Further Writedowns Likely to Follow despite Incipient Economic Recovery

Slight Drop in Total Assets after Years of High Growth

After years of continued high growth dynamics, the Austrian banking sector’s consolidated total assets declined somewhat in the first half of 2009 as a result of the financial and economic crisis. At the end of June, consolidated assets stood at EUR 1,159 billion. This amount – which includes both Austrian banks’ domestic business as well as their subsidiaries’ operations in Central, Eastern and Southeastern Europe (CESEE) – reflects a decline by 1.4% from the end of 2008. During these six months, the share of Austria’s five largest banks\(^1\) dropped slightly from 57.6% to 57.1%. The level of unconsolidated assets likewise went down slightly in the first half of 2009, a trend that has since continued into the third quarter. In the first half of 2009, the decline amounted to 1.0% (see chart 27) and was entirely attributable to external operations suffering under the economic setback that hit the CESEE area in early 2009, lower demand for new loans abroad and heightened risk aversion. Claims on foreign nonbanks, for instance, shrank by 3.1% compared with end-2008.

Conversely, domestic business was very stable despite the repercussions of the financial crisis on Austrian banks and despite the recession in the real economy. Claims on domestic nonbanks increased by 3.1% to EUR 305.6 billion from mid-2008 levels.

The slight decline in total assets went hand in hand with a decline in banks’ dependence on the interbank market, in exchange for public support. The share of government-guaranteed bonds in total gross issuance of debt securities amounted to close to 29.2% in the first half of 2009, which means that government-guaranteed bonds accounted for as much as 7.7% of the consolidated issuance of debt securities by mid-2009. At the same time, banks were able to increase their deposit funding: the ratio of unconsolidated claims on nonbanks to retail deposits declined by 1.8 percentage points to 130.5%. The average residual maturity of liabilities shrank somewhat as the crisis progressed, but has remained stable since end-2008.

While the trends in the aggregate figures for the Austrian banking sector broadly mirror developments at the top-tier and other major banks, changes at small- and medium-sized banks with mainly regional operations can be highlighted by specifically looking at the second and third-tier banks, referred to as primary banks.\(^2\) These banks had a combined share of around 19% in unconsolidated total assets at the end of June 2009. What sets them off from the banking sector as a whole is above all the fact that their claims on nonbanks account for a higher share of total assets (57.5% at the primary banks, compared with 40.5% on average in the entire banking sector). The uncon-

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\(^1\) In terms of consolidated total assets, the five largest banks at end-June 2009 and end-December 2008 were: UniCredit Bank Austria AG, Erste Group Bank AG, Raiffeisen Zentralbank AG (RZB), Oesterreichische Volksbanken AG (VBAG), and Hypo Group Alpe Adria.

\(^2\) The primary banks sector includes certain joint stock banks; the savings banks without Erste Group Bank and Erste Bank; the Raiffeisen credit cooperatives without RZB; the regional Raiffeisen cooperatives and Raiffeisen holdings; as well as Volksbank credit cooperatives without VBAG.
solidated total assets of the primary banks rose by 3.5% to EUR 201 billion in the 12 months to June 2009, with the rise in the first half 2009 being a mere 0.1%.

**Operating Profits (before Risk Provisions) Driven by Cost-Cutting Measures as well as Good Interest Income and Trading Results**

Mirroring international trends, the earnings situation of Austrian banks has been improving. Driven by interest income, unconsolidated operating profits before risk provisions rose by 16.2% to EUR 3,331 billion by June 2009 year on year. Specifically, operating income increased by 4.8% to EUR 8.8 billion, while operating expenses dropped by 1.2% to EUR 5.4 billion. Consequently, banks’ cost-to-income ratio improved to 62% (compared with 65.9% in the second quarter of 2008).

Apart from weak profits in 2008, the recovery on the income side was above all driven by strong interest income. Net interest income jumped by 10.5% to almost EUR 4.4 billion in the 12 months to June 2009. With a share of 50% in total operating profits (end-2008: 40.1%), net interest income turned into the single biggest and hence increasingly important profit factor.

The other main driver behind the earnings recovery were financial transactions, which accounted for EUR 0.34 billion at the end of June 2009, following a negative result in 2008. At the same time, the share of financial transactions in total operating profits was rather small at 3.9%.
Despite reviving markets, fee-based income fell 16.1% short of the year-earlier figure at EUR 1.8 billion. Consequently, the share of fee-based income in operating income dropped by 5.1 percentage points to 20.6%. Income from securities and participating interests totaled EUR 1.49 billion at the end of June 2009, which corresponds to a share of 17% in unconsolidated operating profits.

On the expenditure side, administrative expenses dropped by 1.2% to EUR 4.7 Mrd billion, with staff costs stagnating in an annual comparison, and expenditure for goods and services having been cut by 2.2%.

Compared with the banking system as a whole, the operating profits of the smaller banks dropped by 0.1% from EUR 0.89 billion in June 2008 to EUR 0.8 billion in June 2009. Declining operating income (−3.3% year on year) and a small rise in operating expenses (+0.3%) caused the cost-to-income ratio to deteriorate from 66.2% to 68.6%. The decline in operating income was broad-based, reflecting an annual drop of net interest income by 0.7%, a decline in fee-based income by 7% and a decline in income from participations by 19.9%. Financial transactions, which are of rather limited importance for the primary banks, contributed EUR 48 million to operating income.

Given a sharp reversal in expectations in the third quarter of 2009, the Austrian banking sector’s unconsolidated expected profit for the year dropped by 15.8% below the comparable figure for 2008, following 6% growth in the second quarter of 2009 over the corresponding figure for 2008. In addition, there was a marked increase in expected credit risk costs. As a percentage of the profit expected for the year, expected credit risk costs jumped to 62.6%, from just 49% in the second quarter.
Consolidated Profits Lower despite Higher Operating Profits as a Result of Credit Risk Provisions

Before adjustment for risk provisions, consolidated operating profits improved sharply, broadly in line with unconsolidated profits. The former jumped by 50.4% or EUR 2.8 billion to EUR 8.5 billion, driven by a 6.8% rise in interest income and a marked rise in trading income year on year. While consolidated operating income increased by 14.3% year on year, operating expenses were cut by 3.8%. The consolidated cost-to-income ratio thus stood at 56% by the end of June 2009. Adjusted for taxes and minority interests, the consolidated end-of-period result continued to decrease by EUR 0.96 billion or 29.5% to EUR 2.3 billion, reflecting a major increase in risk provisions for loans (for further details on risk provisions see the section entitled “Lower Loan Quality Increases Risk Costs”).

