breakdown by loan purpose for the period prior to 2005.

Household debt rises moderately

are signaling a resurgence in credit demand. Although no information is available on finished new construction projects, the rising number of residential building permits indicates a slight upturn in residential building activity. After stabilizing in 2009, a notable increase was observed 2010, and as of the third quarter of 2010, the number of residential building approvals stood 23% above the respective 2009 figure. Concurrently, rising real estate prices are causing an upward shift in the demand for funding requirements for the acquisition of real estate on the secondary market. Conversely, households' consumer spending on durable goods declined in 2010, both in nominal and real terms.

Financing conditions remain favorable

The situation of household loans changed only marginally during 2010 and into the current year. Credit standards have remained unaltered both for housing loans and consumer loans since the third quarter of 2010, and lending conditions stayed favorable. Interest rates on loans remained low despite the rise in key interest rates in spring 2011. In March 2011, interest rates for new housing loans stood at 2.56%, dipping to their lowest level since the inception of the time series in 2003. Interest rates on consumer loans took an upward turn during 2010 and in the first quarter of 2011: at 4.93%, they were 64 basis points up from year-end 2009 yet remained 2.25 percentage points below the peak recorded in fall 2008.

Households' Risk Situation Shaped by Currency and Interest Rate Risks

While low levels of borrowing and low interest rates curbed the increase in household debt during the crisis, the appreciation of the Swiss Franc against the euro[7] in 2010 demonstrated that the persistently high share of foreign currency lending in the volume of total household loans continues to pose a risk, as evidenced by the development of household liabilities[8] according to the national financial accounts. In 2010, (net) borrowing amounted to 1% of households' liabilities at year-end 2009, but due to valuation changes the household sector's debt burden rose by almost 3 percentage points in 2010, to 98% of households' net disposable income. However, the debt ratio remained lower than in the euro area as a whole, where the corresponding value was 105.4%.

Reduced interest expense due to variable interest loans

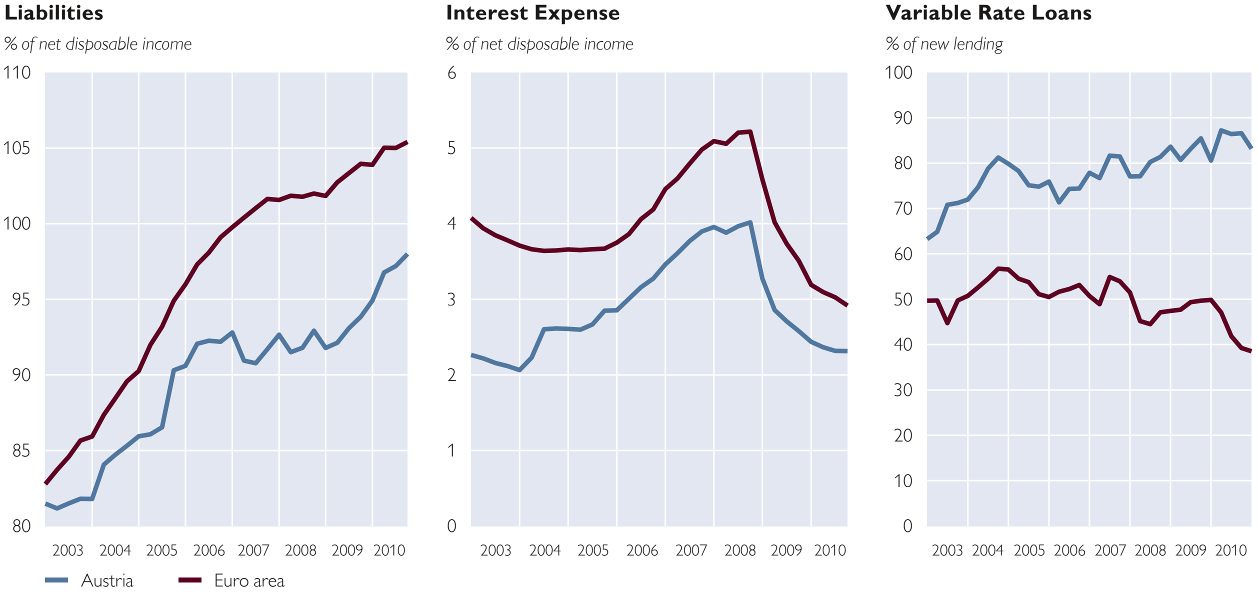
Low interest levels and moderate borrowing also led to a further decline in households' interest expense, which in 2010 averaged 2.3% of disposable

