The business environment for the Austrian financial sector has remained challenging since the publication of the previous Financial Stability Report in June 2013. Under difficult macroeconomic conditions, the profitability of the Austrian banking system weakened in the first half of 2013, reflecting faltering net interest income and a further deterioration of asset quality, especially in CESEE. Nevertheless, the region remains an important contributor to profitability, although increasingly heterogeneous developments across countries entail a growing concentration of Austrian banks’ CESEE activities on a handful of profitable markets.

To ensure a sustained recovery, Austrian banks have to tackle the challenges of a “new normality” in banking, which is characterized by slow growth, lower profitability and tighter regulation; they have to continue to address weaknesses such as the cost base and below-average margins in Austria.

Some success has been achieved over the previous years by increasing capitalization, but given the current fragile environment and higher capital adequacy ratios posted by banks in the peer group, the OeNB still considers a further strengthening of the capital base as crucial. With that in mind, banks should focus on core business areas and even consider selling off (non-core) assets where appropriate.

Further steps have also been taken in the implementation of financial reforms both on the national and the international levels. In July 2013, the Austrian Banking Intervention and Restructuring Act was adopted. In the same month, the Austrian Alternative Investment Fund Managers Act entered into force. On the European level, the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) IV were published. All those steps will increase financial stability and lay the foundation for banking union. A successful banking union needs strong institutions. The formal enactment of the single supervisory mechanism (SSM) in October was — institutionally — a large step toward a true banking union. Before the SSM becomes fully operational, the ECB —
together with the national competent authorities – is carrying out a comprehensive assessment of the asset quality for significant banking groups, six of which are Austrian. This exercise is to increase the transparency and comparability of banks and therefore enhance confidence in financial stability in Europe. Going forward, besides a rigorous analytical and comparable design of the exercise across jurisdictions, an effective framework for dealing with insolvent institutions together with credible national backstops will be critical for the success of banking union.

**A New Normality in the Banking Industry**

The mispricing of risks in the run-up to the financial crisis continues to place a significant burden on the balance sheets of creditors and banks in Europe as the deleveraging cycle in the real economy and the banking sector continues. Moreover, regulatory reform requirements aimed at preventing a recurrence of past mistakes contribute to a new normality of lower growth and lower returns that banks need to adapt to.

**Setback in Consolidated Profitability of Austrian Banks in 2013**

In the euro area, the profitability of significant banks, i.e. banks that will be directly supervised by the ECB under the SSM, remained subdued in the first half of 2013.\(^1\) This is especially true for banks from countries with stressed sovereign and macroeconomic conditions, which result in high credit risk costs and sluggish revenue growth.

After a rebound in 2012, the consolidated profitability of the Austrian banking system has been affected by increasing risk costs, while low interest rates and sluggish lending growth have put pressure on inter-

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\(^1\) See also ECB (2013). Financial Stability Review. November.
est income. In the first half of 2013, Austrian banks’ consolidated net profits after taxes fell by nearly 60% to EUR 1.1 billion. Even adjusted for one-off effects in 2012, results declined by about one-third, keeping banks’ profitability well below pre-crisis levels (see chart 15). Reflecting the continued unfavorable economic prospects in Western Europe and adverse developments in individual CESEE countries, risk costs have been rising (see further below), putting pressure on banks’ profitability. Moreover, in light of low margins in the domestic business, weaker new business and the ongoing low interest rate environment, net interest income – by far the most important source of income – declined by 4.2% on a consolidated level in the first half of 2013 compared to the previous year. However, income on fees and commissions grew, primarily on the back of an improved securities business, by 3.3% year on year. Apart from that, an increasing cost-to-income ratio points to some deterioration of banks’ cost base. Another factor impacting banks’ profitability are bank levies in several core markets. Some of these levies are particularly burdensome in times of low income, as they are not based on current profits but on measures of size to varying degrees.

Austrian banks are still facing weak profitability in the domestic market. Operating income has declined since 2011, as new business is sluggish and margins remain low due to growing operating expenses (see chart 16) and tight competition. The latter is reflected, for instance, in the average branch density of the Austrian banking system of nearly 1.900 inhabitants per branch, which is substantially below the European average of 2.300 (see chart 17). Another piece of evidence is the situation of inherently low interest margins in the domestic market. Together with the Belgian banking system, Austria registers the lowest interest margin rates within the EU. Lending rates for new consumer loans in Austria have increased steadily, however, but are also well below the European average.

In addition to improving the income-based earnings potential, further consolidation and efficiency-enhancing efforts announced by several banking groups are desirable and need to be continued. Furthermore, an effective bank recovery and resolution framework will, once in place, play an important role in this respect. It will reduce the

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2 The rebound in 2012 was substantially driven by one-off effects, i.e. mainly repurchases of hybrid capital.
3 Unconsolidated operating costs are somewhat overestimated as administrative expenses related to the activities of Austrian subsidiaries in CESEE are covered by headquarters in Vienna.
4 In Austria the increase in the number of branches in 2011 (mirrored in a steep of the red line in chart 17) was driven by a one-off effect, as most of the post offices took on banking services. The dotted line therefore shows the change in branch density without this effect.
value of implicit guarantees\textsuperscript{5} and thus affect banks’ profits.

The profits of Austrian subsidiaries remained substantial in the first half of 2013. Austrian subsidiaries in CESEE generated nearly EUR 1.4 billion in profits in the first six months of 2013. Operating profits weakened and risk provisioning was almost unchanged, nevertheless, profits remained flat compared to the previous year, which resulted mainly from a one-off-effect in Romania. The annualized return on assets of all subsidiaries in CESEE is currently expected to come in at around 1% for 2013.

