

Developments in the Sovereign Debt Crisis Will Be Crucial for Financial Stability

The stability of the European financial system is increasingly threatened by the intensifying euro area government debt crisis and the ongoing indecision of policymakers in the EU. Doubts about the creditworthiness of Greece and other highly indebted countries again undermined trust in the banking sector as well as banks' trust in each other in 2011. While its exposure to those highly indebted euro area countries which are at the greatest risk is comparatively low, the Austrian banking system will not be able to emerge fully unscathed by the negative effects of the government debt crisis on business activity and refinancing.

The Oesterreichische Nationalbank Calls on Austrian Banks to Act

In its Financial Stability Report of June 2011, the Oesterreichische Nationalbank (OeNB) pointed out that Austrian banks needed to take measures to strengthen business model sustainability and thus Austria's financial stability. Now that the need of banks to take measures appears more urgent than ever half a year down the line, the OeNB and the Financial Market Authority (FMA) have formulated a set of prudential measures for Austrian banks in Central, Eastern and Southeastern Europe (CESEE).

The package of measures devised by the OeNB and the FMA for Austrian banks operating in CESEE are meant to strengthen banking groups' capital adequacy and to improve CESEE subsidiary banks' refinancing options.

First, under Pillar 2 (the Supervisory Review Process) of Basel III, the three biggest banks are called on to implement the Basel III rules as soon as they take effect on January 1, 2013 (without

a transition period). Second, as from January 1, 2016, banks will be obligated to hold an additional common equity tier 1 ratio of up to 3%. Under Pillar 2, banks are also called on to link future credit growth to the growth of stable sources of refinancing (mainly local deposits). The refinancing of local lending of many CESEE subsidiary banks hinges on intragroup liquidity transfers and as a rule even increases during a crisis. In the past, countries with a high loan-to-deposit ratio were also those that had a greater credit risk. Against the backdrop of increasingly higher market expectations and the steady rise in the capital bases of comparable international banking groups, strengthening CESEE subsidiaries' refinancing structure, in order to render them less dependent, and parent companies' capital adequacy will help to secure the sustainability of the Austrian banks' business models.

The OeNB considers it important for Austrian banks to stop unhedged foreign currency lending and to successively strengthen current measures in CESEE as another key component of a sustainable business policy.

As Austrian banks exhibit very high foreign currency exposure in Austria and in CESEE, as exchange rate risk has recently materialized (the Swiss franc has appreciated against the euro and most CESEE currencies have depreciated against the euro), and as economic policymakers have taken unilateral measures, the restriction on new foreign currency lending in Austria and in CESEE agreed with banks has been set just in time. Banks operating in CESEE will also have to successively extend these restrictions to euro lending.

The OeNB considers it important for Austrian banks to reduce, in the medium term, existing structural weaknesses that affect profitability.

In the interest of the long-term sustainability of banks, addressing structural weaknesses is necessary not just to strengthen banks' capital bases, but also to wean them from their dependence on the comparatively high profits in their CESEE business – profits that come at the expense of high risks.

The Outlook for Economic Activity Deteriorates Markedly

Euro area economic developments in the first half of 2011 were characterized by an upturn that was increasingly driven by services in addition to manufacturing. However, rising uncertainty about the sustainability of European – and U.S. – public finances have clouded the economic outlook in recent months.

By and large, the emerging markets have remained driving forces of global growth throughout the year 2011 so far. In the CESEE region, however, growth lost momentum in comparison with other emerging markets.

The powerful surge in commodity prices and expectations that inflation would accelerate in the medium term exerted marked upward pressures on prices. The ECB's target of keeping inflation rates of below, but close to, 2% will be missed this year.

International securities markets experienced unprecedented volatility in 2011. Most political stabilization measures only alleviated conditions temporarily. Against this background, most companies decided to postpone non-essential capital measures.

No Improvement in Austrian Companies' and Households' Risk Situation

With global economic growth faltering and domestic demand in Austria weakening, the recovery of the Austrian economy came to a halt in mid-2011 after having posted robust growth in the first half of 2011. In the second quarter, corporate profits recovered to the precrisis level on the back of the strong economy. These higher profits for one thing boosted companies' capacity for internal financing, so that in the first half of 2011, companies required only a low volume of external financing. The share of bank lending in external financing growth stayed comparatively low, whereas the amount of funds raised in the form of bond issues was fairly high. For another thing, the improved profits in tandem with moderation in expanding corporate debt improved companies' debt-servicing capacity.

Moreover, lower interest rates on loans in the past two years relieved the cost burden for the corporate sector as well as for households. This development was additionally supported by the above-average share of variable rate loans. On a note of caution, though, such loans are fraught with substantial interest rate risk for companies and households. The continued high share of foreign currency loans in lending represents another risk factor for households. Although adjusted for exchange rate changes, the volume of foreign currency loans has fallen throughout the past two years, the share of such lending in total loans has decreased only little, given exchange rate developments in recent years, and still accounted for nearly 28.7% of all credits in the third quarter 2011.

Households' financial investment remained subdued in the first half of

2011. At the same time, price losses in international capital markets led to substantial (unrealized) valuation losses in securities portfolios and for insurance plan and pension fund investments.

Government Debt Crisis Has Negative Repercussions for Banking

Since mid-2011, the uncertainties in the international capital markets have also had a negative impact on Austrian banks' stock price developments and refinancing options. Furthermore, Austrian banks' trading income was affected by valuation losses in several asset categories, which is why the positive development of the first half of 2011 cannot possibly continue and why earnings prospects for the rest of 2011 are bound to worsen.

The structural weaknesses affecting Austrian banks' domestic performance were, however, offset by the continued comparatively favorable performance in CESEE. In the first half of 2011, the operating profits of Austrian banks' subsidiaries, mainly interest income, rose marginally against the same period of the previous year. At the same time, credit risk provisions diminished, so

that semiannual profits were substantially higher than 2010 first-half profits. However, these figures did not yet reflect the most recent fiscal policy measures passed in individual countries or disruptions in the international financial markets in the second half of 2011. This environment, combined with the forecast decline in economic activity, had a negative impact on banking business in Austria and in CESEE in the second half of 2011. When total lending rose, foreign currency lending in CESEE also increased somewhat again. In Austria, though, supervisory action helped keep new lending in foreign currency at a very low level.

In the first half of 2011, the Austrian insurance sector faced a substantial fall in premiums. The higher return on investment the insurance sector had in the first half of 2011 came under pressure in the second half, as the sovereign debt crisis flared up once more. A longer period of low interest rates and low yields poses a considerable challenge for the Austrian insurance industry. The rise in synthetic Exchange-Traded Funds (ETFs) warrants a critical appraisal from the financial stability perspective.