

Austria's Financial Intermediaries Are on a Dynamic Growth Path

The Austrian Banking System Has Become More Resilient to Shocks

Total Assets Continued to Increase Sharply

Mirroring the trend of recent months, Austrian banks' total assets continued to grow in 2006. Unconsolidated assets as reported by banks for the end of June 2006 totaled approximately EUR 765 billion, reflecting a 5.5% increase since the beginning of the year and a 9.7% increase compared with the same month of 2005. The share of the five largest banks¹ in this aggregate remained virtually unchanged at 44.3% even though their total assets expanded by an above-average 13% year on year. On a consolidated basis, the assets of the Austrian banking sector grew by 10.8% to EUR 874 billion in the year to June 2006.²

As in previous periods, external business was the key driver of the increase in Austrian banks' unconsolidated total assets.³ External assets increased by 10.3% from January to June 2006 (thus contributing 63% to overall growth) and by as much as 16% from June 2005 to June 2006. This compares with a more moderate rise of 6.5% in the domestic share of assets, and an expansion of external liabilities by 7.9% in the June 2005-to-June 2006 period.

The strong growth of cross-border activities is also reflected by individual balance sheet items. While domestic interbank claims rose by 2.9% year on year, claims on foreign banks jumped by 16.2%; and while claims on domestic nonbanks expanded by 6.4%, claims on foreign nonbanks climbed by 11.9% in the same period. Foreign interbank claims accounted for 50.3% of total external assets, and claims on foreign nonbanks for 27.3%.

Mirroring developments on the assets side, foreign interbank liabilities jumped by 15.4% and liabilities to foreign nonbanks by 16.8%, compared with a more moderate rise of 3.4% in liabilities to domestic banks and of 5.1% to domestic nonbanks.

The nominal value of special off-balance financial transactions (derivative business) totaled EUR 1,565 billion on June 30, 2006, which reflects a slight increase by 2.4% over the previous 12 months. Quantitatively, this volume is basically twice the amount of unconsolidated assets, but the meaningfulness of such a comparison is of course limited.⁴

The ongoing decline of banking offices in Austria has continued also in 2006. As at June 30, 2006, 5,165 banking offices operated in Austria, which reflects a reduction by 59 offices compared with mid-2005.

¹ Bank Austria Creditanstalt AG (BA-CA), Erste Bank der oesterreichischen Sparkassen AG (Erste Bank), Raiffeisen Zentralbank Österreich AG (RZB), Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG (BAWAG P.S.K.) and Österreichische Volksbanken AG (ÖVAG).

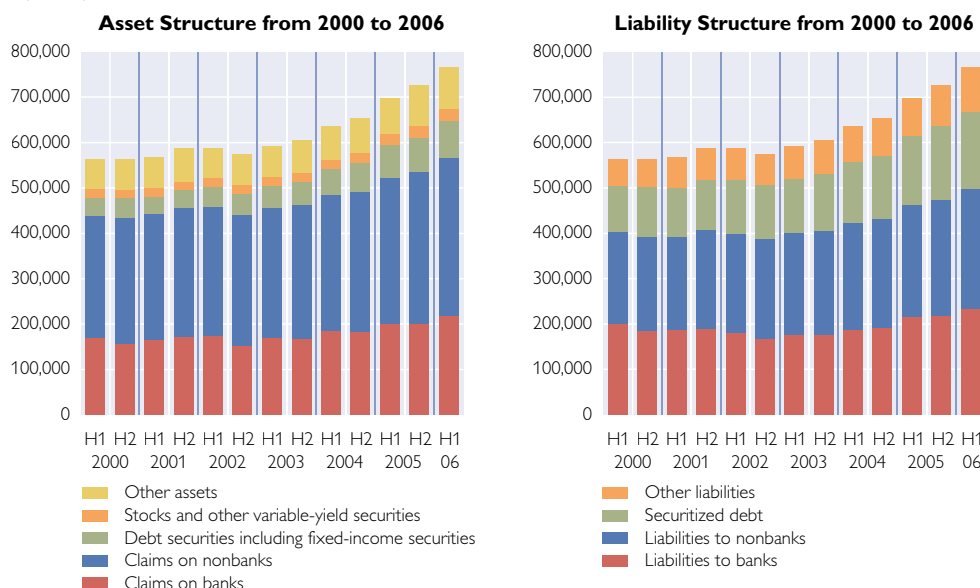
² As banks use different financial reporting systems, aggregated data may provide a slightly distorted picture.

³ An expansion of cross-border activities has also been reported at the international level (see for instance BIS Quarterly Review, September 2006, pp. 11, or the IMF's Global Financial Stability Report, September 2006, especially chapter 2).

⁴ Nominal figures do not provide a direct indication of the underlying risk of the derivatives business. Moreover, it should be noted that the position of off-balance sheet financial transactions tends to fluctuate heavily.

**Balance Sheet Structure of the Austrian Banking Sector
(on an Unconsolidated Basis)**

EUR million



Source: OeNB.

Profits Continued to Grow

Seizing upon a favorable business climate in both Central and Eastern Europe (CEE) and in Austria, Austrian banks improved their operating results further in the first half of 2006.

On a consolidated basis, the entire sector⁵ managed to improve its operating profits by 19% to EUR 4.5 billion in the first half 2006 compared with the same period one year earlier. Furthermore, the operating profit margin⁶ improved from 0.92% in 2005 to 1.04% in the first half of 2006, even though total assets were pushed up by new acquisitions and dynamic business conditions in Central and Eastern Europe. At the same time, the cost/income ratio continued to drop in the first half of 2006, from 63.3% in 2005 to 61.7%. Oper-

ating income rose by 14%, whereas operating costs increased by 11%. Fee income accounted for slightly more than half of overall operating income growth, thus remaining the key driver of income. The second key pillar (close to 40%) was interest income, which includes income from participating interests on a consolidated basis, and which moreover reflects the highly profitable lending and deposit-taking business in Central and Eastern Europe. Trading transactions, finally, contributed somewhat more than 10% to income growth.

Credit risk costs accounted for 9% of operating costs in the first half of 2006, compared with 11% in 2005. After tax, the period result was 44% higher than in the first half of 2005, while the consolidated return on as-

⁵ The aggregation of financial statements prepared in compliance with either the Commercial Code or the International Accounting Standards may result in minor imprecision.

⁶ Consolidated operating profit to consolidated total assets.

sets (ROA) improved considerably from 0.63% in 2005 to 0.72% in the first half of 2006.⁷

Domestic Interest Margin Narrowing Continually

While operations in Central and Eastern Europe account for the lion's share of Austrian banks' steadily rising profits, profitability has been improving also on the domestic market. The analysis of unconsolidated results, which reflects the domestic performance, shows that operating profits continued to rise in the first half of 2006, albeit, at a rate of 7%, somewhat less strongly than before. Unconsolidated operating income growth weakened slightly to 7%, whereas operating costs expanded somewhat more strongly (also by 7%). Fee income is the main driver of income growth also in domestic operations.

Reflecting higher credit growth in the first half of 2006 compared with the first half of 2005, unconsolidated interest income inched up 0.4%. At the same time, the interest margin – which ten years ago had stood at 1.75% – continued to decrease markedly, by 11 basis points to 1.03%. This decline mirrors the steady decrease in operating costs in relation to total assets since 1996, the strong increase in interbank competition and the sharp increase in foreign currency loans as well as – to a lesser extent – the rising share of noninterest income.⁸ Looking ahead, the in-

terest rates on new business would not imply an improvement of the interest margin. The difference between the interest rates on euro loans and euro deposits⁹ has in fact been below 1% since mid-2006 according to interest rate statistics.

Meanwhile, as much as 56% of unconsolidated operating income is noninterest income, compared with just 40% ten years ago. The higher growth rate of noninterest income observed in the past has also gone hand in hand with somewhat higher volatility. Yet the robust economic growth in recent quarters as well as the favorable economic outlook continue to support operating profits and the individual income categories.¹⁰

Loan Growth Increased Considerably

In recent months lending by banks operating in Austria has increased considerably. In August 2006, loans outstanding to domestic nonbanks totaled EUR 274.4 billion, which corresponds to a growth rate of 6.5% year on year, compared with a growth rate of 4.8% registered in August 2005 (see chart 17). Thus, the favorable economic climate seems to have compensated for dampening supply-side implications for loan growth, such as this year's further increases of the ECB's key rates and the subsequent interest rate pass-through to retail rates.

The considerably higher growth rate of loans to domestic nonbanks compared with earlier periods is

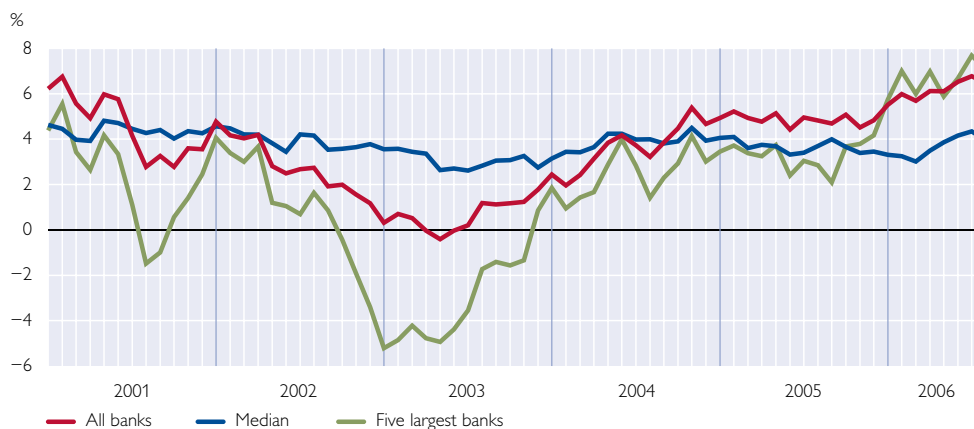
⁷ This increase reflects the sale of HVB Splitska banka by BA-CA in the first half of 2006 for EUR 684 million. Without this transaction, ROA would have been broadly unchanged from 2005.