Interest rate income fell by 2.7\%, driven by material declines in the Czech Republic, Croatia and Ukraine. Nevertheless, margins in CESEE are still significantly higher than in the Austrian market and to some extent compensate for banks’ higher risk costs in the region. Higher interest margins in CESEE are, however, also linked to the subsidiaries’ retail-oriented business model.

This notwithstanding, the profitability of Austrian banks’ subsidiaries in CESEE is getting increasingly heterogeneous. The wide distribution of profits of Austrian subsidiaries across CESEE has diminished over the past few years; recently, profits have been up only in a handful of countries, namely the Czech Republic, Slovakia, Russia and Turkey\textsuperscript{6} (see chart 18). With regard to the profitability of the latter two markets, however, exchange rate effects on the valuation of the equity position in the respective subsidiaries have to be taken into account. In Romania, profitability remains fragile as recent results are based on one-off effects, and Croatia is facing sustained macroeconomic difficulties that are now beginning to significantly eat into profits, implying a limited future earnings potential. Previously profitable markets like Hungary or Ukraine became loss generating – macroeconomic imbalances as well as political and/or regulatory risks are reasons behind this development and may continue to affect bank profitability in these markets. On the upside, this growing concentration reflects well on banks’ strategy of broad asset

\textsuperscript{5} See the paragraph on banks’ liquidity situation below.

\textsuperscript{6} As a significant joint venture in Turkey is not included separately under the Austrian supervisory reporting, the results are not included in the analysis of subsidiaries. In the first half of 2013, the joint venture generated profits of EUR 320 million.
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Diversification across the region. On the downside, however, the dependency on a few countries underpins the need to pursue growth in a sustainable way.

In the light of rapid credit growth in countries like Russia and Turkey, Austrian banks should heed the lessons from past boom phases and proceed with due caution and a focus on risk management. While business in these countries is particularly attractive at the moment, as it involves comparatively high margins and low risk costs on the back of high economic growth, low market penetration as well as a still modest level of private sector indebtedness, banks need to be cautious, heeding the lessons from past rapid credit expansions in CESEE, especially with respect to stepped up risk buffers and risk management practices.

Credit Risk Costs Remain Elevated

The asset quality of significant euro area banks, especially of smaller banks, continued to deteriorate in the first half of 2013. Differences in nonperforming loans and provisioning trends across countries have mainly been driven by cyclical factors. Both the upcoming comprehensive assessment of banks’ risk exposures under the SSM and initiatives to harmonize the definitions of nonperforming loans across jurisdictions are welcome steps toward increasing the transparency and comparability of banks’ credit risk metrics.

Box 2

Harmonized Definitions of Nonperforming Exposures and Forbearance Are Key in Enhancing Transparency in Asset Valuations

Nonperforming exposures (NPEs) are exposures that are classified as either defaulted according to the regulatory framework or impaired according to the applicable accounting framework (except for exposures with incurred but not reported losses under IAS 39), and all exposures that meet the following harmonization criteria:

- (Harmonized) entry criteria: An exposure has to be considered nonperforming when it is 90 days past due and/or the debtor is unlikely to pay its credit obligations without collateral realization. This applies even if the exposure is not recognized as defaulted or impaired in accordance with the applicable accounting framework.
- Pulling effect: All exposures to a debtor have to be considered as nonperforming when its on-balance sheet exposures that are 90 days past due reach 20% of the outstanding amount of the on-balance sheet exposures to that debtor, even if no pulling effect is used for the default or impairment classification.

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7 Since end-2009, the loan volume of Austrian subsidiaries in Russia and Turkey has risen by roughly two-thirds. See also Barisitz, S. 2013. Credit Boom in Russia despite Global Woes — Driving Forces and Risks, in this issue.

The asset quality of Austrian banks continued to deteriorate on a consolidated basis. While it has remained fairly benign in the domestic market, the credit quality of Austrian banks’ CESEE subsidiaries has again worsened. The share of nonperforming loans in the Austrian banking system increased slightly in the first half of 2013 as a result of sluggish or negative credit growth and continued inflows of net NPLs. This is especially true for banks’ foreign operations, where the consolidated NPL ratio (the share of nonperforming loans in total nonbank loans) climbed to 8.8% in June 2013. In contrast to that, the unconsolidated NPL ratio (as a proxy for domestic business) remained quite close to 4.5%. The persistently high level of NPLs also led to high consolidated current credit risk costs in the first half of 2013. Net flows of loan loss provisions amounted to EUR 3.2 billion, representing an increase by about EUR 500 million compared to the first half of 2012 (see chart 19). It has to be noted, however, that this increase was driven to a significant part by developments in one state-owned bank that had to raise provisioning significantly in the course of 2013.

Despite some large corporate defaults in the domestic market, credit quality in Austria remained largely unchanged in the first three quarters of 2013. This is confirmed by the unconsolidated LLP ratio (stock of specific loan loss provisions as a share of total nonbank loans), which has remained slightly above 3% since 2009. The consolidated loan loss provision ratio — representing the stock of loan loss provisioning — has

Quality of domestic loan portfolio remains stable
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The overall NPL ratio of the top 6 Austrian banks’ CESEE subsidiaries increased further, from 14.8% in December 2012 to 15.3% in June 2013, while the NPL ratio of foreign currency loans increased from 19.4% to 20.2% over the same period, reflecting the additional risk embedded in this type of lending instruments. Overall, this increase was driven especially by developments in Croatia, Romania, Slovenia and Hungary. At the same time, country-specific differences with respect to NPL ratios remain high, reflecting heterogeneous economic developments in CESEE as well as different definitions of nonperforming loans.9 The NPL ratio remained below 10% and even decreased in some of the most important host countries of Austrian banks (e.g. in the Czech Republic, Russia and Slovakia), while it reached levels close to or above 20% in many Southeastern European countries.

