

Austrian Financial Intermediaries Burdened By Difficult International Environment

In the wake of the renewed tensions that gripped the international financial markets by mid-2011, the conditions underpinning the Austrian financial system have worsened progressively, thereby placing the country's financial stability at increased risk.

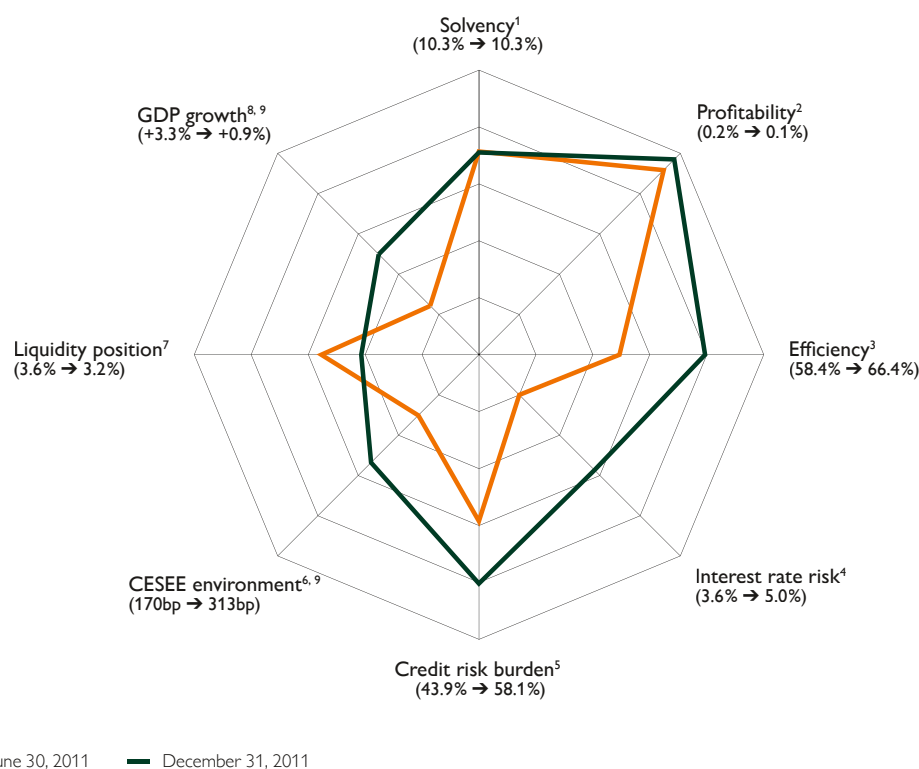
A slight decrease in operating income paired with rising expenses that were driven (among other factors) by write-down requirements caused a significant

decline in the profitability of Austria's banking sector in 2011. Given an increase during the first half of the year, capital adequacy ratios went up slightly year on year, although capitalization remained below peer levels. Despite heightened macroeconomic and political risks, Austrian banks' subsidiaries in Central, Eastern and Southeastern Europe (CESEE) again accounted for a substantial share in the total earnings of their

Heightened risks to financial stability in 2011

Chart 13

Banks and Financial Market Stability



Source: OeNB.

¹ Tier 1 ratio.

² Return on assets.

³ Cost-to-income ratio.

⁴ 200-basis-point interest rate shock (loss of eligible capital).

⁵ Credit risk provisions in % of operating result.

⁶ Weighted CDS spread.

⁷ Cumulative 12-month funding deficit in % of total assets.

⁸ Real GDP growth per annum.

⁹ Most recent value available at the cutoff date.

Note: Consolidated figures, largely scaled on the basis of historical data. The closer the data points fall to the center, the better/less risky/more favorable the ratio. bp stands for basis points.

parent banks. Nevertheless, further improvements in efficiency are required and should be pursued. Austrian banks' foreign claims on the euro area countries most severely hit by the sovereign debt crisis was further reduced in 2011 and remained low by international comparison.

Despite the challenging international environment, Austrian banks' liquidity situation improved slightly in 2011, an outcome attributable to banks' early efforts to reduce their funding deficit. Although the level of new foreign currency lending was low in recent years, the substantial volume of outstanding foreign currency loans still constitutes a risk factor for domestic banks. While the measures implemented by the Swiss National Bank have curbed the appreciation tendency of the Swiss franc for the time being, the volatile market environment is exerting pressure on the repayment vehicles often used to back foreign currency loans.

In light of the difficult environment they encountered in 2011 – a condition exacerbated by the continued uncertainty in international markets – Aus-

trian banks must take steps to permanently strengthen their capital base, further improve their liquidity situation and enhance the sustainability of their business models. Published in March 2012 by the FMA and the OeNB, the "Supervisory guidance on the strengthening of the sustainability of the business models of large internationally active Austrian banks" was another decisive move in that direction.

2011 proved a difficult year for the Austrian insurance sector since a decline in premium income was accompanied by higher costs. Moreover, low interest rates continued to be one of the major challenges for insurers and pension funds.

CESEE subsidiaries again contribute significantly to banks' total profitability

Austrian insurance sector faces tough market environment

Austrian Banking System Affected by European Sovereign Debt Crisis

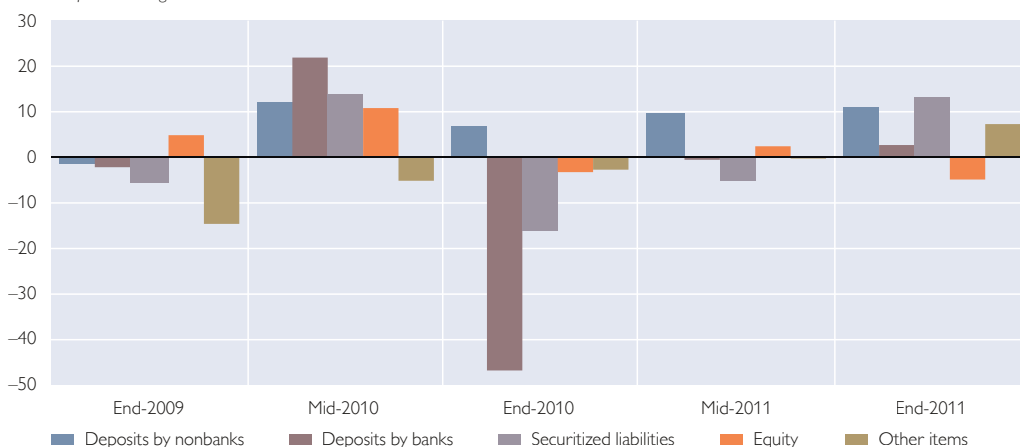
Domestic Banks Report Stable Business Activity

Although Austrian banks suffered from the fallout of the sovereign debt crisis in 2011, their consolidated total assets went up slightly to EUR 1,166.3 billion, thus overcoming the trend toward

Chart 14

Change in Austrian Banks' Refinancing

Period-to-period change in EUR billion



Source: OeNB.

shrinking balance sheets observed during the preceding two years. At around 17.2, leverage remained at the level posted at end-2010. Austrian banks responded to the tightening international funding conditions by offering favorable deposit rates aimed at fostering retail deposit growth. Retail deposits have augmented by nearly EUR 40 billion since 2009, with the Raiffeisen sector accounting for the lion's share of that increase. The level of securitized liabilities also rose during the second half of 2011, driven mainly by a higher share of derivatives in the trading portfolio.

Leverage ratio of Austrian banking sector remains constant

After experiencing a slight uptick in 2011, lending in Austria continued to rise in the first few months of 2012, with Raiffeisen credit cooperatives and joint stock banks posting above-average growth figures. The volume of loans to domestic nonbanks amounted to EUR 329.2 billion at the end of March 2012, a level nearly 2.1% higher than the year before. Lending to corporations rose more strongly than lending to households, which, due to the uncertain economic environment, took a cautious approach to taking out consumer loans in the second half of 2011. At present, there is no indication of a credit crunch in Austria.