⁸ See the paper by David Liebeg and Markus S. Schwaiger on "Determinants of the Interest Rate Margins of Austrian Banks" in this issue.

⁹ The interest rates are calculated as the volume-weighted average rates applied to all euro-denominated loans and deposits of households and nonfinancial corporations.

¹⁰ See Financial Stability Report 11. OeNB, June 2006, 40–41.

Growth of Loans to Austrian Nonbanks



Source: OeNB.

likely to reflect above all lending by the largest banks and, among them, by a few particular banks. The annual growth rate of the amount of loans outstanding of Austria's five largest banks (in terms of total assets) came to 7.1% in August, compared with 2.9% a year earlier. At 4%, the median loan growth rate was considerably below the figure for the largest banks in August 2006.

A breakdown by banking sectors shows that – leaving aside special purpose banks – annual loan growth was particularly robust in the Raiffeisen sector (11.9% in August 2006). By comparison, the joint stock bank sector reported particularly weak lending growth rates in the first half of 2006 (3.1% in August 2006), similar to building and loan associations, which were bringing up the rear in recent months (2.3% in August 2006).

Share of Foreign Currency in Household Loans Remained High

Developments in 2006 have so far mirrored the pattern observed since 2002 in foreign currency borrowing: demand from nonfinancial corporations has weakened, while demand

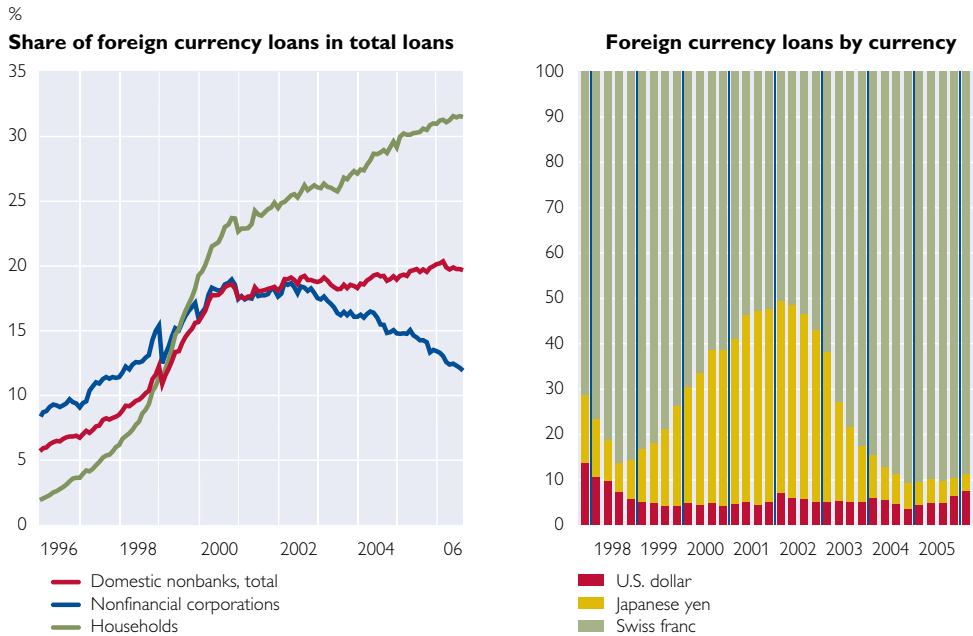
from households has continued to grow. In August 2006, foreign currency loans accounted for 31.5% of all loans taken out by households, which is close to the historical peak. This compares with a figure of 11.9% for nonfinancial corporations, which was well below the historical peak of almost 19%. Households and businesses apparently judge the advantages and underlying risks of foreign currency loans in fundamentally different ways. However, the statistics show that in the two provinces leading the ranks of foreign currency borrowers (Tyrol and Vorarlberg) households have become more cautious about foreign currency loans in recent periods.

On balance, EUR 53.9 billion foreign currency loans were outstanding to domestic nonbanks in August 2006, which translates into a foreign currency share of 19.7%. Regarding currency allocation, the share of the Swiss franc increased slightly from high levels and accounted for the lion's share at 89.8% in August 2006. In contrast, the share of Japanese yen-denominated loans shrank to 3%.

In a joint initiative, the Financial Market Authority (FMA) and the

Chart 18

Foreign Currency Loans in Austria



Source: OeNB.

Oesterreichische Nationalbank (OeNB) at the end of June 2006 launched a brochure educating the public about the risks of foreign currency borrowing. The brochure, which is available at bank branches throughout Austria, provides a clear and concise overview of the risks of such financing instruments. This joint initiative reflects the continued concerns that the FMA and the OeNB have about households' strong demand for foreign currency loans and is an attempt to enhance households' risk awareness.

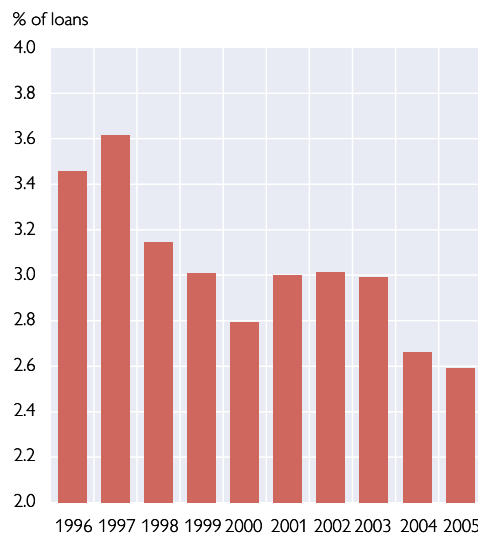
Loan Quality Continued to be Favorable

Austrian banks have benefited from a favorable loan cycle since 2003. With the rise in loan growth since 2003, loan quality improved as well, and continued to do so in 2006. Data on nonperforming loans, which are available only on an annual basis, show that the share of loans that had to be written down or off decreased

steadily from 3.0% in 2003 to 2.6% in 2005 for all banks operating in Austria (see chart 19).

Chart 19

Nonperforming Loans



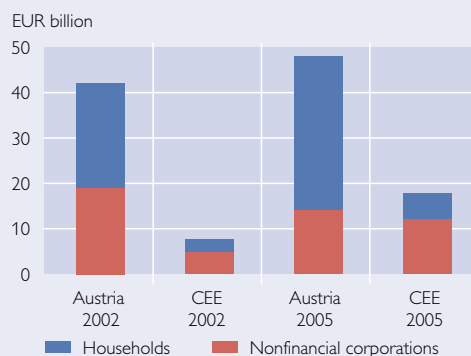
Source: OeNB.

The development of specific allowances for impaired loans implies that the loan quality should remain

Foreign Currency Lending Risks of Austrian Banks are Basically Domestic Risks

Foreign currency lending by Austrian banks is not limited to domestic clients; foreign currency loans are also extended to foreign clients, above all to residents of the Central and Eastern European countries in which Austrian banks' subsidiaries hold substantial market shares. In the case of the latter, these loans are basically euro and, in addition, Swiss franc loans. At present, there are no statistics available on the amount of foreign currency lending by Austrian banks' CEE subsidiaries. Therefore the underlying risks of foreign currency lending (including loans indexed to foreign currency loans) in Bulgaria, Croatia, the Czech Republic, Poland, Romania, Slovakia – i.e. the CEECs most relevant for Austria – must be estimated to be able to compare them with the corresponding Austrian figures. For the purpose of these estimates, it was assumed that the Austrian subsidiaries' share in the aggregate amount of foreign currency loans taken out by nonfinancial corporations and households in the individual CEECs corresponds to their local market share in terms of total assets. With the exception of Croatia, the estimates are based on data compiled by the ESCB Working Group on Macroeprudential Analysis (WGMA) in the first half of 2006.

Outstanding Foreign Currency Loans of Austrian Banks



Source: WGMA, OeNB.

