

A Review of the Impact of the Crisis on Austria's Financial Sector

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Given its economic structure and the business model generally used by its banks, Austria became exposed to the current crisis with a certain lag but has since felt the impact quite strongly in some respects. This article provides a rundown of the repercussions of the financial crisis on Austria, focusing on the financial sector, i.e. banks and the capital market.²

Assuming that financial crises tend to follow a typical pattern, this study uses this pattern to shed light on the specifics of the current crisis and of the Austrian financial sector. Austrian banks, for instance, are characterized by the strong regional focus of their activities in Central, Eastern and South-eastern Europe (CESEE) and by their strong strategic focus on retail banking. So far, the crisis has caused default rates to rise, credit conditions to become more restrictive for companies and households, and retail demand for stocks to shrink; some of those effects, though, are yet to fully emerge. Likewise, banks' core business – lending in Austria and in the CESEE area – is just beginning to feel the full impact of the crisis.

1 Typical Financial Crisis Cycles and Triggers

Borio (2003) applies the frame of boom-bust cycles to characterize financial crises. Differences notwithstanding, financial crises are typically characterized by various phases and share a

common crisis determinant, namely aggressive risk-taking.³ The current crisis arguably differs from other crises, such as the Asian crisis or the crises in Latin America in the 1980s and 1990s, in terms of magnitude – but it does not differ as far as the fundamental causes are concerned.⁴

First, financial imbalances build up, as evidenced by excessive credit growth and the overshooting of stock prices. Second, the boom leads to looser financing conditions and makes loans easier to obtain. Banks take a more relaxed approach to risk assessment and risk premiums decline. Such phases of credit expansion are usually highly correlated with a rapid increase in asset prices.

In the third stage, a trigger may reverse the dynamics. This leads to a repricing of long-term assets submitted to banks as collateral. The resulting credit squeeze and the undermined confidence in the system weigh on the economy, which eventually slips into recession. If banks' capital base is poor, a banking and financial crisis ensues and banks could collapse.

Compared with this conceptual framework, the current crisis unfolded at an unusually swift pace, and it remains subject to substantial uncertainty with regard to the path of recovery. In the financial sector, the widespread build-up of mark-to-market assets in banks' balance sheets caused expected losses to be realized prematurely on a

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² *Examining medium-term effects of the financial crisis on the real economy (e.g. demand and growth setbacks, unemployment and bankruptcies) would go beyond the scope of this article; these effects are briefly referred to whenever necessary.*

³ *In this context, Borio (2003 and 2008) explicitly cites limited perception of systemic risk over time.*

⁴ *See also Goodhart et al. (2004).*

large scale. In the real economy, a range of economic fundamentals were revised downward drastically within very short timeframes. The Austrian economy, for instance, contracted by 2.8% in real terms in the first quarter of 2009 against the last quarter of 2008 (fourth quarter 2008 against previous quarter: -0.4%). Confidence indicators point to a deceleration of the downtrend, but at -4.2%, the economic contraction will nevertheless be substantial in 2009 as a whole; and for 2010, the OeNB expects the economy to stagnate at -0.4%.

2 Austrian Banks and the Financial Crisis

The current crisis is traceable to the U.S. subprime market for structured credit securities. In a nutshell, rising risk aversion to these structured credit products caused more and more market participants to lose confidence, as a result of which refinancing in the interbank market and later also in capital markets became more restrictive. In a second stage of the crisis beginning in the fall of 2008, the unfavorable conditions increasingly spread to the emerging markets, including Central, Eastern and Southeastern Europe. CESEE risk premiums soared as a consequence. The slowdown in real economic activity eventually reached Eastern Europe via the advanced economies.

Owing to their “originate and hold” business model,⁵ Austrian banks were comparatively little affected by the turmoil in the structured credit product markets. At about 1.5% of total assets or EUR 15.9 billion⁶, the 25 largest Austrian banks had a relatively modest

total exposure to structured credit products at end-2008. The share of the six largest banks⁷ accounted for EUR 14.6 billion. Besides, 57.6% of the respective exposure was rated AAA or AA.⁸ For this reason, the necessary write-downs were small by international standards: in 2007, they came to around 0.1% of total assets (about EUR 1.1 billion) and until the end of 2008 increased by about EUR 2.1 billion (EUR 1.9 billion for the six largest banks) or some 0.2% of total assets in 2008 to approximately EUR 3.2 billion for both 2007 and 2008.

