Austria's Financial System Benefits from Improvement in Eastern Europe, but Economic Environment Remains Challenging

Rising Risk Costs Weigh On Austrian Banks' Domestic and International Profits

Market Conditions Ease, New Business Is Sluggish, Banks Deleverage in Response to Crisis

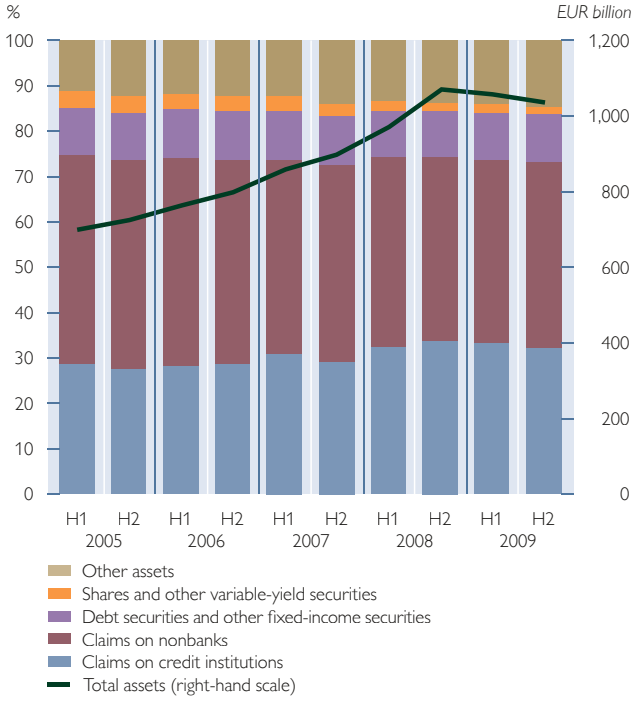
In the second half of 2009, Austrian banks' business developments were marked by the easing of tensions in the market, hesitant new business and further deleveraging in the wake of the crisis.

While Austrian banks' consolidated assets diminished by 1.7% to approximately EUR 1,140 billion in the second half of 2009, unconsolidated assets developed along similar lines, contracting marginally as well. The 2.3% decline can be attributed fully to a substantial reduction in Austrian banks' international business (including claims on subsidiaries abroad in the unconsolidated breakdown). All in all, Austrian banks international claims plummeted by 7.5% in the second half of 2009; while domestic assets edged up by 0.4% in the same period.

On the liability side, interbank liabilities had fallen in the first half of 2009; in the second half, longer-term refinancing also declined somewhat. For example, not just Austrian banks' gross issues but also their volume of fixed-income securities outstanding sank by roughly 5% from the high measured in February 2009. In addition,

Chart 26

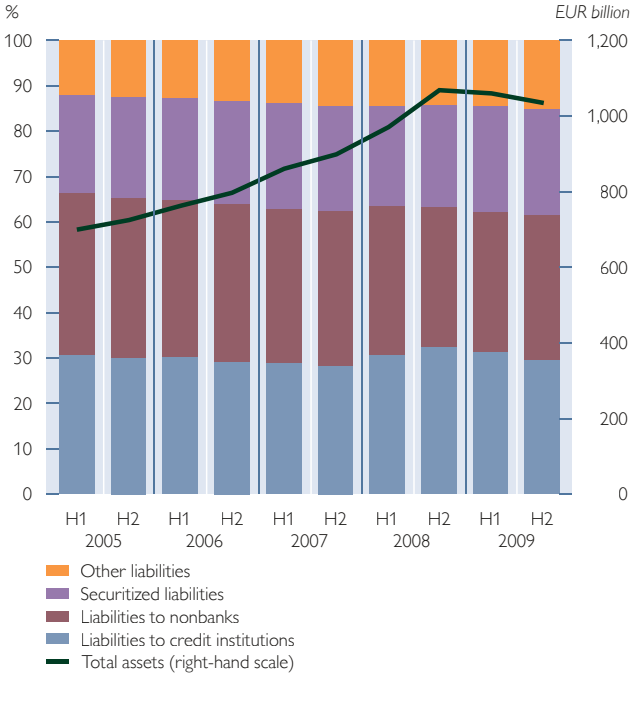
Balance Sheet Structure of the Austrian Banking Sector (Unconsolidated)



Source: OeNB.

Chart 27

Change in Liabilities 2005 to 2009



Source: OeNB.

financing through deposits measured as the ratio of nonbank loans to nonbank deposits improved by 2.1 percentage points to 128.4% on an unconsolidated basis. Moreover, in the upcoming five years, some 60% of large Austrian banks' bonds will mature, with a pronounced peak in 2011.[1] The slight downtrend of unconsolidated total assets continued in the first quarter of 2010 as well, notably featuring a contraction of customer deposits year on year (–0.9%) for the first time.

While the banking sector as a whole suffered a drop in business, local banks[2] succeeded in expanding total assets by roughly 0.4% in the second half of 2009. Coming to around EUR 201 billion, their total assets have grown to account for 19.5% of the Austrian banking sector's total unconsolidated assets. This development was driven above all by a 1.4% rise in claims on customers. Smaller local banks traditionally have a stronger orientation toward claims on private customers rather than other banks in structuring the asset side of their balance sheets.

End-2009 Result Marred by Higher Credit Risk Provisions

One-off effects in income from equity investment in 2008 reduced unconsolidated operating profits before risk provisioning[3] by –26% to EUR 6.77 billion as per end-2009 even though interest income continued to expand year on year. The 3% drop in operating expenditure was insufficient to offset the 13.2% decline in operating income. Consequently, the cost-to-income ratio worsened from 55.5% at end-2008 to 62.1% at the end of 2009.

Interest income as per December 2009 was boosted by 6.4% to just under EUR 8.8 billion year on year, benefiting among other things from the steep yield curve. The net interest margin recovered from 0.77% to 0.85% year on year at end-2009, but remained small by historical standards. However, rising refinancing costs could rekindle pressure on the interest margin. At the same time, fee-based income plunged by 14.6% to EUR 3.6 billion. With the markets recovering, the trading income, which had been negative in 2008, made a positive contribution of EUR 0.5 billion in 2009. But with Austrian banks' subsidiaries in Eastern Europe displaying shrinking profits income from equity shares was slashed by 53.8% to EUR 3.3 billion.[4]

With credit risk costs persistently high at EUR 8.5 billion in the fourth quarter of 2009, representing a 21.6% rise against end-2008 levels, operating profits after risk provisioning were negative at –EUR 1.8 billion. High extraordinary income brought operating profits back up to zero, though.

Operating profits of local banks contracted by 15.1% year on year in 2009, from EUR 2.14 billion to EUR 1.8 billion. Operating income went down by 7% year on year to EUR 5.4 billion, a decline that the 2.2% drop in operating expenses to EUR 3.5 billion was not large enough to offset. The

[1] *Source: Bloomberg.*

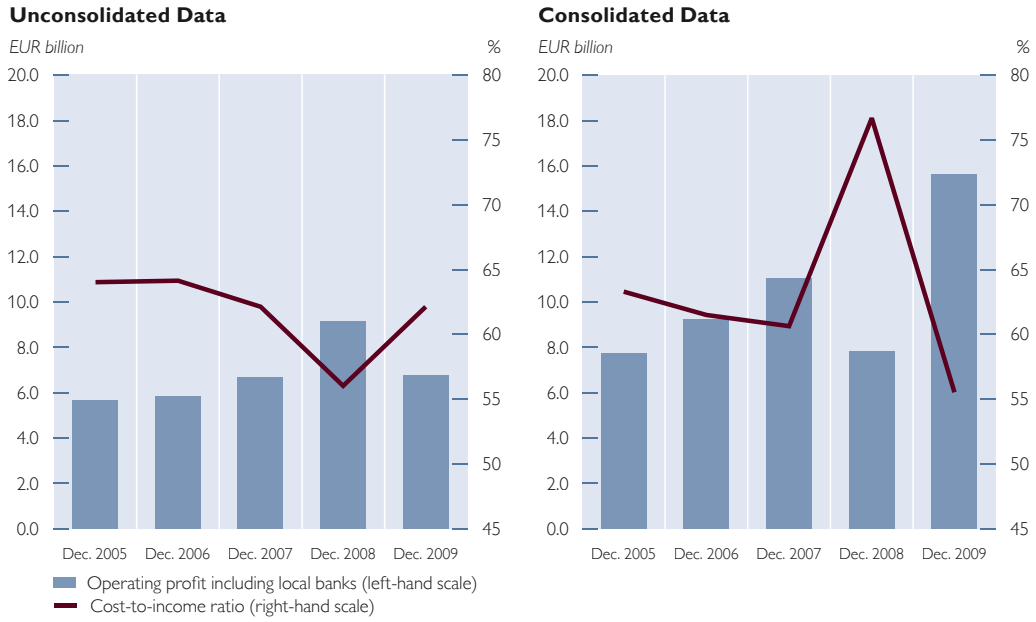
[2] *The local smaller banks include certain joint stock banks; the savings banks without Erste Group Bank and Erste Bank; the Raiffeisen credit cooperatives without RZB, the regional Raiffeisen cooperatives; and the Volksbank credit cooperatives without VBAG.*

[3] *Not adjusted for one-off and special effects at individual banks.*

[4] *However, sales of equity interests had accounted for the very high volume of income from securities and equity shares by historical standards at end-2008.*

Chart 28

Austrian Banks' Unconsolidated and Consolidated Operating Profit



Source: OeNB.

