Framework Conditions

Relatively Swift Recovery from the Uncertainty Triggered by the Events of September 11, 2001

All in all, Austria's credit institutions mastered the difficult year 2001 successfully, having weathered the episode of uncertainty in the aftermath of September 11, 2001, and the concomitant economic slowdown. Banks' exposures to the industries hardest hit, such as tourism (especially airlines) and insurance, did not pose any threat to stability.

The events of last September further hurt the performance of mutual funds, pension funds and insurances, which was already adversely affected by the stock market's weakness of recent years. The developments of the first few months of 2002 compensated for this falloff, however, as the assets managed by Austrian mutual funds expanded by 6% to EUR 92.6 billion.

The operating performance of the major Austrian banks largely improved in 2001, with subsidiaries in Central and Eastern European countries (CEECs) contributing significantly to boosted interest income. Deteriorating credit quality and increasing insolvencies, however, caused banks to step up their provisions for loan losses in 2001.

The consolidation drive in the Austrian banking sector did not let up. Bank Austria AG's integration into Bayerische Hypo- und Vereinsbank AG (HVB) is almost complete; Creditanstalt is scheduled to be fully integrated into Bank Austria AG by mid-2002. Banks in the multi-tier sectors are increasingly keen on strengthening their sectoral infrastructures. Within the savings bank sector, a loss sharing agreement with mutual guarantees – complementing the existing deposit insurance scheme – and centralized liquidity management took effect in January 2002. With a view to streamlining structures, Erste Bank der oesterreichischen Sparkassen AG (Erste Bank) – the lead bank of the sector – transferred branches in the provinces to the respective regional savings bank in exchange for a corresponding stake in the latter. In this context, Erste Bank gained a majority stake in Tiroler Sparkasse at the end of 2001. The Volksbank credit cooperatives transferred their Österreichische Volksbanken-AG (ÖVAG) shares to a newly set up Volksbanken Holding, which now holds a 55% stake in ÖVAG.

The introduction of euro banknotes and coins, an undertaking requiring meticulous planning and sophisticated cash logistics, went smoothly. Austria, in addition, frontloaded EUR 500 million to neighboring CEECs via existing commercial banking channels.

Comprehensive Reform of Financial Market Supervision

Several EU countries and European forums are currently contemplating measures to overhaul financial market supervision and to further improve cooperation between central banks and supervisory authorities. Austria launched a new Financial Market Authority (FMA) on April 1, 2002.[1]) The reform of Austria's financial market oversight was aimed at producing a high-quality, effective and, at the same time, cost-efficient supervisory framework. In addition, the new

1 *See also: Würz, M. (2001). Reform of Financial Market Supervision in Austria – The New Financial Market Supervision Act (Finanzmarktaufsichtsgesetz – FMAG), OeNB Financial Stability Report 2 of December.*

supervisory regime accounts for changes in the regulatory framework, such as the Basel Committee's Core Principles for Effective Banking Supervision and the New Basel Capital Accord, also known as Basel II, currently in the making. Moreover, with Austrian banks increasingly engaged in cross-border activities and with the complexity of financial services ever on the rise, it is imperative to step up supervision, extend examinations and cooperate more closely with international supervisory bodies.

Integrated Financial Market Supervision

- *Austria's new integrated supervisory regime took effect on April 1, 2002.*
- *The Financial Market Authority (FMA) is organized as an autonomous institution under public law with a separate legal personality which performs banking, insurance, pension fund and securities supervision ("single regulator").*
- *The FMA has the power to impose administrative penalties and to enforce its supervisory rulings.*
- *The costs of the new supervisory regime are borne largely by the institutions subject to supervision; the central government contributes EUR 3.5 million p.a. to the FMA budget.*
- *To foster cooperation and the exchange of views and to provide advice on supervisory matters, a Financial Market Committee was set up at the Federal Ministry of Finance, serving as a platform for the institutions (FMA, OeNB and Ministry of Finance) jointly responsible for financial stability.*
- *The new legislation safeguards the OeNB's solid operational involvement in banking supervision. It is mandatory for the FMA to commission the OeNB with on-site examinations of credit institutions' market and credit risk. In the case of other types of on-site examinations of banks (e.g. money laundering audits), requesting the OeNB's participation is optional. FMA staff is entitled to participate in on-site examinations performed by the OeNB. According to various provisions of the Austrian Banking Act (e.g. paragraph 26 et seq.), the OeNB is required to draw up expert opinions. The framework under which banks have to report data to the OeNB and the latter processes these data has been left in place. The exchange of information between the OeNB and the FMA has been ensured through a clause that explicitly requires them to provide mutual administrative assistance.*
- *The OeNB has been invested with payment systems oversight and, in fulfilling this mandate, is not bound by instructions.*

The overhaul of financial market supervision in Austria and the OeNB's far-reaching operational involvement in supervisory tasks ensure that the OeNB may effectively contribute to maintaining financial stability also in the Eurosystem.

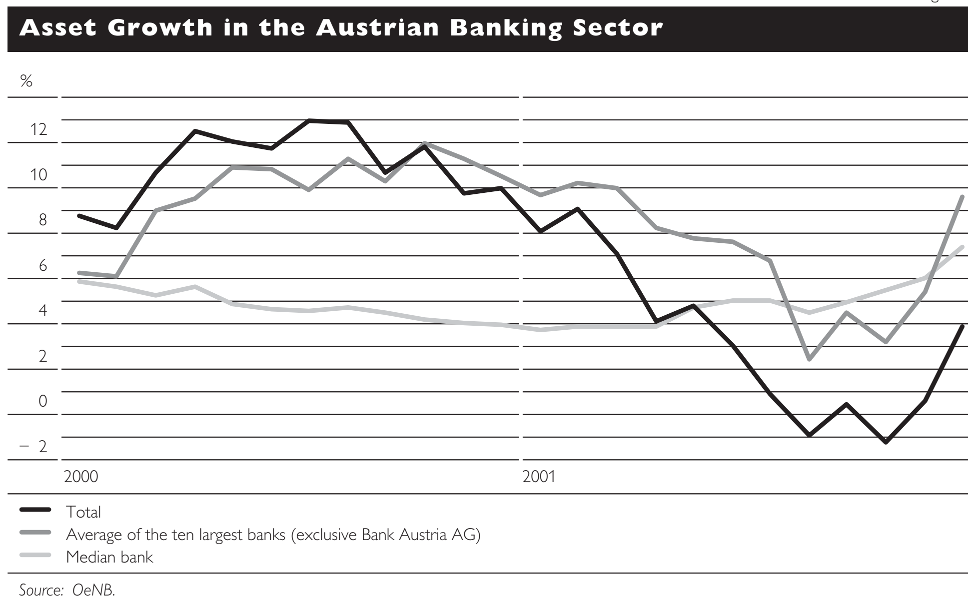
Banks

Total Asset Growth Increases in the Second Half of 2001

Since the second half of 2000 the annual growth of total assets of all Austrian credit institutions declined steadily. This trend was ascribable primarily to the restructuring measures accompanying the merger of Bank Austria AG and HVB.[1]) In the months that followed, a change in the development of Austrian credit institutions' total assets was observable, and in the last quarter of 2001 its growth rate increased to 3.9% p.a. The total assets recorded by all Austrian banks amounted to EUR 581 billion at end-December 2001 (unconsolidated, as reported in the monthly returns). When the consolidated balance sheets of the five largest Austrian banks are considered, which include foreign subsidiaries and participations, total assets, based on the 2001 annual accounts, stood at some EUR 650 billion.

Figure 14

Asset Growth in the Austrian Banking Sector



Source: OeNB.

