Recovery of Austrian Financial System on Course, while Overall Conditions Remain Challenging

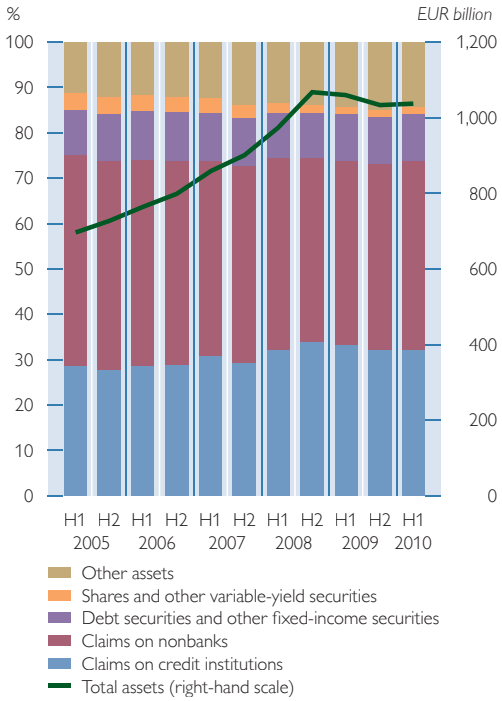
Austrian Banks Benefit from Recovery, Credit Risk Costs Remain High

Business of Austrian Banks Stable in the First Half of 2010

In the first half of 2010, the unconsolidated total assets of Austrian banks rose slightly by 0.4% against the second half of 2009, thus coming to stand at about 3% below the end-2008 figure. The downtrend since end-2008 has above all been attributable to interbank claims (–8%) and interbank liabilities (–13%) and ties in with developments in other European banking systems. In the third quarter of 2010, special effects resulting from restructuring measures of individual banks drove down the unconsolidated total assets by 4.9% quarter on quarter to EUR 987 billion.

Chart 21

Change in Austrian Banking Sector Assets (Unconsolidated)



Source: OeNB.

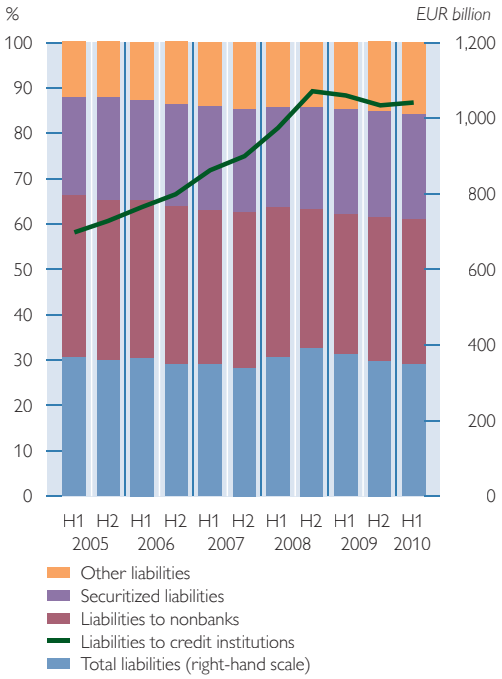
Claims on nonbanks increased by 2.4% in the first half of 2010. As liabilities to nonbanks augmented only by 1%, the loan-to-deposit ratio rose slightly from 128.4% to 130.2%. The retail banking activity of local banks[1] basically mirrors banks' overall business activity. The decrease of external assets and liabilities seen in the second half of 2009 was partly offset again in the first half of 2010 (+4%), while domestic assets and liabilities shrank by 1.6% and 0.7%, respectively. The balance-sheet deleveraging process thus continued at a rather slow pace.

Bank density continues to be very high in Austria (June 2010: 853 credit institutions). Moreover, most banks are affiliated with central institutions in decentralized sectors – a fact that needs to be taken into account when assessing Austrian banks' dependence on the interbank market. A sizeable share of liquidity transfers within the Austrian banking sector are in fact transactions within the Raiffeisen credit cooperative, savings bank and Volksbank credit cooperative sectors. In July 2010, such intrasectoral liquidity transactions accounted for around 36% of total unconsolidated liabilities to credit institutions.

[1] *The sector of the local smaller banks includes certain joint stock banks; the savings banks without Erste Group Bank AG and Erste Bank der oesterreichischen Sparkassen AG; the Raiffeisen credit cooperatives without Raiffeisen Zentralbank Österreich AG and the regional Raiffeisenlandesbank cooperatives; as well as Volksbank credit cooperatives without Österreichische Volksbanken AG.*

Chart 22

Change in Austrian Banking Sector Liabilities (Unconsolidated)



Source: OeNB.

On a consolidated basis, Austrian banks' assets rose by 4.7% to EUR 1,194 billion from January to end-June 2010, driven above all by loans and claims (+4.8%). Increases were likewise reported for liabilities to credit institutions (by 8.6% to EUR 243 billion) and liabilities to nonbanks (by 2.6% to EUR 492 billion). As banks' capital levels rose, consolidated leverage[2] continued to trend downward in the first half of 2010 to reach 16.9 in mid-2010 (end-2009: 19.2).

Recovery of Profitability Depends on Credit Risk Developments

In the first half of 2010, Austrian banks' unconsolidated operating profits rose to EUR 3.8 billion, up 14.0% year on year, as operating income advanced more strongly (+6.4%) than operating expenses (+1.7%). At 59.3%, the cost-to-income ratio thus improved against the first half of 2009 (62%). Since the first quarter of 2010 expectations for the unconsolidated annual net profit of Austrian banks have been up again for the first time in two years (+17.2% year on year). That said, the projected annual surplus is based on expectations about annual risk costs (expected at EUR 3.4 billion for 2010), and those costs were significantly underestimated last year by the reporting banks.[3]

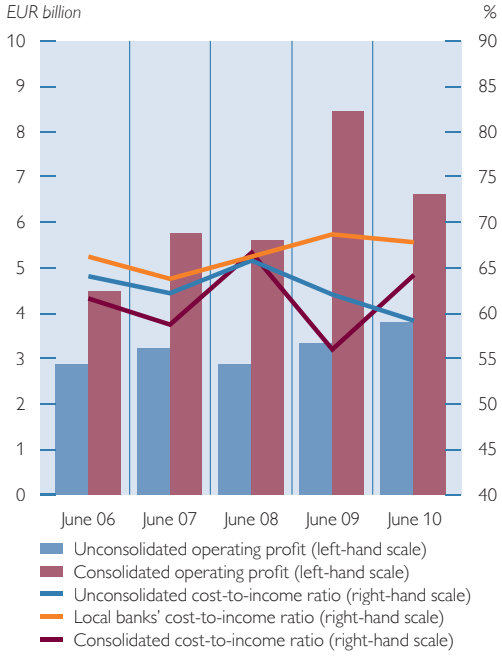
Interest income continued to play the most important role, accounting for 49% of unconsolidated operating profits (first half 2009: 50.1%). For the first time since 2006, the contributions of domestic (45.5%) and international business were broadly balanced again. The 4.3% rise in interest income continued to be driven by low refinancing costs. Fee-based income expanded again for the first time since 2007 – by 8.0% – which was above all due to the increased income from securities transactions and lending operations. More variable income components likewise posted growth, with income from securities and participations rising by 5.5% and the result of financial opera-

[2] *Leverage is defined as the ratio of total assets to eligible tier 1 capital (less deduction items) on the basis of the consolidated data reported to the OeNB.*

[3] *In mid-2009, total risk costs had been estimated to reach EUR 3.5 billion by end-2009, which contrasted with an actual EUR 8.5 billion. More specifically, credit risk costs (i.e. value adjustments in respect of loans and advances and provisions for contingent liabilities and for commitments) had been projected to amount to EUR 3 billion in mid-2009. At end-2009, these costs actually ran to EUR 4.4 billion.*

Chart 23

Operating Profit and Efficiency of Austrian Banks



Source: OeNB.

tions by 35.7%. Administrative expenses remained almost unchanged year on year, with staff costs having been cut by a slight 1.1%. Local banks also managed to raise their efficiency, albeit to a lesser extent than the banking sector as a whole (see chart 23).