Decline in exchange rate-adjusted foreign currency loans

On average, foreign currency lending accounted for just under 6% of new Austrian retail loans in 2011. However, the stock of foreign currency loans, which at the end of March 2012 came to EUR 56.2 billion (i.e. 17.1% of total loans), remains high. At 27.6%, the share of foreign currency lending to households in total loans also continued to be high despite having fallen somewhat in recent quarters. The risk associated with exchange rate effects becomes evident when comparing year-on-year figures. Specifically, while the volume of foreign currency lending increased in absolute terms by 0.8%, that of

foreign currency loans adjusted for exchange rate effects actually declined by 6.5%. Approximately three-quarters of all foreign currency loans to Austrian households are backed by repayment vehicles (usually traditional life insurance policies or other capital market products). According to a 2011 survey, those vehicles posted considerable performance losses in the wake of the financial market turmoil. In that vein, banks should be taking appropriate measures to close their funding gaps, some of which are quite substantial.

The first quarter of 2012 saw a slight decline in the unconsolidated total assets of Austrian banks, a metric that reflects a general reduction in other assets. Concurrently, banks were more inclined to use retail deposits to meet their funding needs.

Deterioration in Credit Quality Pushes Up Risk Provisioning

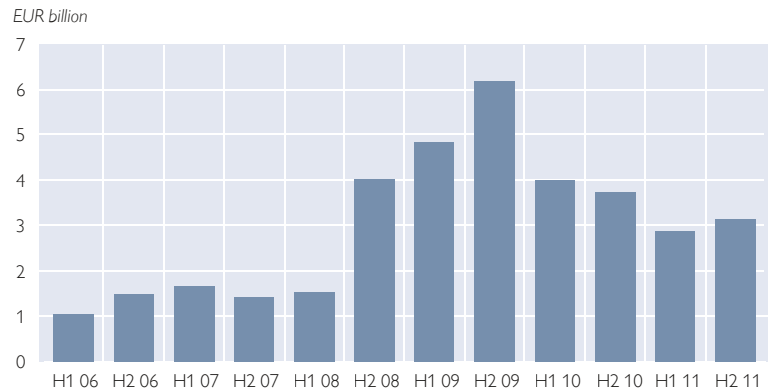
In the second half of 2011, the consolidated risk provisions set aside by Austrian banks for lending operations (new net loan loss provisions) again posted a slight increase (see chart 15). In 2011, risk provisions amounted to around EUR 6 billion, down 20% against 2010, yet still notably higher than in pre-crisis years. The persistently strong need for risk provisioning can be attributed to the fact that credit quality deteriorated during the previous crisis years and that borrowers are still struggling to cope with the subdued economic outlook.

The rise in credit risk costs prompted by the decline in credit quality is also evident in the development of loan loss provision ratios (see chart 16). In terms of both levels and dynamics, regional differences in loan loss provision ratios remain evident. Following a period of relatively moderate (single percentage point) growth from mid-2008, the unconsolidated loan loss

Increase in loan loss provisions driven by foreign subsidiaries

Chart 15

Consolidated Credit Risk Costs of Austrian Banks



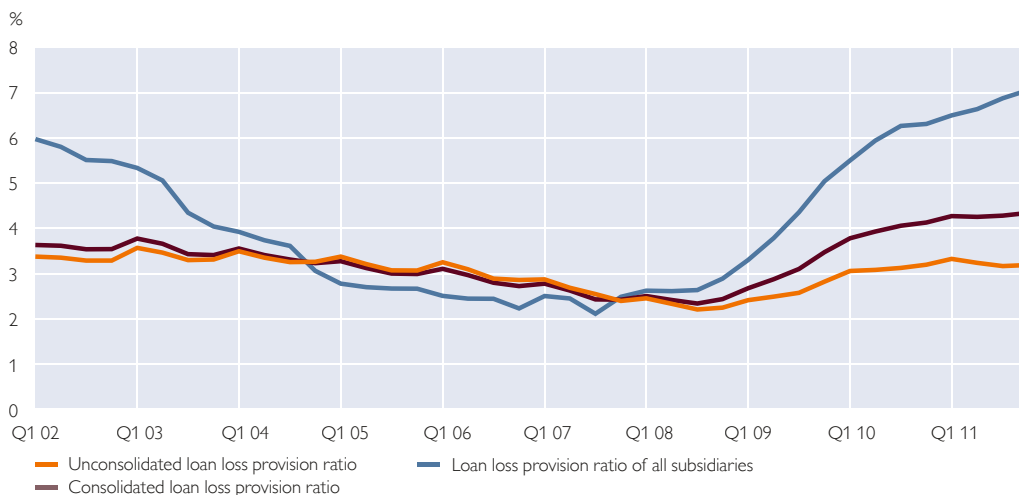
Source: OeNB.

provision ratio¹, which focuses primarily on loans to domestic customers, experienced a slight decline since the end of the first quarter of 2011 and stood at 3.2% as at end-2011, which corresponds to the long-term average recorded during the pre-crisis years. By contrast, the loan loss provision ratio of Austrian banks' foreign subsidiaries increased to 7.1% (+0.7 percentage points) in 2011, a change driven mainly by banks' subsidiaries in EU Member States outside Austria (NMS-2004: +1.2 percentage points, NMS-2007: +1.4 percentage points). As before, the highest ratio was observed among CIS-based subsidiaries (10.4%), although that trend has taken a downturn since the end of the first quarter of 2011. Compared to the mid-2008 level, foreign subsidiaries' loan loss provision ratio has risen by 4.4 percentage points.

The consolidated loan loss provision ratio² for nonbank lending posted a scant increase in the second half of 2011, which can be attributed to the downward trend in the unconsolidated

Chart 16

Loan Loss Provision Ratios of Austrian Banks



Source: OeNB.

¹ Stock of specific loan loss provisions for claims on nonbanks as a share of total outstanding claims on nonbanks.

² The numerator of this ratio is the stock of unconsolidated specific loan loss provisions for claims on nonbanks plus the stock of specific loan loss provisions reported by fully consolidated subsidiaries. The denominator is the sum of unconsolidated gross claims on nonbanks and the gross claims of fully consolidated subsidiaries on nonbanks. Owing to regional differences in accounting rules, the consolidated loan loss provision ratio may convey a slightly distorted picture.

loan loss provision ratio, which covers more than 70% of all nonbank loans. Credit risks to which the Austrian banking system is exposed through

possible adverse economic developments and the associated further deterioration in credit quality are analyzed in depth via macroeconomic stress tests.