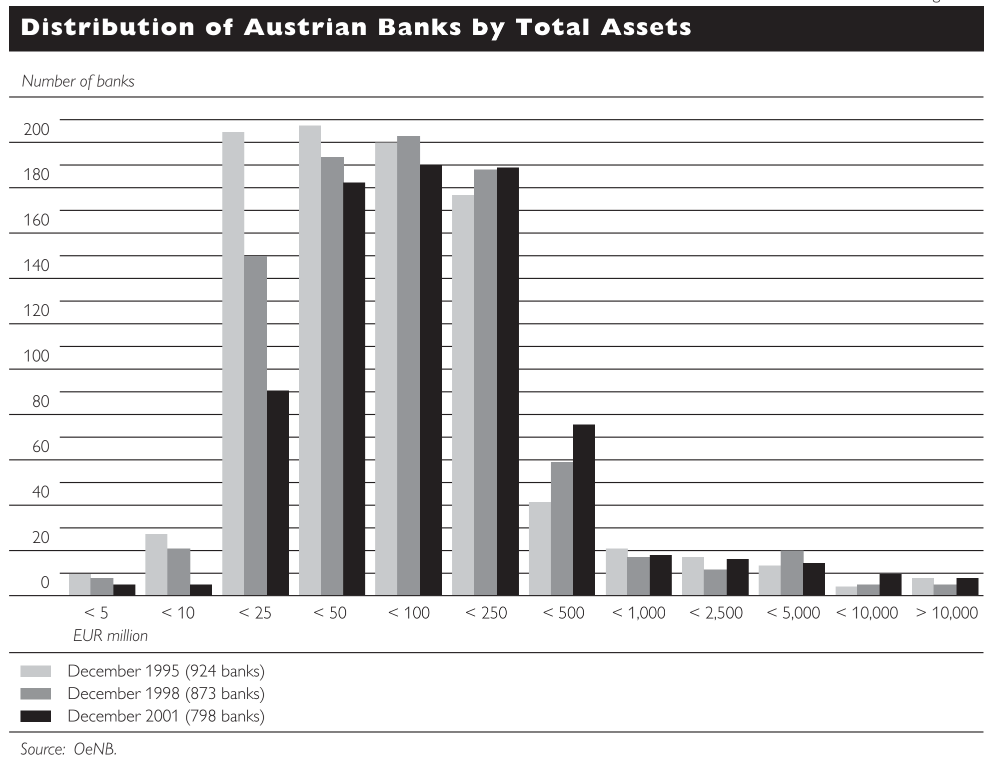
Figure 14 highlights two developments. On the one hand, as of mid-2000, the contraction of Austrian credit institutions' total assets (excluding special purpose banks) can not be attributed exclusively to Bank Austria AG's restructuring measures, since total asset growth posted by the ten largest Austrian banks – even when Bank Austria AG is factored out – fell from 12% in the last quarter of 2000 to just slightly over 2% by end-September 2001. The decline in total asset growth may therefore be partly ascribable to the economic slowdown. Total asset growth of an "average" Austrian credit institution, a so-called

1 *During the restructuring, part of the business volume of Bank Austria AG was transferred to HVB, which reduced Bank Austria AG's total assets substantially in 2001. Since Bank Austria AG, by far the largest bank in Austria, accounts for 25% of credit institutions' total assets, this decline had a marked impact on Austrian credit institutions' total assets.*

median bank,[1]) likewise reflected a, albeit modest, contraction from as early as the beginning of 2000 to the end of the first quarter of 2001. On the other hand, total asset growth of the ten largest banks excluding Bank Austria AG[2]) indicates a trend reversal already at the end of the third quarter of 2001. In the second half of 2001, total asset growth mounted from just over 2% to almost 10%. In the same vein, total asset growth calculated for the median bank climbed from close to 4% in the second quarter to 7.5% by the end of 2001. The median bank showed less pronounced total asset growth compared to the major banks, just as the preceding slowdown had been more subdued, too. Thus, the economic environment seems to impact the "average" Austrian bank to a lesser degree than the large banks.

Figure 15

Distribution of Austrian Banks by Total Assets



Source: OeNB.

1 *The term median bank refers to the credit institution for which it is true that 50% of all credit institutions show a given higher indicator (e.g. total asset growth, total assets, cost/income ratio); special purpose banks are not considered. Since the median bank differs depending on the indicator and varies over time, the median bank does not denote a specific credit institution. Rather, the median bank is a notional credit institution which represents a "typical" or "average" Austrian bank for a given indicator or ratio. Using the concept of a median bank instead of the average value ensures that the result is not distorted by outliers. For instance, the total assets calculated for the median bank are about EUR 80 million as at end-2001, while the average of the Austrian credit institutions' total assets stands at EUR 708 million. When we compare these values with the distribution of banks by total assets shown in figure 15, it is evident that the median bank provides a much more accurate picture of the total assets of a "typical" Austrian bank than the average, because the latter gives disproportionately more weight to the few major banks which record very large total assets.*

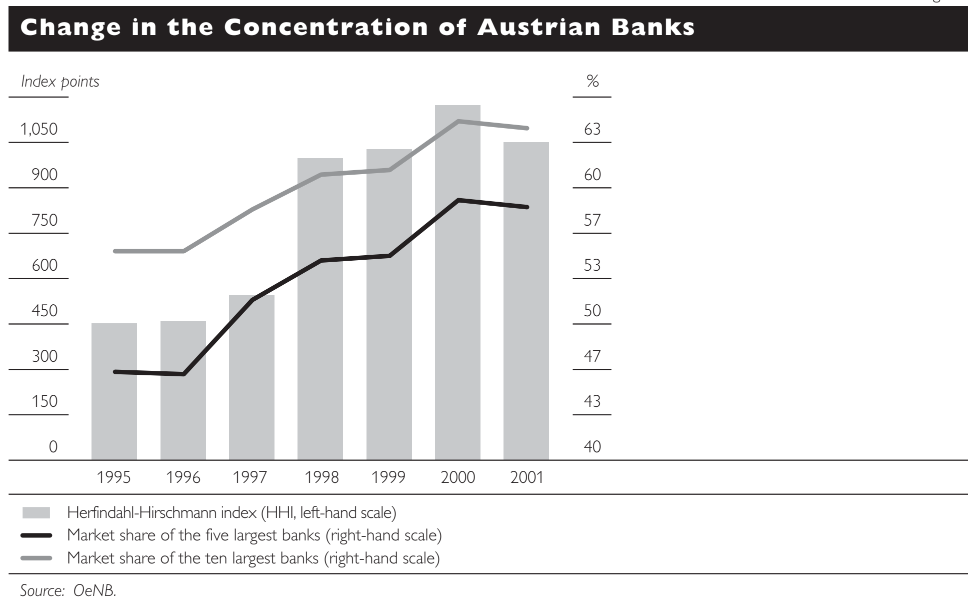
2 *This trend reversal is also observable for Bank Austria AG whose total asset growth started to increase again as of the fourth quarter of 2001. This would imply that the restructuring measures have been completed.*

The increase in total asset growth was mainly driven by stepped-up interbank business, which in the fourth quarter of 2001 expanded by 9.3% on the asset side and by 2.1% on the liabilities side year on year. At the same time, liabilities to nonbanks advanced by 6.1%, while claims on nonbanks edged up by a mere 2.9%. The differing asset-side and liabilities-side interbank growth rates are probably ascribable to the fact that nonbank deposits were plowed increasingly into foreign banks, especially to refinance Eastern European subsidiaries.

As at December 31, 2001, less than 10% of Austria's 798 credit institutions (excluding special purpose banks) registered total assets exceeding EUR 500 million, and only 4 large banks posted total assets of more than EUR 30 billion. Since the late 1990s the Austrian banking system has been subject to an accelerating concentration process given the mergers among smaller banks – especially Raiffeisen credit cooperatives. As a result, the number of credit institutions has decreased by some 13% since 1995. As is evident from figure 15, there has not been a gradual shift from one category to the next higher category of banks in recent years, which points to ongoing concentration. From 1995 to 2001, the number of banks whose total assets amounted to up to EUR 100 million decreased by nearly 30%, whereas the number of banks with total assets of between EUR 100 million and EUR 500 million rose by just slightly more than 20%. At the same time, the total assets of the median bank increased from EUR 52 million to EUR 80 million.

Figure 16

Change in the Concentration of Austrian Banks



Source: OeNB.

Concentration has also been underway among major banks, whose merger activities are of much greater systemic relevance. Figure 16 portrays the concentration path since 1995 via the Herfindahl-Hirschmann index (HHI)[1]) and by spelling out the shares of the five and ten largest banks, respectively, in banks' total assets (excluding special purpose banks). The pronounced rise of the HHI

1 *The HHI is calculated by summing the squared market shares in percent of total assets and (theoretically) yields values ranging from 0 (perfect competition) to 10,000 (monopoly).*

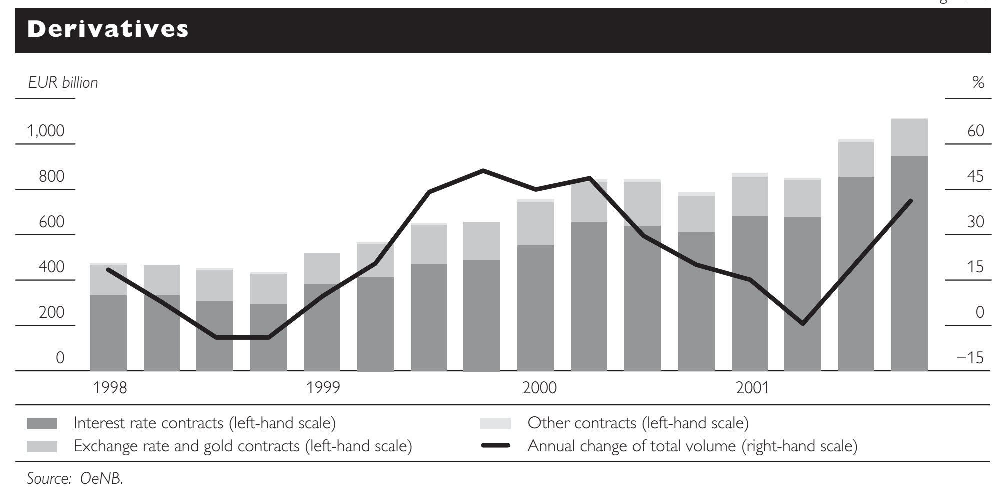
from 1995 to 2000 is attributable primarily to large-scale mergers (1998: Bank Austria AG/Creditanstalt AG; 2000: Bank für Arbeit und Wirtschaft AG (BAWAG)/Österreichische Postsparkasse AG (P.S.K.)). The 2001 drop in the HHI is traceable to Bank Austria AG's restructuring mentioned above.