As shown by the chart, the estimated amount of foreign currency loans of Austrian subsidiaries in the major CEECs was still considerably below the amount outstanding in Austria at the end of 2005. Yet growth rates in this field were considerably higher in those countries than in Austria. Between 2002 and 2005 foreign currency loans extended to CEE residents increased eight times as fast as foreign currency loans to Austrian residents, with over two-thirds of the expansion attributable to new business and close to one-third attributable to gains in market share. In addition, direct loans extended by the parent banks to CEE clients, which are not covered by these calculations, increase the total foreign

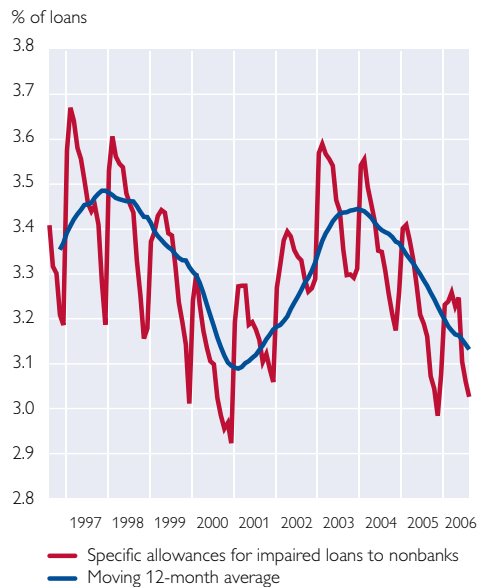
currency exposure of the Austrian banking system by another estimated EUR 10 billion in 2005.

Thus, the underlying risk of foreign currency lending by Austrian banks is clearly concentrated on the domestic side of business, but not for quantitative reasons alone. As the chart shows, the bulk of foreign currency loans taken out in CEECs goes to nonfinancial corporations, whereas in Austria the amount of foreign currency household loans is twice as high as the corporate share. As household loans are less likely than corporate loans to be hedged against exchange rate risk naturally or with derivatives, households are more exposed to currency risk. Moreover, unlike in most CEECs, foreign currency loans in Austria tend to be bullet loans linked with repayment vehicles, which creates a concentration risk over time and additional market risks.

Chart 20

Specific Allowances for Impaired

Loans to Nonbanks



Source: OeNB.

satisfactory in 2006. In August 2006, specific allowances for impaired loans reported by Austrian banks corresponded to 3.0% of loans to nonbanks, 0.2 percentage point less than in August 2005.¹¹ In fact, apart from 2000, such allowances have not been as low since 1995 (see chart 20).

The historically already relatively low specific allowances for impaired loans, the steady improvement of the quality of loans over the past three years as well as the fact that such cycles have typically lasted two to three years (see chart 20) would imply that a turnaround may be in the offing. In addition, the slight deterioration of financing conditions might adversely affect the risk assessment of Austrian banks' loan portfolios. In contrast, the steady decline of Austrian corpo-

rations' debt ratio over the past few years and the recent increase in the real income of Austrian households would support a continued favorable risk assessment – as would the higher growth rates forecast for the domestic economy for the years ahead.

Unchanged Exposure to Market Risk

A major part of the market risk to which banking systems are exposed stems from their trading book positions, such as their holdings of debt or equity securities and derivative instruments. Consequently, banks heavily trading for their own account must meet special regulatory capital requirements to contain the underlying market risks. Other sources of market risk for banks are interest rate risks in the banking book and foreign currency risks resulting from open foreign exchange positions.

In mid-2006, 28 Austrian banks were subject to the regulatory capital requirements for sizeable securities trading positions, of which 4 had implemented internal value-at-risk models to calculate such requirements. From a historical perspective, the share of the regulatory capital requirement to cover the trading book market risk in overall capital requirements peaked at an annual average of 6.0% in 2000. This figure subsequently dropped to 2.7% in 2001 and has since been rising steadily at a moderate rate (mid-2006: 4.1%). The relatively low level of this share reflects the fact that the Austrian banks' market risk in the trading book is

¹¹ The assessment of a decline in allowances remains unaffected by the government guarantee provided for BAWAG P.S.K. – the amount of specific allowances in relation to loans to nonbanks declines for the banking sector both with and without BAWAG P.S.K.

fairly insignificant compared with the default risk in their loan portfolios. In absolute figures, the regulatory capital requirement for trading book interest rate instruments rose from EUR 703 million to EUR 793 million in the first half of 2006, while the capital requirement for stock positions remained unchanged at roughly EUR 95 million.

Interest rate risk in the banking books declined somewhat throughout the banking sector in the first half of 2006: The asset-weighted average of the Basel ratio for the interest rate risk in the banking book¹² of banks operating in Austria dropped from 6.6% to 6.3%. Thus, this indicator has moved fairly constantly since early 2005 within a 0.5 percentage point range above the historical low of 6.1%. With regard to currencies, the interest rate risk is highest by far for euro holdings, followed by U.S. dollar holdings; all other currencies are fairly irrelevant.

The direct foreign exchange risk – i.e. the risk of valuation losses stemming from foreign exchange fluctuations – expanded only moderately at the level of the banking system in the first half of 2006: The regulatory capital requirement for outstanding foreign currency positions increased from EUR 93 million to EUR 102 million.

Payment and Securities Settlement System Security Remained High

Based on articles 44a and 82a of the Nationalbank Act, which established

the OeNB as the overseer of payment and settlement system security in Austria, 20 payment systems, 5 infrastructure providers and 15 Austrian participants in international payment systems are currently subject to oversight by the OeNB. Compared with December 31, 2005, the number of payment systems/participants overseen by the OeNB thus increased from 39 to 40.

In the first half of 2006, a total of 227.8 million transactions worth EUR 6,767 billion were routed through Austrian payment systems or handled by Austrian participants in such systems. The highest number of transactions (around 216.5 million) was processed through retail payment systems (dominated by the direct debit system Maestro POS¹³). The highest-valued transactions (approximately EUR 5,781 billion) were processed through the ARTIS/TARGET¹⁴ payment system operated by the OeNB. Securities settlement systems reported the highest growth rates in terms of both transactions (approximately +55%) and transaction values (approximately +57%) in the first half of 2006. In terms of value, Austrian banks relied most heavily on the large-value payment system EURO1, through which they routed transactions worth about EUR 563.9 billion. In terms of volume, the international retail payment system STEP2 was the single largest provider for Austrian banks, processing some 5.8 million transactions. Generally speaking, Austrian banks have been

¹² Defined as the estimated decline in the economic value of interest rate-sensitive on-and off-balance sheet positions, following a parallel shift in all currencies by 200 basis points relative to a bank's eligible capital. Non-interest rate-sensitive on-balance sheet positions whose performance banks assess on the basis of market interest rates are also included here.

¹³ POS: point of sale.

¹⁴ ARTIS: Austrian Real Time Interbank Settlement; TARGET: Trans-European Automated Real-time Gross settlement Express Transfer.

Manipulations of POS Terminals Caused No Systemic Risks

In summer 2006 a number of fraud cases involving the manipulation of point-of-sale (POS) terminals made headlines in Austria. So far unidentified individuals tampered with POS terminals to “fish” payment card information and PINs¹, and reencoded counterfeit (magnetic stripe) cards with this information. These cards were subsequently used to withdraw cash abroad, with numerous attempts failing as the providers’ security systems were triggered. None of the fraud victims suffered any financial damage.

With a view to maintaining system security, the OeNB has liaised intensively with the providers of the targeted payment system Maestro POS (operated by Europay Austria Zahlungsverkehrssysteme GmbH – Europay) and of the POS terminal network (operated by First Data Austria GmbH – FDA). Expert analyses undertaken so far have shown that the fraudulent manipulations have not created any systemic risks. Most importantly, the chip technology used for POS transactions in Austria remains safe, and the providers managed to keep the incidence of fraud low. More detailed technical analyses are still ongoing. Furthermore, the providers are intensively working towards improving and speeding up fraud detection with regard to counterfeit swipe cards, and making such manipulation impossible in the first place.

To be sure, the security levels for electronic transactions are very high in Austria in an international comparison. The most recent fraud incidents have, however, shown that like in other areas, the developers of new e-payment security standards are competing with omnipresent criminal minds. Moreover it is important to remember that payment security is an issue that cannot be solved at a national level alone; to be effective, measures need to be coordinated at a European and at a global level. The OeNB is therefore readily pursuing the issue in the relevant ESCB bodies.

¹ PIN: Personal identification number.

using the services of international payment systems more and more readily.¹⁵

In the first half of 2006, altogether 27 system disturbances¹⁶ were reported for the supervised payment and securities settlement systems (compared with 40 system disturbances reported in the first half of 2005). One incident concerned the interlinking access to TARGET, and another incident the participation of an Austrian bank in an international payment system. All other distur-

bances involved smaller infrastructure providers of retail payment systems, which typically process a mere 0.6% of all retail payments. The latter reported such incidents as server downtimes for maintenance or migration to new software systems.

Growing Exposure of Austrian Banks to Central and Eastern Europe¹⁷

Central and Eastern European countries have been continually growing in importance for the Austrian bank-

¹⁵ With 6 new participants having joined in the first half of 2006, a total of 30 Austrian institutions participated in international payment systems as at June 30, 2006 (up from 22 participants as at December 31, 2004).

¹⁶ 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.

¹⁷ Based primarily on the reports of condition and income Austrian banking groups have submitted on a quarterly basis since early 2002.

ing market. The period under review – end-June 2005 to end-June 2006 – saw existing foreign subsidiaries expanding their business, and domestic banks increasing direct lending¹⁸ as well as, in particular, new acquisitions. Looking ahead, the forthcoming integration of recent acquisitions like Romanian Banca Comerciala Româna (BCR) into the Erste Bank group and the planned restructuring of the UniCredit group's CEE business are going to further increase the exposure of the Austrian banking system to the area.

