

Austria's Financial Intermediaries

Develop Dynamically

Banks' Profitability and Shock Resilience on the Rise

Total Assets of Banks Continue to Grow Strongly

The strong growth of Austrian banks' unconsolidated total assets continued in the past months, reaching a new peak of EUR 697.7 billion in June 2005. This equals a year-on-year growth rate of 9.7% – the highest since end-2000. Once more, external business was important for this growth trend, both on the assets side (+20% year on year) and the liabilities side (+12.7%). Domestic interbank liabilities also increased considerably (+10.2%), as did Austrian banks' domestic issues (+18.1%), whereas domestic nonbank deposits only rose by 5.3% year on year.

In June 2005, the consolidated total assets of Austrian banks (including both subsidiaries in Austria and in particular in Central and Eastern Europe) were almost 13% higher than the unconsolidated result,¹⁷ with Austria's five major banks¹⁸ accounting for approximately 60% of total assets.¹⁹

The total number of banking offices, which, since its peak in 1992, has gone down steadily owing to increased consolidation of the Austrian banking sector, continued to decline in recent months. In June 2005, the number of banking offices in Austria came to

5,224 (–9.5% as compared to the 1992 peak), breaking down into 886 head offices and 4,338 branch offices. Taking into account newly opened banking offices, the number of head offices dropped by 9 year on year, that of branch offices by 21. The strongest reductions were recorded in Tyrol (–11 banking offices), Burgenland (–10) and Lower Austria (–7). A year-on-year increase could particularly be observed in Salzburg (+4). Despite the overall downtrend, bank density in Austria is still high by international comparison, with one banking office serving 1,570 inhabitants.

Banks' staff capacity came to 65,573²⁰ in June 2005, marking a year-on-year decrease of 2.5%. Unconsolidated total assets per full-time equivalent (FTE) employee rose from EUR 9.9 million at end-2004 to EUR 10.7 million²¹, which points to a more efficient utilization of human resources. This increase means that Austrian banks are approaching the EU average, which was EUR 11.1 million at end-2004.²² In this respect, however, pronounced differences exist between the various banking sectors in Austria. While special purpose banks recorded total assets per FTE employee of approximately EUR 18.7 million in June 2005 and state mortgage banks and the branch offices of foreign banks posted EUR 15.8 million and EUR 15.4 mil-

¹⁷ As banks use different accounting systems, aggregated data may provide a slightly distorted picture.

¹⁸ Bank Austria Creditanstalt AG (BA-CA), Erste Bank der oesterreichischen Sparkassen AG (Erste Bank), Raiffeisen Zentralbank Österreich AG (RZB), BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG (BAWAG P.S.K.) and Österreichische Volksbanken AG (ÖVAG).

¹⁹ In a Europe-wide comparison, Erste Bank, the largest Austrian credit institution in terms of consolidated total assets (end-2004), was ranked as the 43rd-largest bank; RZB ranked 66th, BAWAG P.S.K. 74th and ÖVAG 111th (Source: *The Banker: September 2005, Top 300 European Banks*). Bayerische Hypo- und Vereinsbank AG, the owner of BA-CA at that time, ranked 18th in this comparison.

²⁰ Part-time employees are included on a pro rata basis.

²¹ It should be noted, however, that off-balance sheet instruments are not included in this figure, which somewhat limits the informative value of this indicator.

²² See European Central Bank. 2005. *EU Banking Structures* (p. 10). This publication cites figures for Austria which slightly diverge from those quoted above owing to a different definition of credit institutions.

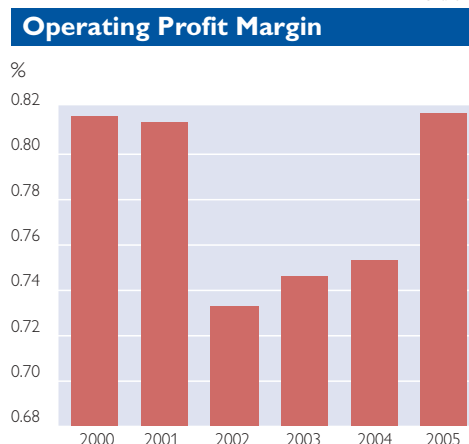
lion, respectively, the corresponding figures for Raiffeisen and Volksbank credit cooperatives only came to EUR 8.1 million and EUR 7.1 million, respectively. Joint stock banks (EUR 12.3 million), savings banks (EUR 10.1 million) and building and loan associations (EUR 11.9 million) produced mid-range results.

The nominal value of Austrian banks' special off-balance sheet operations (derivatives transactions), which has a history of pronounced fluctuations, dropped by 29.4% year on year, reaching EUR 1,527.9 billion (unconsolidated) in June 2005. This means that the nominal value of special off-balance sheet transactions was only 2.2 times as high as unconsolidated total assets.²³ Interest rate contracts once more accounted for the major share of special off-balance sheet operations (82.9%), followed by foreign exchange derivatives and gold contracts (16.1%).

Banks' Profits Continue Their Uptrend

In line with the positive trend of the previous two years, Austrian banks' profit growth continued to accelerate in 2005. In the first half of 2005, operating profits grew by 12% against the first half of 2004; in 2003 and 2004 operating profits had risen by 4.5% and 7.6%, respectively. At 0.82%, the operating profit margin²⁴ again reached the level recorded in 2000 and 2001 (see chart 17), but still fell short of the high level of the mid-1990s (around 0.90%).

Chart 17



Source: OeNB.

Note: The 2005 operating profit margin is based on the annualized result of the first six months of 2005.

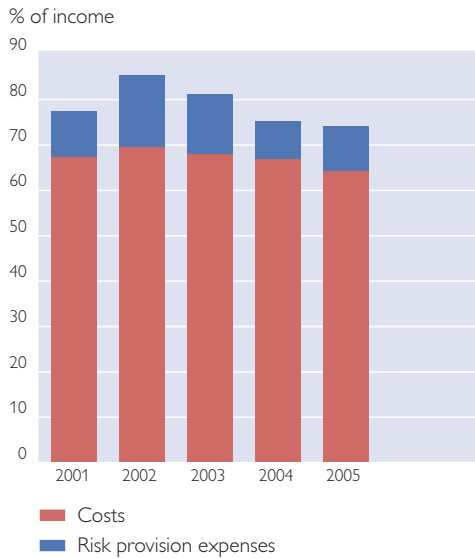
The favorable trend in Austrian banks' operating business was also mirrored by the positive development of the cost/income ratio, which reached its lowest level since 1995 in the first two quarters of 2005 (64%). Per June 30, 2005, banks expected risk provision expenses to go up in the full year 2005 compared to 2004, when securities risk had boosted profits due to a one-off effect from releasing hidden reserves for participating interests. Per June 30, 2005, credit risk (which also features in risk provision expenses), by contrast, was expected to decline in 2005 for the fourth year in a row; based on banks' estimates, it was to decrease by 10% year on year. Even if the altogether slightly higher risk provision expenses are taken into account, the risk-adjusted cost/income ratio²⁵ for 2005 will reach a level clearly below the values of the past ten years (for a five-year comparison see chart 18).

²³ This considerable decline is, above all, attributable to the reduced business activity of one single major bank. If the results of this bank are not taken into account, the nominal volume of special off-balance-sheet operations only went down by 0.8%.

²⁴ Operating profit relative to average total assets (annualized).

²⁵ Sum of operational costs and risk provision expenses relative to income.

Chart 18
Risk-Adjusted Cost/Income Ratio



Source: OeNB.

Note: The cost and income figures for 2005 are based on the annualized result of the first six months of 2005; risk provision expenses for 2005 are expected annual values.

Banks expect unconsolidated return on assets (ROA) for 2005 to be slightly lower (0.42%) than in 2004 due to the above-mentioned valuation effect on expenses for securities risk provisioning. This effect had an impact on unconsolidated return on equity (ROE) as well, which is expected to fall from 9.1% in 2004 to 8.6% in 2005 according to preliminary estimates. A breakdown of the change in ROE into three components – risk-adjusted ROA, risk profile and regulatory leverage²⁶ – shows that the major part (91%) of the reduction in ROE is attributable to the decline in risk-adjusted ROA. The latter, in turn, was affected by the slight (expected) decrease in annual profits (–1.1%) and the simultaneous increase in risk-weighted assets (+4.6%). Given the fast growth of total assets and the constantly high capital ratio, neither risk

profile nor regulatory leverage are going to have a significant impact on ROE. The major factors driving the deterioration of ROE thus are the decrease of reported profits after risk provision expenses (owing to the valuation effect in 2004) on the one hand and the high increase in total assets on the other.