Derivative Business on the Rise as the Volume of the Securities Portfolio Diminishes

After trading in derivatives (options, futures, swaps, etc.) had posted progressive annual growth rates in 1999, it slowed subsequently and almost came to a halt by the end of the second quarter of 2001. Figure 17 shows that this trend reversed in the second half of the year. By the end of the fourth quarter of 2001, the volume of derivatives traded amounted to more than EUR 1,100 billion (+41% year on year). Since December 2000, derivative transactions as a percentage of total assets jumped by 49 percentage points to 190%.

Figure 17

Derivatives



Source: OeNB.

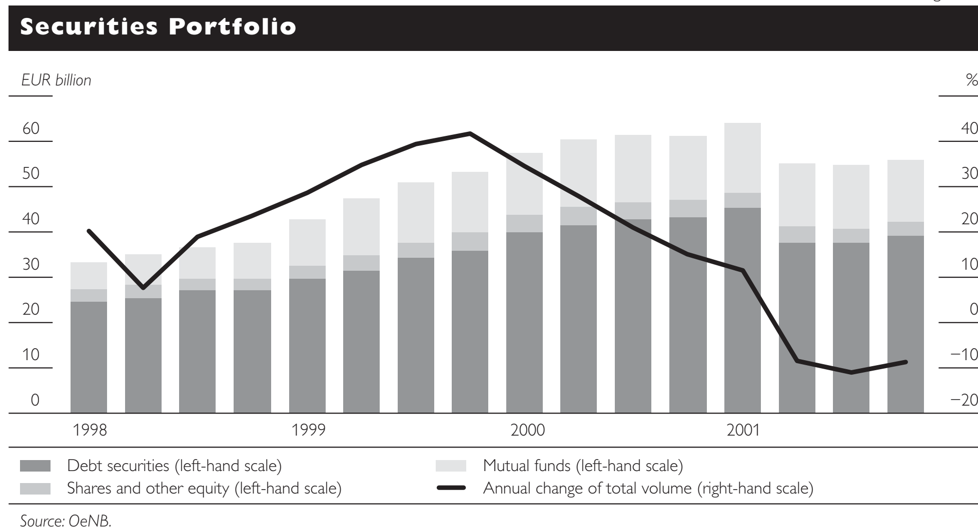
The increase derives almost exclusively from interest rate contracts, whose volume reached nearly EUR 950 billion in the fourth quarter of 2001. The bulk of interest rate contracts is made up of interest rate swaps, i.e. the exchange of fixed rate and floating rate interest payments, with floating rates linked to a money market rate, such as the EURIBOR.[1]) Since the establishment of monetary union, interest rate contracts have grown at a considerable pace, which seems to be largely due to the uniform yield curve that emerged on the swap market following the introduction of the euro.[2]) Banks use interest rate swaps, very much like government bonds, for instance to fine-tune cash flows in active/passive portfolio management and to control interest rate risk. According to figure 18, the share of debt securities in the entire securities portfolio

1 *The volume presented in figure 17 refers to the notional amount used to calculate the interest payments; the counterparties exchange only the difference of the fixed rate and floating rate interest payment. The notional amount as such is not exchanged, which is why the actual amounts transferred are much lower than the volume shown here. In addition, the trading volume is no indication of the risk inherent in the underlying transactions.*

2 *By contrast, the government bond market to this date has not been fully integrated given the differences in liquidity and credit risks as well as in the provisions on taxation.*

Figure 18

Securities Portfolio



Source: OeNB.

decreased perceptibly in the second quarter of 2001. In line with the global trend, Austrian credit institutions also seem to increasingly favor interest rate swaps over government bonds in performing active/passive management and in controlling interest rate risk.

Exchange rate and gold contracts account for the second largest share in the volume of derivatives traded. Their volume even edged up slightly in the first half of 2000, mainly owing to hedging transactions linked to foreign currency loans. Since the third quarter of 2000 their volume contracted by 18% from EUR 192 billion to EUR 152 billion. The diminished exchange rate risk (following the introduction of the euro) apparently did impact the trading volume of exchange rate derivatives, albeit with a time lag.

The volume of the securities portfolio of the Austrian credit institutions (see figure 18) expanded until the end of 1999, registering increasing annual growth rates. Growth subsequently slowed and turned negative in the third quarter of 2001. The volume of mutual funds rose steadily until early 2000, recording annual growth rates of up to 100%. From then onward growth rates continued to decline, and as of the second quarter of 2001, the volume of mutual funds even diminished year on year, closing the year 2001 at EUR 14 billion. The decrease in the volume of the entire securities portfolio is ascribable to the reduction in debt securities from EUR 45 billion to EUR 38 billion in the second quarter of 2001.[1])

Interest rate-sensitive instruments account for a significant share both in the derivatives traded (swaps) and in the securities portfolio (debt securities). In the light of the reporting requirements in place, it is not possible to provide a definitive assessment of interest rate risk, in particular regarding swaps. As of December 31, 2002, all Austrian credit institutions must provide quarterly reports on interest rate risk at the level of the individual institution, i.e. in an unconsolidated form. These reports are to outline the risk profile of a bank

1 *This marked decrease in the volume of debt securities is traceable to one single large bank and is likely to be connected to internal restructuring measures.*

in the area of interest rates, detailing a breakdown by the initial period of fixation, product category and currency. The statistics will shed light on an institution's interest rate risk and will support the supervisory review process with regard to assessing interest rate risk in the banking book as called for by Basel II. Among the banks which were subject to reporting as of end-2001, 13 institutions decided not to make use of the transitional period and to start compiling these statistics already as of December 31, 2001. The reported statistics have already been subjected to a rough analysis focusing in particular on financial stability, but given the small number of reporting institutions, a caveat applies to the preliminary findings, which do not point to a heightened risk potential for the system as a whole.

Continued Strong Presence of Austrian Banks in Central and Eastern European Countries

To date, the large Austrian commercial banks have established subsidiaries in 12 CEECs. In 2001, the focus of their activities was shifting increasingly to countries in the east of Europe, such as Bosnia and Herzegovina or Serbia, where Austrian credit institutions are at the vanguard of foreign banks entering the market. The Austrian commercial banks established in the CEECs posted total assets of around EUR 59 billion[1]) at the end of 2001, no less than roughly 10% of all Austrian banking assets. Having continually expanded their operations, they now form a network of 38 banks with 2,611 banking offices and with some 51,700 employees – approximately two thirds of the employment count of the domestic banking sector. The large Austrian banks Bank Austria AG, Erste Bank and Raiffeisen Zentralbank Österreich AG (RZB) even employ considerably more staff abroad than at home.

Table 6 lists key ratios for the subsidiaries of Austrian banks in Croatia, Slovakia, Slovenia, the Czech Republic and Hungary.[2]) Their combined assets jumped to EUR 40.2 billion in the course of 2001 from EUR 24.0 billion at the end of 2000.

Austrian banks have a particularly high profile in the Czech Republic, Slovakia, Hungary and Croatia. At the end of 2001, the Slovakia-based banks topped the list with a share of roughly 40% of the local market (Slovenská Sporiteľňa being the largest, and Tatra Banka the third largest Slovak bank). Next in line are the banks based in the Czech Republic with a market share of 25% (Česká Spořitelna being the second largest, and HVB Czech Republic a.s. the fourth largest bank of the country), followed by Croatia (18%) and Hungary (17%).