[7] *Between the third quarter of 2009 and the first quarter of 2011, the Swiss Franc picked up some 24% against the euro.*

[8] *Households and nonprofit institutions serving households.*

Chart 21

Household Risk Indicators



Source: OeNB, ECB, Eurostat.

income, thus slipping by approximately 0.5 percentage points over the preceding year. One of the factors that favored this drop was the rising proportion of variable interest loans. In the first quarter of 2011, 83% of new loans had an initial rate fixation period of up to one year. That share, which is particularly high by international comparison, contributed to the speed with which the ECB's interest rate reductions were transmitted to lending rates, and to the fact that levels of consumer interest rates are lower in Austria than in the euro area in general. However, this development could produce the opposite effect on interest expense if interest rates were to climb again.

Box 1

Payment Difficulties in Austrian Households

Upon the unfolding of the financial crisis, household indebtedness moved into the spotlight of central banks' research activities. An extensive understanding of the different credit obligations of various types of households is an essential aspect of ensuring financial stability. In recent years, households' debt burden has increased only moderately, with divergent patterns being observed across loan types: while housing loans posted growth, albeit at a modest scale, consumer loans decreased in recent years (see chart 20).

Statistics Austria's specific module within the 2008 EU Statistics on Income and Living Conditions (EU-SILC)[1] survey enables a more precise analysis of the payment difficulties encountered by Austrian households carrying credit debt.[2] In the context of that survey, house holds were asked if, during the preceding 12 months, financial constraints had caused them to

[1] *Conducted annually, the EU SILC survey has captured comprehensive data on income and living conditions in Europe since 2003. In Austria, the survey is conducted under the leadership of Statistics Austria. More detailed information in German is available from Statistics Austria at http://www.statistik.at/web_de/frageboegen/private_haushalte/eu_silc/index.html (as retrieved on April 21, 2011).*

[2] *In contrast with box 1 of the OeNB's Financial Stability Report 19 (June 2010, p. 32) which is based on the same data, this year's analysis focuses on outlining the differences between housing and consumer loan debtors.*

fall into arrears on servicing housing/consumer loans, credit card payments or other payment-obligations such as rental charges, utility bills or similar expenses. For this analysis, households were divided into two categories: those with housing loans (i.e. repayment obligations arising from loans for their main residence) and those with consumer loans (i.e. obligations arising from personal loans, lease agreements and hire-purchase agreements for cars, vacations, education, furniture and similar expenditures).

The table below reflects the fundamental differences in payment difficulties experienced by a total of 5,711 Austrian households with housing/consumer loans, which appeared in the Austrian dataset of the EU-SILC survey. Essentially, around one quarter of those households (27.3%) had taken out housing loans and 15.6% consumer loans. Of the households that carried a housing loan (consumer loan), 18.3% (32.0%) had acquired at least one additional consumer loan (housing loan). This survey, however, does not provide any data on the average amount of household' outstanding debt obligations or the resulting risk of potential default by loan type. As the size of consumer loans generally tends to be lower than housing loans, the potential for default places less of a strain on banks than nonperforming housing loans. According to national financial accounts, for example, the entire volume of consumer loans in 2008 (the year of the survey) represented only around 14% of the total lending volume, while housing loans accounted for almost two-thirds (not including non-profit institutions serving households) and other loans constituted just over 20%.

Evidence from microdata shows that housing loans are more prevalent among higher-income households, a tendency that – while much less pronounced – is also seen in consumer loans (see table, columns 3 and 4). The frequency of households' credit debt also varies according to the education level, marital status and employment situation of the principal earner.

In a further step, groups with different sociodemographic characteristics, categorized by housing and consumer loans, are assessed for payment difficulties, and hence possible risks of loan defaults for banks (see table, columns 5 to 7).

