Austrian financial intermediaries: banks post strong profits but weaker operating results in 2016

Structural reforms continue

In an environment of low economic growth in Europe and political uncertainty in several regions in the world, Austrian banks continued their structural adjustment process to increase efficiency and to remain competitive over the long-term. The restructuring of UniCredit Bank Austria AG, the merger of Raiffeisen Zentralbank Österreich AG and Raiffeisen Bank International AG, and the further consolidation among Volksbank credit cooperatives are the most prominent examples.[1]

In 2016, the Austrian banking sector generated a consolidated net profit of EUR 5 billion. This corresponds to a 5% decline year on year, which was, however, driven by the restructuring of UniCredit Bank Austria AG. Adjusted for this effect, profits increased by nearly 13% year on year. The return on average assets came to 0.6% and the return on average equity was around 8%. Results had been propelled by significantly lower risk provisioning, however, and boosting profitability by lowering risk costs is not a viable long-term solution to restore weakening operating profits. Since 2009, the share of operating profits in average assets has tended to decline, indicating weaker operating efficiency.

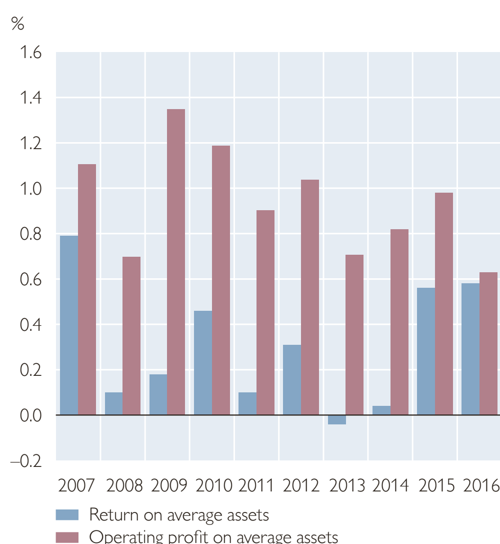
Profitability improved due to reductions in risk provisioning

In the following paragraphs, the results of UniCredit Bank Austria AG are excluded from the discussion, as the restructuring effect would distort data comparability and economic validity. Since 2014, the recovery of profitability has been driven by a significant reduction in risk provisioning. In 2016, credit risk provisions declined by 63% year on year and by more than 80% against 2014. Credit risk costs for some portfolios are even below pre-crisis levels.

Austrian banks' consolidated operating profit decreased by 16% in 2016, due to weakened operating income (–4%) and rising operating expenses (+3%). As a consequence of smaller business volumes and the low interest rate environment, interest expenses declined by 11% and interest income by 6%, which in turn reduced net interest income by 3%. Despite positive financial market developments and the firming economic recovery in Austrian

Chart 19

Profitability of the Austrian banking sector



Source: OeNB, consolidated data.

[1] *For more information on these restructuring measures, please refer to box 1. The restructuring of UniCredit Bank Austria AG is particularly important for analyzing the year 2016, as ownership of the bank's CESEE subsidiaries was transferred to the parent bank in Italy. For the Austrian banking sector, this move resulted in a strong year-on-year decline in absolute consolidated and (subconsolidated) CESEE figures and in changes to the related financial ratios.*

banks' core markets, fee and commission income declined slightly by 2%. This shows how complex it is to compensate lower interest income by higher fee and commission income. On the positive side, trading income went up markedly against the previous year. But given Austrian banks' retail banking model, trading income plays a minor role in terms of profit contribution and was not able to offset negative developments in the other income categories.

Operating expenses increased by 3%, driven mainly by higher write-downs (+16%) – in particular on subsidiaries, joint ventures and associated companies – and a 2% rise in staff costs, while general administrative expenses declined slightly by 0.4%. In addition, banks have been paying into funds for deposit insurance and bank resolution since 2015 to help increase the stability of the banking system. Moreover, the Austrian bank levy has been reduced to around EUR 100 million as of 2017, after having come to EUR 640 million in previous years. As a prerequisite, banks have to make an advance payment of EUR 1 billion (either by making a bullet payment or by spreading payments over four years), which will be used for education and research initiatives.

All in all, the Austrian banking sector's consolidated cost-to-income ratio (CIR) deteriorated to 67% in 2016 from 63% a year earlier.[2] Although Austrian banks benefit from the higher cost efficiency of their CESEE subsidiaries (CIR: 53%), they are still burdened by lower efficiency in the domestic market and thus continue their cost-cutting efforts. At EU level, the average CIR of the banking sector stood at 66% at end-2016.[3]

Consolidation process continues

For the Austrian banking system, the adjustment process gathered pace in 2016, as reflected in a number of indicators. The total number of credit institutions in Austria declined to 672 (from 738 at end-2015, or down 22% against 2008 figures), driven by the consolidation in the cooperative banking sectors. The total number of branches decreased by 4% to 3,926 (i.e. to their 1995 level), which marks an acceleration in the downsizing of the branch network. Also, the number of bank employees in Austria declined further to 74,543 (–0.7%), the lowest level since 1995.[4] As in previous years, this reduction was below the EU average (–1.4%).[5] Since the outbreak of the financial crisis in 2008, when banking sector employment had peaked, the number of bank employees in Austria decreased by 7.2% (compared with a 14% decrease in bank employee numbers across the EU).