Negative Financial Result, Cost Pressure and Credit Risk Put Brake on Consolidated Profits in the First Half of 2010

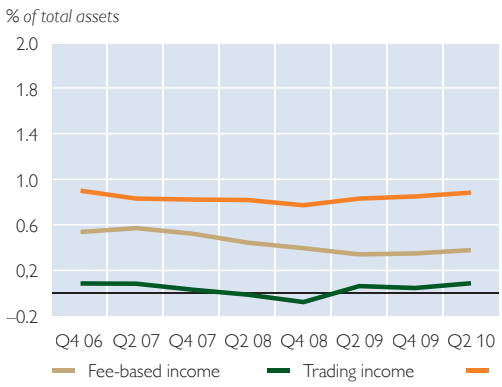
On a consolidated basis, the year-on-year result gives a different impression: The consolidated operating profits before adjustment for risk provisions came to EUR 6.6 billion in the first half of 2010, a decrease of 21.8% against the year-earlier period. This reduction was due to a considerably weaker trading result and a 4.1% increase in operating expenses, as also reflected by the rise in the cost-to-income ratio from 51% to 58%. Compared with more variable components, such as the financial result, which was slightly negative in mid-2010 (see chart 24), the stable interest income component made the most important contribution to operating income.

Credit risk provisions were cut by 17% to EUR 4 billion in the first half of 2010 and accounted for 60.6% of the overall operating result. After taxes the subsequent period profit amounted to EUR 1.8 billion, down 22% year on year. Hence, the consolidated return on assets after taxes dropped from 0.47% in mid-2009 to 0.36% in mid-2010.

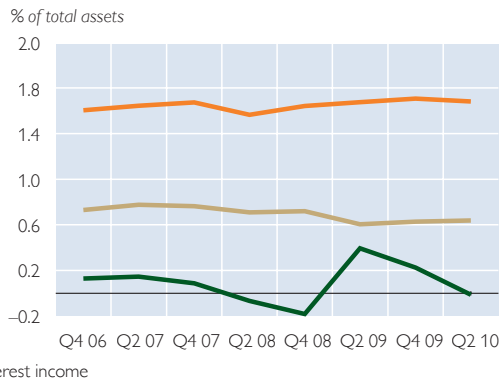
Chart 24

Development of Operating Income by Components...

...based on unconsolidated data



...based on consolidated data



Source: OeNB.

Lending Stagnates as Business Environment Remains Difficult[4]

In the first nine months of 2010, Austrian banks' lending to domestic nonbanks[5] stagnated. At EUR 319.8 billion, the volume of loans outstanding was a mere 0.4% higher at end-September 2010 than a year earlier. Loans to households had increased by 0.9%, while loans to nonfinancial corporations had declined marginally. The former's increase was traceable to housing loans; the latter's decrease above all to large loans.

As to credit growth by sectors, joint stock banks posted a slight rise, while cooperative banks' lending stagnated. Savings banks, in turn, even registered a slight decrease.

The financing conditions of Austrian banks continued to improve slightly in the first half of 2010, with respect to money and bond markets as well as to securitization. Except for a slight relaxation at the beginning of the year, credit conditions remained unchanged.

Foreign currency lending, which had contracted rather significantly year on year (adjusted for exchange rate movements), came to some EUR 56.8 billion at end-September 2010. The foreign currency share in total loans hence amounted to 17.8%. The reduction concerned both households and nonfinancial corporations more or less equally. Given the high share of loans denominated in Swiss franc (almost 86%) and this currency's appreciation over the first eight months of 2010, borrowers were faced with considerable book losses – a fact that has, once more, driven home the risk associated with foreign currency loans.

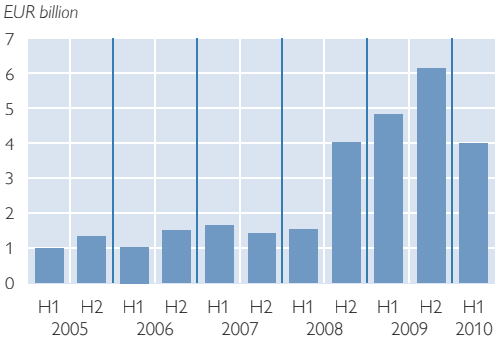
Slowdown in Credit Quality Deterioration Differs across Regions

Austrian banks still bear high costs for building up loss provisions covering their credit risk. Consolidated credit risk costs amounted to EUR 4 billion in the first half of 2010. Even though they had shrunk by 17% year on year, such costs were still markedly higher than in former years (see chart 25). Over the past three years – from mid-2007 to mid-2010 – Austrian banks had set aside a total of EUR 22 billion in risk provisions.

The rise in credit risk costs reflects a general deterioration in credit quality. Yet, both the level of credit quality and the pace of deterioration differ considerably across regions. The increase of the unconsolidated loan loss provision ratio[6] – which does not cover subsidiaries' business activity and is thus clearly focused on Austria – basically stopped in the second and third quarters (maroon line in chart 26). At 3.1%, this ratio amounted to merely half of the aggregate loan loss provision ratio of all subsidiaries (5.9%; blue line in chart 26) in mid-2010. The latter continued to

Chart 25

Consolidated Credit Risk Costs of Austrian Banks



Source: OeNB.

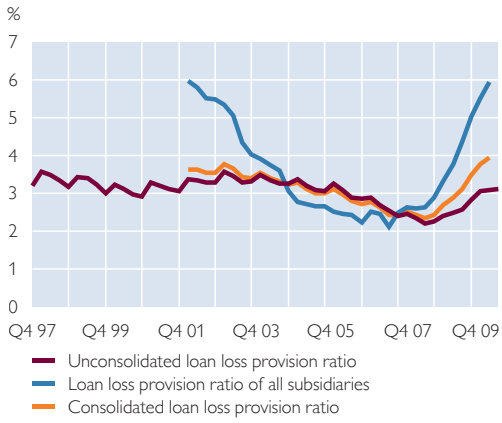
[4] *The analysis of loan growth is based on unconsolidated MFI balance sheet statistics data adjusted for exchange rate effects, value adjustments and reclassifications. These are adjustments for effects that do not arise from transactions.*

[5] *In this respect, "domestic nonbanks" are defined as all financial market participants other than credit institutions.*

[6] *Stock of specific loan loss provisions for claims on nonbanks (i.e. customers) as a share of total outstanding claims on nonbanks.*

Chart 26

Loan Loss Provision Ratios of Austrian Banks



Source: OeNB.

grow at an almost unchanged pace, namely by almost 1 percentage point, in the first half of 2010. Subsidiaries in the CIS continued to post the highest increase in loan loss provision ratios, which climbed by 1.4 percentage points, already a much slower growth rate compared with 2009. The aggregate loan loss provision ratio of CIS-based subsidiaries stood at 11.8% in mid-2010.

The resulting consolidated loan loss provision ratio[7], which covers total credit to domestic and nondomestic customers, ran to 3.9% in the middle of 2010. As claims on domestic customers did not give rise to additional provisions recently, the increase of the consolidated loan loss provisions ratio slowed down (orange line in chart 26).

The share of the market risk capital requirements in the total capital requirements of the Austrian banking system continues to be small.[8] In mid-2010, this share amounted to 3.3% (unconsolidated) or 3.4% (consolidated), which in both cases corresponds to a 0.1 percentage point rise from the end of 2009. All relevant risk categories of the market risk capital requirements, i.e. interest rate instruments and shares in the trading book as well as open foreign currency positions of the bank as a whole, registered slight increases from January to June 2010.

Interest rate risk in the banking book (in a consolidated view) rose slightly in the first half of 2010,[9] which is above all attributable to the positioning of some major banks. In this area, the overall risk exposure of the Austrian banking system stands at a historically modest level.

Liquidity Situation Stable

Austrian banks' liquidity situation is stable, both at the consolidated and unconsolidated level. On an unconsolidated basis, liquid claims (with maturities of up to three months) and liquid assets (e.g. euro government bonds) held by Austrian banks as at June 30, 2010, amounted to 122.9% of short-term liabilities (with maturities of up to three months). This represents a slight decrease of 1.9 percentage points compared with the figure as at December 30, 2009.

On a consolidated basis, the counterbalancing capacity after 12 months[10] (before money market) totaled EUR 90 billion on October 29, 2010. In other words, even based on conservative estimates of cash flows 12 months ahead, banks' liquidity conditions remain stable, a marginal improvement compared to December 30, 2009 (EUR 87 billion).