Note: The bars reflect the operating profit at the end of each quarter (cumulated). Due to changes in the financial reporting regime at the beginning of 2008, the consolidated cost-to-income ratio for 2008 and beyond is not comparable with pre-2008 data.

cost-to-income ratio worsened somewhat from 62.8% to 66.1%. Much as in the case of the banking sector as a whole, local banks boosted risk provisions by 14.8% to EUR 1.5 billion, so that the operating result after risk provisioning decreased to EUR 0.3 billion from EUR 0.9 billion at end-2008. Their annual surplus dropped steeply, falling by 81% to EUR 0.1 billion.

CESEE Business Makes a Positive Contribution to Profits

The consolidated operating profits of the Austrian banking sector before adjustment for risk provisions[5] shot up by 98.9% to EUR 15.6 billion year on year, driven by higher interest and trading income as well as a positive valuation result following revaluations in line with IFRS principles, but also by sharp cost-cutting. While consolidated operating income increased by 12.5% year on year, operating expenses were cut by 13.8%. The consolidated cost-to-income ratio before adjustment for risk costs came to 58.7% at the end of December 2009, which compares to 76.7% a year earlier. The considerable 97.7% rise in credit risk provisioning – this step required the use of 70.5% of the total operating profit – resulted in a period profit of EUR 1.5 billion that was positively influenced by banks' CESEE business.

In the first quarter of 2010, the unconsolidated operating result before risk provisioning declined by 2.1% com-

[5] *Unconsolidated profits also include the Austrian banking sector's CESEE business. As banks use different accounting standards, aggregation may produce fuzzy results.*

pared to the first quarter of 2009 in the wake of further growth in operating expenses and a dip in operating income. Risk costs continued to rise, albeit at a noticeably slower pace. Although Austrian banks expect a comfortably positive annual result for 2010, this forecast is subject to heightened uncertainty in light of the increase in external risks. The biggest risks to profitability – in addition to the issue of whether the trading result can be maintained and whether the yield curve, which had given interest income a lift, will remain steep – include higher market refinancing costs and a persistently high need to make provisions for risks.

Loan Growth Decelerates in the Face of Continued Difficult Conditions[6]

Following a further contraction in the growth of lending to domestic nonbanks[7] in the second half of 2009, the annual growth rate was even marginally negative at –0.4% in the first quarter of 2010. Austrian banks' outstanding credit to domestic customers (nonbanks) came to about EUR 310.5 billion at quarter-end. But while the volume of lending to households rose slowly but surely in recent periods, lending to nonfinancial corporations dipped year on year as of end-March 2010, with loans to households coming to EUR 123.2 billion and loans to nonfinancial corporations standing at EUR 132.9 billion.

By comparison to euro lending, banks were conspicuously careful in providing foreign currency loans. EUR 55.2 billion of the loan total were denominated in a foreign currency at the end of the first quarter of 2010, which corresponds to a cutback by roughly 4.3% year on year and a foreign currency share of around 17.8% in total loans. Most of the foreign currency lending was in Swiss francs (roughly 86.1%), followed by U.S. dollars (nearly 6.9%) and Japanese yen (about 5.5%).

Joint stock banks as well as building and loan associations generally exhibited the strongest credit growth according to the most recent figures. The results for the networks of cooperative banks present a mixed picture: Whereas the Raiffeisen credit cooperatives exhibited fair credit growth, the volume of lending by the Volksbanken credit cooperatives went down.

The financing conditions of banks improved somewhat most recently. The banks also partly passed on the easing of funding conditions to the interest rates they charge. Households profited above all from a recent drop of the annual percentage rate of charge on new housing loans. In the case of lending to the corporate sector, the rates charged declined most on short-term loans.

[6] *The analysis of loan growth is based on unconsolidated MFI balance sheet statistics data adjusted for exchange rate effects, value adjustments and reclassifications.*

[7] *"Domestic nonbanks" are defined as all financial market participants other than credit institutions.*

Box 2

Prudential Initiatives to Curb Foreign Currency Loans and Repayment Vehicle-Linked Loans to Austrian Households

The OeNB and the FMA have taken numerous prudential measures aimed at curbing foreign currency loans and repayment vehicle-linked loans to households in Austria, the most recent of them being the extension of the FMA's respective minimum standards.

Just as the IMF has repeatedly highlighted the risks arising from foreign currency loans and repayment vehicle-linked loans in Austria in its Financial Sector Assessment Programs and Article IV consultations over the past decade, the OeNB and the FMA for years have been working to improve borrowers' and lenders' risk awareness by pursuing a wide range of measures and activities: Press conferences and the publication of the OeNB's Financial Stability Report ensure the provision of information on a regular basis; in 2003, the FMA published its Minimum Standards for Granting and Managing Foreign Currency Loans as well as Loans with Repayment Vehicles; and the OeNB and the FMA also jointly created a consumer information brochure about the risks of foreign currency loans that was first distributed at banks in 2006. Up until autumn 2008, the effects of these measures were limited, however. While there was some success in reducing the share of Japanese yen-denominated loans and the share of foreign currency loans in corporate funding, in October 2008, the overall volume of foreign currency loans to households peaked at EUR 39.1 billion as did its share in total loans to households at 31.7%.

In October 2008, the FMA issued a recommendation calling on banks to stop granting foreign currency loans to households. The OeNB and the FMA then drew up supplementary provisions to the FMA's minimum standards mentioned above, which were published in March 2010. According to these new provisions, foreign currency loans may be extended only to households[1] which earn sufficient income in the currency in which the loan is denominated or which belong to the group of customers with the highest creditworthiness. In addition, banks are called upon to pay particular attention to the risk that repayment vehicles carry in the case of euro-denominated loans linked to such (capital accumulating) instruments, and they are required to maintain a list of eligible repayment vehicle products. Furthermore, banks are requested to develop strategies for a sustained reduction in the volume of foreign currency loans and repayment vehicle-linked loans and for mitigating the refinancing risk of foreign currency loans. Finally, banks have committed themselves to fulfilling the enhanced consumer information requirements set out in the new EU Directive on credit agreements for consumers. Consumers wishing to reduce their risk from (existing) foreign currency and repayment vehicle-linked loans by converting these loans into euro-denominated loans must receive active support from their bank.

Apparently, these additional measures have proved effective: Between October 2008 and March 2010, foreign currency loans to households contracted by EUR 3.1 billion or 8% (exchange-rate adjusted), and the volume of repayment vehicle-linked loans was also reported to have diminished markedly. It can be ruled out that this decline was driven by the weak economy, since euro-denominated loans to households rose by EUR 3.6 billion over the same period.

[1] The target group of these provisions includes consumers as defined by the Austrian Consumer Protection Act; they apply to self-employed persons and members of the liberal professions only if they take out a consumer loan.

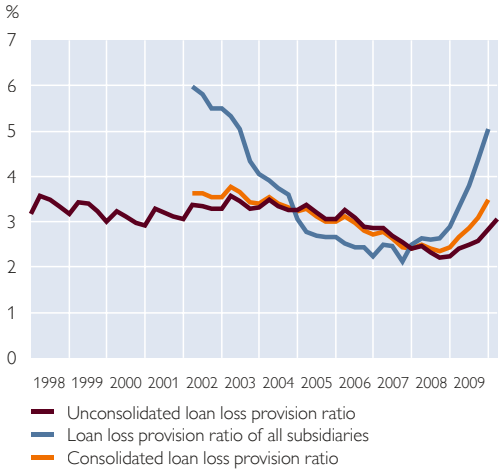
Increased Credit Risk Boosts Costs

In 2009, Austrian banks undertook substantial efforts to create provisions to cover their credit risk, which had increased significantly in the wake of the global recession. In a consolidated view, banks' credit risk costs totaled EUR 11 billion in 2009, about twice as much as one year earlier. The adjustments in credit risk provisioning were visibly influenced by regional factors. The unconsolidated loan loss provision

ratio[8] climbed by 0.57 percentage points to 2.82% in 2009 (see violet line in chart 29). Taking into account domestic customers only reduces the increase to 0.31 percentage points. By contrast, the consolidated loan loss provision ratio,[9] covering total credit to domestic and nondomestic customers, rose by 1.04 percentage points in 2009 (orange line in chart 29). The loan loss provision ratio of fully consolidated bank subsidiaries increased by 2.15 percentage points to 5.04% (blue line); within this aggregate, the sharpest rise by far (+6.18 percentage points) was recorded for the CIS, where the subsidiaries' loan loss provision ratio now stands at 10.38%.

Chart 29

Loan Loss Provision Ratios of Austrian Credit Institutions



Source: OeNB.

The unconsolidated figures for the first quarter of 2010 show that the uptrend seen in 2009 is set to continue; at end-March, the loan loss provision ratio came to 3.06%, which corresponds exactly to the average of the past 12 years.

Market risk[10] as measured by capital requirements continued to play a subordinate role (both in the unconsolidated and the consolidated view) compared with credit risk in the Austrian banking system in 2009.[11] During 2009, the capital requirement for interest rate instruments in the trading book edged up somewhat, while it remained broadly constant for shares in the trading book and open foreign currency positions. Since market-based valuation regulations must be applied to trading book positions, the severe fluctuations in market risk factors seen since the onset of the crisis caused high volatility in the trading result. After –EUR 2.1 billion in 2008, this income component came to EUR 2.6 billion in 2009, which equaled two-and-a-half times the average of the pre-crisis years. Interest rate risk in the banking book (in a consolidated view) rose in the first half of 2009 but fell back to the level before the increase by the end of the year.