However, headcount figures alone do not reflect the increase in part-time employment in the banking sector, which continued in 2016 while the number of full-time jobs decreased for the fifth year in a row. By end-2016, more than one-quarter (29%) of bank employees were employed part-time, which means the part-time ratio in the banking sector was almost as high as in the overall economy (30%). The Austrian banking sector's share in total employment has been steadily declining since the onset of the crisis. At end-2016, the banking sector accounted for

[2] *Not adjusted for write-downs on subsidiaries, joint ventures and associated companies, Austrian banks' CIR worsened to 74%, up from 63% in 2016.*

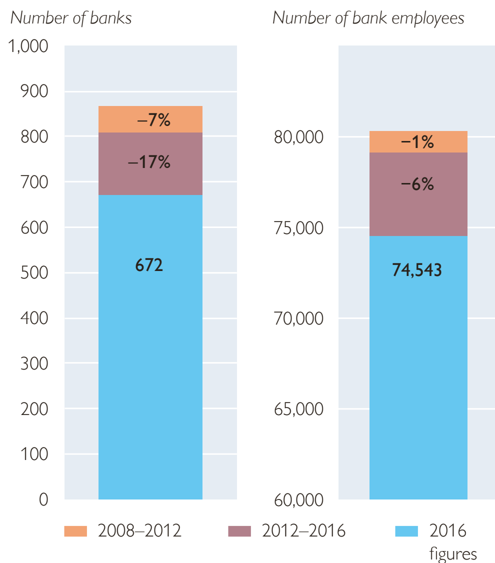
[3] *Source: ECB, consolidated banking statistics.*

[4] *Headcount.*

[5] *Source: ECB preliminary data.*

Chart 20

Structural developments in the Austrian banking sector



Source: OeNB.

1.9% of all employed persons in Austria (0.3 percentage points less than in 2008).

The consolidated total assets of the Austrian banking sector, which had stood at EUR 1,176 billion in 2008, when the crisis began, and came to EUR 1,057 billion in 2015, decreased by 20% to EUR 946 billion at end-December 2016, which corresponds to 270% of GDP. The decline recorded in 2016 was primarily driven by the restructuring of UniCredit Bank Austria AG. The sector's foreign exposure, especially to the CESEE region, was markedly reduced, but claims against CESEE still account for more than half of Austrian banks' total foreign claims. Within the CESEE region, exposures against EU countries gained further importance (e.g. Czech Republic, Hungary and Romania), while exposures to e.g. Russia and Turkey declined.

Banks' subsidiaries in CESEE further reduced risk provisioning

The profitability of Austrian banks' subsidiaries in CESEE improved in 2016 as their aggregated net profit increased to EUR 2.4 billion (+15% year on year) – this is the highest reading since 2008 despite the fact that results no longer include those of subsidiaries of UniCredit Bank Austria AG.[6] This rise in aggregated net profit mainly resulted from a further decline in loan loss provisions. Loan loss provisions reached levels unseen since 2007, which leaves limited room for further reductions of loan loss provisions in the region.

In 2016, the highest profit came from banks' subsidiaries in the Czech Republic, Slovakia and Russia. While the net results of subsidiaries in the Czech Republic and Slovakia increased further, operations by subsidiaries in Croatia, Hungary and Ukraine were positive again after losses in 2015. The profits of Austrian banks' subsidiaries in Russia declined slightly as a result of higher loan loss provisions.

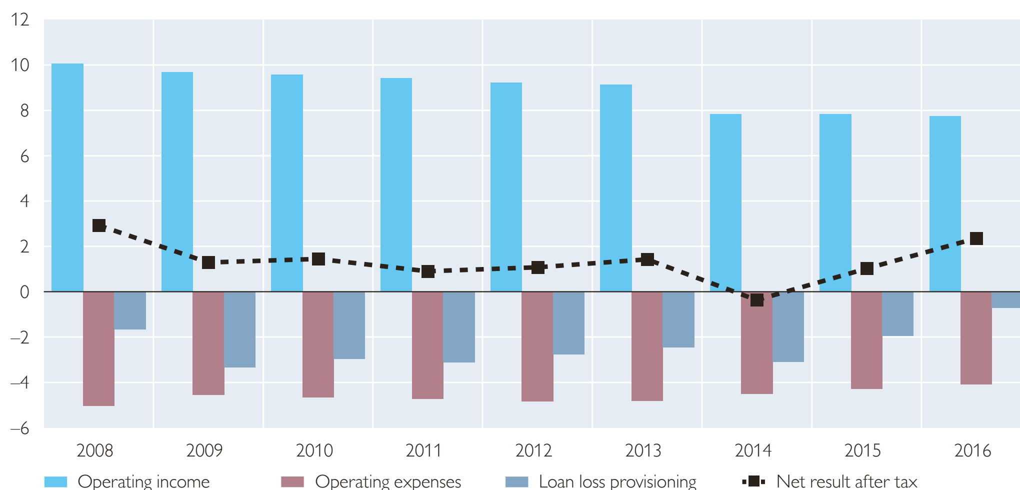
Austrian banks' CESEE subsidiaries recorded a reduction in net interest income by EUR 0.4 billion (–6%) to EUR 5.1 billion in 2016. Declines in this important source of income were rather widespread and especially pronounced in Croatia and Russia, and could not be offset by stronger credit growth in the Czech Republic and Slovakia. The second most important income component, which is fee and commission income, weakened by 6% year on year. The composition of operating income has remained almost unchanged in recent years, with net interest income accounting for around two-thirds of operating income. The total operating income of Austrian banks'

[6] *From October 2016 onward, figures no longer include data on UniCredit Bank Austria AG's subsidiaries. Thus, year-on-year and long-term changes have been adjusted for one-off effects driven by UniCredit Bank Austria AG's restructuring. See footnote 1 and box 1 for further details.*

Chart 21

Profitability of Austrian banks' CESEE subsidiaries

EUR billion



Source: OeNB.

Note: Figures exclude UniCredit Bank Austria AG.

Weaker operating profits in banks' domestic business

subsidiaries in CESEE decreased by 1% against 2016. At the same time, operating expenses shrank by 5%. As a result, net operating profit amounted to EUR 3.7 billion, which corresponds to a 3% increase. Operating efficiency continued to be high with a cost-to-income ratio of 53%; this ratio has remained within a range of between 47% and 57% since 2008.

Overall, Austrian banks' operations in CESEE have been a key contributor to their consolidated profitability and continue to offset their relatively weak profitability in the domestic market. Moreover, in the current low interest rate environment in Western Europe, banks' CESEE operations act as a buffer against interest income pressures, as interest margins in CESEE are still above Western European averages.