The CEEC-based banks plan to boost their market shares in the various countries by taking over further banks, developing key accounts in the retail market and expanding their branch networks. In this respect, they stand to benefit from continued strong catching-up demand for financial services, which should remain a key driver of growth in the years ahead. Another pillar of

1 *Inclusive of the 34% share of Bank Austria AG in BPH PBK, Poland, which is managed by the Bank Austria-Creditanstalt group.*

2 *Exclusive of Poland for data protection reasons; following the merger of the two Polish subsidiaries of Bank Austria AG and HVB, only one bank continues to be majority-owned by an Austrian bank.*

Table 6

Eastern European Commercial Banks

Majority-Owned by Austrian Banks[1])

Country	Total assets	Operating profit	Risk costs	Market share	ROE	Staff	Banking offices
	EUR million			*%*		*Number*	
Croatia							
December 2000	1.715	57	– 25	13	20	1.108	58
December 2001	3.885	90	– 8	18	38	2.108	81
Poland							
December 2000	7.664	155	– 71	7	15	9.839	414
December 2001[2])	×	×	×	×	×	×	×
Slovakia							
December 2000	2.789	79	– 13	16	28	2.365	98
December 2001	8.507	115	1	40	21	8.851	566
Slovenia							
December 2000	706	14	0	5	17	380	12
December 2001	944	13	– 5	5	3	413	15
Czech Republic							
December 2000	15.256	170	– 100	21	3	17.303	749
December 2001	21.159	272	– 87	25	11	15.486	756
Hungary							
December 2000	3.484	59	– 11	18	26	2.813	134
December 2001	5.742	98	– 16	15	17	3.455	160
Total (exclusive Poland)							
December 2000	23.951	379	– 148	×	×	23.969	1.051
December 2001	**40.237**	**588**	**–114**	**x**	**x**	**30.313**	**1.578**

Source: OeNB.

[1]) *Rounded national totals; data for December 2001 reflect the merger with subsidiaries of HVB.*

[2]) *Not available for this reporting date for data protection reasons.*

growth is the substantial progress made in enhancing banking structures and preparing the ground for EU accession. The other side of the coin of the strong presence of Austria's large banks in the CEECs is, of course, an increasing dependency on the financial stability and soundness of the banking systems in these countries amid cyclical downturns. When the parent company of a group uses its capital to finance acquisitions and takeover activity is strong, the capital buffer declines continuously. Accordingly, the large Austrian banks have increased their capital (at RZB a EUR 363 million capital increase, mostly earmarked to fund the bank's eastward expansion, has already been approved) or are planning to do so (Erste Bank) in order to finance their activities in Eastern Europe.

The subsidiaries are a key source of group income: in 2001 they contributed substantially to the operating profit achieved by the Austrian banking groups. In the case of Bank Austria AG, for instance, the Central and Eastern European (CEE) subsidiaries generated 25% of the group's operating profit for 2001 while accounting for just around 8% of the assets of the group. The medium-term target of Bank Austria AG is for its subsidiaries to deliver 50% of the group's operating profit. The highest profit contribution (63%) was generated by the CEE subsidiaries of RZB, representing 24% of the group's total assets. Erste Bank owes its favorable assessment by rating agencies and the good performance of its stock at the Wiener Börse, among other things, to the success of its oper-

ations in Eastern Europe and the swift integration of both Česká Spořitelna and Slovenská Sporiteľňa into the group network. The return on equity (ROE) of the subsidiaries, reaching up to 46% at individual banks, also attests to their high profit potential. Risk costs likewise developed favorably in 2001, with the exception of Poland.

Bank Profitability Roughly Unchanged in 2001

The performance of the Austrian banking industry was stronger in 2001 than the initial quarterly statements and the events of September 11, 2001, first implied. By and large, profits were as high as in 2000, notably because of the favorable developments in the final quarter. The profitability assessment based on unconsolidated quarterly report data can be refined with (preliminary) group analyses.[1]) These results are, however, not fully comparable with the previous year's data because three large banks switched to IAS reporting in 2001. Moreover, the results reflect a number of one-off effects stemming from changes in the group structure of the large banks.

Judging from unconsolidated data, the operating profit of all Austrian banks taken together has remained fairly constant over the past five years (except for a low in 1999) when measured as a percentage of total assets. At the end of 2001, this ratio stood at 0.8% (unconsolidated; 0.84% on a consolidated basis[2])) for all banks, while the smaller banks achieved a better result at 0.92%.

Year on year, the (unconsolidated) operating profit of all banks rose by 1.3% to EUR 4.58 billion in 2001. This compares with a rise by 4.6% on a consolidated basis, reflecting a 14% increase in consolidated operating income and a 19% expansion of consolidated operating expenses. Here, the big banking groups provided the key impetus, improving their operating profit by up to 16%. By contrast, the operating profit of the smaller banks deteriorated by 4.7%, thus falling short of expectations, but nonetheless exceeding the year-earlier figure because risk costs were lower in 2001.

Both the unconsolidated and the consolidated analysis show net interest income to have risen in 2001, specifically by 5.2% on an unconsolidated basis. After having consistently deteriorated from 1.9% to 1.2% from 1993 to 1999 and subsequent stabilized in 2000, net interest income (in % of total assets) climbed to 1.24% in 2001 for the banking industry as a whole, or to as much as 1.66% when the large banks are factored out. The slight rebounding can probably be ascribed to an easing of refinancing conditions given lower money market rates and to an improvement in retail margins. The additional income generated by the subsidiaries abroad boosted the consolidated result.

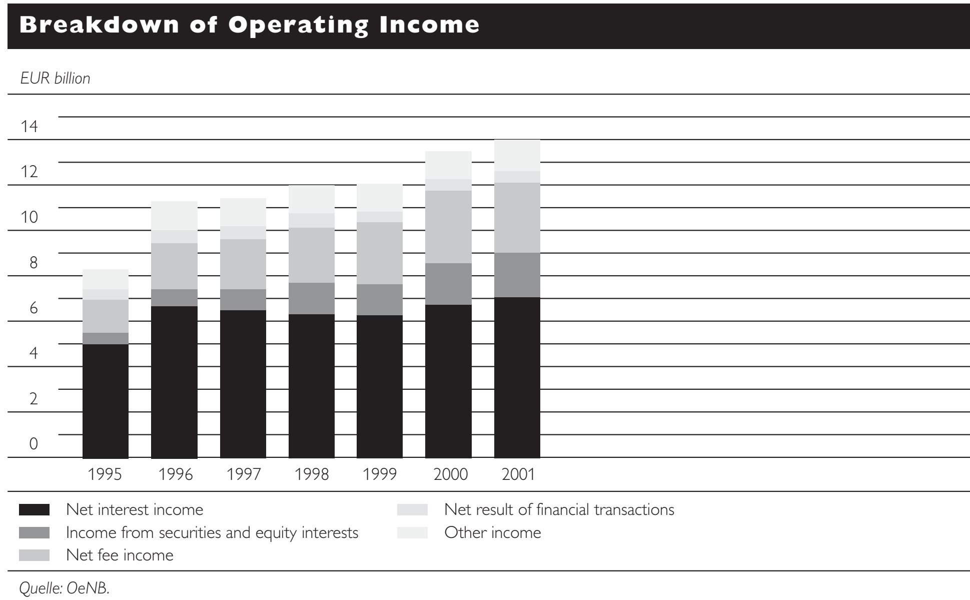
As is evident from the structure of operating profit since 1995 (see figure 19), net interest income has been accounting for an increasingly lower share of operating income. Its end-2001 share of 50.4% is in fact a slight improvement on the 2000 result, on account of the weak performance of

1 The OeNB is scheduled to receive the final results for the fourth quarter and the full year following the audit of the banks' financial statements.

2 Consolidated data were calculated for Bank Austria AG, Erste Bank, BAWAG/P.S.K. group, RZB and ÖVAG from the preliminary consolidated group results of these banks for 2001. Therefore, consolidated data are supplied only for the banking sector as a whole and for the major banks.