Loan Growth Decelerated given Continued Difficult Conditions

The annual growth of loans to domestic nonbanks dropped markedly in the first nine months of 2009, especially since mid-year. At the end of September 2009, lending to domestic customers totaled approximately EUR 308.7 billion, which is about 1% more than the corresponding amount of 2008. In this context, loans denominated in euro rose by 2.3% whereas foreign currency loans decreased by as much as 4.7%. Loan growth was driven by (largely short-term) loans to nonbank financial intermediaries (+5.4%) and nonfinancial corporations (+2.1%); in contrast, growth of lending to households was disproportionately low (+0.3%) and fueled above all by demand for home financing. The highest growth rates were reported by savings banks, state mortgage banks and Raiffeisen cooperative banks, whereas growth was a lot more limited at joint-stock banks and special purpose banks.

Foreign currency lending, in particular to households, continued to decelerate in Austria in the first nine months of 2009; at the same time, nonbank financial intermediaries visibly increased their foreign currency lending (but from very low levels). Austrian banks had approximately EUR 53 billion in foreign currency loans outstanding (of which about EUR 36 billion had been taken out by households) at the end of September 2009, which corresponds to a reduction by 4.7% or by about EUR 2.6 billion year on year. This means that foreign currency loans accounted for about 17.3% of total loans granted to domestic clients, compared with about 18% at the beginning of 2009. The Swiss franc continued to be the single most important currency with a share of almost 87%. The developments during the financial crisis have starkly highlighted the risks that are associated with foreign currency lending (above all the risks associated with repayment vehicles, to which close to 70% of all bullet foreign currency loans taken out by households are linked). Thus, the decline in foreign currency lending partly reflects the rising risk aversion of borrowers and lower incen-
tives for taking out new loans given a higher volatility in foreign exchange markets and lower interest rate differentials. In the fall of 2009 the Austrian Financial Market Authority (FMA) and the OeNB, moreover, launched a framework of “self-regulation under supervision,” which will require banks to reduce their foreign currency lending to households. Its implementation is being monitored by the OeNB and the FMA.

**Lower Loan Quality Increases Risk Costs**

The repercussions of the global economic slump on the core markets of domestic banks — Austria and CESEE — have also markedly affected bank’s loan portfolios. The insolvency rate of Austrian companies has been on an increasing trend for more than a year. So far, however, the increase appears moderate and the rate remains far below past peaks (orange line in chart 29). In the CESEE countries for which corresponding data are available the insolvency rate of companies has also been going up. As historical data show that an economic slowdown typically triggers a rise in corporate insolvencies with a certain lag, the insolvency rate is bound to keep rising in the near future.

Consequently, Austrian banks have increased their credit risk provisions of late, but to different extents and at different paces. According to unconsolidated reports which provide an outlook on annual results, banks expected at end-September to have to write down claims on nonbanks by EUR 3.9 billion, which is EUR 1.6 billion above the corresponding figure for 2008. Domestic and foreign activities required different degrees of risk provisioning: While the unconsolidated loan loss provision ratio for domestic exposures increased fairly moderately in the first half of 2009 – by 7% (blue line in chart 29) – the consolidated loan loss provision ratio, which refers to the sum of domestic and foreign operations, rose by 24% over the same period (violet line in chart 29). The chart also shows that, on a consolidated basis, risk provisions

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6 The insolvency rate reflects the number of insolvencies that occurred in the given quarter, divided by the total number of companies at the end of the respective quarter; the resulting figure is annualized through multiplication by 4. Data source: Kreditschutzverband von 1870.

7 In this context, writedowns refer to flows of provisions that will have an impact on the profit or loss for 2009.

8 Stock of specific loan loss provisions for claims on nonbanks as a share of total outstanding claims. Claims are defined as loans and unlisted debt securities.

9 This ratio covers IFRS-reporting groups, which account for 81% of the consolidated total assets of the Austrian banking system. The consolidated loan loss provision ratio cannot directly be compared with the unconsolidated loan loss provision ratio, among other things because, for reasons of data availability, the consolidated ratio also includes interbank claims. Moreover, the two ratios may reflect different dynamics due to different underlying accounting provisions (unconsolidated: national commercial code; consolidated: IFRS).
have already come within close reach of the historical peak recorded at the end of 2002, whereas on a purely domestic basis the current level of risk provisions is still far below the historical peak.

The rising risk costs do represent a sizeable burden for the profitability of the Austrian banking system. While consolidated operating profits before risk provisioning have in fact increased by 50% in the first half of 2009 compared with the same period of 2008, the period results after tax and minority interests deteriorated by 30%.

The question remains as to whether risk provisions suffice to adequately cover the rise of credit defaults that is to be expected as a result of banks’ higher credit risk. Some indicators suggest that problem loans have been growing at a faster pace than the risk provisions made. For instance, the above-mentioned rise in the consolidated loan loss provision ratio by 24% in the first half of 2009 compares with a 30% rise in the ratio of provisioned claims. Against the backdrop of an uncertain outlook for the development of clients’ creditworthiness, adequate credit risk provisioning will be among the key challenges for Austrian banks in the future.