Ever since 2002, which was a bad year for Austria's banks, income growth rates have been markedly higher than those of costs. In the first half of 2005, however, the acceleration of income growth (6.2%) was accompanied by an increase in costs which was somewhat more pronounced than in the previous years (3.2%). On the earnings side, fee-based income and income from participating interests remained the main driving forces; on the cost side, the growth of staff costs was subdued (+1.5%), while administrative expenses increased markedly (+7.5%).

While in the first half of 2005 fee-based income, income from participating interests and trading income increased by 13.9%, 13.6% and 7.8%, respectively, interest income, which has remained more or less constant since 2002, grew by a mere 0.5%, with the continuously declining interest margin being offset by moderate credit growth. In particular, the interest margin for euro transactions has contracted strongly; the interest margin for foreign exchange transactions has been approaching the level of the interest margin for euro transactions from a lower starting point, but still remains somewhat narrower. Moreover, the share of securitized liabilities in overall interest liabilities, which has slightly increased in recent years, came to

²⁶ Risk-adjusted ROA depicts annual profits relative to risk-weighted assets; risk profile captures risk-weighted assets relative to total assets; regulatory leverage denotes total assets relative to equity.

24% in the first half of 2005. Refinancing via securitization is much costlier than via customer deposits and inter-bank liabilities. Based on the development of interest rates on new business, it is likely that the interest margin will further decline: While interest on customer deposits remained broadly stable between June 2004 and June 2005, the interest rates on loans – particularly on consumer credit and home loans – have gone down considerably.

An analysis of fee-based income reveals that three-quarters of the recorded 13.9% growth are accounted for by securities transactions, which had strongly dropped in the two-and-a-half years following 2000 but which, since mid-2003 have experienced accelerating growth: In the first half of 2005, fee-based income from securities transactions shot up by 30.5%, a growth rate which was previously only achieved in 2000. Income from participating interests also picked up considerably (+13.6%); 80% of this increase stemmed from domestic sources. Trading income, whose significance is relatively limited for Austrian banks, rose by 7.8% in the first half of 2005, following a rather weak performance in 2004 (–1.7%). In this area, banks benefited from price gains on the stock and bond markets, while income from foreign exchange trading and off-balance sheet financial transactions decreased. The negative correlation between trading income on securities transactions and income on off-balance sheet financial transactions seems to indicate that trading activities are, at least in part, being hedged. Fee income margin and participating interest margin²⁷

have only slightly improved year on year owing to the strong growth in total assets; the trading margin, by contrast, has remained unchanged.

Consolidated Profits Much Higher than Unconsolidated Results

Consolidated profits developed similarly to unconsolidated results, but margins were much higher on a consolidated basis given the higher margins of banking business in Central and Eastern Europe: At 63% the consolidated cost/income ratio was only slightly below the unconsolidated ratio, while the consolidated profit margin²⁸ at 0.96% clearly surpassed the unconsolidated value. The result for the consolidated total banking sector after risk provisioning and taxes (ROA: 0.65%) clearly illustrates the relatively low profitability of domestic business (expected unconsolidated ROA for 2005: 0.42%).

As in previous periods, the rise in costs (+11%) and income (+12%) was much more pronounced on a consolidated basis, which is attributable to Austrian banks' expansive business activities in Central and Eastern Europe. Interest earnings continue to account for the major share of Austrian banks' operating income. In the first half of 2005, interest income – on a consolidated basis, including income from securities and participating interests – increased by 12% year on year, which meant that it accounted for around 63% of total operating income. Fee-based income grew by 15% year on year, while trading income remained unchanged. On the cost side, staff costs went up by 8%, administrative costs by 13% and write-downs by 14%.

²⁷ These margins represent fee-based income, income from participating interests and trading income, respectively, relative to average total assets (annualized).

²⁸ End-of-period profits relative to total assets.

Business in Central and Eastern Europe²⁹ is thus much more profitable than domestic business, which, however, has also clearly picked up. In the period under review, the cost/income ratio reached its lowest level since 1995, and the profitability of domestic operating business returned to the high level of 2000. Due to fierce competition in the banking sector, however, it seems unlikely that Austrian banks are going to reach the even higher profit margins of the mid-1990s in the near future. Consequently, the profitability of the Austrian banking sector – even when including consolidated external

business results – remains low compared to banking sector profitability in other European countries.

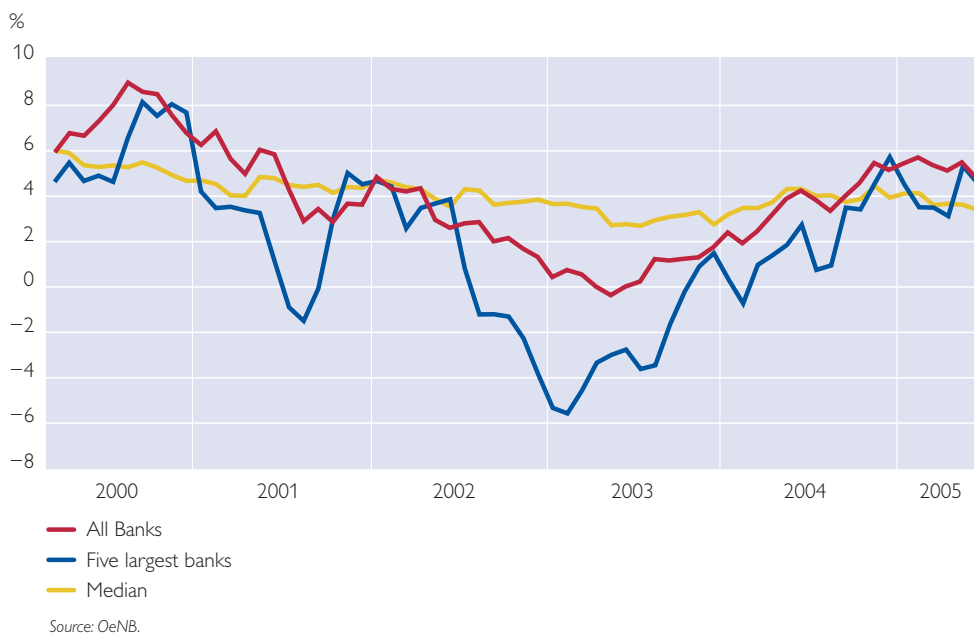
Loans Expand as Loan Loss Provisions Continue To Decline

Steady Growth in Bank Lending

Following steady growth in bank lending in 2004, loans in Austria continued to grow at a constant pace of around 5% on average against the backdrop of a favorable interest rate trend in the first half of 2005. In June 2005, the annual loan growth of all Austrian banks was 4.7% (see chart 19).

Chart 19

Annual Loan Growth of Austrian Banks



After the first six months of 2005, the annual loan growth of the five largest banks was 4.5%. The loan growth posted by these banks in recent months can be traced back to a single major Austrian bank, in particular. However, this sample contains a large spread of

values and also includes major banks whose financing performance developed extremely poorly compared with the previous year.

The median value of loan growth is less influenced by the performance of a single bank and has been largely stable

²⁹ For details on Austrian banks' business activities in Central and Eastern Europe see the corresponding section below (p. 48–51).

in the past. In mid-2005, the median value for the change in lending was 3.3% year on year.

An analysis of loan growth by individual banking sectors also reveals a similar picture. Loan growth, which started to accelerate in 2004, is visible in almost all banking sectors. The building and loan association sector has performed very favorably in recent months. Whereas this sector registered a drop in lending of 2.05% in mid-2004, its financing performance continued to advance strongly in the first half of 2005, posting an annual growth of 2.6%. If this sector's past sluggish lending was attributable, inter alia, to the appeal of foreign currency loans (which building and loan associations are only permitted to grant to a limited extent for statutory reasons), in the last few months it seems to have succeeded in attracting new customers. In addition, educational and private nursing loans recently provided for under the Act on Building and Loan Associations are also likely to have an impact in the future.

An analysis of loan growth by economic sectors shows that nonbank financial intermediaries such as insurance companies and investment funds have strong borrowing requirements (+11.9% in the first half of 2005) vis-à-vis banks. Lending to enterprises and households, by contrast, remained unchanged. At mid-2005, the annual growth of loans to enterprises stood at 2.2%. The annual growth rate of

loans to households³⁰ was 6.8%, with foreign currency loans continuing to advance at a well above-average pace. Loans to general government grew only slightly, posting an annual growth rate of 2.5% in June 2005.

Continued Boom in Foreign Currency Loans for Households

Coming to slightly more than EUR 50 billion in July 2005, total foreign currency loans to domestic nonbanks have remained persistently high. This figure is equivalent to a 19.5% share in all loans issued to Austrian nonbanks.³¹ Once again, households are responsible for this scenario. Whereas the share of foreign currency loans to nonfinancial corporations recently declined slightly to 14.2%, the trend in foreign currency loans to households has continued unbroken, posting an annual growth of 11.9% since July 2004. Almost every third loan to households is denominated in a foreign currency (30.4% as at July 2005).

