

# The Austrian Financial System Has Recovered, Yet Challenges Remain

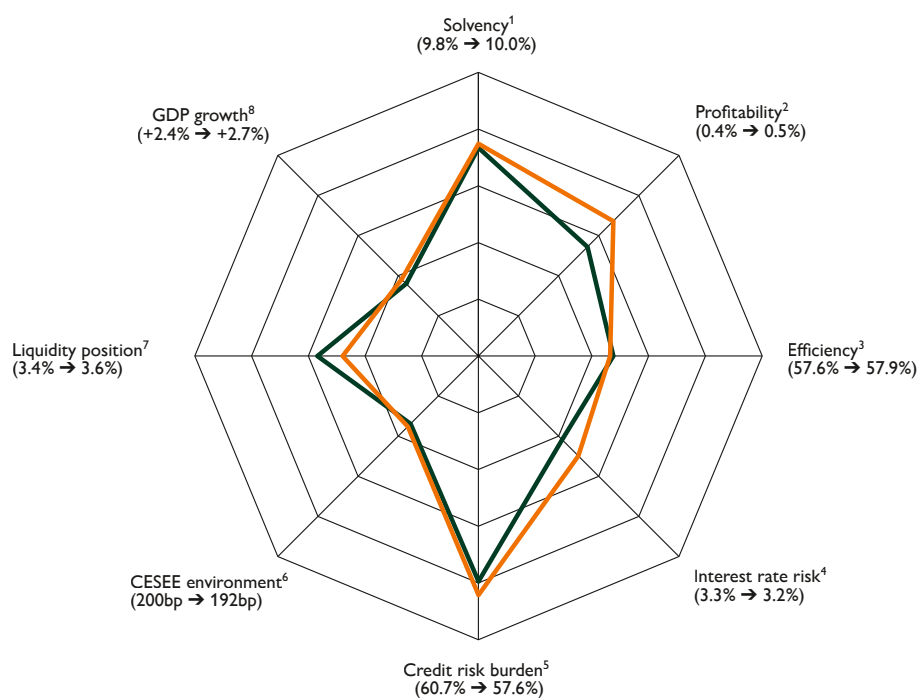
In 2010, Austria's financial intermediaries benefited from the economic upturn in Austria and in Central, Eastern and Southeastern Europe (CESEE). The economic recovery has created a window for reducing prevailing structural weaknesses, given that so far the domestic banking market has seen only gradual consolidation despite the high intensity of competition and the low degree of structural profitability. Another structural pattern – the high

share of retail deposits resulting from the traditional business model of Austrian banks – has actually been working in favor of the Austrian banking system, as it has kept its dependence on interbank funding fairly low.

Following a severe slump during the financial crisis, the consolidated profitability of the Austrian banking system recovered considerably in 2010. Given declining operating results, this recovery was fully attributable to the

Chart 22

## Banks and Financial Market Stability



— June 30, 2010    — December 31, 2010

Source: OeNB.

<sup>1</sup> Tier 1 ratio.

<sup>2</sup> Return on assets.

<sup>3</sup> Cost-to-income ratio.

<sup>4</sup> 200-basis-point interest rate shock (loss of eligible capital).

<sup>5</sup> Credit risk provisions in % of operating result.

<sup>6</sup> Weighted CDS spread.

<sup>7</sup> Cumulative 12-month funding deficit in % of total assets.

<sup>8</sup> Real GDP growth in % p.a.

Notes: Consolidated figures scaled on the basis of historical data. The closer to the center, the better/less risky/more benign. bp = basis points.

declining need for new credit risk provisions. The capital situation of Austrian banks has improved but will need to be strengthened further in light of the CESEE risk exposure profiles of Austrian banks and the higher capital ratios of their international peers. Another point to consider is that a significant part of capital increases at some institutions in recent years is attributable to government participation capital, which will have to be paid back.

The CESEE exposure of Austrian banks continues to entail high prospects for success but also risks. The higher risk is reflected in the strong growth of the aggregated loan loss provision rate of the CESEE subsidiaries. Credit risk provisions are, however, expected to peak in the course of 2011. Another concern from a financial stability perspective is the high dependence of some CESEE subsidiaries on intracompany liquidity transfers. Yet these transfers have diminished somewhat lately, as have subsidiaries' loan-to-deposit ratios. Nonetheless, measures should be taken to put the refinancing of CESEE subsidiaries, in particular deposit-based refinancing, on a largely autonomous and sustainable basis.

The continuously high proportion of foreign currency loans at the subsidiaries, which accounted for nearly half of total lending at the end of 2010, also contributes to the elevated risk stemming from Austrian banks' exposure to CESEE. As a result of regulatory and supervisory measures, new foreign currency lending in Austria was very low in 2010. Yet given the high levels of outstanding foreign currency loans and their long residual maturities, banks remain vulnerable to adverse exchange rate developments and falling asset prices in the case of loans backed by repayment vehicles. Considering the

risks, new foreign currency lending should be reduced even further in the future.

The claims of the Austrian banking system on euro area countries with an elevated risk profile are comparatively small, as are the claims of Austria's insurance companies and mutual funds. At an international level and especially compared to the market assessment two years ago, the external stability assessment of the major Austrian banks by the markets has improved. Banks should take advantage of the favorable market environment and expand their capital buffers.

### **The Austrian Banking System Has Recovered Business Has Stabilized**

While the Austrian banking system came out of the economic and financial crisis relatively unscathed, the process of domestic structural reforms has been sluggish. At the end of 2010, the consolidated total assets of Austrian banks, which also comprise their subsidiaries' business, stood almost unchanged over the previous year at EUR 1.131 billion (–0.8% year on year). A positive point to highlight from a financial stability perspective is that the moderate deleveraging process which had commenced in the second half of 2008 continued in 2010. Consolidated leverage, which indicates the level of debt financing, dropped to a ratio of 17.1 (end-2009: 19.2) in the course of the year. While consolidated liabilities to credit institutions fell by 7.6% to EUR 207 billion, liabilities to nonbanks rose markedly by 3.9% to EUR 498 billion. This means that, at year-end, some 44% of consolidated total assets were funded by retail deposits, which reflects the strong retail focus of Austrian banks. Data on the first quarter 2011

Modest deleveraging continues

Domestic lending growth subdued

Deterioration of credit quality flattens in 2010

Foreign currency lending shrinks considerably, risks persist

(on an unconsolidated basis) reveal that total assets rose noticeably compared to year-end levels, which was among other things a result of increased interbank business.

In terms of lending to domestic nonbanks, banks' lending growth in 2010 was subdued. At EUR 321.5 billion, the volume of loans outstanding was approximately 0.5% higher at end-December 2010 than a year earlier. Foreign currency loans accounted for some 18.3% of total outstanding loans at the end of 2010. Domestic lending growth continued to be moderate in the first few months of 2011. The slight growth was traceable to increased lending to households (in particular as housing loans) as well as to nonfinancial corporations, while loans to nonbank financial intermediaries declined year on year.

The additional measures taken by the Financial Market Authority (FMA) and the OeNB since the onset of the financial crisis which aimed to reduce the systemic risk resulting from foreign currency lending and repayment vehicle-linked loans have been quite effective. Between October 2008 and March 2011, foreign currency lending to households diminished by 15.3% or EUR 6.2 billion adjusted for exchange rate changes, and in the fourth quarter of 2010, foreign currency loans accounted for only 4% of new loans to households. The outstanding volume of loans – some EUR 38 billion at the end of March 2011 – will, however, continue to pose a risk to Austrian banks for some time to come, as they remain vulnerable to adverse exchange rate and asset developments (in case of repayment vehicle-linked loans). A case in point is the firming of the Swiss franc against the euro by approximately 15.7% in 2010. As at end-2010, some

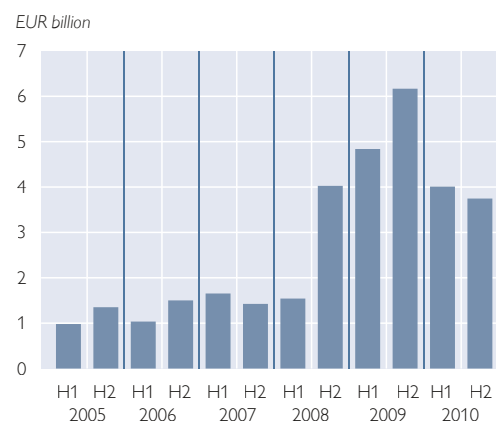
86% of all outstanding foreign currency loans to households had a residual maturity of more than five years (67% had more than ten years). The overwhelming majority (more than 80% of foreign currency loans with a residual maturity of more than five years) were bullet loans linked to repayment vehicles.