The global financial crisis has also highlighted the credit risks associated with securitized instruments. In the second quarter of 2009, a total of 17 Austrian banks reported investment exposures to securitized assets with a (consolidated) gross asset value of EUR 11.7 billion – down from EUR 13.6 billion at the end of 2008. Of those securitized assets, 37% (EUR 4.4 billion) qualified as most-senior capital, 56% (EUR 6.6 billion) as mezzanine capital and 3% (EUR 0.3 billion) as first-loss capital. The remaining 4% (EUR 0.4 billion) were securitized off-balance-sheet positions. Furthermore, not more than two banks were active in securitization origination, having securitized assets worth EUR 11.5 billion in mid-2009. Thereof, 91% (EUR 10.4 billion) qualified as most-senior capital, 3% (EUR 0.4 billion) as mezzanine capital and 6% (EUR 0.7 billion) as first-loss capital. Securitization activities were not sponsored by a single domestic bank.

Judging from capital requirements for backing position risks, banks’ exposure to market risk – i.e. the risk of value changes in respect of financial instruments triggered by general fluctuations of market risk factors such as interest rates, stock prices, exchange rates or commodity prices – continues to remain low relative to their exposure to credit risk; at the same time, the higher volatility of market risk factors during the crisis has had an impact on the profitability of Austrian banks.

While the contribution of the trading book to operating profits had been markedly negative in 2008 following positive pre-crisis results, trading activities revived in the first half of 2009. At the same time, interest rate risk in the banking book also increased again on a consolidated basis in early 2009, after having been slashed considerably in the second half of 2008. This sug-

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10 Again, this ratio refers only to IFRS-reporting groups.
11 In this respect, banks do not report the market value of the securitized assets but the value of the underlying assets, which consequently determine the volume of capital requirements. For a detailed overview of securitization, see the joint OeNB/FMA guideline on “Best Practices in Risk Management for Securitized Products” published in 2004. The guideline is available at http://www.oenb.at/en/img/ff_securit_engl_pcm16-23501.pdf.
12 Position risk refers to the risk of stock price and interest rate fluctuations in respect of positions in the trading book as well as to the risk of exchange rate and commodity price fluctuations in respect of all bank positions.
gests that banks have increasingly used the steepening yield curve to gain additional profits.

**Liquidity Conditions Have Improved Significantly**

Compared with the height of the financial crisis, liquidity conditions have improved significantly at Austrian banks, both on a consolidated and on an unconsolidated basis. (Unconsolidated) liquid claims (with maturities of up to three months) and liquid assets (e.g. euro government bonds) held by Austrian banks as at June 30, 2009, amounted to 125% of short-term liabilities (with maturities of up to three months). This corresponds to a rise by 16 basis points compared with December 31, 2008.

Even on a consolidated basis, the counterbalancing capacity over six months totaled EUR 114 billion (after money market and FX swaps) and EUR 92 billion (before money market and FX swaps) on December 4, 2009. In other words, even based on conservative estimates of cash-flows six months ahead, have banks got stable liquidity conditions, which have improved above all compared with December 31, 2008. For a detailed overview of liquidity conditions in the Austrian banking system, readers should refer to the studies section (from page 60 onward).

**New Legal Framework for Payment Services**

The Austrian Payment Services Act has been effective since November 1, 2009. This act transposes Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market — which provides the legal framework for SEPA — into national law. While consumers stand to benefit above all from a more rapid execution of payment transactions and from enhanced consumer protection clauses, the biggest innovation from a supervisory perspective is the emergence of a new category of payment service providers, the so-called payment institutions. Such payment institutions have been granted authorization to provide payment services, which used to be the prerogative of credit institutions as providers of classical banking services. To be able to provide payment services and to passport these services to other EU countries, payment institutions must be licensed.

It remains to be seen how much the new category of payment service providers is going to change the payment services landscape in Austria. At any rate, growth of retail payment transactions — which is the field in which payment institutions would operate — stagnated for the first time in the first half of 2009 after years of continued expansion. Likewise, securities settlement systems reported a decline in both the number (−18.4%) and the value of transactions (−26.6%) compared with the second half of 2008 as a result of developments in financial markets; this downward trend started to reverse, however, in March/April 2009. The vast bulk of payment transactions were processed through the OeNB’s HOAM.AT system.

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13 The counterbalancing capacity comprises expected net cash inflows plus additional liquidity that may be realized in the observation period.

14 Single Euro Payments Area.

15 In particular the deposit-, current account- and lending business, the issuance and administration of payment instruments as well as the remittance service business.

16 The Home Accounting Module Austria (HOAM.AT) is a real-time gross settlement system for processing euro payments provided by the OeNB to participants.
tem, as in the past (roughly 700,000 transactions worth approximately EUR 4,500 billion in the first half of 2009).

Regarding system security, system disturbances occurred six times in the first half of 2009, mostly as a result of maintenance works or software problems. In addition, the Austrian cash machine network went down in a number of areas in July 2009. This failure had been caused by a system migration that happened to activate security mechanisms, which caused the system to withdraw cash cards. The network operator has since designed in cooperation with the OeNB a number of measures that should prevent similar incidents in the future. To conclude, it should be noted that the turbulences in financial markets have in no way adversely affected the security or the availability of payment and securities settlement systems.

**Risk Costs on the Rise amid Difficult Environment in CESEE**

Even though the past few months saw first signs of recovery in the real economy and the financial markets had started to partly reflect this, forecasts about the sustainability and intensity of a potential economic upswing in CESEE remain subject to a high degree of uncertainty. With real economic developments typically having a delayed impact on risk measures and accounting treatment likewise exhibiting a lag, banks are expected to feel some further strain arising from exposures to credit risk before they will benefit from the improving situation.

Yet, high loan loss provisions notwithstanding, Austrian banks’ CESEE business posted a surplus in the first half of 2009. According to the business segment reports submitted to the OeNB, large Austrian banks’ activities in CESEE generated a consolidated profit before taxes of EUR 2.6 billion as at end-June 2009 (June 2008: EUR 3.3 billion). A comparison with the combined result of the two segments “domestic business” and “rest of the world” (June 2009: EUR 0.6 billion, June 2008: EUR 0.7 billion) patently attests to the continued great significance of the CESEE business segment. As total assets attributable to CESEE activities contracted by 4.5% to EUR 300 billion over the same period of time, this region’s share in Austrian banks’ consolidated total assets dropped from 31.2% (end-2008) to 30.7% (June 2009).\(^{17}\)

The downtrend in CESEE business was, however, not confined to Austrian banks. This is why Austrian banks’ fully consolidated subsidiaries in the CESEE region (68 following a merger in Croatia)\(^{18}\), with CESEE covering the NMS-2004\(^{19}\), the NMS-2007\(^{20}\), SEE\(^{21}\) and the CIS\(^{22}\), managed to retain their market share\(^{23}\) of 15.1% (without Rus-

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\(^{17}\) This figure for total assets was not distorted by significant restructuring in 2009 and therefore reflects developments in business activity of existing subsidiaries and in cross-border lending.

