Supervisory guidance on the strengthening of the sustainability of the business models of large internationally active Austrian banks

14 March 2012

Following intensive consultations with the largest internationally active Austrian banks, host and home supervisors, the European Commission, international financial institutions and politicians, as well as rating agencies and other market participants, the Oesterreichische Nationalbank (OeNB) and the Austrian Financial Market Authority (FMA) have devised principle-based measures to make these banks' business models more sustainable.[1]

1. Prudential motivation for the supervisory necessity to act

The motivation for this supervisory guidance is to improve the sustainability of Austrian banks' foreign operations, particularly in Central, Eastern and South-Eastern Europe (during crises times and beyond) as well as to secure financial market stability in the Austrian banks' host countries and in Austria. The prudential rationale for the supervisory guidance rests on three pillars:

a. Building up risk-adequate capital buffers

In line with international efforts to strengthen the capitalisation of banks, the Austrian supervisor aims at higher ratios especially at the large internationally active Austrian banks.

b. Proactively avoiding boom-bust-cycles in lending

The recent crisis showed that some of the most important factors for financial stability have to be addressed at the level of specific business and growth models. The Austrian supervisors' experience highlights that subsidiaries which exhibited high loan growth rates in boom times that were not backed by strong local stable funding – and thus translated into high Loan-to-Local Stable Funding Ratios (LLSFRs) – were more vulnerable to credit risks (and write-offs) during the ensuing crisis, which negatively affected the concerned banking groups and national economies.

In order to strengthen the stability of the local funding base of banking subsidiaries and to improve the quality and sustainability of future credit growth, the Austrian supervisors therefore aim at improving the balance of the refinancing structure of banking subsidiaries by using the LLSFR as a monitoring tool and early warning indicator for non-sustainable lending growth. According to historical evidence, the LLSFR monitoring would also send anticyclical signals: warning about excessive credit growth in boom periods, while not requiring deleveraging in times of crisis. Furthermore, focussing on balanced refinancing structures may also lead to positive side-effects given the importance attached to the development of local capital markets, the reduction of foreign currency lending and the more robust perception by market participants (e.g. rating agencies), which should lead to better funding conditions for Austrian banking groups and their subsidiaries in the medium term.

[1] The supervisory guidance is accompanied by an interpretation note and a separate background note (containing an impact assessment and frequently asked questions).

c. Preparation of recovery and resolution plans for potential crisis situations

Given the lack of a definitive European legal framework on recovery and resolution plans, as well as cross-border burden sharing agreements between home and host countries, the Austrian supervisors require parent institutions to submit recovery and resolution plans before the end of 2012, in order to proactively prepare for potential crisis situations in line with European and global considerations.

2. The three tools in detail

The above stated objectives shall be attained by the following tools, and the Austrian supervisors will closely monitor their effectiveness.

a) Increasing the capitalisation of the banking groups

The Austrian supervisors require from the parent institution the full implementation of the quantitative and qualitative Basel III rules in respect of Common Equity Tier 1 (minimum requirement of 4.5% CET1 and capital conservation buffer of 2.5% CET1) at consolidated level from 1 January 2013 without making use of any related transitional provisions - with the exception that private and state participation capital subscribed under the bank support package (which is fully loss absorbing) will be fully included in the capital base. The treatment of participation capital subscribed by the state and by private investors under the Austrian banking support package will be fully in line with the final CRR grandfathering/phasing-out provisions.

Furthermore, the Austrian supervisors will apply an additional capital surcharge to banking groups at consolidated level of up to 3 percentage points of CET1 from 1 January 2016, following the international G-SIBs regime, taking into account specificities of the Austrian banks' risk profile.

As of 2012, the supervisory guidance regarding banks' capital levels will be integrated in the capital adequacy and joint risk assessment process under Pillar II.

b) Strengthening the local stable funding base of subsidiaries

Internationally active large Austrian parent institutions are well advised to ensure a balanced refinancing structure in the net new lending business at their banking subsidiaries and the FMA and OeNB will closely monitor developments in the Loan-to-Local Stable Funding Ratio (LLSFR). The results of this monitoring will then be openly discussed with the competent host and home supervisors in the framework of supervisory college cooperation with a view to agreeing whether constraining supervisory measures are necessary.

