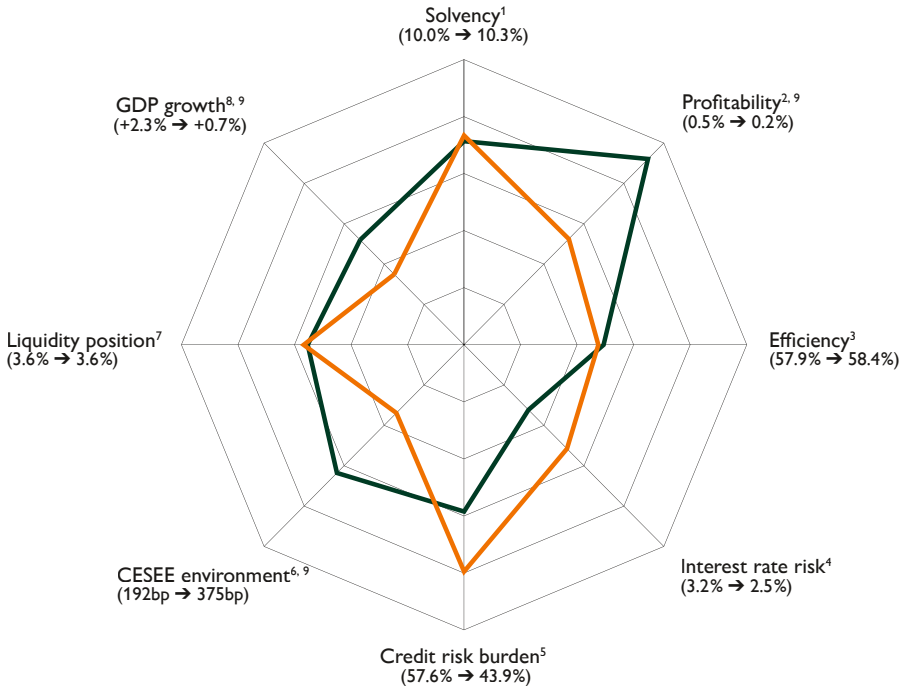
Austrian Financial System Faces a Persistently Difficult Environment

Following a marked economic upturn in the first half of 2011, the lingering uncertainty over public debt problems caused the macroeconomic environment to deteriorate noticeably in recent months. This development also affected Austrian financial intermediaries. Highly volatile stock markets and value losses in certain asset classes led to a substantial decline in profitability, even though this decline was not yet reflected in the consolidated data for the first half of 2011.

While Austrian banks' capital adequacy ratios improved somewhat in the first half of 2011, building up additional capital buffers would be advisable in light of the volatile market environment and below-peer capitalization levels.

Chart 21

Banks and Financial Market Stability



Source: OeNB.

[1] *Tier 1 ratio.*
[2] *Return on assets.*
[3] *Cost-to-income ratio.*
[4] *200-basis-point interest rate shock (loss of eligible capital).*
[5] *Credit risk provisions in % of operating result.*
[6] *Weighted CDS spread.*
[7] *Cumulative 12-month funding deficit in % of total assets.*
[8] *Real GDP growth in % p.a.*
[9] *Most recent value available at the cutoff date for data; GDP growth: forecast for 2012.*

Note: Consolidated figures scaled on the basis of historical data. The closer to the center data points are, the better or less risky. bp stands for basis points

In the first half of 2011, Austrian banks' business in Central, Eastern and Southeastern Europe (CESEE) again accounted for a substantial share in total profitability. This share even increased year on year, which was, however, primarily attributable to a decline in new risk provisions. Therefore, in addition to taking cost-related measures, banks should improve their low domestic profitability, which is due to structural weaknesses.

The liquidity situation of Austrian banks is above all influenced by the difficulties in Europe. Domestic banks responded early on by taking steps to lower liquidity risk. Still, many CESEE subsidiaries continue to rely on their Austrian parent banks for liquidity supply.

In 2011, Austrian banks drastically reduced new foreign currency lending as a result of supervisory initiatives, among other things. The large volumes of outstanding foreign currency loans – both in Austria and in CESEE – constitute a considerable credit risk for domestic banks, though. Moreover, recent data again show that repayment vehicles, which are often used to back such loans, are also subject to substantial market risk.

Retail deposits: an important source of bank funding

The claims of the Austrian banking system on euro area countries with an elevated risk profile remain comparatively small and even continued to decline somewhat in the first two quarters of 2011.

Even though the profitability of the Austrian insurance industry improved in the first half of 2011, the public debt crisis and low interest rates posed a challenge for insurers.

In light of recent developments, Austrian banks need to further strengthen the sustainability of their business models in the near future, with respect to both their capitalization and their liquidity supply.

Austrian Banking System Is Affected by New Market Turmoil

Focus on Retail Business Strengthened Further

Austrian banks did not continue the moderate deleveraging process in the first half of 2011. The trend to shrinking balance sheets seems to have come to an end, as the consolidated total assets of domestic banks increased again slightly compared to end-2010 figures, reaching around EUR 1,137 billion in mid-2011. The consolidated leverage ratio was 16.8 at end-June 2011 (end-2009: 19.2).

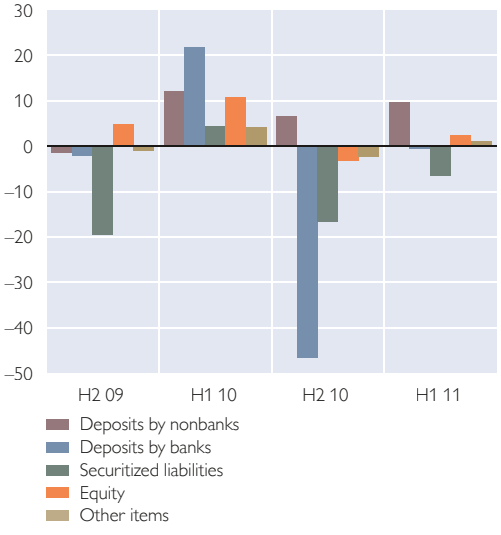
Austrian banks' refinancing strategies have changed markedly in recent years. The share of consolidated retail deposits in total assets continued to rise in the first half of 2011, which further strengthened the banking system's focus on retail business.

Having stagnated in 2010, new lending by Austrian banks increased again slightly in the first half of 2011. The volume of loans to domestic nonbanks was EUR 326.1 billion as at Sep-

Chart 22

Change in Austrian Banks' Refinancing

Period-to-period change in EUR billion



Source: OeNB.

tember 2011, and thus around 0.9% higher than one year earlier. This rise was mainly driven by lending to households and nonfinancial corporations, whereas loans to the public sector stagnated and loans to nonbank financial intermediaries declined substantially.

New foreign currency lending remained low in 2011, which was attributable to turmoil in foreign exchange markets and the associated higher risk aversion of borrowers, among other things. Austrian banks still hold a significant volume of foreign currency loans, though: As at September 2011, the volume of such loans to nonbank customers in Austria alone was around EUR 58.5 billion, which equals a 17.9% share in total loans to this group. Foreign currency loans to households amounted to EUR 41.2 billion at that time. The measures taken by the Austrian Financial Market Authority (FMA) and the OeNB since the onset of the financial crisis to reduce the systemic risk resulting from foreign currency lending thus continued to prove effective. Between October 2008 and September 2011, the volume of foreign currency loans to households declined by 17.4% or EUR 6.9 billion adjusted for exchange rate changes.

A survey among Austrian banks on the risks associated with repayment vehicle-linked loans – which account for 75% of foreign currency loans to households (18% of such loans to businesses) – revealed a funding gap[1] of around EUR 5.4 billion (19% of the outstanding volume of repayment vehicle-linked loans) as at June 2011. At end-2008, the aggregate funding gap had been EUR 4.5 billion (14%). Owing to the appreciation of the Swiss franc against the euro between end-2008 and mid-2011, funding gaps have also emerged in repayment vehicle products that are no direct financial market investments, especially traditional life insurance products. Between June 2011 and early September 2011, the Swiss franc did not appreciate significantly thanks to measures taken by the Swiss National Bank. Still, given the major disruptions in capital markets in the second half of the year, funding gaps in capital market products (almost three-quarters of all repayment vehicles) widened even further.