The exposure to foreign currency loans stagnated at particularly high levels in Western Austria. In Vorarlberg, for instance, more than 60% of all loans to households were foreign currency loans. By contrast, even in those Austrian provinces with a traditionally lower share of foreign currency loans to households (e.g. Carinthia, Lower Austria, Styria and Vienna), a steady catch-up process has been observed in recent years (see chart 20).

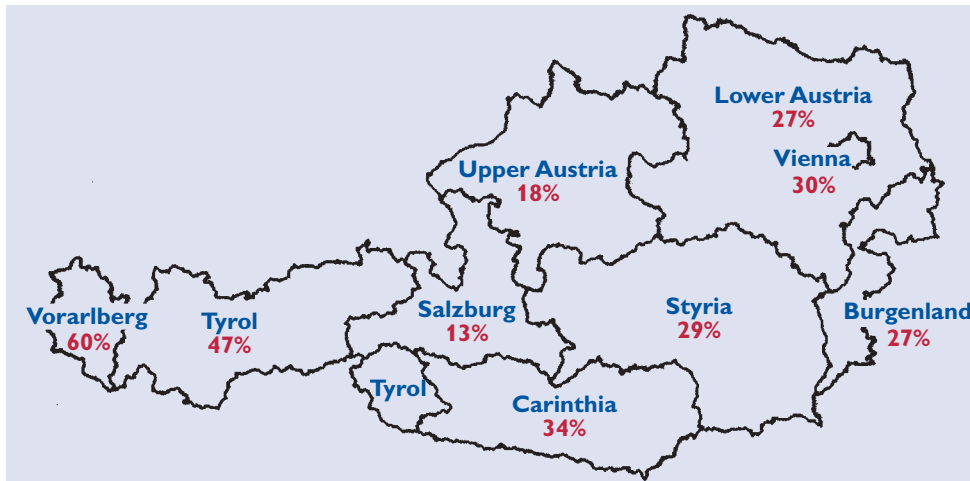
³⁰ Data on household loans are inclusive of foreign currency loans. Since data on the repayment vehicles saved to repay these loans are not available, these figures accordingly represent upper limits. However, it should be borne in mind that, whereas an existing repayment vehicle reduces some of a foreign currency loan's credit risk, the foreign currency risk – and thus the resulting indirect credit risk – is reduced only if the repayment vehicle matches the currency in which the loan is denominated.

³¹ On the problem of repayment vehicles, see footnote 30.

Chart 20

Share of Foreign Currency Loans in Overall Loans to Households

July 2005



Source: OeNB.

With a share of 89.8% in all foreign currency loans issued to nonbanks as at July 2005, the Swiss franc maintained its position as the dominant currency. The Japanese yen's importance is currently stagnating at a low level, on a par with that of the U.S. dollar.

In view of this altogether very high share of foreign currency loans, the question arises as to whether Austrian households are sufficiently aware of currency risks. It is particularly striking that the popularity of the Swiss franc and Japanese yen – both traditional foreign currency loan currencies – depends less on their exchange rate movements than on their realizable interest rate advantages vis-à-vis the euro. Thus, the boom in yen-denominated loans that took place in the period from 1999 to 2002 was clearly determined by the interest rate developments of yen-denominated loans compared with those denominated in euro. Although it appears quite ra-

tional to accept the higher volatility of e.g. the Japanese yen only with correspondingly higher interest rate advantages, the latter should not be the sole decision-making criterion. Instead, currency risk should also be taken into account. In view of the continuing uptrend in loans issued to households, it seems appropriate that lending banks further promote customers' risk awareness in this field.

Growing Risk Awareness at Major Banks

An analysis of the assets side of Austrian banks' balance sheets shows that credit risk is the most important risk for most Austrian credit institutions. The OeNB's Financial Stability Report assesses credit risk in two different ways: first, by means of the external auditor's annual prudential report and, second, by assessing specific loan loss provisions on an intrayear basis.

The prudential report prepared for 2004 is now available for examination (see table 5). In assessing the credit quality of loans granted by Austrian

banks, the report draws a distinction between *nonaccrual and nonearning claims*, *nonperforming loans* and *irrecoverable loans*.³²

Table 5

Credit Quality According to the External Auditor's Annual Prudential Report

As a percentage of total lending

	1997	1998	1999	2000	2001	2002	2003	2004
Nonaccrual and nonearning claims on nonbanks								
50% quantile (median)	0.11	0.19	0.16	0.12	0.10	0.11	0.14	0.11
Mean of five largest banks	1.15	1.08	0.98	0.77	0.46	0.65	0.70	0.61
95% quantile	3.89	3.82	3.93	3.37	3.54	3.08	2.88	2.36
Nonperforming Loans								
50% quantile (median)	2.28	2.43	2.30	2.44	2.34	2.30	2.22	2.23
Mean of five largest banks	2.81	2.01	1.99	1.51	1.55	1.89	1.79	1.44
95% quantile	8.67	8.64	8.87	9.07	9.25	8.22	8.05	7.69
Irrecoverable Loans								
50% quantile (median)	0.53	0.55	0.57	0.55	0.49	0.57	0.57	1.00
Mean of five largest banks	0.33	0.38	0.44	0.37	0.36	0.61	0.66	0.65
95% quantile	4.17	4.15	4.11	4.01	4.04	3.83	3.91	4.28

Source: OeNB.

In general, the report states that the credit quality of loans issued by Austrian banks can be considered satisfactory and that, from a systemic point of view, worrying developments are not looming on the horizon. However, irrecoverable claims, in particular, have increased. The median value for irrecoverable claims as a percentage of the total claims of Austrian banks rose from 0.57% in 2003 to 1% in 2004. As a result, irrecoverable claims have reached a record high compared with previous years. Likewise, irrecoverable claims rose for the 95% quantile, also posting a long-term record high. This development points to the fact that many Austrian banks now classify previously nonperforming loans as irrecoverable loans and have adjusted their credit portfolio accordingly.

The credit quality of major banks appears to have improved across all loan categories as defined by the prudential report. In 2004, the five largest Austrian banks (in terms of total assets) posted a year-on-year decline in the share of problem loans as a percentage of total loans in all of the above categories. This improvement in credit quality and the reduced requirement for loan loss provisions (see below) indicate that up to and including 2004 major banks showed greater risk awareness in their credit risk management.

Finally, the share of irrecoverable loans as a percentage of total lending has increased. Since, however, this suggests portfolio adjustments and as the share of nonaccrual claims has fallen at the same time, i.e. no additional

³² *Nonaccrual and nonearning claims on nonbanks are defined as claims for which payments are not anticipated in the near future. Nonperforming loans are loans that are expected to default. Irrecoverable loans are loans that have already defaulted at the time of data compilation.*

new problem loans arose, the overall development of banks' credit quality was positive from the perspective of financial stability in 2004.

Slight Decline in Loan Loss Provisions

Specific loan loss provisions form the basis for assessing the credit quality of the loan portfolio of the Austrian banking sector on an intrayear basis. In June 2005, the ratio of specific loan loss provisions to Austrian banks' claims on nonbanks³³ amounted to 3.2% on an unconsolidated basis. This signifies a slight decline in required loan loss provisions compared with the previous year, when 3.4% of claims on nonbanks required provisioning.

This trend toward lower specific loan loss provisions is visible at the major banks, in particular. In June 2005, the average ratio of specific loan loss provisions to claims on nonbanks of the five largest banks was 2.9%, thus remaining below the Austrian average. This means that after having set a record high in February 2004, the five largest Austrian banks succeeded in reducing their requirement for loan loss provisions by 12%. This decline in loan loss provisions reflects the current EU-wide trend of historically low levels of loan loss provisions.

The median value for loan loss provisions generally exceeds both

that of the major banks and the average of all Austrian banks. At 4.6%, it also surpassed these two values in mid-2005.

A sectoral breakdown of the ratio of loan loss provisions to claims on nonbanks reveals that the sector of Volksbank and Raiffeisen credit cooperatives requires the most provisions. Comparatively many smaller Raiffeisen banks, which from a risk policy perspective do not particularly influence the overall situation of the Austrian financial market, rank among the banks with a higher-than-average requirement for loan loss provisions (more than 15%). Compared with the previous year, the loan loss provisions of the Volksbank and Raiffeisen sectors have declined. State mortgage banks posted a sharp decline in the ratio of specific loan loss provisions to claims on nonbanks (June 2005 ratio: 1.8%). The other sectors do not indicate much change in the development of specific loan loss provisions.

As experience from previous credit cycles shows, loan growth, which has been improving in Austria since the end of 2003, could in future trigger a modest rise in credit risk costs following a period of decline. Several factors such as the growing risk exposure of households and, inter alia, oil price-induced economic risks can be put forward for this scenario.

³³ As experience shows that provisions for interbank loans are rather low, these are not taken into account in the following analysis.