Liquidity Situation of Austrian Banks Stable

On an unconsolidated basis, Austrian banks' liquidity situation remained stable

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

[9] *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.*

[10] *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.*

[11] *At end-2009, market risk capital requirements amounted to 3.6% (on an unconsolidated basis) or 3.8% (on a consolidated basis) of credit risk capital requirements.*

between mid- and end-2009. Short-term claims accounted for 72.5% of short-term liabilities, thereby standing at a level higher than the pre-crisis average (June 30, 2005, to June 30, 2007: 67.8%). Liquid assets more than offset the maturity mismatch in the short-term segment. Short-term claims plus liquid assets came to 124.8% of short-term liabilities. At 117.6%, the average of the two years preceding the outbreak of the crisis was somewhat lower.

More information compared with the unconsolidated data based on residual maturity statistics can be obtained from the data of the weekly liquidity reports, which are based on projected cash flows.[12] In addition, the reports include a simple stress scenario imputing the drying up of the unsecured money market and the foreign exchange swap markets. Under this scenario, the liquidity available after accounting for the cumulated net funding gap amounts to some EUR 96 billion after 12 months (reporting date: April 30, 2010; this reflects an increase by 18% since the reports submitted for January 8, 2010); more than one-half of this amount is unencumbered eligible collateral deposited at central banks. The aggregate short position of the Austrian banking system in the unsecured interbank market is very small, amounting to below 0.4% of the sector's consolidated total assets. At the reporting date April 30, 2009, this short position had still come to some 3% of aggregate total assets. These figures imply that the Austrian banking system's net position on the interbank market is very conservative and therefore not vulnerable to potential effects from sovereign risk developments in the euro interbank market.

Financial Market Infrastructures Increasingly Relevant to System Stability

Financial market infrastructures are a fundamental element of the financial system enabling the settlement of transactions. They include stock exchange and trading platforms as well as downstream systems for clearing (e.g. by central counterparties – CCPs) and settling payments, financial instruments and securities (e.g. by securities depositories) and their technical infrastructures. These systems facilitate the secure and efficient processing of financial market transactions.

Due to the crucial importance of financial market infrastructures, an extensive debate has been underway at the EU level about a new regulatory framework and reinforced oversight, with proposals ranging from enhancing transparency and strengthening European cooperation in oversight to the introduction of mandatory clearing of standardized contracts through CCPs. The OeNB fulfils two roles in this area: First, it operates the large-value payment system HOAM.AT,[13] which in the second half of 2009 processed some 700,000 transactions worth about EUR 4,800 billion. Second, the OeNB is the

[12] *This report comprises detailed data both about banks' expected inflow and outflow of funds as well as data regarding the counterbalancing capacity over the 12 months following the report. The data are broken down by five maturity buckets (up to 5 days, 6 days to 1 month, 1 to 3 months, 3 to 6 months and six to twelve months) as well as by six currencies (euro, U.S. dollar, Swiss franc, pound sterling, Japanese yen and other currencies). For a detailed description of the weekly liquidity reports and the long-term development of data see Schmitz, S.W. and F. Weidenholzer. 2009. Recent Developments in the Austrian Banking System's Liquidity Situation and the International Regulatory Debate, Financial Stability Report 18, 60–66.*

[13] *The Home Accounting Module Austria (HOAM.AT) is a real-time gross settlement system for processing euro payments provided by the OeNB to participants.*

authority in charge of payment systems and financial market infrastructures oversight in line with Article 44a of the Federal Act on the Oesterreichische Nationalbank. Apart from regular monitoring activities, the OeNB carried out three system assessments in retail payments in the second half of 2009 (retail payments – which include, for instance, credit card or e-money payments – accounted for a total of 302 million transactions worth some EUR 24.3 billion in the second half of 2009).

The payment systems and financial market infrastructures operating in Austria proved stable also in a crisis-ridden environment; none of the system disturbances recorded affected the Austrian financial market.

Risks in CESEE Remain Elevated despite Improving Conditions

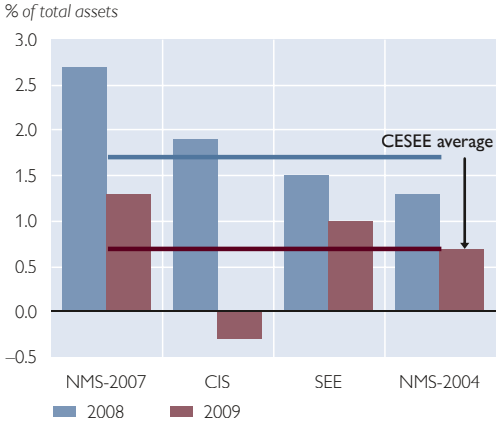
Against the background of massive international support for CESEE, conditions in the region over the past few months were characterized by lower interest rates, currency stabilization and – in some countries – a positive growth outlook. As a result, Austrian banks' CESEE subsidiaries can expect some improvement in their situation in 2010; the unwinding of international support measures, however, is one of the reasons why the risks in the region remain elevated nonetheless.

The total assets of Austrian banks' fully consolidated subsidiaries in CESEE shrank by almost 1% from EUR 256.8 billion at mid-2009 to EUR 254.4 billion at year-end. The market share of the 68 fully consolidated CESEE subsidiaries[14] edged down slightly, from 15.1% at end-2008 to 14.4% one year later (excluding Russia: from 21.9% to 21.1%). The volume of on-balance sheet loans to nonbanks contracted by 3.2% from mid-2009 to end-2009 to EUR 160.2 billion. While the share of loans of Austrian banks' subsidiaries in the NMS-2004,[15] Southeastern Europe (SEE)[16] and the NMS-2007[17] increased, that of Austrian subsidiaries in the CIS[18] dropped (see table in the annex).

The profitability of Austrian banks' CESEE subsidiaries remained subdued and rather heterogeneous across countries in the second half of 2009 (see chart 30). Despite diminishing interest

Chart 30

End-of-Period Result of Austrian Banks' Subsidiaries in CESEE



Source: OeNB.

[14] *Excluding Bank Austria's not fully consolidated joint venture in Turkey (Yapı ve Kredi Bankası).*

[15] *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.*

[16] *Southeastern Europe covers Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME), FYR Macedonia (MK), Serbia (RS) and Turkey (TR).*

[17] *NMS-2007 refers to the Member States that joined the EU in 2007: Bulgaria (BG) and Romania (RO).*

[18] *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).*

income, operating profits stagnated at EUR 7.1 billion thanks to extraordinarily high financial results. Risk costs were reported to have increased for all regions; the pace of this increase, however, varied very strongly at the country and regional levels. In total, CESEE subsidiaries continued to post better results than Austrian banks in 2009, earning a consolidated end-of-period result of EUR 1.8 billion or around 0.7% of total assets. Losses were reported for only three markets (Ukraine, Kazakhstan, Montenegro).

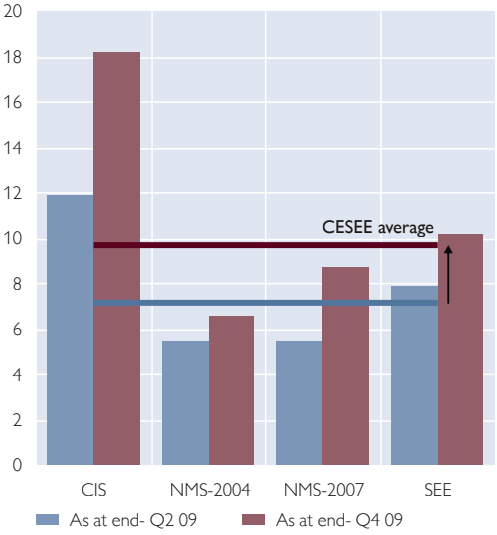
Credit risk ratios, accordingly, did not indicate an improvement, as illustrated by chart 31, which shows the share of nonperforming loans. While the loan loss provision ratio continued to increase in the aggregate – from 3.9% at mid-2009 to 5.2% at end-2009 – survey results suggest that provisions for nonperforming loans decreased further in the second half of the year. The sharpest increase in loan loss provisions was recorded in the CIS, where the provisioning ratio for loans to nonbanks rose by 3.1 percentage points to 10.4% (NMS-2007: by 1.9 percentage points to 6%; SEE: by 1.8 percentage points to 5.6%; NMS-2004: by 1.1 percentage points to 3.7%). The level of loan loss provisions will remain elevated at least until end-2010.

The CESEE subsidiaries' capital buffers continued to be sound despite substantial write-downs and, in some cases, were even strengthened further. In the second half of 2009 alone, both the tier 1 ratio and the capital ratio were raised by 0.3 and 0.5 percentage points to 11.6% and 13.9% respectively. Actual excess capital varied strongly across countries, not least due to different minimum requirements. Strengthening capital ratios should generally remain an important objective; after all, Austrian parent banks still reported below-average capital adequacy compared with their CESEE peers at end-2009. The capital increases already made by parent and subsidiary banks have certainly been helpful in this context.

Chart 31

Nonperforming Loans of Austrian Banks' Subsidiaries in CESEE

As a percentage of loans to households and companies

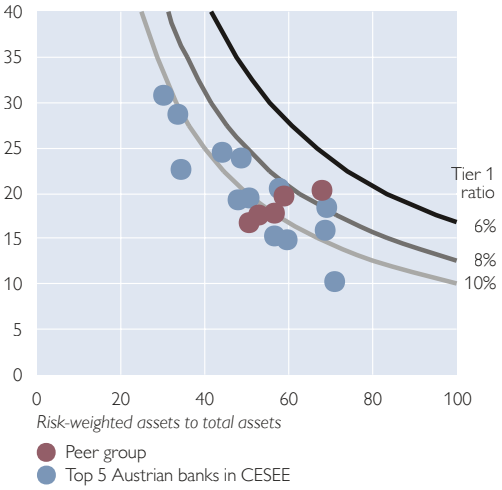


Source: OeNB.