Foreign currency loans stagnate at a high level

In the third quarter of 2011, the unconsolidated total assets of Austrian banks edged up again slightly year on year, with cash liquidity increasing markedly, which can be interpreted as a precautionary measure in times of uncertainty.

Loan Loss Provision Ratio Remains High

At EUR 2.9 billion in the first half of 2011, the new risk provisions set aside by Austrian banks for lending operations were again lower than in previous periods but still markedly higher than in the precrisis years (see chart 23). This can be explained by the fact that the credit cycle (changes in loan quality) lags behind the economic cycle.

Deterioration in loan quality continued to slow down somewhat in the first half of 2011

Persistently high (albeit shrinking) credit risk costs lead to a lasting deterioration of credit quality, which is reflected in rising loan loss provision ratios. Considerable regional differences can be observed both in the credit quality level and in how quickly and sharply credit quality deteriorates.

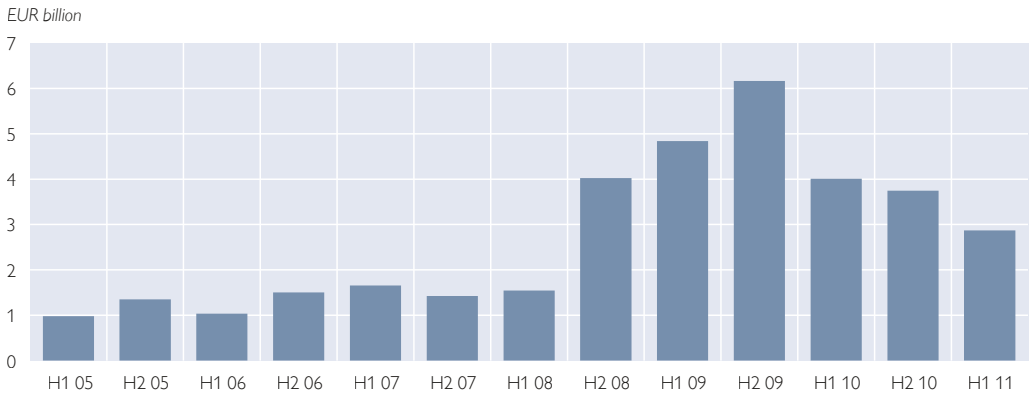
The Austrian banking sector's unconsolidated loan loss provision ratio[2]

[1] *The funding gap denotes the difference between the capital that must be accumulated in the repayment vehicle to cover 100% of the loan at maturity and the forecast value based on the repayment vehicle's current market value and current yield assumptions.*

[2] *Specific loan loss provisions for claims on nonbanks as a share of total outstanding claims on nonbanks.*

Chart 23

Consolidated Credit Risk Costs of Austrian Banks

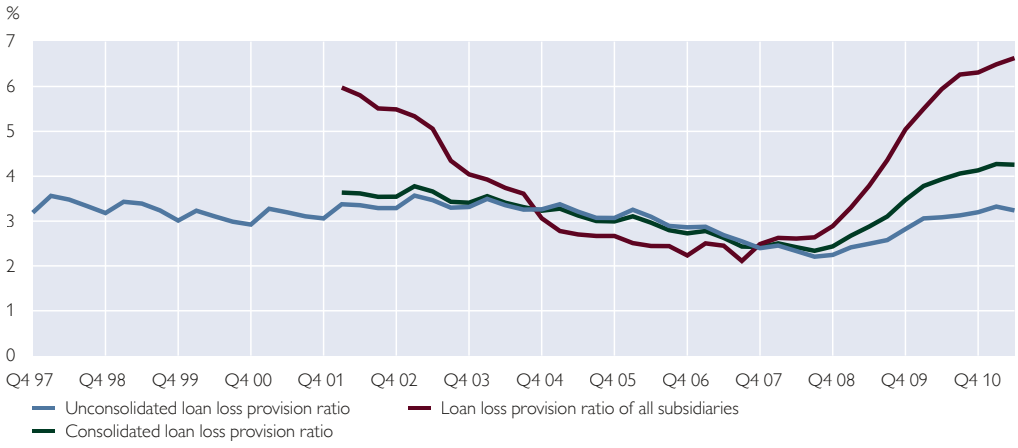


Source: OeNB.

– which does not cover foreign subsidiaries and is hence clearly focused on Austria – remained almost unchanged at 3.2% in the first half of 2011 (blue line in chart 24). By contrast, the loan loss provision ratio of all Austrian bank subsidiaries rose again sharply to 6.6% (red line in chart 24), up by 0.3 percentage points from end-2010, when it had slowed its growth. A breakdown by country groups[3] shows substantial regional differences, though: CIS –0.2 percentage points, NMS-2004 +0.6 percentage points, NMS-2007 +0.3 percentage points and SEE +0.4 percentage points.

Chart 24

Loan Loss Provision Ratios of Austrian Banks



Source: OeNB.

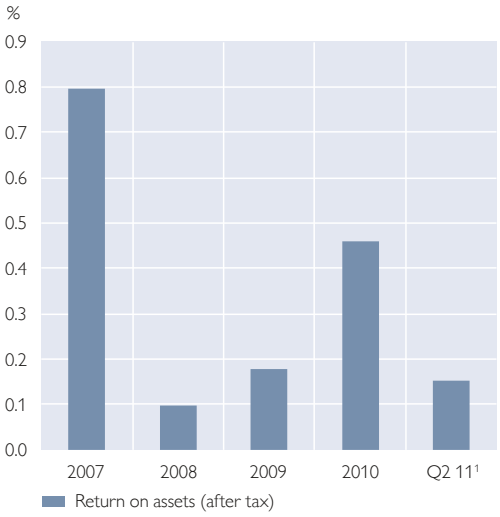
[3] *In this section, the following regions and country groups are reviewed: NMS-2004 refers to countries that joined the EU in 2004, here: Latvia (LV), Poland (PL), Slovakia (SK), Slovenia (SI), the Czech Republic (CZ) and Hungary (HU). Southeastern Europe (SEE) includes Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME), FYR Macedonia (MK), Serbia (RS) and Turkey (TR). NMS-2007 refers to the Member States that joined the EU in 2007: Bulgaria (BG) and Romania (RO). The Commonwealth of Independent States (CIS) aggregate covers Armenia (AM), Azerbaijan (AZ), Belarus (BY), Kazakhstan (KZ), Kyrgyzstan (KG), Moldova (MD), Russia (RU), Tajikistan (TJ), Turkmenistan (TM), Ukraine (UA) and Uzbekistan (UZ); Georgia (GE) is also included here.*

The resulting consolidated loan loss provision ratio[4] covering the entire retail lending business of domestic banks both in Austria and abroad was 4.3% as at end-June 2011 (green line in chart 24) and thus 0.1 percentage points higher than at end-2010. In light of the deteriorating economic outlook, loan loss provision ratios are unlikely to decline in the near future.

The stock of loan loss provisions changes when new ones are made (inflows) or when they are used to cover bad debt or released (outflows). The ratio of inflows to outflows peaked in 2009 (unconsolidated: 2.4; foreign subsidiaries: 2.8), declined in 2010 (1.3 and 1.8, respectively), but started rising again recently for foreign subsidiaries.

Chart 25

Profitability of Austrian Banks (Consolidated)



Source: OeNB.

[1] The value for 2011 is an extrapolation as at end-June 2011 that takes into consideration published expected losses.

Banks' Profitability Is Again Subdued

Following very favorable developments in the first half of 2011, the profitability of Austrian banks (consolidated data) weakened considerably from August 2011, which was attributable to the challenging market situation, the deteriorating macroeconomic outlook and the writedowns on government bonds. Based on the unconsolidated data reported as at end-June 2011, the annual surplus for the full year 2011 is estimated to be almost 60% lower than in 2010.

