

# Austrian Financial Sector Stable in General with Risks in Particular Business Segments

## **Government Debt Crisis Affects International Financial Markets**

In the first few months of 2011, the growth perspectives for the global economy remained benign. The emerging markets, especially those in Asia, proved to be the driving force of global growth, but the United States also continued to post robust growth figures. Following a slowdown in the second half of 2010, the economy in the euro area returned on an expansionary path, with growth being fueled predominantly by net exports and, to a lesser extent, by final domestic demand.

Risks to the economic upturn arose from increasing commodity and food prices, which put a sustained upward pressure on inflation, and persisting problems in the financial and banking systems that were related to the government debt crisis. Expansive fiscal policy measures taken to support the economy during the economic and financial crisis as well as structural reasons drove up some countries' debt levels considerably; as a consequence, these countries' country risks and, subsequently, the risk premiums on their government bonds increased substantially. After Greece and Ireland had received financial assistance from the EU in 2010, Portugal made a request for financial assistance from the IMF and the EU in spring 2011.

In the Central, Eastern and South-eastern European (CESEE) countries, the gradual economic recovery continued, but developments were somewhat heterogeneous across countries. The composition of GDP growth is an indicator of ongoing stabilization. Apart from exports, which contributed substantially to economic growth in many CESEE countries, domestic demand

has become an important driver of growth in some of them as well. While the crisis had caused the external position to improve in a number of CESEE countries – and quite markedly in some –, current account balances remained mostly stable or even improved in most countries of the region.

## **Financing Volumes of Austrian Companies and Households Remain Moderate**

Driven by robust foreign demand, Austria's economy continued to expand heavily in the first few months of 2011. Already in 2010, the economic upturn had sent corporate profits up again, consequently boosting their stability and creditworthiness as well as their potential for internal financing. By contrast, corporate sector external financing actually dropped to just under the previous year's level in 2010.

The corporate sector's financial situation, which had – in part – been massively shaken by the crisis in 2009, stabilized in the course of 2010. In the fourth quarter of the year, corporate debt posted the smallest growth in almost four years; the debt-to-equity ratio remained quite stable in the past two years. The relatively low debt ratios and the low interest rate level may also have contributed to the comparatively small increase in the number of corporate insolvencies during the crisis so far.

Bank loans to both companies and households grew only moderately in the first few months of 2011. During the crisis, moderate credit expansion and low interest rates clearly reduced the ratio of interest expense to income. This effect was reinforced by the above-average share of variable rate loans in total loans; however, if interest rates

rise, the effect on interest expenses will be the opposite.

The sustained high proportion of foreign currency loans still constitutes a major risk factor for households' financial position. Adjusted for exchange rate effects, foreign currency loans to households did decrease in 2010, but their outstanding volume expanded as the Swiss franc appreciated strongly against the euro. Their high volumes and long residual maturities render foreign currency loans vulnerable to adverse exchange rate developments as well as to valuation changes because the majority of them are bullet loans linked to repayment vehicles.

In 2010, households' financial investment fell in line with their savings ratio. In particular, deposits rose only marginally, while capital market investment went up. Financial investments, in turn, were stabilized by investments in life insurance policies and pension funds. Despite repeated price gains, the valuation losses posted during the crisis were not fully offset in 2010.

### **Challenges for the Austrian Banking System Remain despite Economic Recovery**

The economic recovery had a favorable effect on the business developments of Austrian banks. While they continued the moderate deleveraging process of the past few years, their profits rose clearly in 2010 – after a severe slump during the financial crisis – as banks were able to reduce credit risk provisions. Operating profits, however, declined in spite of increasing net interest income and fee-based income as a consequence of sliding trading results and rising operating expenses.

The operating profit of the Austrian banking system continues to depend heavily on the profitability of business

activities in the CESEE region. Over the last few years, however, the higher profitability of business in CESEE was accompanied by higher credit risk. In the past four years, for example, the loan loss provision ratio of Austrian banks' subsidiaries in CESEE rose considerably more sharply than in domestic business, reaching a level which, at 6.5%, was approximately twice as high as that of business in Austria (3.2%) in 2010. The sustained high share of foreign currency loans (just below 50%) granted by Austrian banks' CESEE subsidiaries also contributed to this development. In Austria, the measures taken by the supervisory authorities with a view to reducing the volume of foreign currency loans significantly dampened new foreign currency lending, but the Swiss franc's lasting strength still demonstrates the risks involved with this type of loan.

Unlike the exposure to CESEE, which remained mostly stable in 2010, claims of domestically controlled banks on euro area countries with an elevated risk profile (Greece, Ireland, Portugal and Spain) are comparatively low at 3.8% of GDP.

Following the international trend, Austrian banks' capital adequacy ratio has improved noticeably. Thus, since its low in the third quarter of 2008, banks' aggregated tier 1 capital ratio rose continually by a total of some 2.7 percentage points to 10.0% in the fourth quarter of 2010. A peer group comparison revealed, however, that the capitalization of major banks is still below average.

The Austrian insurance sector posted slight premium growth in 2010. Total assets under management in Austrian mutual funds also increased considerably again, although not as dynamically as the European average.