The coverage of NPLs by loan loss provisions and collateral improved in recent years, with the NPL coverage...
ratio I (ratio of loan loss provisions for NPLs to NPLs) increasing to 49.0% in June 2013 from 47.9% in December 2012. The NPL coverage ratio I for foreign currency loans increased in the same period from 42.6% to 44.4%. Due to the high share of mortgage loans in the CESEE region, the NPL coverage ratio II, which includes eligible collateral according to Basel II for NPLs in the numerator, is significantly higher and amounted to 68.6% in June 2013 (68.7% in December 2012). The coverage ratio II for foreign currency loans in CESEE slightly declined to 66.5% in June 2013 from 66.9% in December 2012.

Box 3

Preparations for a European Banking Union

Over the past year, good progress has been made toward the creation of banking union. On October 15, 2013, the EU Council adopted a regulation establishing the single supervisory mechanism (SSM) for banks in the euro area, which entered into force in November. In fall 2014, banking supervision at the European level will be fully operational.

The ECB has cooperated closely with the national supervisory authorities in preparing the implementation of the SSM. Strategic and other decisive issues are being discussed and negotiated by the High Level Group chaired by the president of the ECB.

The SSM Regulation (SSMR) sets out the tasks of banking supervisors and the effective organization of supervision. Major current challenges are the establishment of the Supervisory Board and organizational structures as well as the formation and staffing of the Joint Supervisory Teams (JSTs). The JSTs will be in charge of the supervision of a “significant entity or group” and will be composed of a team of supervisors, coordinated by an ECB staff member and one or several sub-coordinators from the national competent authorities (NCA).

Besides that, Article 6 SSMR stipulates that the ECB in consultation with the national competent authorities is to adopt a framework to organize the practical arrangement for implementation. Currently the ECB and national central banks are working on detailed operational arrangements, which are supposed to be reflected in the framework regulation and should embrace, among others, the institutional set-up of the SSM and the cooperation between the SSM and other competent authorities and institutions. This comprises:

− the functioning of the SSM, the JSTs, their role and how NCA staff members are involved in JSTs;
− the organization of on-site inspection teams, their composition and how coordination between JSTs and on-site inspection is ensured; and
− the procedures for the adoption of supervisory decisions.

Before the SSM becomes fully operational in November 2014, the ECB together with the NCAs is carrying out a comprehensive assessment of significant banking groups. The scope of the exercise is unprecedented. Overall, 128 banking groups in 18 Member States are participating in the comprehensive assessment, approximately 85% of euro area bank assets are covered. In Austria, the following six banking groups are currently undergoing the comprehensive assessment: BAWAG P.S.K, Erste Group Bank AG, Raiffeisenlandesbank Oberösterreich AG, Raiffeisenlandesbank Niederösterreich-Wien AG, Raiffeisen Zentralbank Österreich AG, Österreichische Volksbanken-AG with credit institutions affiliated according to Article 10 of the CRR.


3 Article 33 of the SSMR states that the ECB “shall carry out a comprehensive assessment, including a balance sheet assessment, of the credit institutions of the participating Member State. The ECB shall carry out such an assessment at least in relation to the credit institutions not covered by Article 6(4)”. 
The exercise started in November 2013 and will take 12 months to complete. It is carried out in collaboration with the NCAs of the Member States that participate in the SSM and is supported by independent third parties at all levels at the ECB and at the NCAs.

The exercise has three main goals:
- transparency – to enhance the quality of available information on the condition of banks;
- repair – to identify and implement necessary corrective actions, if and where needed;
- confidence building – to assure all stakeholders that banks are fundamentally sound and trustworthy.

The comprehensive assessment rests on three pillars:
- a supervisory risk assessment (RAS) addressing key risks in banks’ balance sheets, including liquidity, leverage and funding;
- an asset quality review (AQR) to enhance the transparency of bank exposures by reviewing the quality of banks’ assets, including the adequacy of asset and collateral valuation and related provisions; and
- a stress test providing a forward-looking view on banks’ shock-absorbing capacity to be conducted by the ECB and the European Banking Authority (EBA).

While the three elements are closely interlinked, the main component is the asset quality review. The asset quality review is risk-based and concentrates on risky or nontransparent parts of individual banks’ balance sheets. The asset quality review consists of three key parts: 1) selection of portfolios considered to be risky or nontransparent 2) on-site reviews of portfolios identified in the selection phase and 3) collation and quality checks to ensure consistency and comparability of results.

The assessment is based on a capital benchmark of 8% common equity tier 1, drawing on the definition of the Capital Requirements Directive IV/Capital Requirements Regulation, including transitional arrangements, for both the AQR and the baseline stress test scenario. The details concerning the stress test will be announced at a later stage, in coordination with the EBA.

The comprehensive assessment will conclude with an aggregate disclosure of the outcomes at country and bank level together with any recommendations for supervisory measures. This comprehensive outcome will be published prior to the ECB assuming its supervisory role in November 2014 and will include the main findings of the three pillars of the comprehensive assessment.