Operating profits in Austrian banks' domestic business dropped by nearly 23% in 2016, driven by substantially lower income and only a slight reduction in expenses. Nevertheless, owing to a plunge in risk provisioning, unconsolidated profits increased by 19% against the previous year, coming to EUR 4.4 billion. In the first quarter of 2017, Austrian banks' operating income declined further. However, as operating expenses also went down (at an even stronger pace), operating profits improved by around one-quarter. After having reduced risk provisions significantly in 2016, Austrian banks slightly stepped up their unconsolidated risk provisioning in the first quarter of 2017.

Box 1

Banking sector restructuring in Austria – actions, impact and the supervisor's role

Just like the entire European banking sector, the Austrian banking sector faces significant cost pressure, most notably resulting from exogenous factors such as the low interest rate environment in the euro area and growing investment pressure arising from the continuous trend toward the digitalization of banking services. The majority of Austrian credit institutions have already launched individual efficiency programs and/or conducted selective asset sales to cut costs. Cost-oriented efficiency measures such as staff and branch reductions or the refocusing on core business lines have been pursued. But widespread initiatives to compensate lower interest income by higher provision income or a rise in (domestic) business volumes have not yet fully materialized throughout the system.

Thus, some credit institutions decided to undergo additional and sometimes deep organizational changes to cut structural costs, make use of further synergies and adapt organizational structures to modified business models and regulatory needs. Here are a few prominent examples:

- *The Volksbanken-Verbund has undergone several restructuring steps since 2009. In 2015, for example, the non-core part of its business was split off into a wind-down vehicle. The remaining entities committed to a strict merger plan, reducing more than 50 independent credit institutions to fit into a target structure of eight regional banks and one specialized institution.*
- *Raiffeisen Bank International (RBI) and Raiffeisen Zentralbank (RZB): After major reductions in risk-weighted assets, the RBI and RZB merged to simplify their organizational structure, improve their capital basis (via the regulatory treatment of minority interests) and strengthen their cost basis.*
- *UniCredit Bank Austria AG: Following a fundamental review of their business model, ownership of their CESEE subsidiaries network was transferred to the Italian parent company and a multi-year restructuring plan was initiated for the Austrian entity.*

For both the more gradual and usually "silent" measures and the larger-scale reorganization measures, the banking supervisory authority acts as sparring partner and assessor during the supervisory approval processes. In this role, it scrutinizes in particular the economic aspects of alternative solutions, the plausibility of credit institutions' budget assumptions, the viability and sustainability of the presented business case as well as their compliance with all relevant regulatory requirements following the implementation of measures. Moreover, upon supervisory approval of the respective measures, the banking supervisor closely monitors the implementation of and strict adherence to the envisaged plans as part of the ongoing microprudential assessment process.

In the three cases mentioned above, a smooth and stable restructuring process has been achieved, resulting in either significantly less risky or significantly less complex banking operations, which in turn help improve cost-efficiency.

Credit quality improved both in Europe and in Austria

European banks made progress in alleviating the burden of nonperforming loans (NPLs) from their balance sheets. The formation of new problem loans has slowed down as the economy has started to recover, write-offs have picked up and NPL sales have increased. Nevertheless, the pace of improvement is still slow, reflecting i.a. the weak profitability of the European banking sector. That is why the SSM put forward its work on this topic.

In Austria, the banking system's consolidated NPL ratio improved significantly in 2016, from 6.6% at end-2015 to 4.9% at end-2016. This reduc-

tion was strongly driven by the transfer of ownership of UniCredit Bank Austria AG's CESEE subsidiaries[7] to the parent bank and other credit institutions' progress in NLP resolution.

When comparing NPL ratios derived from different sources – such as the EBA, the SSM and national authorities – the number and business models of the banks included in the respective samples can vary markedly, resulting in diverging NPL figures (see chart 22). For the consolidated NPL ratio, for example, the difference between significant Austrian institutions (5.8%) and the Austrian banking sector as a whole (4.9%, as computed by the OeNB) is 90 basis points. Also, smaller samples are often dominated by large credit institutions, which in Austria might feature exposures to CESEE that are, in many cases, characterized by weaker loan quality, thus driving the NPL ratio of smaller bank samples further up.

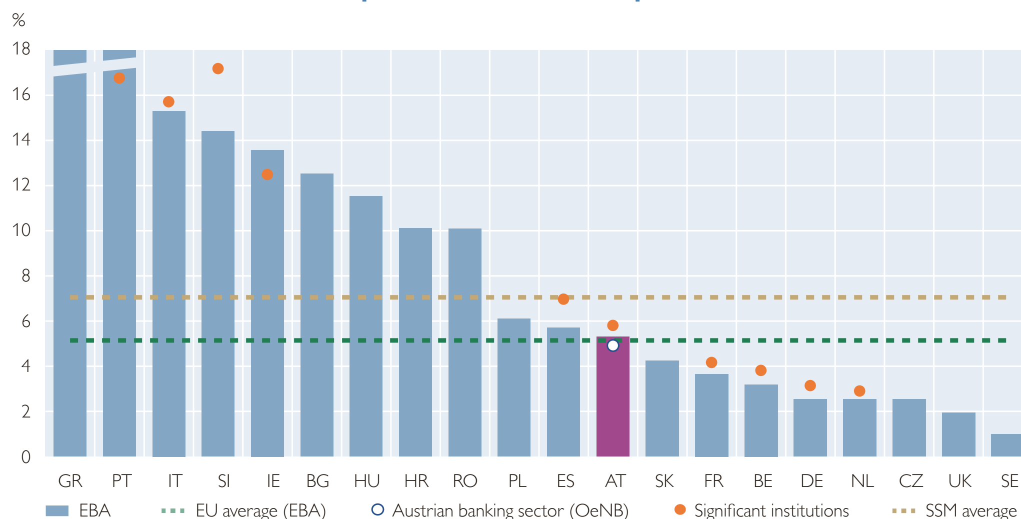
The (domestic) loan quality in Austria also improved in 2016, as the unconsolidated NPL ratio declined to 3.5% by end-2016 due to NPL reductions especially at some state mortgage banks (Landeshypothekenbanken). This improvement was also driven by higher loan quality in the corporate loan portfolio (especially in the sectors trade, maintenance of automobiles, construction and real estate), which is in line with the reduction in the number of insolvencies registered in 2016. In the first quarter of 2017, the NPL ratio in Austria continued to decline to around 3.4%.