Chart 32

Leverage and Capital Adequacy

Total assets to tier 1 capital



Source: Bloomberg, annual reports (as at 2009).

Curbing the risk exposure on the assets side at CESEE subsidiaries (in particular in the CIS) also helped reduce further refinancing risks in 2009. The loan-deposit ratio of Austrian banks' subsidiaries in CESEE was brought down by some 3.7 percentage points to 109.3% in the second half of 2009; in other words, the deposit deficit was halved from its peak in the first quarter of 2009 to EUR 13.7 billion at end-2009. The volume of intragroup interbank loans accordingly contracted (by EUR 1.9 billion from the second quarter of 2009) to EUR 49.1 billion. Still, parent banks' share in interbank liabilities stagnated at 79% over the same period. Credit growth developments at CESEE subsidiaries can be expected to take diverging paths over the next few quarters, depending on the strategic goals of their parent institutions.

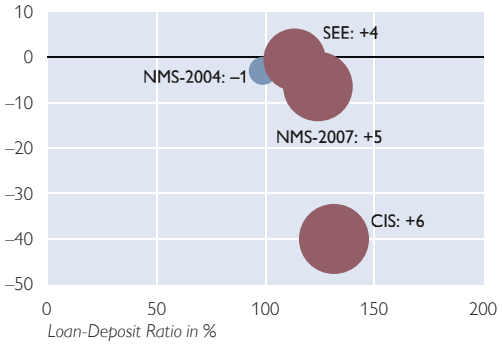
The volume of direct large loans extended by Austrian banks to nonbanks and financial institutions[19] in CESEE fell by 3.8% to EUR 49 billion from mid-2009 to year-end. This decline was observed throughout the region and was strongest in SEE and the NMS-2007. The volume of direct loans to nonbanks contracted less sharply – by 1.4% to EUR 45 billion – than loans to financial institutions. Provisions for direct loans to CESEE increased but continued to be significantly lower than those for indirect loans.

Overall, from mid-2009 to year-end, Austrian banks' exposure to CESEE[20] rose by 9.0% from EUR 187 billion to EUR 204.2 billion (some EUR 300 billion including claims on foreign-owned banks in the region). This increase was mostly due to the nationalization of Hypo Group Alpe Adria, which implied that this institution's CESEE exposure is again considered Austria's. Although the difficult situation in CESEE (in particular CIS) markets visibly stabilized since the onset of the crisis, the

Chart 33

Loan-Deposit Ratio of Austrian Banks' Subsidiaries in CESEE

Change in percentage points since the fourth quarter of 2008



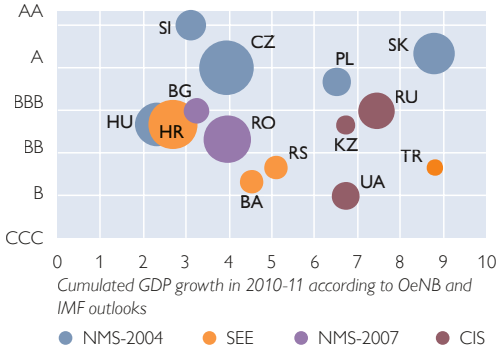
Source: OeNB.

Note: The size of the bubbles indicates the size of the deposit deficit. Blue denotes a negative value.

Chart 34

Country Risk Exposure of Austrian Banks in CESEE

S&P's long-term foreign currency sovereign debt rating



Source: OeNB, Bloomberg, IMF.

[19] *This item comprises direct loans to nonbanks and financial institutions outside the lender's banking group. A historical comparison with previously published data is not feasible since intragroup loans were included until recently (up to the Financial Stability Report 18).*

[20] *According to BIS definition.*

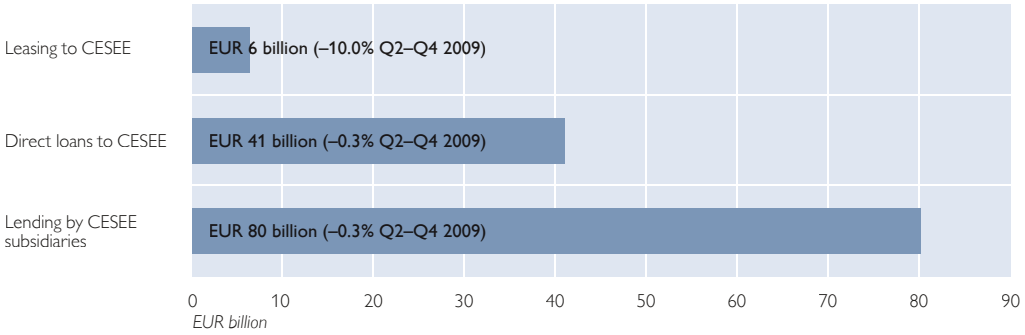
risks for Austrian banks in the region continued to be very heterogeneous. In particular, some markets are facing relatively weak growth prospects or are following fragile growth paths in economies that have suffered severely from the crisis.[21]

Notwithstanding its current stagnation, foreign currency lending in CESEE (and the resulting imbalances and risks) will remain a major issue. In the second half of 2009, the share of foreign currency loans held by Austrian subsidiaries fluctuated around 48.9% or EUR 80 billion, while the corresponding share of direct loans came to around 80% or EUR 41 billion in the fourth quarter.

The FMA and the OeNB have undertaken concerted efforts to reduce the concentration risk from foreign currency lending, e.g. by launching an initiative in the CESEE market aimed at gradually restricting new foreign currency loans to unhedged households and SMEs (i.e. those who do not have income or assets in the respective foreign currency). In a first step, Austrian banks agreed to discontinue lending in Japanese yen and Swiss francs as well as extending foreign currency bullet loans linked to repayment vehicles to CESEE borrowers. Moreover, consumer loans in a foreign currency are to be granted to prime borrowers only. The next step will address longer-term mortgage and investment loans in foreign currency. For measures to be effective in this area, though, they need to be coordinated closely at the international level, involving national authorities, central banks and the relevant international organizations. Therefore, a working group was established under the auspices of the EBRD, the IMF and the European Commission within the framework of the European Bank Coordination ("Vienna") Initiative to develop capital markets for longer-term funding in local currency. The FMA and the OeNB are taking proactive roles in this dialogue. In addition, the EU is currently discussing raising the capital requirements for foreign currency loans.

Chart 35

Austrian Banks' Foreign Currency Loan Exposure in CESEE



Source: OeNB.

[21] *The on-balance sheet exposure of all Austrian banks (including risk transfers) to Greece amounted to some EUR 4.2 billion at the end of 2009. Off-balance sheet claims stood at EUR 0.7 billion.*

Box 3

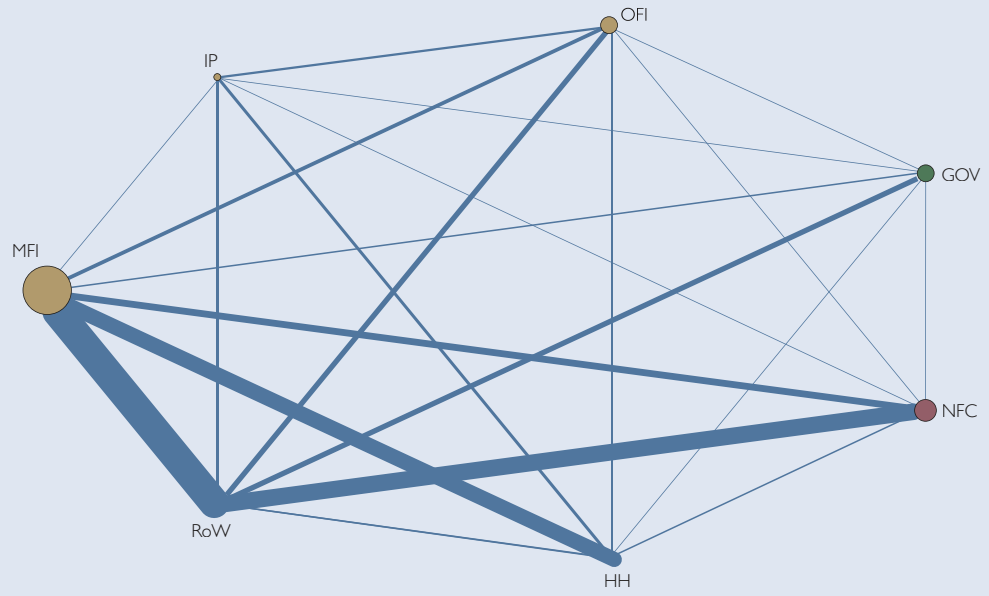
Highlighting the Financial Interlinkages between Economic Sectors for Risk-Oriented Financial Markets Analysis

The financial accounts contain data on financial assets and liabilities (currency and deposits, securities other than shares, loans, shares and other equity, insurance technical reserves and other accounts receivable) for all economic sectors: monetary financial institutions (MFIs), other financial intermediaries (OFIs), insurance companies and pension funds, general government, nonfinancial corporations, households[1] and rest of the world. The financial accounts for Austria (including the valuation approach) are compiled in accordance with the rules of the European System of Accounts (ESA). The data allow calculating a sector's financial claims and liabilities on a who-to-whom basis with all other sectors and thus allow drawing inferences about asset concentrations or asset shifts.[2]

As recent experience has shown, the deep and complex interlinkages both within the financial sector and between this sector and others have contributed to the intensification of the financial crisis. For instance, the U.S. insurance company AIG was considered not only too big to fail but also too interconnected to fail. A risk-oriented evaluation of interlinkages on a gross basis (e.g. without consolidation of interbank business) based on financial accounts data provides first insights into the financial ties of Austrian macroeconomic agents with each other and the rest of the world, which can be useful in financial stability analysis. The available historical data allow drawing preliminary conclusions about the impact of the economic and financial crisis thus far.