In the first half of 2011, the Austrian banks' consolidated operating income was around 1.5% higher than in the same period of 2010. This improvement can be traced to a rise in trading income by around EUR 700 million. The most important income components – net interest income (+1.2%) and fee-based income (–0.5%) – remained broadly unchanged at the levels observed in the first half of 2010. Operating expenses (+3%) rose somewhat faster than operating income, above all because of an increase in staff costs and other operating expenses. As a consequence, the consolidated operating result of the Austrian banking system was around 1.3% lower in the first half of 2011 than in the same period of 2010. The cost-to-income ratio climbed from 57.7% (Q2 10) to 58.4% (Q2 11).

Credit risk costs declined in 2010 and continued to do so in the first half of 2011, reducing operating profits by around 58% in the financial year 2010 but only by 44% in the first half of 2011. This decline was again the main factor in improving the period result for the first half of 2011, which came to some EUR 2.9 billion and thus exceeded the results observed in the first half of both 2009 and 2010. The favor-

Market turmoil and government debt crisis subdue the high profitability observed in the first half of 2011

[4] *The numerator of this ratio is the stock of unconsolidated specific loan loss provisions for claims on nonbanks plus the stock of specific loan loss provisions reported by fully consolidated subsidiaries. The denominator is the sum of unconsolidated gross claims on nonbanks and the gross claims of fully consolidated subsidiaries on nonbanks. The consolidated loan loss provision ratio is subject to some uncertainty, given regional differences in accounting rules.*

able period result for the first half of 2011 can be expected to partly offset the marked decline in profitability observed from the third quarter of 2011. Still, for the full year 2011, the consolidated return on assets after tax is likely to be markedly lower than in 2010. Based on the data available at the cutoff date for data, Austrian banks' return on assets (RoA) is expected to come to between 0.1% and 0.2%.

Improved net interest income of CESEE subsidiaries despite stagnating efficiency

CESEE Exposure Has Increased Somewhat

Austrian banks' CESEE exposure is well diversified

In mid-2011, the exposure[5] of domestically controlled banks to CESEE stood at around EUR 225 billion.[6] While this exposure remains broadly diversified, the lion's share (57.4%) was to the NMS-2004, where political risk has increased again recently (in chart 26 the size of the circles corresponds to the exposure volume).

Increase in lending by CESEE subsidiaries reflects GDP developments in the region

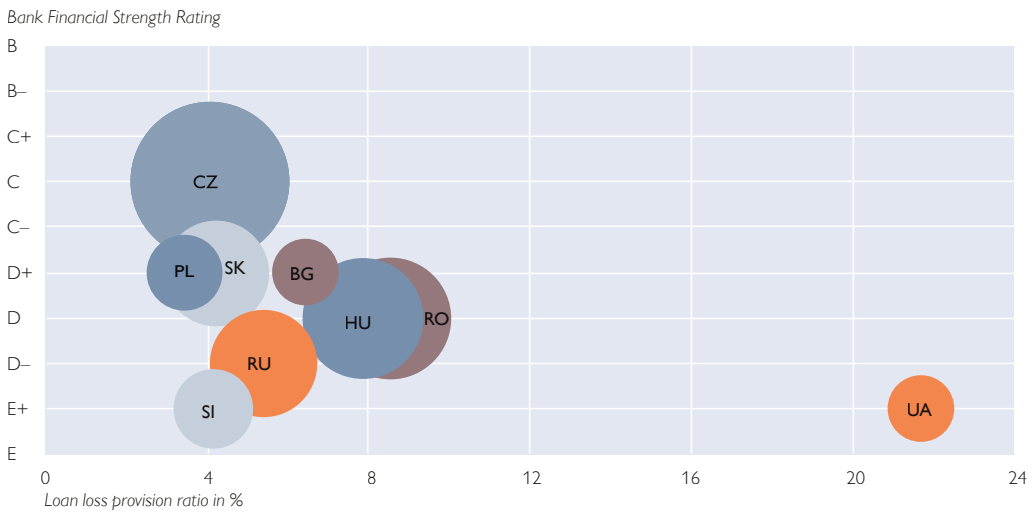
At end-June 2011, the 69 fully consolidated Austrian subsidiaries in CESEE posted total assets of around EUR 269 billion, which is a 1.5% increase year on year. During the same period, the volume of on-balance sheet loans rose by 2.8% to around EUR 173 billion, thus continuing a development that had started already at the end of 2010.

Operating income of Austrian banks' subsidiaries in CESEE was around EUR 7.0 billion at end-June 2011, which represents an increase by 5.3% year on year. Net interest income, which rose by 3.1%, accounted for the bulk of operating income. The three other items (fee-based income, trading income and other operating income) also contributed positively to operating income. Operating expenses increased more sharply (+7.0%) than operating income, which caused the cost-to-income ratio to deteriorate somewhat from end-June 2010. In the second quarter of 2011, the ratio stood at 49.0% (see chart 27).

The period profit of about EUR 1.6 billion posted by Austrian banks' CESEE subsidiaries at June 2011 again under-

Chart 26

Country Risk Exposure in CESEE



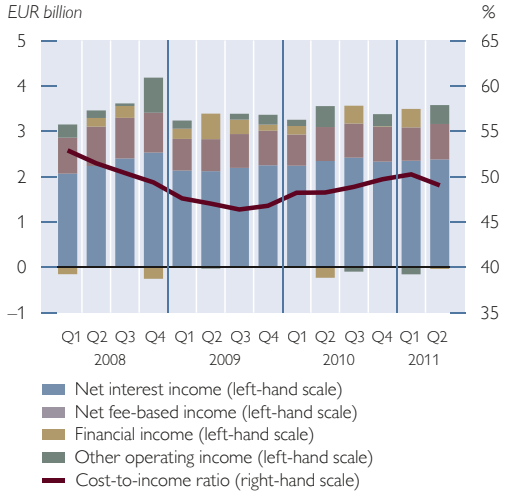
Source: OeNB (Q2 11), Moody's (November 2011).

[5] *Here, exposure refers to the exposure of majority-owned Austrian banks to credit institutions and nonbanks in CESEE.*

[6] *At the same time, these banks held customer deposits of about EUR 116 billion.*

Chart 27

Composition of CESEE Subsidiaries' Operating Income



Source: OeNB.

scored the importance that business activities in CESEE have for domestic banks. In addition, the subsidiaries' RoA after taxes, at 1.2 %, was clearly higher than the return on assets of domestic business. The same is true for the return on equity (RoE) after taxes, which, in mid-2011, was considerably higher in the Austrian banks' CESEE subsidiaries (11.2%) than in Austria (5.2%). Both indicators had increased markedly from June 2010. Compared with the unconsolidated results (which are dominated by the domestic business), Austrian banks' CESEE business is again more profitable but also entails higher credit risks. At end-June 2011, the CESEE subsidiaries' loan loss provision ratio came to 6.8%, which was more than twice as high as the unconsolidated rate (3.2%). Recent financial policy measures, e.g. the Hungarian government's intervention in foreign currency loan contracts or the introduction of a banking tax in Hungary and later in Slovakia, as well as deteriorating economic conditions are set to cause profitability in CESEE to decline in the short to medium term.