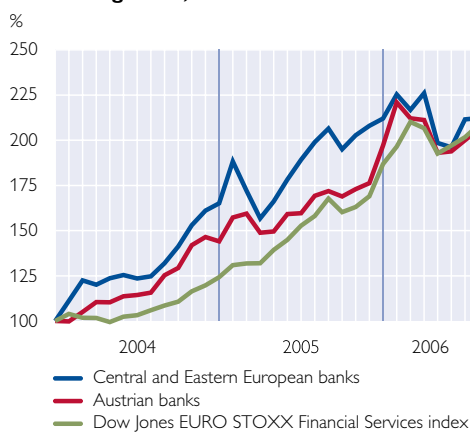
The three largest Austrian financial institutions (BA-CA, Erste Bank and Raiffeisen International) are in the top ranks of the around 20 large international banks that are active in Central and Eastern Europe, as measured by their subsidiaries' aggregated total assets. Altogether, 11 Austrian banks with 62 fully consolidated subsidiaries operated in this market at the end of June 2006. Of these, 28 subsidiaries are active in five EU Member States of the latest enlargement round¹⁹ (+2 compared with June 2005), 14 (± 0) in countries with EU acceding and accession countries²⁰ and 20 (+6) in potential EU candidate countries and other Eastern European countries²¹. These 11 Austrian banks and their subsidiaries currently hold approximately 15.3% of total banking sector assets in Cen-

tral and Eastern Europe, or as much as 22.9 % if Russia is factored out.

Another way to measure Austrian banks' integration with the pan-European financial sector is to compare the stock prices of CEE banks with the three bank stocks covered by the ATX Prime Market index²² and the Dow Jones EURO STOXX Financial Services index (see chart 21). The stronger fluctuations of stock prices of CEE banks are clearly mirrored by the three Austrian banks, if in a less pronounced way (correlation coefficient = 0.969). The same holds true for the stock market correction in mid-2006, when emerging market stocks came under pressure worldwide. While stock prices have

Chart 21

**Performance of Stock Exchange-Listed
Financial Institutions**
As at August 31, 2006



Source: Bloomberg, OeNB calculations.

¹⁸ Loans granted by Austrian banks to borrowers resident in other countries.

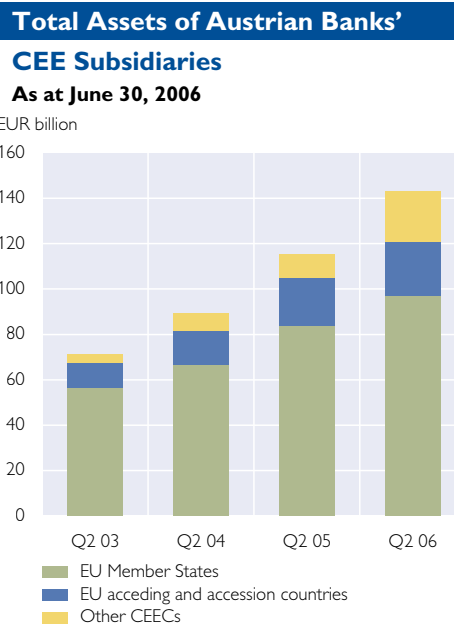
¹⁹ Poland (PL), Slovakia (SK), Slovenia (SI), Czech Republic (CZ) and Hungary (HU).

²⁰ Bulgaria (BG) and Romania (RO) as well as Croatia (HR).

²¹ Albania (AL), Belarus (BY), Bosnia and Herzegovina (BA), Russia (RU), Serbia (SE) and Montenegro (ME) as well as Ukraine (UA).

²² The indices were calculated on the basis of market capitalization-weighted rates. The ATX sample includes BA-CA, Erste Bank and Raiffeisen International. The CEE sample contains all Central and Eastern European banks listed at a stock exchange since 2004 (CZ(2), HR(1), HU(2), LT(3), PL(2), RO(1), SK(2)). Measured as a share of total assets, these banks covered basically 20% of the Central and Eastern European banking market (excluding RU and TR) as at December 31, 2005.

Chart 22



Source: OeNB.

since rebounded, these figures reveal the underlying risks of the Austrian banking system's close ties with Central and Eastern Europe; however, the Dow Jones EURO STOXX Financial Services index was subject to similar, if less pronounced fluctuations.

The latest CEE business segment reports, i.e. the latest consolidated data, show that the six major Austrian banks active in the area²³ increased their total assets by 31.7% to about EUR 146 billion, thus accounting for a share of 16.7% of the Austrian banking system's consolidated total assets at end-June 2006 (June 2005: 14.0%). Corresponding pretax profits doubled to EUR 1.9 billion, driven by the EUR 684 million sale of BA-CA's Croatian subsidiary Splitska banka. Even when this special effect is factored out, the CEE business segment accounted for a share of 34.6% in the consolidated pretax profit of all Austrian banks at the end of June 2006 (June 2005: 30.2%).

The corresponding unconsolidated data in fact tell a similar story. In the year to June 2006 the aggregated assets of all CEE subsidiaries of Austrian banks rose by EUR 27.5 billion to EUR 143.0 billion, reflecting a drop in the growth rate by 5.4 percentage points to 23.8% (see chart 22). Above all subsidiaries in CEECs other than EU member, acceding or accession countries more than doubled their asset totals compared with 2005, basically as a result of acquisition sprees in the area.

Aggregated operating profits of CEE subsidiary banks mirror this pattern: On balance, operating profit rose by 35.7% to about EUR 1.6 billion, which corresponds to a growth rate 1.0 percentage point higher than in the previous year. Here, too, subsidiaries in "Other CEECs" posted higher growth rates at +94.2% than subsidiaries based in EU Member States (+28.3%) or EU acceding and accession countries (+21.8%) (see chart 23).

The cost/income ratio²⁴ of fully consolidated subsidiary banks in the CEECs improved from 56.4% at the end of June 2005 to 54.2% at the end of June 2006; this rise is attributable to a sharper increase in operating income (+29.7%) than in operating expenses (+23.9%).

²³ Bank Austria Creditanstalt AG (BA-CA), Erste Bank der oesterreichischen Sparkassen AG (Erste Bank), Raiffeisen Zentralbank Österreich AG (RZB), Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG (BAWAG P.S.K.) and Österreichische Volksbanken AG (ÖVAG).

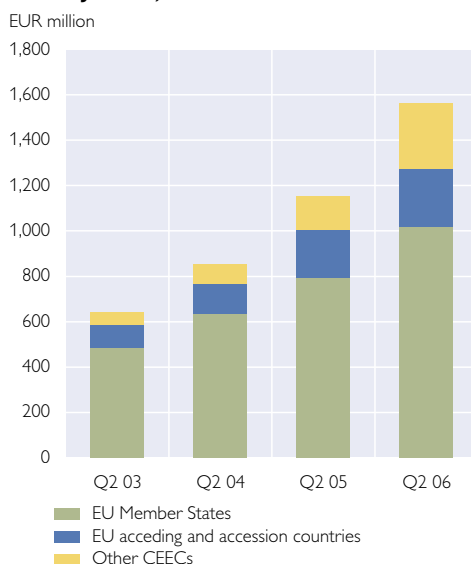
²⁴ Ratio of administrative costs to operating income before deduction of net risk provisioning in the lending business.

Chart 23

Operating Profits of Austrian Banks'

CEE Subsidiaries

As at June 30, 2006



Source: OeNB.

Similarly, the credit exposure of Austrian banks to CEECs shows the dynamic growth and the prominent role of the new EU Member States (see chart 24). Of the direct lending volume of EUR 30.5 billion outstanding at the end of June 2006, 59.4% are attributable to the new EU Member States, 24.9% to EU acceding and accession countries and 15.8% to other CEECs. Indirect loans developed along similar lines. Here, the new EU countries accounted for 68.4%, the EU acceding and accession countries for 15.8% and the other CEECs likewise for 15.8%.

All in all, Austrian banks continue to focus their CEE activities on the new EU Member States. Subsidiaries in the area accounted for 67.9% of all Austrian CEE subsidiaries' total assets at the end of June 2006. This EU bias is clearly a buffer against risks posed by institutional, legal and, thus, economic conditions in those markets. Bulgaria and Romania – which will join the EU on January 1, 2007 – plus

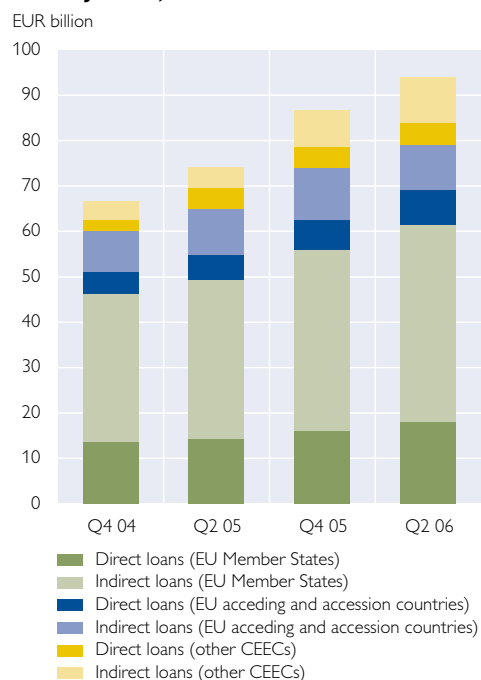
Croatia accounted for another 16.4% of CEE subsidiaries' total assets. In other words, the current exposure figures as well as the second quarter reports, which do not yet reflect the acquisition of Romanian Banca Comerciala Româna by Erste Bank, in fact overstate institutional and legal risks. At the same time, business in the other CEECs, whose share in assets has meanwhile grown to 15.7%, has been expanding more dynamically (see chart 25, left panel).