Completion of the OeNB/FMA Series of Guidelines on Basel II

The publication of the guidelines on operational risk management and on overall bank risk management for the time being completes the OeNB/FMA series of guidelines on Basel II.

The guideline on operational risk management opens with an introduction to the subject areas of this risk category by examining the evolution of the related risk concept as well as the characteristics and significance of operational risk in banks and investment firms and illustrating these issues with case studies. Next, the guide presents operational risk management methods in exemplary fashion and examines in detail the specific situations of smaller credit institutions and of investment firms. Measures of operational risk management are the subject of a separate chapter, which examines key areas of risk and risk reduction measures, presenting in turn the four causes of operational risk (people, systems, i.e. infrastructure and IT, internal processes and external events). This chapter also includes a section devoted solely to legal risk. For each cause, general and specific risks as well as measures taken to reduce them are dealt with individually. The last chapter of the guideline finally describes the various approaches for calculating regulatory capital requirements and their related application requirements: the Basic Indicator Approach, Standardized Approach or Alternative Standardized Approach, and the Advanced Measurement Approaches (AMAs) are all critically assessed and presented with their qualitative and quantitative requirements.

The guideline on overall bank risk management deals in detail with the subject of internal capital allocation. In international forums of debate, the relevant methods are described as Internal Capital Adequacy Assessment Process (ICAAP). By way of introducing the subject, the guide to ICAAP offers a detailed list and explanation of the basic requirements for an adequate capital allocation process as well as a presentation of the regulatory framework (integration of ICAAP into the New Basel Capital Accord (Basel III)). A separate section looks at the idea of proportionality – risk management methods that are adapted to the individual bank's degree of complexity, inherent risk, scope of transactions and size. The main subject of the guideline is the detailed presentation and explanation of all the key components of an ICAAP. It provides an in-depth explanation of how to assess all major types of risks, beginning with the implementation of an appropriate risk strategy. Next, the different types of capital and their suitability for risk cover are examined in greater detail. A separate section then takes a closer look at both the significance of a limit system that is adjusted to the risk scenario and the need to have efficient internal control mechanisms in place. The guideline ends with a chapter on the practical implementation of an internal capital allocation method; this chapter explains the prerequisites for successfully and efficiently implementing ICAAP and presents the key factors for success.

Market Risk Indicates Varying Trends

The decrease in interest rate risk in the banking book is confirmed in the first half of the year. By contrast, a greater willingness to take risks was visible in equity trading and in open foreign exchange positions – albeit starting from a low level.

The reduction in interest rate risk in the banking book, which occurred in the Austrian banking system in 2004, is likely to be of a longer-term nature. In the first half of 2005, indicators only suggest a comparatively small

increase in this risk. During 2004, the average Basel ratio for interest rate risk³⁴ of all Austrian banks – determined by weighting by total assets – shrank from 7.8% to 6.1% (6.4% in mid-2005). This development is probably attributable, inter alia, to the fact that demand for variable rate loans has been growing in relation to fixed interest loans, thereby reducing the scope for maturity transformation and, consequently, the related risks as well. However, the thus reduced interest rate risk is contrasted by higher credit risk, as borrowers may get into

³⁴ Basel ratio for interest rate risk: Decline in economic value as a result of a parallel yield curve shift in all currencies by 200 basis points relative to a bank's eligible own funds.

payment difficulties in the event of rising variable loan rates.

Unlike in the banking book, interest rate risk in the trading book – as measured by the capital requirements for position risk of interest rate instruments – rose markedly from EUR 610 million to EUR 810 million in the first half of 2005. However, this increase, which is attributable to individual major banks, was not sustained later on. At end-August 2005, this figure fell just short of EUR 600 million.

Equity trading operations expanded in the first half of 2005. The corresponding capital requirements climbed from EUR 43 million at the beginning of the year to EUR 71 million – a fact that is attributable to the involvement of certain major market participants. However, exposure to equity price risk did not increase significantly for the Austrian banking system. The corresponding stress test, which is not restricted to trading book positions but covers all quoted shares in both the trading and the banking book, reveals only a minimal increase in equity price risk.

Direct foreign currency risks, to which banks are exposed on account of their open foreign exchange positions, increased in the first half of 2005. Related capital requirements rose from EUR 53 million to EUR 97 million, a level last attained four years ago.

Payment and Securities Trading, Clearing and Settlement Systems Remain Stable

In the first half of 2005, around 206 million transactions worth a total of EUR 5,812.6 billion were processed

through the payment and securities trading, clearing and settlement systems that are subject to the OeNB's payment systems oversight. The highest number of transactions (around 101.1 million) was processed through payment systems with a direct debit function (dominated by Maestro POS). In terms of transaction value, however, the highest-valued transactions (approximately EUR 5,078 billion) were processed through the ARTIS/TARGET³⁵ payment system operated by the OeNB. For securities trading, clearing and settlement systems, over-the-counter business, in particular, posted an impressive year-on-year growth of some 89.5% and 76% in terms of volume and value, respectively.

In the first half of 2005, Central Counterparty Austria (CCP.A), a subsidiary jointly owned by Wiener Börse AG and the Oesterreichische Kontrollbank AG (OeKB), commenced operations as a central counterparty for both Wiener Börse AG's cash and derivatives markets and thus replaced the two previous systems, the settlement and clearing system for options and futures trading and the clearing and settlement system for the cash market of Wiener Börse AG. The establishment of a central counterparty is in line with the European trend and will help further improve the stability of the Austrian financial market.

With a total transaction value of some EUR 485 billion, the large-value payment system EURO1 remained the most important international payment system for Austrian banks in terms of transaction value. As measured by the number of transactions, however, the retail payment system STEP2 led the

³⁵ ARTIS: Austrian Real Time Interbank Settlement; TARGET: Trans-European Automated Real-time Gross settlement Express Transfer.

field with some 4.4 million payment orders.

In the first half of 2005, altogether 17 system disturbances³⁶ were reported for the supervised payment and securities trading, clearing and settlement systems. None of these disturbances had an impact on Austria's financial system, as most of them (12 system disturbances) concerned four retail payment systems that process only about 0.3% of all retail payments incurring in Austria (both measured in numbers of transactions and transaction

value). The remaining system disturbances concerned the participation of one Austrian bank in an international payment system and were not critical, either, as the bank in question was able to switch to other payment systems. It is important to point out that these system disturbances have neither affected ARTIS/TARGET, nor the securities trading, clearing and settlement systems, nor the infrastructure facilities of Austrian Payment Systems Services (APSS) GmbH, which are of importance for many retail payment systems.

Table 6

Transactions and System Disturbances in the Period from January to June 2005

	Transactions		System disturbances
	Number in million	Value in EUR billion	Number
ARTIS/TARGET	1.9	5,077.8	0
Securities trading, clearing and settlement systems	0.8	157.3	0
Retail payment systems	197.4	15.5	12
Participation in international payment systems	5.9	562.0	5

Source: OeNB.

Austrian Banks' Business Activities in Central and Eastern Europe Continue to Expand - Dynamics Vary at the Local Level³⁷

The business activities of Austrian banks' subsidiaries in Central and Eastern Europe continue to post stable growth in terms of both total assets and profitability. In total, 11 Austrian banks with 54 fully consolidated subsidiaries operate in this market. Of

these, 26 are active in EU Member States of the previous enlargement round³⁸ and 14 each in countries with EU accession status³⁹ and other CEECs⁴⁰.

As at end-June 2005, the aggregated total assets of all fully consolidated foreign subsidiaries operating in these markets were approximately EUR 115.5 billion, which is equivalent to an increase of 29% year on year. This equals a year-on-year acceleration of

³⁶ System disturbance is defined as an interruption of the system during running times that lasts more than 30 minutes and is induced by the payment system, or as any interruption of the system that is induced by failure and occurs within the 30-minute period before the end of accounting.

³⁷ According to data from the reports of condition and income Austrian banks have published on a quarterly basis since early 2002. This publication contains selected items from the consolidated annual reports of parent banks and their fully consolidated subsidiaries abroad.

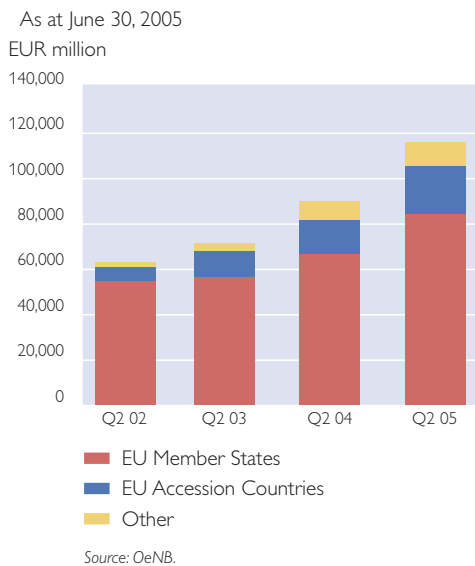
³⁸ EU Member States: Poland (PL), Slovakia (SK), Slovenia (SI), Czech Republic (CZ) and Hungary (HU).