NPL transactions in CESEE gain momentum

2016 has been the most active year to date for NPL transactions in CESEE, with completed or on-going deals exceeding EUR 10 billion. The surge in loan sale transactions across the region largely comes down to a narrowing of the gap between book values and market prices. While sellers are becoming more realistic in their price expectations, driven by a mix of increased regulatory pressure and the acceptance of market pricing, investors have lowered their return requirements, which reflects

Chart 22

NPL ratios of selected European countries – comparison of different sources



Source: EBA, ECB, OeNB, end-2016 data.

[7] *See footnote 1 and box 1 for further details.*

their ongoing hunt for yield and higher willingness to conclude deals. CESEE has seen the highest activity in corporate secured loans, with fewer deals in corporate unsecured and retail loans, where debt recovery specialists tend to buy relatively small portfolios. Most transactions took place in Hungary, Romania, Bulgaria and Slovenia. The most active sellers were AXA, HETA, Bancpost (Eurobank), Erste Group Bank AG and Intesa Sanpaolo.[8]

Since 2014, the NPL ratio of Austrian banks' subsidiaries in CESEE has steadily declined, but it was still elevated at 8.6% by the end of 2016 (end-2015: 11.5%). The ratio of nonperforming foreign currency loans (FCLs) is much higher than that of nonperforming domestic currency loans (13.5% and 6.5%, respectively), but the coverage ratio[9] of nonperforming FCLs has improved markedly to 71% (from 58% at end-2015[10]) and is now higher than that of nonperforming domestic currency loans (63%). From a single country perspective, NPL ratios continue to be highly heterogeneous, reflecting different economic developments. In the Czech Republic and Slovakia, the NPL ratios of Austrian banks' subsidiaries are close to Austrian levels at 3.5% and 4.4%, respectively, while in other host markets, such as Romania, Hungary and Croatia, NPL ratios range from 11% to 17%, albeit exhibiting a downward trend over the past three years.

Credit quality of Austrian banks' subsidiaries in CESEE improved further

Box 2

The SSM's targeted review of internal models (TRIM) and its impact on Austrian banks

The objective of the SSM's targeted review of internal models (TRIM) project is to enhance the credibility and confirm the adequacy and appropriateness of internal models currently used by 68 significant institutions to calculate their own funds requirements for hedging against credit risk, market risk and counterparty credit risk. TRIM has been the biggest single project in SSM history so far; it can be considered a follow-up on the Asset Quality Review (AQR) carried out in 2014 and 2015. Its basic principles are

- *to assess the reliability and comparability of internal models with a view to ensuring compliance with regulatory requirements and harmonizing supervisory practices within the SSM,*
- *to verify that risks are modeled correctly and hence capital requirements are calculated adequately,*
- *to publish a guide of harmonized principles and make recommendations to credit institutions that ensure that internal models deliver consistent results across the SSM, and*
- *to make a risk-based ("targeted") selection of a subset of all models to be used for in-depth on-site inspection based on uniform inspection techniques.*

TRIM constitutes an important step toward reducing the unwarranted variability in banks' own funds requirements as induced by the interpretation of the regulatory framework by both banks and supervisors. It creates a level playing field by harmonizing supervisory practices. This is necessary as most of banks' internal models had been approved by the national competent authorities on the basis of their individual supervisory practices before the start of the SSM. In this respect, Austria can look back on many years of high-quality model supervision.

[8] *See the Deloitte Report on Deleveraging Europe 2016–2017 for more details on NPL transaction activities.*

[9] *Defined as risk provisions for NPLs over total NPLs.*

[10] *The substantial improvement of the nonperforming FCL coverage ratio is largely attributable to the restructuring of UniCredit's CESEE operations.*

The OeNB actively shared its model-related expertise in the preparatory phase of TRIM, both from a conceptual and organizational point of view. From April 2017 onward, the focus of TRIM will be on on-site model inspections, covering a substantial part of Austrian banks' high default portfolio credit risk models (approximately 60% of all exposures) in 2017 and concentrating on low default portfolio models from 2018 onward. Both the OeNB and Austrian banks involved are investing significant resources in TRIM with the aim of fostering a sound and resilient banking system.

There will be challenges for Austrian banks that use internal models. Given the past intensity of model supervision and investigation in Austria, however, banks are already accustomed to in-depth investigation procedures and supervisors are aware of areas that need attention. As internal models are indispensable risk management tools, the OeNB welcomes TRIM as a valuable project that will certainly contribute to strengthening model supervision within the SSM.

Capitalization of Austrian banks improved markedly in 2016

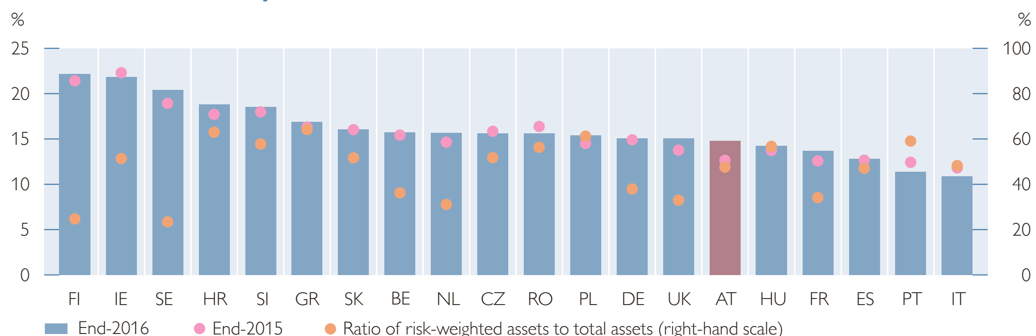
The long-running strengthening in the solvency of European banks has continued in 2016, with the increase of common equity being the main driver of this improvement.