During this first stage of the current crisis, the direct exposure of Austrian banks was largely limited to refinancing problems in interbank markets, as it became increasingly difficult to raise funds from other banks, especially funds in U.S. dollars. To stabilize the situation, central banks conducted additional tenders, including operations with longer-term maturities (initially 6 months; 12 months from June 2009), switched to fixed rate tenders and extended the list of collateral eligible for repo operations. Moreover, U.S. dollar funding was made available through the USD/EUR swap line implemented by the ECB and the Federal Reserve System at end-2007 (and through the EUR/CHF swap agreement concluded with the Swiss National Bank in October 2008). In Austria, the establishment of the Oesterreichische Clearingbank AG, which began operations on November 13, 2008, further contributed to smoothing interbank market operations, in particular for banks lacking sufficient eligible assets to obtain

⁵ “Originate and hold” means that assets remain in the banking book of the bank, whereas according to the “originate and distribute” model, assets are securitized and sold.

⁶ Excluding credit default swaps (CDS).

⁷ Erste Group Bank AG, UniCredit Bank Austria AG, Raiffeisen Zentralbank AG, BAWAG P.S.K., Oesterreichische Volksbanken AG (incl. Kommunalkredit), Hypo Group Alpe Adria.

⁸ 19.5% of the total volume is rated BBB, 7.2% is non-investment grade.

liquidity from the ECB. All in all, Austrian banks profited from their solid retail base in this respect. Since the outbreak of the financial crisis, retail customer deposits in Austria increased by EUR 40.2 billion until the end of the first quarter 2009 (+EUR 34.2 billion by end-2008), and in consolidated terms (including cross-border operations), customer deposits even grew by EUR 60 billion by end-2008.

By international standards, the dislocation in the interbank market, however, impaired Austrian banks much less than the spillover of the crisis to CESEE. Even though Austrian bank groups' CESEE exposure equals only some 20% of western banks' total exposure in the region, at EUR 199 billion, it is nevertheless substantial above all in relation to GDP (about 70% at end-2008). This phenomenon not only triggered a drastic widening of CDS spreads in the final quarter of 2008 but also had Austrian bank stocks plummet (see also p. 47 in this issue). A certain recovery was discernible in the spring 2009, which went hand in hand with

news about the willingness of both the IMF and the European Commission to swiftly provide new funds for CESEE.

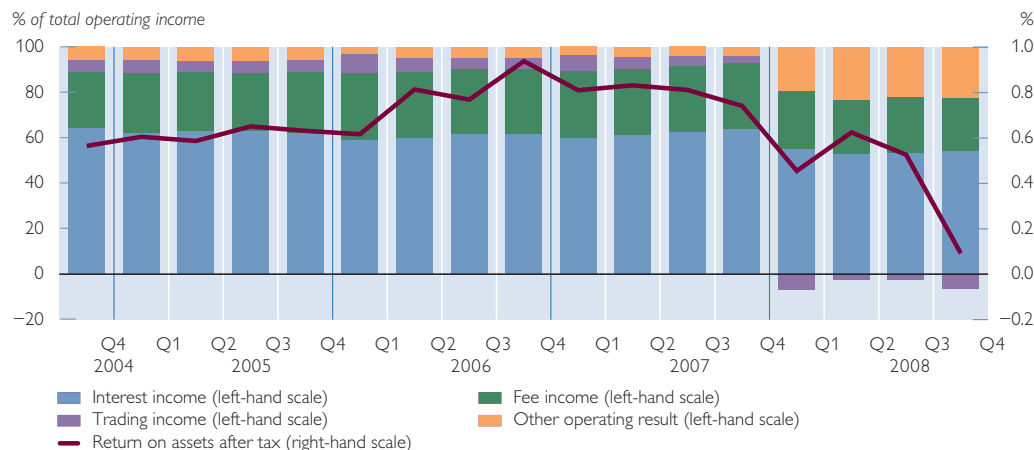
2.1 Austrian Banks' Profitability Decreased Markedly

A host of measures adopted by central banks, governments, the IMF, the European Commission and the World Bank contributed to mitigating the negative impact of the crisis on banks' liquidity situation and performance. The Austrian banking package for instance helped prevent a liquidity squeeze and expand banks' capital buffers. Even though the Austrian banking system still posted a profit in 2008, banks' profitability had deteriorated considerably. Their (consolidated) return on assets after tax fell to 0.09% in 2008.