### Credit Risks Still High

By historical standards, the risk provisions created by Austrian banks (new net loan loss provisions) for lending operations are still high but nonetheless considerably lower than in the crisis year 2009. In 2010, at the consolidated level, net credit risk costs amounted to EUR 7.8 billion, which is a 30% decline in comparison with 2009 but still notably higher than in the pre-crisis years (see chart 23).

Chart 23

### Consolidated Credit Risk Costs of Austrian Banks (New)

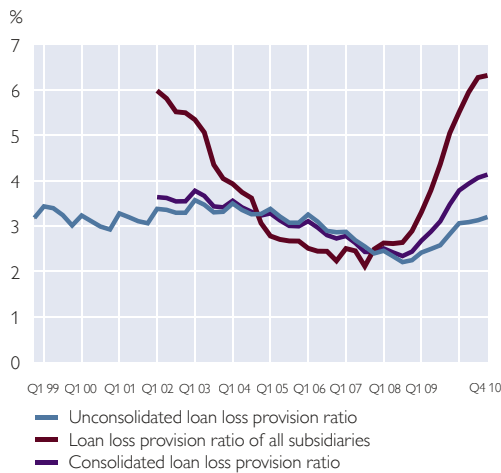


Source: OeNB.

The lasting deterioration of credit quality resulted in a hike of loan loss provision ratios. In this context, regional differences, especially between Austria and the CESEE region, remain considerable.

Chart 24

### Loan Loss Provision Ratios of Austrian Banks



Source: OeNB.

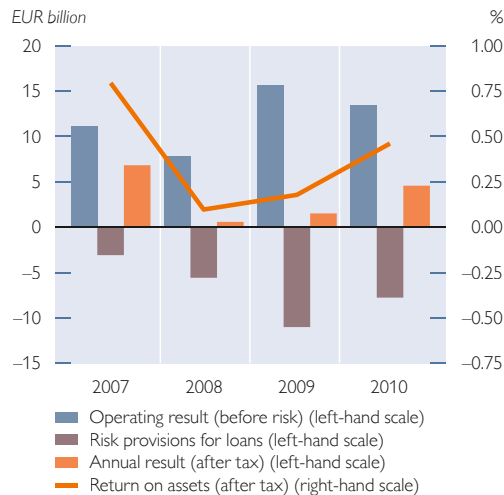
In 2010, the unconsolidated loan loss provision ratio<sup>1</sup> of Austria's banking sector – which does not cover foreign subsidiaries' business activity and is hence clearly focused on Austria – climbed only slightly to some 3.2%. The loan loss provision ratio of all subsidiaries was almost twice as high by comparison at 6.5%. As a consequence, the Austrian banking system's consolidated loan loss provision ratio also stood clearly above the comparable level of the previous year. Lively economic activity in Austria and the CESEE region, however, suggests that the deterioration of credit quality will slow down further in the future. Data from the first quarter 2011 support this assumption. In the first three months, the unconsolidated loan loss provision ratio was only slightly up at 3.3%.

### Profitability Visibly Recovers Due to Lower Credit Risk Provisions

Driven by the lower volume of new credit risk provisions in comparison

Chart 25

### Profitability of Austrian Banks (Consolidated)



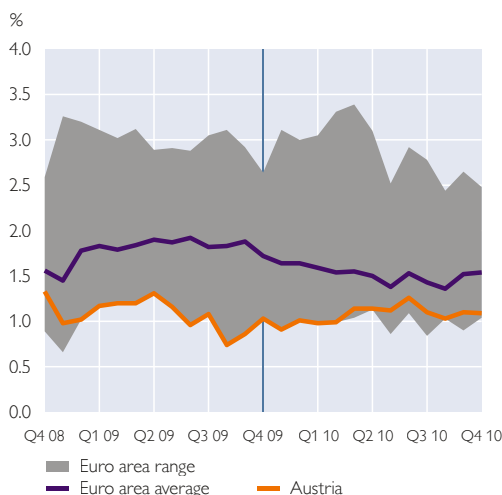
Source: OeNB.

with 2009, the consolidated result of Austrian banks improved notably in 2010. Overall, the consolidated return on assets after tax rose from 0.18% in 2009 to 0.46% in 2010. To a large part, the decline in consolidated operating income by 0.9% to EUR 37.5 billion was caused by the absence of extraordinary income (strong reversal of impairment losses in 2009), whereas net interest income and fee-based income accounted for growth contributions. As operating expenses advanced by 8.1% to EUR 24.0 billion, consolidated operating profits dropped by some 14% to EUR 13.4 billion and adversely affected the cost-to-income ratio, which rose from 53% (2009) to 58% (2010). The increase of the annual result after tax by EUR 3.1 billion to EUR 4.6 billion in spite of lower operating profits could therefore be traced to net risk provisions recognized in profit and loss, which were some EUR 3.3 billion lower in 2010 at EUR 7.8 billion.

<sup>1</sup> Stock of specific loan loss provisions for claims on nonbanks (i.e. customers) as a share of total outstanding claims on nonbanks.

Chart 26

**Interest Margin on New Business: Austria Compared to Euro Area**



Source: OeNB.

Rising profitability spread among “top six” banks

Intense competition leads to low domestic profitability

Exposure to CESEE region slightly up

To a large part, the profitability of activities in the CESEE region still determines the consolidated result of the Austrian banking system, whereas domestic profitability – in terms of local banks<sup>2</sup>, for example – remains rather subdued.

The narrow interest margin on new domestic retail business is another indicator for low domestic structural profitability, which is essentially a consequence of intense competition. Despite a slight increase of the interest margin on new business with nonbanks to 1.09% at end-2010, it remained clearly below the average euro area margin of

1.54%, even though the latter shrank somewhat in the course of the year, partly due to higher deposit rates in some euro area countries (see chart 26).

In the first quarter of 2011, Austrian banks were able to further boost their unconsolidated operating result on an annual basis. The result for 2011 is likely to remain in the range of the 2010 result.

Another major trend as regards profitability is the rising spread of results among the “top six” banks. While the “top three” banks’ return on assets in 2010 was higher – at 0.52% – than the ROA of a peer group of 15 European banking groups with significant CESEE exposure (0.32%), the reference value of Austria’s “top six” banks (0.17%) was below average. It is important to note, however, that in relative terms, Austrian banks’ CESEE exposure is even larger than the peer group members’ exposure, and that the elevated risk requires higher risk premiums and, subsequently, higher profitability.

**Austrian Banks’ International Activities Still Focused on CESEE**

**CESEE Region Continues to Drive Profits**

At end-2010, the exposure<sup>3</sup> of domestically controlled banks to CESEE<sup>4</sup> amounted to some EUR 210 billion, which corresponds to a marginal in-

<sup>2</sup> The sector of the local smaller banks includes certain joint stock banks; the savings banks without Erste Group Bank AG and Erste Bank; the Raiffeisen credit cooperatives without Raiffeisen Zentralbank (RZB); the regional Raiffeisenlandesbank cooperatives and holding; as well as Volksbank credit cooperatives without Volksbanken AG (VBAG).

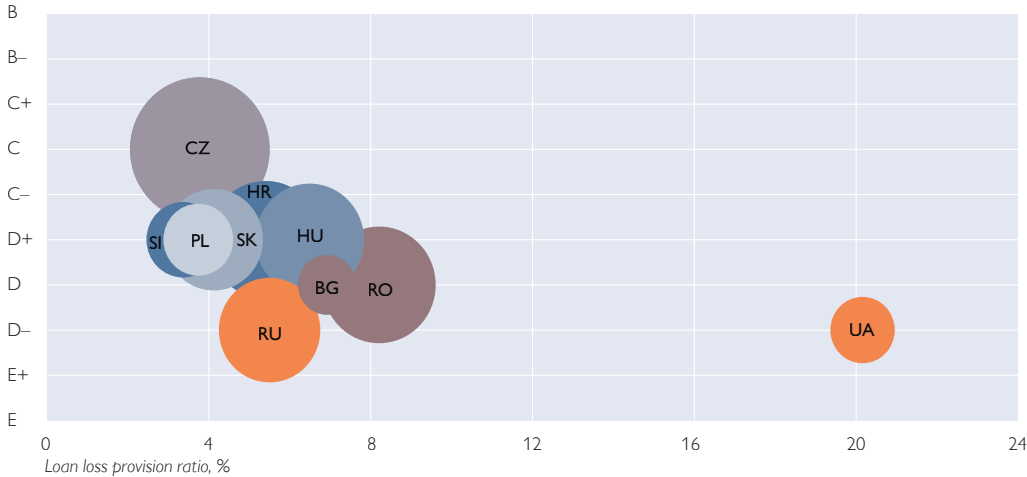
<sup>3</sup> Here, the exposure is measured by the ultimate risk of the domestically controlled banks.