\(^{18}\) Excluding Bank Austria’s not fully consolidated joint venture in Turkey (Yapi ve Kredi Bankası).

\(^{19}\) New Member States that joined the EU in 2004: the Czech Republic (CZ), Hungary (HU), Latvia (LV), Poland (PL), Slovakia (SK) and Slovenia (SI).

\(^{20}\) New Member States that joined the EU in 2007: Bulgaria (BG) and Romania (RO).

\(^{21}\) Southeastern Europe: Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME), FYR Macedonia (MK), Serbia (RS) and Turkey (TR).

\(^{22}\) Commonwealth of Independent States: Armenia (AM), Azerbaijan (AZ), Belarus (BY), Georgia (GE), Kazakhstan (KZ), Kyrgyzstan (KG), Moldova (MD), Russia (RU), Tajikistan (TJ), Turkmenistan (TM), Ukraine (UA), Uzbekistan (UZ).

\(^{23}\) Both figures excluding Turkey.
The Financial Sector Benefits from Improvement in Financial Markets

sia: 21.9%) despite the 4% decline in their CESEE-based subsidiaries’ total assets since year-end 2008 (see chart 30).

As is evident from chart 31, the CESEE-based subsidiaries’ profitability clearly deteriorated, though, once loan loss provisioning was taken into account. In mid-2009, aggregate operating profit and the end-of-period result after taxes came to EUR 3.5 billion and EUR 1.2 billion, respectively (second quarter of 2008: EUR 3.2 billion and EUR 2.1 billion, respectively). Burdened by the comparatively steepest increase in risk provisions, the Austrian subsidiaries’ CIS business was affected most by the crisis. Consequently, the CIS share in Austrian subsidiaries’ aggregate end-of-period result after taxes plunged from 19% in mid-2008 to 3.5% in mid-2009.

Austrian subsidiaries’ claims on nonbanks (before provisions) remained broadly unchanged, with the 2% decline to EUR 172.3 billion, registered from the fourth quarter of 2008 to June 2009, mainly attributable to activity in the CIS. As to the subregions’ shares in loans extended by Austrian subsidiaries in CESEE (indirect credit volume), three posted a rise compared with end-2008: the NMS-2004 (from 46.9% to 48.1%), SEE (from 17.7% to 18.8%) and the NMS-2007 (from 15.3% to 15.4%). By contrast, the respective CIS share decreased from 20% to 17.7%.

Following its low in the third quarter of 2008, the aggregated loan loss provision ratio for indirect loans of Austrian subsidiaries in CESEE climbed steadily to reach 4% in the second quarter of 2009. While loan loss provision ratios increased particularly markedly for the CIS since end-2008, namely from 4.2% (year-end 2008) to 7.3% (end-June 2009), they also rose for the NMS-2007 (from 3.5% to 4.1%). Somewhat less pronounced were the increases for SEE (3.4% to 3.9%) and for the NMS-2004 (2.1% to 2.7%). A further rise in the loan loss provision ratios is on the horizon, above all in the CIS, given the increasing share of non-performing loans (as a precursor of provisions) and intensified loan restructuring.

The volume of direct loans extended by Austrian banks to nonbanks
and financial institutions in CESEE fell by 3.1% to EUR 51 billion from year-end 2008 to end-June 2009. While loans to nonbanks remained almost unchanged at some EUR 46 billion, loans to nonaffiliated financial institutions declined markedly throughout the CESEE subregions, namely by 21.5% to EUR 5.4 billion. The loan loss provision ratios for cross-border loans in CESEE continued to be considerably lower than those recorded for indirect loans. In a regional breakdown, the NMS-2004 account for the lion’s share in cross-border lending (53.5%), followed by SEE (24.3%), the NMS-2007 (15.1%) and the CIS (7.1%). Compared with year-end 2008, the NMS-2007 and the CIS each posted a decline in their share, which contrasts with increases in the shares of the NMS-2004 and of SEE.

On balance, Austrian banks’ CESEE business proved significantly less dynamic in the wake of the crisis, but an abrupt outflow of loanable funds from the region was avoided, inter alia, through concerted action of the concerned banks, the IMF, the EU and other international financial institutions under the European Bank Coordination Initiative. The exposure of Austrian banks to CESEE contracted by close to 6.6% to EUR 186 billion (EUR 297 billion including foreign-owned banks) over year-end 2008, but this is, apart from exchange rate effects, mainly ascribable to the interbank market and the CIS region.

Refinancing conditions improved owing to the consolidation of activities: The relation between loans to customers and customers’ deposits held at Austrian subsidiaries came down to 113% in mid-2009, after having peaked at 120%. Sharply rising loan loss provisions, strengthening local currencies and in part the return of previous deposit outflows were the main drivers of this development. Parent banks succeeded in cutting lending to their CESEE subsidiaries by 7%, after having increased their support (including derivatives) by almost 25% in the second half of 2008. Nevertheless, the share of

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24 This item covers cross-border loans to nonbanks and financial institutions captured in the Central Credit Register (reporting threshold > EUR 350,000) excluding intragroup credit. A historical comparison with earlier figures is not feasible as intragroup loans had previously been included.

25 In connection with the support packages offered by supranational organizations, Romania, Hungary, Bosnia and Herzegovina as well as Serbia also benefited from foreign banking groups’ commitments to maintain their exposures in CESEE (see chart 32), to participate in local stress testing exercises and to inject capital into subsidiaries should the need arise.