A sharp increase in loan loss provisions and a negative trading result were offset by continued robust interest income, including net year-on-year gains in the first quarter of 2009. This development was mainly attributable to continued high credit growth in 2008.

Chart 1

Consolidated Operating Income by Type of Income and Return on Assets after Tax



Source: OeNB.

2.2 Austrian Banks' Loan Supply Policy Compared with Other European Banks

Such an analysis naturally gives rise to the question about a potential credit crunch in Austria, which to date has more or less been refuted (OeNB, 2009). While new lending by banks has not let up noticeably, it nevertheless has not offset the decreases in other types of financing, which have been sharp in some segments.

However, according to the general trend in the euro area as gleaned from the Eurosystem's quarterly bank lending survey (BLS), banks in all countries have continually tightened their credit approval standards and/or credit conditions for corporate loans since the onset of the crisis. The margins on both average and riskier loans were increased in all countries, with the increase more marked for riskier loans.

When comparing the Austrian BLS data with the aggregate euro area data, we see that Austrian developments closely correlate with the euro area average. In light of the financial market turbulence, several Austrian banks captured in the BLS, among other things, markedly tightened their credit stan-

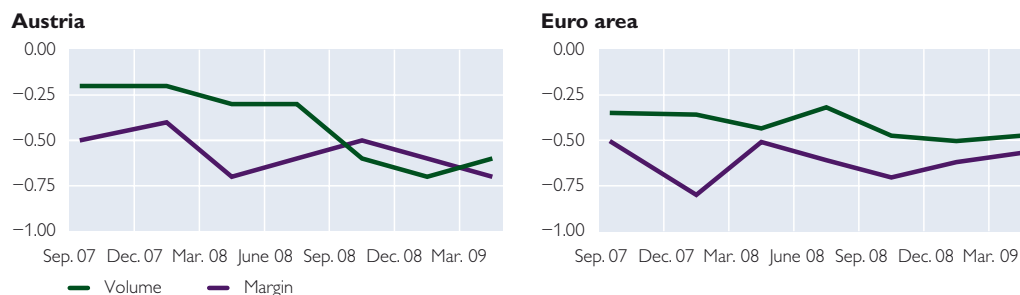
dards for corporate loans. On a consolidated basis, the tightening was even more pronounced than in the euro area as a whole.

The unfavorable refinancing conditions in the money and bond markets impaired Austrian and euro area banks' lending activities. The effects on the volume of loans extended in Austria were by comparison more pronounced than the effects on margins (see chart 2).

Since the beginning of the financial turmoil, banks have tightened their standards⁹ more sharply for corporate loans than for consumer loans. Interest margins for riskier corporate loans and – somewhat less – for borrowers with average credit ratings were raised for the seventh time in a row in the first quarter of 2009. Large corporate loans were affected more markedly than SME financing. The credit standards applicable to households were tightened much less in contrast. Households' credit demand is weak in view of current economic developments. Yet, Jobst and Kwapil (2008) show that in the short term, interest rates were passed on to households at a markedly slower pace than to corporate borrowers.

Chart 2

Impact of Financial Market Situation on Lending Volume Money and Bond Markets – Volume and Margins



Source: ECB, OeNB (bank lending survey).

Note: 0: mainly unaffected; -0.5: slightly affected; -1: clearly affected.

⁹ Credit standards refer to the criteria banks use to evaluate new loans.

The lending restraint was above all traceable to the financing conditions prevailing in money and bond markets as well as banks' liquidity position. Financing via short-term (one-week) money market instruments and short-term debt securities was impaired in particular. Clear effects were, however, also evident for medium- to long-term debt securities (including mortgage bonds). Furthermore, changes in banks' perception of risk amid the general economic outlook, industry- and company-specific factors as well as the risk on collateral demanded caused banks to slightly tighten their credit standards.