<sup>4</sup> In this section, the following groups of countries belonging to the respective regions are observed: NMS-2004 refers to the ten Member States that joined the EU in 2004: here, Latvia (LV), Poland (PL), Slovakia (SK), Slovenia (SI), the Czech Republic (CZ) and Hungary (HU) are covered. Southeastern Europe covers Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME), FYR Macedonia (MK), Serbia (RS) and Turkey (TR). NMS-2007 refers to the Member States that joined the EU in 2007: Bulgaria (BG) and Romania (RO). The Commonwealth of Independent States (CIS) aggregate includes Armenia (AM), Azerbaijan (AZ), Belarus (BY), Georgia (GE), Kazakhstan (KZ), Kyrgyzstan (KG), Moldova (MD), Russia (RU), Tajikistan (TJ), Turkmenistan (TM), Ukraine (UA) and Uzbekistan (UZ).

Chart 27

### Country Risk Exposure in CESEE

Bank Financial Strength Rating



Source: OeNB (Q4 10), Moody's (November 2010).

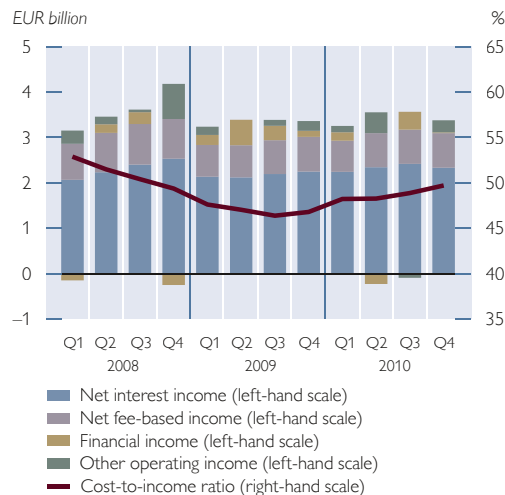
crease year on year. When including foreign-owned Austrian banks, which brings the overall exposure up to some EUR 314 billion, a similar trend can be observed. Among the EU-15, the exposure of Austrian banks to CESEE continues to be the largest at roughly 21%. The biggest share of this exposure – at 56% – was to NMS-2004, the banking sectors of which stood out again at end-2010 thanks to a better bank financial strength rating in comparison with CESEE (see chart 27, the size of the circles corresponds to the exposure volume).

At end-2010, the 70 fully consolidated Austrian subsidiaries posted total assets worth EUR 264 billion, which is a 1.3% increase year on year. The volume of on-balance sheet loans augmented by a similar margin to some EUR 169 billion, which suggests that the crisis-related slowdown in regional demand for loans has come to an end. Operating income of Austrian banks' CESEE subsidiaries was marginally up in 2010 compared to the previous year, amounting to EUR 13.4 billion. As in the past, net interest income, which

rose by 7.4% to EUR 9.3 billion year on year, accounted for the lion's share. The three other items, i.e. fee-based income, financial income and other operating income, also contributed positively to operating income. The increase in operating expenses, which was notably sharper in comparison to operating income, triggered a 2.9 per-

Chart 28

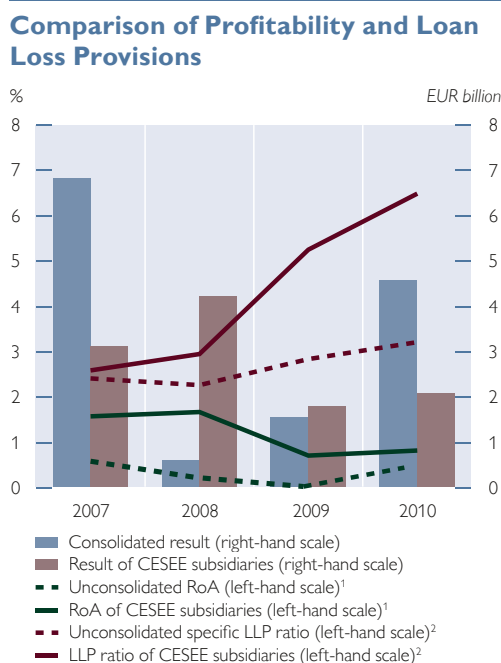
### Composition of CESEE Subsidiaries' Operating Income



Improved net interest income of CESEE subsidiaries despite lower efficiency

Source: OeNB.

Chart 29



Despite higher loan loss provisions, CESEE subsidiaries post profits

CESEE remains essential for Austrian banks' profitability

Source: OeNB.

<sup>1</sup> Return on assets (after tax).

<sup>2</sup> LLP = loan loss provision.

centage point rise of the cost-to-income ratio to 49.7% in the course of the previous year.

With a result of EUR 2.1 billion, Austrian banks' CESEE subsidiaries accounted for some 45%<sup>5</sup> of Austrian banks' consolidated result in 2010, which is again disproportionately high. As in the three previous years, CESEE subsidiaries' return on assets (RoA) (0.80%) was clearly above the unconsolidated figures (0.42%). Compared to the unconsolidated, domestic business-dominated results, CESEE business shows higher profitability but also entails higher credit risks. The loan loss provision ratio of the CESEE subsidiaries, for example, rose considerably more sharply in the past four years than

that on an unconsolidated basis, reaching 6.48% in 2010, which is approximately twice the unconsolidated ratio (3.20%). The 2011 economic outlook for the euro area<sup>6</sup> – but in particular for CESEE – suggests that credit quality will become more stable in the coming months.

Austrian banks' CESEE subsidiaries seem to have pursued an adequate pricing policy, as most of them turned a profit even in the years of the financial crisis despite considerably higher loan loss provisions. This does not apply to some individual institutions, however, especially to those which expanded aggressively in the pre-crisis years.

Since mid-2010, foreign currency-denominated lending of Austria's "top six" banks<sup>7</sup> CESEE subsidiaries has declined only marginally on a currency-adjusted basis and thus still hovered around EUR 80 billion at end-2010. On a CESEE average, this corresponded to a foreign currency loan ratio of 47.5% of total loans extended by the subsidiaries. A separate observation of households and nonfinancial corporations also revealed the same value for the foreign currency ratio on a CESEE average.

As in the previous reporting period, at end-2010, foreign currency loans were again characterized by a worse credit quality than local currency loans. On a CESEE average of 15.9%, the nonperforming loan ratio (NPL ratio) of foreign currency loans was 2.5 percentage points higher than that of all loans. Not only did foreign currency loans more often turn into nonperforming loans, they were also covered

Subsidiaries maintain high share of foreign currency loans...

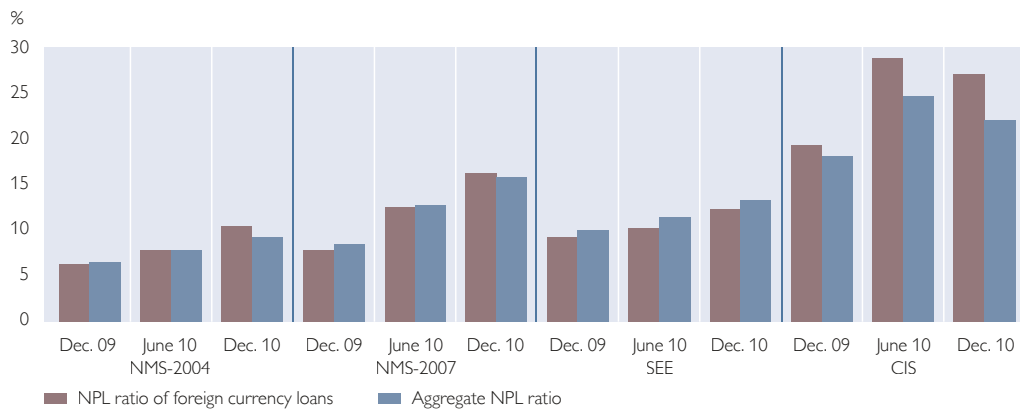
...which results in a higher NPL and a lower NPL coverage ratio

<sup>5</sup> Result of CESEE subsidiaries in comparison with the consolidated result of the entire Austrian banking system.