The EU bias will be softened through acquisitions in Eastern and Southeastern Europe that may be in the pipeline. Likewise, the planned restructuring within the UniCredit group will lead to a shift away from the EU area. BA-CA has sold its Polish subsidiary to its parent UniCredit, but will in turn become responsible for the Central and Eastern European

Chart 24

Credit Exposure to Central and Eastern European Countries

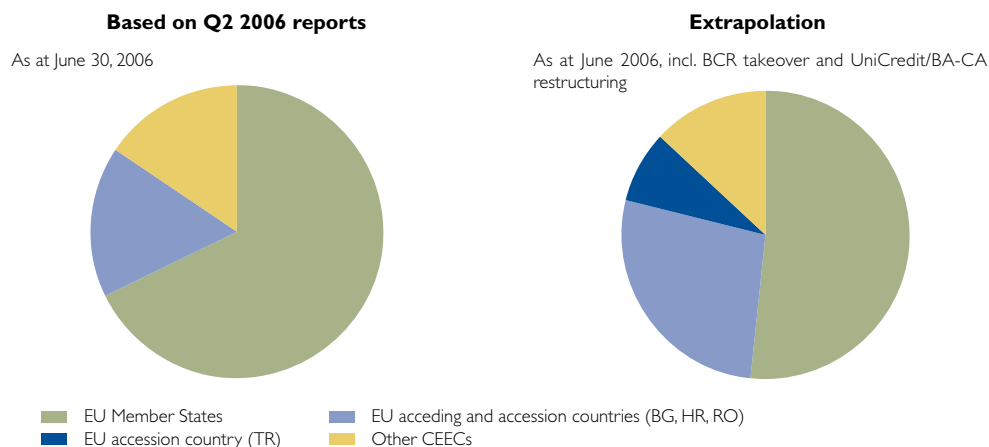
As at June 30, 2006



Source: OeNB.

Chart 25

Total Assets of Austrian Banks' CEE Subsidiaries



Source: OeNB, BankScope, OeNB calculations.

subsidiaries of UniCredit²⁵ as well as for HVB's business in the Baltic states. In addition, there are plans for BA-CA to take over the 50% stake in Turkish Koç Bank, a joint venture of UniCredit. In other words, BA-CA is going to venture into new and as yet fairly uncharted markets that are fairly big as a share of aggregate assets (see chart 25, right panel).

Judging from the market sentiment, as reflected in bank ratings, on the underlying risk position of individual banking markets in general or Austrian subsidiaries in particular (see table 5), the outlook is stable or slightly positive. The risk positions of all Austrian subsidiaries match national averages.

Stress tests simulating the effects of extreme shocks to the Austrian banking system are a tool for quantifying the significance of the CEE banking markets for Austria. In the past, the OeNB conducted these stress tests on the general assumption that the share of nonperforming loans

(NPL), as derived from past fluctuations, was going to rise by 40%.²⁶ On this assumption, the consolidated capital ratio of the Austrian banking system for the first half of 2006 would have dropped by 26 basis points.

Given that in a budding growth market, past fluctuations may not be a very sound indication of future credit risk, a significantly more stringent scenario has recently been used for CEE-related stress tests in order to determine the resilience of the Austrian banking system to an extreme deterioration of foreign subsidiaries' loan quality.

As some banks have relatively low NPL ratios (NPL as a share of all loans to nonbanks), the CEE scenario has now been adjusted to reflect the higher of (1) the relative increase or (2) the absolute increase of the NPL ratio. The strength of the shock varies in line with the underlying country risk, ranging from low (relative increase of the NPL ratio by 50% or absolute increase by 6 percentage

²⁵ Bulbank (BG), Živnostenská banka (CZ), Zagrebačka banka (HR), UniCredit Romania (RO), IMB (RU) and UniBanka (SK).

²⁶ The calculation of the stress test scenario is based on allowances for bad loans as reported by banks and on the assumption that such allowances had to be established for 50% of all nonperforming loans.

Table 5

**Average Ratings of CEE Banking Systems
and Selected Austrian Banks' CEE Subsidiaries¹**

As at September 30, 2006

Country	Bank	Deposit rating – LT ²	BFS rating ³	Outlook
Bulgaria		Ba2	D–	positive/stable
Croatia		Ba1	D+	positive/stable
	<i>Zagrebačka banka</i>	<i>Ba1</i>	<i>D+</i>	<i>positive</i>
Poland		A2	C–	stable
	Bank BPH	A3	C–	developing ⁴
Romania		Ba2	D–	positive
	Banca Comerciala Romana	Ba2	D–	under review ⁵
	Raiffeisen Bank	Ba2	D–	under review ⁵
Russia		Ba1	D–	stable
	Impexbank	Baa2	E+	positive
	ZAO Raiffeisenbank Austria	Baa2	D	stable
Slovak Republic		A2	D+	positive
	Slovenská sporiteľňa	A2	D+	stable
	Tatra banka	A3	C–	stable
	UniBanka	A2	D	stable
Slovenia		A2	C	stable
Czech Republic		A1	C	stable/positive
	Česka spořitelna	A2	C	stable
	Živnostenská banka	A2	D	stable
Turkey		B1	D	stable
	Koçbank	B1	D	negative
	Yapı ve Kredi Bankası	B1	E+	positive
Ukraine		B2	E+	stable
	Raiffeisen Bank Aval	B2	D–	stable
Hungary		A1	C	Stabil
	Erste Bank Hungary	A2	D	under review ⁵

Source: Moody's Investors Service.

¹ *Italics indicate banks that are expected to become subsidiaries through new acquisitions or the forthcoming restructuring of the UniCredit group.*

² *LT = Long-term: Long-term deposits are rated on a scale from Aaa, Aa, A, Baa, ... to C.*

³ *BFS = Bank financial strength, rated on a scale from A, B+, B, B–, ... to D– and E.*

⁴ *Bank BPH's rating may come under pressure given uncertainty surrounding its merger with Bank Pekao.*

⁵ *May be upgraded.*

points) to medium (relative increase of the NPL ratio by 75% or absolute increase by 8 percentage points) to high (relative increase of the NPL ratio by 100% or absolute increase by 10 percentage points). The different risk buckets reflect above all the notion that EU membership reduces the risk exposure of individual countries. The severity of this scenario is highlighted by the fact that the current NPL volume more than doubles for more than 40% of all subsidiaries.

Under the assumptions of this more stringent scenario, the capital

ratio is found to decrease by 79 basis points rather than 26 basis points, causing the consolidated capital ratio of the banking system to drop from 12.4% to 11.6% at the end of the second quarter of 2006. In other words, the capital ratio remains safely above the statutory 8% threshold, and the Austrian banking sector is well poised to withstand the assumed extreme shock. Moreover, the good income situation of Austrian subsidiaries in Central and Eastern Europe serves as an additional buffer that may absorb adverse developments.

CEE Banking Sector Remains Stable despite Strong Credit Growth

Amid continued favorable macroeconomic conditions, credit to private nonbanks in the second quarter of 2006 exceeded the level recorded one year earlier by 15% to 25% (adjusted for inflation) in the Czech Republic, Hungary, Slovenia, Slovakia and Croatia; in Romania it was even 40% higher. Poland and Bulgaria recorded real credit growth rates of 11% and 8%, respectively. The vigorous lending activities are also reflected in the ratio of the increase in outstanding credit to GDP¹, which was higher in all these countries with the exception of Bulgaria. This development has increasingly raised concerns about potential macroeconomic imbalances and financial instability. The countries concerned have become more and more dependent on capital inflows from abroad, and the high credit growth rates may be related to substantial external imbalances and rising inflation rates in several countries; in addition, credit risks may also be on the rise. In this context, Bulgaria stands out positively from the other CEECs: the monetary and prudential measures implemented over the past three years have contributed to slowing down domestic lending dynamics to a considerable extent recently. Although the external debt of domestic corporations (including nonbank financial institutions), in particular the amount of cross-border intercompany loans, has expanded notably, the growth of total (domestic and cross-border) loans outstanding to private nonbanks has clearly been on the decline. In Romania and Croatia, by contrast, the measures launched by the central banks so far have not had the full desired effect.

