

The Financial Crisis Takes Its Toll on the Austrian Financial System

Exposure to Eastern Europe Draws International Attention to Austrian Banks

Asset Growth Continued Robust in 2008 despite Crisis

In 2008, Austrian banks' consolidated total assets, which in addition to domestic business include Austrian subsidiaries' operations in Central, Eastern and Southeastern Europe (CESEE), continued to rise by a healthy 9.5% or EUR 102.4 billion to EUR 1,176 billion despite the turbulence in international financial markets. In terms of consolidated total assets,¹ the share of Austria's five largest banks dropped from 62% to 57.6% compared with end-2007. Austrian banks' unconsolidated total assets jumped to EUR 1,069 billion; the growth rate of 18.9% (a rate last achieved in 1985) was mainly attributable to new establishments and restructuring within two banking groups. These developments do not affect consolidated figures.

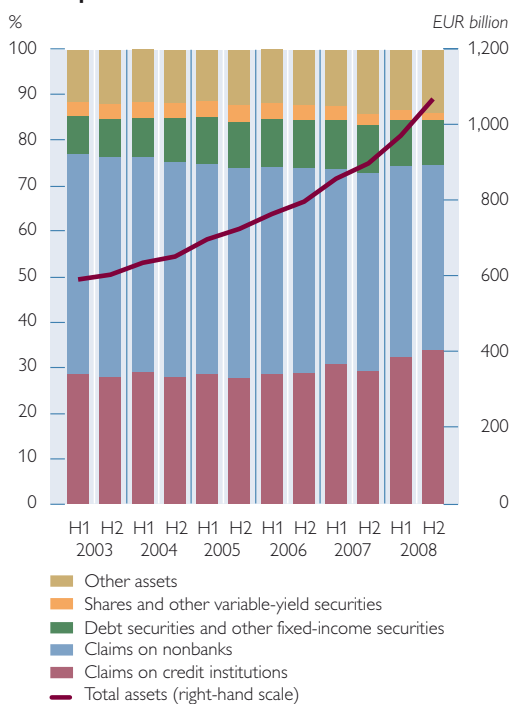
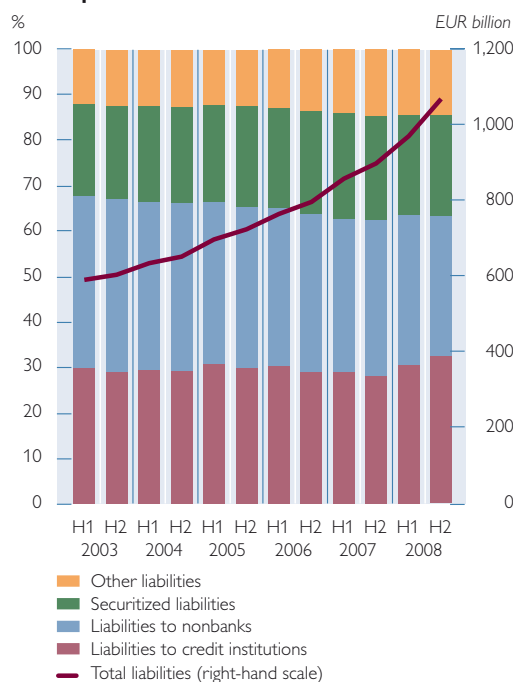
As a consequence of slowing foreign business in the fourth quarter of 2008, Austrian banks' foreign assets grew at a slightly lesser pace compared with 2007, inching up 7.3% to just under EUR 377 billion. Cross-border claims on nonbanks advanced by 11% year on year. Foreign assets declined from 39% (end-2007) to 35.2% (end-2008). On the liabilities side, the external share fell from 30.4% to 25.2% (-5.2% year

on year), mainly due to a decline in foreign liabilities against credit institutions.

Compared with previous periods, the domestic business of Austrian banks has gathered considerable momentum. For instance, claims on domestic nonbanks rose by 7.3% to EUR 308.7 billion year on year, compared with a growth rate of merely 3.4% in the same period 2007. On the liabilities side, the volume of domestic deposits showed sustained growth, advancing by 3.9% to EUR 275.7 billion, which reflects, among other things, the continued uncertainty in financial markets. The key drivers of this growth were demand and savings deposits, which picked up in the fourth quarter of 2008, as well as fixed-term deposits, which expanded at a slightly slower rate. Also, the volume of direct domestic issues to nonbanks expanded by 18.5% to EUR 113.3 billion, growing above average year on year, albeit at a slower rate than in previous periods.

The number of Austrian banking offices continued to decline in 2008, decreasing by 35 to 5,121 outlets (867 head offices and 4,254 branch offices). At the same time, staff numbers increased by 1.4% year on year to 80,293. Including the staff of Austrian subsidiaries abroad, the overall headcount expanded by 12.8% to 219,439 employees.

¹ The five largest banks at end-2008: UniCredit Bank Austria AG, Erste Group Bank AG, Raiffeisen Zentralbank AG (RZB), Oesterreichische Volksbanken AG, Hypo Group Alpe Adria.

Balance Sheet Structure of the Austrian Banking Sector (Unconsolidated)**Development of Assets 2003–2008****Development of Liabilities 2003–2008**

Source: OeNB.

Deepening of Financial Turmoil Further Dampens Profits

Unconsolidated operating profits² grew significantly from December 2007 to year-end 2008, surging 37.2% (or EUR 2.5 billion) to EUR 9.141 billion, owing to special and one-off effects on operating income and a moderate increase in operating expenses. Operating income increased by EUR 3 billion (17.3%) to EUR 20.6 billion, while operating expenses inched up by EUR 0.6 billion (5.2%) to EUR 11.4 billion in the same period. Consequently, the banks' unconsolidated cost-to-income ratio improved considerably by 6.5 percentage points to 55.5%.

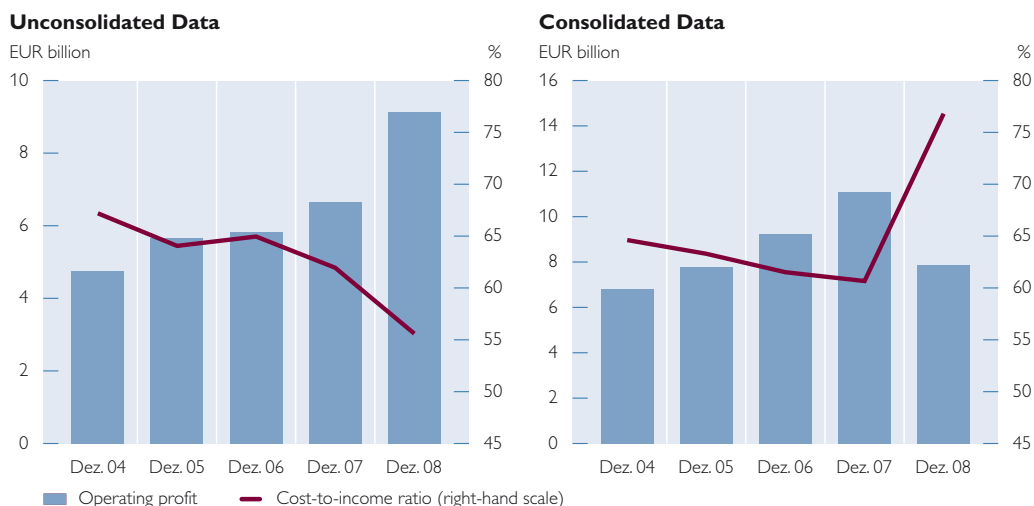
As at end-2008, net interest income maintained a high growth rate, climbing 11.5% year on year to slightly below EUR 8.2 billion. Lower key inter-

est rates and decreasing interbank rates were passed on to borrowers only with a certain time lag, a fact reflected towards end-2008 in consistently higher interest rates on new loans compared with 2007: capital-weighted rates on new consumer loans to households inched up from 6.29% to 6.82%. The rates on housing loans rose from 4.79% to 5.33% and those on other loans from 5.35% to 5.77%. By contrast, interest rates on loans to nonfinancial corporations grew at a slower rate: capital-weighted interest rates on new loans under EUR 1 million advanced from 5.11% to 5.47% year on year, while interest rates on loans over EUR 1 million climbed from 4.69% to 5.04%. However, in the first three months of 2009, all interest rates dropped significantly. At the same time, the interest

² Not adjusted for one-off and special effects at individual banks.