26 As defined by the BIS.
The Financial Sector Benefits from Improvement in Financial Markets

Central banks likewise made an important contribution to Stabilizing refinancing conditions in CESEE by expanding euro liquidity provision and agreeing on foreign currency liquidity swap lines, especially in Swiss franc. The crisis has highlighted the importance of sustainable refinancing, i.e. of placing greater weight on deposits and on matching currencies in lending, which basically raises the autarky of subsidiaries.

At end-June 2009, Austrian subsidiaries’ capital ratios were robust in all subregions. The aggregate CESEE capital ratio came to 11.9% at the end of June 2009, up from 11.7%, and the tier 1 capital ratio equaled about 10%. One cannot rule out, however, that over the medium term, the capital buffer has to be increased. The rise in capital ratios is primarily due to capital injections from parent banks and supplementary capital provided by international financial institutions. At end-February 2009, the largest lenders in CESEE – the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the World Bank – pledged to provide the banking sector with EUR 24.5 billion. The EBRD, set to channel up to EUR 6 billion into the CESEE financial sector in 2009 and 2010, for instance, extended long-term, subordinated loans (which raise the tier 2 capital ratio) to Austrian subsidiaries in Ukraine.

Trend Reversal in Capital Ratios Continues

Contrary to economic theory, which, given the links between finance and the real economy, assumes, ceteris paribus, capital ratios to decline during a pronounced economic downturn amid increasing risk-weighted assets, shrinking capital bases due to defaulting loans and difficulties in obtaining funding in the capital markets, the aggregate core capital ratio of all Austrian banks rose by some 141 (162) basis points from its low in the third quarter of 2008 to reach 8.71% (12.07%) by mid-2009. Two reasons can be identified for this increase:

First, the injection of government participation capital to the amount of – up to now – EUR 4.9 billion as well as (limited) private placements (EUR 1.3 billion) increased banks’ capital

27 See, for instance, the study “Quantifying the Cyclicality of Regulatory Capital – First Evidence from Austria” by S. Kerbl and M. Sigmund in this issue.

28 Limited private placements refer to the capital injections that banks added to their own funds in addition to the capital provided by the government in order to reduce dividend payments to the government from 9.3% to 8% (where these private placements account for more than 30% of the total capital injected).
The Financial Sector Benefits from Improvement in Financial Markets

buffers. Until the second quarter of 2009, Erste Group, RZB, VBAG and Hypo Group Alpe Adria had received government participation capital.\textsuperscript{29,30} Erste Group raised its capital stock by way of private placement on the stock exchange by EUR 1.74 billion. Although a large portion of the bank package has not yet been utilized, the capital injections have so far exceeded loan loss provisions.

Second, since end-2008, the Austrian banks have recorded a reduction in risk-weighted assets relative to total assets in both absolute and relative terms. This effect has been especially

\textsuperscript{29} Every additional EUR 1 billion capital injected under the bank support package would raise the banks’ aggregate capital ratio, ceteris paribus, by 0.15 percentage points. The full allotment of government funds (which, however, is unlikely at this point) would push the aggregate capital ratio over the 10% level.

\textsuperscript{30} A government support package for BAWAG P.K.K., comprising EUR 550 million of participation capital and guarantees worth EUR 400 million for the bank’s structured credit portfolio, is currently being reviewed by the European Commission.
The Financial Sector Benefits from Improvement in Financial Markets

Quantifying the shares of all the effects mentioned that contributed to the rise in the capital ratio until the second quarter of 2009 reveals that about 73% can be ascribed to the increase in eligible capital. Of these 73%, government participation capital accounts for some 78%, (largely limited) private placements make up some 20% and other net capital injections some 2%. The remaining 27% share in the increase in the capital ratio has been brought about by the reduction in risk-weighted assets and can be considered balance sheet streamlining.

Stress Test Results Improve but Differences at Individual Bank Level Increase Significantly

As part of its close monitoring process, the OeNB regularly conducts stress tests to assess the risk-bearing capacity of the Austrian banking system. The stress test of June 2009 showed that the large Austrian banks’ capital ratios would remain above the regulatory minimum requirement even if the crisis deepened severely. The outlook for the real economy has however not deteriorated since then: on the contrary, there have been first signs of a general recovery. The OeNB’s backtesting, which compares actual developments with the scenarios of June 2009, shows that this improvement in economic conditions has a positive impact on do-

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31 The top 6 Austrian banks are UniCredit Bank Austria, BAWAG P.S.K., Erste Group, RZB, VBAG and Hypo Group Alpe Adria. The sector “all banks without top 6” was adjusted for Oesterreichische Kontrollbank (OeKB), Oesterreichische Clearingbank AG (OeCAG) and Kommunalkredit.

mestic banks. In the first half of 2009, Austrian banks fared much better than projected even in the baseline scenario of June 2009 – particularly, in terms of operating income before risk provisioning. Still, the OeNB assumes that additional loan loss provisions will have to be made as developments in the real economy feed through to banks’ books with a certain lag. This situation is reflected in the baseline scenario of the current OeNB stress test, which is based on the OeNB’s most recent economic outlook for Austria and the IMF outlook for the rest of the world. Furthermore, to be able to assess the effects of another global economic slump – which from today’s perspective is not likely but quite useful to assume in a stress scenario – the OeNB in its “global double dip scenario” imputes that after recovering briefly in the second half of 2009, GDP growth will again plunge in

On a cumulated basis over both years, GDP growth in CESEE and the CIS would be 8.2 percentage points lower than expected in the current economic outlook (+1.5%, see chart 36). In addition, such a scenario would imply macroeconomic feedback effects on GDP growth in Austria, which would increase pressure on Austrian banks in the domestic market. For Austria, GDP growth would be 4.5 percentage points lower on a cumulated basis over two years, compared with +0.7% GDP growth as projected in the OeNB outlook for Austria of December 2009.