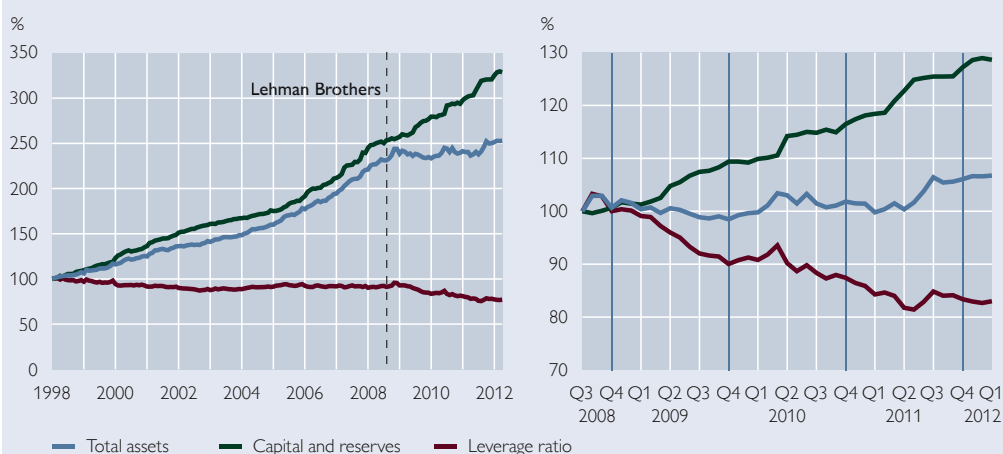
Box 1

More Deleveraging in Europe – A First Empirical Analysis

The OeNB's Financial Stability Report 22 provided insights into how risks were priced improperly in the run-up to the financial crisis and showed that, as a result, lending was made available to the real economy at interest rates too low to cover risk costs. Parts of these funds went into lending for projects that only appeared to be profitable or were used to sustain private consumption. Consequently, high lending growth at low interest rates did not contribute to sustainable economic growth. Today, these loans place a significant burden on the balance sheets of creditors and banks alike. As a result, international agencies such as the BIS or the IMF have voiced their concerns that in seeking to repair their balance sheets, banks would reduce their lending activities and thereby fail to provide the real economy with sufficient volumes of new loans.¹ While the ongoing deleveraging efforts represent a desirable process of adjustment, appropriate steps must be taken to ensure that this deleveraging can be achieved without dramatically curbing loans to the real economy.

What do the figures say? Since end-2008, the leverage of euro area banks has experienced a significant decline. While the leverage multiplier for these banks stood at 18 when the crisis erupted, it declined to 15 by end-2011. The chart below indicates that this drop is not linked to a reduction in assets. In fact, credit exposures to corporations and households have increased since end-2008 (albeit more slowly than in pre-crisis years). At the same time, however, capital and reserves surged nearly five times as much. This leads to the conclusion that in the aggregate, the deleveraging observed to date results from a strengthening of the capital base rather than from lending scarcity.

Assets, Capital and Leverage Ratio of MFIs



Source: ECB. Figures are indexed at year-end 1997 (left-hand panel) and re-indexed at the end of the third quarter of 2008 (collapse of Lehman Brothers, right-hand panel).

¹ See BIS, 2012. Quarterly Review March 2012, and IMF, 2012. Global Financial Stability Report. April.

ECB data also show that the share of loans and bonds to the nonfinancial sector (businesses, households and public entities) only amounts to some 45% of total assets. This gives banks the opportunity to shrink their balance sheets by, for example, reducing interbank positions (the volume of interbank loans corresponds to 130.5% of the volume of loans to nonfinancial corporations and to as much as 61.8% of the latter including loans to households), securities held for trading or unsecured consumer loans, without restricting their lending for sustainable investments.

This conclusion is supported by data from the European Banking Authority (EBA), which reveal that only some 3% of the measures planned under the recapitalization exercise can be attributed to genuine deleveraging efforts.² An internal OeNB analysis of the annual reports and press releases of 61 European banks participating in the recapitalization exercise shows a similar picture. Of the banks involved, half are unaffected by recapitalization since their core tier 1 capital ratios already exceed the 9% limit. Most banks intend to continue to retain profits; approximately one-third of them plan to buy back hybrid capital instruments in order to strengthen their capital base; around 20% aim to sell off some of their subsidiaries (predominantly equity holdings); and nearly 10% are prepared to partially withdraw from individual business segments and/or countries.

The first available data thus indicate that euro area banks have been able to reduce their leverage in recent years by strengthening their capital base. As a result, they definitely have the latitude necessary to deleverage their balance sheets without endangering the level of lending to the real economy. With a view to financial market stability in Europe, this development is to be welcomed as reduced leverage decreases both the potential for risks and the degree of financial interconnectedness and thus mitigates systemic risk.

² See EBA, 2012. Overview of Capital Plans following the EBA recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA 2012-005).

Banks' Profitability Reflects Difficult Environment

Austrian banks' profitability severely suffered under the difficult economic conditions in 2011. Although their income remained comparatively stable, domestic credit institutions posted weak total earnings as expenses rose and risk costs continued to be high.

Thanks to Austrian banks' focus on the retail business, their consolidated operating income proved resilient in 2011 and, at around EUR 37.2 billion, was only slightly lower than in 2010. Stable interest income (+0.2%) and a slight rise in other operating income (+3.2%; above all from participating interests in nonbanks) almost fully compensated the drop in fee and commission as well as trading income (-1.1% and -15.3%, respectively). On the expenses side, however, Austrian banks had to face i.a. an increase in

writedowns, particularly with regard to goodwill (+67.2%) and staff costs (+3.4%). As a consequence, their consolidated operating result declined by just under one-quarter to around EUR 10.4 billion, and the cost-to-income ratio went up from 57.9% at the end of 2010 to 66.4% at end-2011.

Unlike credit risk provisions, which were lower than in the previous year (although remaining at a high level of EUR 6.0 billion), risk provisions on securities holdings augmented markedly. The consolidated 2011 net profit of the Austrian banking sector as a whole reflected the difficult international economic and financial situation but remained at least positive at EUR 0.7 billion. The consolidated return on assets (RoA) after tax, however, went down considerably year on year, coming to around 0.1% in 2011.

Austrian credit institutions' business in the CESEE countries remained

Risk provisions remain high

Operating profits burdened by writedowns

CESEE business contributes significantly to Austrian banks' income in 2011

a cornerstone of profitability in 2011, making major contributions to total earnings despite higher risks and losses in some countries.

CESEE subsidiaries remain profitable

Market turmoil caused by the sovereign debt crisis continued to affect Austrian banks' profitability in the first quarter of 2012. However, amid a continuously uncertain macroeconomic and political environment, operating profits turned out to be slightly higher than in the corresponding period in 2011. With respect to the year 2012 as a whole, banks appear to be clearly more optimistic than before, although high risk provisions point toward lasting uncertainties.

CESEE subsidiaries record positive loan growth in 2011

Austrian banks' exposure to CESEE is broadly diversified

can be seen e.g. from unilateral financial policy measures such as the Hungarian government's intervention in existing foreign currency loan contracts).

At the end of 2011, the 69 fully consolidated CESEE subsidiaries of Austrian banks posted total assets of around EUR 270 billion, up 2.4% year on year. Over the same period, the volume of on-balance sheet loans rose by 1.5% to around EUR 171 billion, thereby continuing – albeit in a slightly less dynamic manner – the positive trend in subsidiary lending that had already been observed in 2010.

At end-2011, the operating income of Austrian banks' CESEE subsidiaries came to around EUR 14 billion for the year as a whole (+1.3% year on year). Net interest income climbed by 0.8% and, just like in the past, accounted for the bulk of total operating income at around EUR 9.4 billion. The three other items (fee-based income, trading income and other operating income) also made a positive contribution to operating income. As total operating expenses rose only marginally by 1.9% to around EUR 6.8 billion, the cost-to-income ratio remained almost unchanged at approximately 50%. The period profit after tax came to around EUR 1.8 billion.

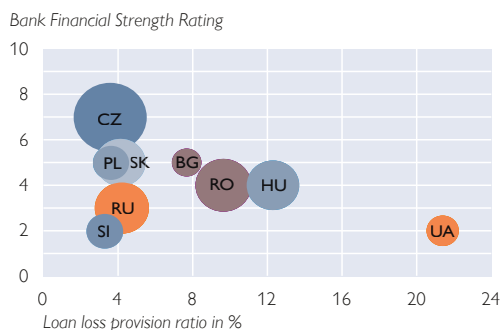
At 0.7%, the after-tax RoA of Austrian banks' CESEE subsidiaries was above that recorded for domestic business. The same holds for after tax return on equity (RoE), which came to 1.6% in Austria at end-2011 and was thus clearly below the figure recorded for the CESEE business (6.1%). Both indicators fell slightly in the course of the year, however. Compared with the unconsolidated results (which are dominated by banks' domestic business),

Profits in CESEE Gained on the Back of Higher Risks

The exposure³ of majority-Austrian owned banks to CESEE came to around EUR 216 billion as at end-2011.⁴ While this exposure remains broadly diversified, the lion's share at 55% (size of circles in chart 17 corresponds to volume of exposure) was recorded vis-à-vis the NMS-2004, where political risk has recently been on the increase again (as

Chart 17

Austrian Banks' Exposure to CESEE



Source: OeNB (Q4 11), Moody's (December 2011).