Chart 27

Austrian Banks' Unconsolidated and Consolidated Operating Profit



Source: OeNB.

Note: The bars reflect the operating profit at the end of each quarter (accumulated). Due to changes in the financial reporting regime at the beginning of 2008, the consolidated cost-income ratio for 2008 and beyond is not comparable with pre-2008 data.

margin reached a historical low, dropping from 0.95% at end-2007 to 0.87% in December 2008. The share of net interest income in total operating income³ reached approximately 40.1% (from 42.3% in the previous year). Owing to one-off and special effects, income from equity investments showed a 204% surge (year on year) to just below EUR 7.2 billion as at December 2008. The corresponding share in total operating income expanded to 35% (from 20.1% in the previous year).

Setbacks in fee-based income (by EUR 0.5 billion or 10.4% to EUR 4.2 billion) and the clearly negative net result of financial operations, which contracted by EUR 0.8 billion or 280% compared with the previous year, reflected the impact of the financial crisis particularly strongly. The drop in the net result of financial operations is a

consequence of banks not treating security transactions as financial investments but as part of the trading portfolio.

On the expenditure side, administrative expenses climbed EUR 0.6 billion (6.1%) to EUR 9.7 billion, accounting for 85.2% of total expenses as at end-2008 (84.5% at end-2007). At 5.6%, staff costs grew less markedly than expenditure for goods and services, which increased by 6.7%.

Consolidated operating profits,⁴ which also include the activities of the Austrian banking sector in Central, Eastern und Southeastern Europe and were considerably less exposed to special and one-off effects, shrank by EUR 3.2 billion (–29.1%) to EUR 7.9 billion year on year in 2008. While consolidated operating profits jumped 19.7% year on year to EUR 33.6 billion, operating expenses surged by 51.3% to EUR

³ It should be noted that the negative net result of financial operations has resulted in a slight upward bias in the other components of overall operating income.

⁴ As banks use different accounting standards, aggregated consolidated data may convey a slightly distorted picture.

25.8 billion. At the end of the fourth quarter of 2008, the consolidated cost-to-income ratio before risk provisions was 76.8%.

Adjusted for taxes and minority interests, the consolidated end-of-period result plunged by EUR 6.2 billion (91.4%) to EUR 0.6 billion. All things considered, the Austrian banking sector successfully coped with the challenges of the year 2008.

Thanks to good first quarter results, with operating profits growing by 17.7% to EUR 1.67 billion compared with the first quarter of 2008, which were mainly attributable to increased net interest income and positive trading income, and despite rising value adjustments, Austrian banks expect the annual result for 2009 to be higher than the relatively low annual result of 2008.

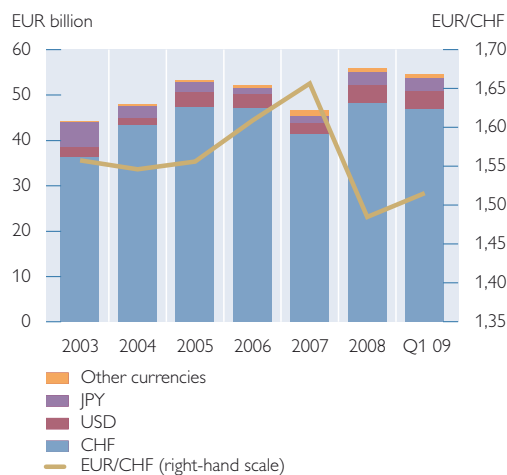
Slowing Loan Growth⁵ in a Difficult Environment

The annual growth of loans to domestic customers⁶ had dropped to 4.6% by end-March 2009, with euro-denominated loans increasing by 4.2% and foreign currency loans by 6.3% year on year. In the first quarter of 2009, lending to domestic customers fell by 0.9% (euro loans: -0.4%, foreign currency loans: -2.7%). The amount of loans to domestic customers totaled approximately EUR 253 billion as at end-March 2009 (euro loans: EUR 204 billion; foreign currency loans: EUR 49 billion).

As chart 28 indicates, the strong growth in foreign currency loans in 2008 is mainly attributable to the appreciation of the Swiss franc against the euro. This development once again highlighted the risks associated with

Chart 28

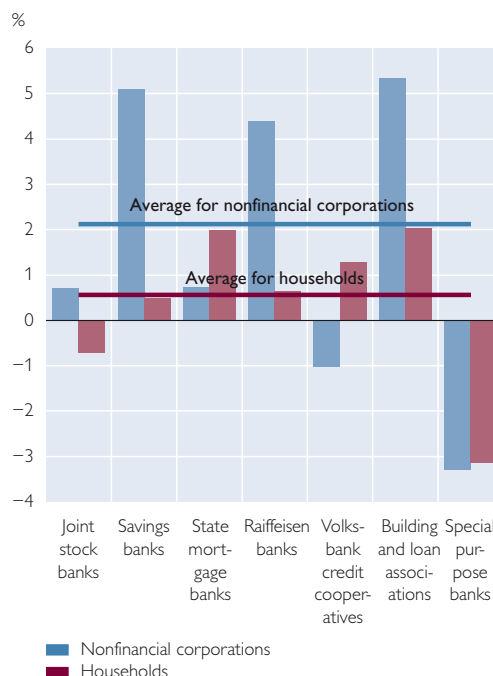
Foreign Currency Loans to Domestic Customers (Nonbanks)



Source: OeNB.

Chart 29

Loan Growth by Sector between September 2008 and March 2009



Source: OeNB.

⁵ The analysis of loan growth is based on the unconsolidated asset statement in the prudential statistics.

⁶ "Domestic customers" comprises the economic sectors "nonfinancial corporations" and "households."

foreign currency lending and supports the FMA's and the OeNB's critical stance on this issue. As risk aversion increased and volatile currency markets as well as lower interest margins made foreign currency loans less attractive for customers, the share of foreign currency loans in total lending to domestic nonbanks, adjusted for currency effects, continued to decrease between September 2008 and March 2009, dropping by another 0.7 percentage points to 17.3%. Foreign currency

loans to households suffered the sharpest decline, contracting by 0.92 percentage points to just under 30%.

A breakdown by banking sector (see chart 29) shows that in particular joint stock banks and special purpose banks recorded below-average growth of lending to domestic customers between September 2008 and March 2009. It also reveals that lending to nonfinancial corporations (2.1%) expanded significantly more rapidly than lending to households (0.6%) in the same period.

Box 2

Survey on Austrian Banks' Structured Credit Portfolio

Owing to the financial crisis, banks worldwide have been forced to make in part massive write-downs on their structured credit portfolios (securitizations, credit derivatives) since mid-2007. Therefore, the OeNB has taken to regularly assessing the volume of Austrian banks' structured credit portfolios and to identifying the write-downs required on these portfolios, even though domestic banks' exposure to these products is all in all relatively small. The most recent update of this survey, which covered the 25 largest Austrian banks, was carried out as at end-2008.

As at December 2008, Austrian banks' total exposure to typical structured credit products (especially securitized products like asset-backed securities, mortgage-backed securities and collateralized debt obligations) came to EUR 15.9 billion, with the six largest Austrian banks¹ accounting for slightly more than 90% or EUR 14.6 billion. Compared with end-2007 figures, the six major domestic banks reduced their structured credit portfolios by 8.3%. In the survey, the banks reported EUR 2.1 billion in write-downs as at end-2008, which equals 13.4% of the total structured credit portfolio.

In a separate part, the survey also covers banks' exposure to credit derivatives. At end-2008, protection sold in credit default swap (CDS) transactions by the banks surveyed amounted to EUR 29.1 billion and protection bought came to EUR 9.7 billion.

As regards the risk exposure of Austrian banks' structured credit portfolio, the survey showed that taking into account any rating migrations in 2008, AAA- and AA-rated products accounted for significantly more than half (57.6%) of the entire portfolio, while BBB-rated products represented 19.5% and non-investment grade 7.2%.