The chart highlights the degree of financial interlinkages of all sectors in the Austrian financial accounts. The size of the nodes reflects the level of intra-sectoral exposures, and the thickness of the connecting lines indicates the size of gross exposures between sectors (assets and liabilities)[3].

Financial Interlinkages of Macroeconomic Sectors at the end of 2009



Source: OeNB.

Note: This visualization was done using the Pajek software. MFI stands for monetary financial institutions (including OeNB), IP for insurance companies and pension funds, OFI for other financial intermediaries, GOV for general government, NFC for nonfinancial corporations, HH for households (including nonprofit institutions serving households) and RoW for rest of the world.

[1] *Including nonprofit institutions serving households.*

[2] *The ECB already used this balance sheet approach for financial assets in an analysis based on euro area financial accounts data. See www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1124.pdf.*

[3] *Changes in stocks result not only from transactions but also from changes in value and sector reallocations.*

The gross exposure of Austrian MFIs (including the OeNB) to each other, for instance, increased by 82% to EUR 327 billion in the period from end-2006 (i.e. before the crisis) until end-2009, which was above all attributable to a rise in interbank deposits but also to intra-sectoral purchases of debt securities issued by banks. This sum currently represents 30% of total bank liabilities (2006: 21%) and 20% of assets held domestically (2006: 14%). The sharp increase in interbank exposures underscores that the mutual dependencies in the Austrian banking sector are growing and has made the banking sector itself the most important source of funding for MFIs; back in 2006, Austrian MFIs had still been only the third-largest creditors of MFIs after foreign creditors and households.

A look at OFIs (mainly mutual funds, holding companies of other MFIs, OFIs and insurance companies in Austria and abroad) shows that mutual funds' financial assets shrank by around EUR 30 billion from end-2006 to end-2009 (one-half of this decrease was due to the fall in the prices of tradable securities). Moreover, restructuring measures taken above all in the banking sector using financial holding companies led to a reallocation of foreign claims to domestic claims of OFIs on MFIs. Generally speaking, OFIs strongly increased their gross exposure to MFIs (+54%). This means that these intermediaries have become more important for financial stability and require special attention, given potential financial contagion risks.

For a small economy like Austria, international financial relations are naturally of key importance. In the period from 2006 to 2009, foreign creditors' claims on Austrian OFIs, nonfinancial corporations and the general government rose by 24%, 22% and 17%, respectively, while the liabilities of foreign borrowers to Austrian nonfinancial corporations and MFIs increased by 37% and 25%, respectively. The net claims (claims minus liabilities) of the rest of the world on Austria declined by more than 90% from 2006 (EUR 23 billion) to 2009 (EUR 2 billion). At end-2009, foreign creditors held one-third of Austrian debt, with domestic MFIs (EUR 321 billion) and nonfinancial corporations (EUR 250 billion)[4] having higher liabilities than the general government (EUR 153 billion).

The refinancing sources of Austrian debtors (especially of MFIs and the general government) will play a key part in the further financial and economic recovery. Between end-2006 and end-2008, domestic MFIs increased their gross liabilities most strongly vis-à-vis other domestic MFIs (by EUR 192 billion), but reduced them again markedly in 2009 (on balance +EUR 147 billion). Over the same period of three years, MFIs also increased their liabilities to households (+EUR 42 billion), OFIs (+EUR 41 billion)[5] and the general government (+EUR 6.5 billion or +34%). At the same time, the Austrian government mainly increased its gross liabilities to foreign creditors (+EUR 23 billion), within the government sector[6] (+EUR 7 billion) and to MFIs (+EUR 3 billion). Using the past experience as a guide, the future refinancing situation of Austrian banks strongly depends on the financial strength of the domestic financial sector, households and foreign investors.

[4] *Nonfinancial corporations also include special purpose entities, which accounted for a volume of around EUR 80 billion in 2009.*

[5] *See the above passage on restructuring in the OFI sector.*

[6] *E.g. using intermediary funding transactions between the different levels of government.*

Bank Support Package Increases Capital Ratios

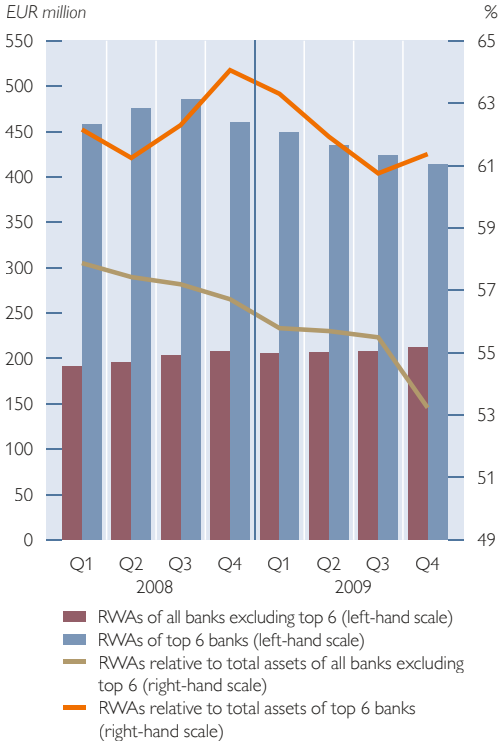
Following its low in the third quarter of 2008, the aggregated consolidated tier 1 capital ratio (solvency ratio) of all Austrian banks improved by around 197 (236) basis points to 9.27% (12.81%) by the end of 2009. This improvement was achieved through a combination of privately raised capital and government measures implemented until end-2009, which included strengthening banks' capital buffers[22] by EUR 5.7 billion and providing guarantees worth EUR 1.7 billion.

At the same time, the risk-weighted assets (RWAs) of the six largest Austrian banks[23] declined from their peak in 2008, which was attributable to several partly overlapping effects. First, the government guarantees reduced the risk weight of the underlying assets.[24] Second, writedowns on defaulting loans and balance sheet downsizing contributed to the drop in RWAs. And third, RWAs declined owing to weak and partly even negative total asset growth.

A bank's leverage (total assets divided by tier 1 capital) is an important measure in the discussion on banks'

Chart 36

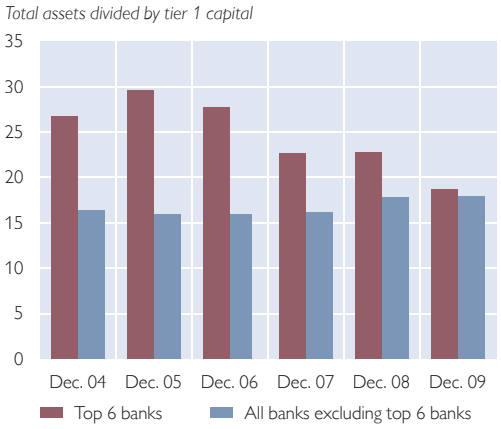
Development of Risk-Weighted Assets (RWAs)



Source: OeNB.

Chart 37

Leverage in the Banking Sector



Source: OeNB.

[22] *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 total capital injected).*

[23] *These are UniCredit Bank Austria, BAWAG P.S.K., Erste Group, RZB, VBAG and Hypo Group Alpe Adria. To avoid distortions, the sector "all banks without top 6" was adjusted for Oesterreichische Kontrollbank, Oesterreichische Clearingbank AG and KA Finanz AG.*

[24] *In the context of the national bank aid package, the Austrian parliament passed an amendment to the Austrian law on balance of payments stabilization (Zahlungsbilanzstabilisierungsgesetz) on May 11, 2010, which allows allocating up to EUR 15 billion in unused guarantees from the national bank rescue package to stabilization measures in euro area countries experiencing difficulties, if required.*

risk-bearing capacity, and specifically, on how to avoid future financial crises. The European Commission and the Basel Committee on Banking Supervision are considering introducing a maximum leverage of 25 but are still discussing certain deduction and change items for total assets and tier 1 capital (instead of balance sheet equity). The introduction of a binding leverage level as an additional measure of capital adequacy will be implemented only after the upcoming Quantitative Impact Study[25] has been evaluated, though. Imposing such a limit to prevent extremely high leverage levels seems reasonable in light of the problems encountered during the financial crisis.

A breakdown of the Austrian banks' leverage by the top 6 institutions and the other banks provides a very heterogeneous picture; however, based on the current definition of tier 1 capital, both groups currently have leverage levels of well below 25. While leverage has declined continuously since 2005 at the top 6 banks, it has increased slightly at the banks of the other group, so that the current levels are almost equally high in both groups. Based on a more narrow definition of tier 1 capital, leverage would be considerably higher.

Stress Tests Assume Historically High Initial Default Probabilities, Yet Provide Evidence of a Firming Trend in Aggregates

The OeNB regularly performs macroeconomic stress tests to assess the risk-bearing capacity of the Austrian banking system. In 2009, the results of these tests were mixed. While the top-down analysis of Austria's largest banks showed that, in aggregate, capital ratios would remain above the regulatory minimum requirements even if the crisis were to deepen severely, a disaggregate look at the adverse scenarios assumed by the OeNB revealed further recapitalization needs for those banks that had already been weakened by the crisis.[26]

Meanwhile, the outlook for the real economy has further stabilized, and even credit cycles, which tend to react with a lag, have since bottomed out in a number of countries. The brightening outlook has had a positive impact on conditions in the Austrian banking sector, as is evidenced by the backtesting exercises that the OeNB conducted to compare last year's estimates with actual developments.[27] In actual fact, Austrian banks fared much better in 2009 than projected even in the baseline scenario, which reflects current expectations – particularly in terms of operating income before risk provisioning.