The OeNB’s scenario over a two-year horizon expects a nonperforming loans (NPL) ratio of 8% for Austrian banks in their home market and of 16% for their exposure in CESEE and the CIS. Austrian banks’ subsidiaries in the region would have to expect close to one-fifth of their outstanding loans to default. This NPL ratio would be three times as high as the ratio that is projected under the expectations as at end-June 2009. Apart from a deterioration in loan quality and an ensuing increase in loan loss provisions, the macroeconomic stress test scenarios imply a decline in operating income before risk provisioning and an increase in risk-weighted assets of banks using the internal ratings-based approach. All three measures, in turn, drive capital ratios, of which the key ratio for assessing overall risk is the tier 1 ratio. At an aggregate level, the stress test scenario leads to a decline in the tier 1

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Footnotes:
34 The impact of the macroeconomic scenarios was estimated on the basis of the data reported as at end-June 2009 for a two-year forecast horizon. The calculations are carried out as a joint bottom-up exercise of the OeNB and the six largest Austrian banks (“top 6”: UniCredit Bank Austria, Erste Group, RZB, VBAG, BAWAG P.S.K. and Hypo Group Alpe-Adria; this approach helps validate the assessment of possible adverse developments as realistic as possible.
ratio of both the six major Austrian banks and the entire Austrian banking system. In the stress scenario, the tier 1 ratio of the top 6 banks falls by 3.0 percentage points and that of the entire Austrian banking system by 2.4 percentage points over the two-year horizon, which, however, leaves both ratios well above 7% (top 6) and 8% (system) in 2009 and significantly above 6% (top 6) and 7% (system) at end-2010 and thus also clearly above the regulatory minimum requirement (see chart 37). While conditions are apparently improving at the system level, developments at individual bank level show large differences. On the one hand, most large banks still post far better results than aggregate figures suggest; on the other hand, though, some banks are harder hit by the repercussions of the crisis than others, expecting high writedowns and losses as early as 2009.

All in all, the OeNB’s most recent stress test shows that the prospective positive turnaround in the real economy has a favorable impact on the Austrian banking system’s capital ratios also under stress test conditions. This suggests that the Austrian banking system would be able to weather another slump in GDP growth, which, however, is unlikely from today’s perspective. However, should the severe scenario of the OeNB stress test occur, banks that have already suffered greatly from the current crisis would require further recapitalization. For this reason, the OeNB will continue to closely monitor developments in the real economy, the banking sector and the entire financial system in order to take counter measures as it has in the past if deemed necessary.

New Downgradings amid Mixed Picture of Major Austrian Banks’ Ratings

The downgradings of major Austrian banks’ ratings that started in fall 2008 continued in 2009. Between May and July 2009, Moody’s lowered the long-term deposit and the bank financial strength ratings (LTDR and BFSR) of both Hypo Group Alpe-Adria (from A2 and D– respectively) and ÖVAG (from Aa3 and C– respectively) to Baal (LTDR) and E+ (BFSR) and maintained the negative outlook for both institutions. Although a negative outlook prevails, none of the banks has been placed on credit watch negative. Standard & Poor’s and Fitch did not change...
any of the major Austrian banks’ ratings in the past two quarters. Fitch assigned an initial long-term issuer default rating of A with a stable outlook to RZB, however.

**CDS Spreads and Stock Prices Show Positive Trend**

Since the outbreak of the financial crisis on June 1, 2007, the stock prices of the listed large Austrian banks have moved roughly in line with those of other large European banks (Dow Jones EURO STOXX Bank Index). However, owing to Austrian banks’ large exposure to CESEE and the CIS, their stock price losses were some percentage points higher. After stock prices bottomed out in March 2009 however, a pronounced upward trend has been observed.

!![](chart38.png)

**Austrian Banks’ Stock Prices and CDS Spreads**

![](table2.png)

<table>
<thead>
<tr>
<th>Bank financial strength rating</th>
<th>Deposit rating</th>
<th>Long-term</th>
<th>Outlook</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>UniCredit Bank Austria</td>
<td>A1</td>
<td>Negative</td>
<td>D+</td>
<td>Negative</td>
</tr>
<tr>
<td>BAWAG P.S.K.</td>
<td>Baa1</td>
<td>Stabile</td>
<td>D</td>
<td>Stabile</td>
</tr>
<tr>
<td>Erste Group</td>
<td>Aa3</td>
<td>Negative</td>
<td>C–</td>
<td>Negative</td>
</tr>
<tr>
<td>Hypo Group Alpe-Adria</td>
<td>Baa1</td>
<td>Negative</td>
<td>E+</td>
<td>Negative</td>
</tr>
<tr>
<td>ÖVAG</td>
<td>Baa1</td>
<td>Negative</td>
<td>E+</td>
<td>Negative</td>
</tr>
<tr>
<td>RZB</td>
<td>A1</td>
<td>Stabile</td>
<td>D+</td>
<td>Negative</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service.

21 The Dow Jones EURO STOXX Bank index, which is a weighted index of bank shares, includes 39 European banks (e.g. Erste Group, Raiffeisen International and UniCredit).
The discrepancy between the price performance of Raiffeisen International and Erste Group stocks may be traced back to the fact that the regional distribution of the two banks’ exposure to CESEE differs. The CIS countries have been hit by the global downswing much more severely than the CEE and SEE countries.

The CDS spreads of the major Austrian banks have also mirrored the brighter outlook. Compared with the European financial industry’s average figures, represented by the iTraxx Senior Financials Index, the risk premiums of Austrian banks have fallen to a level adequately reflecting their substantial exposure to CESEE. Since the collapse of Lehman Brothers, the CDS levels of Austrian banks have fallen notably but still reflect market participants’ concerns about the quality of the CESEE subsidiaries’ credit portfolios. The implicit volatilities of at-the-money call options on the stocks of the two listed Austrian banks have also dropped to a level below 50% and therefore do not point to excessive price uncertainty in the near future.

Other Financial Intermediaries See Some Recovery

Even though markets started to recover in spring 2009, the risk appetite of Austrian financial intermediaries’ clients, which had declined during the financial crisis, continued to be subdued. Austrians were still hesitant to invest in new capital through mutual funds and life insurance contracts. Mutual funds – for the first time since the onset of the crisis – reported increases in assets under management, which were, however, mostly attributable to price gains. Fund- and index-linked life insurance products recorded sinking premium income. Investment service providers also suffered from investors’ smaller risk appetite, earning considerably less commission income.