[7] *The numerator of this ratio is the stock of unconsolidated specific loan loss provisions for claims on nonbanks plus the loan loss provisions reported by the fully consolidated bank subsidiaries. The denominator is the sum of unconsolidated gross claims on nonbanks and the fully consolidated subsidiaries' gross claims on nonbanks. Due to regional differences in accounting rules, the consolidated loan loss provision ratio may convey a slightly distorted picture.*

[8] *Market risk refers to the risk of value changes in financial instruments triggered by fluctuations of market risk factors, such as interest rates, stock prices, exchange rates or commodity prices.*

[9] *Based on the so-called "interest rate risk statistics."*

[10] *The counterbalancing capacity comprises expected net cash inflows plus any additional liquidity that may be realized in the observation period.*

Box 2

Basel III and Its Impact (QIS)

Against the backdrop of the most recent financial crisis, a comprehensive range of proposals to tighten the regulatory framework for banks ("Basel III") is meant to strengthen and sustain the stability of the banking sector. The measures under this framework, which were adopted by the Board of Governors and Heads of Supervision of the member states of the Basel Committee on Banking Supervision in November 2010, reach far beyond a mere revision of the existing capital requirements. They comprise proposals to raise the quality and quantity of equity capital (through tighter eligibility criteria for capital instruments and higher minimum capital ratios), introduce a leverage ratio (maximum overall debt ratio), improve liquidity management (through the introduction of liquidity ratios) and implement a regime that reduces procyclicality (through the introduction of capital buffers and countercyclical adjustments in minimum capital requirements). Further measures aim at limiting the specific risks associated with systemically important institutions and at raising their ability to absorb losses.

The financial market crisis had unmasked the inability of some capital components to adequately absorb losses. This is why Basel III targets an overall improvement in the quality of regulatory capital. The new framework thus applies a stricter definition as to what qualifies as capital in accordance with loss absorbency: First, tier 1 capital must be sufficiently loss-absorbent on a going concern basis. Therefore, a distinction will henceforth be made between core tier 1 capital (referred to as "the common equity component" of tier 1 under the Basel III framework – basically paid-up capital and reserves) and non-core tier 1 capital (additional going concern capital). In addition, once an institution is no longer viable (gone concern), tier 2 capital will be used to redeem debt. Moreover, the application of capital deductions will be harmonized at the international level; deductions will in the future as a rule have to be applied to tier 1 capital.

Following multiyear transition periods, in 2019 at the latest, the minimum ratio for common equity capital is meant to equal 4.5%, that for tier 1 capital 6% and that for total capital 8% (10.5% including a capital conservation buffer). These periods are meant to allow banks which have only limited access to the capital market owing to their size or ownership structure to use their profits to gradually attain the raised capital ratios.

A capital conservation buffer, set to reach 2.5% of risk-weighted assets by 2019, is scheduled to diminish the cyclical effect of capital requirements. Noncompliance with this target ratio will result in the phase-in of greater constraints on earnings distributions. In addition, during periods of excess credit growth, supervisory authorities will be able to impose a countercyclical capital buffer at the national level, covering a range of 0% to 2.5% of risk-weighted assets.

As a backstop to the risk-based measures, the Basel III framework envisages the introduction of a non-risk-based leverage ratio (maximum debt ratio) to curb excessive balance sheet growth not underpinned by capital. The supervisory monitoring period for the leverage ratio, set to start in 2011, will be followed by a trial period ("parallel run") beginning in 2013.

With regard to liquidity, the following problems became particularly evident during the crisis: great dependence on short-term refinancing and inadequate liquidity management. Hence, the new framework includes new ratios to improve the liquidity situation (liquidity coverage ratio – LCR, and net stable funding ratio – NSFR) as well as tighter liquidity management requirements. The liquidity coverage ratio is scheduled to undergo an observation period from 2011 to 2015, when it will become a minimum standard. Beginning in 2012, especially the impact of the net stable funding ratio on business models will be under observation before application of this ratio will become mandatory in 2018.

At the European level, the new standards have yet to be adopted by the Council of the European Union and the European Parliament. The European Commission is expected to present its new proposals on capital requirements, i.e. the respective amendments to the Capital Requirements Directive ("CRD IV") in the summer of 2011. Austria takes the stance that the requirements should not be watered down when they are transposed into European law; at the same time, European specifics, such as the structures of decentralized multi-tier banking sectors (cooperative banks, savings banks) should be taken into account.

To assess the impact of the proposals made by the Basel Committee on Banking Supervision, the Committee conducted a comprehensive quantitative impact study (QIS) both at the international and at the European level. Based on this study, Austrian banks concluded that the new requirements – depending on the final definition of capital categories – will result in an additional capital need in the low double-digit billion euro range. From today's perspective, the transition periods set forth by the Basel Committee seem to be long enough to allow banks to adjust their business models in a way that does not affect the real economy in an adverse manner. On balance, the long-term benefits of Basel III are set to far exceed the short-term costs. For more details on the impact of Basel III on Austria, see the study "The Economic Impact of Measures Aimed at Strengthening Bank Resilience – Estimates for Austria" in this issue.

Harmonized Legal Framework for Financial Market Infrastructures

At the EU level, work on harmonizing the legal framework for central counterparties (CCPs) and central securities depositories (CSDs) has made further progress. In September 2010, the European Commission presented a Proposal for a Regulation on OTC derivatives,[11] central counterparties and trade repositories. Apart from implementing stringent organizational and prudential requirements for CCPs, the regulation will include the much-discussed clearing obligation for OTC derivatives (i.e. standardized OTC derivative transactions will have to be cleared through CCPs). Additionally, the proposal seeks to enhance transparency by providing for a reporting requirement of such transactions to registered trade repositories that will be accessible to regulators. The key features of the Commission's Proposal for a Regulation on short selling and certain aspects of Credit Default Swaps (CDS) are, first, to establish harmonized notification requirements across the EU; and second, to determine standards and organizational procedures for CDSs. The competent (national) supervisory authorities have not been specified yet. The European Commission views both proposals as further contributions to making financial market infrastructures in Europe safer and more transparent.

It must be noted that the Austrian financial market infrastructures and payment systems have shown themselves to be safe and sound as well as fully operational under all conditions, even during periods in which the financial market was beset by turbulence. There were no system disturbances with an impact on the Austrian financial system in the first half of 2010.

First Signs of a Return to Growth in Some CESEE Countries[12]

The business environment for banks proved to be ambiguous in 2010. Whereas the global economy was on the path to recovery and emerging markets were regaining attractiveness for

[11] *Over-the-counter (OTC) trade refers to transactions in securities between financial market participants that do not occur on an organized securities exchange.*

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

investors, several factors were cause for concern, above all the reassessment of country risks and the associated exchange rate fluctuations. Moreover, concerns about whether economies would suffer after phasing out the support measures and about the political situation in the region were widespread. Overall, the recovery firmed across Central, Eastern and Southeastern Europe (CESEE),but developments in individual countries diverged.

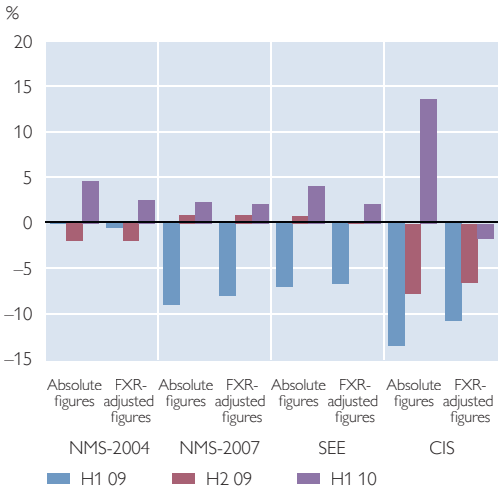
For the first time since the outbreak of the financial turmoil, the figures reported by Austrian banks' subsidiaries in CESEE indicate a return to a growth path, albeit still at a low level by historical standards and adjusted for exchange rate changes. Compared with the second half of 2009, the total assets of Austrian banks' 68 fully consolidated subsidiaries in CESEE rose by roughly 4% to EUR 264.5 billion at mid-2010, bringing Austrian banks' CESEE market share to 13.6% (2009: 14.4%); excluding Russia, this share is 21% (2009: 21.1%).

A comparable increase by about 3.3% to EUR 165.5 billion was also reported for the volume of on-balance sheet loans to nonbanks (see chart 27).