Yet despite the turn in the credit cycle, the OeNB continues to see a need for further loan loss provisions. This assessment is reflected in the baseline scenario that the OeNB constructed for its latest stress test, based on its most recent macroeconomic projections for Austria and the OeNB and IMF outlook for the rest of the world.[28] To be able to assess the effects of another global economic slump – which, while unlikely from today's perspective, does provide useful benchmarks in a stress scenario – the OeNB constructed a separate "global risk premium" scenario which assumes that,

[25] *See www.bis.org for more information.*

[26] *See the OeNB's Financial Stability Report 18 (December 2009).*

[27] *See Summary of OeNB Stress Test Results published on the occasion of the press conference release of Financial Stability Report 17 in June 2009.*

[28] *See IMF. 2010. Global Economic Outlook. April.*

following the ongoing recovery in early 2010, risk premiums start to rise again after a global reassessment of risk and contribute to yet another contraction of GDP growth in the second half of 2010.

On a cumulative basis over a two-year horizon, the global risk premium scenario implies a 4.6% contraction in GDP in the CESEE countries that joined the EU in 2007 (NMS-2007) and a 3.8% contraction in Southeastern Europe (SEE). These regions are most severely hit by the stress scenarios as compared to baseline projections (+3.8% and +3.5%, respectively, see chart 38).[29] Such a scenario also triggers macroeconomic feedback effects on GDP growth in Austria, which would further increase the pressure on Austrian banks. As a result, GDP growth in Austria would contract to a cumulative –0.2% over the two-year horizon rather than reach a cumulative 3.4%, as projected in the OeNB outlook for Austria of June 2010.

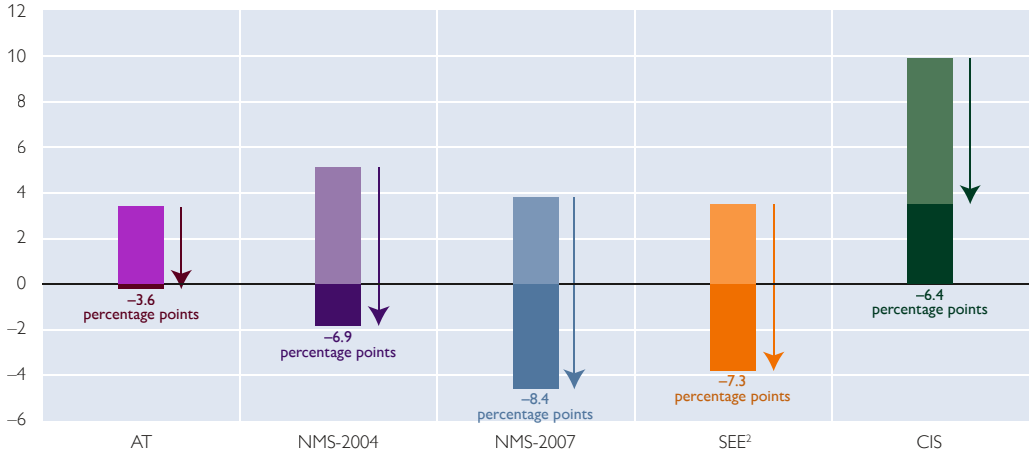
Over a two-year horizon, the global risk premium scenario produces an expected NPL ratio (nonperforming loans as a share of total loans) of almost 7% for Austrian banks in their home market and of almost 15% for their aggregate exposure in CESEE and the CIS. The CESEE and CIS subsidiaries alone would have to expect 19% of their outstanding loans to default in the stress scenario. In other words, the aggregate NPL ratio for the subsidiaries is three times as high – subject to regional differences in line with different GDP growth setbacks (see chart 38) – in the stress scenario as the aggregate ratio reported for the end of 2009.

Apart from a deterioration in loan quality and the ensuing higher need for loan loss provisions, the global risk

Chart 38

GDP Growth According to the OeNB Spring 2010 Stress Test[1]

Cumulative annual GDP growth in %



Source: OeNB.

[1] *Cumulative growth over the two-year stress horizon; the baseline scenario (lighter color) and the stress scenario (darker color) for Austria are based on the Austrian Quarterly Model.*
[2] *Southeastern Europe excluding Turkey.*

[29] *SEE as shown in this chart covers Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME), FYR Macedonia (MK), Serbia (RS); does not include Turkey (TR).*

premium scenario produces a decline in operating income before risk provisioning and also an increase in risk-weighted assets. All three measures, in turn, drive the development of the capital ratios, of which the key ratio for assessing overall risk is the tier 1 ratio.[30]

At an aggregate level, the stress scenario leads to a decline in the tier 1 ratio of both the six largest Austrian banks and the entire Austrian banking system.[31] In the global risk premium scenario, the tier 1 ratio of the "big six" banks falls by 1.5 percentage points, and that of the entire Austrian banking system by 1.1 percentage points over a two-year horizon. At the same time, the tier 1 ratio remains above 8% (big six) or at 8.7% (system) even at the end of 2011 – in other words, more than twice as high as the regulatory minimum requirements (see chart 39). As in the past, the results are rather mixed at the individual bank level. The baseline scenario, which reflects current expectations, finds Austria's banks in aggregate to be in a position to cover their – still high – risk costs from operating results and to strengthen their capital base further from the second half of 2010 onward.

All in all, the spring 2010 stress test of the OeNB confirms the positive development path the Austrian banking system has followed since the fall of 2009. The Austrian banking system is strong enough to withstand even a severe risk scenario (which is, however, unlikely to materialize), as the operating results would suffice to offset most of the additional risk costs. At the same

Chart 39

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

Source: OeNB.

[1] The initial tier 1 ratio includes recapitalization measures worth EUR 2.6 billion that are already in the pipeline.

[30] The impact of the macroeconomic scenarios was estimated on the basis of data reported as at end-2009 for a two-year forecast horizon. Specifically, the OeNB conducted a top-down test, and the six largest Austrian banks conducted bottom-up tests based on the OeNB scenarios.

[31] Big Six: UniCredit Bank Austria, Erste Group, RZB, VBAG, BAWAG P.S.K. and HGAA.

time, the stress tests have confirmed that those banks which emerged fundamentally weakened from the latest crisis need to persevere with their structural adjustment and restructuring measures. Finally, in the light of the ongoing regulatory initiatives (Basel III), there appears to be a medium-term need for the Austrian banking sector to strengthen its capital position further despite the positive developments that have prevailed since 2008. However, if current expectations are correct, at least some of the required funds will come from banks' profits.

Box 4

Basel III and Quantitative Impact Study 2010

In essence, the forthcoming changes to regulatory requirements for banks, as being worked out by the Basel Committee on Banking Supervision/BCBS (Basel III), and the European Commission (Capital Requirements Directive IV, or CRD IV) subject to guidance by the G-20 are aimed at aligning the risk-bearing capacity of banks – in terms of the size and quality of equity – more adequately with the risks banks incur. While Basel II would probably have helped contain the effects of the crisis, had it been implemented earlier, a number of items must still be adjusted, and there is also a need for some complementary measures.

The key elements of the proposals include measures to strengthen the capital framework by increasing the level of tier 1 capital, combined with more stringent eligibility criteria for the inclusion of financial instruments in this regard. This would raise both the level and the quality of the capital requirements. Furthermore, banks are expected to build up capital buffers in good times that could be drawn down during crises. Countercyclical adjustments in minimum capital requirements would contribute to financial stability and support the sustained provision of loans by banks. Moreover, a – somewhat controversial – leverage ratio is to provide a simple new metric designed to constrain the build-up of leverage at banks, thus compensating for potential shortcomings of banks' internal risk measurement models. The capital requirements for risks in banks' trading books (specifically relating to short-term transactions) are to be raised as well.

Last but not least, the reform responds to the need, as evidenced by the latest financial crisis, for regulatory constraints that will ensure an adequate liquidity supply for banks through appropriate liquidity buffers and long-term refinancing structures; in this respect, there are plans to implement new compliance ratios for banks. At the same time, enhanced accounting and disclosure requirements for banks are meant to increase transparency.

With a view to testing the impact of the changes to the Basel Capital Accord and to the CRD on the financial system, relevant data are currently being compiled within the framework of a quantitative impact study (QIS) in 2010. The QIS findings will be an essential input for calibrating the new regulatory framework. In Austria, 20 credit institutions are taking part in the quantitative impact study. These credit institutions have been selected for their size as well as for the sector and region for which they are representative. The QIS exercise was launched on February 16, 2010, with a kick-off event and the mailing of worksheets, in which participants need to enter a variety of balance sheet positions, indicators and product characteristics. The participating banks submitted the required data to the OeNB up to April 28. Following plausibility checks, the OeNB is going to send the data via the eBIS platform to the BCBS and to CEBS (Committee of European Banking Supervisors). In a next step, the data will be evaluated. The final results are to be expected in July 2010.

The OeNB sees a need for a truly comprehensive review of the planned measures. The quantitative impact study is a first step in evaluating key changes and their consequences for banks. However, the planned rules will also need to be reviewed thoroughly with regard to the impact they will have on lending and on the real economy. In this respect, the BCBS is working on a joint study with the Financial Stability Board and the IMF on the macroeconomic implications of the new framework. Initial findings are to be expected by July 2010; detailed results will be prepared for the G-20 meeting forthcoming in November.