Measures to limit new foreign currency lending remain a priority for supervisors…

In spring 2010, the FMA and the OeNB published Guiding Principles to limit new foreign currency lending by Austrian banks' CESEE subsidiaries. The banks in question continued to comply with these principles in the second half of 2011, as they had done at end-2010. In a first step, the principles require banks to refrain from extending highly risky types of foreign currency loans, e.g. Swiss franc loans to unhedged households or unhedged small and medium-sized enterprises, or consumer loans denominated in euro to households with a low degree of creditworthiness. Mortgage loans denominated in euro have not been addressed so far, given that local capital markets are not yet fully developed. At the international level, the "Vienna Plus" initiative, which was launched jointly with the European Bank for Reconstruction and Development (EBRD) in March 2011 to promote the development of local currency capital markets, also issued recommendations for limiting new foreign currency lending, which are broadly consistent with those of Austria's Guiding Principles.[7] In addition, in spring 2011, the newly founded European Systemic Risk Board (ESRB) established a working group to identify the risks specific to foreign currency lending and prepare recommendations on how to handle these risks at the EU level. The recommendations were published in September 2011.[8]

Profitability of Austrian banks' CESEE business improves despite higher loan loss provision ratios

[7] *The executive summary of the report drawn up by the Local Currency and Capital Markets Working Group is available at http://www.ebrd.com/pages/news/press/2011/110408a.shtml (retrieved on November 18, 2011).*

[8] *The ESRB's recommendations are available at http://www.esrb.europa.eu/pub/pdf/recommendations/ESRB-2011-1.pdf?e669fd3a89bc20be364fb5c569f36ed7 (retrieved on November 18, 2011).*

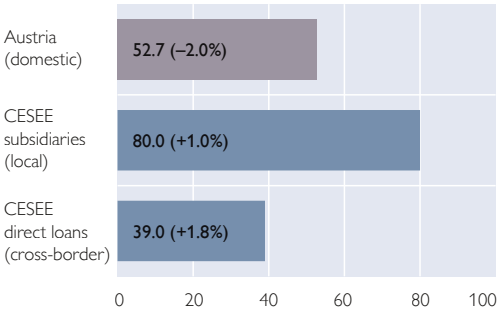
… as the stock of foreign currency loans has stagnated at a high level

Owing to regulatory measures taken by supervisory authorities in Austria and in CESEE countries, Austrian banks' subsidiaries in CESEE essentially stopped granting new loans denominated in Swiss franc. As a result, the stock of these loans declined by 5.8% in the first half of 2011 compared to six months earlier. With a volume of EUR 15.8 billion, Swiss franc loans still accounted for around one-fifth of all foreign currency loans granted by the CESEE subsidiaries of Austria's "top six"[9] banks to households and nonfinancial corporations. Overall, new foreign currency lending contracted significantly in compliance with the Guiding Principles the banks had committed themselves to. The share of foreign currency loans in total loans hence declined somewhat to 45.8%. As in the past, the euro was the dominant foreign currency, accounting for 59.4% of foreign currency loans in the region. Similar developments were observed for cross-border foreign currency loans to CESEE borrowers: As shown in chart 28, the total volume of such loans increased slightly to EUR 39.0 billion (1.8%), whereas the volume of direct loans denominated in Swiss franc declined by 7.9% to EUR 2.4 billion.

Chart 28

Austrian Banks' Foreign Currency Loan Exposure to Households and Nonfinancial Corporations

EUR billion (change on Q2 10 in %)



Source: OeNB.

Note: As at Q2 11. Growth rate adjusted for exchange rate effects.

Intragroup liquidity transfers remain significant

Credit risk still elevated due to foreign currency lending

Country-specific differences notwithstanding, in mid-2011, the credit quality of foreign currency loans was again lower than that of local currency loans in mid-2011. The nonperforming loan ratio (NPL ratio) of foreign currency loans was 17.5% on a CESEE average, and thus higher than that of total loans (14.1%), where both ratios had again increased over time. Compared with local currency loans, foreign currency loans not only became nonperforming more often but were also to a lesser extent covered by risk provisions. As regards credit claims overall, the NPL coverage ratio II[10] stood at 72.8% in June 2011; in the case of foreign currency loans, it was only 62.5%.

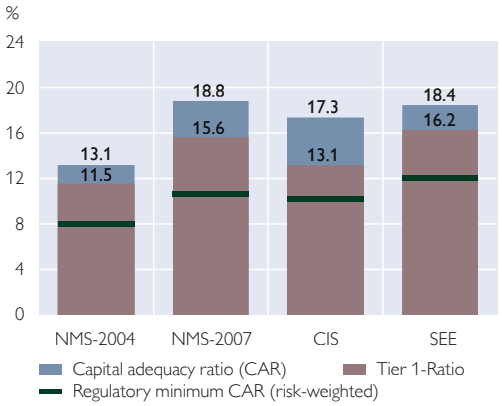
Another risk-relevant feature of Austrian banks' CESEE exposure is that intragroup liquidity transfers are of considerable importance for numerous subsidiaries. Such transfers came to EUR 48.3 billion at end-June 2011, which was reflected in a loan-to-deposit ratio (LDR) of 108.3% on average in CESEE. The results for the individual countries are highly heterogeneous, though. Low local deposit volumes can cause CESEE subsidiaries to become even more dependent on their parent banks, especially in times of crisis. The LDR has remained unchanged since the end of 2010, however, and the rise in the volume of intragroup liquidity transfers can be largely

[9] *The "top six" banks comprise Austria's six banking groups with the largest exposure to the CESEE region (in terms of external assets). Between end-2008 (when the subsidiaries' foreign currency loan exposure peaked) and mid-2011, the Swiss franc firmed by 18.7% against the euro. This alone resulted in estimated book value losses of around EUR 4.5 billion, of which 80% were related to Swiss franc loans to households.*

[10] *NPL coverage ratio II = (risk provisions on nonperforming loans + collateral according to Basel II) / NPLs.*

Chart 29

Capitalization of CESEE Subsidiaries (Q2 11)



Source: OeNB.

attributed to structural breaks in the data reported to the Central Credit Register in the first quarter of 2011.

In the first half of 2011, the CESEE subsidiaries' capital situation improved in all regions year on year. The ratios exceed the regulatory minimum requirements in all countries under review, in some of them considerably (see chart 29). This holds true both for the capital adequacy ratio and the tier 1 ratio, with the former climbing to 15.8% on CESEE average and the latter rising slightly to 13.4% as at end-June 2011. While the tier 1 ratio came to 11.5% in the NMS-2004, it was (in part markedly) higher in the three other regions (NMS-2007, CIS and SEE), reflecting higher regulatory capital minimum requirements in some countries but also elevated country risk.

Tier 1 ratio increases on a consolidated basis but still remains below European peers

While the tier 1 capital ratio of Austria's "top three" banks has increased over time (consolidated data), it still remains below the tier 1 ratio of 12 European peers which also have a sizable CESEE exposure, even though the Austrian banks have a higher exposure to CESEE (see chart 34). Therefore, the recent initiatives to raise Austrian banks' capitalization are welcome measures.

CESEE subsidiaries' capital situation continues to improve

Box 2

Austrian Supervisors Present Measures to Strengthen the Sustainability of the Business Models of Internationally Active Large Austrian Banks

In November 2011, the OeNB and the Austrian Financial Market Authority (FMA) presented a principle-based set of measures that aims at strengthening the sustainability of the business models of the three largest internationally active Austrian banking groups. The measures will be issued as supervisory guidance to the concerned banks in early 2012. The guidance is based on the following three pillars of sustainability-enhancing measures:

1. *The banking groups concerned have to further strengthen their capital base so as to improve their (long-term) risk-bearing capacity. Specifically, the Basel III rules on common equity tier 1 (CET 1) capital will be fully implemented from January 1, 2013, without making use of any transitional provisions (7% CET 1,[1] but including the participation capital subscribed under the bank support package). From January 1, 2016, these banking groups will be required to hold an additional variable CET 1 capital buffer of up to 3 percentage points, depending on the riskiness of their business model.*
2. *The foreign banking subsidiaries of the addressed banking groups must strengthen the independence and stability of their funding base in order to improve the sustainability of their future lending growth. To this end, particularly exposed foreign banking subsidiaries[2] must make sure that the volume of net new loans to nonbanks does not exceed the growth in stable funding[3] by more than 10%. This measure includes flexibility clauses for smaller subsidiaries and for exceptional circumstances.*

[1] *Effectively, this includes the 4.5% CET 1 minimum requirement and the 2.5% CET 1 capital conservation buffer.*
[2] *This requirement applies only to those subsidiaries where the ratio of loans to nonbanks to stable funding exceeds 110% in the stock.*
[3] *Including deposits from nonbanks, supranational funding, third-party capital, as well as the outstanding volume of debt securities with (original) maturities of one year or more that were issued by the subsidiaries to investors outside their consolidated banking group.*

3. The banking groups have to submit recovery and resolution plans before the end of 2012 to prepare themselves and the supervisory authorities for potential crisis situations.

This balanced set of measures aims at strengthening financial stability both in Austria and in the host countries (above all in CESEE). It will promote sustainable growth and help avoid pronounced boom-bust cycles, thus strengthening the three Austrian banking groups' conservative and retail-focused business models.