In the first half of 2010, the profitability of the core business of Austrian banks' CESEE subsidiaries improved compared to the first half of 2009 even though credit portfolios contracted, but the net loss on financial operations had a negative impact on the overall result. Total operating income thus dipped to roughly EUR 6.6 billion following an above-average result in 2009. At EUR 4.6 billion, net interest income stood at a historical high in absolute terms and represented a record share of 71% of operating income (Q2 09: 60%). Significantly higher expenditure in the Commonwealth of Independent States (CIS) caused the cost-to-income ratio to deteriorate by approximately 1 percentage point to 48.3%, ultimately dampening operating profit by 3.1% to EUR 3.4 billion.

Chart 27

Growth of Lending by Austrian Banks' Subsidiaries in CESEE

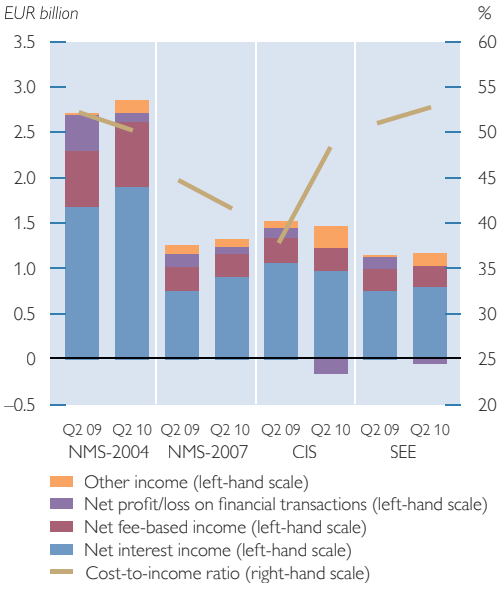


Source: Surveys of the "big five" Austrian banks in CESEE.

Note: Figures were adjusted for foreign exchange rate (FXR) movements.

Chart 28

Profitability of Austrian Banks' Subsidiaries in CESEE



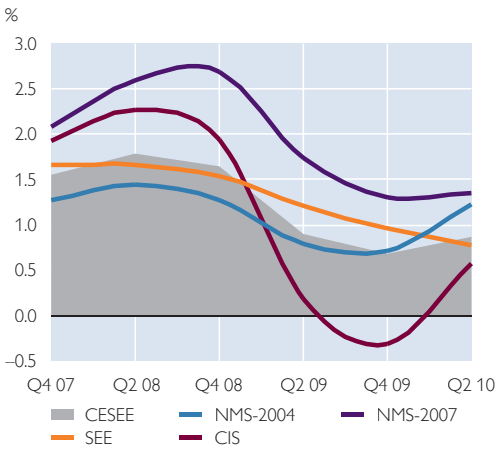
Source: OeNB.

The return on assets of Austrian banks' subsidiaries in CESEE fell slightly year on year, dropping to around 0.9% (annualized) in the first half of 2010. However, this represents a slight improvement compared to the end-2009 result, among other things because of lower new loan loss provisions in the CIS. Profitability developed along different lines in individual CESEE countries and regions in the first two quarters of 2010. Whereas most of the profits still came from countries like the Czech Republic, Romania, Russia or Croatia, six CESEE countries posted a negative result at end-June 2010. Overall, Austrian banks' CESEE subsidiaries made profits of around EUR 1.1 billion in the first half of 2010, down by some 6.2% on the same period of 2009.

The speed at which credit risks unfold and the corresponding loan loss provisions are made remains heterogeneous across regions. The share of nonperforming loans in the region as a whole rose from 9.8% at the end of 2009 to 12.2% at mid-2010. However, the rise in the loan loss provision ratio from 5.3% at end-2009 to 6.2% at mid-2010 was smaller than that in the nonperforming loan ratio, causing the coverage of nonperforming loans by loan loss provisions to sink (coverage ratio at mid-2010: 40.3%).[13] With the exception of the CIS, where restructuring measures were taken and risk transfers were made in addition, all regions posted higher risk costs at end-June 2010 than at mid-2009. Principally, given e.g. the continued strength of the Swiss franc and ongoing problems in individual countries, loan loss provisions are expected to stay above average. Considering that the level of loan loss provisions is already high, the current forecasts for economic developments

Chart 29

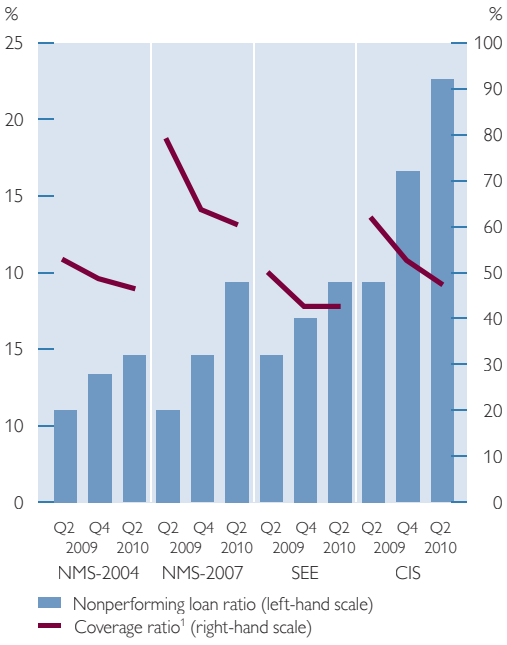
Annualized Return on Assets of Austrian Banks' Subsidiaries in CESEE



Source: OeNB.

Chart 30

Nonperforming Loan and Coverage Ratio of Austrian Banks' Subsidiaries in CESEE



Source: OeNB.

[1] Total loan loss provisions divided by nonperforming loans.

[13] The coverage ratio is approximate and is calculated not on the basis of loan loss provisions on nonperforming loans but as the ratio of total loan loss provisions to nonperforming loans. The calculation does not take the degree of collateralization into account.

do not signal a massive increase in credit risk costs at the aggregate level.

The capital buffers of Austrian banks' subsidiaries in CESEE were again strengthened in 2010. A variety of methods were used to achieve this goal: reducing loan portfolios, making risk transfers, retaining earnings and making capital injections. Consequently, the aggregate tier 1 ratio and the capital ratio ran to 12.7% and 15.1% at end-June 2010, reflecting a rise in capital calculated in euro by around 7% against the background of a stagnation of risk-weighted assets. In the second quarter of 2010, only four subsidiaries reported a capital ratio of under 10%, and nine additional banks had a ratio of less than 12%. As some of these banks operate in critical markets, however, it is crucial that these banks continue to boost their capital ratios.

With business growth remaining slow, the structural refinancing position of the subsidiaries as a whole stabilized further, but at the country level, exchange rate-related divergences in developments were observed. As a case in point, the loan-to-deposit ratio diminished by some 0.5 percentage points to 108.8% from end-2009 to mid-2010, and the deposit gap fell further by EUR 0.3 billion to EUR 13.4 billion. This development was fueled by the EUR 3.1 billion rise in deposits in the Czech Republic, part of which was absolute and part of which was related to exchange rate changes. In markets with a high share of loans denominated in Swiss francs or U.S. dollars but with a low share of offsetting foreign currency deposits, notably Russia, Hungary, Romania and Croatia, the deposit gap widened by 20% on average, as reflected by an increase in intragroup claims (including guarantees) by about EUR 2.4 billion to EUR 51.5 billion. Thus, banks still face the challenge of having to reduce currency mismatches and of embarking on a sustainable development of retail banking. A trend break was observed in intragroup refinancing of other financial intermediaries, which augmented steadily until end-2009 and then diminished by EUR 0.5 billion to EUR 19.1 billion in the first half of 2010. The latter development primarily reflects the slow decline in the portfolio holdings of leasing subsidiaries.

The volume of large direct (i.e. cross-border) loans Austrian banks extended to nonbanks and financial institutions[14] in CESEE grew marginally compared to end-2009, rising by 1.1% to EUR 49.6 billion until mid-2010 (not adjusted for exchange rate effects owing to data unavailability). The volume of loans to nonbanks granted by Austrian banks directly increased by 1.5% to EUR 45.6 billion in the first half of 2010, with loans to nonbanks in the CIS jumping by 13.2% in the same period as a result of the U.S. dollar's strength. Loan loss provision ratios increased once again for loans granted directly, but still remain at only a little more than half the level for loans granted by Austrian banks' subsidiaries in CESEE.