Figure 19

Breakdown of Operating Income



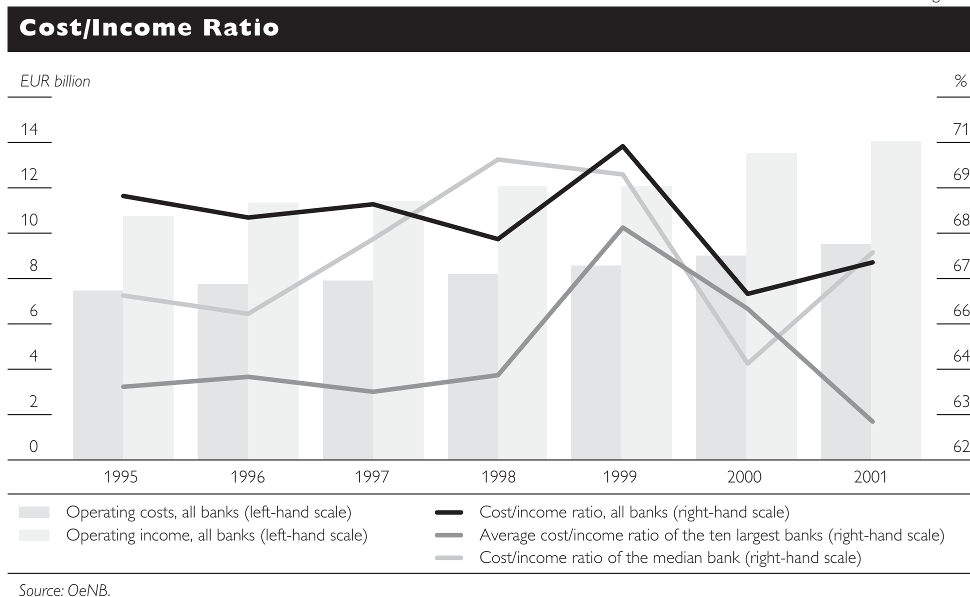
Quelle: OeNB.

noninterest, fee-generating business. Fee-based income (on a net basis) contracted by 4.4% in 2001, reflecting the sharp drop in fee income from securities transactions. Overall, interest income activities have, however, consistently lost in importance over the past years. Fee-based income and income from financial transactions tend to be more volatile as they are linked to capital market performance. When the stock market is weak, the – by international standards – comparative strong reliance of Austrian banks on interest income activities thus stabilizes earnings.

The gains in operating income (+3.9%) registered in 2001 were slightly lower than the increase in operating expenses, as both staff costs (+4.5%) and administrative expenses (+7.5%) rose substantially. As a result, the

Figure 20

Cost/Income Ratio



Source: OeNB.

cost/income ratio deteriorated by 0.8 percentage point year on year to 67.4% at the end of 2001. The cost/income ratio has not exhibited a uniform trend since 1995 (see figure 20). What is striking is that the ten largest banks tend to score a better ratio than the median bank and than all banks taken together.[1]) The cost/income ratio of the ten largest banks has improved consistently since 1999 and measured 63% at the end of 2001 whereas that of the median bank deteriorated in the past year.

As the distribution of banks by the cost/income ratio shows, most banks are in the range of 60% to 80%. However, the number of banks in the 50 to 60 percentage band was visibly lower year on year at the end of 2001, while the number of banks in the range of 70% to 80% was markedly higher. The number of banks whose expenses cancel out more than 80% of their income also rose in 2001.

The expected requirement for additional loan loss provisioning in 2001 exceeded the corresponding expectations in 2000 by 14%. Holdings of securities and equity interests generated income through appreciation, causing risk costs to shrink overall. As a percentage of the profit for the year or of total assets, the risk costs of the Austrian banking sector have in fact declined consistently over the past five years. Broken down by sectors, (unconsolidated) risk costs have been going down in all sectors but the savings bank sector. The consolidated assessment reveals an increase of risk costs in the group balance sheets but a decrease in the balance sheets of the smaller banks, which adds up to a slight reduction in the bottom line.

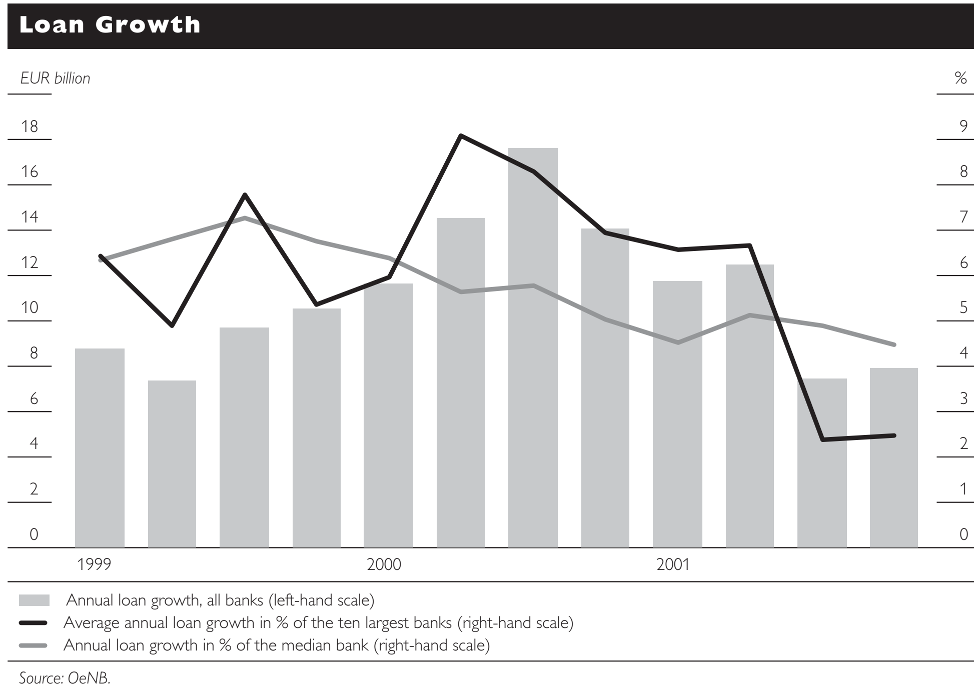
Loan Growth Decelerated Visibly,
Demand for Foreign Currency Loans Stabilized

At a total end-2001 credit volume of EUR 233 billion, lending continues to be a major business area of Austrian banks. Demand for loans has, however, been decreasing markedly since the end of 2000 even though interest rates declined. As is evident from figure 21, annual loan growth decelerated further, from EUR 12 billion to an annual low of EUR 7.9 billion in the third quarter of 2001. The ten largest banks were clearly hit much harder than the median bank, whose loan growth rates contracted only slightly in recent years. In the second half of 2001, loan growth dropped from 5.1% to 4.5% at the median bank, but from 6.3% to 2.5% at the ten largest banks.

A breakdown by economic sectors reveals that loan growth declined above all as corporate sector demand softened amid the economic slowdown. While in the first two quarters of 2001 nonfinancial corporations accounted for roughly two thirds of loan growth, their share dropped to 43% by the fourth quarter, falling from EUR 8.5 billion to EUR 3.5 billion. Over the same period, growth of loans to households contracted merely from EUR 4.5 billion to EUR 3.6 billion; this translates into a growth contribution of loans to households of 44%, which is even somewhat better than that of loans to the corporate sector. The slight rebounding of loan growth in the fourth quarter of 2001 can be traced to domestic financial intermediaries (excluding banks), mostly insurance compa-

1 The calculation of the cost/income ratio is based on the data of the quarterly report; it does therefore not reflect consolidated group returns for the major banks.

Figure 21

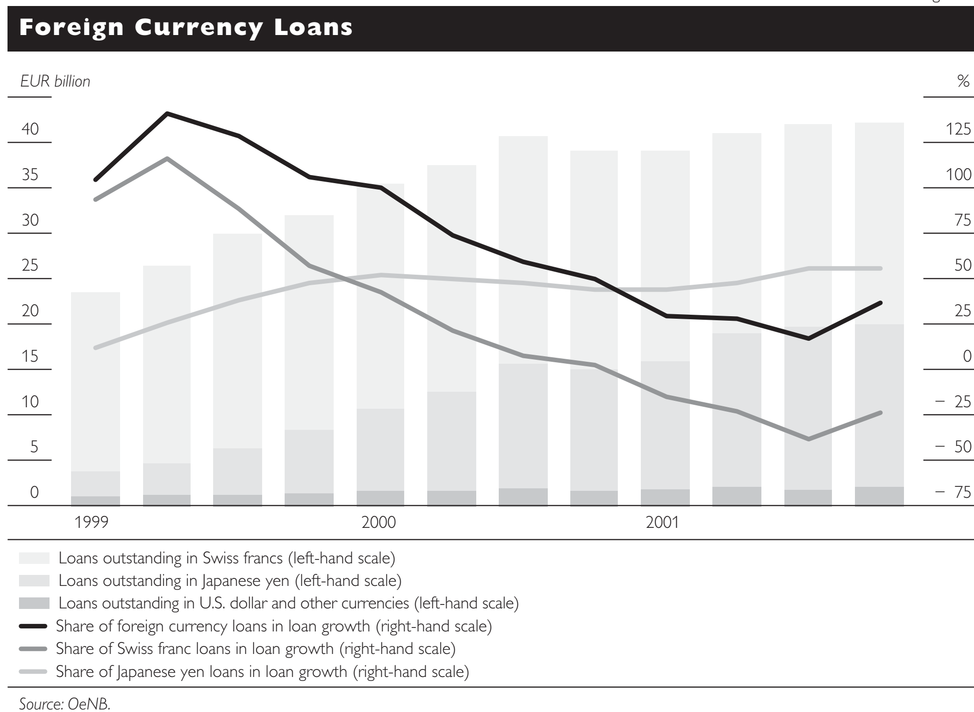


Source: OeNB.

nies, whose funding needs increased in the wake of the terrorist attacks of September 11, 2001.