³⁹ EU accession status: Bulgaria (BG), Croatia (HR), Romania (RO) and Turkey (TR).

⁴⁰ Other CEECs: Albania (AL), Bosnia and Herzegovina (BA), Russia (RU), Serbia and Montenegro (CS), Ukraine (UA) and Belarus (BY).

the growth rate by four percentage points. Subsidiaries in countries with EU accession status and in other CEECs indicate more dynamic growth (+38% and +40%, respectively) than those located in EU Member States (+26%), although starting from lower levels (see chart 21).

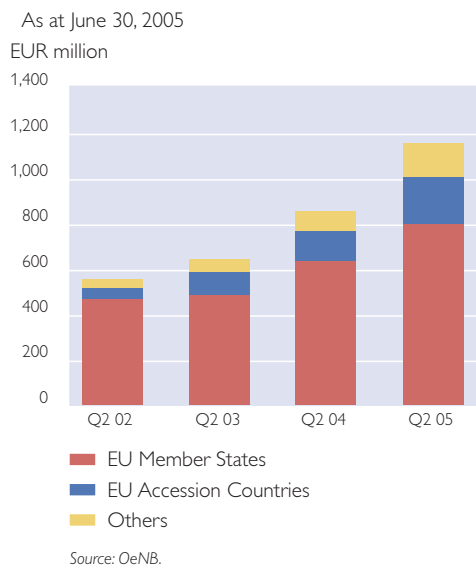
Chart 21
Total Assets of Austrian Banks' Subsidiaries in Central and Eastern Europe



The aggregated operating profit of CEE subsidiary banks reveals the same picture. From end-June 2004 to end-June 2005, aggregated operating profit grew by 35% to some EUR 1,152 million, which is equivalent to growth accelerating by 2 percentage points. Also in the area of aggregated operating profits, the growth rates of subsidiaries in countries with EU accession status (+56%) and in other CEE countries (+71%) appear to be more dynamic than those of EU Member States (+25%) (see chart 22).

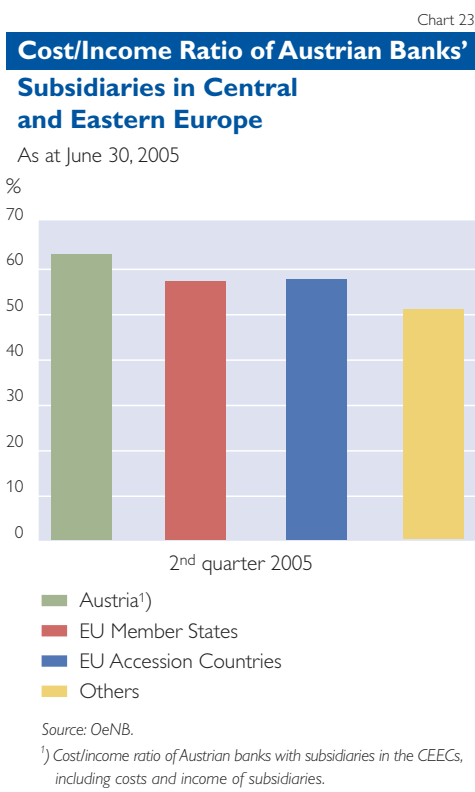
The cost/income ratio⁴¹ of fully consolidated subsidiary banks in the CEECs improved from 58.9% in June 2004 to 56.4% in June 2005; this rise is attributable to a sharper increase in operating income (+27%) than in operating expenses (+22%) (see chart 23). The importance of Austrian banks' business activities in CEE in terms of their profitability is reflected in the ratio of the share of subsidiary banks in the aggregated total assets of their 11 parent banks (around 23%) to their share of aggregated operating profit (around 42%).⁴²

Chart 22
Operating Profit of Austrian Banks' Subsidiaries in Central and Eastern Europe



⁴¹ Ratio of administrative costs to operating income before deduction of net risk provisioning in the lending business.

⁴² These shares refer to unweighted aggregated total assets/unweighted aggregated operating profits of fully consolidated subsidiaries in CEE.



The exposure of the Austrian banking system to credit risk in CEE comprises two components: First, loans

that are issued to this region (direct cross-border loans) by banks based in Austria, and second, loans that are issued by Austrian banks' subsidiaries operating in the region (indirect loans). Taken together, these two components represent a foreign lending exposure of EUR 122.3 billion (+4% since the start of the year), with the CEECs accounting for EUR 74.2 billion (+11%) of this figure. The new EU Member States, in turn, make up two-thirds of the CEECs' share (see table 7).

This figure confirms the key role the CEECs play for the Austrian banking system. By focusing their business activities on the new Member States, Austrian banks have succeeded in keeping within limits, in particular, risks arising from the institutional, legal and economic framework of these markets.⁴³ An important factor in this context, however, is that business activity is by far more dynamic in those countries that have not (yet) joined the EU.

⁴³ In this context, let us point to the new method of assessing systemic banking risk that was introduced by the rating agency Fitch Ratings Ltd. in late July 2005. In its first assessment, Austria was awarded a merely average rating. One of the reasons for this evaluation is probably an undifferentiated analysis of the risk concentration in the CEECs.

Table 7

Credit Exposure to Central and Eastern European Countries

As at June 30, 2005
EUR billion

	Abroad															
	Central and Eastern Europe															
	EU Member States					EU Accession Countries				Other Countries ³⁾						
			CZ	HU	PL	SI	SK		BG	HR	RO		BA	RU	UA	
Direct loans¹⁾	68.5	24.6	14.3	4.5	2.3	3.2	2.8	1.5	5.5	0.4	3.8	1.4	4.7	0.3	3.5	0.1
Share in foreign loans (%)		35.9	20.9	6.5	3.4	4.7	4.0	2.3	8.1	0.5	5.5	2.1	6.9	0.5	5.1	0.2
Indirect loans²⁾	53.9	49.6	35.0	13.1	8.3	6.7	1.9	4.9	10.1	1.4	6.9	1.8	4.6	1.5	1.5	0.4
Share in foreign loans (%)		92.1	65.0	24.3	15.4	12.5	3.6	9.2	18.7	2.5	12.8	3.4	8.4	2.7	2.8	0.8
Total	122.3	74.2	49.3	17.6	10.6	9.9	4.7	6.5	15.6	1.7	10.7	3.2	9.3	1.8	5.0	0.6
Share in foreign loans (%)		60.7	40.3	14.4	8.7	8.1	3.8	5.3	12.8	1.4	8.7	2.6	7.6	1.5	4.1	0.5

Source: OeNB.

¹⁾ Nonsecuritized loans granted by Austrian banks to foreign nonbanks.

²⁾ Nonsecuritized loans granted to nonbanks by subsidiaries of Austrian banks.

³⁾ In addition to Bosnia and Herzegovina (BA), Russia (RU) and Ukraine (UA), the item "Other Countries" also includes Albania (AL), Serbia and Montenegro (CS) and Belarus (BY).

Banks in Central and Eastern Europe Remain Highly Profitable¹

In some of the countries examined in this section (Czech Republic, Bulgaria), GDP growth accelerated in the first half of 2005 on a year-on-year basis. In others (Slovakia, Romania), it remained at a relatively high level. In Hungary, Slovenia and Croatia, annual growth rates returned to considerably higher levels in the second quarter of 2005. Although they were somewhat stronger in Poland in this period, growth rates remained at a relatively low level. GDP growth was fueled by net exports in the Czech Republic, Hungary, Poland and Slovenia. By contrast, domestic demand as a whole shrank and, in some cases, stagnated. In Slovakia, Bulgaria, Romania and Croatia, growth was primarily driven by domestic demand. In this economic climate, growth in loans granted to enterprises and households remained the most dynamic in Bulgaria and Romania, while accelerating in Slovakia and Croatia and also – despite sluggish domestic demand – in the Czech Republic and in Slovenia. In the Czech Republic and in Slovakia, this development (starting from hitherto very low growth rates) was based on more buoyant growth in corporate loans, which did not, however, match the continued robust growth of household loans. In the other countries under review, loans to households also grew at a faster pace than loans to enterprises. Despite the acceleration of growth in corporate and household loans, the momentum recently seen in these four countries (15% to 25% year on year) remained well below that registered in Bulgaria and Romania (35% to 40%). However, growth dynamics in these two countries were considerably weaker than in mid-2004. This downtrend is likely to reflect – at least, in part – central bank measures taken to contain the growth in lending. In addition, credit growth in Hungary continued to gradually slow down in the first eight months of 2005 (to some 15% year on year). In Bulgaria and Romania, where a very high share of domestic loans is issued to enterprises and households in foreign currency, slowing credit momentum between end-2004 and July 2005 was accompanied by a slight decline in the share of foreign currency loans in total loans

¹ This section examines the performance of the entire banking sector in the Czech Republic, Hungary, Poland, Slovakia, Slovenia, Bulgaria, Croatia and Romania and does not focus only the performance of the Austrian banks' subsidiaries in these countries.

outstanding. However, the risk that attempts to check domestic loan growth causes enterprises and – to a lesser extent – households to accumulate more debt abroad cannot be dismissed. In fact, gross foreign corporate debt in Bulgaria increased more strongly in the first half of 2005 than in the comparable period of 2004. By contrast, in Hungary, a country with a similarly high share of foreign currency loans, declining loan demand impacted primarily on loans denominated in domestic currency. As a result, the share of foreign currency loans continued to climb above the 40% mark in the first seven months of 2005. At the same time, the share of the Swiss franc in foreign currency loans continued to climb at a dynamic pace, reaching 40% already by mid-2005, while the share of the euro went down to 51%. In almost all countries under revision, bank profitability improved, or largely held steady at high levels, except for a slight decline in Croatia.