In the case of foreign currency lending, the sharp decline in new business may be observed to have reduced risk, but the old portfolio continues to represent a considerable burden. The foreign currency loan portfolios of Austrian banks' CESEE subsidiaries shrank further in the first half of 2010; adjusted for exchange rate changes, these holdings dropped by 1.3% to EUR 81.1 billion. Foreign currency lending above

[14] *This item comprises loans to nonbanks and financial institutions outside the lender's banking group. A comparison with historical data is impossible, though, since this item included intragroup loans up to the data reported in the Financial Stability Report 17.*

all to households diminished at an above-average rate of –2.2%, albeit with strong regional discrepancies: It rose by 4.36% in the NMS-2007 and declined by 7.70% in the CIS, by 6.05% in the NMS-2004, and by 1.02% in SEE. As a result, the share of foreign currency credits in total loans granted by Austrian banks' subsidiaries in CESEE decreased from 49.3% at end-2009 to 47.9% at mid-2010. In turn, foreign currency loans to CESEE customers granted directly by Austrian banks went down by 3.2% to EUR 39.7 billion in the first half of 2010. Compliance with the OeNB/FMA Guiding Principles on Foreign Currency Lending in CESEE cannot be examined in detail so far. However, compliance will become more important once lending revives in a more competitive business environment.

The exposure of Austrian banks[15] to CESEE has continued to grow since 2009, rising by 4% to EUR 212.5 billion (including foreign-owned banks roughly EUR 300 billion) at end-June 2010. The increases in Ukraine and Russia reflect the temporary depreciation of the euro in the first half of 2010. Exposures declined above all in Serbia, Hungary and Romania. In the latter two countries, the decline reflects the current expectations that economic growth will be sluggish (see chart 31). From the country risk perspective, the level of Austrian banks' investment in bonds of euro area countries with a high risk premium is noticeably below average, but Austrian banks have a high exposure to the CESEE region. Therefore, credible fiscal consolidation is an issue of importance for Austrian banks, too.

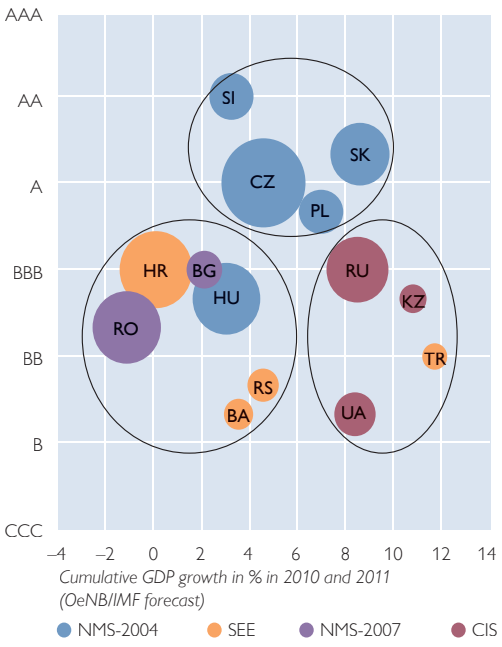
Boost in Capital Buffers Raises Capital Ratios

The aggregated tier 1 capital ratio (capital ratio) of all Austrian banks recovered from a low observed in the third quarter of 2008, rising by roughly 247 (280) basis points to 9.78% (13.25%) at end-June 2010. This recovery may largely be attributed to two factors: to an increase in eligible capital, which accounted for about 80% of the rise in the capital ratio until the second quarter of 2010, and to a decline in risk-weighted assets, which accounted for about 16% of this increase.[16]

The improvement in the capital ratio resulting from the increase in eligible capital breaks down into several categories, with roughly 43% of the total attrib-

Chart 31

Country Risk Exposure of Austrian Banks in CESEE at Mid-2010



Source: OeNB, Bloomberg, IMF.

[15] *According to BIS definition.*

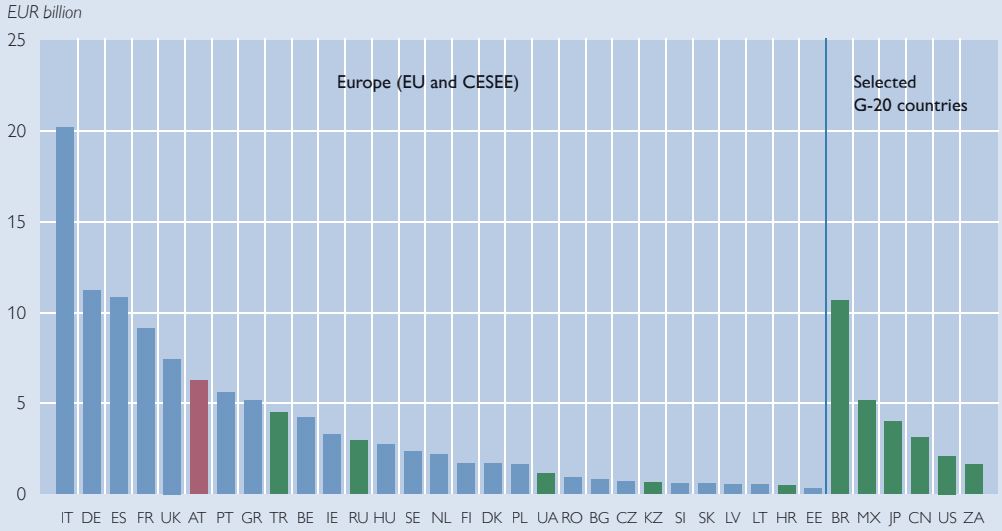
[16] *The remaining 4% are the result of a combination of risk-weighted asset and eligible capital effects.*

Box 3

Credit Default Swaps (CDSs) on Austrian Reference Entities

The Depository Trust & Clearing Corporation (DTCC) collects data on CDS transactions for the bulk of the international CDS market. In the course of the crisis, the CDS market became a focus of attention not just because of its high trading volume but also because of the associated financial stability issues. This box provides a short overview of CDSs on Austrian reference entities. DTCC registered CDSs outstanding on a current total of 17 Austrian reference entities. The total net nominal amount of these CDSs – i.e. the volume of economic risk transfer – ran to roughly EUR 8.5 billion as at September 24, 2010. Since March 2010, the volume of CDSs outstanding has been fairly stable. Around 95% of the net nominal amount outstanding was on only four reference entities: the Republic of Austria, Telekom Austria, Erste Group Bank and RZB. The net nominal amount outstanding on Austrian sovereign CDSs amounted to about EUR 6.3 billion or 3.4% of government debt as at October 1, 2010. In an international comparison, the volume of CDSs is rather high both in absolute terms and as a percentage of government debt despite the excellent AAA sovereign rating (see chart below). However, there is no indication that trades in Austrian CDSs involve any targeted speculation by investors expecting the Republic of Austria to default. Much rather, Austrian sovereign CDSs may serve as a proxy for investor sentiment about Austrian banks and the CESEE region.

Net Notional Sovereign CDSs Outstanding – An International Comparison



Source: DTCC (volume of CDSs on October 1, 2010).

utable to government participation capital and about 10% to limited private placements.[17] Most of the remaining 47% are attributable to privately raised capital (e.g. in 2009 and 2010, earnings were booked into capital).

Until the fourth quarter of 2009, banks reduced risk-weighted assets, obviously reacting directly to the financial crisis. Above all the "top six" banks cut back on risk-weighted assets by streamlining balance sheets, reducing off-balance sheet business and the like.

[17] *The additional limited private placements of approximately EUR 1.2 billion further increased Austrian banks' capital buffers and thus improved their risk-bearing capacity. Limited private placements refer to the capital injections that banks added to their own funds in addition to the capital provided by the government in order to reduce dividend payments to the government from 9.3% to 8% (where these private placements account for more than 25% of the federal capital injected).*

Moreover, capital – in terms of eligible capital, eligible tier 1 capital and core tier 1 capital[18] – has augmented considerably since the third quarter of 2008, especially in the wake of the bank rescue package (about EUR 6.3 billion).