¹ Erste Group, UniCredit Bank Austria, BAWAG P.S.K., RZB, VBAG (including Kommunalkredit), Hypo Group Alpe Adria.

Credit Quality: Loan Loss Provisions on the Rise

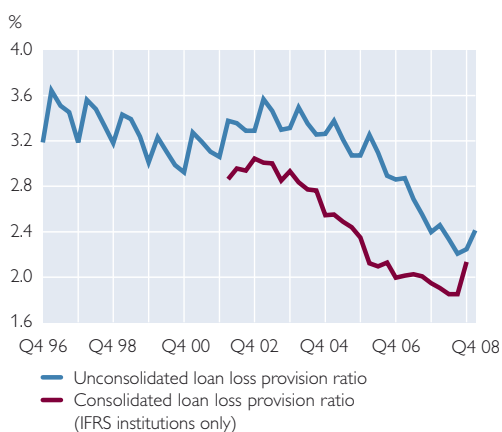
The recession-ridden economic environment in which Austrian banks have been operating started to affect Aus-

trian banks' credit risk provisioning in late 2008. The unconsolidated loan loss provision ratio⁷ for the entire Austrian banking system, which usually experienced a downtrend towards the end of

⁷ Specific loan loss provisions for claims on nonbanks in proportion of total outstanding claims. Claims are defined as loans and unlisted debt securities.

Chart 30

Loan Loss Provision Ratios of Austrian Credit Institutions



Source: OeNB.

the year edged up by 0.04 percentage points to 2.25% in the fourth quarter of 2008.⁸ The decline by 0.15 percentage points for the entire year 2008 is attributable to the ratio's pronounced contraction in early 2008. The upward

trend in the unconsolidated loan loss provision ratio continued in the first quarter of 2009 (see blue line in chart 30).

According to current projections and given the rising number of insolvencies of domestic corporations, it can be expected that the need for loan loss provisioning continues to rise. During the last economic downturn, the unconsolidated loan loss provision ratio peaked at 3.57% (first quarter of 2003).

While unconsolidated data clearly reflect the trend reversal regarding credit risk provisioning, consolidated data – including the entire non-domestic business – make it even more apparent. At IFRS-reporting institutions,⁹ the sustained decline in the loan loss provision ratio of past years¹⁰ came to a halt in the third quarter of 2008 and rose sharply in the fourth quarter (red line in chart 30).

Box 3

Survey on the Risks of Loans Linked to Repayment Vehicles

The bulk of foreign currency loans are bullet loans linked to repayment vehicles (RPV), i.e. repayment does not take place in regular installments but at maturity; during the life of the loan, the borrower makes payments towards an RPV, usually a life insurance plan or a mutual fund. At maturity, these payments and the returns earned on the paid in capital are used to pay back the principal. Such loans linked to RPVs involve the risk that in case of adverse financial market developments, the capital accumulated through the RPV may not suffice to repay the loan at maturity. If such loans are denominated in foreign currency, foreign exchange risk on the outstanding amount of the loan will add to the market risk underlying the RPV.

At end-2008, EUR 27.9 billion of credit to domestic households were foreign currency loans linked to RPVs. Euro-denominated loans linked to RPVs accounted for another EUR 4 billion. Loans linked to RPVs play a smaller role in lending to nonfinancial corporations: At end-2008, foreign currency loans with RPVs represented EUR 2.4 billion, euro-denominated loans with RPVs came to EUR 1.2 billion.

⁸ Over the past 12 years, the decline in loan loss provision ratio in the last quarter averaged 0.09 percentage points.

⁹ These groups' share in the consolidated total assets of the Austrian banking system is just over 80%.

¹⁰ These ratios cannot directly be compared with the unconsolidated loan loss provision ratios because for reasons of data availability, the consolidated ratios also refer to claims on banks.

The most important question in the survey, which covered the 166 most exposed banks, was to what extent the distress in financial markets had consumed the capital saved under RPV plans. The results show that as at December 31, 2008, according to projections¹ on an aggregate level, the amounts saved under RPV plans were 14% below the amount required to fully repay the principle at maturity in the case of household loans and 17% below this level in the case of corporate loans.

The funding gaps² differ depending on the type of RPV. Some 25% of the funds in households' RPV plans are invested in classic low-risk life insurance policies; this group does not show a funding gap at the aggregate level across all banks. Another 55% are invested in unit-linked life insurance plans, whose aggregate funding gap comes to 16%. "Other types" of RPVs, representing 8% of the total RPV volume, show the largest funding gap (54%). 5% of RPV funds are invested in equity funds, which have a funding gap of 26%. Fixed-income funds show a funding gap of 5%, but represent only 1% of the total RPV volume. Like life insurance contracts, balanced funds (6% of the RPV volume) do not show a funding gap.

The loans coupled with RPVs are collateralized with 53% of the outstanding loan volume.

¹ The projections indicate the amount that the RPV plan will have earned at the end of the life of the loan on the basis of current market values and current return expectations.

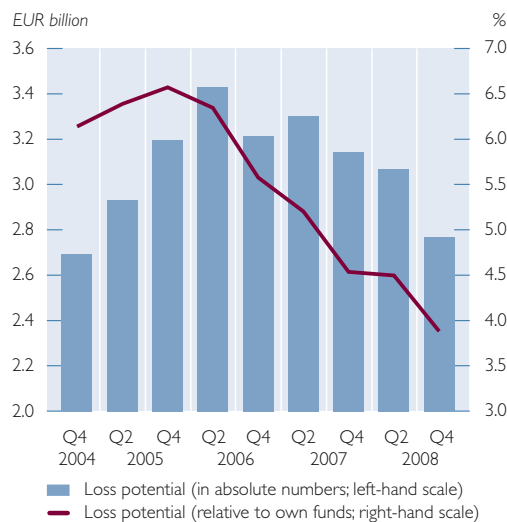
² Funding gap = 1 – projection of RPV/volume of loans coupled with RPVs.

Market Risk: Reduced Exposure to Interest Rate Risks in the Banking Book

The deterioration of the financial crisis has led to Austrian banks' exposure to market risk¹¹ remaining low relative to their credit risk exposure, even though capital requirements for position risk¹² as a percentage of total unconsolidated capital requirements have risen by just under 1 percentage point since mid-2008, coming to 4.2%. This development is attributable to increased capital requirements for interest-based instruments calculated on the basis of a value-at-risk method; increased volatility has played a major role in this context.

In addition to position risk, for which capital charges are required, banks are exposed to market risk through the interest rate risk in the banking book. The declining exposure to this risk category observed in past years continued in the second half of

Chart 31
Interest Rate Risk in the Banking Book (Unconsolidated)



Source: OeNB.

2008. Austrian banks' loss potential (on an unconsolidated basis) stemming from a change in interest rates has declined in the past two and a half

¹¹ Market risk refers to the risk of value changes in respect of financial instruments triggered by general fluctuations of market risk factors such as interest rates, stock prices, exchange rates or commodity prices.

¹² Position risk refers to the risk of stock price and interest rate fluctuations in respect of positions in the trading book as well as to the risk of exchange rate and commodity price fluctuations in respect of all bank positions.

years both in absolute numbers and in relation to the banks' own funds (see chart 31).¹³

Recent data about the consolidated interest rate risk in the banking book reveal that the risk decreased even more strongly between mid-2008 and end-2008. The large banking groups played a major role in this development.

Households' Investment Behavior Keeps Austrian Banks' Liquidity Afloat

The macroprudential analysis of the Austrian banking system's liquidity profile relies mainly on two data sets: the residual maturity statistics based on unconsolidated data as well as the weekly liquidity report, which is drawn up from consolidated data.

Analyzing the residual maturity statistics reveals the following: liquid claims (with a maturity of up to three months) and liquid assets (e.g. euro government bonds) held by Austrian banks as at December 31, 2008, amounted to 109% of short-term liabilities (with a maturity of up to three months); this is a decrease by 4 percentage points compared with the figure as at June 30, 2008. However, despite the prevailing tight money and capital market conditions, the data suggest that Austrian banks will be able to maintain their stable liquidity profile.