Table 2

Ratings of Selected Austrian Banks

As at May 25, 2010

	Deposit Rating		Bank Financial Strength Rating	
	Long-Term[1]	Outlook		Outlook
UniCredit Bank Austria	A1	Negative	D+	Negative
BAWAG P.S.K.	Baa1	Stable	D	Stable
Erste Group	Aa3	Negative	C–	Negative
Hypo Alpe-Adria-Bank International	Baa2	On review for possible further downgrade	E	Stable
VBAG	Baa1	Negative	E+	Negative
RZB	A1	Stable	D+	Negative

Source: Moody's Investors Service.

[1] *Domestic currency.*

Downgrading of Hypo Alpe-Adria-Bank International Is the Exception, as other Ratings Remain Unchanged

The situation of Hypo Alpe-Adria-Bank International in early December 2009, before the bank was nationalized, prompted Moody's to lower its bank financial strength rating (BFSR) from E+ to E (now with a stable outlook) and its long-term deposit rating (LTDR) from Baa1 to Baa2 (placed on review for possible further downgrade). For all other large Austrian banks, Moody's has left its ratings and outlooks unchanged since end-October 2009, but negative outlooks continue to prevail.

Stock Price Recovery Has Lost Momentum since Q4/09; CDS Spreads Rising Slightly

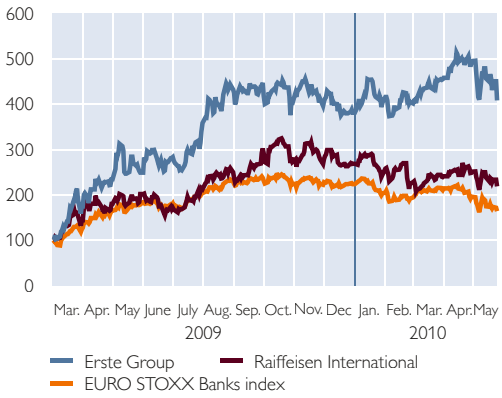
Following strong price gains for the stocks of Erste Group and Raiffeisen International since March 2009, the upward trend lost considerable momentum towards the end of 2009. The paths of the two stocks have diverged noticeably since the beginning of 2010.[32] While the stocks of Erste Group have gained 7% year-to-date, those of Raiffeisen International have lost more than 18%, reflecting investor uncertainty about the future structure of Raiffeisen International (some of the losses have, however, been recouped since the beginning of March 2010). This notwithstanding, the stocks of both Erste Bank and Raiffeisen International have outperformed the EURO STOXX Banks index, which serves as a benchmark for bank stocks of the euro area. Possible explanations include the diversified and profitable exposure of Austria's largest banks to CESEE as well as the decline in risk aversion to the region.

The CDS[33] spreads of Austria's largest banks have only partly mirrored the development of their stock prices. CDS spreads have been tightening (i.e. improving) compared with their peaks

Chart 40

Changes in Stock Prices of Banks

March 1, 2009 = 100



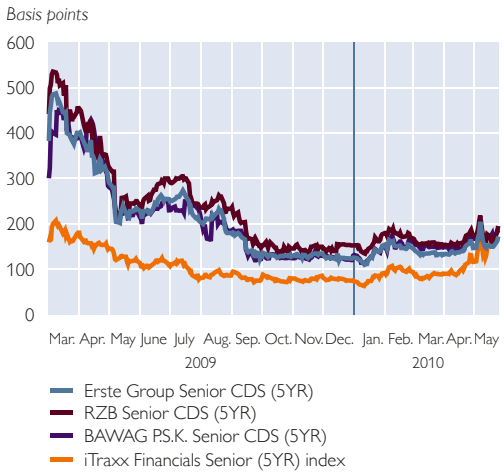
Source: Thomson Reuters.

[32] *Last update: May 25, 2010.*

[33] *Credit default swaps (CDS) are generally used as hedging instruments against the default of the underlying claim, but they may also be used for speculative purposes. CDS thus reflect the prevailing market sentiment, but not the actual refinancing costs of the respective businesses.*

Chart 41

CDS Spreads of Austrian Banks



Source: Thomson Reuters, Bloomberg.

registered in March 2009 and remained broadly unchanged in the fourth quarter of 2009. While market participants have been somewhat more pessimistic again about the default probabilities of Austrian banks since the beginning of 2010, domestic banks' CDS spreads have not widened as much as the (European) iTraxx Financials Senior index (five years).

In other words, while the concerns of market participants about the public debt levels of some euro area countries also affected the stock prices and the CDS spreads of Austrian banks, the impact has not been as strong as for the European peer group.

Insurance Companies and Mutual Funds Benefit from Financial Market Recovery

Improved conditions in financial markets since March 2009 have had positive repercussions also for Austrian nonbank financial intermediaries. Given their business model, nonbank financial intermediaries are particularly dependent on developments in financial markets. After an exceedingly difficult period at the beginning of 2009, sentiment in markets brightened; stock prices rose, risk premiums fell, and the high-yield currencies appreciated. In addition, assets under management were bolstered by strengthening capital inflows. However, these positive developments should not conceal the fact that profitability ratios are under strong pressure as a result of the financial crisis. Moreover, an important factor to note is that the financial and ownership interrelations in the financial sector can serve as channels for contagion.

Austrian Insurance Companies Benefit from Improved Climate in the Financial Markets

The pronounced upswing in financial markets in 2009 also had an impact on the Austrian insurance sector, with total assets (+4.9%), investments (+5.2%) and net income on investments (+15.1%) rising year on year. Unit- and index-linked life insurance policies benefited most from the recovery of stock markets, as the asset portfolios underlying these policies are more heavily based on stocks than those of conventional life insurance policies. Premium income in the insurance sector went up by 1.2% overall in 2009, which breaks down to 0.8% in the life insurance segments, 1.2% in the property/casualty insurance segments and 3.7% in the health insurance segment. Expenses for payouts of insurance claims augmented by 6.4%, rising in equal measure in the life insurance and in the property/casualty insurance segments. Income on ordinary activities skyrocketed by more than 80% to EUR 0.7 billion in 2009, albeit starting from a low level. At the end of 2009, the solvency ratio was nearly unchanged at 340%.

The stabilization of the CESEE region in the course of 2009 was im-

portant also for the Austrian insurance companies doing business in the area, as the stabilization was accompanied by a rise in confidence in the financial markets, which enhanced the value of insurance companies' investment, and by a slower decline in economic growth, which was important for premium growth.

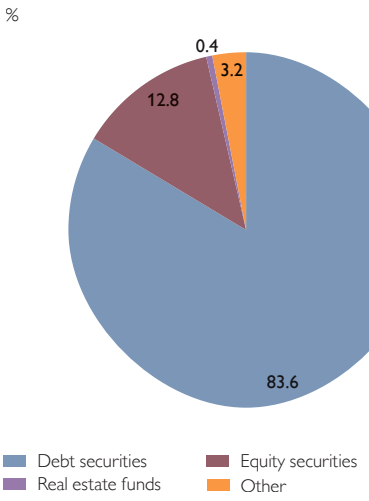
The insurance sector's investment plays a key role in the analysis of financial stability and potential contagion. The OeNB's securities statistics, which, among other things, list all securities held by Austrian insurance companies, provide more detailed insights into insurance sector investment. At the end of 2009, Austrian insurance firms held roughly EUR 68 billion worth of securities (mostly debt and equity securities), which corresponds to nearly 70% of total assets (EUR 99 billion). Breaking down these assets, EUR 56.9 billion or 84% were invested in debt securities, EUR 8.7 in equity securities[34]. The maturities of the debt securities are such that long-term liabilities are offset by long-term assets, which is typical of insurance companies, as more than half of the debt securities (EUR 34.5 billion) have more than ten years to run.

By type of instrument, securities issued by banks accounted for the lion's share of insurance companies' financial investment (EUR 32.7 billion), with a share of EUR 14 billion being attributable to Austrian banks. Foreign bank instruments stemmed above all from German banks (EUR 7.4 billion), U.K. banks (EUR 2.1 billion), and French banks (EUR 1.9 billion). The exposure to banks from Portugal, Ireland, Italy, Greece and Spain totaled EUR 2.3 billion. Finally, the Austrian insurance sector had EUR 0.3 billion worth

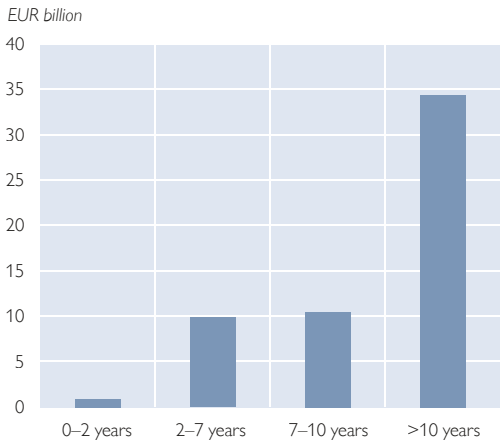
Chart 42

Breakdown of Securities Held by the Austrian Insurance Sector

Breakdown by Type of Security



Maturities of Austrian Insurance Companies' Debt Securities (Total: EUR 56 billion)



Source: OeNB.