Demand for foreign currency loans stabilized from mid-2000 compared with previous years. While the share of foreign currency loans in total loan growth (including loans to financial intermediaries other than banks and to

Figure 22



Source: OeNB.

the public sector) was more than 100% in 1999 owing to a decline in euro-denominated loans, this share dropped to 17% by the third quarter of 2001 (see figure 22). Notably the annual growth of loans in Swiss francs and their share in overall loan growth decelerated from 1999 onward and turned negative at the beginning of 2001. Over the same period loans in Japanese yen soared, causing their contribution to overall loan growth to increase to 56% in the third quarter of 2001, from 44% in the corresponding quarter of 2000. In the fourth quarter demand for yen loans stabilized, while the decline of loan growth in Swiss francs dropped from –37% to –25%. In the bottom line, the share of foreign currency loans in total loan growth rebounded to 37%.

Reflecting increased demand for loans in Japanese yen, the share of the latter in total foreign currency loans outstanding at the end of the final quarter of 2001 increased from 34% to 41% year on year, which corresponds to an outstanding volume of EUR 17.8 billion. Over the same period the share of lending in Swiss francs contracted from 61% to 52%. Notwithstanding the recent negative growth rates, Swiss francs continue to account for the bulk of foreign currency loans outstanding, namely EUR 22 billion.

At a rate of nearly 18%, the share of foreign currency loans in total loans outstanding continues to be high in an international comparison. While demand for foreign currency loans appears to have stabilized in 2001, these loans must be monitored closely with a view to the stability of the Austrian banking sector. After all, the share of yen loans, which entail a higher exchange rate risk than loans in Swiss francs, in total loan growth has increased year on year. Even though the exchange rate and interest rate risk inherent in foreign currency loans must be met by the borrower, such loans have nonetheless indirect implications for the risk positions of banks. At any rate, banks take a stern line on adequate collateralization and pay heightened attention to monitoring loan accounts.

Credit Risk Rose Slightly, but Risk-Bearing Capacity is Satisfactory

For virtually all Austrian banks credit risk is the most critical source of risk they are faced with. The current credit risk can be assessed on the basis of the data banks report under the prevailing capital adequacy directive as defined by the Basel Accord of 1988. In calculating the regulatory capital requirement, loans must be weighted according to the credit standing of the borrower; hence the share of risk-weighted assets in total assets may serve as an indicator of credit quality.

This ratio was considerably smaller at 45% for the ten largest banks at the end of 2001, compared with 58% for the median bank. This implies that, on average, the large banks tend to grant fewer higher-risk loans than the "average" Austrian bank. To some extent this may be due to the fact that the large banks tend to grant comparatively more loans to the public sector, i.e. to prime borrowers, than the "average" Austrian bank.

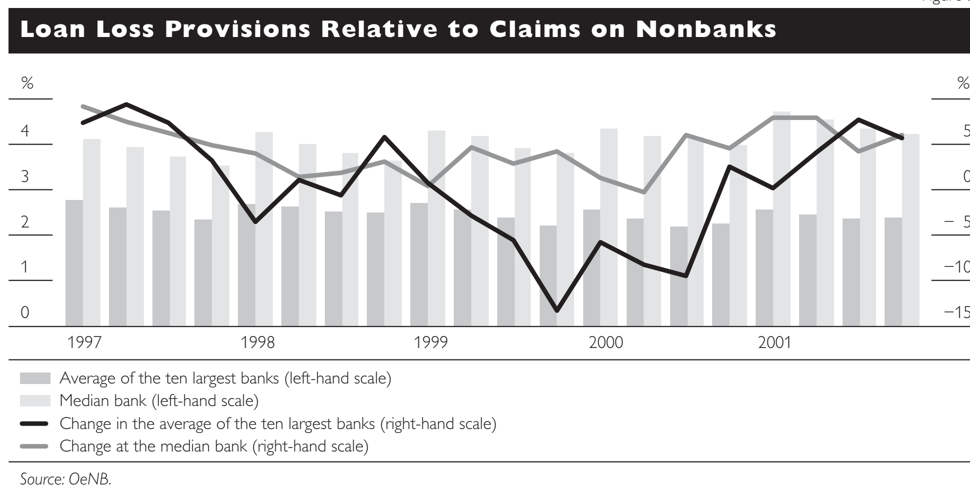
Another important indicator for assessing credit risk within the current Basel framework is the ratio of loan loss provisions to total claims, i.e. the level of risk provisions that banks report in their monthly returns in respect of loans that are likely to be irrecoverable. Regarding interbank loans, banks reported a very low level of loan loss provisions in the past two years, on average below

0.1% of interbank claims. As loans to nonbanks account for a considerably larger share of the credit risk of Austrian banks, the requirement for loan loss provisions is much higher in this segment. In the past few years total loan loss provisions in respect of claims on nonbanks were at a relatively low level (between 3% and 3.75%). The figure for the fourth quarter of 2001 was 3.16%, which is a slight increase (0.15%) year on year.

Figure 23 plots the loan loss provisions in respect of loans to nonbanks taken by the systemically important banks against such provisions taken by the "average" Austrian bank. In recent years, the loan loss provision rate of the ten largest banks was consistently 1 to 2 percentage points below that of the median bank. The ten largest banks closed the year 2001 with a loan loss provision rate of 2.4%, and the median bank at 4.2%. In both cases this corresponds to an increase by more than 5% on the previous year, though.

Figure 23

Loan Loss Provisions Relative to Claims on Nonbanks

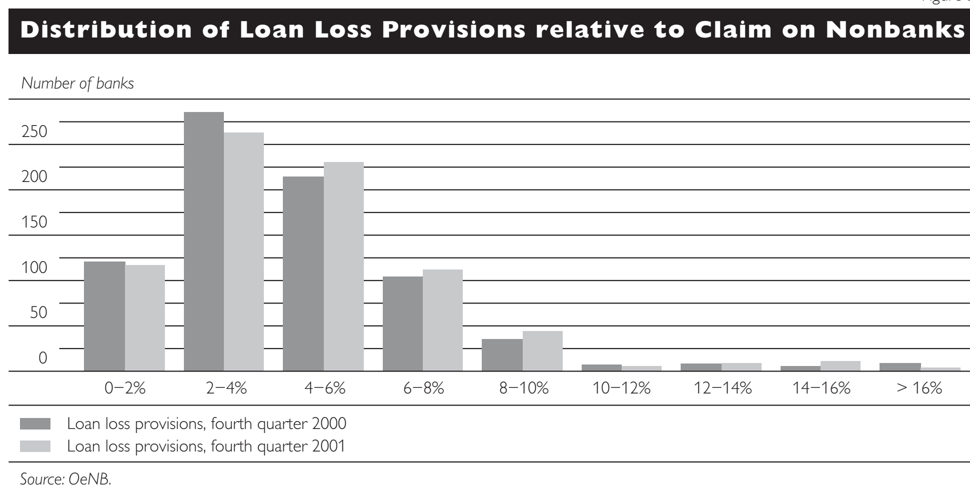


Source: OeNB.

Figure 24, which shows the distribution of Austrian banks in accordance with their loan loss provision rate, confirms the slight annual deterioration that loan portfolios have undergone. The distribution has generally shifted to the right; in other words, a larger number of banks were taking higher loan loss

Figure 24

Distribution of Loan Loss Provisions relative to Claim on Nonbanks



Source: OeNB.

provisions. In 2001, 25 banks (or about 4% of the banking industry) moved from the category of banks with a loan loss provision ratio of up to 4%, while roughly the same number shifted to the category of banks with a ratio between 4% and 10%. The number of banks that reported loan loss provisions above 10% in the final quarter of 2001 has remained constant at 29 (3.6% of credit institutions) year on year; in other words, the deterioration of credit quality is not that dramatic. The number of banks with loan loss provisions of 16% or more even shrank from 10 to 5 banks over the same period.

To round off the evaluation of the risk-bearing capacity of the Austrian banks, their capital ratio must be critically assessed along with credit quality and credit risk. The average year-end ratio of capital allocated against credit risk[1]) across the banking sector has hovered between 13% and 14% since 1998. This is safely above the minimum ratio required under the Banking Act (8%), which was not missed by a single bank in the final quarter of 2001.