Net interest income (as a percentage of assets) declined in several countries; however, banks were able to offset this decline by enhanced cost efficiency and/or improved noninterest income. Given the favorable development of the share of nonperforming loans,² the reduction in loan loss provision charges also made a positive contribution to banks' performance in most countries. However, this trend could change in the future as loan portfolios mature.

² Nonperforming loans are defined as substandard, doubtful and irrecoverable loans. In view of differences in both national classification rules and the range of loans included in this classification, a cross-country comparison is difficult.

Nominal Return on Equity

%						
	2001	2002	2003	2004	H1 04	H1 05
Bulgaria	18.9	14.6	14.8	16.6	18.5	18.6
Croatia	6.6	13.7	14.5	16.1	17.9	14.5
Poland	12.8	5.3	5.5	17.4	17.7	21.2
Romania	26.3	21.0	17.7	18.0	20.5	19.7
Slovakia	7.9	11.5	10.5	12.3	13.8	14.6
Slovenia	0.6	8.5	8.2	8.7
Czech Republic	16.4	27.1	23.4	23.1	22.4	29.3
Hungary	16.0	16.1	18.7	23.8	25.8	27.1

Note: Based on profits after tax. Intra-year data are annualized linearly.

Net Interest Income

% of annual average bank assets						
	2001	2002	2003	2004	H1 04	H1 05
Bulgaria	4.2	3.9	4.7	4.9	4.9	4.4
Croatia	3.6	3.3	3.3	3.0	3.1	3.0
Poland	3.7	3.4	3.1	3.2	3.2	3.2
Romania	2.6	3.4	4.7	4.8	5.4	3.7
Slovakia	2.5	2.7	2.9	2.8	2.9	2.2
Slovenia	3.6	3.7	3.2	2.8	2.9	2.7
Czech Republic	2.5	2.4	2.1	2.3	2.2	2.3
Hungary	4.2	4.3	4.0	4.3	4.0	3.9

Note: Data not comparable between countries. Intra-year data are annualized linearly.

Operating Costs

% of current operating income

	2001	2002	2003	2004	H1 04	H1 05
Bulgaria	64.1	63.5	63.0	58.3	55.4	51.6
Croatia	65.6	59.3	56.9	54.3	55.5	56.4
Poland	62.4	63.5	68.7	65.3	64.8	60.8
Romania	57.8	62.0	65.1	61.6	58.4	64.0
Slovakia	65.7	57.9	64.6	56.2	56.6	56.3
Slovenia	65.2	59.7	62.5	60.8	57.8	53.7
Czech Republic	53.4	51.4	52.6	47.2	49.0	45.7
Hungary	66.7	64.7	60.1	53.0	49.8	49.4

Net Change in Loan Loss Provisions

% of current operating income

	2001	2002	2003	2004	H1 04	H1 05
Bulgaria	-8.7	1.3	3.7	9.4	6.2	12.9
Croatia	13.7	6.6	7.7	6.6	4.5	4.9
Poland	18.9	22.9	15.2	7.9	7.0	4.4
Romania	4.7	2.0	5.5	7.3	6.3	3.0
Slovak Republic	-33.4	-9.8	-12.5	-9.2	-14.2	-3.3
Slovenia	25.9	19.8	16.6	16.0	17.1	18.5
Czech Republic	22.8	9.3	0.8	9.9	11.1	8.6
Hungary	4.3	4.7	5.5	7.5	8.7	2.4

Nonperforming Loans

% of all loans

	2001	2002	2003	2004	H1 04	H1 05
Bulgaria	4.5	3.6	4.2	3.6	2.4	2.8
Croatia	7.3	5.9	5.1	4.6	5.1	4.3
Poland	18.4	21.6	22.1	15.1	17.9	14.0
Romania	3.3	2.3	8.3	8.1	8.5	8.2
Slovak Republic	21.0	11.0	9.1	7.0	7.8	6.9
Slovenia	7.0	7.0	6.5	5.5	6.0	9.6
Czech Republic	14.1	8.5	5.0	4.1	4.6	4.3
Hungary	3.6	3.7	3.0	2.9	3.4	2.8

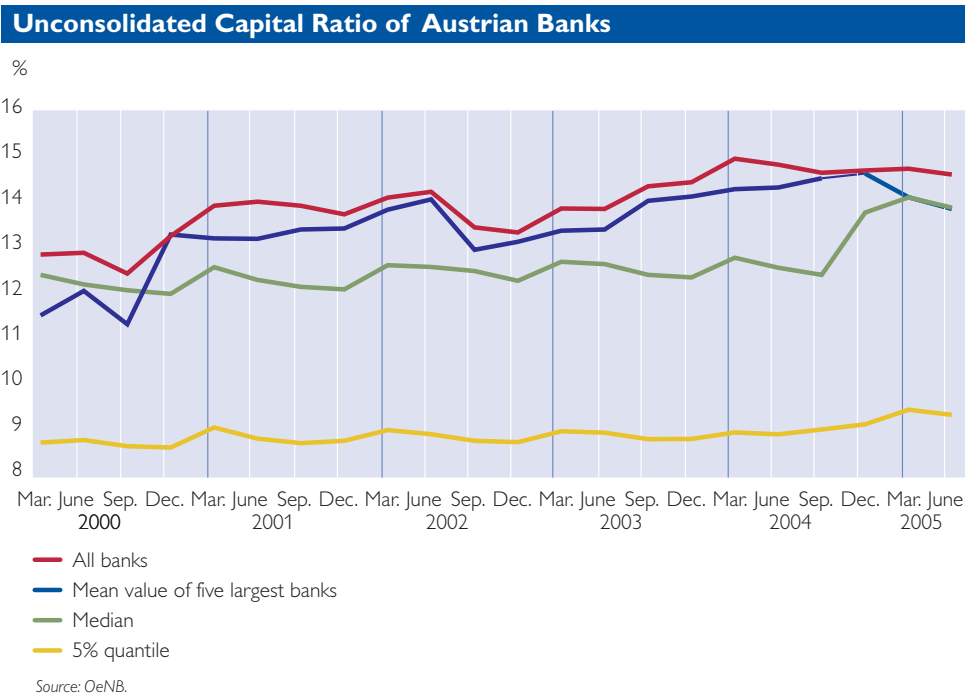
Source: National central banks, OeNB calculations.

Austrian Banks' Risk-Bearing Capacity Continues to Strengthen Capital Ratio Remains High

The capital ratio is a key indicator used to assess banks' risk-bearing capacity. In recent years, the unconsolidated capital ratio, which relates banks' own funds to their risk-weighted assets, has been high for all Austrian

banks compared with the rest of Europe. Although it eased slightly against its 15.0% record of March 2004, in June 2005 it still stood at 14.6% (see chart 24). In mid-2005, the consolidated capital ratio was 12.4%. This means Austrian banks' capital ratios continue to exceed the required minimum capital ratio of at least 8% by a wide margin.

Chart 24



In early 2005, major banks' average capital ratios approached the median value for the Austrian banking sector (excluding special purpose banks). Whereas the capital adequacy of the five largest banks (as measured by total assets) mostly exceeded the median value in the past, in June 2005 both values showed almost identical levels of 13.9% after the median had gone up sharply a few months earlier. Major Austrian banks also exceed the capital ratio of major EU banks, which is 11.3% (see ECB, Financial Stability Report, June 2005). Owing to the current level of excess capital of BAWAG P.S.K. the granting of a large-scale loan to REFCO does not pose any threat to financial market stability.

A good capital cushion is also indicated by the value for the 5% quantile, which represents banks with relatively weak capital ratios. In early 2005, the value for the 5% quantile went up to 9.4% from 8.8% in January 2004 and fell back slightly to 9.3% by mid-year.