Work is also continuing on the second building block of the institutional framework for banking union: the single resolution mechanism (SRM). The SRM will be the body responsible for resolving banks and, in particular, coordinating the application of resolution tools to EU banks and ensuring that taxpayers should no longer be first in line to pay for the costs of bank failures. Any resolution costs would have to be borne mainly by shareholders, followed by creditors and by the use of resolution funds. The latter would be built up gradually through bank levies. The European Commission has already submitted two proposals to address these issues:

First, the proposed Directive on Bank Recovery and Resolution (BRRD), adopted by the European Commission in early June 2012 and agreed by the Ecofin Council on June 27, 2013, is now being discussed by the European Parliament. The directive is to provide a comprehensive and effective arrangement to deal with failing banks at the national level. The BRRD includes key elements of prevention, preparation, early intervention and credible resolution tools. It is expected to be finalized at first reading by way of “trilogue” before the end of this year and should enter into force on January 1, 2015.

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Sluggish Credit Growth

In the euro area, bank lending has remained generally subdued but sector and country developments continued to be diverse. While in the EU peripheral countries, lending – especially to non-financial corporations – continued to decline strongly, lending volumes in other countries, especially loans to households, grew moderately.\textsuperscript{10}

Although credit growth in Austria turned slightly negative for the first time since 2010,\textsuperscript{11} it is still above the European average, as the decline in growth rates in other countries was even more pronounced. In CESEE, the bulk of new lending by Austrian subsidiaries was attributable to selected countries. The total volume of loans to nonbanks shrunk slightly, by 2% compared to the previous year.

The decline in lending in Austria has been driven by both supply- and demand-side factors (see the section on Corporate and Household Sectors in Austria in this report). By September 2013, loans to domestic nonbanks amounted to EUR 329 billion, down 0.4% year on year. Though lending for housing and home improvement recently lost momentum (chart 21), it continued to outpace general lending growth. In Austria the role of housing loans slightly increased over the past few years, although the share of housing loans to total loans is still below the European average. Likewise, the recent increase in residential property prices reflects also a catching-up process, as prices had been virtually flat since 2007 (for more details see the section Residential Property Prices Continue to Rise in this issue). Nevertheless, potential cyclical risks associated with a rapid price increase in the real estate sector cur-

\textsuperscript{10} See also ECB (2013). Financial Stability Review. November.

\textsuperscript{11} In contrast to the figures provided in the previous section on households and nonfinancial corporations, this figure also includes (negative) growth of credit to nonbank financial intermediaries and the Austrian government.
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Currently warrant close monitoring by supervisory authorities.

Various supervisory measures targeting foreign currency lending in Austria have proved effective; the stock of outstanding foreign currency loans has been decreasing gradually. In foreign exchange-adjusted terms, foreign currency lending to Austrian households started to decline in October 2008, after authorities started to apply a stricter stance. As a result, until September 2013, foreign currency loans to households declined by 42% to EUR 29.5 billion. Other customers\(^\text{12}\) owed an additional EUR 12.8 billion in foreign currency as at September 2013 (down from EUR 20.4 billion over the same time horizon).

Despite limited new foreign currency lending to Austrian borrowers, legacy assets will continue to pose a challenge to the Austrian banking system, in particular because 70% of foreign currency loans to households are bullet loans, more than 90% of which are linked to repayment vehicles. These instruments are exposed to financial market developments to a large extent, and therefore they also involve the danger of unexpected low yields, sometimes also a partial loss in principal. Strict compliance with foreign currency minimum lending standards will be an important element in containing the risk emanating from this type of lending.

The total loan volume of the CESEE subsidiaries of Austria’s top 6 credit institutions decreased further (by 2.3% year on year in June 2013). At the same time loans denominated in foreign currency decreased more strongly, by 6.0% to EUR 79.1 billion (taking exchange rate effects into account). Overall, the aggregated share of foreign currency loans decreased from 46.0% to 44.3% year on year, with the euro still being the predominant foreign currency in CESEE.

The large Austrian banks reduced their leasing portfolio in CESEE by 2.1% to EUR 12.6 billion year on year in June 2013. The foreign currency-denominated leasing portfolio decreased over the same period by 3.4% to EUR 5.5 billion. The nonperforming leasing portfolio amounted to 24.8% of all leasing contracts in June 2013, down from 28.2% in June 2012. The credit quality of leasing contracts denominated in foreign currency is still lower than that of local currency leasing contracts, with an NPL ratio of 35.1% in June 2013 (44.5% in June 2012).

Austrian banks’ exposure to CESEE has remained stable. Concerns about widespread deleveraging by Austrian banks in the CESEE region have not materialized, yet data indicate significant differences at the country level (chart 22). Since the height of the CESEE market turmoil in early 2009, Austrian banks’ exposure to the region has increased by a cumulative 6% as reported or close to about 3% when adjusted for exchange rate effects. In countries in which banks are facing a difficult economic environment or a politically-induced tightening of bank regulation and taxation – e.g. in Ukraine, Kazakhstan and Hungary – the exposure shrank significantly.\(^\text{13}\) This reduction was more than compensated for by an aggregate increase of almost 19% in other CESEE coun-

\(^{12}\) Corporates, nonbank financial institutions and the public sector

\(^{13}\) The reduction in exposure to Kazakhstan was driven by the sale of a subsidiary at end-2012, which does not constitute deleveraging as it was a simple transfer of ownership.
tries, in particular Russia, the Czech Republic and Slovakia. The picture looks somewhat different when considering the foreign claims in the consolidated statistic of the BIS, because those figures are not adjusted for exchange rate effects. Furthermore, changes in banks’ ownership can lead to shifts in volume, as recently happened in Austria, when Volksbank International sold most of its subsidiaries to Sberbank Europe.