Higher profitability entails higher credit risk

³ Here, exposure refers to the exposure of majority-Austrian owned banks to credit institutions and nonbanks in CESEE.

⁴ At the same time, these banks held around EUR 162 billion worth of customer deposits in CESEE.

Chart 18

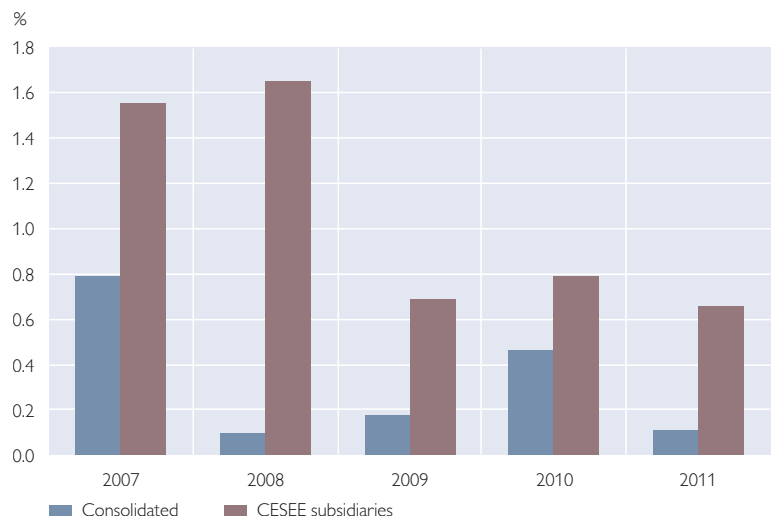
Austrian banks' CESEE business was again more profitable but also entailed higher credit risks. At year-end, the CESEE subsidiaries' loan loss provision ratio came to 7.3% and was thus more than twice as high as the unconsolidated rate (3.2%). As a consequence, the consolidated loan loss provision ratio came to 4.3% (see chart 16).

At end-2011, around EUR 84 billion in loans granted by CESEE subsidiaries were denominated in foreign currencies. This corresponds to a 3.3% rise over the year (adjusted for exchange rate effects). As the overall loan volume increased at a similar pace, the aggregate share of foreign currency loans in total loans went up only marginally to around 48%. As in the past, the euro was the dominant foreign currency, accounting for around 60% of the foreign currency loan volume in the region. The U.S. dollar played an important role in foreign currency lending only in the CIS.

In 2011, new foreign currency lending by the CESEE subsidiaries of the top six Austrian banks⁵ continued to be in compliance with the Guiding Principles the OeNB and the FMA agreed upon with these banks with the aim of reducing the riskiest forms of new foreign currency lending. In particular, the stock of Swiss franc-denominated loans decreased continuously, coming to around EUR 14 billion at year-end, which represented a 17% share (down by around 3 percentage points year on year) in CESEE subsidiaries' total foreign currency loan portfolio. The overall increase in foreign currency lending, however, showed that the problem persists despite the decline in the riskiest foreign currency loans.

Likewise, in cross-border foreign currency lending to CESEE the total

Austrian Banks' Return on Assets



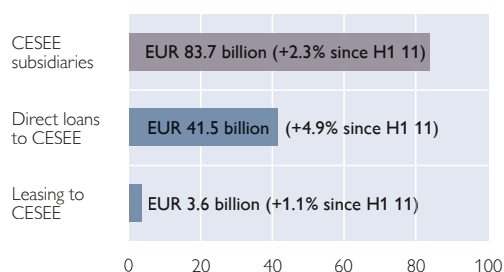
Source: OeNB.

volume of loans augmented by 4.9% to around EUR 42 billion, while the share of Swiss franc-denominated direct loans went down by 12% to EUR 2.1 billion. Foreign currency-denominated leasing to households and nonfinancial corporations went up only marginally (+1.1%) to EUR 3.6 billion. This means that there are no signs of leasing contracts – as a form of shadow banking –

Swiss franc becomes less important in foreign currency lending

Chart 19

Austrian Banks' Foreign Currency Loan Exposure to CESEE



Source: OeNB.

Note: Growth rates adjusted for exchange rate effects. Values as at end-2011.

⁵ Here, the top six banks comprise Austria's six banking groups with the largest exposure (in terms of external assets) to the CESEE region at end-2011.

Foreign currency loans still imply higher credit risk

being increasingly used in CESEE to circumvent the ever stricter regulatory provisions on foreign currency lending by banks (see chart 19).

As in previous reporting periods, at end-2011 the credit quality of foreign currency loans was lower than that of local currency loans, although country-specific differences need to be considered. The nonperforming loan ratio (NPL ratio) of foreign currency loans in CESEE averaged 18.8% and was thus higher than that of total loans (15.0%); both ratios have again increased. Compared with local currency loans, foreign currency loans not only became nonperforming more often but were also to a lesser extent covered by risk provisions. The NPL coverage ratio II⁶ of total loans stood at 67.3% at end-2011; the respective ratio for foreign currency loans came to only 63.4% despite a year-on-year rise.

Sustainability package: Well-balanced refinancing increasingly important

Another risk-relevant feature of Austrian banks' exposure to CESEE is that intragroup liquidity transfers are of considerable importance. While dropping by 5.1% year on year, such transfers still came to EUR 42 billion at end-2011, resulting in a loan-to-deposit ratio (LDR) of 106%. This means that the average LDR in CESEE went down by more than 2 percentage points year on year; across the various regions, however, results remain highly heterogeneous. In times of crisis, therefore, many CESEE subsidiaries may become even more dependent on their parent banks.

Loan-to-deposit ratio continues to decrease

CESEE subsidiaries' capital situation continues to improve

As chart 20 shows, the capital ratios of Austrian banks' CESEE subsidiaries – sometimes significantly – exceeded the regulatory minimum requirements.

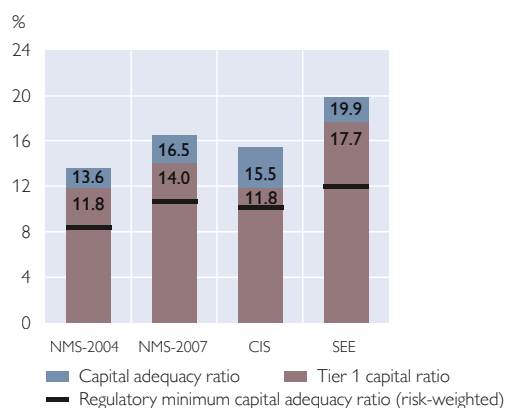
This holds true for both the capital adequacy ratio, which remained unchanged at 15.6% year on year on CESEE average, and the tier 1 ratio, which rose slightly to 13.3% over the same period. In both the NMS-2004 and the CIS, the tier 1 ratio came to 11.8%, while in the NMS-2007 and SEE, it was (in part considerably) higher, reflecting not only stricter regulatory minimum capital requirements in some countries but also elevated country risks.

While the tier 1 capital ratio of Austria's top 6 and top 3 banks has increased over time (consolidated data), it is still below that of a peer group of 12 European banks, despite the comparably higher exposure. It is important to note, however, that the leverage of these Austrian banks is lower than the leverage of the peer group.