The outlook for the other financial intermediaries sector has improved, in part thanks to the strong upswing in financial markets. Risks remain elevated, however, as the situation continues to be generally fragile and profitability has come under pressure in the wake of the financial crisis.

Insurance Companies Benefit from Market Recovery

The visible recovery in financial markets has led to some improvement in European insurers’ capital investment in the short term. However, as the momentum of the real economy remains subdued and, consequently, uncertainty continues to be high, the business outlook is still cloudy. According to Bloomberg, between summer 2007 and mid-November 2009, insurance companies’ write-downs caused by the financial turmoil totaled USD 234.5 billion worldwide, with the U.S.A. accounting for the lion’s share (USD 192 billion). European insurers were faced with write-downs of USD 40.6 billion. While initially insurers had felt the impact of the crisis primarily through capital investment losses, the global recession later additionally reduced premium growth, especially in the life insurance segment. The deteriorating conditions and lower operating results were also mirrored in European insurers’ ratings, which were mostly downgraded in 2009.

The iTraxx Senior Financials Index, which is a subindex of iTraxx Europe Index and includes 25 European financial stocks (16 banks and 9 insurance companies), is a CDS index for financial stocks.

Bloomberg does not specify figures for the Austrian insurance sector.
The pronounced upswing in financial markets, which continued throughout the entire second quarter of 2009, also had an impact on the Austrian insurance sector, with total assets (+4.9%), capital investment stocks (+5.1%) and net income on capital investment (+4.2) rising year on year.

Premium income was up slightly year on year (+0.5%). Demand for life insurance declined in Austria, just like at the European level, due to the difficult economic environment, heightened job uncertainty and reduced loan demand. The decrease in premium growth in the life insurance segment is attributable mainly to lower one-off payments for index-linked life insurance policies (–16% year on year). Changes in consumers’ risk appetite tend to affect demand for this insurance product particularly quickly, as policyholders bear the full investment risk. The property/casualty business hardly suffered under the recession in the first half of 2009. Thanks to high reinsurance ratios, weather-related damage that occurred in the first half of the year did not have a large impact on this segment’s results. Health insurance, accounting for slightly below 10% and hence the smallest share of the Austrian insurance market, continued to record robust annual premium growth of some 4% despite the financial crisis.

In light of the financial market recovery, the OeNB’s outlook for the Austrian insurance business has improved somewhat since the publication of the last Financial Stability Report. Still, the risks to the insurance sector remain elevated as the economic upswing and financial market conditions continue to be fragile. In particular, credit risk in the bond portfolio has an impact on hidden reserves and, as a consequence, insurers’ risk-bearing capacity. Market observers expect Austrian insurers’ premium income to fall slightly overall in 2009, mostly due to

Policyholders of unit-linked life insurances also bear the full investment risk.
the life insurance segment. In the present environment of low interest rates and a comparatively low share of stock investments, life insurers on their part may face problems in earning the guaranteed rate of interest on traditional life insurance contracts.

**Contagion Risk between Banking and Insurance Sectors**

The investments of Austrian insurance companies in the banking sector and the latter’s investments in the former serve as the basis for analyzing the contagion risks between these two sectors. At end-June 2009, the insurance sector’s exposure to the banking sector totaled EUR 17.4 billion or around 18% of the former’s total assets, with debt securities issued by domestic banks accounting for the lion’s share (EUR 11.2 billion). Accordingly, insurance companies’ investments with domestic credit institutions came to slightly more than 1.4% of Austrian banks’ consolidated total assets. At the same time, Austrian banks’ exposure to the domestic insurance sector in the form of loans and debt securities (according to Central Credit Register data) amounted to EUR 1.3 billion. This corresponds to 1.3% of the insurance sector’s and 0.1% of the banking sector’s total assets.

The mutual investments appear to be manageable in view of business and profit developments at the systemic level. The risk of contagion through the reputation channel, which plays a crucial role especially for listed companies with substantial CESEE business segments, shrank in line with market developments in the second quarter of 2009 but remains elevated.

**Mutual Funds Recover Notably after Slump in the First Quarter of 2009**

After a decrease in the first quarter of 2009 (–3.5%) assets under management by Austrian mutual funds recov—

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**Mutual Exposures of Insurance Companies and Banks**

<table>
<thead>
<tr>
<th>Austrian Insurance Companies’ Investments with Domestic Credit Institutions</th>
<th>EUR billion; share of insurance companies’ total assets in %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Insurance companies’ investments with banks:</strong></td>
<td>17.4; 18%</td>
</tr>
<tr>
<td><strong>Other:</strong></td>
<td>79.5; 82%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Austrian Credit Institutions’ Investments with Domestic Insurance Companies</th>
<th>EUR billion; share of insurance companies’ total assets in %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banks’ investments with insurance companies:</strong></td>
<td>1.3; 1%</td>
</tr>
<tr>
<td><strong>Other:</strong></td>
<td>98.7; 99%</td>
</tr>
</tbody>
</table>

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39 According to financial accounts data.

40 Loans of EUR 350,000 and higher must be reported to the Central Credit Register.
The Financial Sector Benefits from Improvement in Financial Markets

Within the framework of the ongoing financial market reforms, a number of securities markets were launched or significantly improved notably. Driven primarily by significant valuation gains (+EUR 7.8 billion) and less by net capital inflows (EUR 737 million), they posted a substantial 6.4% increase to EUR 135.6 billion in the year to end-August 2009. Investors withdrew capital invested in the market especially in February and March 2009, at a time when international financial markets were bottoming out and prices started to rally.

While in the first quarter of 2009, assets under management by retail funds dropped in all defined investment strategies (−5.6% in total), total assets under management by retail funds have increased since January 2009 by 1.4% (+EUR 1.2 billion) to EUR 83.9 billion as at end-August 2009. It should be borne in mind, however, that developments varied greatly across fund categories. While assets under management by equity funds have increased very strongly since February 2009 (+36.9% in the year up to August 2009), those managed by hedge funds and money market funds have contracted sharply (−50.3% and −25.2%, respectively).