Furthermore, in a number of CEECs, the share of domestic foreign currency loans is high, which can be seen as problematic, as interest rates in the euro area and in Switzerland (the bulk of these loans is denominated in euro and Swiss francs) have been rising and several countries of the region experienced increased exchange rate volatility in the first half of 2006. A higher debt-service burden in local currencies due to increased interest rates and exchange rate losses suffered by debtors who have not hedged their exposures against exchange rate volatilities may impact negatively on banking sector stability. As a result, borrowers may on the one hand become unable to service their debt or, on the other hand, households and enterprises that continue to be able to do so may cut back expenditures in other areas, thus contributing to a slowdown in economic growth and, subsequently, a growing number of nonperforming loans. In the first half of 2006, the share of domestic foreign currency loans soared particularly in Hungary and Slovenia. In Hungary, the risk entailed in foreign currency lending is further aggravated by the local currency's susceptibility to exchange rate volatility caused by a high dependence on foreign capital inflows, which may, however, be reduced by sustainable and credible fiscal consolidation. Also, supervisors in Hungary are making efforts to increase banks' and borrowers' risk awareness and seem to be considering measures to put a damper on the foreign currency lending boom. As a first step, a recommendation for banks on better credit risk management was issued. In Slovenia, by contrast, where banks' foreign currency portfolios are overwhelmingly denominated in euro, the imminent introduction of the euro has had a significant risk-mitigating effect. The share of domestic foreign currency loans continues to be high but is on the decline in Bulgaria and Romania owing to central bank measures, which in the case of Bulgaria were directed at credit growth in general and in the case of Romania primarily targeted foreign currency lending. In the latter country, the share of domestic foreign currency loans has declined sharply despite banks' efforts to circumvent these central bank measures (e.g. some increased their capital stock to shrink the share of foreign currency loans in equity capital), which have been confirmed by anecdotal evidence. In Poland, where domestic foreign currency lending plays a far smaller albeit somewhat increasing role, supervisors have recommended to banks to minimize risks by improving risk management systems and stepping up customer information on exchange rate risk. In addition, there have been talks with banking sector representatives about stricter prudential rules. The Croatian central bank has obliged banks to assign higher risk weights and apply more comprehensive reporting requirements to foreign currency loans taken out by unhedged borrowers. Moreover, it issued guidelines for banks on better foreign exchange risk management in connection with domestic foreign currency loans.

¹ Measured as the share of nominal change in outstanding loans compared with the same quarter of the previous year in percent of GDP of the respective four quarters.

The profitability of the CEE banking sectors has remained stable at a generally high level in the first half of 2006. Only in Romania, where operating income was slightly down (mainly due to net interest income), did the nominal return on equity decrease noticeably compared with the same period of 2005, whereas it improved markedly in Poland (thanks to higher net income from interest as well as fees and commissions and improved cost management). Owing to the continued expansion of lending to households and corporations, capital adequacy ratios, though remaining at double-digit levels, fell throughout the region. The drop in the share of nonperforming loans (as a percentage of the total loan portfolio) in all CEECs (except for Romania) may have also been traceable to strong loan growth. This may change in future, however, as portfolios will be maturing and/or the pace of lending growth could be slowing down, in particular as the amount of nonperforming and watch loans increased considerably in several countries. Furthermore, it cannot be ruled out that in accessing a broader customer base, banks eased their credit standards or failed to adequately adapt risk management to the new conditions. Finally, it should be noted that so far, the banking business in CEE has benefited from an overall friendly macroeconomic environment (with the exception of Poland in the early years of the decade); thus, the resilience of the banking sectors against a pronounced economic downturn or a less favorable financial climate has largely not been tested as yet. (Stress tests conducted by national central banks recently showed that stress resilience was on the whole satisfactory, but – in part – declining.)

Nominal Return on Equity (after Tax)

	%					
	2002	2003	2004	2005	H1 05	H1 06
Bulgaria	14.6	14.8	16.6	18.4	18.6	18.1
Croatia	13.7	14.5	16.1	15.6	14.5	14.7
Poland	5.3	5.5	17.4	20.0	21.2	28.0
Romania	21.0	17.7	17.7	15.1	19.7	14.2
Slovak Republic	11.5	10.5	12.3	13.4	14.6	16.4
Slovenia	8.5	8.2	8.7	11.1
Czech Republic	27.1	23.4	23.1	49.9	29.3	24.8
Hungary	16.1	18.7	23.8	23.2	27.3	23.2

Net Interest Income

	% of annual average bank assets					
	2002	2003	2004	2005	H1 05	H1 06
Bulgaria	3.9	4.7	4.9	4.5	4.4	4.3
Croatia	3.3	3.3	3.0	2.9	3.0	2.8
Poland	3.4	3.1	3.2	3.1	3.1	3.1
Romania	3.4	4.7	4.8	3.5	3.7	3.2
Slovak Republic	2.7	2.9	2.9	2.2	2.2	2.2
Slovenia	3.7	3.2	2.8	2.5	2.7	..
Czech Republic	2.4	2.1	2.3	2.2	2.3	2.2
Hungary	4.3	4.0	4.3	4.1	3.9	3.7

Operating Costs

% of annual average bank assets

	2002	2003	2004	2005	H1 05	H1 06
Bulgaria	4.5	4.5	4.2	3.6	3.5	3.5
Croatia	2.7	2.6	2.3	2.2	2.2	2.1
Poland	4.1	3.9	3.7	3.7	3.7	3.5
Romania	6.6	6.9	6.1	5.4	5.3	5.0
Slovak Republic	2.5	2.6	2.4	2.1	2.1	2.0
Slovenia	3.2	2.9	2.7	2.5	2.4	..
Czech Republic	1.9	1.9	1.9	1.8	1.8	1.7
Hungary	3.8	3.4	3.3	3.1	2.8	2.6

Net Change in Loan Loss Provisions

% of annual average bank assets

	2002	2003	2004	2005	H1 05	H1 06
Bulgaria	0.1	0.3	0.7	0.8	0.9	0.4
Croatia	0.3	0.3	0.3	0.2	0.2	0.2
Poland	1.5	0.9	0.4	0.2	0.3	0.2
Romania	0.2	0.6	0.7	0.5	0.2	0.3
Slovak Republic	-0.4	-0.5	0.2	-0.1	0.0	0.1
Slovenia	1.1	0.8	0.7	0.7	0.8	..
Czech Republic	0.3	0.0	0.4	0.5	0.3	0.4
Hungary	0.3	0.3	0.5	0.3	0.1	0.4

Nonperforming Loans

% of total loans

	2002	2003	2004	2005	H1 05	H1 06
Bulgaria	3.6	4.2	3.6	2.8	2.8	2.7
Croatia	5.9	5.1	4.6	4.0	4.3	3.6
Poland ¹	21.1	21.2	14.7	11.0	13.2	9.4
Romania	2.3	8.3	8.1	8.3	8.2	8.4
Slovak Republic	11.0	9.1	7.0	5.5	6.9	..
Slovenia	7.0	6.5	5.5	4.7	5.3	..
Czech Republic	8.5	5.0	4.1	4.0	4.3	3.8
Hungary	3.1	2.7	2.7	2.5	2.6	2.4

¹ For Poland, nonperforming loans also include "irregular claims."

Source: National central banks.

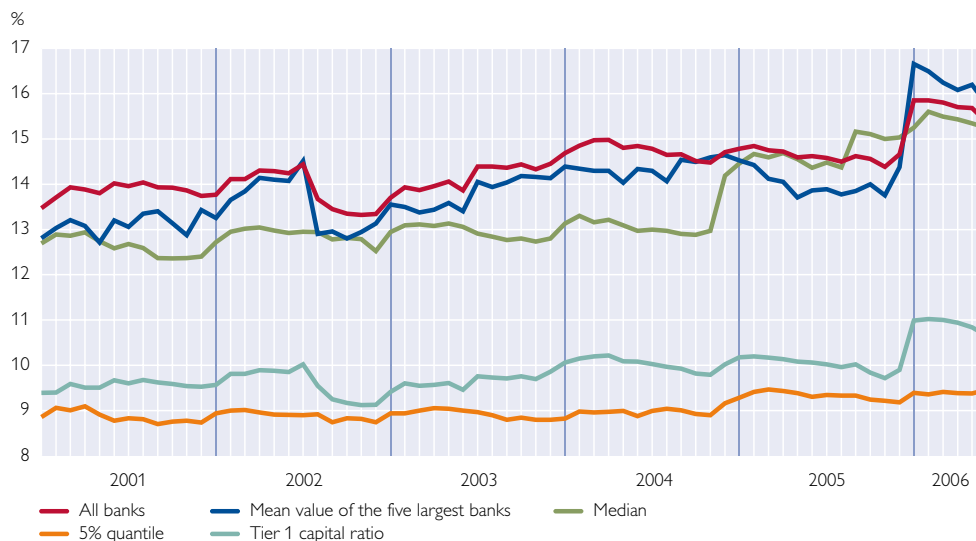
Note: Data are not comparable between countries. Intra-year data are annualized linearly.

Austrian Banks' Capital Ratios Remained High

Banks' solvency as measured by the capital ratio, i.e. a bank's own funds in relation to risk-weighted assets, are an essential indicator for assessing the Austrian banking sector's risk-bearing capacity. Both by historical and European standards, Austrian banks'

capital adequacy has traditionally been at high levels over recent years, and in the first half of 2006, the unconsolidated capital ratio of the Austrian banking sector reached a new high, averaging 15.9% in January and February (see chart 26). Even though it had declined moderately to 15.4% by mid-year, it still remained at a very

Austrian Banks' Unconsolidated Capital Ratio



Source: OeNB.

high level compared with the levels observed over the past few years. Similar to the unconsolidated value, the consolidated capital ratio of all Austrian banks stood at a remarkable 12.4% by mid-2006.