The analysis of the cumulated net financing gap confirms this assessment. Assets and liabilities are netted in three maturity bands (next banking day, up

to one month, up to three months). Consideration is given to positions vis-à-vis both banks and nonbanks on both sides of the short-term balance sheet. The net positions are subsequently totaled over the three maturity bands. Austrian banks' cumulative net funding gap is negative, which results inevitably from maturity transformation, the banking system's key function. At end-2008, this indicator had risen to 11.1% of total assets, which represents a slight increase of 0.8% compared with the first half of 2008. A negative cumulative net financing gap gives rise to a certain liquidity risk. While the Austrian banking system's coverage of the cumulative net funding gap by liquid assets decreased from 164% to 145% in the first half of 2008, its risk-bearing capacity remains high.

Austrian banks' high resilience to liquidity shocks is attributable above all to their – by international standards – very sound financing structure, where customer deposits play a greater role than in other banking systems. At end-2008, 46.8% of Austrian households' financial assets were domestic bank deposits, which is a very high rate by international standards. The saving rate edged up from 11.7% of disposable income in 2007 to 12.4% in 2008; the net acquisition of financial assets (financial investment) thus came to EUR 18.8 billion, 70% of which are bank deposits (66% in 2007). Funds available at short notice at Austrian banks by far exceeded short-term bank deposits held by their customers.¹⁴ The

¹³ The blue bars in the chart show the loss potential referring to the change in the present value of the banking book that follows a parallel yield curve shift of 2 percentage points for all currencies, aggregated over all banks. The red line displays each banks' loss potential put in relation to its eligible own funds (Basel ratio of interest rate risk), weighted by total assets and averaged across all Austrian banks.

¹⁴ Liquid assets held by Austrian banks grew from EUR 164 billion (first half of 2008) to EUR 172 billion, while liquid claims increased from EUR 266.1 billion to EUR 275 billion. In total, this represents approximately 247% of short-term deposits (with a maturity of up to three months) held by nonbanks (households and nonfinancial corporations) or, in other words, 230% of Austrian households' total bank deposits.

solid liquidity profile was also attributable to the successful issue of government-guaranteed bank bonds (EUR 15.6 billion as at June 5, 2009) as well as the creation of the Oesterreichische Clearingbank AG (EUR 6.6 billion of allocated funds as at June 5, 2009).

Austrian banks' cumulative net funding gap vis-à-vis other banks outside Austria is only 4.6% of total assets, its coverage by liquid assets being approximately 385%.

An analysis of the consolidated data¹⁵ of the weekly liquidity report, which includes 32 banks and banking groups as well as sectors, produces a similar picture: for this report, detailed data both about banks' expected inflow of funds and outflow of funds as well as data regarding the counterbalancing capacity of the report have been taken into account. The data is broken down to four maturity bands (up to 5 days, between 6 days and 1 month, between 1 and 3 months, between 3 and 6 months) as well as to six currencies (EUR, USD, CHF, GBP, YEN and other currencies). As at early June, the additional liquidity available after six months came to EUR 104 billion. In other words, even if banks use a conservative approach when estimating their future cash flows over six months, they would still have a stable liquidity profile¹⁶ that can be considered adequate in the current situation characterized by fragile money and capital markets (even though conditions have

improved notably compared with October and November 2008).

Given the turmoil in the financial market, it must be highlighted that payment and securities settlement systems have maintained their full functionality even in times of major workload caused by the financial crisis. No disturbances with an impact on the financial system were recorded at the national or European levels.

Uncertainty Regarding Exposure to CESEE Rises Significantly

The CESEE economies are now suffering the full blow of the financial crisis. Against the background of a very gloomy short- and medium-term outlook and emerging problems in the real economy, risk aversion towards investment in CESEE in international financial markets has increased. While financial markets are already factoring in the region's economic downturn, which is also clearly reflected in macro-economic indicators and projections, the risk positions in banks' balance sheets as well as reported data mirror this development with a lag.

Overall, earnings in the CESEE segment in 2008 offset the negative results in other business fields. According to the data in the business segment reports submitted to the OeNB,¹⁷ large Austrian banks' activities in CESEE generated consolidated profit before taxes of EUR 2.9 billion in 2008, compared with a negative result recorded in

¹⁵ The definition of consolidation used for the liquidity report differs from the definition in the Austrian Banking Act. Here, it refers to all companies of a group or sector for which the respective parent bank or a sector's central institution assumes liquidity risks.

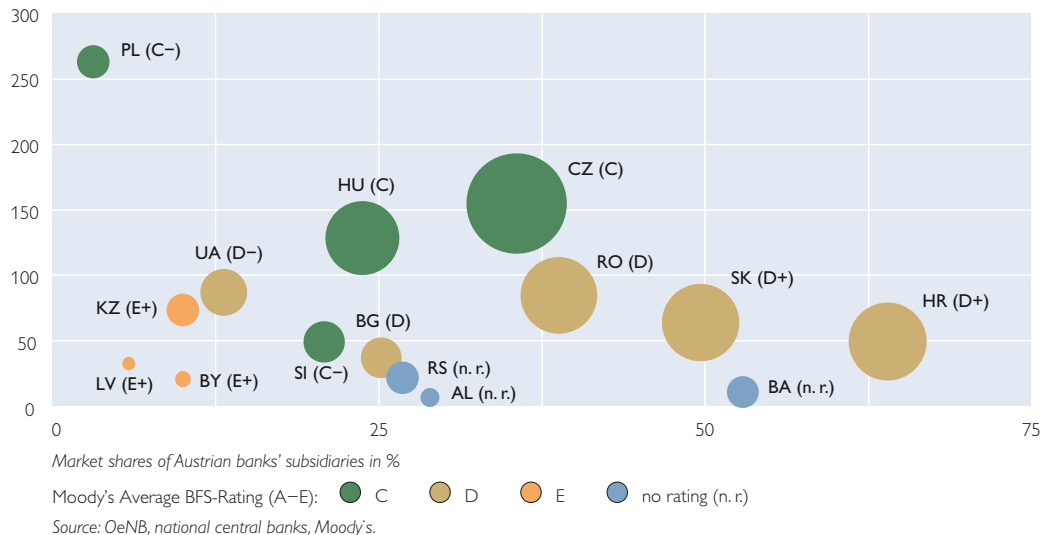
¹⁶ Since the introduction of the weekly liquidity report, banks have been observed to make conservative projections (according to the respective reporting guidelines). The actual payment flows turned out to be much more balanced than projected by banks in their periodical reports. As a consequence, the short-term liquidity (funds realizable within five days) climbed from approximately EUR 95 billion in early 2009 to EUR 120 billion as at June 5, 2009.

¹⁷ In 2008, only 40 Austrian banking groups provided data for these business segment reports. Therefore, figures on profitability and business performance in this paragraph differ from previous sections, which cover all banking groups.

Market Share of Austrian Banks' Subsidiaries¹

As at December 31, 2008

Aggregated national total assets of banks



¹ In this chart, all countries with aggregated total assets of Austrian banks' subsidiaries exceeding EUR 1 billion have been taken into account. Therefore, the latest acquisitions in CIS and CEE countries, with the exception of Kazakhstan and Montenegro, have not been included. Note: The chart shows the individual countries according to the Austrian subsidiary banks' market share (x-axis) and the aggregated total assets of the national banking industry (y-axis). The size of the circle corresponds to the total exposure of Austrian banks vis-à-vis the respective country. Because of the large size of the Russian banking sector (EUR 676 billion as at end-2008), the chart does not show Russia, where Austrian subsidiaries held a market share of 4.3%. The countries are colored according to Moody's average bank financial strength (BFS) rating.

the domestic business and in the segment rest of the world (EUR –1.2 billion and EUR –1.5 billion respectively). The data reported also show continued slight total asset growth – by some 2% to EUR 314 billion – in CESEE in the second half of 2008, accounting for a percentage of just under 31.16% (31.24% in the second quarter of 2008) of the consolidated assets of all Austrian banks.¹⁸ In view of the adverse environment, the contribution of the CESEE segment to profitability can be expected to shrink notably in the near future.