2.3 Crisis yet to Reach Austrian Banks' Core Business

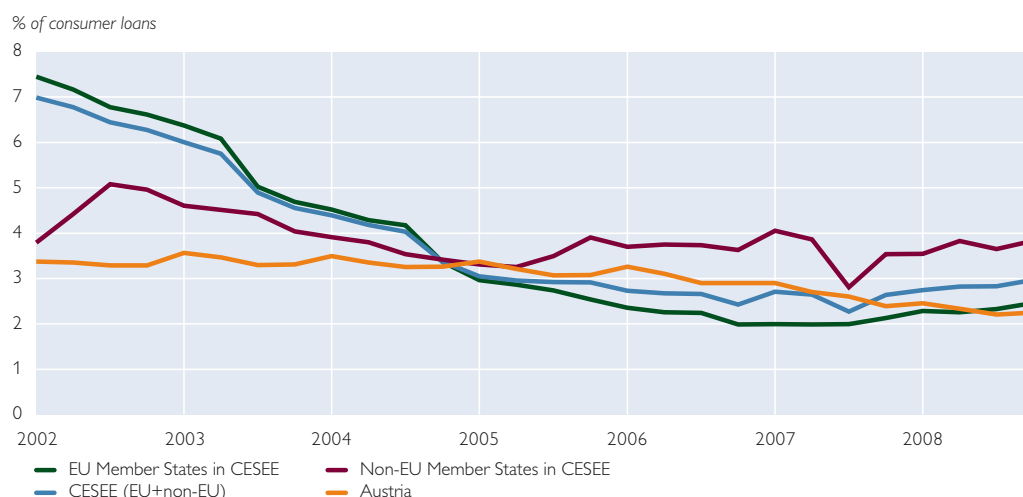
Up to year-end 2008, Austrian banks' core business had not yet been affected by the upheavals on the financial market (write-offs on exposures to Lehman Brothers, Washington Mutual and Iceland), as it proved to be relatively

robust with regard to asset quality until the fourth quarter of 2008. As a case in point, the loan loss provision ratios for both domestic and CESEE assets were at a historically very low level:¹⁰ the ratio came to around 2.2% in Austria, where it had peaked at 3.8% in the first quarter of 1997, when the economy had by today's standards been in a better condition. The notable economic downturn is, however, bound to weigh on banks' profitability in the quarters to come. In CESEE, such a pass-through has already started, as evidenced by chart 3.

Comparing today's situation with previous emerging market crises is not really possible in this respect. Drawing a cautious analogy to the Asian crisis would, however, imply a sharp increase in the loan loss provision ratios. At end-2008, the ratios ran to about 2.5% (CESEE EU Member States) and to around 3.8% (CESEE non-EU Member States). During the Asian crisis, loan

Chart 3

Loan Loss Provision Ratios for Consumer Loans in CESEE and in Austria



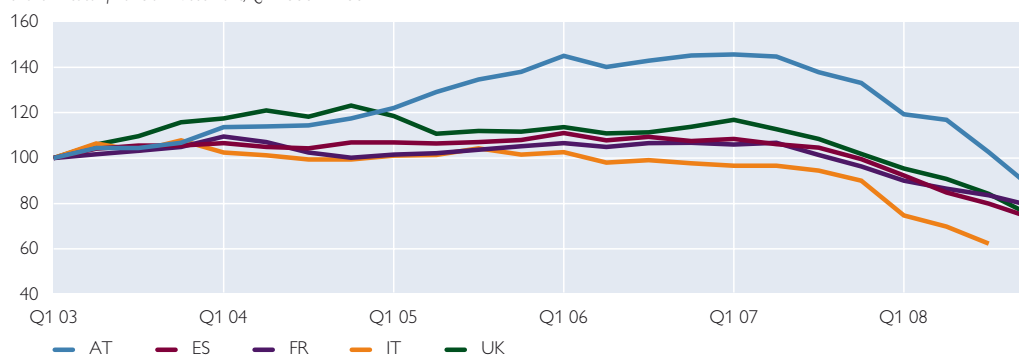
Source: OeNB.