European Banks Face Funding Difficulties

Austrian banks have been affected by the very difficult liquidity situation in Europe. Since July 2011, transaction volumes have been rather low in the unsecured euro money market, the market for unsecured euro bank bonds and U.S. dollar funding markets. The respective spreads, too, are at historically high levels.

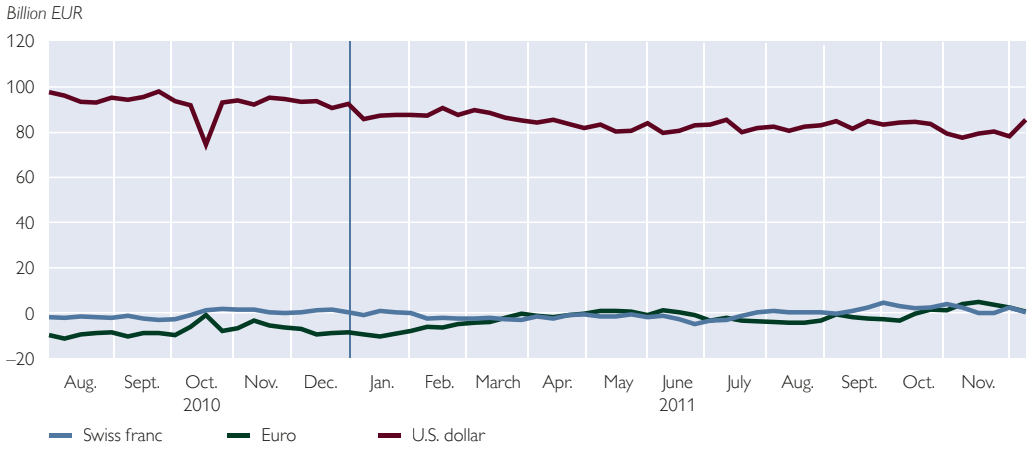
Competition for deposits

These developments can be partly attributed to the high uncertainty surrounding the European government debt crisis, the resulting change in investors' risk assessment of the banking sector and the high volatility in capital markets as well as the uncertain economic outlook. While these factors are, in principle, temporary, long-term structural changes have also played a role. As a result of the government debt crisis, the discussion about bank insolvency laws and the banks' role in restructuring Greek government bonds, investors have lost confidence in the implicit government guarantees for bank bonds. While the abolishment of the implicit government guarantee for banks is a long-term goal of international regulatory reforms, it explains the sobering situation in the market for unsecured bank bonds in the short and medium term.

In response to the turmoil in funding markets, Austrian banks substantially reduced their liquidity risks (above all for maturities of up to 1 month), stepped up the competition for deposits and lowered their funding needs. As at November 11, 2011, the aggregate net position of reporting banks in the unsecured money market was positive at around EUR 1.4 billion

Chart 30

Cumulated Counterbalancing Capacity (Up to 1 Month, Before Unsecured Money Market)



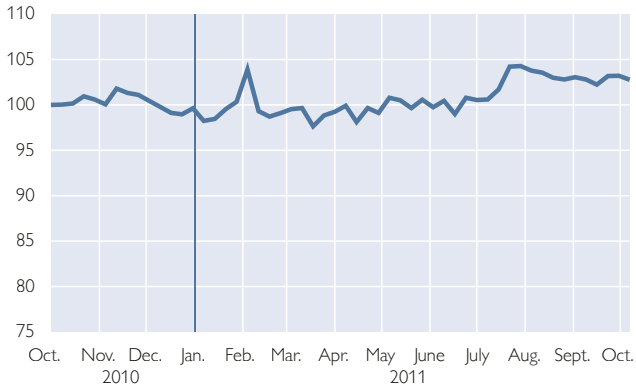
Source: OeNB.

Chart 31

Liquidity Conditions in the Austrian Banking System

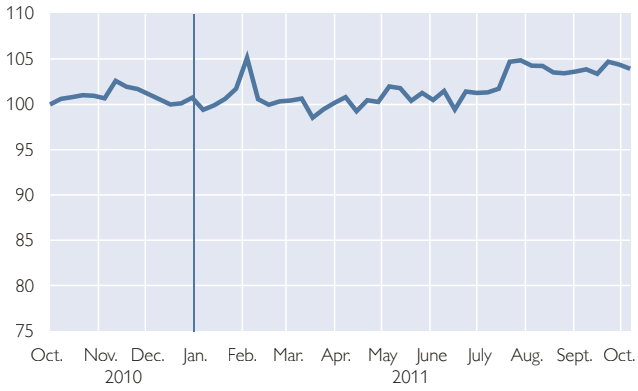
Expected Capital Inflows

Index: October 22, 2010 = 100



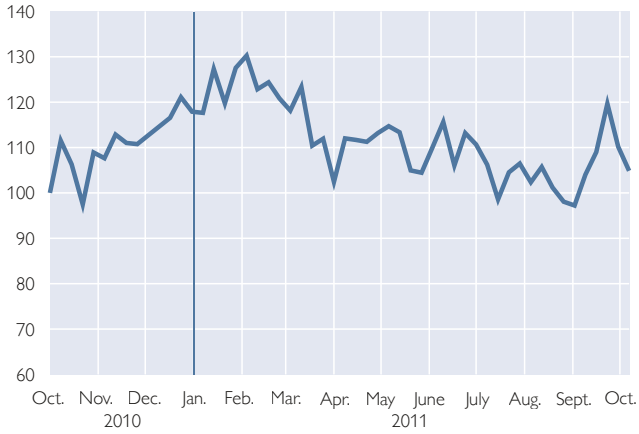
Expected Capital Outflows

Index: October 22, 2010 = 100



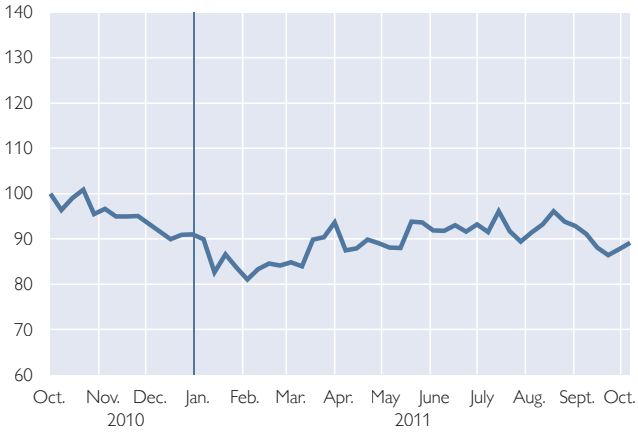
Cumulative Net Funding Gap (After 12 Months, Before Unsecured Money Market)

Index: October 22, 2010 = 100



Cumulative Additional Counterbalancing Capacity (After 12 Months, Before Unsecured Money Market)

Index: October 22, 2010 = 100



Source: OeNB.

in the maturity band of up to 1 month. The Austrian banking system's medium-term liquidity situation, too, is stable: In a simple stress test with a time horizon of 12 months, it was assumed that both the unsecured money markets and the foreign currency swap markets would dry up completely and that wholesale and retail deposits would decline by almost 10%. In addition, it was assumed that only around 50% of the long-term debt securities issued could be rolled over. Under these assumptions, the Austrian banks' cumulated counterbalancing capacity (liquidity buffer across all currencies) was still almost EUR 83 billion after 12 months. The liquidity buffers in the most important foreign currencies, U.S. dollars and Swiss francs, were satisfactory in the maturity band of up to 1 month, despite the assumption that all foreign currency swaps would be discontinued. In response to the tensions in U.S. dollar funding markets that emerged in Europe in August 2011, Austrian banks built up additional liquidity buffers in U.S. dollars. As a result, the banks' cumulated counterbalancing capacity has been positive both in the short-term

band (EUR 2.8 billion, maturities of up to 1 month) and in the longer-term band (EUR 2.0 billion, maturities of up to 12 months) since September 2011, which is a first since the introduction of liquidity reporting in Austria.