<sup>6</sup> According to the IMF World Economic Outlook of April 2011, the projected real GDP growth rate in Emerging Europe in 2011 comes to 3.7% as opposed to 1.6% for the euro area.

<sup>7</sup> The "top six" banks comprise Austria's six banking groups with the largest exposure (in terms of external assets) to the CESEE region.

Chart 30

**NPL Ratios: Aggregate Ratio vs. Regional Ratios for Foreign Currency Loans**

Source: OeNB.

by risk provisions to a lesser extent. As regards credit claims overall, the NPL coverage ratio II<sup>8</sup> stood at 82.4% at the end of 2010; in the case of foreign currency loans, it was somewhat lower at 80.4%.

At the national level, the Guiding Principles on Foreign Currency Lending of the FMA and the OeNB have been applicable to Austrian banks' subsidiaries doing business in the CESEE region since spring 2010. In the first instance, banks have been advised to stop extending particularly risky foreign currency loans. Also at an international level, several regulatory initiatives have been introduced with a view to strengthening local currency markets and avoiding a resurgence of foreign currency lending in CESEE. In this context, the "Vienna Plus" Initiative for developing local currency capital markets is particularly worth mentioning; launched in March 2011, its recommendations for limiting new foreign currency lending broadly overlap with

those defined in the Austrian Guiding Principles. Also in March 2011, an ESRB working group was established to identify and assess foreign currency lending-specific risks, which will prepare recommendations for specific political measures until the second half of 2011.

Another risk-relevant feature of Austrian banks' CESEE subsidiaries is the considerable importance of intra-company liquidity transfers, which came to EUR 43.7 billion at end-2010, which was reflected in a loan-to-deposit ratio (LDR) of 108.1% on CESEE average, albeit with high regional differences.<sup>9</sup> In times of crisis in particular, many CESEE subsidiaries strongly depended on their parent banks as a consequence of low local deposit volumes and the size of loans extended by their parent institutes. On a positive note, however, both intracompany liquidity transfers and the loan-to-deposit ratio have gone down slightly year on year from the prevailing high levels.

Requirements to limit new foreign currency loans on course

Intragroup liquidity transfers still very significant

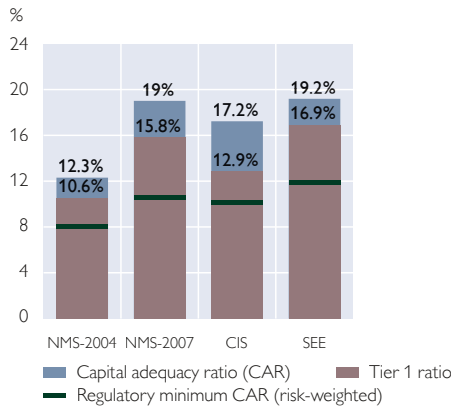
<sup>8</sup> NPL coverage ratio II = (risk provisions for nonperforming loans plus collateral pursuant to Basel II) / NPLs.

<sup>9</sup> Loan-to-deposit ratios were highly mixed for Austrian banks' subsidiaries in CESEE at the end of 2010: LDRs were disproportionately high for instance in Slovenia (321.1%), Ukraine (151.2%) and Hungary (144.3%), whereas retail loans were fully funded by deposits in the Czech Republic (77.5%), Slovakia (81.7%) or Poland (100.2%).



Chart 31

**Capital Adequacy of CESEE Subsidiaries (Q4 10)**



Source: OeNB.

By international comparison, parent banks' capital base remains small

Targeting a "new normality" of long-term business models in CESEE as a factor for success

CESEE subsidiaries' capital situation improves slightly

In all regions, the CESEE subsidiaries' capital situation has continuously improved over time and exceeds the regulatory minimum requirements in all countries and regions, in some of them considerably. This holds true both for the subsidiaries' capital ratio, which climbed to 15.6% on CESEE average at end-2010, as well as for the tier 1 ratio, also rising slightly to 13.0%. In the NMS-2004 the tier 1 ratio amounted to 10.6%. In the NMS-2007, SEE and the CIS it was noticeably higher, which is a

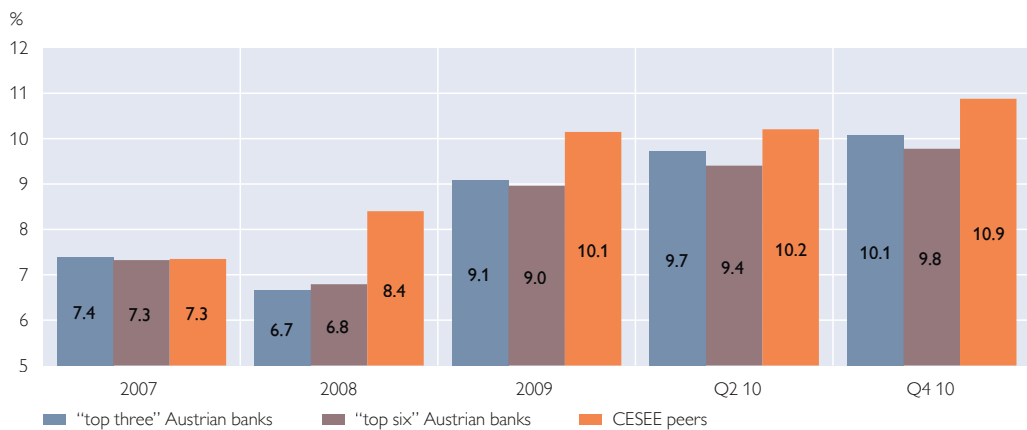
result of the higher regulatory capital minimum requirements in some countries in that region but also gives evidence of the elevated risk in these countries.

A comparison of Austria's "top six" and "top three" banks with a peer group of 12 banks which have a sizeable CESEE exposure established that, on a consolidated basis, the Austrian banks post a lower tier 1 capital ratio in comparison with their peers, despite their clearly higher exposure to CESEE.

In light of the above-mentioned risks of activities in the CESEE region, but also because of this region's growth potential and the associated opportunities for profitability, it is desirable for Austrian banks to target a "new normality". In particular, stronger capitalization, the expansion of local refinancing through deposits as well as risk-adequate intracompany liquidity transfers should be part of this "new normality". As a result, Austrian banks' profitability in the region can be safeguarded in the long run, the risk-bearing capacity of Austria's entire banking system can be enhanced on a sustainable basis and, in addition, a contribution can be made to local market development.

Chart 32

**Tier 1 Ratio of Banking Groups with CESEE Exposure**



Source: OeNB.

### *Exposure to Countries on the Periphery of Euro Area Marginal*

By international comparison and given their activities in CESEE countries, Austrian banks' exposure to Greece, Ireland, Portugal and Spain is small. While the spotlight has been on Greece and Portugal given their budgetary pressures, the banking systems in Ireland and Spain are facing major challenges after the burst of the real-estate bubble.

Since September 2009, external assets of domestically controlled banks to these four countries have declined continuously, amounting to roughly EUR 10.8 billion at end-2010 (3.8% of Austria's GDP)<sup>10</sup>. Along the same lines, the exposure to the four countries' government sectors<sup>11</sup> shrank to EUR 3.2 billion by end-2010, with Greece accounting for more than half of it. An international comparison reveals that the exposures of the Belgian, UK and Dutch banking sectors are significantly higher than Austria's. Vis-à-vis Africa and the Middle East, with some politically unstable countries, Austria's banking system posts external assets of approximately 1.3% of GDP. The exposure to Japan runs up to a mere 0.1% of GDP.

### **Liquidity Situation Deteriorates Slightly**

In the past six months, the liquidity situation in Austria's banking system worsened slightly. Between April 2010 and April 2011 – on a cumulative 12-month basis and before taking money markets into account – the net deficit of the 30 largest domestic financial institutions increased by roughly EUR 7 billion. The main drivers were a deterioration of net claims on banking

deposits, a decline in net redemptions as well as a strong decrease of the "Other" category, which mostly contains reverse repos. As a consequence, additional liquidity that may be realized (on a cumulative 12-month basis, excluding money market transactions) fell slightly from EUR 96 billion to EUR 87 billion in the same period. Thanks to the high share of retail deposits, Austrian institutions depend on the international money market to a below-average degree by international comparison (on the unsecured money market, the system's net position hovers around 1% of consolidated total assets).