Hence, the Austrian banking sector has maintained a comfortable capital cushion, ensuring that credit institutions are generally highly resilient to financial stress or crisis. Yet, the overall current capital ratio is very much influenced by one single bank, or, put more precisely, the acquisition-driven capital increase by Erste Bank. The capital ratio of the five largest (in terms of total assets) domestic banks has therefore increased particularly strongly, reaching 16.7% on an unconsolidated basis at the beginning of 2006 and a still remarkable 15.8% in June 2006. As mentioned earlier, this development is to a considerable extent attributable to the acquisition-driven capital increase by Erste Bank. Since the ac-

quisition can be expected to be entered into the books by Erste Bank in the course of 2006, Austrian banks' aggregate capital adequacy is likely to move back to a somewhat lower level toward year-end. The analysis of the major banks shows that their current capital levels are necessary, in particular, to be prepared for potential future acquisitions. Compared with other euro area banks, the consolidated capital ratio of the major Austrian banks at present corresponds to the euro area average.²⁷

The tier 1 capital ratio, i.e. core capital in relation to the assessment base, climbed to a peak of an average 11% (on an unconsolidated basis) in January 2006 and remained high at 10.7% in June 2006.

All in all, Austrian banks currently have large capital cushions, which enable them to carry out acquisitions without jeopardizing the risk-bearing capacity of the Austrian banking sector.

²⁷ This value (11.3%) refers to the capital ratio of a representative sample of major euro area banks as given in the ECB's Financial Stability Review 2006.

Sufficient Credit Risk Cover Confirms Austrian Banking Sectors' Satisfactory Shock Resilience

The following section presents the results of stress tests based on a Monte Carlo simulation of the Austrian banking sector's network model developed under the Systemic Risk Monitor (SRM) project.²⁸ Contrary to the sensitivity stress tests presented in previous Financial Stability Reports, which involved only the calculation of the loss resulting from changes in one particular risk factor with all other factors assumed to remain constant, these stress tests calculate the entire loss distribution given the change of one risk factor. In the simulation, all other risk factors are drawn from the conditional common distribution of all risk factors corresponding to the crisis scenario.

Table 6 presents selected results of such stress tests for the end of the first half of 2006 and the results of a simulation reflecting the current situation without a crisis scenario. The results of the kind of sensitivity stress tests presented in previous issues of the Financial Stability Report were also calculated on the basis of the data stemming from end-June 2006. In qualitative terms, these results are similar to those of previous half-year periods, but due to space constraints, they are not shown here.²⁹ These stress tests and the SRM stress tests based on a Monte Carlo simulation shown in table 6 therefore confirm

that the Austrian banking sector's resilience to shock remains satisfactory.

The results summarized in table 6 are presented in a way different from that of previous Financial Stability Report issues, which used to show the effect of sensitivity stress tests on the capital adequacy ratio. Here, the table displays the mean value and the 95% quantile of the loss distribution over the third quarter of 2006 resulting from credit, market and contagion risk in the Austrian interbank market as well as the sum of these three risk categories, i.e. total risk, relative to eligible capital. Existing risk provisions were deducted from the calculated losses; with respect to credit risk, they consist of provisions for claims on domestic and foreign nonbanks as well as foreign banks and, in the case of contagion risk, provisions for claims on domestic banks. Gains or losses from market risk are shown relative to eligible capital without deducting provisions. Consequently, the total risk figures show the loss from all risk categories minus total credit risk provisions relative to eligible capital.

The simulation reflecting the current situation, i.e. not involving a crisis scenario, yields a mean value of -3.25% for total risk, which means that the existing risk provisions for claims on banks and nonbanks exceed the expected loss from all three risk categories by 3.25% of eligible capital. The maximum loss occurring

²⁸ For details on the methodology which provides the basis for the SRM see: Boss, M., G. Krenn, C. Pühr and M. Summer. 2006. *Systemic Risk Monitor: A Model for Systemic Risk Analysis and Stress Testing of Banking Systems*. In: OeNB. *Financial Stability Report 11*. 83–95.

²⁹ In particular, the stress test for the indirect credit risk of foreign currency loans yielded a decline by 0.28 percentage point (for Swiss franc-denominated loans) and by 0.04 percentage point (for Japanese yen-denominated loans), respectively. As regards the credit exposure in CEECs, a new scenario was devised. The results are presented in the chapter "Robust International Economy Fuels Recovery of Financial Markets Following Corrections in Spring."

Table 6

**Results of Selected SRM Stress Tests on the Basis of
Monte Carlo Simulations for End-June 2006**

	Total risk		Market risk		Credit risk		Contagion risk	
	mean value	95% quantile	mean value	95% quantile	mean value	95% quantile	mean value	95% quantile
Current situation	-3.25	0.28	-0.42	2.24	-2.89	-1.05	0.05	0.81
Doubling of domestic probabilities of default	-2.24	1.38	-0.34	2.36	-2.00	-0.23	0.10	0.81
Increase of euro interest rates by 120 basis points	-0.26	2.76	2.54	4.58	-2.89	-1.10	0.09	0.81
Appreciation of the euro by 10%	-3.98	0.04	-1.12	2.21	-2.90	-1.09	0.04	0.81
Depreciation of the euro by 10%	-2.57	1.45	0.26	3.71	-2.89	-1.05	0.06	0.81

Source: OeNB.

Note: The figures represent the mean value and the 95% quantile of the loss distribution corresponding to the respective risk category over the third quarter of 2006 relative to eligible capital. Provisions for claims on domestic and foreign nonbanks and foreign banks were deducted from credit risk loss; provisions for claims on domestic banks were deducted from the loss from contagion risk in the Austrian interbank market (which corresponds to credit risk vis-à-vis domestic banks). Accordingly, provisions for all claims were deducted from the loss from total risk.

with a probability of 95%, i.e. the 95% quantile, exceeds the existing risk provisions by 0.28% of eligible capital. This result is mainly traceable to market risk, for which the calculations yielded a gain of 0.42% in the mean value, but a loss of 2.24% of eligible capital in the 95% quantile. At 1.05% of eligible capital, the maximum loss from credit risk which occurs with a probability of 95% is still sufficiently covered by existing risk provisions. The stress test for contagion risk, which relates to credit risk in the Austrian interbank market, yields positive values – albeit they are very low relative to eligible assets – in both the mean (0.05%) and the 95% quantile (0.81%).

Similarly, in none of the stress scenarios displayed in table 6, the mean total loss exceeds the existing credit risk provisions. Even if the domestic probabilities of default were assumed to double, the expected loss from credit risk would be lower than the existing risk provisions (by an amount of 2% of eligible capital). For total risk, factoring in all risk categories, the stress test yields a loss of 1.38% of eligible capital in the 95%

quantile, but here it must be borne in mind that this value relates to the maximum loss occurring with a probability of 95% given the doubling of the probabilities of domestic default; in other words, this corresponds to a crisis in addition to the underlying crisis scenario. Regarding market risks, like in the past, increasing interest rates in the euro area are observed to have the largest impact. The expected loss from market risk following a parallel upward shift in the yield curve of the euro by 120 basis points comes to 2.54% of eligible capital. As regards exchange rate risk, an appreciation of the euro would result in a 1.12% gain in the mean for the entire Austrian banking system; conversely, a depreciation would bring about a mean loss of 0.26% of eligible assets.

All in all, the SRM stress tests carried out on the basis of Monte Carlo simulations for end-June 2006 confirm that the shock resilience of the Austrian banking system as a whole has remained satisfactory. This finding is underpinned by credit risk provisions which are considered to be sufficient in their entirety. This con-

clusion, however, is subject to the qualification that the loss distributions calculated on the basis of SRM relate to one quarter, whereas risk provisions tend to be made for longer periods. In any case, the results of the stress tests described here do not allow any conclusions about individual banks, for which certain stress scenarios may very well bring about higher losses relative to eligible capital.

Stabilization of Major Austrian Banks' Ratings

Financial stability analysis may involve not only the consideration of supervisory reporting but also stock exchange valuations and publicly available information in the form of indicators of international rating agencies such as Moody's. These indicators include long-term deposit ratings and the so-called bank financial strength (BFS) rating.

After the developments in the Austrian banking sector in the fourth quarter of 2005 and the first quarter of 2006 sparked some changes in

the ratings of the credit institutions involved,³⁰ Moody's has not changed its ratings since end-May 2006 (see table 7). In particular, BAWAG P.S.K.'s rating has stabilized, and the sale process has been initiated. Some uncertainty remains, however, as to whether the downgrading of Hypo-Alpe-Adria Bank's financial strength from C+ to D- can be considered to be final, as the review process that might result in another downgrading is still under way. The second rating which Moody's considers not to be stable is BA-CA's financial strength. Originally, Moody's had argued that it was not clear which part of the banking group the lucrative CEE business would be assigned to after BA-CA's parent bank HVB had been taken over by UniCredit. Still, Moody's did not change the negative outlook even after it became public that the CEE activities would be regarded as part of BA-CA's business, reasoning³¹ that there was continued uncertainty about the complex integration of UniCredit's subsidiaries into BA-CA.

Table 7

Ratings of Selected Major Austrian Banks

As at September 30, 2006

	Deposit rating		BFS rating	
	LT	outlook		outlook
BA-CA	A2	stable	B-	negative
Erste Bank	A1	stable	C+	stable
RZB	A1	stable	C+	stable
BAWAG P.S.K.	A3	stable	E+	stable
ÖVAG	A2	stable	C	stable
Hypo Alpe-Adria Bank	Aa2	stable	D-	under review

Source: Moody's Investors Service.