All in all, at end-2008, 12 Austrian banks operated 69 fully consolidated subsidiaries in CESEE (not including Yapi ve Kredi Bankasi, UniCredit Bank Austria's nonfully consolidated joint venture in Turkey). Of these 69 subsidiaries, 27 operate in the Member States that joined the EU in 2004 (NMS-2004),¹⁹ 7 in the Member States that joined the EU in 2007 (NMS-2007)²⁰ and 24 in the remaining Southeastern European (SEE) countries²¹ and 11 do business in countries of the Commonwealth of Independent States (CIS).²²

¹⁸ This figure for total asset growth was not distorted by significant restructuring in 2008 and is therefore based on the organic growth of existing subsidiaries and the expansion of cross-border direct lending.

¹⁹ NMS-2004: Latvia (LV), Poland (PL), Slovakia (SK), Slovenia (SI), the Czech Republic (CZ) and Hungary (HU).

²⁰ NMS-2007: Bulgaria (BG) and Romania (RO).

²¹ SEE: Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME), Macedonia (MK) and Serbia (RS).

²² CIS: Kazakhstan (KZ), Kyrgyzstan (KG), Russia (RU), Ukraine (UA) and Belarus (BY).

Austrian subsidiaries continued to play a prominent role in the region in the second half of 2008. Their share in the entire CESEE banking market decreased only marginally between end-2007 (15.3%) and end-2008 (15.1%); if Russia is not included, the decline would have been from 22.7% to 21.9%.²³

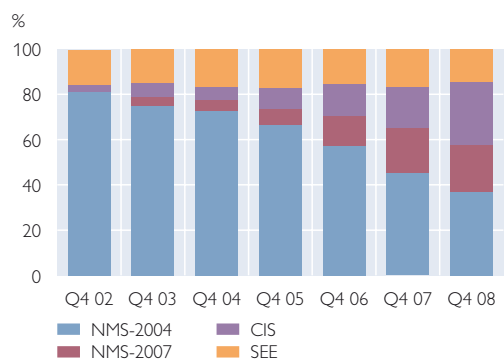
Unconsolidated total asset growth of Austria's fully consolidated subsidiaries in CESEE rose by 15.4% in 2008 as a whole, confirming that expansion continued in the year under review (see chart 33). More than 80% of this expansion was achieved in the first half of 2008. In the second half of 2008, continued growth was recorded in the CIS only, while business stagnated in all other countries. Total asset growth also reflects Austrian banks' strategic interest in this region.

Accounting for almost 50% of the CESEE subsidiaries' total assets, Austrian subsidiaries in the NMS-2004 contributed only 37% to the total operating earnings of the CESEE segment (some EUR 2,653 billion). The shift to-

wards countries where less capital investment produced higher gains seen in previous periods continued in 2008. For instance, CIS subsidiaries contributed 28% or EUR 1,985 billion to total operating earnings in CESEE, whereas their share in total assets was only 18%; Austrian subsidiaries in the NMS-2007 contributed 20% or EUR 1,464 billion (total assets share: 15.2%), and SEE subsidiaries accounted for 15% or EUR 1,039 billion (total assets share of 17.5%).

Chart 34

Operating Profit of CESEE Subsidiaries

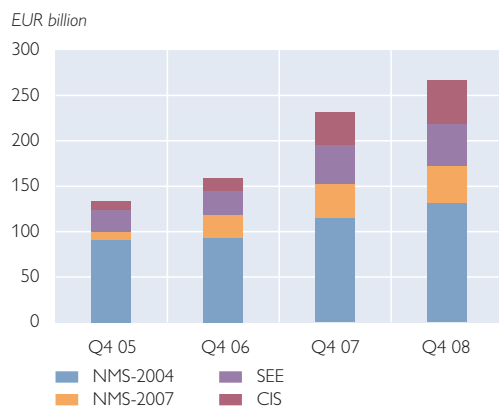


Source: OeNB.

Chart 33

Total Assets of Austrian Banks' Subsidiaries in CESEE

As at December 31, 2008



Source: OeNB.

Austrian subsidiaries' total exposure through loans increased by 16.3% to EUR 170.6 billion compared with the fourth quarter of 2007 (for developments in foreign currency lending, see box 4 below). While the NMS-2004's share in the total CESEE exposure dropped from 48.5% at end-2007 to 47.4% at end-2008 and the SEE countries' share also shrank from 18.2% to 17.7% over the same period, the share of the NMS-2007 remained almost unchanged at 15.2% at end-2008 (15.1% at end-2007). At the same time, the CIS countries' share increased from 18.2% at end-2007 to 19.8% at end-2008.

²³ Both figures excluding Turkey.

Direct lending by Austrian parent banks picked up by 24.7% to EUR 68.5 billion between end-2007 and end-2008.²⁴ The NMS-2004 accounted for the lion's share of loans extended directly by Austrian banks (45.3%), followed by SEE countries (30.9%), the NMS-2007 (15.6%) and the CIS (8.1%).

However, the rapid expansion seen in recent years resulted in deposits growing at a lesser pace than lending. Correspondingly, the relation between loans to customers and customers' deposits held at Austrian subsidiaries in CESEE deteriorated from 66% in early 2002 to 117% at end-2008. Yet, more than 85% of all credit extended by Austrian subsidiaries in CESEE were still funded by local deposits. It needs to be borne in mind, however, that there is a currency mismatch between deposits and loans in many markets.

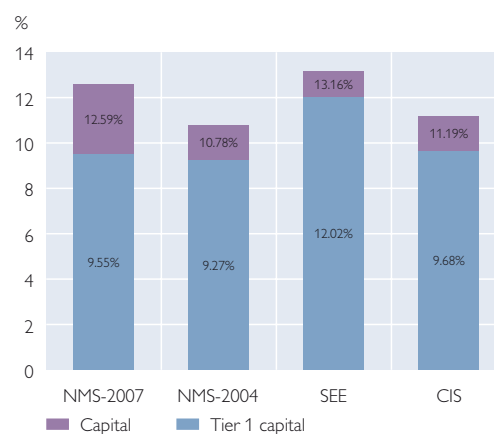
The aggregated loan loss provision ratio of Austrian subsidiaries in CESEE, which has climbed steadily since its low in the third quarter of 2007, edging up from 2.3% to 3% at end-2008, indicates that the credit cycle has peaked and that a pronounced increase in credit risk provisioning can be expected in the near future (for details, see the study by Schürz, Schwaiger and Übeleis in this Financial Stability Report). As a consequence of the latest aid packages provided by the IMF and the European Commission, an escalation of the situation now appears much less likely. In any case, CESEE cannot be regarded as a homogeneous region, as

certain countries or country groups have been affected by the financial crisis to varying degrees. Similarly, the activities of the Austrian financial intermediaries in CESEE are regionally well diversified, which reduces the danger of a country-specific or subregional concentration risk.

Chart 35, which shows the average weighted capital ratios of fully consolidated Austrian subsidiaries in CESEE, points to the fact that most banks have, in addition to profit before risk costs, excess equity (i.e. the weighted mean capital ratio was 11.7% at end-2008), which can be used for risk provisioning if need be. Despite this buffer, recapitalization will be required at certain subsidiaries, as has been the case at subsidiaries in Ukraine. For such recapitalizations, funds from the Austrian bank support package can be used.

Chart 35

Average Capital and Tier 1 Capital Ratio of Austrian Banks' Subsidiaries in CESEE



Source: OeNB.

²⁴ As there were changes in reporting to the Central Credit Register in early 2008 (among other things, Austrian banks' direct loan exposure to the region has been included), a historical assessment of loan growth is possible only to a limited extent.