This means that banks currently need to focus on restoring investor confidence in unsecured bank bonds by raising capital ratios (in line with the EU decisions of October 26, 2011, among other things), increasing liquidity buffers as well as improving transparency. These steps – in combination with the implementation of new liquidity standards (the liquidity coverage ratio, LCR, and the net stable funding ratio, NSFR) through amendments to the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) – will ensure more economically adequate pricing of liquidity (risk) and of bank loans. As a result, the allocation of capital in Austria will become more efficient, as investment projects that only generated a positive net cash value because the cost of loans was too low and because interest margins were too low to cover liquidity risk costs will be no longer be realized. New pricing of bank bonds in the long run will therefore prompt changes in banks' business models and in the financing choice of large companies. A rising number of companies will obtain funding from capital markets; in Austria, this trend is limited, though, given the large share of SMEs.

Box 3

The Role of Short-Term Wholesale Funding for Austrian Banks

During the financial crisis, the strong and opaque connections between banks proved to be one of the major problems for counterparties, investors and supervisors in assessing the risks of credit institutions and the entire banking system. The increased build-up of short-term interbank liabilities played a crucial role in some international banks' rapid total asset growth, which in turn contributed to contagion effects when confidence was dwindling in the interbank market after the onset of the crisis. In 2008, investment banks like Bear Stearns and Lehman Brothers were hit particularly hard: Within just a few days, they were cut off from interbank funding sources. The severe liquidity crunch resulted in the takeover of Bear Stearns by another bank, while Lehman Brothers had to file for bankruptcy protection. These events quickly affected other financial institutions and money market funds and drastically intensified the financial crisis; the effects of which are still reverberating around the world.

The analysis of the importance of short-term wholesale funding for Austrian banks is based on financial accounts data adjusted for certain structural features of the Austrian banking system. Specifically, the data on decentralized sectors and their multiple tiers artificially inflate the share of their wholesale funding; a distortion, which needs to be addressed. Therefore, only deposits and debt securities with short maturities[1] held in the interbank market, but which were not held in the same multi-tiered sector,[2] were counted toward short-term wholesale funding instruments.[3] At end-June 2011, these types of funding accounted for around 8% of Austrian banks' total financial liabilities (excluding equity capital), which is roughly the same share as the one recorded at the end of 2007. Including cross-border interbank deposits (also by a bank's own foreign subsidiaries or branch offices), the share came to 17.4% at the end of June 2011. Even though the available data on linkages to foreign interbank market participants is thus less granular and includes intragroup transactions, these results highlight the relatively low importance of volatile, short-term wholesale funding in the refinancing of Austrian banks (also because the role of investment banking is rather insignificant for them).

[1] *With original maturities of up to 12 months.*
[2] *Transactions within the same multi-tiered sector are not considered wholesale funding.*
[3] *Unfortunately, the supervisory statistics do not include data on the maturity of deposits. Therefore, all deposits were included, as they were assumed to be of a short term nature.*

Capital Adequacy Continues to Improve in 2011

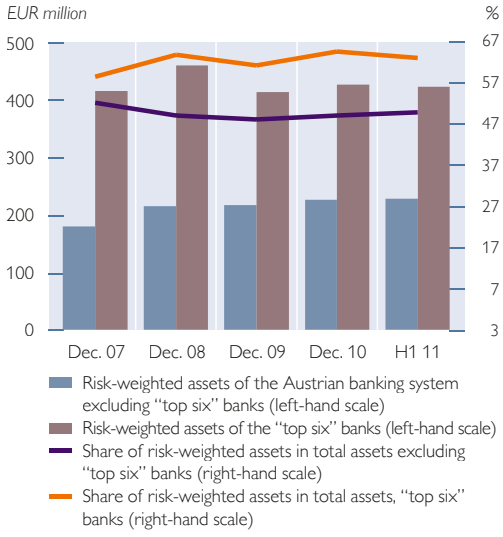
After its low in the third quarter of 2008, the aggregate tier 1 capital ratio (capital adequacy ratio) of all Austrian banks rose continually, gaining around 300 (303) basis points to 10.3% (13.5%) in the second quarter of 2011. The increase in the aggregate tier 1 capital ratio was essentially traceable to two factors:

First, the volume of eligible tier 1 capital grew by 34% from the third quarter of 2008, reflecting government measures under the bank rescue package worth EUR 6.1 billion as well as internal capital increases (private placements, capital injections from the parent group, retained earnings and other measures) in the amount of EUR 10.9 billion.

Second, banks sharply reduced risk-weighted assets until the fourth quarter of 2009 (see chart 32), which can be considered a direct response to the financial crisis. This reduction was mainly achieved by balance sheet streamlining, but also e.g. by lowering new lending and cutting off-balance sheet activities. While risk-weighted assets were still on the rise in 2010 (+2.9% compared with end-2009), they declined slightly by 0.7% until mid-2011.

Chart 32

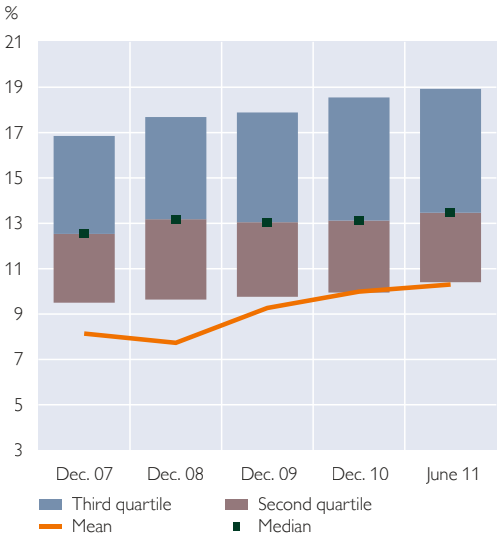
Risk-Weighted Assets at Austrian Banks



Source: OeNB.

Chart 33

Development of Aggregate Tier 1 Capital Ratio of Austrian Banks



Source: OeNB.

Capitalization of large banks remains below average

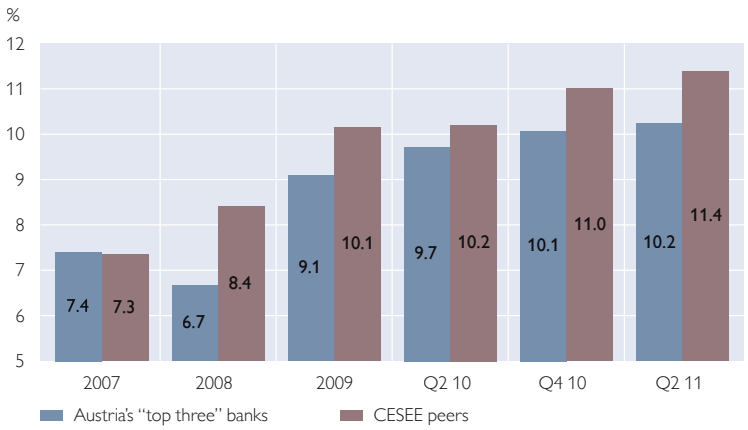
At the end of June 2011, the median tier 1 capital ratio of all Austrian banks was 13.5% and thus above the aggregate average (see chart 33). The difference between the two metrics results from the structure of the domestic banking system, which features a large number of small regional banks with above-average capitalization alongside the dominant large banks. Half of all Austrian banks (the second and third quartile) post tier 1 capital ratios between 10.4% and 18.9%.

The aggregate tier 1 capital ratio, i.e. the mean ratio weighted by RWA,[11] is dominated by the country's "top six"

[11] *RWA: Risk-weighted assets.*

Chart 34

Tier 1 Capital Ratios of Austrian Major Banks with a CESEE Focus



Source: OeNB.

Further capital increases required

banks. An international comparison of tier 1 capital ratios shows, however, that the Austrian major banks (9.8% on average) are less adequately capitalized than their international peers[12] (11.4% on average)(see chart 34).

Even though the major Austrian banks improved their tier 1 capital ratios in recent years, the gap between them and their peers has ultimately widened, as the latter strengthened their ratios even more than the Austrian banks did. This gap between the "top six" Austrian banks and their peers widened from 1.1 percentage points in 2009 to 1.6 percentage points as at June 30, 2011.

Austrian banks are well advised to further increase their capital ratios in light of the facts outlined above, the change in the credit cycle, higher capitalization requirements due to current regulatory plans and crisis measures at the European level.