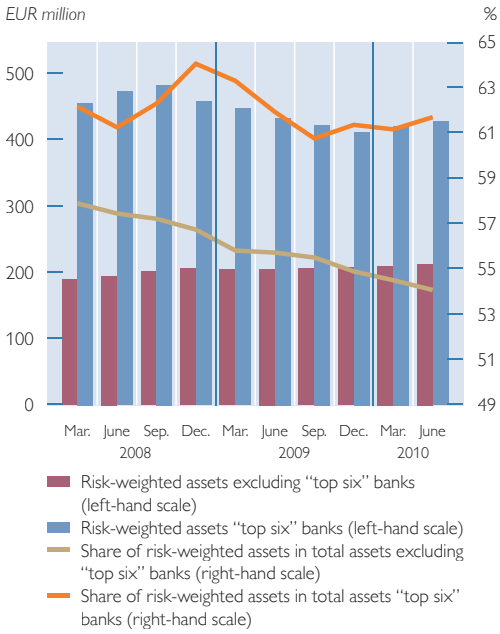
Notably, core tier 1 capital expanded by 30% from the low recorded in the third quarter of 2008 until the second quarter of 2010, i.e. more strongly than eligible capital and than eligible tier 1 capital.

Stress Test Results Indicate that the Austrian Banking System's Resilience to Shocks Is Intact

The OeNB regularly performs stress tests to assess the resilience of the banking system to potentially negative developments of the economic environment, regarding them as a fundamental element of financial stability analysis. As in the past, the OeNB's most recent fall stress test included two scenarios, this time for the period until the end of 2012. The first one is the benchmark scenario, based on the OeNB's most recent economic forecast for Austria and selected CESEE countries and supplemented by the IMF's forecast[19] for all other countries. The second one is a "refinancing crisis" scenario simulating a severe strain on the economic environment for the Austrian banking sector.[20] This stress scenario, a double-dip scenario like the one used for the spring exercise, simulates a renewed slump in investor confidence worldwide from the beginning of 2011 that leads to a

Chart 32

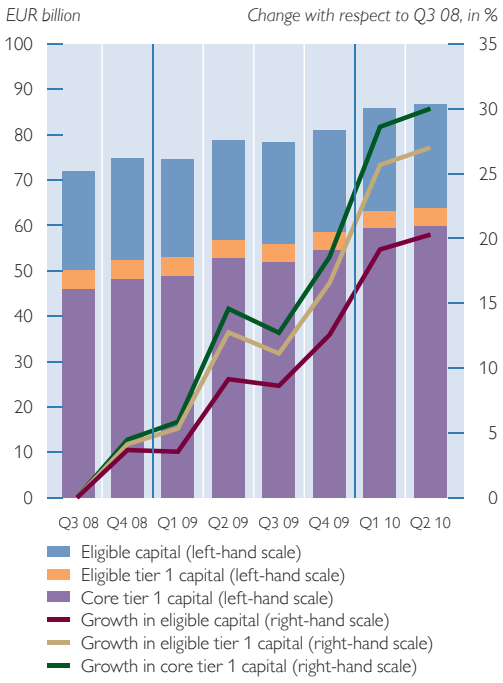
Development of Risk-Weighted Assets



Source: OeNB.

Chart 33

Growth in Capital Positions



Source: OeNB.

[18] *Eligible tier 1 capital adjusted for innovative hybrid capital.*

[19] *See IMF, 2010, World Economic Outlook, October.*

[20] *Note that this is a hypothetical scenario only, serving as a basis for the stress test. From today's perspective, this scenario is not expected to occur.*

sharp rise in risk premiums and in interest rates. In the currently fragile economic environment, such a shock to investor confidence would have a direct, negative impact on the real economy, given the higher refinancing need of many sovereigns and banks: The slump in global demand would be further reinforced by lending restrictions and the greater need to consolidate public finances. Many countries have no budgetary room for maneuver to address a renewed downturn; much rather, they would be forced to cut costs even more.

As the economic outlook has improved overall, the growth rates assumed for most regions in the refinancing crisis scenario are somewhat higher than in the stress scenario of the spring stress test. While the differences between the growth rates in the benchmark and the stress scenario are somewhat larger than in the previous exercise, they are nevertheless comparable to those of earlier stress tests. For Austria, the cumulative GDP growth gap between the two scenarios over the 2½ year simulation period totals 5.4 percentage points, with GDP growth assumed to be just barely positive at 0.4% over the entire period in the stress scenario. For the CESEE region as a whole, the corresponding cumulative growth gap comes to 9.0 percentage points. At 9.8 percentage points, the gap is largest for the CIS (see chart 34).

The evaluation of the impact of the two scenarios on the Austrian banking system mainly focuses on the following transmission channels: operating income before risk provisioning, credit risk costs, and the development of risk-weighted assets. In the refinancing crisis scenario, operating income is affected above all by more stringent refinancing conditions. Moreover, both the probabilities of default and losses given default (LGDs) increase, which in turn causes credit risk costs to rise;[21] and finally, the higher risk parameters in the stress scenario influence the development of risk-weighted assets. These three components in turn determine the development of our key measure for assessing overall risk, the tier 1 ratio.

In backtesting analyses, the development of these three key components in the benchmark scenario of past OeNB stress tests is compared ex post with the actual developments. In the case of the spring 2010 exercise, banks performed somewhat better in reality than in the benchmark scenario.[22]

In the most recent stress test, the benchmark scenario shows a positive development both for the Austrian banking system as a whole and for the "top six" banks:[23] The tier 1 ratio for both aggregates rises by somewhat more than 1 percentage point over the entire period (see chart 35).[24] The rise in the tier 1 ratio is some 0.5 percentage points higher than in the spring stress test, partly because the economic outlook has improved and partly because the fall exercise was based on a longer period.

[21] *This becomes particularly obvious when the effect of the refinancing crisis scenario takes hold at the beginning of 2011. Here, the increase in LGDs of defaulted exposures entails noticeable one-off effects on credit risk costs.*

[22] *For one thing, this can be traced to some simplifying assumptions, which are required to treat all banks equally in the exercise. For another thing, some aspects of the tests are deliberately based on conservative modeling.*

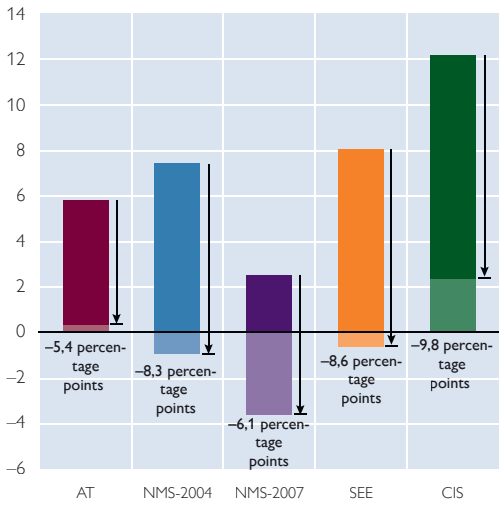
[23] *UniCredit Bank Austria AG, BAWAG P.S.K. AG, Erste Group Bank AG, Raiffeisen Bank Int. AG, Österreichische Volksbanken AG, and Hypo Alpe-Adria-Bank International AG.*

[24] *The results refer to the OeNB calculations (top-down approach) based on reporting data of mid-2010. In the exercise, profits of the first half of 2010 have been taken into account in the capital position and thus in the tier 1 ratio for mid-2010.*

Chart 34

GDP Growth in the OeNB Fall 2010 Stress Test[1]

Cumulative GDP growth in %



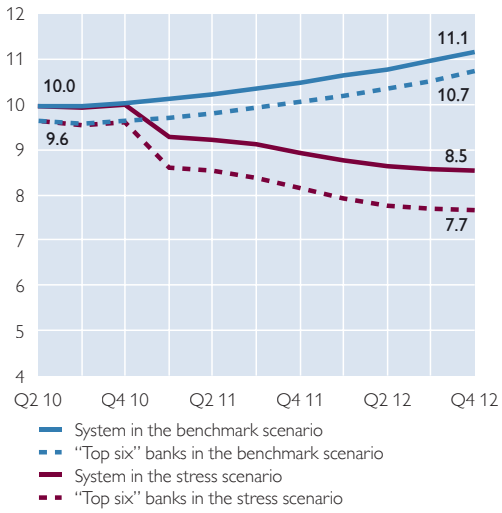
Source: OeNB.

[1] Cumulative rate over the 2½ year stress test horizon in the benchmark scenario (dark) and in the stress scenario (light).

Chart 35

Development of the Tier 1 Ratio in the OeNB Fall 2010 Stress Test[1]

Tier 1 ratio in %



Source: OeNB.