**Significant Improvement in Bank Capitalization but Further Strengthening Required**

In an environment of subdued profitability, euro area banks have continued to strengthen their capitalization. These improvements have been achieved through a combination of capital increases, e.g. via rights issues and retaining earnings, and reductions in risk-weighted assets (RWA), which continued in the first half of 2013.

The tier 1 ratio of the Austrian banking system continued to improve in early 2013. After its low in the second quarter of 2008, the aggregate tier 1 capital ratio (capital adequacy ratio) of all Austrian banks rose steadily and reached 11.5% (14.8%) by mid-2013. The increase of the aggregate tier 1 capital ratio can be mainly attributed to two effects:

First, the volume of eligible tier 1 capital has risen by more than EUR 22 billion since 2008. Nearly EUR 9 billion of the increase in eligible tier 1 capital is currently attributable to government measures under the bank stabilization package, with the rest reflecting private capital increases (private placements, capital injections from the parent group, retained earnings and other measures).

Second, in response to the financial crisis, banks reduced their RWA until the fourth quarter of 2009 (see chart 23), inter alia by streamlining their balance sheets and cutting off-balance sheet activities. While there was a slight increase in RWA in 2010, the trend of RWA reductions has continued ever since: RWA shrank by 3.2% in the first

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14 Of the countries with a substantial exposure of Austrian banks, reductions in reported (i.e. unadjusted) exposure since the first quarter of 2009 have been largest in Kazakhstan (due to the sale of operations), Ukraine (-34%) and Hungary (-13%), reflecting economic difficulties as well as elevated levels of political risk. By contrast, exposures to other countries grew substantially, with Poland (+113%), Russia (+34%), the Czech Republic (+23%), and Slovakia (+20%) featuring prominently.

15 As Sberbank is Russian-owned, the exposure is not reported in the consolidated banking statistics for domestically-owned banks in Austria.


17 This figure is based on data as at mid-2013 as more recent data were not available at the cutoff date.

18 For further details on the current value of government measures see https://www.bmf.gv.at/finanzmarkt/finanzmarkstabilitaet/einzelinstitute.html (available in German only).

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Half of 2013, at the top 3 banks the decrease (–2.7%) was slightly lower than in the rest of the banking sector (–3.8%).

The distribution of capital ratios among Austrian banks highlights the solid capitalization of small local banks compared to larger banks. At the end of the second quarter of 2013, the median tier 1 capital ratio of all Austrian banks stood at 14.8% and thus 3.2 percentage points above the aggregate mean (see chart 24). The higher median ratio essentially reflects the high number of local banks with above-average capitalization: Half of all Austrian banks (i.e. the second and third quartiles) post tier 1 capital ratios between 11.2% and 19.9%. But the chart also shows that the range is increasing over time, indicating a growing differentiation at those small banks.

Because of relatively high RWA compared to total assets, the leverage ratio of large Austrian banks is higher than that of their peer groups. For the top 3 banks the leverage ratio was 6.5% in June 2013 compared to 4.1% for their European peers and 3.9% for their CESEE peers. A higher leverage ratio (reflecting lower leverage) is an important indicator of financial stability as it is (in contrast to RWA, which are calculated in different ways, as a recent analysis by the BIS shows) independent of banks’ internal models and/or changes in external ratings.

At the same time, despite recent improvements, Austrian banks are still facing challenges in strengthening their capital base. Even though the top 3 banks have improved their tier 1 capital ratios in recent years, the gap between them and

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19 This RWA reduction is partly driven by the merger of a former Austrian bank with its foreign parent, which contributed approximately 50 basis points.
20 The leverage ratio is defined as tier 1 capital over total assets.
their peers even widened. In addition to the need to replace state participation capital (so far one major bank has paid back state capital, another has begun to do so), this underpins the need for further action by Austrian banks.

Analysts and rating agencies have also pointed out the below-average capitalization of internationally active Austrian banks, considering it as one of their key weaknesses, although clear improvements have been noted since 2007. The stability of the Austrian banking system is supported by a generally sound business model (retail banking) and a solid liquidity position. In addition, improvements have been acknowledged as regards the reduced volumes of foreign currency loans in Austria. For these reasons, Standard and Poor’s, for example, assigns the Austrian banking system to the second best group (out of ten). However, a higher capitalization of Austrian banks is warranted as banks’ ratings currently benefit from comparatively high government support. The role of government support in banks’ ratings is widely expected to diminish against the background of a European resolution regime, which provides another reason why banks should make the necessary moves toward increasing their capitalization further. This assessment by external institutions confirms the findings and recommendations of the OeNB.

Financial market conditions have remained positive, although volatility increased somewhat. Equity prices of listed Austrian financial institutions have underperformed their European peers since the beginning of 2013. While price-to-book ratios of European banks recovered further and reached a level of approximately 0.9, the related ratios of Austrian banks remained unchanged or even declined. The slower performance can also be attributed to their capital positions and concerns about potential dilutions due to capital increases as well as to continuously high NPL levels in the CESEE region.