Overall, 8.5% of all Austrian households were late in servicing their obligations during the 12 months preceding the survey (see table, column 5), with considerable disparity being noted between households holding housing loans (9.2%) and those carrying consumer loans (25.1%). On average, the relative frequency of payment arrears among holders of consumer loans is two to three times greater than that of housing loan debtors. Some minor fluctuations aside, this ratio remains relatively stable across income categories, educational levels and employment status.

About half (48.3%) of all first income quintile households with consumer loans reported being in arrears on their payment obligations. In the housing loan subgroup, lower-income households likewise show a greater prevalence of payment difficulties, although to a less pronounced degree. One reason for this difference could be that due to their lower credit-worthiness, households with consumer loans are faced with tighter credit constraints on housing loans.

The frequency of payment arrears is highest among the group of households in which the principal earner is unemployed (households with home loans: 45.5%; households with consumer loans: 58.3%), whereas only about 10% of all households with different employment status have fallen behind on their payment obligations (see table, column 5). However, these static results do not indicate that differences in the prevalence of households in payment arrears might by induced by changes in the unemployment rate. Dynamic simulation models have shown that these effects play a relatively minor role.[3] To sum it up, the evidence derived from these data shows that households with consumer loans exhibit a significantly higher frequency of payment arrears than those with housing loans, and that, due to their relatively low volume, consumer loan arrears do not pose a risk to financial stability. Only upon completion of the

[3] For a more extensive analysis of the impact of unemployment on the vulnerability of households in Austria, see Albacete and Fessler (2010), Stress Testing Austrian Households, Financial Stability Report 19, June 2010, OeNB. 72–92.

Household Finance and Consumption Survey (HFCS) in Austria[4] will a more comprehensive analysis capable of capturing households' full asset and liability positions be facilitated, as the asset variables required for calculating potential losses in the financial sector are not available in the EU-SILC dataset.

Sociodemographic Characteristics of Households with Credit Liabilities and Financial Constraints

				% of households with payment arrears in the last 12 months ...		
	Number of households	% of households with housing loans	% of households with consumer loans	... all households	... if owing on a housing loan	... if owing on a consumer loan
		%				
All households	5,711	27.3	15.6	8.5	9.1	25.1
Quintile of net income (household)						
1	1,058	10.4	9.3	13.4	22.2	48.3
2	1,092	18.1	16.3	10.6	11.8	29.6
3	1,151	26.5	12.8	7.7	10.6	30.9
4	1,215	36.7	19.4	6.5	7.3	19.8
5	1,195	45.0	20.4	4.1	5.7	12.2
Age (main earner)						
Up to 19 years of age	28	24.0	21.3	19.0	22.9	43.2
20 to 39 years of age	1,547	32.3	22.2	12.3	11.1	29.2
40 to 64 years of age	2,704	34.2	18.1	9.3	8.2	23.5
65 years of age and older	1,432	8.8	3.5	2.2	6.3	7.4
Highest education level (main earner)						
Compulsory schooling	944	14.4	15.8	12.2	23.3	42.9
Intermediate or higher technical/vocational school	3,111	29.0	15.4	8.1	9.2	24.3
High school graduation	978	33.0	16.6	8.9	4.9	19.1
University degree	678	30.5	14.9	4.1	5.7	11.2
Family status (main earner)						
Unmarried	1,373	23.9	16.5	11.4	12.0	30.4
Married	2,824	35.1	17.8	6.7	7.3	20.9
Separated or divorced	834	25.2	16.8	13.1	11.9	30.5
Widowed	680	8.4	4.4	3.1	9.6	19.4
Activity status (main earner)						
Employed	2,964	38.2	20.1	8.6	8.4	21.5
Self-employed	399	35.2	24.2	11.7	14.6	27.0
Unemployed	169	11.3	30.6	33.3	45.5	58.3
Nonemployed	2,179	12.4	6.3	5.1	5.8	23.1

Source: EU-SILC 2008 (Statistics Austria).

Note: The few "Don't know" or "No answer" responses were ignored.

[4] *The HFCS, conducted at the national level by the OeNB during 2010/11, collects micro-level data on the structure of liabilities, assets, spending and income of Austrian households.*