Background note on the strengthening of the sustainability of the business models of large internationally active Austrian banks

14 March 2012

1. Impact assessment on CESEE

By strengthening the sustainability of large internationally active Austrian banks' business models, the sustainability package aims at strengthening the stability of financial markets by increasing the risk bearing capacity of banking groups and by reducing the likelihood of unsustainable credit growth fuelling boom-bust-cycles. During the consultation process, some stakeholders raised their concern regarding potential unintended consequences and more specifically regarding any induced deleveraging pressure in Central, Eastern and South-Eastern Europe (CESEE). According to the Austrian supervisors' impact assessment, none of the measures will lead to additional deleveraging pressure for Austrian banks abroad – a central point in the careful policy making process. Also, the Austrian supervisors' impact assessment came to the conclusion that the sustainability package will not lead to any sudden disruption in the business activities of Austrian banks, but places the Austrian banks' continued and long-term commitment to their foreign operations, their retail banking model and the continued flow of credit on a more crisis resilient and sustainable footing. In this respect, the Austrian sustainability package is fully compatible with the spirit of the Vienna Initiative, in which the Austrian authorities played a pivotal role.

a) Capital

Undeniably, the European Banking Authority's (EBA) recapitalisation initiative to a 9% Core Tier 1 ratio (incl. state participation capital) by the end of June 2012 and market expectations put pressure on the banks to improve their capitalisation. However, there will not be an additional capital shortfall due to the frontloading of the Basel III CET1-requirement in the Austrian sustainability package (when compared to the EBA requirement) and the additional capital surcharge will only be applicable from 2016 on.

b) Liquidity

According to the Austrian supervisors' analysis, the LLSFR is a very adequate early warning tool for excessive credit growth during boom times (the biggest threat to financial stability in retail oriented markets) and therefore banking subsidiaries with an LLSFR above 110% in their stock ("exposed subsidiaries") are to be closely monitored in this respect. The results of this monitoring will then be discussed with the competent host and home supervisors in the framework of supervisory college cooperation.

The study of historical data does not point to additional deleveraging pressure from applying a 110% flow-LLSFR at exposed subsidiaries in times of crisis, which underlines the anti-cyclical character of the LLSFR (please also refer to the maps below):

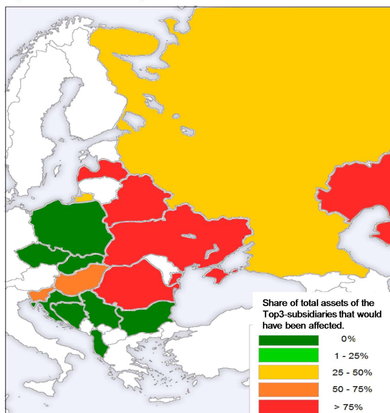
- The LLSFR's use as an early warning indicator could have prevented many of the past boom's lending excesses that were followed by rapidly increasing nonperforming loan ratios with material effects on banks' profitability and capital position.

- During 2009, at the height of the crisis, when lending growth was subdued by macroeconomic realities and deposits remained stable, only very few exposed subsidiaries would have exceeded a flow-LLSFR of 110%.

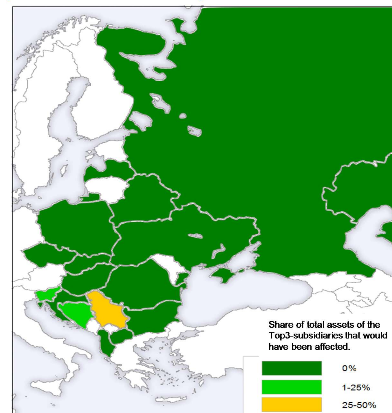
It is important to note that when monitoring the flow-LLSFR, the rollover of the existing loan portfolio is not counted, as the flow-LLSRF is calculated as the change between the stock of loans at the beginning and the end of year. Furthermore, the close monitoring of the funding situation promotes local capital markets and the perception of a less volatile, sustainable business model should in the medium term even be rewarded with better funding conditions for Austrian banking groups and their subsidiaries.

Anti-cyclicality: Monitoring the funding situation does not lead to deleveraging, but would send warning signals in times of excess

Avoiding excessive credit growth (Q1-Q4 2008)



No deleveraging during the crisis (Q4 2008 – Q4 2009)



Source: OeNB.

The above representations actually exaggerate the consequences of possible constraining supervisory measures. First, due to limited data availability, these representations use the stricter Loan-to-Deposit Ratio (LDR) in order to show which exposed bank subsidiaries in which countries would have been affected from a hypothetical 110% flow-LLSFR. Moreover, they do not take into account proportionality and flexibility considerations. Finally, these maps only represent the impact on the currently concerned parent institutions' subsidiaries and do not include any information on their respective market share in each country.

2. Frequently asked questions

- **Why is the Austrian liquidity ratio (LLSFR) not aligned with the Basel III liquidity ratios (LCR/NSFR)?**

The LLSFR is designed to address the specific risks inherent in some of the Austrian subsidiaries' funding model, which will not be addressed by the LCR or NSFR. Furthermore, the latter two concepts are not yet finally agreed or calibrated and their implementation will take some time, while the Austrian authorities felt the need to act now. The monitoring of the LLSFR may however partially help in fulfilling the NSFR by promoting the issuance of debt securities with longer maturities (one year or more).

- **How does the LLSFR compare to the countercyclical capital buffer (CCB)?**

Both the LLSFR and the CCB are anticyclical concepts that are meant to avoid excessive credit growth in booms and deleveraging pressures during times of crisis: They compare developments based on or directly linked to the real economy (such as deposit and GDP growth) to loan growth in the banking sector. But while the CCB foresees a capital buffer, the LLSFR aims at a more balanced funding structure at the subsidiary level.

- **Does the liquidity monitoring aim for a certain LLSFR (e.g. 110%) in the stock to be reached at a given time?**

No. It is important to clarify that the LLSFR-monitoring only focuses on the flow of net new lending and does not include any provisions concerning the future attainment of a specific LLSFR in the stock (nor any timeframe to do so).

- **Why are leasing subsidiaries not subject to the LLSFR monitoring?**

The business model of Austrian banks' leasing subsidiaries does not include the transformation of deposits into loans. Therefore, the LLSFR monitoring process does not apply to these subsidiaries. However, in order to ensure a sustainable business model in the whole banking group and its non-regulated entities, the Austrian supervisors will closely monitor lending growth trends at leasing subsidiaries.

- **How are circumventing measures treated?**

The Austrian supervisory authorities are aware that (inter alia) direct lending may be used to window-dress the LLSFR at the subsidiary level: They will monitor the situation closely and appropriately take into account any circumventing actions in the course of the monitoring process.

- **How would the flow LLSFR be affected, if subsidiaries were to participate in asset/liability purchases/sales?**

Acquired/sold loan and local stable funding portfolios will be considered in the same way as any other new business and be part of the LLSFR-calculation of the respective banking subsidiary during the next regular monitoring; either at the acquiring/selling subsidiary level or at the new legal entity. Therefore, the takeover/sale of a loan and/or funding portfolio is treated as an increase/decrease in the numerator and/or denominator of the LLSFR (exactly as if loan/local stable funding volumes had been extended/generated/reduced during the same year).