In the Austrian banking system, the restructuring of UniCredit Bank Austria AG[11] significantly reduced the volume of banks' risk-weighted assets in 2016,[12] while capital declined by less. At the same time, and adjusted for this one-off effect, Austrian banks increased their common equity tier 1 (CET1) capital via the retention of profits, which substantially improved the consolidated CET1 ratio to 14.8% (compared with 12.8% at end-2015). This system-wide figure comes close to the European average, which stood at 15.0%.[13] Austria's biggest institutions, however, still lag behind these levels with their CET1 ratio at 12.9% (at end-2016) and should therefore seek to further increase their capitalization in light of their systemic importance.

From a macroeconomic point of view, strengthened capital levels did not burden lending activities, as Austrian domestic loan growth came to 1.5% in 2016, which is well above the growth

Chart 23

CET1 ratios of European banks



Source: ECB, consolidated banking data.

[11] *See footnote 1 and box 1 for further details.*

[12] *The consolidated risk weight of total assets also decreased (from 51% to 47%). Compared with other European banking systems, this figure is still above average, but it also indicates that Austrian banks apply a more conservative risk assessment to their portfolios (especially regarding mortgages).*

[13] *Source: ECB.*

rates recorded over the past three years. This development should finally dispel fears that more capital might have a negative effect on credit supply.

Austrian banks post solid short-term liquidity positions

The liquidity coverage ratio (LCR) was introduced as a regulatory minimum requirement for all credit institutions at the individual and consolidated level in 2015. It aims to ensure that credit institutions have a sufficient amount of highly liquid assets at their disposal to withstand conditions of severe funding stress for at least 30 days at all times. The LCR minimum requirement is defined as the ratio of high-quality liquid assets (HQLA) relative to stressed net outflows arising over a period of 30 days. It amounts to 80% in 2017 and will increase to 100% in 2018.

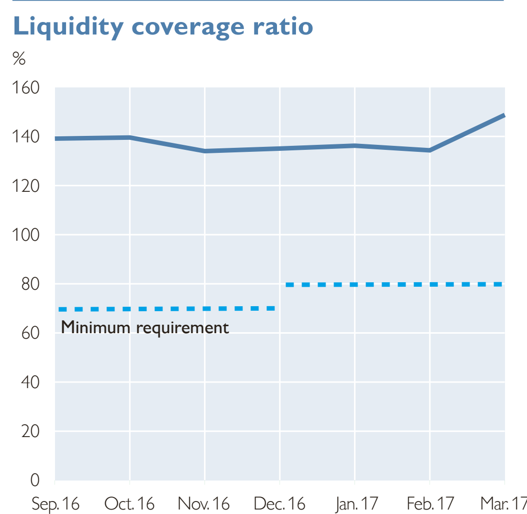
The weighted average LCR for all Austrian credit institutions has been stable and well above minimum requirements since it was first reported in September 2016, reflecting the overall solid liquidity position of Austrian banks. In early 2017, all Austrian credit institutions reported ratios above the regulatory minimum, with the weighted average LCR amounting to 149% at the unconsolidated level.

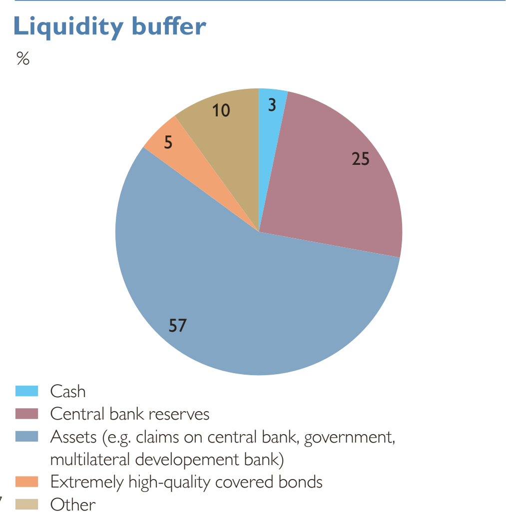
93% of the liquidity buffer consist of the highest category of eligible Level 1 assets, while the share of Level 1 covered bonds remains at 5%. Level 2a and Level 2b assets account for 1% each. Within Level 1 assets, government bonds and central bank assets account for more than 80%.

Stronger local stable funding causes liquidity transfers to CESEE credit institutions to shrink

An Austrian supervisory guidance adopted by the OeNB and the FMA in 2012 (the so-called "sustainability package")[14] stipulates that the stock and flow loan-to-local stable funding ratios (LLSFRs) of Austrian banks' foreign subsidiaries be monitored. With the transfer of ownership of UniCredit Bank Austria AG's CESEE subsidiaries to its Italian parent bank, the monitoring requirement now only applies to Erste

Chart 24



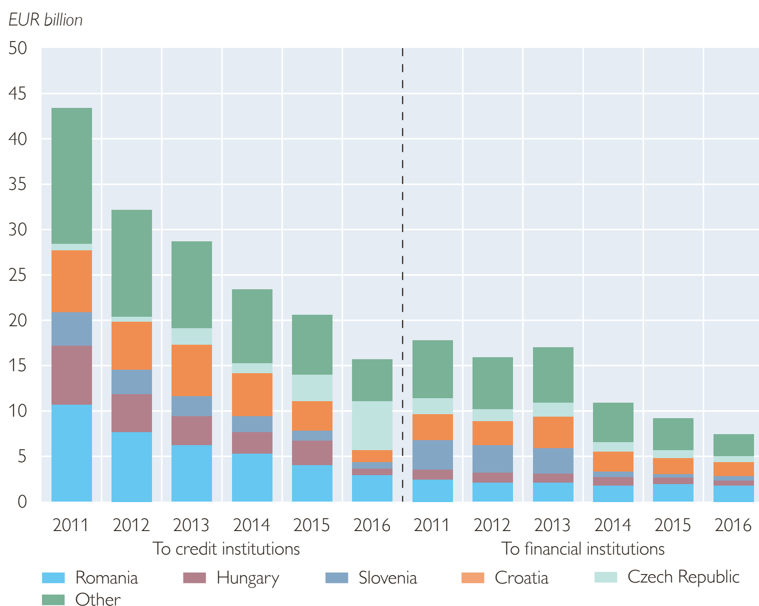


Source: OeNB.