The supervisory guidance⁷ on the strengthening of the sustainability of the business models of large internationally active Austrian banks⁸ issued in

Chart 20

CESEE Subsidiaries' Capital Adequacy at End-2011



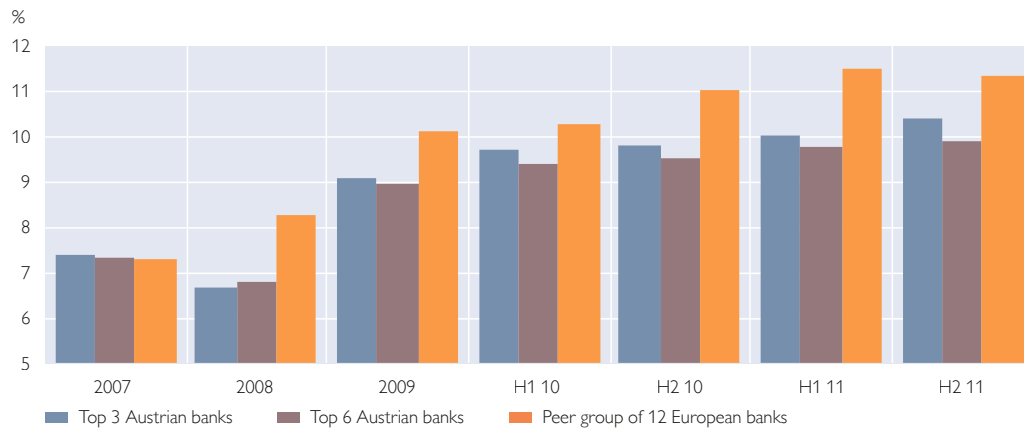
Source: OeNB.

⁶ NPL coverage ratio II = (risk provisions on nonperforming loans + collateral according to Basel II) / NPLs.

⁷ See the OeNB's press release of March 14, 2012.

⁸ The supervisory guidance currently applies to Erste Group Bank AG, Raiffeisen Zentralbank Österreich AG and UniCredit Bank Austria AG.

Chart 21

Tier 1 Capital Ratio

Source: OeNB, BankScope.

March 2012 aims at, inter alia, ensuring a balanced refinancing of net loan growth at Austrian banks' subsidiaries, including those in CESEE. The Austrian Financial Market Authority (FMA) and the OeNB monitor this balance by applying a loan-to-local stable funding ratio (LLSFR)⁹. As an analysis of the recent financial crisis showed that credit risk was higher for subsidiaries with a high stock LLSFR (i.e. above 110%), the supervisory authorities established a mechanism that triggers a warning signal when a stock or flow LLSFR exceeds 110%. The results of the regular monitoring of these indicators are evaluated and discussed with the competent home and host supervisors in the cross-border supervisory colleges; if deemed necessary, supervisory measures are then taken to proactively curb tendencies of unsustainable credit growth (boom-bust cycles) and to improve subsidiaries' refinancing structure.

External Claims on Euro Area Countries with High Risk Premiums Continue to Decline

Austrian banks' exposure to euro area countries whose bonds carry high risk premiums (in particular those supported under international programs, i.e. Greece, Ireland and Portugal) is low. Moreover, by end-2011 (majority Austrian-owned) Austrian banks' claims on Greece, Ireland, Portugal, Spain and Italy went down to around EUR 22 billion or to around 7% of GDP, which is low by international comparison.

The restructuring of Greek government debt in March 2012 caused banks' external assets to decrease markedly in the first quarter of 2012.

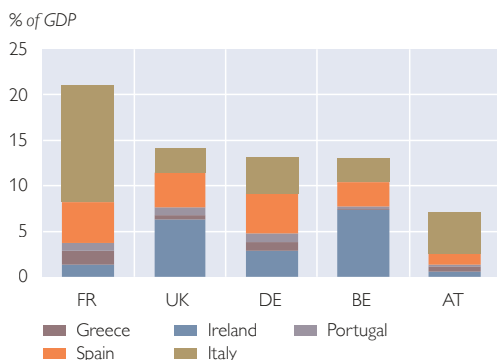
Liquidity: Temporary Easing of Conditions and New Regulatory Challenges

The liquidity situation of Austrian banks has lately been characterized by the significant easing of liquidity tensions that

⁹ Local stable funding comprises deposits by nonbanks, supranational funding, capital from third parties and the total outstanding volume of debt securities with original maturities of at least one year issued by the subsidiaries in question to investors outside their consolidated group.

Chart 22

Exposure of Selected Banking Systems to GR, IE, PT, ES and IT



Source: BIS, Eurostat.

Note: Data as at Q4 11 (before Greek government debt restructuring).

has been observed in European markets since early 2012, reversing a tightening of liquidity and refinancing conditions in fall 2011, in particular for banks operating in sovereign debt crisis countries. Banks have benefited above all from the provision of long-term liquidity by the ECB and the halving of the minimum reserve ratio. The ECB conducted two refinancing operations with a maturity of three years in December 2011 and February 2012, which totaled EUR 1,000 billion. This amount includes liquidity shifted from earlier open-market operations with a shorter maturity.

To date, the refinancing costs of Austrian banks have not been affected significantly by the fact that Standard & Poor's downgraded the credit rating for the Republic of Austria by one notch to AA+ in late 2011. The banks have actually been able to lower their refinancing costs.

Austrian banks used the initial months of 2012 to reduce their liquidity risks, based on aggregate data. As they anticipate a strong increase of net deposit inflows, the cumulative net funding gap twelve months ahead (excluding activity in the unsecured segment of the money market) has

narrowed by EUR 7 billion to EUR 30 billion since the beginning of the year. In the unsecured money market, banks' net position is significantly positive one month ahead. At the same time, banks have increased the amounts of collateral that they can mobilize at short notice, above all their holdings of cash assets. Systemically, the total amount of liquidity that can be realized 12 months ahead before money market operations has improved considerably, from EUR 87 billion to EUR 102 billion.

In the first quarter of 2012 Austrian banks returned to the capital market with higher issuance volumes than in the last quarter of 2011, which had been a very difficult period. By mid-March 2012 issuance activities were, however, slowing down again. To some extent this can be attributed to the ECB's longer-term refinancing operations with a maturity of three years, as a result of which refinancing pressures have decreased. At the same time, market conditions have been influenced by renewed bouts of uncertainty. Issuance activities were characterized by a structural change, with the pendulum moving from uncovered bonds toward collateralized forms of refinancing (covered bonds and pfandbriefe). Such crowding out is, however, fraught with risks of its own, as it drives up the volume of prime assets locked up in the collateral pool and puts creditors of uncollateralized debt instruments in a less favorable position. The volume of bank bonds to be rolled over or redeemed six months ahead decreased from EUR 35 billion at the beginning of 2012 to EUR 29 billion in early June, which is positive for financial stability.

On the regulatory front, banks need to gear up to meet the new minimum liquidity requirements (liquidity coverage ratio – LCR; net stable funding ratio – NSFR) as defined by the Capital

Refinancing costs lower following ECB action

Gearing up for the new liquidity requirements

Requirements Directive (CRD) IV and the corresponding Capital Requirements Regulation (CRR). With a view to assisting banks in their preparations, the OeNB started in early 2012 to monitor compliance with LCR requirements, which will be binding from 2015.