As for the core capital ratio, which relates tier 1 capital (core capital) to the assessment base, the unconsolidated total of all Austrian banks was high compared to the level of previous years. In June 2005, the core capital ratio of Austrian banks was 10.2%. Since the core capital ratio plays a crucial role in the assessment of banks by rating agencies, it is useful to look at the tier 1 ratios of rated Austrian banks. In June 2005, the average core capital ratio of these banks (excluding special purpose banks) was 8.2%. This ratio is largely in line with the European average of major banks, even though these banks are not entirely comparable owing to size differences. At end-2004, the ECB stipulated a core capital ratio of 8.3% for the major banks within the euro area.

In short, Austrian banks' risk-bearing capacity is currently following a satisfactory trend. In addition, their capital adequacy is on par with the euro area average and, at times, slightly above trend.

Deposit Guarantee

Directive 94/19/EC of the European Parliament and the Council of 30 May 1994 on deposit-guarantee schemes (Deposit-Guarantee Directive) stipulates that all EU Member States are required to set up deposit guarantee schemes which guarantee that, in the event of a bank failure in an EU Member State, bank customers are reimbursed their deposits to a level of up to EUR 20,000.00 (maximum retention: 10%). This guarantee scheme takes consumer protection considerations into account and promotes financial stability by avoiding potential panic bank runs. However, there are considerable differences between the individual national deposit guarantee schemes, both in terms of coverage level and the volume of deposits insured and from the perspective of structure and financing.

Given this heterogeneity of deposit guarantee schemes on the one hand and the growing integration of the EU banking sector on the other, the Deposit-Guarantee Directive is currently undergoing a comprehensive review by the European Commission. The review is to examine whether the Directive has achieved its original objectives in full and improved the functioning of the internal market by guaranteeing a minimum coverage level throughout the EU. In particular, the review explores the question of whether and to what extent there is a need for further harmonization of national deposit guarantee schemes (e.g. in terms of coverage level and the volume of deposits insured), and to what extent current arrangements for cross-border regimes are still appropriate.

Against this background, the OeNB organized an international workshop on June 1, 2005. This workshop served to present the deposit guarantee schemes of selected EU Member States, to discuss the pros and cons of specific forms of structure and financing from both national and cross-border perspectives and to evaluate the potential for further harmonization. In this context, observations made on several occasions about a possible EU-wide harmonization based on the ex ante funding model were considered to be particularly sensitive. A survey carried out in 2004 shows the funding mechanism of deposit guarantee schemes to be as follows: 14 are ex ante, 5 are ex post and a further 6 are a mixture of ex ante and ex post schemes. A general commitment to establish an ex ante financed guarantee scheme would have far-reaching consequences for the countries concerned, such as Austria, and in any case could only be envisaged if appropriate transition periods were set for the changeover. In addition to the fact that the question of the optimal funding model is clearly associated to a considerable degree with the structure of the relevant national banking sector, the debate also made clear that the advantages of ex ante funded schemes (e.g. immediate availability of financial funds) – at least, in their current form – are also offset by significant disadvantages (above all, possible high administrative costs and a sizeable commitment of funds). Finally, risk-based premiums were considered to be of major importance.

Stress Tests Prove Banking System's Good Resilience to Shocks

In 2003, stress tests were developed in the course of the IMF's Financial Sector Assessment Program to evaluate the risk-bearing capacity of the Austrian banking system. Ever since, the OeNB has regularly published the results of these tests in its Financial Stability Report⁴⁴. Table 8 shows the development of results for credit and market risk over time. To establish comparability

of results that are measured at different points in time, the capital ratios resulting from individual stress scenarios are not indicated. Instead, the table shows the gap between these capital ratios and the relevant current ratio. In mid-2005, for instance, the unconsolidated capital ratio was 14.62%; this figure went down by 0.96 percentage point to 13.66% in the "domestic credit risk" stress scenario.

⁴⁴ The related methodology is described in the OeNB's Financial Stability Report 7. Let us point out that, to economize on space, we present only the results that relate to the aggregate Austrian banking system, i.e. the relevant positions held by individual banks have been combined into aggregate positions.

Table 8

Stress Test Results for the Aggregated Austrian Banking System over Time

	End-2003	End-2004	Mid-2005
Current capital ratio	14.45	14.71	14.62
Gap between current and stressed capital ratio (in percentage points)			
Credit risk			
Domestic credit exposure			
30% increase in the ratio of loan loss provisions to loans outstanding	0.87	0.92	0.96
Credit exposure in Central and Eastern Europe			
40% increase in the ratio of loan loss provisions to loans outstanding	0.28	0.27	0.26
Foreign currency loans			
10% appreciation of the Swiss franc against the euro	0.28	0.30	0.30
20% appreciation of the Japanese yen against the euro	0.16	0.07	0.07
Accumulated credit risk			
Simultaneous analysis of all three credit risk components ¹⁾	1.38	1.39	1.41
Market risk			
Interest rate risk			
Euro: Upward parallel shift of the yield curve by 130 basis points	0.61	0.35	0.29
U.S. dollar: Upward parallel shift of the yield curve by 110 basis points	0.04	0.06	0.06
Swiss franc: Upward parallel shift of the yield curve by 150 basis points	0.04	0.01	0.02
Japanese yen: Downward shift of the yield curve ²⁾	0.06	0.03	0.00
Equity price risk			
Domestic stock market crash, 30% decline in ATX	0.16	0.16	0.16
International stock market crash, 35% decline in international stock indices	0.22	0.21	0.23
Exchange rate risk			
Worst case estimate ³⁾ for 10% appreciation/depreciation of the euro	0.10	0.09	0.11

Source: OeNB calculations based on data reported to the OeNB.

¹⁾ Increase in the ratio of loan loss provisions to total outstanding loans by 30% for loans to domestic nonbanks denominated in euro, by 40% for direct and indirect loans to nonbanks in the CEECs, and appreciation of the Swiss franc by 10% and the Japanese yen by 20%.

²⁾ In the case of the Japanese yen, there was no parallel downward shift of the yield curve so as to avoid a negative interest rate scenario. The scenario consists of a cut by 20 basis points in short-term interest rates, by 40 basis points in mid-term interest rates and by 130 basis points in long-term interest rates.

³⁾ Reduction in absolute values of all banks' open foreign exchange positions in 12 major currencies (excluding CEE currencies).

The stress test results show a relatively constant development over time in most risk categories. An exception to this is the interest rate risk, which mainly exists in the euro area and which has noticeably decreased since end-2003. This aggregate analysis of interest rate risk is in line with findings on market risk saying that the average interest rate risk is also decreasing at the level of the individual banks. However, it cannot be ruled out that this reduction in risk – triggered by higher demand for variable rate loans, together with potential payment difficulties on the part of borrowers in the case of a rise in variable loan rates – will be offset by increased credit risk. In the credit risk scenario, this additional risk component has still not been taken into

account: The scenario for domestic credit risk assumes a uniform increase in loan loss provisions of 30% for the different points in time. Nonetheless, credit risk vis-à-vis domestic debtors has gone up slightly. Whereas the stressed capital ratio of the aggregate banking system was 0.87 percentage point below the current ratio at end-2003, in mid-2005 it was just 0.96 percentage point short.

The stress tests for the additional credit risk of foreign currency loans that arises from possible appreciations in the loan currency have shown a marginal increase in the risk profile for the Swiss franc and a reduction for the Japanese yen since end-2003. This increase corresponds to shifts in foreign currency loans out of Japanese yen

and into Swiss franc that were continued at end-2003. Whereas the combined scenario for Swiss franc- and Japanese yen-denominated loans led to a decline in the capital ratio by 0.44 percentage point at end-2003, in mid-2005 this decline was a mere 0.37 percentage point.

The stress test shows that the loss potential for the Austrian banking system arising from the credit risk vis-à-vis the CEECs is decreasing slightly despite ever growing business activity in this region. The gap between the actual capital ratio and the stressed capital ratio narrowed from 0.28 percentage point at end-2003 to 0.26 percentage point in mid-2005. This trend can largely be explained by the fact that the going public of Raiffeisen International Bankenholding AG (Raiffeisen International) has resulted in a marked diversification in shareholder structures⁴⁵ and has accordingly had a reducing effect on the stress test result.

Compared with the significance of business in the CEECs for the profitability of the Austrian banking system, the credit risk potential implied by the stress test looks relatively modest. This should be seen as a consequence of the fact that, in a consolidated analysis, the profits generated in the region will be disproportionately large compared with the total assets employed. Relating the losses arising from the scenario of a 40% increase in loan loss pro-

visions for claims on nonbanks to the aggregate operating profits of the 11 Austrian parent banks operating in the region reveals that a shock of this kind would hit the profitability of these banking groups far more grievously. At mid-2005, this loss would represent 18% of operating profits before risk provisioning for 2004, or 40% of the 2004 annual profits after tax.