[1] The tier 1 ratio for Q2 10 takes mid-year profits into account.

In the refinancing crisis scenario, the tier 1 ratio of the banking system drops by 1.5 percentage points to 8.5% by the end of 2012; the decline for the "top six" banks is 1.9 percentage points (to 7.7%). Thus, the stress scenario produces a result similar to that of the spring stress test, except that the tier 1 ratio is reduced by just under 0.5 percentage points more. This reduction, however, is not the outcome of a more severe stress scenario in absolute figures, but of the banking system's stronger sensitivity to the current scenario (in response e.g. to more stringent refinancing conditions for banks themselves). This factor, together with the extension of the simulation period by one-half year and the somewhat greater growth reduction in the stress scenario, explains why the difference between the tier 1 ratio in the benchmark and the stress scenarios is now somewhat larger than in the spring exercise. Overall, the current stress test results indicate that the Austrian banking system's resilience to a renewed outbreak of a global crisis is intact. As far as the size of scenario impact is concerned, differences exist at the individual bank level.

Clear Signs of a Recovery on the Financial Markets

New Ratings for the Raiffeisen Group and Further Downgrade of Hypo Alpe-Adria-Bank International[25]

On August 3, 2010, the rating agency Moody's Investors Service lowered the long-term deposit rating (LTDR) for Hypo Alpe-Adria-Bank International from Baa2 to Baa3, but left the bank financial strength rating (BFSR) unchanged at E. Moody's also issued new ratings for the Raiffeisen group, after it had undergone a corporate reorganisation. The LTDR and BFSR for Raiffeisen Bank International were set

[25] As at November 18, 2010.

at A1 and D+, respectively, while the LTDR for Raiffeisen Zentralbank (RZB) was reduced from A1 to A2, with a BFSR no longer being assigned. The ratings of other major Austrian banks were left unchanged.

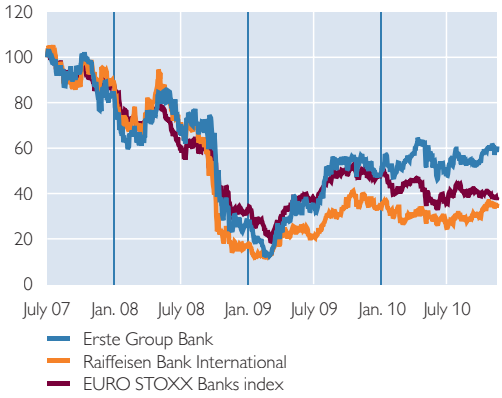
Banks' Stock Prices Still Far Below their Mid-2007 Levels

The evolution of the stock prices of the two large Austrian banks Erste Group Bank and Raiffeisen Bank International since the beginning of the global financial crisis can be divided into two distinct phases. From the onset of the crisis in the third quarter of 2007 to the end of the first quarter of 2009, the prices of the two banks' stock declined more or less synchronously, namely by 78% and 82%, respectively. Since then, they have risen significantly, but the magnitude of the increases differed markedly: by November 18, 2010, the stock of Erste Group Bank had gained 175%, while that of Raiffeisen Bank International had risen by 95%. The EURO STOXX Banks index, a benchmark for bank stocks in the euro area, was less volatile in both these phases: it declined by 74% during the downturn, but gained only 45% during the subsequent recovery. A comparison of the two Austrian banks' stock performance with the benchmark shows that the stock of Erste Group Bank has outperformed the index by 22 percentage points since the start of the financial market turbulences in summer 2007, while the stock of Raiffeisen Bank International performed 3 percentage points worse than the benchmark. The stock prices of both banks, as well as the benchmark index, are still well below the levels recorded in mid-2007.

Chart 36

Bank Stock Prices since Mid-2007

Index: July 2, 2007 = 100



Source: Thomson Reuters.

Insurance Companies and Mutual Funds Benefit from Financial Market Recovery

Insurance Industry in Europe Recovers

Better financial results enabled the European insurance industry to raise its resilience, as measured by the solvency ratio, by 16 percentage points to 194% in 2009,[26] a trend that continued in 2010. The stock prices of listed insurance companies stabilized, but the level of the EURO STOXX Insurance index at the end of October 2010 was still some 50% lower than on July 1, 2007. At the moment, the insurance industry in Europe is preparing for the new Solvency Directive (Solvency II), which will enter into force in January 2013, by participating in the fifth Quantitative Impact Study (QIS 5), which was launched by the European Commission with a view to ensuring as precise a formulation of the new Solvency II framework as possible. Market participants currently expect Solvency II, which is more risk-oriented than Solvency I, to lead both to higher capital needs in the insurance sector and to increased investment by that industry in less risky assets.

[26] *Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). 2010 Spring Financial Stability Report.*

The Insurance Sector in Austria

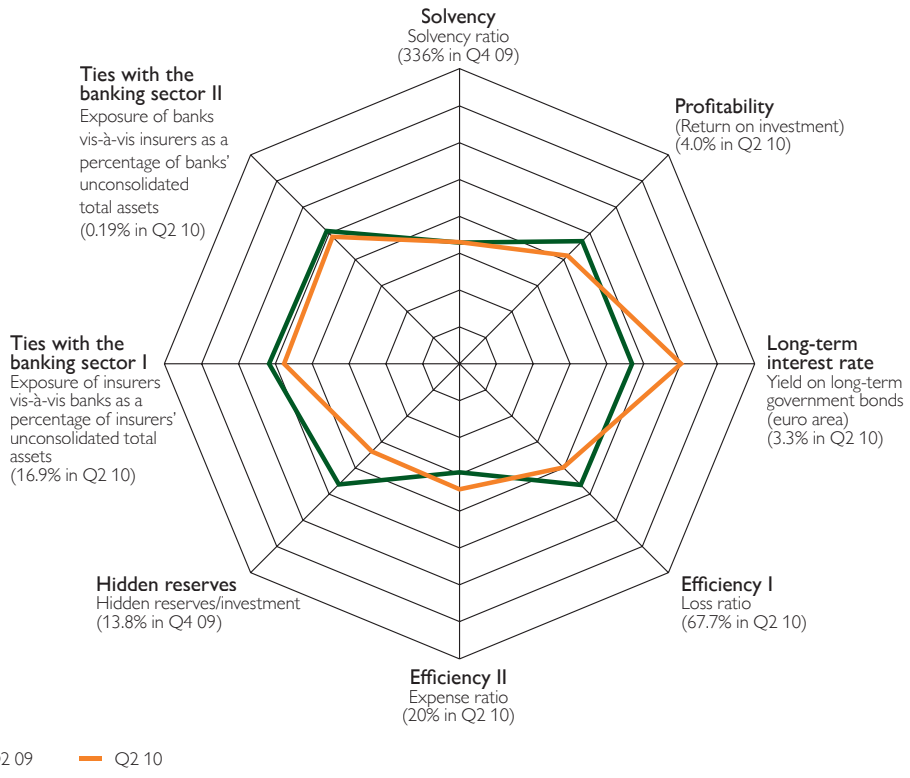
The ongoing recovery of both the financial markets and the real economy is also reflected in the results of Austrian insurance companies. The growth of premiums written in the first quarter of 2010 (3.2% year on year) slowed down somewhat in the second quarter, in which net premium income increased by 1.8% year on year, with the premiums earned in the life insurance segment rising by 1.7%, while those in the property and casualty insurance and the health insurance segments increased by 1.6% and 2.7%, respectively. The result of financial operations[27] increased by 27%, year on year, to just under EUR 1.6 billion, thus again almost reaching the level recorded prior to the crisis (EUR 1.7 billion in Q2 07). Both the expense ratio (the share of operational expenditure in the insurance premiums written) and the loss ratio (the proportion of insurance premiums written that is spent on the settlement of claims) improved slightly over the year (see chart 37).

In the second quarter of 2010, the assets of Austrian insurance companies were mainly debt securities (62%). The OeNB's securities issuance statistics, which cover 69% or EUR 70 billion of

Chart 37

The Insurance Sector and Financial Market Stability

The closer the data points are to the center, the better the ratio.



Source: Austrian Financial Market Authority (FMA), OeNB.

Note: Unconsolidated data as at the end of the second quarter of 2010; scaling on the basis of historical data.