The comparatively minor extent to which Austrian banks use the interbank market (including money market funds) for short-term funding¹⁰ was discussed in issue 22 of the OeNB's Financial Stability Report. The calculation method has since been refined further on the basis of financial accounts and consolidated banking data and has been adjusted for structural characteristics of the Austrian banking sector. In the past, the multi-tiered structure of the decentralized banking sectors in Austria had distorted the public perception of the importance of wholesale funding, causing its share in the refinancing structure of Austrian banks to appear overly inflated. Following the necessary data adjustments for this structural distortion, short-term wholesale funding (including cross-border transactions)¹¹ accounted for approximately 15% of Austrian banks' consolidated total assets at the end of 2011 (instead of 19% on an unadjusted basis).

Capital Adequacy Continues to Improve in 2011

After its low in the third quarter of 2008, the aggregate tier 1 capital ratio (capital adequacy ratio) of all Austrian banks rose continually, gaining around 303 (310) basis points to reach 10.3% (13.6%) in the fourth quarter of 2011.

The increase of the aggregate tier 1 capital ratio can, in essence, be attributed to two effects. First, the volume of eligible tier 1 capital grew by 39% from the third quarter of 2008, reflecting internal capital increases (private placements, capital injections from the parent group, retained earnings and other measures) as well as government measures under the bank stabilization package worth EUR 8.1 billion (or 47% of the increase in eligible tier 1 capital). Second, in a direct response to the financial crisis, banks had sharply reduced their risk-weighted assets (RWA) until the fourth quarter of 2009 (see chart 23), by streamlining their balance sheets in general as well as by cutting off-balance sheet activities, etc. Risk-weighted assets thus shrank by 0.4% in 2011 (following a slight increase in 2010), with the aggregate rate masking divergent developments of the "top six" banks on the one hand (-2.9%) and the rest of the banking sector on the other hand (+4.2%).

At the end of 2011, the median tier 1 capital ratio of all Austrian banks was 13.6% and thus above the aggregate mean (see chart 23). The higher median ratio essentially reflects the high number of small regional banks with above-average capitalization that operate in Austria alongside the few large banks that dominate the industry. Half of all Austrian banks (the second and third quartile) post tier 1 capital ratios between 10.4% and 18.8%.

The aggregate tier 1 capital ratio (i.e. the RWA-weighted mean) of the Austrian banking industry is dominated

Short-term
wholesale funding of
minor importance
in Austria

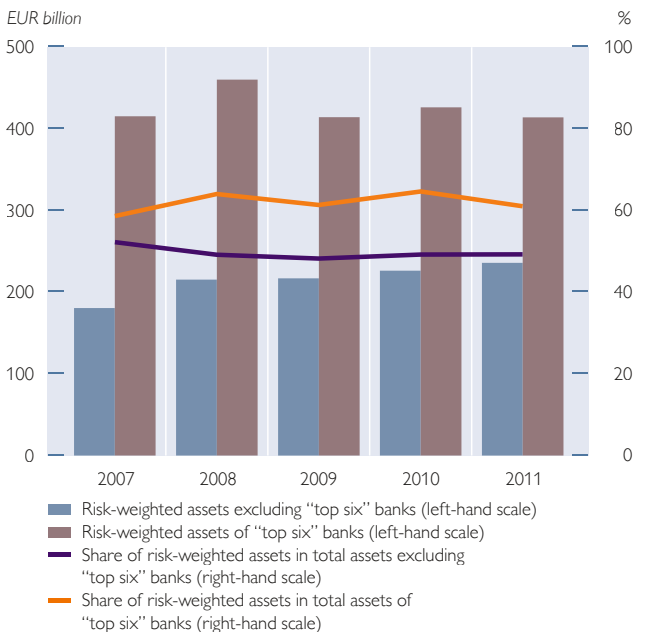
Austria's regional
banks better
capitalized than
large banks

¹⁰ Our calculations of short-term wholesale funding through interbank or money market transactions are based on the amount of short-term deposits and debt securities (with an original maturity of up to 12 months) that banks have issued to other banks (outside their multi-tiered sector). As the supervisory statistical data on deposits do not include a maturity breakdown, we included all deposits on the assumption that they are generally of a short-term nature.

¹¹ Given a lack of data granularity it was not possible to adjust the data for transactions between Austrian subsidiaries and their foreign parent banks. Therefore, the indicated ratios should be seen as upper limits.

Liquidity Conditions of the Austrian Banking System

Risk-Weighted Assets



Aggregate Tier 1 Capital Ratio



Source: OeNB.

by the country's "top six" banks, which are less adequately capitalized than a group of international peers¹² (9.9% versus 11.3% on average; see chart 21).

Even though the major Austrian banks have continually improved their tier 1 capital ratios in recent years, the gap between them and their peers has ultimately widened, as the latter strengthened their capital positions even more. In the case of the "top six" Austrian banks and their peers, the gap thus widened from 1.1 percentage points in 2009 to 1.4 percentage points at the end of 2011. The "top three" banks, in contrast, managed to narrow their gap somewhat in the second half of 2011 as their tier 1 capital ratios

improved and those of their peers deteriorated. At the end of 2011, they were 0.9 percentage points behind their peers, compared with 1.0 percentage points at the end of 2009.

In view of the implementation of Basel III at the European level and judging from the results of the EBA recapitalization exercise, the large Austrian banks had best increase their capital ratios further already in the short term. Moreover, given their heightened CESEE exposure, they should, over the medium term, strive to close the gap with their international peers or to surpass them ultimately, and to achieve a degree of capitalization that works adequately for the respective business models.

¹² This comparison is based on the following banks, all of which are also active in the CESEE region: Banco Santander SA, Bayerische Landesbank, BNP Paribas, Commerzbank AG, Crédit Agricole S.A., ING Bank N.V., Intesa Sanpaolo, KBC Bank N.V., OTP Bank PLC, Skandinaviska Enskilda Banken AB, Société Générale, Swedbank AB.

Market Assessment of Austrian Financial Institutions Worsens Markedly

The reintensification of the sovereign debt crisis in some euro area countries in the second half of 2011 prompted a range of economic and monetary policy measures, which helped improve market sentiment vis-à-vis financial institutions slightly. Yet the respite was short-lived; it already ended in March 2012 as uncertainty resurged about budgetary compliance in some euro area countries and as political risks intensified. Moreover, the prospect of further downward revisions of the ratings for individual banks and countries added to the fragility of the European banking sector.

Market assessment of Austrian financial institutions was highly volatile in this period. The price-to-book values of listed Austrian banks, while outperforming those of their European peers, deteriorated sharply in the second half of 2011, but ultimately rebounded in early 2012. The market assessment reflects above all the comparatively small amount of claims of Austrian banks against the IMF/EU euro area program countries, their exposure to the CESEE region, where GDP keeps growing at a faster rate than in Western European economies, as well as the fact that they are domiciled in the euro area. In times of crisis, growth prospects play a minor role, however, whereas risk-bearing capacities are monitored closely by market participants. Following an announcement of the rating agency Moody's, in February 2012, to review 114 financial institutions from 16 European countries, the downgrading of the Austrian banks on June 6, 2012, did not come as a major surprise and did not trigger significant market reactions. The down-

grading came without prejudice to Moody's continued positive assessment of the sustainability and profitability of the business model of the Austrian banks with their network banks in CESEE.

Major Changes in the Austrian Payment System's Infrastructure

On November 18, 2011, Austria's first clearing house, i.e. a new infrastructure for settling domestic interbank retail payments, went live: Clearing Service Austria (CS.A), which is of systemic importance for the country. CS.A. is operated by the cash logistics company GSA (GELDSERVICE AUSTRIA Logistik für Wertgestionierung und Transportkoordination GmbH) and has been recognized by the OeNB as a payment system as defined by the Settlement Finality Act. One of the key merits of the system from a financial stability view is the higher degree of security that comes with the settlement of payments in central bank money.

