

Reports

Fragile Recovery of Austria's Financial System

Industrialized Economies Return to Growth

Following the severe recession in 2009, the industrialized economies are set to return to growth in 2010 although the recovery will be more fragile in the euro area than in the U.S.A. and in Japan. In the international financial markets, the perception of corporate risks improved in the first few months of 2010, as indicated by the narrowing of corporate bond yield spreads and the rally on stock markets. By contrast, uncertainties about fiscal sustainability and thus the risk premiums on government debt securities of some euro area countries (particularly, Greece) increased in spring 2010. Only the measures implemented by the EU and the IMF stabilized the euro area's government bond markets in early May.

In Central, Eastern and Southeastern Europe (CESEE), economic stabilization which had commenced in mid-2009 continued in almost all countries, buoyed by the return to import growth in the industrialized countries and by the EU and IMF's country-specific financing programs. Current account deficits decreased significantly and, in certain cases, turned into surpluses. While credit growth was in marked decline and, in some cases, even negative in 2009, credit risks increased on the back of currency depreciation and sluggish growth. In the course of 2009, this increase has slowed down noticeably, however. Country-specific risks still persist, particularly in respect of fiscal consolidation.

Small Increase in Corporate and Household Financing

Modest annual growth is projected for the Austrian economy in 2010. In 2009, when the Austrian economy was in recession, corporate balance sheets reflected the impact of the economic

crisis: Corporate profits fell by 9% and external financing was down to a third of the previous year's level. Annual growth in bank lending has been negative since end-2009. This decline in financing volumes is likely to have had both demand and supply-side causes. First, the drop in investment activity reduced corporate financing requirements. Second, owing to the deterioration of corporate ratings in the wake of the economic crisis, the banking sector's credit standards were markedly higher in spring 2010 than before the crisis. Nothing suggests that banks tightened their credit supply more than is usual in an economic downturn. Historically low interest rates in the wake of the 2008/09 rate cuts strengthened banks' loan financing.

Households have so far increased their borrowing by only a very modest extent. Low levels of both new household debt and interest rates have reduced households' debt ratio and interest expenses. An additional contributory factor is the – by international standards – very high share of variable interest rate loans which, however, implies increased interest rate risks in case interest rates go up. The share of foreign currency loans in loans outstanding is still very high despite the latest reductions. As for Austrian households' financial assets, the valuation losses of 2007 and 2008, which arose as a result of the economic crisis, have been recouped only to some extent.

Austrian Banking Environment Remains Challenging

Austria's financial system benefited from the recovery in the financial markets. For the banking sector, this development was reflected in improved refinancing conditions and trading income. Interest income, the most important income component, proved to be a sta-

bilizing factor. On an unconsolidated basis (which is the applicable basis for domestic business), the profitability of Austrian banks was marginally positive only owing to extraordinary income. In 2009, despite the economic downturn and persistent uncertainties in CESEE, Austrian subsidiary banks in the region made a significantly positive contribution to income of some EUR 1.8 billion.

However, increased credit risk owing to the global recession and the accompanying rise in loan loss provisions posed some problems to the banks, although the increase in bank lending in Austria was significantly smaller than that at subsidiary banks in the CESEE region. Overall, credit risk provisions absorbed a growing share of profits.

In respect of foreign currency loans, bank lending was very restrained, not least owing to the publication, by the FMA and OeNB, of extended minimum standards governing the granting of foreign currency and repayment vehicle-linked loans to Austrian households.

At end-2009, the consolidated core capital ratio was 9.3%, up significantly on the previous year (+7.7%). This rise,

which was attributable to capital injections from both the private and public sector, undoubtedly also increased banks' risk-bearing capacity. Nonetheless, in view of current developments in the economic environment and ongoing regulatory initiatives, the Austrian banking sector is expected to require additional capital in the medium term.

Even if Austrian banks' business model is fundamentally sustainable and the banking system is sound overall, the banking environment will continue to remain challenging. Credit risk is expected to remain heightened in both Austria and abroad, at least until the end of 2010. Uncertainties also persist about the extent to which the recent income improvement will prove sustainable.

The visible upturn in financial markets in 2009 was also reflected in the investment income of insurance companies, mutual funds, pension funds and severance funds. Even so, the confidence of fund investors in Austrian funds only returned gradually. The CESEE region's stabilization, which occurred in 2009, was also important for Austrian insurance companies active in these countries.