**Liquidity Situation of Austrian Banks Remains Stable but Challenging**

On the European level, the liquidity and funding situation of banks has remained calm for the past six months, yet vulnerabilities persist. Debt issuances remained at a low level throughout the first three quarters of 2013 compared to 2012. Nevertheless, market conditions have improved on average for European banks, as has been reflected by reduced volatilities in funding markets, narrowing spreads and a stable three-month EONIA swap rate since the beginning of 2013. Net issu-

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**The two peer groups analyzed here consist of, first, 12 European banks with relevant CESEE exposure and, second, of 31 European banks with similar business models.**
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The ongoing bail-in discussion will most likely affect the pricing and availability of bank funding in the medium term and could lead to increasing disintermediation, since larger nonfinancial corporations could become incentivized to tap debt markets themselves. While banks – mainly from euro area core countries – made use of the early repayment option of the two longer-term refinancing operations (LTRO) due to cost benefits in the money market, banks – especially those in the European periphery – still rely on central bank liquidity.

Austrian banks have reduced their participation in ECB open market operations considerably, by more than 65% since the beginning of 2013 compared to year-end. The actual total volume of the allotments to Austrian banks equals 0.7% of the ECB total, well below the proportional share of Austrian banks in the Eurosystem (3.8% measured by total assets).

The liquidity buffer of Austrian banks has remained stable for the last six months (chart 26), while the cumulated net funding gap of the 29 largest Austrian banks (maturities up to 12 months without money market operations) decreased since then from EUR 41 billion to EUR 34 billion until the end of September 2013. Due to changes in the reporting regime in February 2013, the level of the current figures is somewhat higher than a year ago. Adjusted for those changes, the most recent value is nevertheless only slightly above the long-term average. The net position of planned debt issuances to repayable debt has continued to improve moderately, while the counterbalancing capacity remained stable at EUR 99 billion.

Turning to foreign currency funding, banks continued to narrow their liquidity gaps in U.S. dollar and Swiss franc funding. However, some banks still rely heavily on short-term foreign currency swaps to fund their foreign currency operations and also hold low levels of liquidity buffers denominated in U.S. dollars and Swiss francs, which lowers their stress resilience. Therefore, banks should continue their efforts to reduce their U.S. dollar and Swiss franc positions, diversify their funding sources and strengthen their liquidity buffers in these currencies.

The Austrian banking system has traditionally featured a very stable liquidity position, as deposits play an important role in funding. Austrian households hold roughly 50% of their financial wealth as bank deposits, much more than their peers in the U.S.A., the U.K. and the euro area, which contributes to a stable refinancing source. While the deposits of domestic customers increased by EUR 0.8 billion in Austria as at June 2013 year on year, foreign customers reduced their deposits by EUR 2.4 billion due to expectations of persistently low interest rates. As a result, customer deposits at Austrian banks totaled EUR 358 billion, down EUR 1.6 billion compared to mid-2012.

Similar to developments in Austria, deposit growth at Austrian subsidiaries in CESEE was negative over the past few quarters up to June 2013. Therefore the funding gap (as indicated in chart 27) turned positive again. The decline became especially apparent in the decrease in retail deposits in the Czech Republic, Poland and some Western Balkan countries.

The recent financial crisis has shown that banks with limited local funding sources were significantly more likely to suffer higher loan losses than others. In 2012, the OeNB and the FMA published a “sustainability package”\(^{24}\) (geared in particular to subsidiaries of the top 3 Austrian banking groups) stipulating that banks with loan-to-local stable funding ratios\(^{25}\) (LLSFRs) of above 110% are considered “exposed.” Since then, the sustainability of banks’ new business has been monitored more closely than ever. Besides, a special focus has been put on the risk-adequate pricing of intragroup liquidity transfers. The results of these processes are updated quarterly, and while the focus is clearly on year-end data, interim analyses provide insights on emerging trends. The results are regularly shared.

\(^{24}\) FMA and OeNB (2012). Supervisory guidance on the strengthening of the sustainability of the business models of large internationally active Austrian banks.

\(^{25}\) The definition of the LLSFR and its components (in the stock) is: volume of loans to nonbanks after provisioning divided by the local stable funding (i.e. deposits from nonbanks + supranational funding + capital from third parties + the total outstanding volume of debt securities with original maturities of one year or more issued by the subsidiary to investors outside their consolidated group).
Austrian Financial Intermediaries: Achieving Sustainable Profitability and Strengthening the Capital Base Remain Key Challenges

The latest available data are from June 2013, when three quarters of the monitored subsidiaries were considered to be not exposed, since their stock LLSFRs were below 110%; only two exposed subsidiaries were found to also exhibit an unsustainable trend in their new (year-on-year) business. Again it should be noted that the locus is on year-end data; intra-year data are being used for steering measures.

Intragroup liquidity transfers to all CESEE subsidiaries have substantially declined (from EUR 40 billion in mid-2012 to EUR 29 billion in June 2013). The average LLSFR for the sample of monitored subsidiaries remained broadly flat at around 90% in the first half of 2013.

Box 4

Key Recommendations of the Austria Financial Sector Assessment Program (FSAP) 2013

The Austrian financial system and supervisory practices underwent a comprehensive assessment by the International Monetary Fund (IMF) during 2013 in the context of the Financial Sector Assessment Program (FSAP). The findings are summarized in the Financial Sector Stability Assessment (FSSA), which – together with the results of the 2013 Article IV Consultation – was published by the IMF in September 2013.1 This box gives an overview of the key results and recommendations regarding the three core elements of the FSAP: (1) financial stability assessment, (2) financial sector oversight and (3) crisis prevention and management.