The deadline for migrating proprietary home accounts (PHAs) run by the respective central banks to TARGET2, the Eurosystem's real-time gross payment system, ended on November 21, 2011. Accordingly, all relevant payments have since been migrated from the OeNB's PHA (HOAM.AT) to the Single Shared Plattform of TARGET2. HOAM.AT continues to operate, however, with a reduced functionality as a payment system recognized under the Settlement Finality Act.

Overall, the Austrian financial market infrastructures and payment systems remained stable also in the crisis-ridden environment of the second half of 2011; none of the system disturbances recorded affected the Austrian financial market.

Fragile condition of the European banking sector

New clearing service contributes to financial stability

Dimmer outlook for
Austrian insurance
companies

Natural disasters
and sovereign debt
crisis as a burden
for insurers

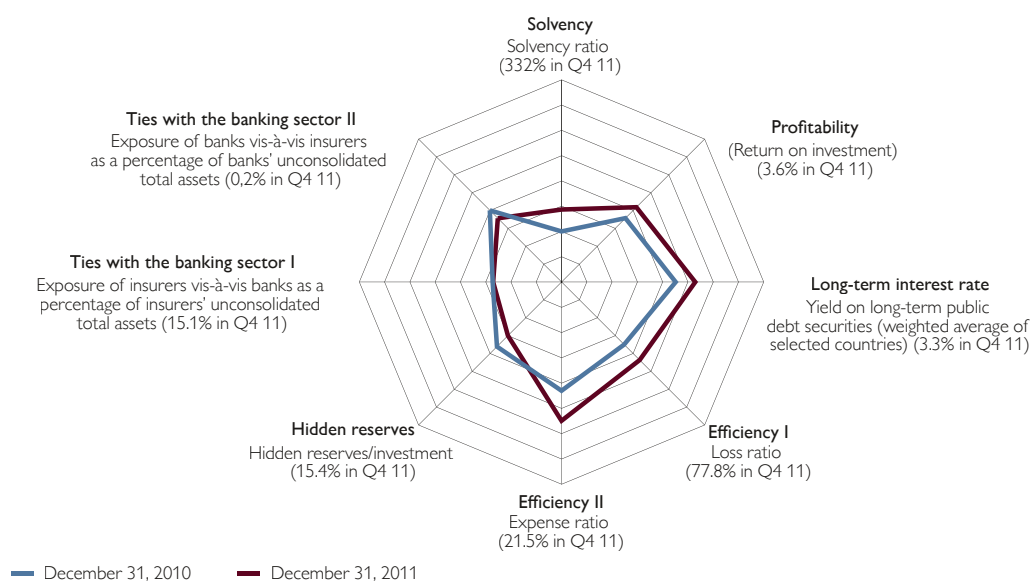
Difficult Market Conditions for Other Financial Intermediaries Insurance Companies Face Increased Challenges

Natural disasters and the intensification of the European sovereign debt crisis were a particular burden for European insurers in 2011. In the long run, insurers will find it difficult, amid low interest rates and low yields on liquid and “risk-free” government bonds, to achieve the guaranteed minimum returns on life insurance plans. At the same time new life insurance plans may be less attractive for new policy holders given the prevailing low level of guaranteed returns (which may be even negative in real terms) against the backdrop of long maturities. Under the current regulatory framework, these conditions may prompt insurance companies to take on higher risks in search of higher yields. A number of European insurance companies have in fact already announced plans to step up lending transactions.

The Austrian insurance sector recorded a nominal decrease in premiums of 0.7% in 2011, which was driven by a sharp decrease in premiums for life insurance products (–7.2%), which in turn reflected a sharp decrease in one-off deposits (–31%) following an unfavorable change in the underlying tax regime. The intake of premiums for property and casualty insurance as well as for health insurance remained stable with growth rates of 4.8% and 3.6%. Depending on risk profiles, higher claims payments and operational costs as well as a lower return on assets (–7.5%) have been a smaller or larger drag on the profitability of insurance companies. The solvency ratio decreased by 24 percentage points to 332% given a marked drop in the capital ratio of the life insurance segment. This decrease reflects realized losses which eroded capital. Within the insurance industry, solvency was mixed. Irrespective of the adverse environment, a number of

Chart 24

Financial Stability Map of the Austrian Insurance Industry



Source: FMA, OeNB.

Note: Scaling on the basis of historical data. Unconsolidated data for the end of the fourth quarter of 2011. The closer the data points are to the center, the better the ratio, the less risky and the more favorable.

insurance companies even managed to strengthen their capital base.

The analysis of contagion risks is based on the aggregated securities holdings of the insurance industry (including fund-linked and index-linked life insurance plans) as reflected in the securities issuance statistics of the OeNB. Of the aggregate securities portfolio of EUR 71.5 billion, some EUR 17 billion were invested in government bonds¹³ and EUR 31.4 billion in domestic or foreign banks at the end of 2011. The exposure to the EU/IMF program countries (Greece, Ireland, Portugal) as well as Italy and Spain totaled EUR 5.9 billion¹⁴ (–15%), of which EUR 2.1 billion were government bonds and EUR 2.4 billion bank bonds. Throughout 2011, the market value of the exposure decreased by almost EUR 1 billion or 13%, above all driven by Greek securities, which registered a contraction of 65% year on year. In the first quarter of 2012, when private sector involvement had already been implemented, the volume of Greek securities held directly¹⁵ by insurance companies dropped further from EUR 145 million to EUR 16.8 million, which corresponds to a decrease by another 88% (quarter on quarter).

The main short-term risks for the Austrian insurance industry are the European sovereign debt crisis and its repercussions on financial markets and the economy in Austria and in the CESEE area. In the longer term, the low level of interest rates (above all with regard to products with guaranteed returns) might prove challenging.

Mutual Funds Suffer From Weak Market Environment

Assets under management in Austrian mutual funds totaled EUR 140.5 billion in February 2012, which means that they shrank by almost 5% year on year. This decrease reflects mostly price losses. The annual investment performance was negative at –2.4%, driven above all by the strongly negative performance of equity funds (–17.5%). Funds targeted at institutional investors outperformed retail funds (–1.3% versus –3.3%), with assets invested by retail funds contracting visibly (by –11%), whereas institutional fund volumes remained broadly stable (–0.3%). Private investors apparently continue to show restraint amid the uncertainty prevailing in financial markets and tend to prefer products with deposit insurance.

The widespread practice of securities lending has come under discussion as a risk for mutual funds worldwide. In Austria institutional funds may lend up to 100% of their securities, and retail funds up to 30% of their securities (subject to specific preconditions¹⁶). Securities lending is considered an “efficient portfolio” strategy, is not subject to any exposure limits and – if done between investment companies, banks and insurance companies – it increases the potential for contagion within the financial system. Moreover, under current practice in Austria, intra-group securities lending tends to be unsecured. This is going to change: the FMA has already indicated that

Assets under management on the decline

Higher contagion potential through securities lending

¹³ Includes securities issued by state and local governments.

¹⁴ Spain: EUR 1.7 billion, Greece: EUR 0.3 billion, Italy: EUR 2.2 billion, Ireland: EUR 1.5 billion, Portugal: EUR 0.2 billion.

¹⁵ See Article 164 paragraph 4 Mutual Funds Act 2011.

¹⁶ This excludes securities held via mutual funds.

securities lending should be collateralized also within individual groups.¹⁷ At the European level, risks related to securities lending risk were identified by ESMA as particularly important for exchange-traded funds (ETFs),¹⁸ which are going to be regulated more strictly. The new regulatory requirements for collateral and securities lending volumes are meant to govern not just ETFs but mutual funds in general.