Fixed-income funds, which accounted for 54% of retail funds’ assets under management, have also recorded a decrease since the beginning of 2009 (−1.8%). Institutional funds recorded smaller losses in relative terms or a higher increase in assets under management than retail funds in each of the first eight months of 2009 (+15.7% until end-August 2009). Interestingly, the share of institutional funds in mutual funds’ total assets under management rose from 29% before the outbreak of the financial crisis (2006) to 38% in August 2009. This is most likely attributable, besides possible return differentials, to the fact that investors in institutional funds shifted their investments within their funds, while retail investors in part liquidated their shares and invested the proceeds in government-guaranteed savings deposits.

A geographical breakdown of assets under management by Austrian funds shows that almost two-thirds are invested abroad. Such investments have

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41. Including income and expenses.
42. The difference between assets invested in the market and assets under management results from domestic mutual fund shares held by mutual funds. The volume of a fund-of-funds, for instance, only forms part of the assets under management, as such a fund does not hold assets invested directly in the market. Assets under management therefore change not only due to their performance as well as capital inflows and outflows but also due to changes in fund structures.
43. The category “other funds” (mutual funds that are neither fixed-income, equity, mixed, real estate or hedge funds) recorded an 11.1% rise in the first quarter of 2009.
44. The data for money market funds for the first quarter of 2009 (−15.6%) may seem surprising at first glance as these funds are very liquid and relatively safe and should have profited from the market uncertainty prevailing at that time. However, investors used this high degree of liquidity when selling their fund shares to cover their own liquidity requirements.
expanded by 9.5% since the beginning of 2009, while assets invested in Austria have gained only 1.5%. These uneven developments could indicate both different performances of local markets and the increasing investment of mutual fund capital abroad.

The share of the Austrian mutual fund market in European mutual fund assets remained stable at 2% in the first half of 2009. Luxembourg (25.6%), France (21.3%), Germany (14.7%) and Ireland (10.5%) continue to account for the largest shares. Aggregated fund assets (in euro) in Austria dropped by 22% from end-2007 to June 2009, slightly more strongly than the volume-weighted European average decline of 19.4%. Greece (−57%) and some CESEE countries have suffered major losses since end-2007; funds’ assets in Bulgaria, Poland and Slovenia shrank by more than half of their total volumes (−64%, −55% and −51%, respectively). In the first half of 2009, European funds’ assets grew by 4.8% to a total of EUR 6,378 billion.

After a very difficult year 2008, when their operating profit had tumbled by almost 50% to EUR 89.5 million, Austrian fund management companies sought to improve their cost-income ratios in the year under review. In the first three quarters of 2009, administrative expenses dropped by 7% compared with the same period of 2008, but operating profit fell even more strongly (−24%). The business outlook for domestic fund management companies hence continues to be subject to uncertainties.

Box 3

Financial Crisis Causes Investment Firms and Investment Service Providers to Suffer Reputation Losses

As at mid-October 2009, the Austrian Financial Market Authority (FMA) listed 116 investment firms and 109 investment service providers licensed to conduct business in Austria. These securities service providers differ mainly in the scope of their licensed business. In accordance with Article 4 Securities Supervision Act 2007, investment service providers are authorized to receive and transmit orders in transferable securities and in shares of mutual and real estate funds, whereas in accordance with Article 3 Securities Supervision Act 2007, investment firms are authorized to manage portfolios, to receive and transmit orders in all financial instruments and, in accordance with their respective license, to operate a multilateral trading facility (MTF). In addition, investment firms may conduct business EU-wide, investment service providers only in Austria.

Private investors’ reduced risk appetite and negative developments involving several listed real estate firms adversely affected the results of Austrian investment firms and investment service providers in 2008. In addition, some providers of investment services were faced with legal proceedings. All these developments caused reputation losses and the new business of providers of investment services to plummet. Investment service providers posted a sharper decline in turnover (−54%) than investment firms (−37%), whose sales revenues depend more strongly on recurring income. All in all, the providers of securities services recorded sales revenues from investment services in the amount of EUR 0.4 billion, the bulk of which is attributable to commission income. In comparison, Austrian banks’ commission income from securities transactions1 came to EUR 2.3 billion in 2008.

1 Banks’ commission income from securities transactions includes all fees and commissions (including trading margins and commissions payable by issuers to banks) that became payable in securities trading and in underwriting (issuances on behalf of third parties). It also covers securities and coupon sale commissions and other revenues and expenses from securities management (e.g. custody fees).
Severance Funds and Pension Funds Post Robust Growth Recently

The financial market environment proved difficult also for severance funds, mirrored mainly in the return on investments that severance funds achieved for prospective beneficiaries (2008: −2%). In the course of 2009, severance funds’ performance improved, however. The amount of assets under management increased sharply for structural reasons (+35% year on year to EUR 2.7 billion in the third quarter of 2009). This amount was driven strongly by contributions rising on an annual basis and hardly reduced by payouts (2008: EUR 127 million).

In the third quarter of 2009 alone, the volume of assets expanded by 9%.

Also thanks to this growth, the annual surplus of severance funds likewise rose steadily (from 2007 to 2008: +EUR 1.4 million to EUR 5.2 million). The costs and earnings of investment groups were balanced over the past five years: In the period from 2004 to 2008, administrative costs accrued totaled EUR 84 million, and investment earnings also amounted to exactly EUR 84 million.

The year 2008 was particularly difficult for pension funds, which invest more heavily in stocks. Their performance deteriorated by 13% (2008) and...
reduced their assets under management to below EUR 12 billion as at end-2008; this volume rose to EUR 13.3 billion by the third quarter of 2009. Factoring in annual contributions of some EUR 1 billion, this increase is traceable to pension funds’ better performance in the year 2009 so far. In 2008, pension funds earned an annual surplus of EUR 4.7 million.