According to the Austrian supervisors' analysis, banking subsidiaries that entered the recent financial crisis with high (i.e. above 110% stock-) LLSFRs were significantly more likely to exhibit higher loan loss provisioning rates than other banking subsidiaries that had a more conservative and balanced business and growth model. This experience led the Austrian supervisors to the prudential conclusion that a business model where a subsidiary's stock-LLSFR is above 110% and its flow-LLSFR exceeds 110 percent – thus worsening the subsidiary's situation further – runs a high risk of not being sustainable and contributes to potential vulnerabilities in crisis situations.[2]

Furthermore, parent institutions are expected to risk-adequately price intragroup liquidity transfers to their subsidiaries, as detailed in the relevant CEBS/EBA guidelines.[3]

[2] Further details on the economic rationale can be found in the accompanying interpretation note.
[3] In particular "Guidelines on liquidity cost benefit allocation (2010)".

The exact definition of the LLSFR and its components (in the stock) is: volume of loans to non-banks after provisioning divided by the local stable funding (i.e. deposits from non-banks + supranational funding + capital from third parties + the total outstanding volume of debt securities with original maturities of one year or more issued by the subsidiary to investors outside their consolidated group). The flow ratio is defined using the year-on-year changes in the stock of these components, i.e. flow-LLSFR = (stock of loan portfolio_t – stock of loan $\text{portfolio}_{(t-1)}$)/(stock local stable funding_t – stock local stable $\text{funding}_{(t-1)}$).

c) Preparation of recovery and resolution plans

Recovery and resolution plans for the group must be submitted by the parent institution to the FMA before the end of 2012.

Annex: Interpretation Note

1. Addressees of the supervisory guidance

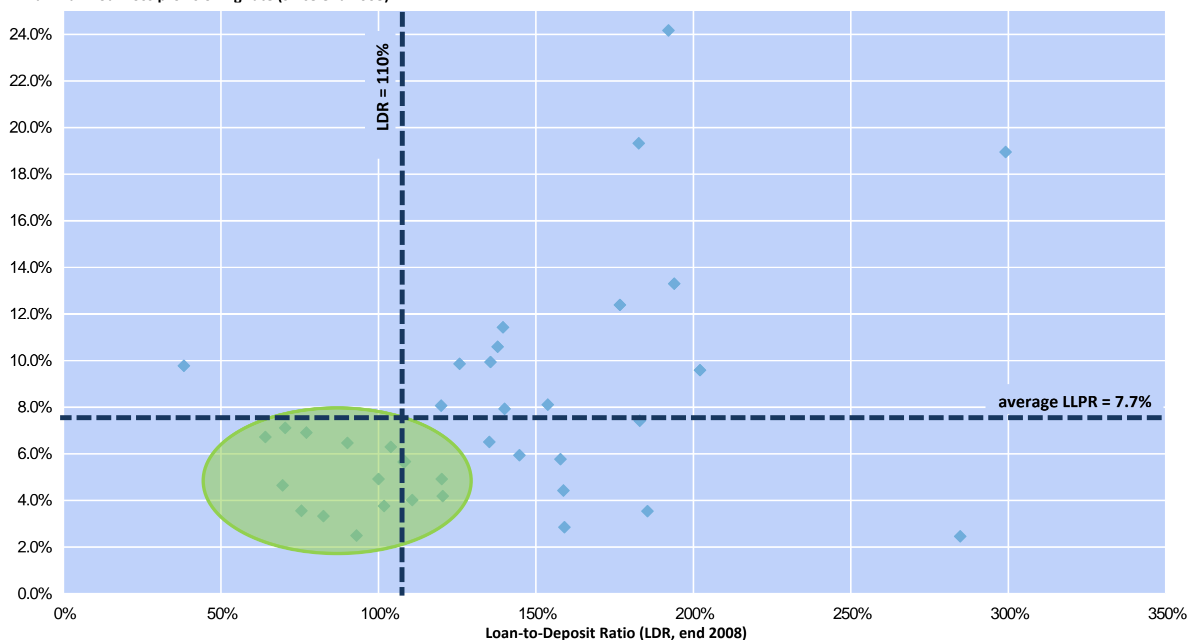
Currently, the Austrian supervisors consider Erste Group Bank, Raiffeisen Zentralbank and Unicredit Bank Austria as large internationally active Austrian banks with respect to this supervisory guidance, given their size, systemic relevance and complex business models with numerous subsidiaries.