To sum up, securities lending transactions may pose the following risks:

- On the part of the lending subsidiary, inherent conflicts of interest, as it may accept rates that are too low, collateral of poor quality or no collateral at all. On the parent bank's side, cherry picking of securities to be borrowed (for instance because of inside knowledge of mutual fund holdings, gained through the depository function of the parent bank).
- Higher counterparty risks of subsidiaries vis-à-vis their parent institution and the drying up of a source of bank funding in the case of capital outflows from subsidiaries (mutual funds, insurance companies) (pro-cyclical effect)
- Finally, owners of mutual fund shares face another default risk (of which they are often not aware): Lending of securities that constitute segregated assets automatically triggers a transfer of ownership rights from the investment fund to the borrowing institution. Should the latter collapse, the investment fund and its investors are among the creditors and the underlying securities will no longer qualify as segregated.

Performance of
severance funds
and pension
funds worsens

Pension Fund Assets Continue to Shrink

At the end of 2011, total assets under management in Austrian pension funds came to EUR 14.7 billion. The annual growth rate was thus negative, at -1.2% , for the third time since 1998 (following 2002 and 2008). Last year, unfavorable financial market developments weighed on the investment performance of pension funds, which was 3% lower at the end of 2011 than at the end of 2010 according to the Oesterreichische Kontrollbank (OeKB), with the performance of individual companies ranging from $+1.7\%$ to -5.4% . Structural issues have made it necessary to completely overhaul Austria's pension fund legislation; a bill to amend the legislation¹⁹ was adopted by the Austrian parliament in mid-May 2012. The amendment provides for more competition, the strengthening of the right of prospective beneficiaries to pick an investment strategy, a guaranteed initial pension and a strengthening of the right to information. Furthermore, the Company Pension Act is to be amended: The vesting period (period after which employees become entitled to pension benefits) will be reduced, and employees will be given the option of switching from one system to another. From the financial stability perspective, these measures are to be rated as positive. However, the amendment should also address problems with the incentive structure in managing pension funds.

Severance fund assets have continued to grow dynamically, as they are still in the development stage. By the end of the fourth quarter of 2011, the sum total of accrued severance benefits

¹⁷ Securities lending with institutions outside the group already needs to be collateralized.

¹⁸ See also box 5 of issue 22 of the Financial Stability Report.

¹⁹ See Stefan W. Schmitz. 2005. Die Governance-Struktur der Pensionskassen in Österreich und ihre politischen Konsequenzen. In: *Wirtschaft und Gesellschaft* 31(3). 407–443.

had increased by almost 21% in comparison with the year before and amounted to EUR 4.3 billion. According to OeKB, investment performance reached 0.2% in 2011. While this is still positive, there was no real increase in value, as the inflation rate reached 3.3% in the same period.

Risks result above all from persistent uncertainty in financial markets and the increased sovereign risks (government bonds account for some 34%²⁰ of all securities held by pension funds and some 23% of those held by severance funds).

OeNB Stress Test Shows Improved Risk-Bearing Capacity and Confirms Existing Weaknesses

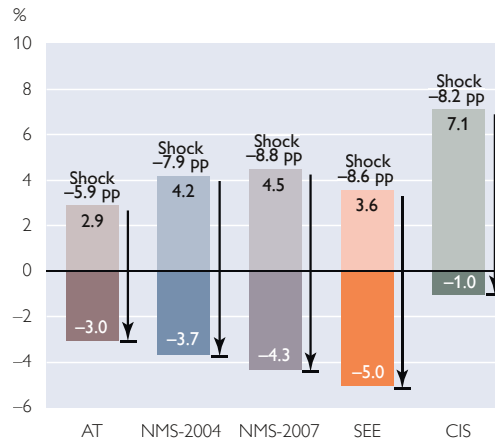
The OeNB's latest stress test, which was conducted in an environment of general uncertainty, indicates an improvement in risk-bearing capacity but also points to existing weaknesses and remaining global risks.

Macroeconomic stress tests are a key instrument in estimating the risk-bearing capacity of both banking systems and individual credit institutions. In the first half of 2012, the OeNB carried out a macroeconomic stress test at the national level. Typically, such a stress test analyzes two macro scenarios: a baseline scenario and an adverse scenario. The macroeconomic scenarios in the current stress test cover a period of two years (Q1 12 to Q4 13).

The baseline scenario is based on the latest OeNB outlooks for Austria, CESEE and CIS, supplemented by the IMF's World Economic Outlook. The adverse scenario assumes an intensifica-

Chart 25

Cumulated GDP Growth under the Baseline and the Adverse Scenario (Q1 12 to Q4 13)



Source: OeNB.

tion of the European government debt crisis in 2012 and a negative impact on the real economy, given increasing uncertainty, worsening labor market conditions and declining lending. For this reason, the current adverse scenario results in substantially stronger adjustments against the baseline than one year ago.

Aggregate Risk-Bearing Capacity Improves

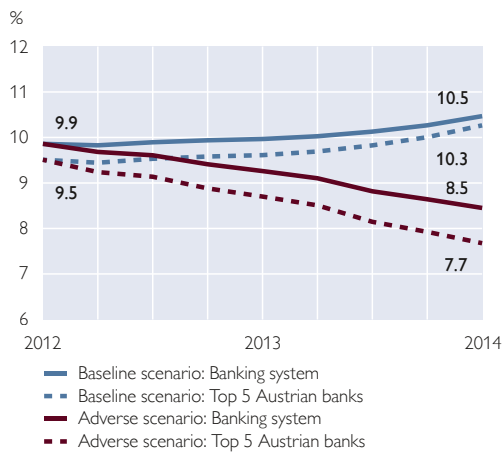
The key indicator for measuring risk-bearing capacity is the core tier 1 (CT1) ratio, which was also used in the EU-wide stress test. In the current OeNB stress test, the aggregate Austrian banking system started with a CT1 ratio of 9.9% (9.2% in the spring 2011 stress test) and managed to improve this ratio to 10.5% (10.2%) in the baseline scenario.²¹ In the adverse scenario, the CT1 ratio went down to 8.5% (8.5%).

²⁰ Includes government bonds with state guarantees.

²¹ Unlike earlier stress tests, which assumed in the baseline scenario that part of banks' profits would be paid out to shareholders as dividends, the current stress test assumes that banks retain all earnings in order to capture banks' full potential to generate capital.

Chart 26

EBA Core Tier 1 Ratio (Q4 11 to Q4 13)



Source: OeNB.

Along the same lines, the aggregated top five banks²² started with a CT1 ratio of 9.5% (8.5% in 2011) to post 10.3% (9.5%) in the baseline scenario and 7.7% (7.4%) in the adverse scenario. These stress test results show that banks – in particular large banks – have made efforts to improve their capital ratios. However, they also show

that many of the problem cases identified in earlier issues of the OeNB’s Financial Stability Report since the onset of the crisis still remain unsolved.

Uncertainty Remains High

The OeNB’s adverse scenario assumes a general economic downturn that causes banks’ profitability to deteriorate and credit risk costs to rise. Apart from these risks, however, which are ultimately driven by the business cycle, the current situation is characterized by great uncertainty about further developments linked to the European debt crisis. Some of these risks – e.g. a rise in refinancing costs or an additional need for loan loss provisions on sovereign assets – can be assessed in separate sensitivity analyses. Other risks, however, such as possible second-round effects of an intensification of the debt crisis, cannot be quantified in a reliable manner because of their complexity and interaction, which is why they constitute a “blind spot” in any stress test.

²² Consolidated reporting data are not available yet, as the restructuring of Volksbank AG is still underway. For this reason, Volksbank AG is not included in the aggregate of major Austrian banks in the current stress test. Volksbank AG and Volksbank International AG are still included in the overall aggregate. The aggregate of top five Austrian banks thus comprises the following banks: BAWAG P.S.K., Hypo Alpe Adria, Erste Group Bank, Raiffeisen Zentralbank and UniCredit Bank Austria.