¹⁰ Foreign currency loans are subject to a separate analysis, see box 4 "Foreign Currency Loans Continue to Play a Prominent Role in CESEE" on page 45.

Chart 4

Listed Stocks and Mutual Fund Shares Held by Households

share in total financial investment, Q1 2003 = 100



Source: OeNB, Banco de España, Suomen Pankki–Finlands Bank, Banque de France, NSI UK, ECB (for Italy).

loss provision ratios exceeded 20% in some countries,¹¹ and the volume of nonperforming loans peaked 1.5 to 5 years after the onset of the Asian crisis.¹² Growth rates in the affected countries recovered relatively quickly, though, as the slump in demand was confined to a particular region.

Given the global nature of this time's growth setback, the IMF reckons that it will take some time for the economy to rebound. At the same time, the additional financial assistance provided by the IMF and the EU helped dramatically reduce the likelihood of very bleak scenarios.

As the pressure on profitability is expected to rise, the Austrian banking sector will increasingly be faced with structural issues. This applies to the overbranched domestic business¹³ as well as CESEE activities, where the incipient consolidation trend is expected to continue. Given the strategic nature of Austrian banks' CESEE activities, banks could also frame the crisis as an opportunity, even though several bank

groups have already begun to increasingly refocus on core markets.

2.4 Massive Revaluation Losses on Capital Market Instruments Held by Households

The crisis did not only hurt banks' balance sheets, but also households' assets. At some EUR 416 billion, households' financial assets in 2008 stagnated at the year-earlier level. Amid the financial crisis, households stepped up saving, with the saving ratio climbing from 11.7% in 2007 to 12.4% in 2008, a level last seen in 1995.

The increase in bank deposits equaled over 70% of aggregate financial investment made in 2008 (EUR 18.8 billion). Households channeled funds above all into saving deposits (+EUR 9 billion), but increasingly also in time deposits (+EUR 3.2 billion). Products with an initial maturity of up to one year were particularly sought after. The broadened deposit guarantees definitely helped bolster demand.

¹¹ See also Laeven and Valencia (2008).

¹² See also Asian Development Bank (2002).

¹³ ECB (2008, p. 38).

Between the first quarter 2003 (11.2%) and the fourth quarter 2008 (9.8%), riskier assets accounted for an average 13.8% of Austrian households' financial portfolio. Chart 4 illustrates that the importance of stocks and mutual fund shares in Austrian households' portfolio differs considerably vis-à-vis other euro area counterparts over time. In Austria, demand for riskier assets increased notably before the financial crisis, to decline more strongly thereafter.

Price losses amid the financial crisis concentrated on stocks, but mutual fund shares also experienced profound price and exchange rate effects. Altogether, households have lost around EUR 29 billion on their investments in tradable securities since the onset of the financial crisis (early third quarter of 2007). At some 22%, the participation rate for stocks and/or mutual fund shares is by international standards rather low in Austria. Only the top 5% holders of gross financial assets have a participation rate of 74%. Since it is primarily wealthier households that hold securities, the wealth effects of

the crisis on consumption are expected to be rather weak (see Fenz and Fessler, 2008).

Investment behavior in Austria has changed more profoundly over the past years than in other euro area countries. The capital market, which economic policymakers had sought to promote in recent years (subsidized personal pension scheme, occupational pension plans, equity culture), considerably gained in importance for households before the crisis. Currently, households are shifting to "safe assets" (see Fessler and Schürz, 2008).

Falling capital market prices also pushed down the market value of the invested assets of insurance corporations and pension funds. Households' net equity in life insurance reserves and pension fund reserves suffered valuation losses of an estimated EUR 2.3 billion.