[14] *https://www.oenb.at/en/Financial-Stability/Systemic-Risk-Analysis/Sustainability-of-Large-Austrian-Banks--Business-Models.html.*

Chart 25

Austrian banks' intragroup liquidity transfers to CESEE institutions



Source: OeNB.

Note: Financial institutions e.g. also comprise leasing companies.

Group Bank's and Raiffeisen Bank International's subsidiaries. At end-2016, all 23 subsidiaries monitored were found to have sustainable business models that comply with the OeNB's and FMA's supervisory guidance.

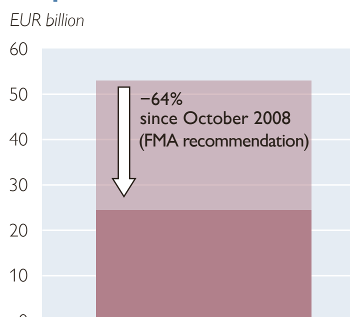
Stronger local funding and lower LLSFRs have been accompanied by a substantial decrease in the (gross) intragroup liquidity transfers from Austrian banks to CESEE credit institutions. For instance, between 2011 and 2016, the decrease amounted to EUR 28 billion or 64%. The noteworthy outliers are credit institutions in the Czech Republic that received more than one-third of all remaining intra-group liquidity transfers to CESEE at the end of 2016, although their refinancing position is typically strong. Intra-group liquidity transfers to financial institutions (e.g. leasing companies) also went down significantly from EUR 18 billion at end-2011 to EUR 7 billion by end-2016, but this decline started later and was less gradual as it was strongly affected by the restructuring of Hypo Alpe-Adria-Bank International in 2014.

Foreign currency loan volumes in Austria have dropped considerably in recent years, but risks from the outstanding portfolio remain

In April 2017, foreign currency loans (FCLs) to domestic nonbank borrowers amounted to EUR 28.8 billion, of which EUR 20 billion were granted to households and EUR 4.4 billion to nonfinancial corporations.[15] FCLs to domestic nonfinancial borrowers have declined continuously since October 2008 when the FMA strongly recommended that banks refrain from granting new FCLs to households.[16] Between then and April 2017, FCLs to households and

Chart 26

Drop in foreign currency loans to households and nonfinancial corporations in Austria



Source: OeNB.

Note: The percentage value indicates the exchange rate-adjusted change in the period from the launch of macroprudential measures in Austria in October 2008 (FMA recommendation) to April 2017.

[15] *The remaining FCLs were extended to the government sector (EUR 2.4 billion) and nonbank financial intermediaries (EUR 2 billion).*

[16] *FCLs denominated in Swiss francs are by far the most common, accounting for more than 96% of all FCLs to households.*

nonfinancial corporations shrank by 64% on an exchange rate-adjusted basis (see chart 26). In the last 12 months alone, the exchange rate-adjusted reduction amounted to about 14%. Based on this steady decline, the share of FCLs in total loans to households and nonfinancial corporations fell as well, coming to 8.3% in April 2017, down from 9.9% one year before.

Volume of foreign currency loans continues to decline

Although the volume of domestic FCLs has been declining steadily, legacy issues continue to be a concern: While in March 2017, 69% of all outstanding FCLs to households had remaining maturities of more than seven years, these FCLs still entail significant future redemption risks for Austrian banks as about three-quarters of them are bullet loans linked to a repayment vehicle (RPV). In this case, the borrower pays regular contributions into an RPV, usually a life insurance policy or another capital market product, to be used to repay the loan at the end of its term. This implies that borrowers are exposed to two main risks: first, the risk that the amount to be repaid at maturity increases as a result of foreign currency appreciation (exchange rate risk) and second, the risk that the originally assumed performance of the RPV is not reached and the amount saved does not cover the entire loan repayment due at maturity (performance risk). Both risks may lead to a gap between the RPV's final value and the amount outstanding at loan maturity. To constantly monitor the development of RPV loans (especially those denominated in foreign currency) and to gain an overview of the potential shortfall of RPV loans, the OeNB, in cooperation with the FMA, conducted a survey among a representative sample of Austrian banks, with the first results expected in the summer of 2017.[17] A very similar survey launched in mid-2016 showed that the total shortfall was approximately EUR 6.2 billion at the end of 2015. (Please note that due to currency movements and the performance of RPVs, this is a volatile figure.) On average, borrowers' RPVs were found to be underfunded by 29%.

Foreign currency loans linked to repayment vehicles involve manifold risks

Based on the residual maturity profile of RPV loans, there is still some time to close the shortfall described above. As of March 2017, almost three-quarters of all RPV loans had remaining maturities of more than seven years, with the bulk (39%) maturing in 10 to 15 years (see chart 27). Given that RPV loans may pose problems for Austrian banks and their borrowers in the medium to long term – especially as shortfalls could widen further if downside risks were to materialize – the FMA, in cooperation with the OeNB, enhanced the FMA Minimum Standards with the objective to increase transparency and raise the risk awareness of both banks and borrowers concerning FCLs and RPV loans.[18] Next to extended information obligations for banks toward borrowers and comprehensive public disclosure obligations, the revised standards also encompass guidance on a forward-looking and adequate risk management approach (including risk provisioning). The intention behind this move is to encourage banks and borrowers to intensify their bilateral negotiations over measures that enable sustainable, tailor-made solutions and thereby reduce financial risks. The enhanced FMA Minimum Standards entered into force on June 1, 2017.