The IMF mission team first evaluated the source, probability and potential impact of the main risks to macrofinancial stability in Austria in the near term. The risk assessment included various stress tests for the Austrian banking system (solvency, liquidity, contagion), whose results were summarized in the Financial Stability Report 25, published in June 2013, and in the FSSA. More information on the stress testing methodology can be found in the special issues section of this issue.2 The overall risk assessment of the IMF is broadly in line with the results the OeNB derives from its continuous monitoring and assessment of systemic risk. The key recommendation of the IMF concerns a further strengthening of banks’ capital buffers, which echoes the stance of the OeNB published in its recent Financial Stability Reports.

The assessment of financial sector oversight in Austria, the second core element of the FSAP, mainly covered the areas of banking, insurance and macroprudential supervision. As in most FSAPs around the world, the regulatory framework and supervisory practices with respect to the banking sector were assessed by analyzing their compliance with the Basel Core Principles (BCP) of Effective Banking Supervision (the revised version of September 2012 was applied for Austria). The key recommendations from the BCP assessment regard further improvements in the “ladder” of supervisory responses, from corrective action to recovery and resolution planning, and in the governance of the FMA. Another area for improvement that was identified is risk management and corporate governance practices in small and medium-size banks. Overall, many of the recommendations for banking supervision require changes in legislation, i.e., action by the relevant executive and legislative bodies.

As regards macroprudential supervision, the IMF recommendation to set up a macroprudential authority with a clear legal mandate for policy formulation and rule-making is broadly but not fully met by the forthcoming establishment of the Financial Market Stability Board starting in January 2014.3

1 http://www.oenb.at/de/presse_pub/aussendungen/IMF_AIV/uebersicht_imf.jsp
In addition to the assessment of financial stability risks and the adequacy of the supervisory framework, the FSAP also evaluated authorities’ capacity to manage and resolve a financial crisis, should the risks materialize. This third element of the FSAP also included an evaluation of the financial safety net, in particular deposit insurance but also bank resolution and the lender of last resort function. The two key recommendations here are to establish a legal framework for orderly bank resolution and to reform the Austrian deposit guarantee system with the aim of creating a single ex-ante funded system with risk-based contributions. To operationalize the latter, the IMF recommends the creation of a high-level working group to prepare a suitable reform proposal for the Austrian deposit guarantee system together with the Ministry of Finance and other stakeholders as soon as possible. While the working group should be guided by the FSAP recommendation, it may be useful to also take into consideration forthcoming changes with respect to bank resolution and possibly also the existing Austrian bank levy.

The OeNB welcomes the comprehensive assessment of the Austrian financial system and supervisory structure. The Austrian parliament and other policymakers would be well advised to take the IMF recommendations into consideration when setting the regulatory and supervisory reform agenda in order to ensure financial stability in Austria while limiting the need to use public funds in the future.

**New Oversight Requirements for Payment Systems**

The Eurosystem-wide harmonization of oversight activities has made further progress in financial market infrastructures (i.e., payment and securities settlement systems, central counterparties and trade repositories). After including the “CPSS-IOSCO Principles for Financial Market Infrastructures” (PFMIs) in the oversight framework of the Eurosystem, the ECB decided to implement the PFMIs by means of a regulation, which is to cover both large-value and retail payment systems of systemic importance. It will replace the “Core Principles for Systemically Important Payment Systems” introduced by the ECB in 2001.

Furthermore, the preparations for the cooperative oversight framework of TARGET2-Securities (T2S) are well underway in order to promote the safety and efficiency of payment systems. The ECB will act as lead overseer of T2S and will closely cooperate with the competent overseers and supervisors of the participating central securities depositories.

Turning to retail payments, in July 2013 the European Commission published a proposal for a revised Payment Services Directive (“PSD2”), which will also cover third-party service providers offering online banking-based payment initiation (“payment initiation services”). Furthermore, the PSD2 will contain enhanced security and authentication requirements for payment services providers, which rely on the “Recommendations for the security of internet payments” released by the European Forum on the Security of Retail Payments (a voluntary cooperative initiative between overseers of payment services providers and overseers from the European Economic Area) and approved by the Governing Council of the ECB in January 2013. The core objective of the recommendations is to ensure that the initiation of internet payments as well as access to sensitive payment data should be protected by strong customer authentication so that only the rightful user can initiate a payment.

The deadline for the mandatory conversion to the SEPA payment instruments is rapidly getting closer. As of February 1,
2014, the national credit transfer and direct debit schemes of the euro area countries will have to be replaced by SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD). The OeNB has cooperated closely with the relevant stakeholders in order to ensure a smooth and timely SEPA-transition in Austria.

### Crisis Planning and Early Intervention Regime for Credit Institutions in Austria

In July 2013, the Austrian Banking Intervention and Restructuring Act (BIRG), amendments to the Austrian Banking Act and the Financial Market Authority Act were adopted. As credit institutions have to prepare recovery and resolution plans, the general purpose of the new laws is to establish a regime for crisis prevention, planning and early intervention at credit institutions. Furthermore, certain early intervention tools are introduced, which the Financial Market Authority (FMA) can use if specified indicators fall below certain thresholds.

The main objective of the new framework is to prevent credit institutions from becoming distressed and, hence, to reduce the likelihood that public funds are used to bail out credit institutions. The law is based on the European Commission’s proposal for a directive on the recovery and resolution of credit institutions and investment firms (the BRRD). However, the Austrian framework does not provide for resolution instruments as proposed in the BRRD. These instruments will be introduced with the transposition of the BRRD into national law.