Box 4

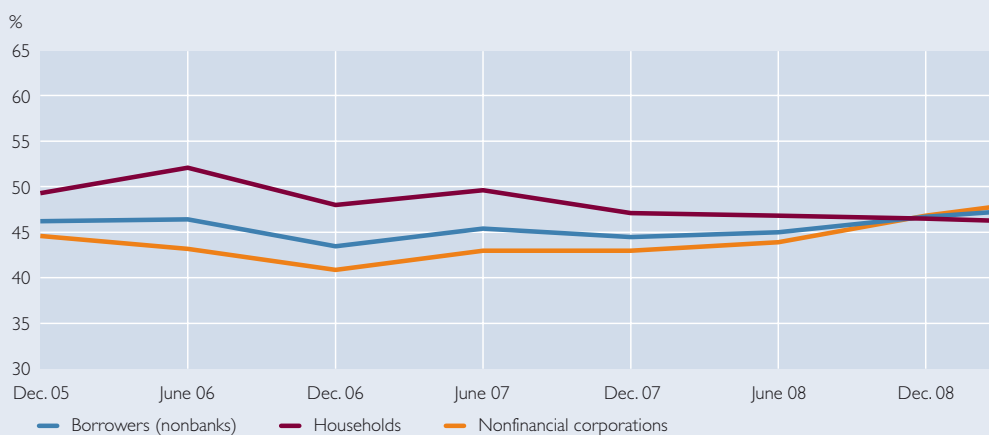
Foreign Currency Loans Continue to Play a Prominent Role in CESEE

Borrowing in foreign currency has been a typical feature of the financing landscape in CESEE. As the financial crisis spread to the region and the local currencies started to feel the ensuing negative impact, foreign currency loans were identified as a key risk factor, thus becoming the focus of international attention. The Austrian Financial Market Authority (FMA) and the OeNB have been skeptical about foreign currency lending in CESEE for some time and have therefore been following developments very closely.

At the end of March 2009, the amount of retail loans (to households and nonfinancial corporations) issued by Austrian subsidiaries in CESEE totaled some EUR 173 billion. About EUR 85 billion or slightly below 49% (exchange rate adjusted: 47%) of this amount were denominated in foreign currency.

Chart 36

Share of Foreign Currency Loans in Total Loans Issued by Austrian Subsidiaries in CESEE



Source: OeNB.

Note: Adjusted for exchange rate effects.

In addition to the foreign currency loans issued by their local subsidiaries, Austrian banks provided some EUR 41 billion in direct lending (i.e. lending from the Austrian parent) denominated in foreign currency. As a result, Austrian banks' total foreign currency exposure to CESEE and the CIS amounted to some EUR 136 billion and is hence considerably higher than their domestic foreign currency exposure (about EUR 50 billion in household and corporate loans).

Financial Market Crisis Drives Up Capital Requirements

In the current international financial market crisis banks' capital ratios are an important gauge of their risk-bearing capacity. The capital ratio and the tier 1 capital ratio are used to assess banks' capital adequacy.²⁵ Following

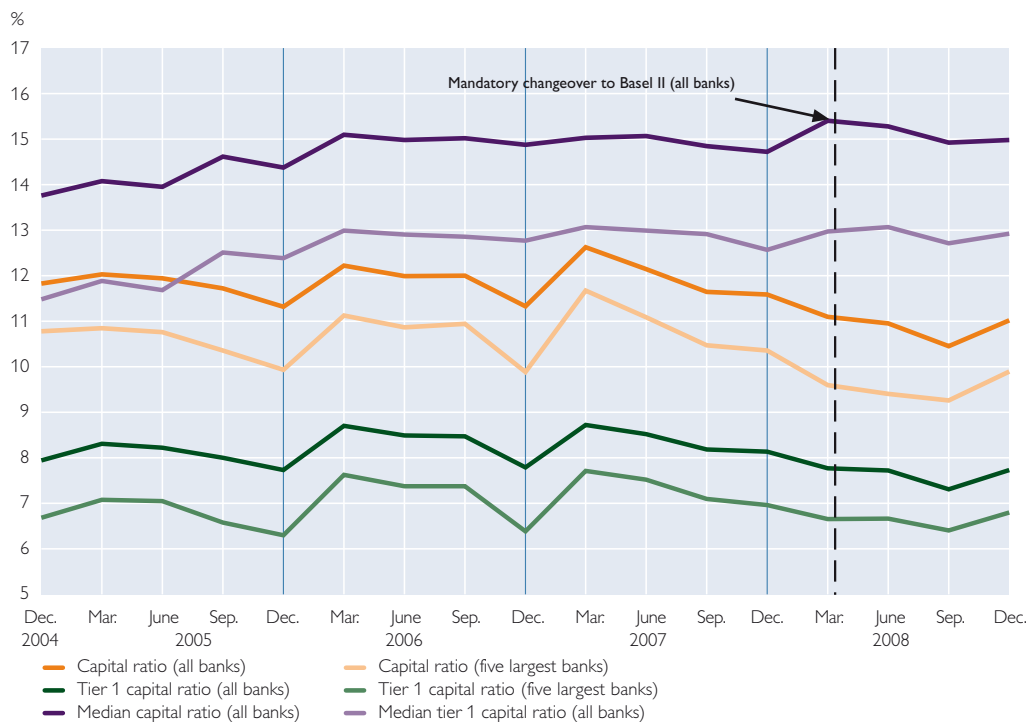
the mandatory changeover to Basel II at all banks in the first quarter of 2008, Basel II transition effects no longer obscure the analysis of changes in capital adequacy.²⁶

At end-2008, Austrian banks' aggregate capital ratio (tier 1 capital ratio) came to 11.02% (7.73%), down by

²⁵ For detailed information regarding the method of calculation, see the Financial Stability Report 16.

²⁶ For a brief description of effects owing to the changeover to Basel II, see the Financial Stability Report 16.

Austrian Banks' Consolidated Capital and Tier 1 Capital Ratios



Source: OeNB.

0.57% (0.40%) compared with the end-2007 figure, but still clearly above the regulatory minimum requirement of 8%.

Following a sharp decline in the third quarter of 2008 to 10.45% and 7.3% respectively, the capital ratio and the tier 1 capital ratio rebounded in the fourth quarter of 2008, mostly due to better ratios reported by the five largest Austrian banks. This improvement was mainly attributable to one-off effects including capital increases through main shareholders, retained earnings, sale proceeds as well as government participation capital.²⁷

In addition, since end-2008, participation capital has been repeatedly increased under the government's bank support package, which boosted the tier 1 capital ratio and the capital ratio

still further. If the EUR 15 billion earmarked for participation capital under the bank package were fully utilized, the capital ratio could increase by approximately 220 basis points compared with end-year figures.

Ratings of Largest Austrian Banks Downgraded or under Review

While the major rating agencies had not changed the ratings of large Austrian banks until the fall of 2008, they acted decisively afterwards, cutting ratings and publishing reports on Austrian banks' exposure to Eastern Europe. In November 2008, Moody's changed the outlook on Hypo Group Alpe Adria's long-term deposit rating to "under review/negative" and VBAG's Bank Financial Strength Rating (BFSR) from C to C- while maintaining the outlook

²⁷ Of the five largest Austrian banks, only Hypo Group Alpe Adria had received government participation capital (in the amount of EUR 900 million) as at December 31, 2008.

Table 2

Ratings of Selected Austrian Banks

As at May 26, 2009

	Deposit rating		Bank Financial Strength Rating	
	Long-term	Outlook		Outlook
UniCredit Bank Austria	A1	negative	D+	negative
BAWAG P.S.K.	Baa1	stable	D	stable
Erste Bank	Aa3	negative	C-	negative
Hypo Group Alpe Adria	Baa1	under review/negative	D-	under review/negative
VBAG	Aa3	stable	C-	under review/negative
RZB	A1	stable	D+	negative

Source: Moody's Investors Service.

at “under review/negative.” In April 2009, several other banks were downgraded: Erste Bank (BFSR from C to C-), RZB (long-term deposit rating from Aa2 to A1 and BFSR from C to D+), UniCredit Bank Austria (long-term deposit rating from Aa2 to A1 and BFSR from C+ to D+). Likewise, Standard & Poor’s changed the long-term foreign issuer rating both for RZB (in November 2008) and UniCredit Bank Austria (in March 2009) from A+ to A.