Since the crisis in 2009, the share of refinancing liquidity allotted to Austrian banks through ECB tenders has gone down considerably both in absolute and relative terms; it amounted to 1.1% in April 2011. Yet the generally stable refinancing patterns are also fraught with structural risks. Internationally, Austrian banks are dependent most on U.S. dollar and Swiss franc funding. Risks related to USD funding are at present limited by the Eurosystem's EUR-USD swap agreements concluded until August 2011 and by the fact that market demand for USD funding provided through such swaps is currently very low. With regard to CHF funding, refinancing risks have shrunk in comparison with 2008 as more collateral has been provided to the Swiss central bank and as transactions have been diversified more strongly (mostly through FX swaps and repos).

At present, the liquidity situation is being closely monitored as the refinancing problems of some market participants in Greece, Ireland, Portugal and Spain may spill over. Banks would be well advised to broaden their liquid-

Austrian banks' exposure to Greece, Ireland, Portugal and Spain manageable

Low demand for ECB liquidity among Austrian banks

<sup>10</sup> The exposure of all Austrian banks taken together amounted to EUR 13.5 billion or 4.8% of Austrian GDP.

<sup>11</sup> Here, government sector refers to both the central government as well as to public bodies.

**Development of Liquidity Conditions between April 2010 and April 2011**

**Capital Inflows  
(for 12 months incl. money market transactions)**

Index: November 13, 2009 = 100



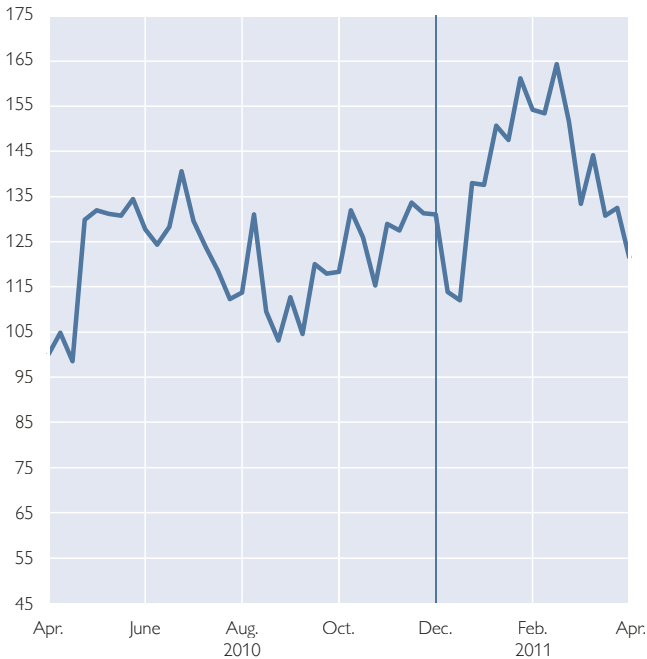
**Capital Outflows  
(for 12 months incl. money market transactions)**

Index: November 13, 2009 = 100



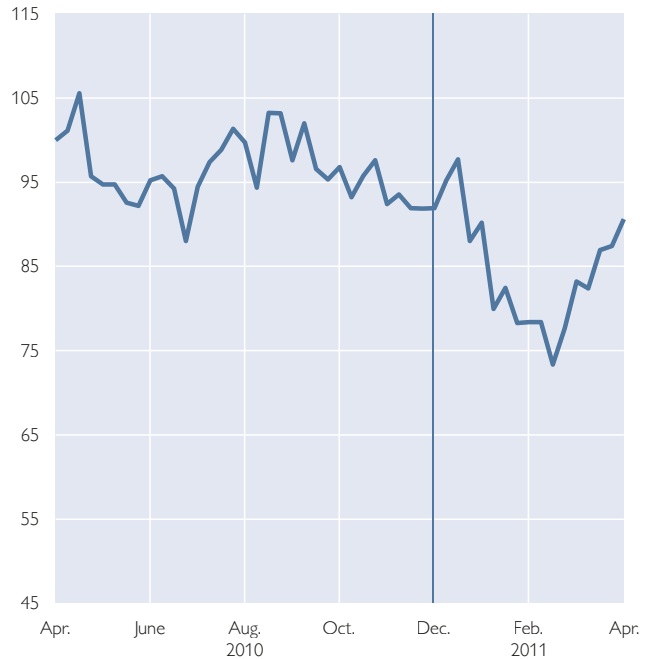
**Cumulative Net Funding Gap  
(for 12 months excl. money market transactions)**

Index: November 13, 2009 = 100



**Cumulative Liquidity That May Be Realized  
(for 12 months excl. money market transactions)**

Index: November 13, 2009 = 100



Source: OeNB.

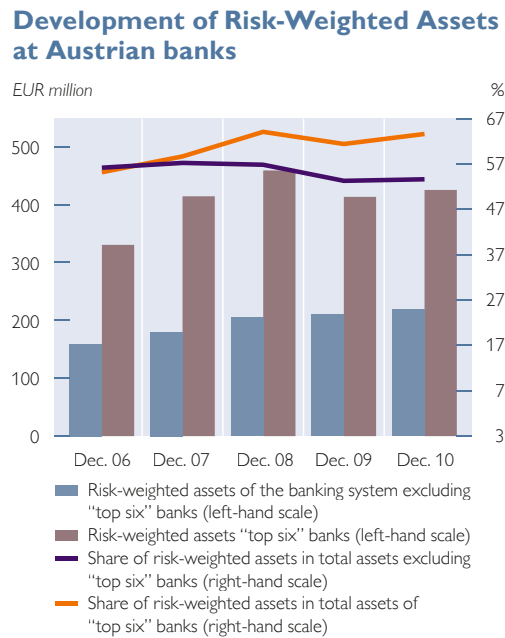
Note: Data based on aggregate reported volumes.

ity profiles to make them “more European” and to hold more liquid assets (among other things in anticipation of bank bonds issued in 2009 with maturities around three years and government guarantees coming up for expiry, and in anticipation of the new liquidity requirements to be met under Basel III). In combination, this will increase refinancing needs next year and competition for nonbank deposits. Given the fragility of the unsecured money market segments, it is important for Austrian institutions to keep their relevant net positions at low levels and to adjust their refinancing strategies to the tightening of refinancing conditions in the euro area well in advance.

**Capital Adequacy Improves**

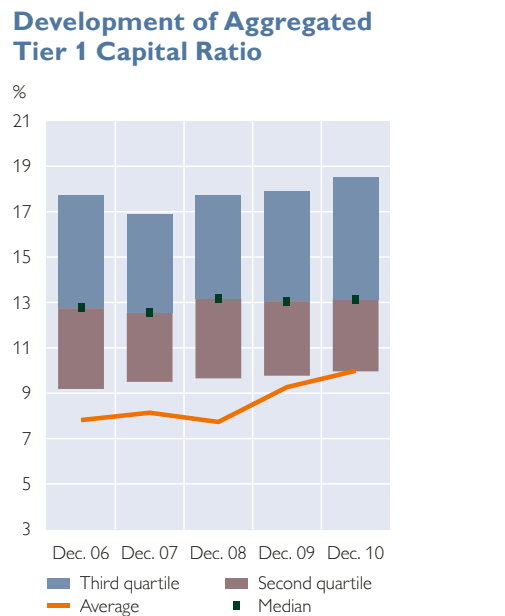
Since its low in the third quarter of 2008, the aggregated tier 1 capital ratio (capital adequacy ratio) of all Austrian banks continually rose by 268 (274) basis points to 10.0% (13.2%) in the fourth quarter of 2010, which corresponds to a 29.2% (19.8%) hike. The increase of the aggregated tier 1 capital ratio was essentially effected by two factors. On the one hand, the volume of eligible tier 1 capital has risen markedly since the third quarter of 2008. This increase reflects both government measures under the bank rescue package worth roughly EUR 6 billion and internal capital increases (private placements, capital injections from the parent group, retained earnings and other measures) worth EUR 8.8 billion. On the other hand, banks responded to the financial crisis by cutting the volume of risk-weighted assets until the fourth quarter of 2009, essentially by shrinking their balance sheets. In addition, there was less new lending (due to lower demand), fewer off-balance sheet activities and similar measures. In 2010, however, banks started to newly

Chart 34



Source: OeNB.