3 Economic Policy Measures in Support of the Austrian Financial Sector

The current crisis drives home the fact that throughout the world banking

Chart 5

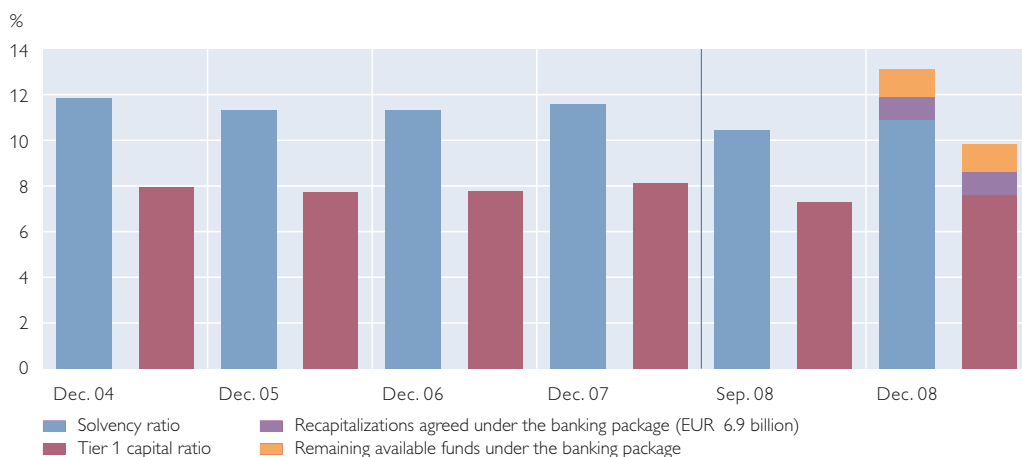
Household Sector, Price and Exchange Rate Effects



Source: OeNB.

Chart 6

Development of the Tier 1 Capital Ratio and the Capital Ratio, including Recapitalization under the Banking Package



Source: OeNB.

systems had relied too heavily on debt financing.¹⁴ The high leverage was attributable to overall low risk aversion and to the fact that the regulatory capital requirements applicable to the trading book were relatively low. Given the absence of large trading books in Austria, this issue did not play a significant role, but Austrian banks' capital ratio likewise declined, falling from 11.8% at end-2004 to 10.5% in the third quarter of 2008, following, among other things, Austrian banks' rapid expansion in CESEE. While the capital ratio still considerably exceeded the 8% regulatory minimum requirement at all times and as from the second half of 2008 banks have increasingly raised new capital (outside of the banking package), banks had – before the crisis – failed to meet investors' demand to build up additional capital buffers.

Since Austrian banks would have otherwise been at a disadvantage and uncertainty about their CESEE exposure was rising, the Austrian government also adopted a banking package to raise banks' capital via participation and hybrid capital. To date, EUR 6.9 billion of participation and hybrid capital have been formally agreed upon. In addition, EUR 15.5 billion and CHF 250 million of bank bonds guaranteed and securitized by the government have been issued.¹⁵ For hybrid capital there is a regulatory ceiling in place, up to which hybrid capital instruments qualify as tier 1 capital (on a consolidated basis). Theoretically, i.e. if taken up in full, the EUR 15 billion banking package enabled Austrian banks to lift their tier 1 capital ratio, as a percentage of the risk-weighted assets, by as much as 222 basis points by end-2008, as is evident from chart 6.¹⁶

¹⁴ See also IMF (2009, p. 4 and p. 27ff).

¹⁵ Under the corporate liquidity support act, EUR 10 billion of the total EUR 75 billion earmarked for state guarantees under the interbank market support act were reappropriated to be used for guaranteeing loans to medium-sized and large Austrian businesses.

¹⁶ For further details, see also Posch et al. (2009) in this issue.

4 Summary

Amid the financial crisis, Austria has been on a downtrend like the rest of the world. Even though structured loans and related losses have played a comparatively minor role in the Austrian banking system, the crisis is already starting to eat into Austrian banks' profits. Credit conditions for companies and households have tightened in Austria more or less in line with moves across the euro area, but banks, unlike capital markets, have continued to fulfill their financing function for the real economy. Judged by the se-

quence of events in previous crisis episodes, at the current juncture, the brunt of the feedback of the real economic downturn on the banking sector is yet to come.

By international standards, Austrian households had been slow to start investing in capital market instruments. The significance of listed securities soared before the financial crisis, but thereafter decreased faster than in other euro area countries. Households' valuation losses have to date amounted to EUR 29 billion and are concentrated on Austria's wealthier households.

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