Note: LT = Long-term; BFS = bank financial strength.

³⁰ As reported in the latest Financial Stability Report, between January and May 2006, Moody's gradually downgraded BAWAG P.S.K.'s BFS rating from C+ to E+. The long-term deposit rating was downgraded from A2 to A3 in March 2006. The downgrading of Hypo Alpe-Adria Bank's BFS rating was also reported.

³¹ Except for the bank's business in Poland; see also the section on the activities of Austrian banks in Central and Eastern Europe in this issue of the Financial Stability Report.

Austrian Major Banks' Stock Prices Showed Volatility

The fact that large exposures in CEE do not only have a positive impact on the market valuation of the three Austrian banks listed in the ATX Prime (BA-CA, Erste Bank and Raiffeisen International) also became obvious in early summer 2006, when emerging markets stocks came under pressure worldwide. The turmoil seen between mid-May and mid-June affected almost all stocks listed in the ATX Prime and resulted in stock price losses of some 20%.³² On the bright side, it should be noted that at EUR 42.7 billion as at September 30, 2006, the market capitalization of the three listed banks continued to be significantly above the level recorded in the same month of the previous year (EUR 32.4 billion)³³ and that relative to the entire ATX Prime, there has been a considerably stronger consolidation of these banks' stock prices since mid-June. As a consequence, the share of these stocks in the ATX Prime's total market capitalization increased to 36.1% in the third quarter of 2006.

The stock market turbulence caused by doubts about the sustainability of economic developments in the CEE emerging markets of early summer 2006 was also reflected in the increased implied volatility of at-the-money call options on the ATX.³⁴ The listed Austrian banks in particular experienced a significantly higher increase of implied volatilities than the Dow Jones EURO STOXX Fi-

ancial Services Index. As 2006 progressed, however, the implied volatilities of both the bank stocks in the ATX and the index itself abated notably.

Insurance Companies Benefit from CEE Business

Insurers in Good Shape

Continuing the positive trend of recent years, the European insurance sector fared well in the first half of 2006. Life insurance contracts increased strongly in most European countries, and unlike in 2005, claims payments made by reinsurers were not affected by major claims in the first six months of 2006. The capital market environment remained benign and improved the profitability and stability of European insurance companies. The stock market downturns in May and June 2006 apparently had no sustained negative impact on insurers' investment results, since stock prices picked up markedly over the summer. The bond markets have also turned bullish recently.

The Austrian insurance industry continued to improve its business and earnings performance. On the back of the increasing popularity of state-subsidized personal pension plans, the life insurance segment made a considerable contribution to the improvement in operating business. Profitability was up despite higher snow and flood claim payments, mostly thanks to better investment results and improved cost management. Business in CEE continued at a buoyant pace, providing a substantial

³² By comparison, the Dow Jones EURO STOXX 50 lost merely some 13% over the same period.

³³ Note: The rise comprises a capital increase of around EUR 2.8 billion by Erste Bank in January 2006. In addition, at the end of the third quarter of 2005, Investkredit was still listed in the ATX Prime. But since Investkredit was taken over by ÖVAG, the bank was delisted at the end of 2005 and has not been considered in this analysis for reasons of data comparability.

³⁴ Source: Datastream, Bloomberg.

contribution to the rise in the major Austrian insurers' operating results. At the end of the third quarter of 2006, the rating outlook for the largest domestic insurance companies was stable. The stock prices of the insurance companies listed on the Prime Market of the Vienna stock exchange slumped as the financial markets witnessed some turbulence in May and June 2006 but picked up again as the year progressed.

Risks to the future outlook for the insurance sector include the historically low interest rates, premiums that are not risk-adequate due to the competitive situation and the increasing occurrence of major claims events. Furthermore, insurers are faced with challenges like the first-time application of the International Financial Reporting Standards (IFRS), the debate on the new IFRS "Insurance Contracts" as well as the preparations for Solvency 2 (the EU project aimed at revising existing solvency regulations). The ultimate objectives of both IFRS and Solvency 2 are to increase transparency, step up risk management and promote market discipline in the insurance sector and thus foster stability.

In the first half of 2006, the Austrian insurance companies' total assets³⁵ expanded by EUR 3.6 billion or 4.7% to EUR 80.3 billion; the annual growth rate stood at 9.4% at the end of June. Since the beginning of 2006, asset growth has been mainly attributable to a 5.9% (EUR 1.6 billion) increase in debt securities, which was driven by investment in foreign debt securities (+6.1% or +EUR 1.1 billion in the first half of 2006). Fur-

thermore, deposits with domestic banks other than overnight deposits (+EUR 0.7 billion or +54.7%), domestic equities and other domestic securities (+EUR 0.6 billion or +2.7%) as well as other assets (+EUR 1.4 billion or +37.8%) supported asset growth. On the asset side, only loans to the government (–EUR 1.0 billion or –26%) and investment in real estate (–EUR 0.2 billion or –5.2%) posted a sizeable decline. The Austrian insurance industry's increasing inclination to invest abroad, which has been observable for several years, helps diversify investment risk geographically. At the end of the first half of 2006, the share of foreign assets in total assets came to 32.7%.

At 10.1%, the insurance sector's total exposure toward domestic credit institutions rose more markedly in relative terms than total assets, amounting to EUR 11.6 billion (14.5% of total assets) at the end of June 2006. The higher exposure was mainly traceable to the significant rise in deposits with domestic banks other than overnight deposits. An over-the-year analysis of the exposure reveals that at EUR 0.4 billion as at end-June 2006, loans to domestic credit institutions almost doubled, reaching their highest level since 1997. The share of insurance companies' investments with domestic credit institutions in Austrian banks' consolidated total assets remained unchanged at roughly 1.3%. Thanks to the insurance sector's business and profit performance and its modest exposure to the banking sector, the risk of contagion between these two sectors continues to be low.

³⁵ Excluding reinsurance business; based on quarterly reports (OeNB insurance statistics).

Austrian Insurance Companies' Activities in CEE

Like Austrian banks, domestic insurance companies entered the CEE market earlier than their foreign competitors. The CEE markets have played an increasingly important role for the Austrian insurance sector, accounting for a rising share in its exposure and large profit contributions. According to six large Austrian insurers¹, the CEE share in total premiums received came to some 21% at the end of 2005; some insurers even reported a share of over 30%. Thanks to high premium growth in these markets, this share has been expanding fast; nevertheless, Austria remains the most important market for domestic insurance companies. With insurance penetration and density at low levels (as regards both life and non-life insurances), growth rates in the CEE markets can be assumed to remain above those seen in traditional markets for quite some time to come; furthermore, the CEE markets still offer favorable cost structures. For these reasons, enhancing their market presence in the region seems particularly attractive for Austrian insurance companies. Like in Austria, life insurers in CEE also benefit from the increasing importance of individual old-age financial provisioning; the share of unit-linked insurance products has been expanding particularly strongly. Since life insurance policies are also used as collateral for household loans, high loan growth indirectly contributes to life insurance growth.

The developments show that the Austrian insurance sector has benefited from the integration of the CEE markets. However, close risk monitoring is vital for insurers especially when doing business in non-EU countries, since these markets involve higher legal, institutional and thus economic risks.

¹ Generali Holding Vienna AG, Grazer Wechselseitige Versicherung AG, Sparkassen Versicherung AG, Uniqa Versicherung AG, Wiener Städtische Versicherung AG, Wüstenrot Versicherungs-AG.

Pension Funds Suffer Capital Losses

In the second quarter of 2006, a total of 20 single- and multi-employer occupational pension funds were operating in Austria. One occupational pension fund was closed down in the first quarter of 2006. Despite regular contributions, their aggregated total assets shrank by 2.6% from EUR 11.9 billion to EUR 11.6 billion in the second quarter of 2006. Some 94% of total assets were held in mutual fund shares, which means that the bulk of investment is outsourced. The share of foreign currency investments was below 3%.

The number of persons eligible for pension fund benefits came to 440,000 at end-2005, with around 77% being members of defined con-

tribution schemes and approximately 23% of defined benefits schemes.³⁶ In the second quarter of 2006, euro-denominated bonds accounted for some 56% of pension funds' investments, euro area stocks for around 22% and non-euro area stocks for approximately 17%. Non-euro-denominated bonds and real estate made up almost 5% of pension funds' investments. In the first half of 2006, Austrian pension funds posted an average loss of 1.20% of the invested capital in nominal terms before costs (asset management costs, custodian fees and, if applicable, minimum return guarantees, etc.).³⁷

By international standards, Austrian pension funds are relatively small; this is not true, however, for

³⁶ Source: Fachverband der Pensionskassen (Austrian occupational pension fund association).

³⁷ Source: Oesterreichische Kontrollbank.

funded pension schemes in general. Under its Global Pension Statistics Project, the OECD published comparative data for 2004 in 2006.³⁸ In three countries, total investments of pension funds amount to more than 100%, in 15 countries to less than 10% of the respective country's GDP. Posting a share of 4.5%, Austria takes

the 22nd place in this ranking. Austria ranks higher (15th) when the investments of life insurances, which are significantly more common in Austria, are taken into account: aggregate pension funds and life insurance assets in Austria equal around 25% of GDP.

³⁸ Source: *OECD Financial Market Trends 90* (April 2006).