Chart 35



Source: OeNB.

build up risk-weighted assets, which suggests a turning point in the credit cycle.

Standing at 13.1% at end-2010, the median tier 1 capital ratio of all Austrian banks was clearly above the cor-

Capitalization  
remains below  
international  
averages

responding aggregated average (see chart 35). The difference between the two metrics results from the structure of the domestic banking environment, which features a large number of small regional banks with above-average capitalization alongside the dominant major banks. Half of all Austrian banks (the second and third quartiles) post tier 1 capital ratios between 9.9% and 18.5%.

The aggregated tier 1 capital ratio, however, is dominated by the major banks (“top six”). A comparison of the tier 1 capital ratios reveals that, with an

average of 9.7%, the Austrian major banks are less adequately capitalized than their international peers (average of 11.5%); see also the section on CESEE activities of Austrian banks. In light of this unfavorable comparison, the change in the credit cycle (resurgence of risk-weighted assets), the higher capital requirements under Basel III and the pressures resulting from the impending strengthening of peer capital ratios (see box 2), Austrian banks are well advised to target substantial further capital increases.

Box 2

### Stricter Capital Requirements for Banks in Many Countries

*Anticipating the new regulatory framework for banks (“Basel III”), several countries have announced and/or adopted recommendations for higher minimum capital requirements for their systemically important and/or poorly capitalized banks in the past few months.*

*In Switzerland an expert commission appointed by the Swiss Federal Council presented a comprehensive range of measures in October 2010, to limit “too big to fail” risks posed by banks that are systemically important to the Swiss economy. A corresponding draft for partial revision of the Banking Act is to come into force in 2012, following its adoption in Parliament. The set of measures comprises tighter capital requirements, organizational measures in the event of crisis, stricter liquidity rules as well as measures limiting the degree of interconnectedness in the banking sector. The requirements for the two major banks identified as systemically important, i.e. Credit Suisse and UBS, are compatible with Basel III but reach far beyond it. Alongside the basic requirement of 4.5% common equity (i.e. capital of the highest quality), banks are required to hold an 8.5% buffer, made up of 5.5% common equity and 3% contingent convertible bonds, which will automatically be converted into capital if pre-defined capital ratios are undercut. In addition and depending on systemic importance, there will be a third, progressive component, which has been calibrated at 6% and is also to consist of contingent convertible bonds. This means that overall, the minimum capital requirements for Switzerland’s two systemically important banks will come to 19%, at least 10% of which will have to be in common equity.*

*Spain adopted a new regulation for banks (Royal Decree Law 2/2011) in February 2011 to strengthen banks’ capital adequacy and accelerate the reorganization of the banking sector. Under the new regulation, banks must generally reach a minimum tier 1 capital ratio of 8%, which may be raised to 10% – depending on the funding structure and access to the equity market. If banks are unable to obtain the necessary funds on the capital market, they may resort to the “Fund for the Orderly Restructuring of the Banking Sector”, established by the Spanish government in 2009.*

*The Portuguese central bank issued a decree in May 2011 to the effect that banks are generally required to meet a core tier 1 ratio of at least 9% by the end of 2011, and of at least 10% by the end of 2012. Even though all banks are expected to be in the position to carry out the necessary capital measures on their own, government recapitalization measures are also possible.*

*In the United Kingdom, a commission created by the Chancellor of the Exchequer published an interim report in April 2011 on reform options for the banking sector. A key demand is the introduction of a common equity tier 1 (CET1) ratio of at least 10% for systemically important banks. A CET1 ratio of 10% is also to be imposed on banks' large retail branches, whereas activities involving wholesale customers and investment banking will not have to meet CET1 provisions that go beyond international standards, provided that credible resolution plans are available for these activities which will help avoid a bailout with tax money.*

*Other EU countries such as Sweden or Italy are also putting more pressure on their banks to upgrade capital adequacy or introduce the Basel III framework more swiftly. The Swedish financial market supervision authority, for example, announced its intention to require minimum capital adequacy ratios of 15% to 16% from major Swedish banks, with 10% to 12% to consist of core tier 1 capital.*

### **Stress Test Results Further Improve in Aggregates, But Known Weaknesses Remain**

Macroeconomic stress tests are a key tool for assessing the risk-bearing capacity of both individual banks and banking systems as a whole. In the first half of 2011, such stress tests were performed by the OeNB<sup>12</sup> as well as by the European Banking Authority (EBA).<sup>13</sup> To ensure comparability, the OeNB has remodeled its stress tests to mirror the EBA design, i.e. adjusted the design of the scenarios tested and enhanced the underlying methodology, thus increasing the degree of risk coverage compared with previous OeNB stress tests. Moreover, the OeNB adopted the core tier 1 (CT1) ratio defined by EBA for the EU-wide stress test as the new key measure in the process.<sup>14</sup>

Like the EBA baseline scenario, the baseline scenario of the OeNB stress tests is based on the European Com-

mission's economic forecasts,<sup>15</sup> which reflects the improved macroeconomic outlook. Unlike the EU-wide stress test, which focuses on a joint Europe-wide scenario, the OeNB stress test continues to put the spotlight on the CESEE & CIS regions, which are after all the key regions where Austrian banks are doing business and hence their greatest sources of potential risk. Chart 36 plots the effects of the stress scenario against those of the baseline scenario (measured in terms of cumulative GDP growth over a two-year horizon).

Alongside the repercussions of the macroeconomic scenarios on credit risk losses and, consequently, on risk-weighted assets, additional risk factors were taken into account due to the harmonization with EU-wide stress tests. In this respect, the shock on the securitization portfolio turned out to be particularly revealing.<sup>16</sup> Increased refi-

OeNB stress tests focus on CESEE and CIS

Risk-bearing capacity improves in aggregate

<sup>12</sup> The OeNB as a rule calculates results for the entire Austrian banking system on a consolidated basis ("top-down stress tests"). In addition, Austria's six largest banks run "bottom-up stress tests."

<sup>13</sup> See also [www.eba.europa.eu/EU-wide-stress-testing.aspx](http://www.eba.europa.eu/EU-wide-stress-testing.aspx)

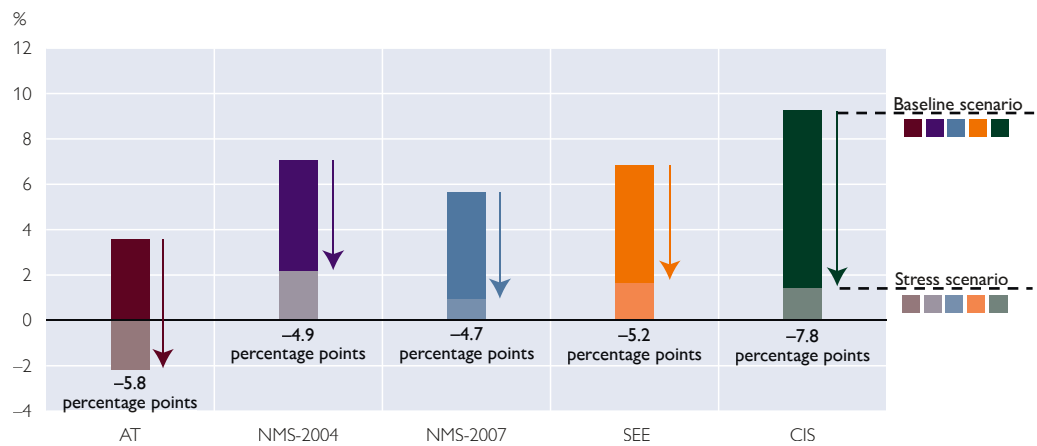
<sup>14</sup> The definition of the EBA core tier 1 ratio slightly deviates from the Basel III definition; in the EU-wide stress test, a CT1 ratio of 5% is considered the critical lower limit.

<sup>15</sup> The baseline scenario is based on the European Commission's autumn 2010 forecast. It spans a two-year horizon, i.e. from the beginning of 2011 through the end of 2012.

<sup>16</sup> Measured in terms of the macroeconomic scenario, this year's EU-wide stress test found the shock to hit the securitization portfolio especially hard.