In order to prepare for crisis scenarios, credit institutions are to establish recovery and resolution plans. Recovery plans must describe the measures a credit institution intends to take in the event of a significant deterioration in its financial situation. Resolution plans are to demonstrate how a credit institution can be wound down or reorganized. The FMA assesses both the recovery and resolution plans and may require amendments if deemed necessary. The FMA seeks the expert opinion of the OeNB as to whether the legal requirements for recovery and resolution plans as defined in the law are met.

The FMA may exempt credit institutions from certain requirements or reduce the level of detail required, if the nature of activities of the credit institution, its size and interconnectedness with other financial market participants allow such an exemption. A full exemption from preparing recovery and resolution plans may be granted if, in the event of that credit institution’s insolvency, there are no concerns that this would have any material adverse impact on the financial markets, on other credit institutions or on funding conditions.

As a supplementary feature to strengthen the preventive powers of the FMA, additional tools for taking early intervention measures are introduced: If a credit institution fails to comply with capital or liquidity requirements under the Capital Requirements Regulation or is at risk of violating these requirements, the FMA will take early intervention measures as set out in the Austrian Banking Act. The FMA may order the OeNB to carry out an on-site inspection in order to determine whether the prerequisites for early intervention are met. To this end, the OeNB has to issue an expert opinion.

### Insurance Companies and Pension Funds Overall Resilient but Challenged by Low Interest Rate Environment

Favorable market conditions led to a better performance of Austrian mutual funds (4.9% year on year), pension funds (6.2% year on year) and insurance companies (4.3% year on year) in the first half of 2013 compared to 2012. However, the negative quarterly performance of mutual funds (−1.7%) and pension funds (−1.3%) in the second quarter of 2013 indicates that conditions can change quickly and that the capital gains registered with bonds during a period of falling or compressed yields can prove volatile in the current market environment.
The persistent low-yield environment poses a challenge to traditional life insurers’ and pension funds’ products with long-term minimum interest guarantees, as reinvestments can only be undertaken at comparatively low yields. Insurers and supervisors in Europe have already responded to the risk of a prolonged period of low interest rates. Some companies have started to shift from fixed and/or long-term guarantees to unit-linked life insurances, transferring the investment risk to the policyholder. The European Insurance and Occupational Pensions Authority (EIOPA) has published an opinion outlining a coordinated supervisory approach to this issue and the FMA continues to cooperate with firms identifying their specific vulnerabilities. The return on investments in the Austrian life insurance business was stable at around 4% (year on year) during the first half of 2013 and covers the guaranteed interest rate, which lies slightly below 3% for the stock and 1.75% for new business.

The life insurance business suffered from a weak macroeconomic environment, from a change in taxation and the competition from other saving products. Nevertheless, after nine consecutive quarters of decreasing premia, nominal premium growth of 1.4% in the first half of 2013 was a positive sign.

A number of natural disasters led to a decline in the underwriting results of property and casualty insurers in early 2013. Premium income increased slightly by 1.7%. The combined ratio for property and casualty insurance was 94% and thus below the critical value of 100%. Health insurance premium income posted average premium growth of about 3.7% and return on investment of 3%.

Contagion risk of insurance companies is mainly driven by their exposure to banks and sovereigns. By June 2013, insurance companies had invested EUR 31.6 billion in bank securities (40% of their total securities investment) and EUR 20 billion in sovereign bonds.

EIOPA has published a guideline for an interim regime that should prepare the industry for Solvency II. The focus was put on the governance system, a forward-looking assessment of undertakings’ own risk, the submission of information and the pre-application for internal models. The implementation in Austria will take place by an amendment of the Insurance Contract Act, which is expected to be enacted in mid-2014.

Pension funds in Austria continued to grow in the first half of 2013. However, the second quarter of 2013 showed a decline compared to the previous quarter, and further reductions of company pensions or supplementary payment obligations for companies with guaranteed pension plans might be possible. Pension funds invest more than 90% of their assets indirectly via mutual funds, the lion’s share of which (EUR 5.6 billion) are foreign mutual funds (44% Luxembourg, 19% German, 18% Irish). EUR 4 billion are invested in sovereign debt, EUR 2.3 billion in corporate securities and EUR 1.6 billion in bank securities.

Net asset value of mutual funds increased steadily, but the pre-crisis level has not been reached yet. In June 2013, the net asset value of mutual funds in Austria stood at EUR 148 billion – 5.8% higher than a year before. Nevertheless, there is still a notable gap to the all-time high of EUR 170 billion (in early 2007). The overall performance in June 2013 was 4.9% (year on year), mainly driven by

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26 A combined ratio of 100% indicates a balance between premium income and the sum of loss and expense ratio.
27 Source: OeNB securities statistics.
the performance of equity funds of more than 10%. However, the performance in the second quarter of 2013 was negative.

In July 2013, the Austrian Alternative Investment Fund Managers Act (AIFM Act), transposing the AIFM Directive into Austrian law, entered into force. Addressing certain shortcomings in the European regulatory framework, the AIFM Directive covers institutional funds, hedge funds, real estate funds and private equity funds. In particular, leveraged alternative investment funds will be analyzed from a financial stability perspective. In this respect, the OeNB will be responsible for identifying systemic risks to financial stability. In case of financial stability concerns, the OeNB is required to inform the FMA, which may impose limits to the level of leverage or other restrictions on AIF managers. In Austria, the share of specialized funds (open to institutional investors) continued to grow over the past 12 months and accounts for about 43% of the total net asset value of EUR 148 billion.