2. The historic evidence of the LLSFR's predictive power concerning credit risks

The representation below highlights the points made in the supervisory guidance: On the one hand, subsidiaries that exhibited a strong and stable funding position at the end of 2008 (LLSFRs below 110%) had below average loan loss provisioning rates during the crisis (from end-2008 to date, i.e. September 2011) and were also a very homogeneous group in this respect (green circle in the diagram). On the other hand, subsidiaries that had grown their loan book from less stable funding were much more likely to subsequently exhibit an above-average worsening in their loan quality (and form a heterogeneous group, partly with high loan loss provisioning rates above 10%).

Ratio of lending to local stable funding is a strong early warning indicator for future credit risks

Maximum loan loss provisioning rate (since end 2008)



Source: OeNB. Note: a) Every dot represents a data point of a subsidiary of EGB, RZB, Unicredit BA as well as Volksbank AG and Hypo Alpe-Adria-Bank. b) Due to limited data availability, the diagram uses the stricter LDR. c) Subsidiaries with a loan portfolio smaller than EUR 500 mio (volatile LDRs) and/or a (very high) LDR above 300% were excluded from this representation.

An IMF analysis on the Latin American banking sector and the involvement of foreign, particularly Spanish banks and their regulatory requirements (which are much more restrictive than the Austrian guidance) further underlines the advantages of the supervisory guidance's approach.[4]

[4] Quotation (p 14): "Across foreign banks of different nationality, Spanish banks showed the most resiliency in their lending behavior. […] overseas affiliates of Spanish banks are required to have financial autonomy in terms of liquidity from their parent banks, funding their operations in each country with retail deposits - thus operating very much like their domestic counterparts (but with foreign capital). This made Spanish banks' locally established offices more resilient and better prepared to withstand the global financial shock." in H. Kamil and K. Rai, "The Global Credit Crunch and Foreign Banks' Lending to Emerging Markets: Why Did Latin America Fare Better?", IMF WP/10/102, April 2010. The quote is from p.14 of the document.

3. Technical details

- The LLSFR monitoring tool will not be applicable to a subsidiary if the competent supervisors agree that:
  a) there are no current or foreseen material practical or legal impediments to the transfer of liquidity between the parent and the subsidiary and the relevant supervisors are satisfied that the ability to move funds between entities would be resilient in a stress situation and
  b) there are adequate burden sharing agreements in place between the supervisory and fiscal authorities of the countries concerned.

- From the Austrian supervisors' point of view, the discussion process in the supervisory college framework could take into account the following aspects:
  - Differentiate between smaller and larger subsidiaries, given that smaller subsidiaries exhibit more volatile LLSFRs, particularly in their net new business. The colleges could therefore ask for a medium-term commitment to a sustainable development of the LLSFR in the stock at these subsidiaries (based on detailed plans).
  - Leave room for flexibility in case a subsidiary temporarily exhibits a high (stock/flow-) LLSFR because of extraordinary, external events.[5]
  - Macroeconomic and market environment in each respective country.

- The Austrian supervisors will place a particular monitoring focus on already exposed subsidiaries whose stock-LLSFR exceeds 110%.

[5] e.g. due to foreign exchange volatility, delays in supranational funding or changes in the central bank's minimum reserve requirement.