[27] *Net investment income.*

the insurance sector's unconsolidated total assets,[28] show that, at the end of the second quarter of 2010, insurers had invested EUR 32.2 billion with domestic and foreign banks, and EUR 46.8 billion in the financial sector as a whole. This makes clear that the risk of contagion spreading from the financial sector to the Austrian insurance sector is significant and needs to be monitored at regular intervals.

For insurance companies with a high proportion of life insurance policies that provide for a guaranteed minimum return, the currently low level of interest rates poses a particular challenge with respect to their long-term profitability and ability to bear risks. Therefore, the minimum yield on classic life insurance policies is to be reduced by 0.25 percentage points to 2% in 2011, but this will apply only to new contracts.

Austrian Insurance Companies in CESEE

In 2009, Austrian insurance groups were active in 21 countries[29] in the CESEE region. The aggregate total assets of their subsidiaries amounted to EUR 12.2 billion (or 13% of the groups' aggregated total assets) at the end of 2009, an increase of 15.2% in comparison with 2008. Even in 2009, a difficult year, business in the CESEE region was profitable for Austrian insurers active there: premiums written by CESEE subsidiaries totaled EUR 5.8 billion (30% of the aggregated premiums written) and their income from ordinary activities amounted to EUR 249 billion (30% of aggregate income from ordinary activities).

Activities in the CESEE region focus on the more stable countries there. Accordingly, 62% of total assets held by Austrian insurance companies in CESEE at the end of 2009 originated in the Czech Republic, Slovakia and Poland, all of which are EU Member States rated A by Standard & Poor's. Over the medium term, these investments promise significant gains, although the growth rates expected for 2011 are only comparatively moderate.

In summary, the currently generally fragile economic environment gives rise to the following challenges for the insurance sector: persistently low interest rate levels over a longer period (particularly problematic in the case of products with guaranteed returns), an increase in sovereign risk and possible setbacks in the financial markets, especially in the banking sector. The risk of contagion spreading from the banking to the insurance sector, and vice versa, has declined somewhat on account of the improved environment, but it remains elevated.

Investors in Austrian Mutual Funds Prefer Bond and Mixed Funds

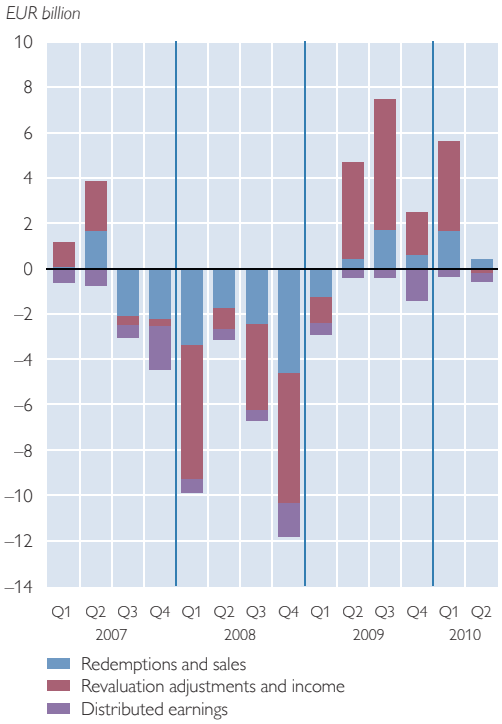
Assets under management in Austrian mutual funds totaled EUR 143.7 billion at the end of June 2010, an increase of 3.7% since the end of 2009. Whereas the assets under management of institutional funds rose in both of the first two quarters of 2010, those of retail funds increased in the first quarter, but declined slightly in the second. In line with these developments, the consolidated net asset value, i.e. assets under management excluding domestic interfund investment, remained virtually

[28] *In these statistics, securities issuance is recorded on a nonconsolidated basis, i.e. excluding investment via subsidiaries in CESEE.*

[29] *Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kosovo, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey and Ukraine.*

Chart 38

Change in the Consolidated Net Asset Value of Austrian Mutual Funds



Source: OeNB.

unchanged in the second quarter, standing at EUR 120.5 billion at the end of June 2010 (+4.5% since the beginning of this year). While mutual funds still enjoyed price gains[30] to the amount of EUR 4.0 billion in the first quarter of 2010, as well as attracting strong investor interest,[31] they suffered from price losses in the order of EUR 200 million and waning investor interest in the second.

In Austria, compared to the euro area, an above-average proportion of mutual funds (excluding money market funds) are bond funds and mixed funds (49% and 36%, respectively, at the end of June 2010). With a share of only 13%, equity funds play a minor role in Austria, while they rank second in the euro area, accounting for 28% of mutual fund assets there.

The operating profit of Austrian investment companies[32] totaled EUR 64 million in the first half of 2010, thus exceeding that recorded in the corresponding period of 2009 by 40%, but still remaining well below that of the first six months of 2007 (EUR 116 million). The improvement in the business situation of Austrian investment companies is also reflected in a significantly lower cost-income ratio (61% at the end of June 2010, compared with 67% twelve months earlier).[33]

Pension Funds and Severance Funds Benefit from the Financial Market Recovery

The recovery from the economic and financial crisis has had a favorable impact on the investment performance recorded by Austrian pension funds and severance funds. After posting a loss of EUR 1.7 billion on their investment in 2008, Austrian pension funds were able to generate profits of EUR 1.1 billion in 2009. The positive trend of 2009 continued in the first six months of 2010,[34] as is shown by the year-on-

[30] *Changes in consolidated net asset value resulting from revaluation adjustments and income.*

[31] *Measured in terms of redemptions and sales.*

[32] *Investment companies as defined in the Investment Funds Act and real estate investment companies as defined in the Real Estate Investment Funds Act.*

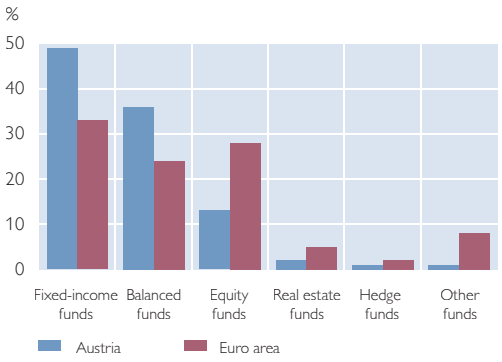
[33] *When considering these year-on-year comparisons of the figures recorded for the investment companies, it should be noted that there were 29 Austrian investment companies in operation at the end of June 2009, while there were 30 at the end of June 2010.*

[34] *With a quarter-on-quarter increase of almost 3%, the first quarter saw a very dynamic investment performance, but the pension funds had to take a quarterly loss of 0.5% in the second.*

Chart 39

Mutual Funds Broken Down by Category[1]

As at end-June 2010



Source: ECB.

[1] Mutual funds excluding money market funds.

year investment performance of +8.6% at the end of the second quarter of 2010.[35] Viewed over a period of three years, however, the investment performance remained clearly negative, at –1.3% per annum. In the 12 months up to the end of the second quarter of 2010, total assets invested by pension funds rose substantially, by 13.5% to EUR 14.1 billion.

In the eighth year of their existence, severance funds have, of course, continued to enjoy significant asset growth; only in 10 to 15 years will inpayments equal outpayments. By the end of the second quarter of 2010, the sum total of accrued severance benefits had increased by almost 30% in comparison with the year before and amounted to EUR 3.2 billion. The Oesterreichische Kontrollbank (OeKB) puts the annual investment performance at 3.65% in 2009, a figure clearly higher than that of almost –2% recorded in 2008.

The risks involved are, in particular, those arising from the persistently uncertain financial market situation, operational risk and the increased sovereign risk (given that, according to the OeNB's securities issuance statistics, EUR 4.4 billion or 28% of the total assets held by pension funds and severance funds were government bonds,[36] while data from the Austrian Financial Market Authority (FMA) put the share of government bonds and bonds of regional and local authorities in the total assets of pension funds as high as 38.8%[37]). EUR 8.2 billion or 53% of the total assets held by pension funds and severance funds are securities issued by domestic and foreign banks; these figures highlight the fact that Austrian pension and severance funds are highly exposed to the financial sector and thus vulnerable to developments there.

[35] *Source: Oesterreichische Kontrollbank (OeKB).*

[36] *EUR 1.2 billion of the EUR 4.4 billion are invested in bonds of countries subject to higher risk premiums (Greece, Italy, Ireland, Portugal and Spain).*

[37] *No data are available for severance funds.*