Chart 36

### Cumulative GDP Growth 2011 to 2012



Source: OeNB.

financing costs and market risk losses had a lower impact.<sup>17</sup> While, given the comparatively small exposure, the first effect can be traced to the relatively heavy stress assumptions, the latter corresponds with the expectations associated with the typical characteristics

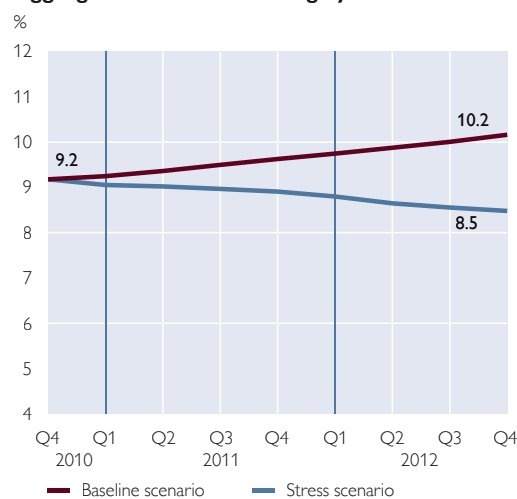
of the Austrian banks' traditional business model.

In terms of the core tier 1 ratio, capitalization in the baseline scenario goes up by 1.0 percentage point both for the banking system (to 10.2%) and the "top six" aggregate (9.5%). Banks

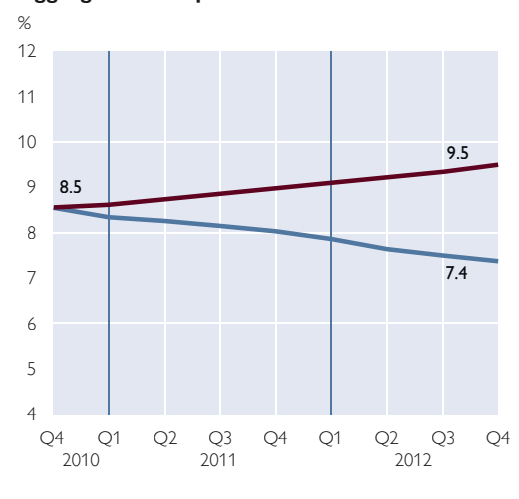
Chart 37

### Development of the Tier 1 Ratio

#### Aggregated Austrian Banking System



#### Aggregate of "Top Six" Banks



Source: OeNB.

<sup>17</sup> The assumptions regarding increased refinancing costs are directly linked with the rating of the country where a bank is headquartered. Thanks to Austria's AAA rating, Austrian banks are affected to a correspondingly smaller extent. In terms of market risk, the traditional business model shows a lower impact, especially when compared with investment banks, not least because sovereign exposure stress is calculated only for the trading book.

stand ready to absorb both the loan loss provisions for credit risk as well as the effects of all other risk drivers assessed in the stress test thanks to their substantial operating profits (see chart 37).

Under the stress scenario, however, the banking system's core tier 1 ratio drops by 0.7 percentage points and the "top six" ratio by 1.1 percentage points. The stronger effect on the "top six" aggregate is a result of the riskier markets in which they do business.

The growing divergence of the results which has been observed since the onset of the crisis, as identified in previous financial stability reports, is also evident from the spring stress test 2011. While results have improved in the aggregate, the stress tests indicate that deficiencies remain in the Austrian banking system.

### Markets Assess Austrian Financial System Favorably

As the economic and financial situation of the CESEE region has stabilized, financial markets now assess Austria's banking system much more favorably. The stock prices of listed Austrian banks, for example, have rallied, predominantly as a result of the emerging economic recovery as well as of the related improved outlook for credit quality in CESEE. Since the onset of the financial crisis, an increased synchronicity has been observed between the market assessment of the creditworthiness of Austrian banks and that of the Republic of Austria (in terms of CDS spreads) – probably because market participants expect government support to kick in for the banking sector should a crisis unfold in CESEE.

Since tensions in the sovereign debt markets of some euro area countries intensified in the first quarter of 2010, market participants have been assessing Austrian banks comparatively more fa-

vorably, as is evidenced by the development of e.g. stock prices and CDS premiums. In addition to other factors, this is due to the beginning economic recovery, comparatively low debt in Austria and CESEE as well as to the relatively few financial ties of Austrian banks with those euro area countries whose risk premiums (governments and banks) have increased.

The current assessment of the Republic of Austria and of Austrian banks by external market participants mirrors the recovery in the real economy and on financial markets, but should also be interpreted as a correction of the rather exaggerated assessment of Austrian institutions at the peak of the crisis in CESEE in early 2009. As market assessments are highly volatile, the current assessment should not lead to complacency, as Austrian banks are still vulnerable because of their extensive CESEE exposure, the high significance of foreign currency loans in Austria and CESEE, and – from an international perspective – their below-average capital adequacy. Rather, the banks should take advantage of the favorable market environment and expand their equity capital buffers.

### Activities to Upgrade Safety for Payment Operations

In the first half of 2011, payment and securities settlement systems as well as financial market infrastructures again proved to be stable; perceptible disturbances to the financial system were registered neither at the national nor at the European level.

As stipulated by the Federal Act on the Oesterreichische Nationalbank, the OeNB is responsible for monitoring the stability and availability of payment systems in Austria and the systemic safety of payment operations. In this capacity, the OeNB is currently systematically

Dispersion of disaggregated results grows further

More favorable market assessment should not cause carelessness



Insurance industry faces challenges due to Solvency II

verifying the stability of bank lobby ATMs operated by Austria's major banking sectors. These retail payment systems are tied to the cash dispenser system to also allow end customers of other banks to withdraw money at 24-hour indoor ATMs.

Moreover, the issue of safety in retail payments is currently subject to an intensive debate at the European level. In early 2011, the Forum on Security of Retail Payment Systems was created. Within this scope, the European supervisory authorities (national central banks, bank supervisors and the European Banking Authority – EBA) are called upon to define common security standards for retail payments (identification, authentication, data integrity, etc.). In a first step, the fields of card payment systems, e-banking and other online-based payment systems are being discussed; the OeNB is actively represented in this Forum.

Harmonization of international legal framework for financial market infrastructures

Another key topic is the current effort to harmonize the European legal framework for financial market infrastructures. In this context, the European Commission – in cooperation with national supervisors – is preparing draft proposals for regulating OTC derivative markets and central counterparties as well as for central securities depositories.

Sovereign risk for Austrian insurance companies limited

### **Insurance Companies and Mutual Funds Benefit from Upswing European Insurance Industry Gains New Ground**

In 2010, the European Insurance industry benefited from the economic recovery and the improved conditions on financial markets. Major loss events such as floods in Australia or the tsunami in Japan have not hit European reinsurance companies too hard, even

though the final damages are yet to be determined.

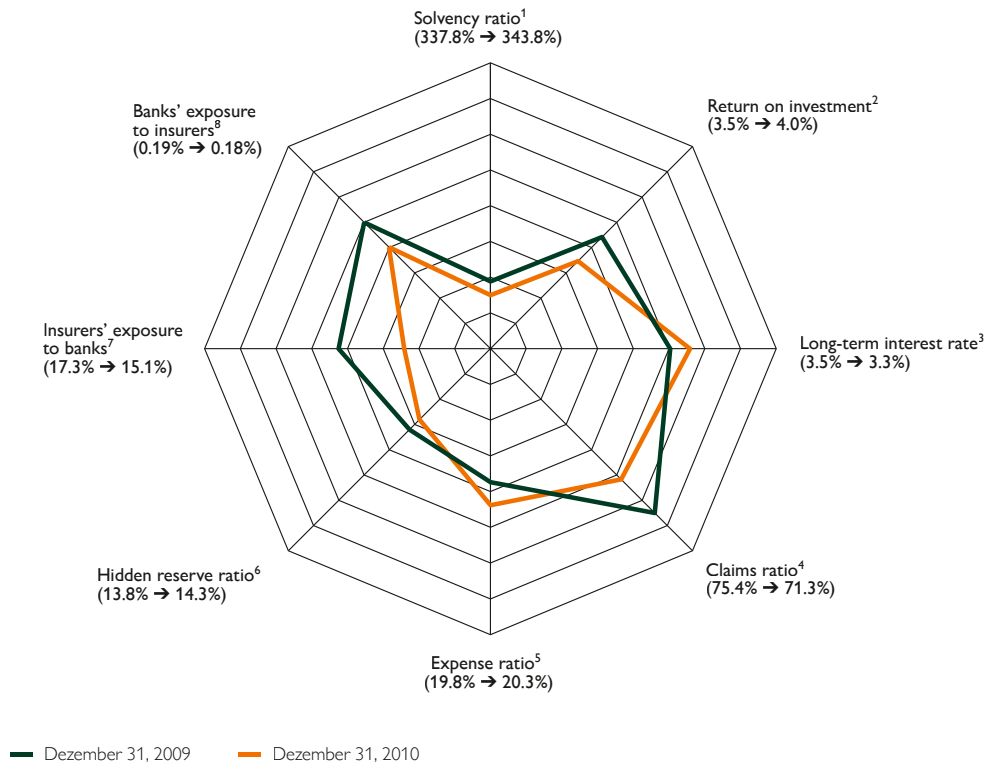
At the end of last year, the European Insurance and Occupational Pensions Authority EIOPA (formerly: CEIOPS) performed an impact study (QIS 5) for Solvency II, the new supervisory regime for insurance companies as of 2013. The EIOPA report on QIS 5 shows a plunge of the solvency ratio<sup>18</sup> from 310% to 165%; the current regime and the new regime are, however, based on fairly different principles for calculating the two components of the ratio (eligible solvency elements and capital requirements). At the same time, the QIS 5 calculations yielded a surplus of EUR 355 billion over the solvency capital requirements. At the country and company levels, the effects are fairly mixed. According to the pan-European results, especially niche insurers may have to strengthen their capital positions under Solvency II. Compared with their European peers, Austrian insurance companies appear to be doing quite well.