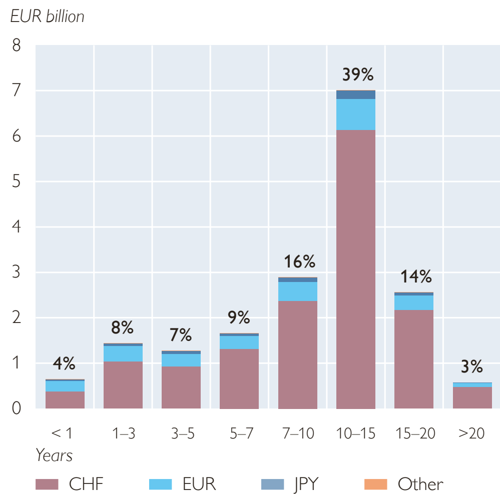
Enhanced FMA Minimum Standards to increase risk awareness and transparency

[17] *The sample covers about 90% of total outstanding domestic RPV loans.*

[18] *For more details on the revised "FMA Minimum Standards for the Risk Management and Granting of Foreign Currency Loans and Loans with Repayment Vehicles," see https://www.fma.gv.at/download.php?d=2885.*

Chart 27

Residual maturity profile of repayment vehicle loans (March 2017)

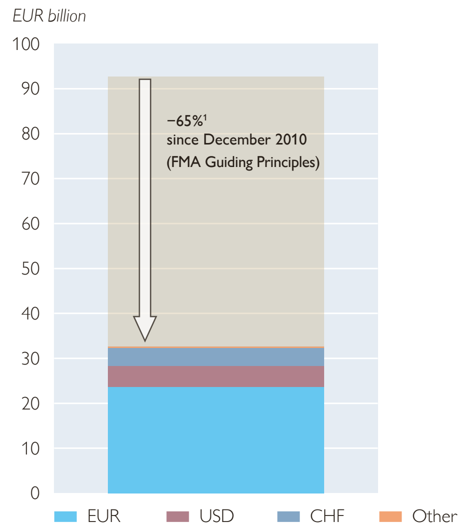


Source: OeNB.

Note: Percentage values indicate the share of each segment in the total volume of outstanding repayment vehicle loans.

Chart 28

Foreign currency loans of Austrian banks' CESEE subsidiaries



Source: OeNB.

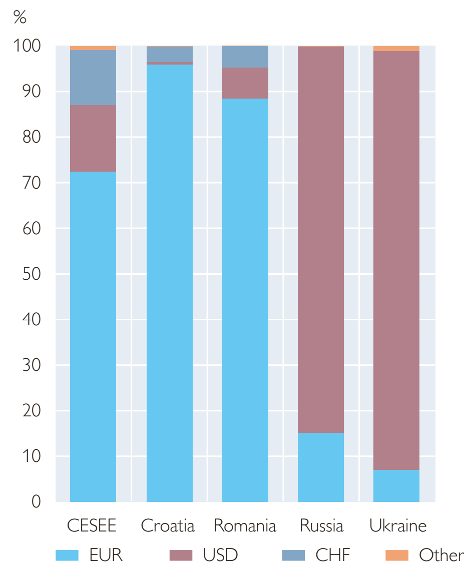
[1] Loans include loans to households and nonfinancial corporations. The percentage value indicates the exchange rate-adjusted change in the period from the launch of macroprudential measures in CESEE in December 2010 (FMA Guiding Principles) to December 2016.

FCL volume at Austrian banks' CESEE subsidiaries continues to shrink

Effective policy measures, including the FMA Guiding Principles and local supervisory initiatives, helped reduce the volume of outstanding FCLs of Austrian banks' subsidiaries in CESEE over the last years. In 2016, however, the 53% decline in FCL volumes to EUR 32.6 billion (adjusted for exchange rate effects) and the drop in the share of FCLs in total loans to customers to 30% (end-2015: 38%) was largely attributable to the transfer of ownership of UniCredit Bank Austria AG's CESEE subsidiaries to its parent bank in Italy. Including this effect, the FCL volumes of Austrian banks' CESEE subsidiaries have gone down by 65% (on an exchange rate-adjusted basis) since the Guiding Principles were adopted in 2010 (see chart 28), but even when excluding this substantial one-off effect, the exchange rate-adjusted decline from end-2010 to end-2016 was still 39%. Despite these positive developments for Austrian banks, political and legal uncertainties surrounding FCLs remain high across CESEE and could result in a further financial burden for Austrian banks.

Chart 29

Composition of outstanding foreign currency loans of Austrian banks' subsidiaries in selected markets (end-2016)



Source: OeNB.

Note: Loans to households and nonfinancial corporations.

Of all FCLs extended by Austrian banks' CESEE subsidiaries to nonfinancial corporations and to households, nearly two-thirds went to nonfinancial corporations, while households account for the remainder. As shown in chart 29, the major currency in the FCL segment is the euro (73% of total FCLs), followed by the U.S. dollar (14%) and the Swiss franc (12%). In recent years, the overall FCL currency composition has become more and more dominated by the euro, while the U.S. dollar overtook the Swiss franc. At the country level, however, the currency split is still highly heterogeneous: At Austrian banking subsidiaries in Croatia and Romania, for example, FCLs are mainly denominated in euro, while the U.S. dollar dominates in Russia and Ukraine.

The substantial decline of outstanding FCLs at Austrian banks' CESEE subsidiaries and the high share of euro-denominated FCLs both indicate a welcome improvement in the financial situation of several Austrian banking subsidiaries in CESEE, but country-specific uncertainties remain and the related risks need to be addressed.

Significant changes for the payments and securities market

The upcoming national implementation of the revised EU Payment Services Directive (PSD2) will entail technical and legal innovations in Austria. The Austrian Federal Act on the Provision of Payment Services (Zahlungsdienstegesetz – ZaDiG) will have to be aligned with EU provisions by end 2017 at the latest. This alignment will enable new market players in the fields of payment initiation and account information services – so-called third-party providers – to enter the regulated payments market by applying for ZaDiG licensing. Credit institutions are expected to develop appropriate strategies to deal or cooperate with these new competitors, which are often referred to as fintechs. Furthermore, new PSD2 requirements in the area of strong customer authentication, incident reporting or consumer protection are going to improve both safety and competitiveness in the retail payments market. The OeNB has actively contributed to the development of the respective technical standards at EU level and will, in the future, be responsible for the national oversight of these innovative payment services.