Box 4

Does Excessive Deleveraging Counteract the Advantages of Recapitalizing European Banks?

At the Euro Summit on October 26, 2011, the European Council agreed on a comprehensive set of measures to address the deepening sovereign debt crisis in the euro area. This set of measures consists of three pillars: 1) the expanded European Financial Stability Facility (EFSF) for market interventions and as a backstop for bank recapitalization, 2) the refinancing guarantees for banks, and 3) the plan to improve the quality and quantity of the large cross-border banks' capital.[1] These measures are aimed at breaking the vicious circle of the banking and sovereigndebt crisis. However, critics fear that the banks will meet the higher capital requirements by resorting to excessive deleveraging, i.e. by reducing borrowed capital while at the same time reducing their assets. Such measures could cause the growth rate of lending to the real economy to contract.[2] This, in turn, would present companies – above all, small and

[1] *See the Euro Summit Statement of October 26, 2011 (item 17 and Annex 2).*
[2] *See the Bank of England's Financial Stability Report, issue no. 30 of December 2011 and the IIF Policy Letter to the Group of Twenty Summit in Cannes of November 2011.*

[12] *This group comprises the following banks that are active in the CESEE region: Banco Santander S.A., Bayerische Landesbank, Commerzbank AG, ING Bank N.V., Intesa Sanpaolo, KBC Bank N.V., National Bank of Greece S.A., OTP Bank Plc., Skandinaviska Enskilda Banken AB, Société Générale, Swedbank AB.*

medium-sized companies – with refinancing problems. If companies cannot refinance themselves, they will default on loans – and this would weaken banks even more.

Reduction of Excessive Debt and Balance Sheet Repair

In the past, the OeNB welcomed the moderate deleveraging process that Austrian banks had embarked on from 2008;[3] in fact, lending to nonfinancial corporations and households is in fact low, representing only just over 60% and only 50%, respectively, of the aggregate total assets of Austrian or European large banks.[4] Thus banks definitely have the scope to reduce the size of their balance sheets without endangering the level of lending to the real economy. Deleveraging could operate through the reduction of interbank positions and securities in the trading book, or through the reduction of unsecured consumer lending without affecting the refinancing of nonfinancial corporations. The most recent monthly data on new and outstanding loans confirms this development, at least in Austria: the annual growth rate of lending to companies stood at 2.2% in the third quarter of 2011, the highest value in nearly two years. Even the sale of credit exposures, e.g. in Asia[5] or, as some banks announced, in Europe as well, merely led to a transfer of assets that in the end has no impact on the refinancing of the real economy.

In Europe, too, the economic crisis was partly triggered by excessive lending at interest rates that were too low, e.g. lending for projects that only apparently had a high net cash value, because the interest margins were too low to cover risk costs. If the banks had taken realistic risk costs into account and had extended such loans at higher rates of interest, many of these projects would have had a negative cash value. Hence, implementing these projects was inefficient and resulted in a misallocation of capital. Consequently, high lending growth at low rates of interest did not contribute to sustainable growth, but to excess capacities and excessive debt in particular sectors, such as the construction industry in Spain or Ireland, and to excessive household debt. In the case of lending to households, banks imported capital that was not invested productively but that was rather allocated to consumer lending, contributing to persistent current account deficits.[6] The subsequent orderly deleveraging becomes apparent in the decrease in loan demand resulting from the ample availability of funding of individual sectors. Therefore, deleveraging as an economic policy goal is to be considered a contribution to structural adjustment and to the long-term stability of the real economy. Numerous large nonfinancial corporations are currently finding it cheaper than banks are to refinance themselves in the money and capital markets. This circumstance is partly attributable of the current crisis, but partly, it also has long-term structural causes, such as the implementation of bank insolvency law that has done away with the implicit government guarantee for loans. With interest rates so low, nonfinancial corporations now have the chance to seek funding directly in the market, and banks have the chance to expand their lending to small and medium-sized enterprises.

The deterioration of average credit quality in many European banks' lending books was also a sign of capital misallocation. As annual lending is significantly lower than the amounts of credit outstanding, the average quality of new loans must be substantially higher than that of loan stock for average credit quality to improve. The need to shore up average credit quality explains why lending standards have been tightening since 2008.[7]

All of these deficiencies have become all the more apparent in European banks' tightening refinancing conditions since mid-2011: Investor trust in European banks has dwindled in light of the European sovereign debt crisis and the steadily worsening economic outlook. As a large volume of unsecured bonds will have to be refinanced in 2012, the tight refinancing conditions in Europe could in fact result in excessive deleveraging. Restoring confidence and thus

[3] *See e.g. the OeNB's Financial Stability Report 21 of June 2011 (p. 37).*
[4] *Based on data published within the framework of the stress test conducted by the EBA in 2011, on- and off-balance sheet exposures excluding commercial real estate.*
[5] *See e.g. press release 0357 of Austria Presse Agentur (APA) of December 2, 2011.*
[6] *Bergin, P. (2011). Asset price booms and current account deficits. FRBSF Economic Letter 37, December 5.*
[7] *See the Eurosystem's bank lending survey of October 2011.*

securing access to the bond markets is the very purpose of bank recapitalization, along with improving the quality of loans in banks' portfolios. Until now, the deleveraging process has been a gradual and sensible one by economic policy standards and has been warranted from the real economy perspective. In the next few months, it will also be important that this deleveraging process does not accelerate too fast, considering that the new capital standards will already apply mid-2012.

Overall, the advantages of recapitalizing European banks outweigh the potential negative repercussions: Without recapitalization, there would be a lack of funding, which could result in even greater deleveraging by banks.

Market Assessment of Austrian Financial Institutions Worsens Markedly

As the euro area government debt crisis intensified, the external assessment of Austria's credit institutions deteriorated markedly in line with overall market developments of European financial stocks. The stock prices of listed Austrian banks declined sharply from August 2011, thus losing most of the ground they had gained since March 2009.

The favorable market assessment observed in the first half of 2011 reflected above all the comparatively low exposure of Austrian banks to euro area countries with an IMF/EU program as well as the fact that growth rates in CESEE were higher than in Western Europe. Given the negative market sentiment about countries and banks in the euro area, contagion effects increasingly spread to financial markets in CESEE in the second half of 2011, affecting also their growth outlooks. The materialization of country-specific political risks in CESEE – like the massive devaluation in Belarus or the Hungarian government's measures addressing foreign currency lending – was another factor that put pressure on Austrian banks.

Lower profit expectations impact market assessment

In addition, price-to-book value ratios have declined to below 1, which implies a negative market assessment of the outlook for Austrian financial institutions. The market assessment of Austrian banks' stocks thus worsened with a small delay after that of other European financial stocks. Listed Austrian banks are particularly affected by this development, as their capital adequacy is below average both in terms of quantity and quality, and the changed sentiment makes it harder for them to improve their risk-bearing capacity through the market. This goes to show that windows of opportunity – when market conditions are favorable – should be used when they occur. An improvement in Austrian banks' capital adequacy would also have a positive impact on their stand-alone ratings (without government support).

The Market Environment for Other Financial Intermediaries Deteriorates

European Insurance Industry Faces Challenges

While the European insurance industry coped relatively well with the financial crisis of 2008 and 2009, it is facing substantial challenges owing to the government debt crisis and the low interest rate level. The assets of insurance companies, which are significant investors, have taken a hit as a result of falling government bond, bank bond and stock prices. Premium growth can be expected to stagnate, given the lower growth forecasts for Europe.

In the first half of 2011, premium growth in the Austrian insurance sec-

tor declined by 7.6% year on year, which was mainly ascribable to a sharp decrease in single-premium life insurance payments (–33%), which, in turn, can be explained by a change in tax treatment. Divergent developments were observed in the other indicators: The industry's return on investment climbed to 4.7%, up by 0.7 percentage points year on year, reflecting quite favorable financial market developments in the first half of 2011 and the slight rise in the interest rate level. In the second quarter of 2011, the expense ratio came to 21.3%, up by 1.4 percentage points year on year, while the claims ratio was 73.7%, which is an increase by 6.1 percentage points year on year. In light of the marked deterioration in financial markets in the second half of the year, expectations are low regarding the annual result for 2011.