In short, the stress tests carried out in the past year and a half do not suggest a significant increase in risk potential for the Austrian banking industry. Since the capital ratio at the level of the banking system as a whole declined only marginally in the first half of 2005, the Austrian banking system can be expected to have satisfactory levels of resilience to shocks.

Ratings of Major Austrian Banks Basically Remain Unchanged

To evaluate financial stability, banking sector analyses make use of the supervisory reporting system. They are complemented by publicly available information and indicators of international rating agencies such as Moody's or Standard & Poor's. These indicators include long-term ratings that cover savings deposits, demand deposits and time deposits as well as interbank business, not to mention subordinated debt and the Bank Financial Strength Rating (BFSR).

⁴⁵ In calculating the shock, loans granted by foreign subsidiaries are weighted with the stake held by the Austrian parent bank, as only these stakes ultimately affect operating income.

Table 9

Ratings of Selected Major Austrian Banks

As at October 31, 2005

	Long-Term Bank Deposit Rating		Bank Financial Strength Rating	
		Outlook		Outlook
BA-CA	A2	under review	B-	under review
Erste Bank	A1	stable	B-	stable
RZB	A1	stable	C+	stable
BAWAG P.S.K.	A2	under review	C+	under review
ÖVAG	A2	stable	C	stable
RLB Upper Austria	A1	stable	B-	negative
Hypo Alpe-Adria-Bank	Aa2	stable	C+	stable

Source: Moody's Investors Service.

Stock Prices of Major Austrian Banks Continue to Rise

As at September 30, 2005, the four banks listed on the ATX Prime Market (BA-CA, Erste Bank, Raiffeisen International, Investkredit) reported a combined market capitalization of EUR 33.3 billion, almost twice the value recorded in the comparable month of 2004 (+EUR 16.3 billion)⁴⁶. As at end-September 2005, these four banks reported a share of more than one-third of domestic securities traded at the Wiener Börse. On balance total market capitalization climbed by EUR 46.7 billion⁴⁷ to EUR 94.9 billion year on year.

Investkredit will be delisted at the end of the year, as it was taken over by ÖVAG. Approximately 2% of shares are currently in free float but were hived off to a settlement company under a squeeze-out in September 2005. According to UniCredit, for the time being there are no plans of delisting for BA-CA, even if a squeeze-out were feasible under Austrian law.

**Insurance Companies and Pension Funds Recover Further
Business Activities in Central and Eastern Europe Make Significant Profit Contributions**

Healthy operating performance and higher investment results have had a positive effect on the stability of European insurance companies.

The Austrian insurance industry continued to improve its business and earnings performance. First, the life assurance segment – also favorably influenced by subsidized personal pension schemes – posted a benign performance. Mortality tables still applicable in 2005 and the guaranteed maximum interest rate of 2.75% could have provided an additional incentive for high demand. Austria's Financial Market Authority (FMA) has lowered the guaranteed maximum interest rate for life insurance contracts to 2.25% owing to low yield levels, which applies to all contracts with a guaranteed minimum yield concluded from January 1, 2006, onward. Second, the insurance industry's improved results are also attributable, in particular, to

⁴⁶ This figure includes EUR 1.11 billion of Raiffeisen International's IPO in April 2005.

⁴⁷ This figure includes the new listing and relisting of Immoeast, Intercell, KTM, Raiffeisen International, Sky-europe, voestalpine and Wiener Städtische.

the growing involvement of Austrian insurance companies in Central and Eastern Europe. The Austrian insurance industry operates some seventy insurance companies in this region and, in certain countries, commands a market share of as much as 35%. The expansion of the insurance industry's market presence in the CEECs is of particular interest on account of the industry's minimal market penetration, which demonstrates the region's growth potential. Higher (anticipated) growth rates and more stringent cost management are also mirrored in the stock price development of Austrian insurers, which is considerably more favorable than that of the European benchmark indices.

The switch to new mortality tables and the lowering of the guaranteed maximum interest rate will support financial stability in the insurance industry, as the calculatory bases will be adjusted to demographic developments and market conditions. However, it should be pointed out that the insurance industry as generally closely observes adverse shocks to the financial markets as well as increasingly occurring major loss events as a potential source of risk.

Foreign Assets Becoming Increasingly Important also for Insurance Companies

In the first half of 2005, the total assets of the insurance industry⁴⁸ (excluding reinsurance business) grew by EUR 5.2 billion to EUR 73.4 billion. Over the same period, Austrian equities and other domestic securities as well as foreign fixed income securities once more outperformed other assets items on the balance sheet (+EUR 1.9 billion

and +EUR 1.4 billion, respectively). Thanks to higher-than-average contributions to growth, both items are jointly responsible for a net growth in assets of 63.5% and together represent almost 50% of assets. Since the introduction of the OeNB's insurance statistics in 1996, foreign equities and other foreign securities have grown from a very low level by more than tenfold to EUR 3.7 billion. In the first half of 2005 alone, growth amounted to EUR 861 million. For both fixed income and equity securities, it is obvious that of the international market for insurance assets is becoming more and more important. The first half of 2005 saw a considerable decline in both loans to the government and domestic government debt securities, which means that the insurance sector's exposure to the government amounted to EUR 5.8 billion, or has gone down by 65.4% since 1996. By contrast, domestic debt securities of Austrian credit institutions have gone up by EUR 471 million to EUR 7.5 billion. Although the exposure of insurance companies vis-à-vis domestic banks has augmented by a total of EUR 486 million to EUR 10.2 billion, its share in the total assets of insurance companies and in the consolidated total assets of Austrian banks has decreased slightly since end-2004. Owing to the banking and insurance sector's business performance and modest share in exposure, the risk of contagion between the banking and insurance sectors is still low.

In the first half of 2005, technical provisions in life assurance dominated actuarial provisions in terms of both amount (EUR 47.1 billion) and contributions to growth (+EUR 2.7 billion).

⁴⁸ Based on quarterly reports (OeNB insurance statistics).

Continued Growth of occupational Pension Funds

As at December 31, 2004, 13 single-employer occupational pension funds and 7 multi-employer occupational pension funds were operating in Austria. In 2004, the aggregate assets of all investment and risk sharing groups rose from EUR 9.12 billion to EUR 10.13 billion (+11.1%). Household claims against occupational pension funds accounted for about 3% of households' financial assets in 2004. At end-2004, occupational pension fund contracts existed with approximately 10,600 companies, involving some 369,000 prospective pensioners and around 44,000 pensioners.

In 2005, the Federal Act on the Establishment, Administration and Supervision of Pensionskassen (Pensionskassengesetz – PKG) was amended (Federal Law Gazette Part I No. 8/2005). This amendment primarily served to implement Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision. In the future, two measures stipulated by the amendment could also boost the intensity of competition in the market for occupational retirement provision. First, the Directive provides for the reciprocal recognition of institutions for occupational retirement provision in all Member States. Regulatory control is subject to the home country control principle. Second, the Insurance Supervision Act approves of a new occupational pension product: occupational group insurance („betriebliche Kollektivversicherung“ – BKV). In terms of tax and employment law, it is on an equal footing with occupational pension funds. Although BKVs follow a more conservative investment strategy than occupational pension funds, they offer a higher fixed interest rate and

guarantee the nonforfeiture of claims upon conclusion of contract. However, BKVs are less transparent, and pensioners (including prospective pensioners) have less influence on their transactions than with occupational pension funds. From a regulatory perspective, this amendment continues with the growing liberalization of investment rules by means of the “prudent person rule,” which will make investment strategies of occupational pension funds more flexible. As a result, the monitoring costs for beneficiaries will increase. In addition, the upper limit of 1% will be waived for asset management fees. Instead, these are to be fair and in line with the general market. This additional flexibility could lead to increases in asset management fees. The 2005 amendment to the PKG created the option for beneficiaries to waive the minimum return guarantee, which had in any case been significantly watered down by the 2003 amendment. Waiving the minimum yield guarantee should substantially reduce the asset management fees for beneficiaries. According to the Austrian occupational pension fund association, almost half of all persons entitled to a pension and almost all those who have recently taken out new pension contracts have exercised their waiver to the minimum yield guarantee.

Very Long-Term Index-Linked Government Bonds Could Support Occupational Pension Fund Risk Management

In 2004, many EU Member States (e.g. France, U.K.), saw an increase in (partly index-linked) government bonds issued with maturities of more than 30 years, which were in great demand by the market. Owing to their long-term liabilities and inflation risk, these types of investments could make

an important contribution to risk management of occupational pension funds, to which they are bound under the 2005 amendment to the PKG. Above all, in the euro area macroeconomic risks (e.g. inflation and demographic developments) are diversifiable only

to a very limited extent. The future role of very long-term index-linked government bonds in managing macroeconomic risks in Austria depends on the federal government's debt management objectives and on market demand.