[34] *Debt securities include mortgage bonds, asset-backed securities, commercial papers, certificates of deposit, fixed-income securities, and fixed-income funds; equity securities include equity interest and equity funds.*

of securities originating with CESEE banks in its portfolio.[35] The exposure to the financial sector as a whole, i.e. to banks, pension funds, financial holding companies and the like, adds up to nearly 70% or more than EUR 46 billion of total financial investment reported by insurance companies. In other words, the stability of the insurance sector is highly dependent on conditions at financial intermediaries.

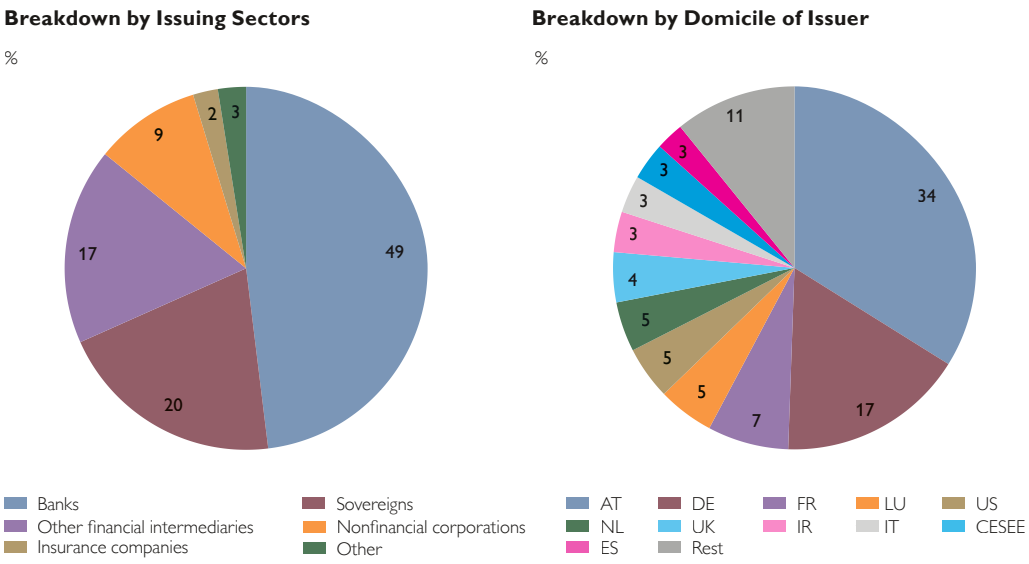
Sovereign exposure amounted to EUR 13 billion or 20% of total securities investment. Against the background of the pronounced rise in sovereign risk in recent months, price risk has materialized more extensively on this investment position than in the past.

The largest exposures were to debtors from Austria (EUR 23 billion), Germany (EUR 11.4 billion) and France (EUR 5 billion). The insurance sector's total exposure in CESEE issued securities came to EUR 2.2 billion; that to securities of Portugal, Ireland, Italy, Greece and Spain to EUR 7.8 billion. Investment in Greek securities, mainly government bonds, ran to slightly more than EUR 0.8 billion at the end of 2009. The seven largest exposures were to AAA-rated countries and accounted for slightly more than three-quarters of total sovereign exposure.

The following challenges for the insurance sector risks may be identified under the current economic circumstances: increased sovereign risk, an extended period of low interest rates, setbacks in the financial markets, and low economic growth in tandem with anemic labor markets. While the contagion risk between the banking and insurance sectors has declined somewhat, it remains elevated.

Chart 43

Breakdown of Securities Held by the Austrian Insurance Sector



Source: OeNB.

[35] *The OeNB's securities statistics cover holdings of securities only at an unconsolidated level, which means that they do not include securities held by Austrian insurance companies' CESEE subsidiaries. These securities could raise the exposure to banks operating in CESEE.*

Trend Reversal for Mutual Funds after a Difficult First Quarter in 2009

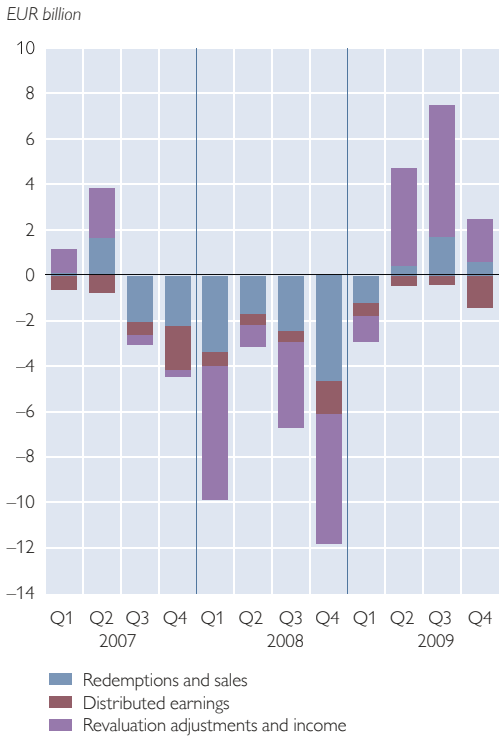
After having suffered price losses[36] and a contraction of assets under management for seven successive quarters to the beginning of 2009, Austrian mutual funds started to recover again from the second quarter of 2009 and staged a trend reversal, with substantial price gains and income (EUR 10.8 billion) for the whole year. Total assets under management by Austrian mutual funds went up by EUR 11.2 billion (+9%) from end-2008 to end-2009 and reached EUR 140.6 billion at the end of February 2010, a level last seen in the third quarter of 2008. Mirroring these developments, the consolidated net asset value actually invested in the market, i.e. assets under management adjusted for fund-of-fund investment, climbed to EUR 117.2 billion at the end of February 2010.

Figures on the structure of the holders of mutual fund shares, which have been compiled since end-2008, indicate that at the end of February 2010, 85% of the consolidated net asset value was held by domestic investors, more than two-thirds of which are attributable to households and nonprofit institutions serving households (EUR 36.0 billion or 36%), as well as insurance corporations and pension funds (EUR 33.8 billion or 34%).

The operating profit of Austrian investment companies[37] was EUR 106 million at the end of 2009, having

Chart 44

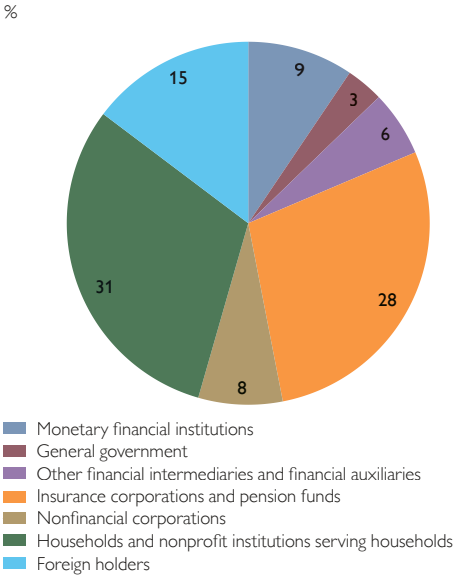
Change in the Consolidated Net Asset Value of Austrian Mutual Funds



Source: OeNB.

Chart 45

Holders of the Consolidated Net Asset Value of Austrian Mutual Funds (Q4 2009)



Source: OeNB.

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

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

grown by 18% during the year. When considering this result, it must be borne in mind that the number of investment companies increased by 1 to 30 in the course of 2009. This positive business trend is gratifying after a very difficult period in 2008, but a comparison with 2007, when operating profit amounted to EUR 178 million, clearly indicates that investment companies are still affected by the financial crisis. Moreover, employment in the industry contracted by more than one-fifth from 963 employees at end-2008 to 763 employees at end-2009. The expected annual surplus of investment companies, finally, came to EUR 77.4 million in 2009 (+7% year on year; peak at end-2006: EUR 147 million).

The study "Assessing the Relevance of Austrian Investment Companies and Mutual Funds for Financial Stability" in the special topics section of this issue of the Financial Stability Report provides a more detailed analysis of the latest developments in the Austrian mutual fund market.

Pension Funds and Severance Funds Display Mixed Results

The recovery from the economic and financial crisis also had positive repercussions on Austrian pension funds and severance funds. Above all pension funds' nominal return on investment, which had declined by 13% in 2008, moved back into positive territory to finish the year 2009 with 9% growth. Severance funds, which tend to invest more heavily in conservative debt securities, posted a far less pronounced negative result in 2008, but also achieved lower gains of +4% in 2009. Improving corporate governance at funds by providing more transparent information about market operations and fees would be desirable. As a case in point, it is currently difficult to assess to which degree return on capital invested, actuarial income or e.g. a change in mortality tables impact on beneficiaries. Moreover, at least for existing contracts, competition intensity must still be judged to be low.[38]

Recent figures for 2009 show that both pension funds and severance funds continued to enjoy stable returns. Important factors with an impact on this result are the retained asset management fees, which correlate with the size of the assets under management and with the level of the regular contributions. Pension funds and severance funds receive a total of about EUR 100 million annually for management, i.e. the collection of contributions and asset management. (Assets under management came to EUR 16.6 billion in the fourth quarter of 2009, so the management fees correspond to around 0.6% of assets under management.)

In a breakdown, severance funds managed assets worth EUR 2.8 billion in the fourth quarter of 2009 (+32% year on year), and pension funds assets worth EUR 13.8 billion (+16% year on year). Assets under management are expected to continue to grow in the future.

[38] *See also Schmitz, S. W. 2008. Governance-Struktur und Verteilung der Risiken im österreichischen Pensionskassensystem. In: Zotter, T. (ed.) Pensionskassen: Europa – Österreich – Strukturen, Erfahrungen, Perspektiven, LexisNexis Verlag ARD Orac. Vienna. 107–129.*