In 2010, the Austrian insurance sector posted nominal premium growth of 1.7% which, however, led to a 0.4% decline in real terms (inflation-adjusted). Unit-linked and index-linked life insurance plans registered the steepest growth at 13.4%, thus accounting for just under 40% of all life insurance premium income. As investment risks lie with the policyholders, which reduces capital requirements for insurance companies, this product group can be expected to keep growing in the medium term because of the risk-oriented features of Solvency II. Compared to the previous year, the key indicators have remained mostly unchanged except for the fact that the interlinkages with Austrian banks, as

<sup>18</sup> The solvency ratio equals eligible capital divided by regulatory capital.

Chart 38

## The Insurance Sector and Financial Market Stability



Source: OeNB, FMA.

<sup>1</sup> Eligible capital or regulatory capital.

<sup>2</sup> Net return on investment divided by investment.

<sup>3</sup> Long-term yield of euro area government bonds.

<sup>4</sup> Expenses for claims and insurance benefit/premiums.

<sup>5</sup> Expenses for insurance operations/premiums.

<sup>6</sup> Hidden reserves/investments.

<sup>7</sup> Exposure of insurers to banks measured in terms of insurers' total assets.

<sup>8</sup> Exposure of banks to insurers measured in terms of banks' total assets.

Note: Figures scaled on the basis of historical data.

The closer to the center, the better/less risky/more benign.

measured as a share of insurance companies' total assets, have dropped by almost 2 percentage points.

The combined (claims and expense) ratio<sup>19</sup> indicating the profitability of insurers' daily operations fell by 8% in the property/casualty insurance segments year on year and amounted to 92.5% at end-2010. In other words, it has dropped clearly below the critical

ratio of 100%, above which insurers would be paying out more money in claims than receiving from premiums. The decline was driven by low settlement amounts for insurance claims, while the expense ratio held almost steady.

The OeNB's securities holdings statistics<sup>20</sup> reveal that insurance companies held securities worth EUR 73.4 billion at end-2010, EUR 60 billion of

Significant exposure to banking sector

<sup>19</sup> The combined ratio indicates the share of operational expenditure and of expenses for settling claims as a percentage of gross insurance premiums written.

<sup>20</sup> The OeNB's securities holdings statistics cover holdings of securities at an unconsolidated level, i.e. without investments via CESEE subsidiaries, but do include all securities held by unit-linked life insurance plans. Domestic mutual funds are split in accordance with the underlying securities.

Share of institutional investors in mutual funds rises sharply

which were invested in fixed-income securities. Overall, insurance companies held EUR 32.5 billion in domestic and foreign securities issued by banks, with EUR 1.5 billion being accounted for by shares. Their exposure to the financial sector as a whole totaled EUR 47.7 billion, corresponding to 64% of the total securities volume. Given increased concerns about some countries' government bonds it should be noted that Austrian insurance companies had invested, directly and indirectly (via funds), the equivalent of EUR 17.3 billion in government bonds at the end of 2010,<sup>21</sup> of which they had invested EUR 5.8 billion in Austrian and German government bonds. Euro area countries with higher risk premiums, i.e. Greece, Ireland, Portugal and Spain, accounted for EUR 1.6 billion,<sup>22</sup> which is also roughly the exposure of Austrian insurance companies to banks of these countries (EUR 1.5 billion). Overall, the risks arising from the exposure in the above-mentioned countries for Austria's insurance industry are, by European standards, somewhat limited.

Some of the biggest challenges the insurance sector currently faces are the uncertainties on financial markets; in this respect, the changing interest rate levels as well as interlinkages with the banking sector, which harbor potential for contagion, need to be monitored particularly closely.

Exposure of Austrian mutual funds to countries on euro area periphery limited

### Mutual Funds Grow Again Thanks to Performance

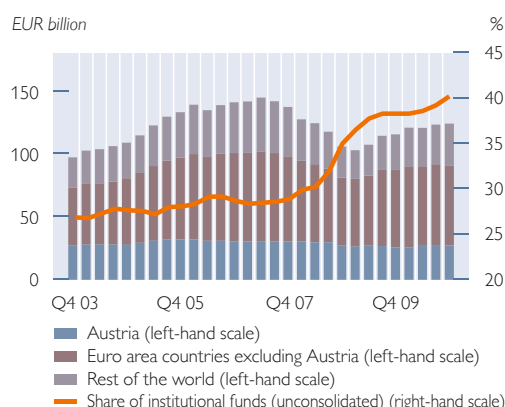
Total assets under management in Austrian mutual funds climbed by 6.5% to EUR 147.6 billion in the course of

2010.<sup>23</sup> Across Europe, the fund industry grew far more dynamically than it did in Austria in 2010, i.e. by 13.7%.

In Austria, growth was mainly driven by institutional funds (+11.9%), which also gained strongly on a proportionate basis. While the share of institutional funds in total net asset value came to only 29% at the end of 2007, it surpassed the 40% mark at end-2010. This is attributable to the steady flow of capital from institutional investors into institutional funds (e.g. for old-age provision) on the one hand, and to the lower risk propensity of private investors on the other.

Chart 39

### Regional Investment Allocation of Funds



Source: OeNB.

At end-2010, the aggregate one-year performance of Austrian funds stood at 6.1%, with equity funds having achieved a disproportionately high result at 17%.

Mutual funds are first and foremost exposed to market risk borne by investors. As some euro area countries are

<sup>21</sup> Including securities issued by state and municipal governments.

<sup>22</sup> Greece: EUR 0.5 billion, Spain: EUR 0.5 billion, Ireland: EUR 0.4 billion, and Portugal: EUR 0.1 billion (rounded).

<sup>23</sup> Assets under management adjusted for fund-of-fund investment reached EUR 123.7 billion at end-2010, up by 7.3%.

facing serious government debt problems, the corresponding government bonds are being closely monitored. Austrian mutual funds held a total of EUR 1.6 billion<sup>24</sup> in government bonds of Greece, Ireland, Portugal and Spain at end-2010. Overall, the exposure to these countries amounted to EUR 5.2 billion, i.e. roughly 4% of the consolidated net asset value, and is therefore relatively limited.

UCITS IV<sup>25</sup>, which will enter into force on July 1, 2011, constitutes an-

other step toward harmonizing the investment fund industry at the European level. As a result, domestic investment companies will be confronted with some changes, some of which will entail higher costs (expanding risk management) but lower trading costs (best-execution principle). The introduction of UCITS IV is anticipated to adversely affect investment companies, which will likely lead to a consolidation of investment companies and mutual funds in the medium term.

UCITS IV poses challenges

<sup>24</sup> Greece: EUR 0.4 billion, Spain: EUR 0.8 billion, Ireland: EUR 0.3 billion, and Portugal: EUR 0.14 billion.

<sup>25</sup> UCITS IV essentially consists of the following: management company passport, master-feeder structures, cross-border fund mergers, more information for investors, simplified notification procedure, and more exchange of information with supervisory authorities.