Within the individual sectors, capital ratios have been developing along relatively constant lines since 1998: At the end of 2001, the savings banks reported the highest capital ratio at 15.7% apart from special purpose banks (25.2%), while the state mortgage banks (10.9%) and the building and loan associations (9.7%) fell clearly short of the 13.8% capital ratio of the banking sector as a whole. The joint stock banks (12.1%), the Raiffeisen credit cooperatives (12.8%) and the Volksbank credit cooperatives (12.9%) are roughly halfway between the extremes.

A comparison of the ten largest banks with the median bank (see figure 25) shows that the systemically important banks have considerably improved their ratios from the fourth quarter of 2000. At the end of 2001, the capital ratio of these banks averaged 13.1%, 1 percentage point above the median value. The capital ratio of the large banks has, however, been a lot more volatile than that of the median bank; while the latter has held steady between 12% and 12.5% since 1998, the former shrank markedly between 1999 and mid-2000, evidently reflecting, among other things, the increased capital needs for funding the expansion into the CEECs. In the first three quarters of 2000, the ratio was even below that of the median bank. From the fourth quarter of 2000 it rebounded visibly[2]) by up to 14% a year, thus trailing the corresponding annual figure (13.2%) by a mere 0.1 percentage point. The dispersion of the capital ratio was also satisfactory at the end of 2001: The 95% quantile[3]) of the capital ratio was 8.7% in the fourth quarter of 2001, and almost 80% of all banks had a capital ratio of above 10%.

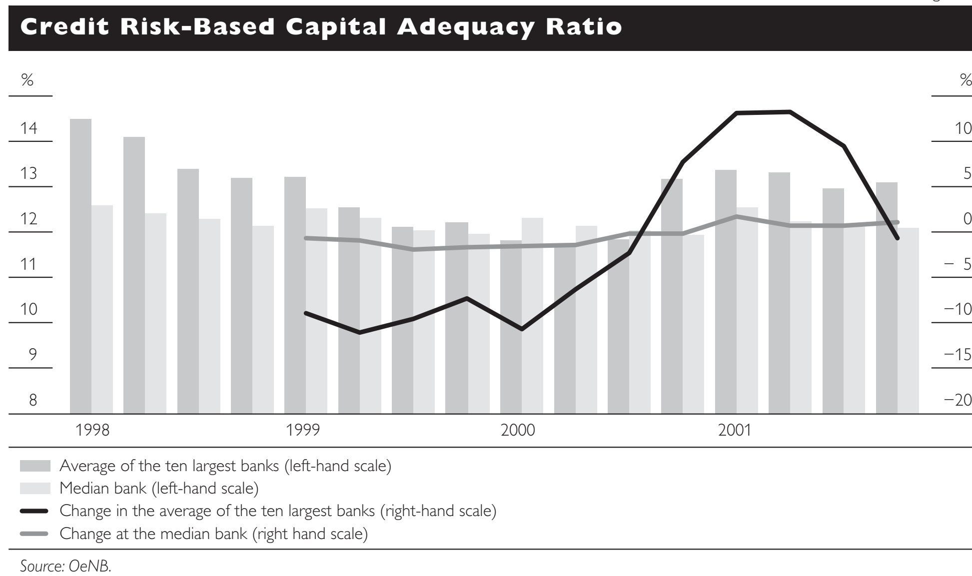
1 *In this context the capital ratio refers to the capital eligible as credit risk cover under the Austrian Banking Act, i.e. core capital (tier 1) plus supplementary capital (tier 2) minus deduction items as a percentage of the assessment base. The capital ratios published in the weekly financial statement of the OeNB and its Financial Stability Report 2/2001 also include tier 3 capital and are therefore higher. Since the latter is subordinated capital that may only be allocated against market risks, it was not included here so as to produce a conservative capital adequacy assessment.*

2 *The high annual growth rates until the third quarter of 2001 can be traced above all to the increase in the average capital ratio of the top ten banks from 11.9% to 13.2% from the third to the fourth quarter of 2000. This rise in turn results basically from the issuance of large volumes of subordinated capital by one of the large banks, which caused the amount of eligible capital – principally tier 2 capital – to increase by 80%.*

3 *The 95% quantile indicates the capital ratio that is exceeded by 95% of all banks.*

Figure 25

Credit Risk-Based Capital Adequacy Ratio



Source: OeNB.

Judging from the data available at the cut-off date for this report, the risk-bearing capacity of the Austrian banks is satisfactory. While higher provisions have been allocated against loans to nonbanks in an annual comparison, this may be mostly due to the economic slowdown. On average, loan loss provisions were some 5% higher at the end of 2001 than a year earlier, but the share of banks with a loan loss provision ratio of over 10% has remained constant year on year. Moreover, banks continue to maintain solid capital ratios, which are on average safely above the statutory minimum 8%.

From a stability perspective it is worth mentioning that the systemically important banks clearly outperform the "average" Austrian bank in terms of all credit quality or credit risk indicators available: Over the past years risk-weighted assets as a percentage of total assets, loan loss provisions as a percentage of claims on nonbanks as well as problem loans as a percentage of total claims[1]) were consistently lower in the average of the ten largest banks than the respective median values. The data available for the fourth quarter of 2001 attest to a continuation of this trend. At the same time, the large banks reported above-average capital ratios since the final quarter of 2000, implying a good risk-bearing capacity for the systemically important banks.

1 *For a detailed description of credit quality as evidenced in the prudential reports for the period 1996 to 2000, refer to issue 2 of the OeNB's Financial Stability Report (2001). The corresponding figures for 2001 were not yet available at the cut-off date for this report.*

Other Financial Intermediaries

Mutual Funds

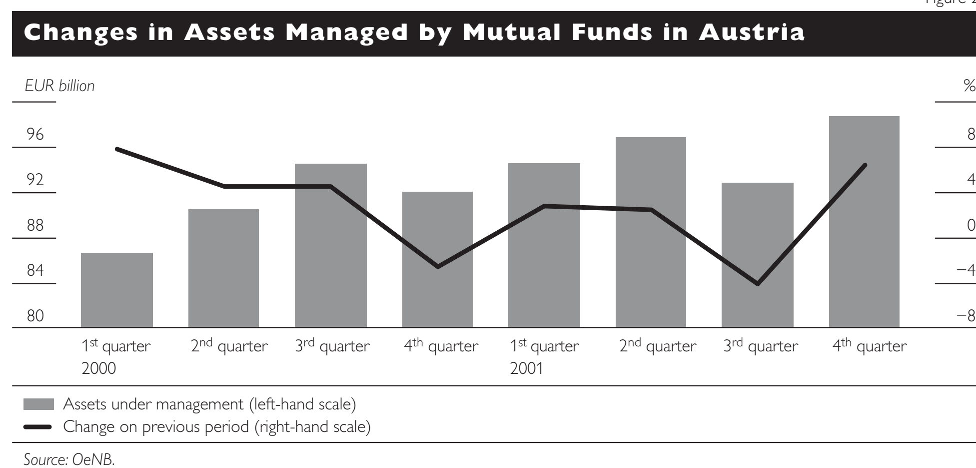
The portfolio[1]) return of Austrian mutual funds in 2001 reflects the situation on the stock market and the events in the U.S.A. Following constant growth in the first two quarters, a setback occurred after the terrorist attacks of September 11. These interim losses did not fully feed through to the bottom line, however. By the end of 2001, Austrian asset management firms had expanded their investment portfolio to EUR 86.8 billion, which corresponds to an annual return of 4.6% and is in fact twice as high as the European average (EU total excluding Austria: 2.3%). The amount of capital newly invested in mutual funds in 2001 grew by 7.6%, causing assets under management to rise to EUR 98.7 billion. While falling short of the impressive growth rates of previous years, this rate came close to the growth rate of savings deposits, which amounted to 7.8% in 2001.

Regarding the investment pattern of Austrian mutual funds, the bulk of assets – over 60% – continued to be invested in fixed-income securities. Investment in mutual fund shares mounted from 9% in 1999 to a share of some 18% by end-2001. The share of stocks and other equity continued to hover around 20%, unchanged from 2000. Thanks to the rather conservative portfolio mix with a fixed-income bias, Austrian mutual funds reported only small price losses at EUR 9 million in the wake of the global adverse stock market developments and the terrorist attacks in the U.S.A. Measured against assets under management at December 2000, this implies an overall performance of close to –0.01%. In 2001, only 74 or 17% of all 441 equity funds performed positively, while as many as 89% of all fixed-income funds gained in value compared with a year earlier.

As a result of their high fixed-income bias, the mutual funds operated by Austrian investment companies do not follow the European trend,[2]) which is increasingly dominated by equity funds. Across Europe, the share of equity

Figure 26

Changes in Assets Managed by Mutual Funds in Austria



Source: OeNB.