CDS Spreads and Stock Prices of Austrian Banks Under Pressure

The stock prices of the large Austrian banks have moved roughly in line with those of other large European banks (Dow Jones EURO STOXX Bank Index²⁸) since the outbreak of the financial crisis (June 1, 2007). However, due to Austrian banks’ large exposure to CESEE and the CIS, their stock price losses exceeded those seen at other large European banks by several per-

Chart 38

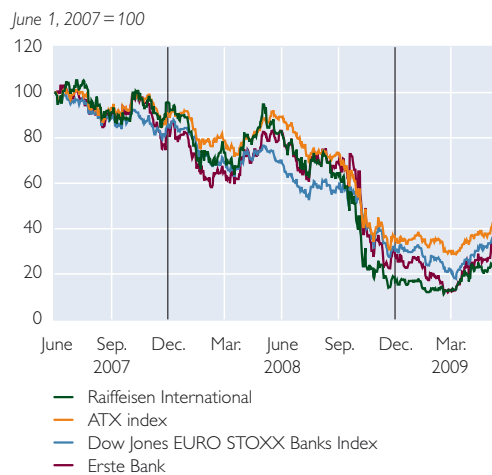
Austrian Banks’ Stock Prices and CDS Spreads

CDS of Austrian banks



Source: OeNB, Bloomberg.

Austrian Banks’ Stock Prices Compared with National and International Stock Price Developments



²⁸ The Dow Jones EURO STOXX Banks index, which is a weighted index of bank shares, includes 39 European banks (e.g. Erste Bank, Raiffeisen International and UniCredit).

centage points. After stock prices reached their trough in March 2009, a pronounced upward trend has been observed.

A comparison of large Austrian banks' CDS spreads with the European finance industry's average figures, represented by the iTraxx Senior Financials Index,²⁹ points to the fact that a reassessment of the situation of Austrian banks took place in the first quarter of 2009. While at the onset of the crisis, the focus of attention was on exposures to subprime loans and then shifted to credit derivatives following the collapse of Lehman, afterwards the financial markets turned their attention to Austrian banks' exposure to Eastern Europe. Many capital market players started to question the quality of Austrian banks' loan portfolios in Eastern Europe; as a result, Austrian banks CDS spreads widened to up to 500 basis points by March 2009, as shown in chart 38. As global financial markets started to recover in mid-March 2009, CDS spreads subsequently fell to below 400 basis points. Nevertheless, the implied volatilities of at-the-money call options on the stocks of the two listed Austrian banks point to significantly increased stock price volatility in the near future.

Financial Crisis Weighs on Investment Returns of Other Financial Intermediaries

Insurers Worldwide Facing Higher Risks

The international insurance sector increasingly felt the impact of the turmoil in financial markets in 2008, albeit to a lesser extent than the banking sector. Inadequate risk management coupled with substantial exposure to the struc-

tured credit market (including credit derivatives) were the main reasons for problems encountered by some major U.S. and European insurers that had to seek government assistance. Aggregate profitability declined in 2008. Investment performance suffered as equity securities and debt securities lost ground. The increase in credit risk premiums also had a negative effect, given that debt securities (including corporate and bank bonds) accounted for the lion's share of the invested capital. It has to be noted though that insurers tend to have more leeway than banks in accounting valuation; this may be one of the reasons why insurance companies have been hit less severely by the crisis than banks. Insurers' hidden reserves fell notably in the second half of 2008, and some insurers may have even built up hidden liabilities. The sector's solvency has deteriorated accordingly.

The difficult economic environment and the high uncertainty prevailing in financial markets have been a big challenge for insurers. Market indicators confirm that the overall outlook for the European and the Austrian insurance industries has deteriorated. However, the insurance sector too has benefited from the general market recovery from March 2009 on. A prolonged period of low interest rates in conjunction with a weak stock market performance would considerably increase pressure on the insurance sector.

The Solvency II framework with its more risk-sensitive regulatory requirements aims to reinforce the harmonization of supervision of the insurance industry at EU level. It was adopted by the European Parliament in April 2009; implementation at the national level is expected to start in 2012.

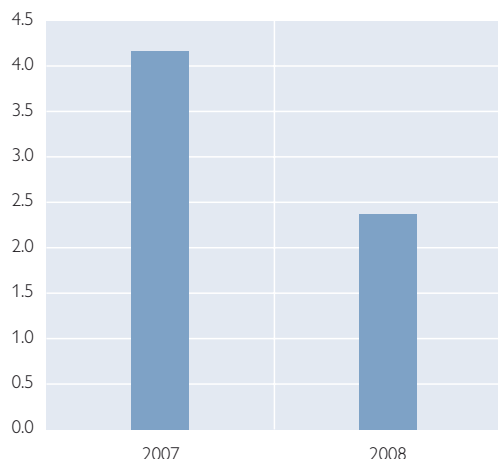
²⁹ The iTraxx Senior Financials Index, which is a subindex of iTraxx Europe Index is a CDS index for financial titles, includes 25 European financial values (16 banks and 9 insurance companies).

Chart 39

Austrian Insurers' Capital Investment

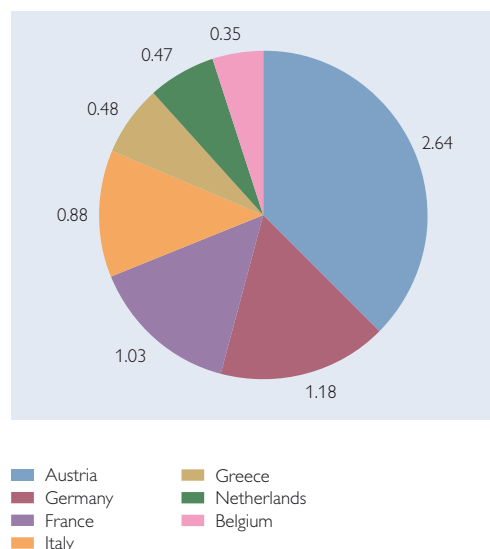
Net investment results

EUR billion



Major government bond holdings

EUR billion



Source: FMA, OeNB, OeNB calculations.

Austrian Insurers Report Declining Profits

The domestic insurance sector has felt the impact of the crisis primarily due to losses in their investment portfolio. In 2008, Austrian insurers' premium income³⁰ increased by some 2.8%; factoring in an average inflation rate of 3.2%, real premium income even shrank slightly year on year. Claims payments rose by 7.5%. The net investment result dropped by 40%; at more than 60%, the decline was particularly strong in the property/casualty business, which can be traced, inter alia, to this segment's fairly high exposure to stocks and equity securities. Aggregate pre-tax profits slumped by three-quarters to slightly above EUR 400 million. Except for life insurance, all segments reported net profits, however.

The reappraisal of risk has led to considerably higher risk premiums even on euro area government debt, feeding through to insurers' bond portfolios. According to the OeNB's securities issues statistics, the seven largest sovereign bond portfolios totaled almost EUR 7 billion at end-2008, the lion's share of which had been issued by prime borrowers. Italian and Greek government bond spreads against German bunds have widened particularly strongly.

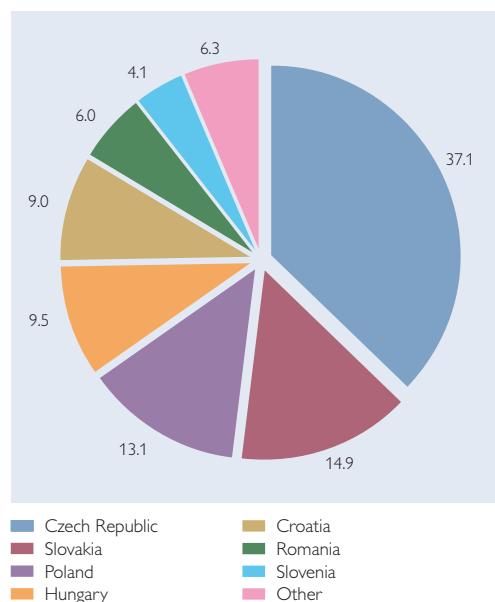
Like Austrian banks, domestic insurers have expanded into CESEE over the past few years, building up a broadly diversified exposure with a strong focus (87%) on the EU Member States of the region.