The OeNB's securities holdings statistics, which comprises all securities holdings by Austrian insurance companies (including unit- and index-linked life insurance plans), show that domestic insurers held securities worth EUR 72.8 billion in the second quarter of 2011. Government bonds[13] accounted for EUR 17 billion of this sum, while securities of domestic and foreign banks accounted for EUR 32.8 billion. Austrian insurance companies had an exposure of EUR 6.7 billion[14] to countries with higher risk premiums (Greece, Ireland, Italy, Portugal and Spain), with investments in government bonds coming to EUR 2.6 billion and investments in bank bonds amounting to EUR 2.5 billion.

Government debt crisis creates challenges for the insurance industry

The main risks for the Austrian insurance industry are the potential intensification of the sovereign debt crisis and a prolonged period of low interest and yield levels (for products with a guaranteed minimum yield). An analysis of the specific risks of Austrian insurance companies in CESEE is provided in "The Austrian Insurance Industry in CESEE: Risks and Opportunities from a Financial Stability Point of View"[15].

Mutual Funds Post Price Losses

Mutual fund assets decline

In August 2011, total assets under management in Austrian mutual funds came to EUR 140.8 billion, down by almost 5% since the beginning of the year. This decline was above all due to price losses. Performance decreased markedly across all asset classes, and the share of specialized funds (institutional investors) continued to increase. Private investors remained cautious in light of uncertainty in financial markets, and tended to invest in products that offer deposit guarantees. The imminent implementation of UCITS IV[16] is another step toward harmonizing the mutual funds industry at the European level, which is expected to lead to a consolidation of mutual funds in Austria in the medium term.

Insurance companies hold significant investments in bank and government bonds

[13] *Including securities issued by provincial and municipal governments.*

[14] *Spain: EUR 1.9 billion, Greece: EUR 0.4 billion, Italy: EUR 2.6 billion, Ireland: EUR 1.5 billion, Portugal: EUR 0.3 billion.*

[15] *See the studies section of this issue.*

[16] *Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).*

Box 5

Exchange-Traded Funds (ETFs)

ETFs are mutual funds that are traded on stock exchanges and are usually managed passively. Because they are exchange traded, ETFs are considered more liquid than shares of other mutual funds; another perceived advantage is that they can be valued at any time and that their passive investment style is keeping their management costs low. To date, ETFs have attracted around USD 1,200 billion in worldwide investor assets; around two-thirds of which were sold in the U.S.A. The European market is still relatively small, but is expanding rapidly, with growth rates of around 40% p.a. over the past ten years. Market concentration is high, as six ETF sponsors dominate around 80% of the market.[1]

There are different types of ETFs: physical ("plain vanilla") and synthetic. While physical ETFs replicate an index by actually purchasing and holding its constituents, synthetic ETFs are essentially a promise to deliver an index return by entering into a swap contract with an investment bank. The ETF sponsor pays the investment bank a fee in cash and in return receives collateral assets that are not necessarily connected to the index the ETF tries to replicate. The ETF sponsor then enters a total return swap with the investment bank, in which the returns on the collateral assets are swapped for the returns of the reference index. While synthetic replication helps reduce transactions costs incurred with physical ETFs and minimizes the tracking error, it entails the following substantial risks:

- *Synthetic ETFs involve a high counterparty credit risk. The ETF sponsor pays the investment bank in cash and in return receives potentially illiquid collateral assets that are not necessarily connected to the reference index. Therefore, if the swap counterparty defaults, the collateral may not deliver the promised index return.*
- *Especially when the market environment is difficult and large outflows are recorded from ETFs, this source of investment banks' funding may dry up, which may have a negative impact on investment banks' liquidity situation.*
- *The impact of ETF trading on the market, especially in connection with high frequency trading, must not be underestimated. ETFs can have a strong influence on the liquidity of individual assets, and the assumed liquidity can dry up quickly under stressed market conditions.*

While physical ETFs are in general solid products, credit risk can be considerable too, given the potentially very high share of securities lending (up to 80%).[2]

ETF structures are evolving constantly, and the complexity of new products is growing (e.g. leveraged ETFs, inverse ETFs and inverse leveraged ETFs). In these market segments, sound risk assessment is difficult for both investors and regulators.

The risks of synthetic ETFs have already been highlighted by the Bank for International Settlements, the International Monetary Fund and the Financial Stability Board, among others. The European Securities and Markets Authority published a Discussion Paper that calls for stricter regulations of ETFs in Europe. The paper addresses above all the following issues: introducing limitations on the distribution of synthetic ETFs to retail investors, requiring ETFs to provide information about the quality and amount of collateral posted, regulating the terms and amount of securities lending more stringently, reducing the use of strategy indices, and implementing other transparency-increasing measures.

[1] *The ETF sponsor is the company that sets up and manages the ETF.*
[2] *The maximum percentage share depends on local legislation.*

Pension Funds and Severance Funds Face Persisting Challenges

Severance funds and pension funds post a worse performance

At end-June 2011, total assets under management in Austrian pension funds came to EUR 14.6 billion, which represents a decline by 2.7% since the beginning of the year. In 2011, unfavorable financial market developments weighed on the investment performance of Austrian pension funds, which declined by 3.9% in the first three-quarters of the year according to the Oester-

reichische Kontrollbank. The annual result for 2011 will reflect this trend, as financial markets tensions are persisting, and total assets invested by pension funds will decline or stagnate despite continued inflows. The exposure of Austrian pension funds to countries with higher risk premiums (Greece, Ireland, Italy, Portugal and Spain) was around EUR 1.1 billion, with Italy accounting for more than one-half of this sum and Greece accounting for EUR 50 million.[17]

The number of pension funds in Austria will drop from 17 to 16 in 2012. The Austrian Federal Economic Chamber plans to outsource its own single-employer occupational pension fund to a multi-employer occupational pension fund; in addition, it will have to make an additional payment of between EUR 88 million and EUR 108 million.[18] Structural issues make it necessary to completely overhaul Austria's pension fund legislation; a bill to amend the legislation has already been[19] drawn up. The amendment provides for more competition, the right of prospective beneficiaries to select from among a variety of investment strategies, safety from insolvency and from creditors because the contributions are put into an investment and risk-sharing group, a guaranteed initial pension and a strengthening of the right to information. Furthermore, the Company Pension Act is to be amended: The vesting period (period after which employees become entitled to pension benefits) will be reduced, and employees will be given the option of switching from one system to another. From the financial stability perspective, these measures are to be rated as positive. However, the amendment should also address problems with the incentive structure in managing pension funds.

Severance funds again posted significant asset growth, as they are still being built up. At the end of the second quarter of 2011, the sum total of accrued severance benefits came to EUR 3.9 billion, which is an increase by 23% compared to one year earlier. No investment performance data are available during the year, but the annual results for severance funds, too, are expected to be modest, given tensions in financial markets. According to the OeNB's securities holdings statistics, EUR 266 million of the total assets managed by severance funds were invested in Greece, Ireland, Italy, Portugal and Spain in the second quarter of 2011, with Greece accounting for a mere EUR 7.6 million.

The risks involved are primarily associated with persistent uncertainty in financial markets, the increased sovereign risk (given that government bonds account for some 34% of the total assets held by Austrian pension funds and for around 23% of the total assets held by severance funds), the risk of contagion spreading from banks and other financial corporations to the insurance industry as well as operational risk.

[17] *90% of the total assets invested by pension funds are managed indirectly via mutual funds. The OeNB's securities holdings statistics allows filtering at the single security level.*

[18] *See the article „Sanierung der Pensionskasse kostet 108 Millionen" at derStandard.at on November 23, 2011 http://derstandard.at/1319183607596/Wirtschaftkammer-Sanierung-der-Pensionskasse-kostet-108-Millionen (retrieved on November 23, 2011).*

[19] *Schmitz, S.W. 2005. Die Governance-Struktur der Pensionskassen in Österreich und ihre polit-ökonomischen Konsequenzen. In: Wirtschaft und Gesellschaft vol. 31(3). 407–443.*