1 *Managed portfolio 2001 equals managed portfolio 2000, plus capital newly invested, minus dividends, plus/minus price gains/losses.*

2 *See Fédération Européenne des Fonds et Sociétés d'Investissement (FEFSI). The State of European Investment Funds Industry, 2001.*

funds rose from 25% in 1995 to 40% at the end of 2001. Apart from the favorable stock market developments in this period, the growing appeal of alternatives to traditional savings products may have been driving this trend.

Given the surge in mutual fund assets, investment companies have come to bear more strongly on systemic stability, and new challenges stand to arise from the reform of employee termination benefits. Stability depends, among other things, on balanced asset allocation, which will sustain the funds also in times of crisis. The institutionalization of investment in securities markets through professional asset managers is becoming more and more important not least for reasons of efficiency and stability. While professional money management has its merits, the growing concentration of funds that it entails evidently creates new risks that need to be controlled effectively for prudential reasons.

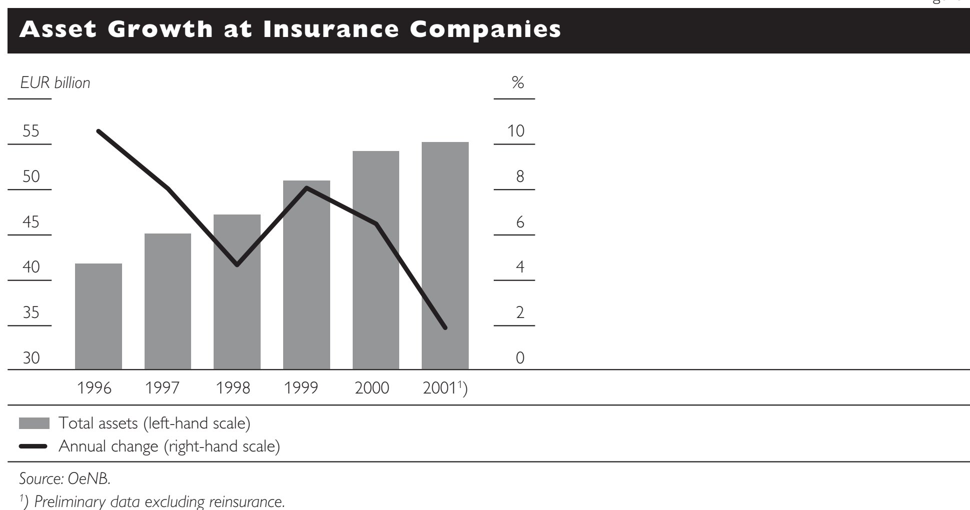
Insurance Companies

Judging from preliminary data, the performance of Austrian insurers was positive in 2001, despite the stock market downturn and the terrorist attacks in the U.S.A. In continuation of the trend established in previous years, the insurance premium volume increased further. Since 1990, insurance density[1]) has in fact grown at a faster rate than the population, reflecting above all the continued boom of private retirement provision. The data that the Association of Austrian Insurance Companies has made available so far indicate that the premium volume expanded by 6.6% in 2001. Most of the premium growth of 2001 is attributable to life insurance plans, and the remainder to health, damage and accident insurance plans.

The development of the investment portfolios of insurance companies was mixed. While the growth rate of holdings of domestic debt securities and lending to the public sector decreased within a range of 1.8% and 24%, that of domestic equity interests and foreign assets contracted slightly in the third quarter of 2001 in the aftermath of the September 11 events; these setbacks could, however, be offset until the end of the year.

Figure 27

Asset Growth at Insurance Companies



Source: OeNB.

[1]) Preliminary data excluding reinsurance.

1 *Premiums per capita.*

The growth in total assets observed in previous years is likely to have continued in 2001, albeit at a markedly lower rate than before. This will also affect bonus payments, i.e. profit share payments which are granted beyond the guaranteed rate of return.[1]) Bonuses, which used to amount to between 6% and 7% of profit in recent years are likely to have dropped to between 5% and 5.5% in 2001. This implies that longer-term weaknesses in capital markets may affect the performance of insurance providers despite the stringent statutory investment regulations. While the private sector insurance market generates comparatively little added value (1.5% in real terms), it is a key player from a stability perspective given the huge sums that are handled by insurers. The negative repercussions of the September 11 events on the insurance industry are a case in point. The Association of Insurance Companies estimates the damage to the Austrian insurance industry to have totaled EUR 7.2 million at most. Thus the impact on Austrian insurance companies was rather moderate, thanks to the European focus of their international business. In this respect their activities in Central and Eastern Europe, which the leading insurance companies hope to expand further, are gaining in importance.

Pension Funds

In the light of the reform of pension systems and the growing significance of occupational pension provision, pension funds are playing an increasingly important role in the domestic financial markets. This is evidenced by the surge in assets managed by Austrian pension funds from EUR 1 billion in 1993 to some EUR 8 billion in 2001. The late 1990s stand out with annual growth rates of between 46% and 52%. Accordingly, the ranks of active and retired pension plan members swelled, jumping from 54,020 in 1993 to 318,000 by the end of 2001. The number of Austrian pension funds rose to 19 in 2001 and comprises 12 in-house pension funds and 7 multi-employer plans.

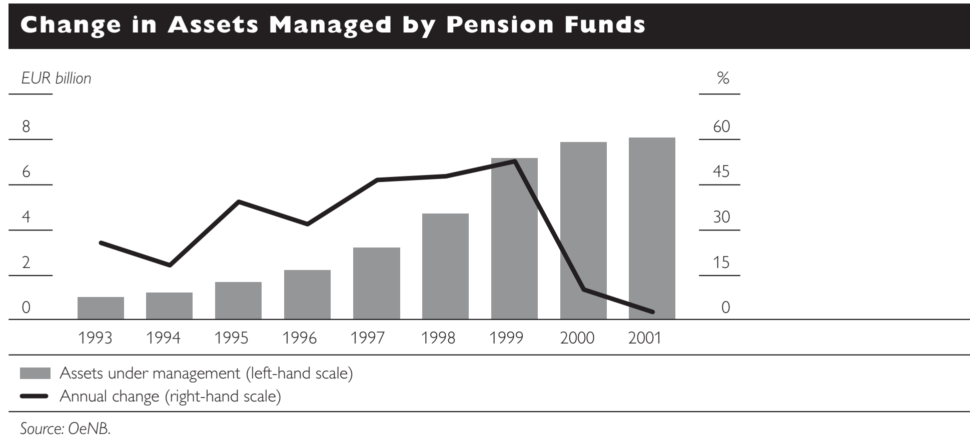
Overall, pension plan assets grew by just EUR 201 million in 2001 or a moderate 2.6% year on year, compared with about 10% in 2000. Affecting not only the performance of mutual funds and insurance companies, the adverse developments on stock markets took their toll on pension funds as well. The 7 multi-employer pension funds, for instance, reported a negative investment return of 1.5% on average. Since, unlike life insurance companies, pension funds do not offer a guaranteed rate of return, such conditions may lead to pension cuts under defined-contribution plans if the effective return on the capital is below the rate of return assumed in the actuarial valuation. To avoid this, legislators have foreseen the creation of a fluctuation reserve[2]) to compensate any shortfalls. However, should investment returns be weak over a succession of years, even the fluctuation reserve could be depleted, so that pensions would have to be cut after all. Pension funds are therefore called upon to adjust their investment strategies in line with capital market requirements.

1 *Insurance companies provide a guaranteed annual rate of return on accumulated premium payments. This rate is fixed at the time the contract is concluded and applies throughout the life of the contract. Currently the maximum guaranteed interest rate on premium payments is 3.25% p.a., according to a decision of the Austrian insurance regulator effective from July 1, 2000.*

2 *The fluctuation reserve consists of any returns on investment that exceed the budgeted returns and the actuarial gains.*

Figure 28

Change in Assets Managed by Pension Funds



Source: OeNB.

In the year under review, pension funds invested primarily in domestic assets. The lion's share, namely 89%, was invested in mutual fund shares, perpetuating the asset allocation pattern of recent years. Looking ahead, the transposition of the UCITS directive[1]) endorsed in December 2001 by the Ecofin Council will widen the range of investment possibilities for pension funds. Whilst maintaining the existing high level of investor protection, UCITS will be allowed to invest in money market instruments and units of UCITS authorized according to this directive. Moreover, UCITS have been permitted to invest in deposits with credit institutions that are repayable on demand or have the right to be withdrawn, and maturing in no more than 12 months, financial derivative instruments dealt in on a regulated market and OTC derivatives as well as index-tracking funds.[2])

1 *Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS.*

2 *Index-tracking funds are funds that mimic stock market or bond market indices.*