Revised framework for payment services will foster innovation and competition

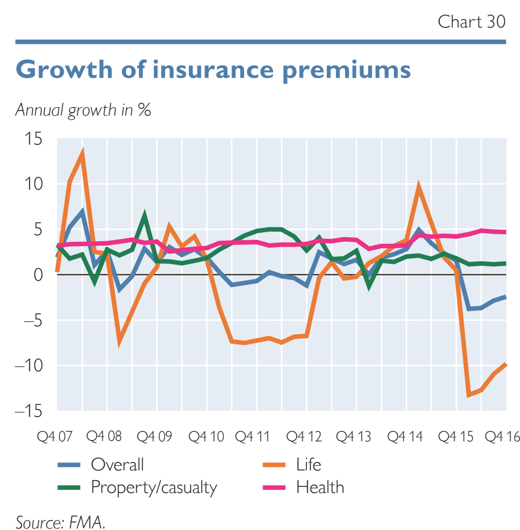
In the area of securities transactions, substantial changes are taking place as well. Austria's only central securities depository (CSD.Austria) successfully completed its TARGET2-Securities migration during the fourth migration wave in February 2017. As a next step, CSD.Austria is currently preparing its licensing procedure under the CSD Regulation. As the competent supervisory authority, the OeNB is accompanying this process.

Prolonged period of low interest rates hits life insurance premium growth

Low profitability caused by a prolonged period of low interest rates and weak

Chart 30

Growth of insurance premiums



Source: FMA.

macroeconomic growth remains the key risk for the insurance sector. However, not all insurance sectors are equally concerned. The life insurance sector is particularly affected, with premiums having decreased by about 10% and more in 2016. This reduction is mainly driven by a fall in single premiums.

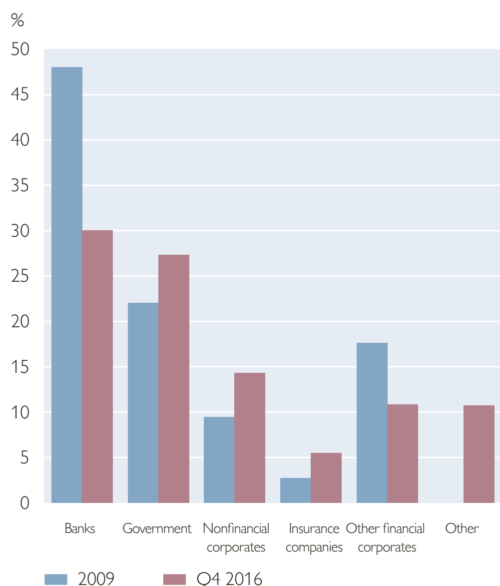
As a reaction to this challenging environment, the insurance sector is shifting its business mix toward products that are directly linked to market performance and whose investment risk is borne by the policyholder.

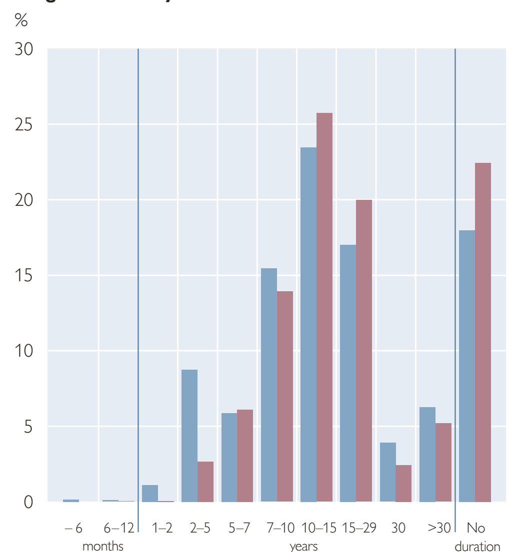
Besides adapting to the macroeconomic environment, insurance companies are also adapting to new regulatory rules. Solvency II, the harmonized EU-wide insurance regulatory regime, entered into force in 2016, imposing transitional rules. Chart 31 shows how Austrian insurance companies have modified their investment behavior to adapt to these new rules. From 2009 to 2016, the securities investments of Austrian insurance companies show a notable shift away from investments in bank securities (–18 percentage points) toward government bonds (+5 percentage points), nonfinancial corporations (+5 percentage points) and insurers (+3 percentage points). There has also been a shift in terms of securities' duration, from short durations (2 to 5 years) toward the 10- to 15- and 15- to 29-year duration band, as the low yield environment makes short-term securities particularly unattractive.

The European Insurance and Occupational Pensions Authority (EIOPA) conducted a stress test for the European insurance sector in 2016. This regular exercise was aimed at assessing the sector's resilience in times of adverse market developments. It focused on two major market risks: the prolonged low yield environment and the so-called "double hit" scenario, which combines low interest rates with a negative shock to asset prices. The exercise covered 236 companies at solo level from 30 different countries.

Chart 31

Considerable changes in the investment behavior of Austrian insurance companies





Source: OeNB.

In aggregate, all participating undertakings show an excess of assets over liabilities in the baseline. Tier 1 unrestricted own funds account for 90% of total own funds of the sample companies, indicating that the quality of their own funds is generally high. However, the composition of available own funds varies markedly across companies.

The double hit exercise resulted in a 9.7% decline (almost EUR 610 billion) of total assets in the baseline. As liabilities only declined by 7.8% (EUR 450 billion) of total liabilities in the baseline, this scenario has a negative impact on the balance sheets of stress test participants of 28.9% (close to EUR 160 billion) of the total excess of assets over liabilities in the baseline. In the event of a low-for-long scenario, the impact for the insurance sector would consist of an 18% fall (about EUR 100 billion) in the total excess of assets over liabilities in the baseline. Detailed results have been published by EIOPA.[19]

[19] *https://eiopa.europa.eu/Publications/Surveys/EIOPA-BOS-16-302 Insurance stress test 2016 report.pdf*