³⁰ Excluding reinsurance transactions.

Chart 40

Austrian Insurers' Exposure to CESEE in 2007 (as a percentage of total assets)¹

EUR million in %



Source: FMA.

¹ Due to differences in accounting rules and in the definition of balance sheet items, the data reported to the FMA may differ from the data reported in individual annual reports.

Note: Country share in the Austrian insurance sector's total assets in CESEE (total: EUR 8.9 billion).

Premium growth was comparatively robust in CESEE in 2008, even though it already lost some momentum in the second half of the year. The gloomier economic outlook for CESEE in conjunction with slower credit growth seems to have affected the demand for insurance products. Moreover, investors' declining risk appetite and the depreciation of local currencies are likely to have dampened demand for life insurances (linked to foreign currencies and funds), which had contributed strongly to premium growth. Still, the CESEE insurance market still holds high potential in terms of catching up and development.

³¹ Including investments held as fund- and index-linked life insurances. Here, the insurance holder bears the investment risk, so that the figures given for the sector's total exposure are slightly too high.

An analysis of the insurance sector's exposure to the banking sector to assess the risk of contagion shows that Austrian insurers' total exposure³¹ to domestic credit institutions increased by some 23% year on year and came to 15.6% of the insurance sectors' total assets. Debt securities issued by domestic banks accounted for the bulk of this exposure, having climbed by 14% to EUR 9.8 billion. Insurance companies' investments with domestic credit institutions thus came to slightly more than 1.3% of Austrian banks' consolidated total assets. The current outlook suggests that the mutual risk of contagion has increased somewhat, albeit from a low level.

Mutual Funds Record Steep Decline

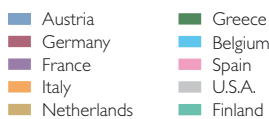
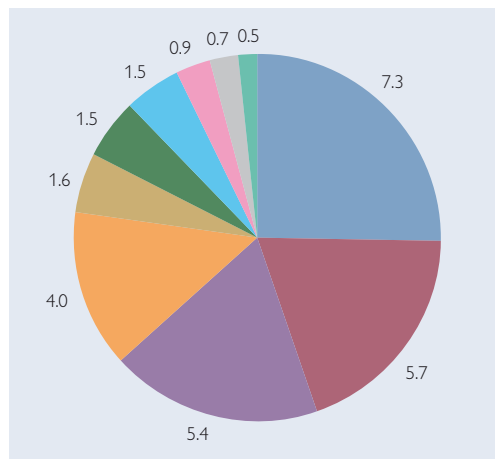
European mutual funds felt the full impact of the financial crisis in 2008. Assets under management by European mutual funds contracted by 22% to EUR 6,142 billion, mostly due to price losses – in particular of stocks – and capital outflows. Outflows peaked in October 2008, when uncertainty about the stability of the international financial system reached its highest levels. Furthermore, the introduction of higher guarantees for bank deposits in the EU reduced the attractiveness of mutual fund shares, in particular in bond and money market funds, relative to bank deposits. In December 2008, the revelations about U.S. investment manager Bernard Madoff led to rising reputational risk, especially in the hedge fund sector. Also, investors increasingly expressed concerns about controls and transparency. Owing to the difficult economic environment, the outlook for the European mutual fund sector continues to be uncertain.

Chart 41

Mutual Funds and Investment Companies

Ten largest government bond holdings

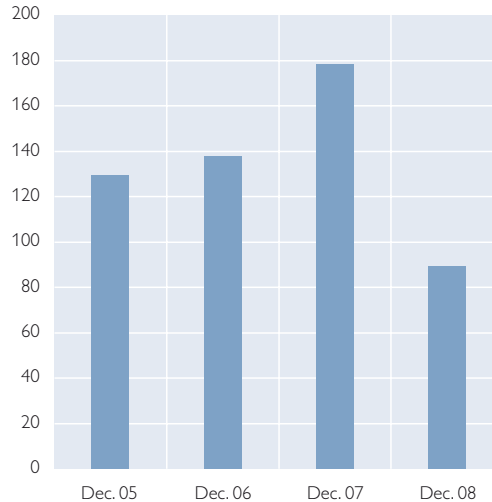
EUR billion



Source: OeNB.

Aggregate operating profits of Austrian investment companies

EUR million



Austrian Mutual Fund Performance on Par with European Average

According to the OeNB's mutual fund statistics, assets under management by Austrian mutual funds (including fund-of-fund investments) performed in line with the European market, falling by 23% or EUR 38.2 billion to EUR 127.4 billion. In October 2008 alone, the decline amounted to more than EUR 10 billion. Price losses and capital outflows are the main reasons for this downward trend. Almost halving in 2008, the volume of equity funds slumped more than any other fund segments. However, even the assets under management by bond funds, which are usually fairly stable in their performance, contracted by 20%. As the situation in international financial markets started to calm down, the decline in assets under management slowed somewhat (–4%) in the first quarter of

2009. Austrian real estate funds were hardly hit by the financial market turmoil up until the third quarter of 2008. However, amid heightened investor uncertainty, an increased preference for liquidity and profit-taking, open-end real estate funds too registered capital outflows and suspended repurchases of fund shares in the fourth quarter of 2008.

More than half of Austrian mutual funds' assets (55%) are invested in debt securities. Because of their relevance for Austrian mutual funds and following a reassessment of credit risk (even for euro area government issuers), the OeNB analyzed the ten largest government bond positions on the basis of its securities issues statistics. As at end-February 2009, the exposure of mutual funds to government bonds was highest vis-à-vis Austria and Germany, two prime issuers. In January and February

2009, German government bonds were sold, however, which can be traced to their high liquidity relative to other bonds.

The capital-weighted average total performance of all Austrian mutual funds stood at -13.4% (equity funds: -61.2% , balanced funds: -14.6% , bond funds: -0.15%) in 2008.

The 29 Austrian investment companies reported a steep decline in profits in 2008. Operating profits halved and stood at just under EUR 90 million at year-end. Decreasing profitability resulted in likewise smaller profit shares for the company owners, primarily Austrian banks. Still, in these economically uncertain times, Austrian mutual funds have contributed to the stable refinancing of Austrian banks.

Pension Funds and Severance Funds Feel Impact of the Crisis

The economic and financial crisis led to a further deterioration in investment results in the fourth quarter of 2008. The nominal return on investment of Austrian pension funds was -12.9% for the entire year of 2008 (first to third quarter: -8.4%). The OECD estimates that pension assets worldwide have shrunk by some EUR 3,800 billion or more than 20%.³²

In the defined benefit system, the crisis has led to a marked increase in the concerned companies' liabilities. While the value of accumulated assets has declined, the discounted present value of future benefits has increased on the back of lower long-term interest rates (discount rates). In Austria, some 16% of (prospective and current) beneficiaries were members of a defined benefit scheme in 2007. Employers were obliged to make supplementary contributions for around 26% of premium reserves. In the defined contribution system, it is mostly the beneficiaries who bear the losses. A recent study shows that the volatility of pension benefits in Austria is high by international standards.³³ The OECD study referred to above concludes that Austrian pension funds require improvements in terms of risk management, governance structures and transparency.³⁴

Austrian severance funds suffered considerably smaller losses in 2008 (return on investment: -2%). This is mainly due to legal provisions requiring capital guarantees. For this reason, severance funds invest mainly in euro bonds.

³² Antolin, P. and F. Stewart. 2009. *Private Pensions and Policy Responses to the Financial and Economic Crisis*. OECD Working Paper on Insurance and Private Pensions No. 36. Paris.

³³ Klec, G. 2008. *Sicherungssysteme und Risikoverteilung bei Betriebspensionen*. Vienna. Study commissioned by Arbeiterkammer Wien. December. Countries for comparison: Denmark, Sweden, Netherlands, Germany, United Kingdom and Belgium.

³⁴ See Schmitz, S. 2006. *The Governance of Occupational Pension Funds and the Politico-Economic Implications: The Case of Austria*. In: Mooslechner, P., H. Schuberth and B. Weber (eds.). *The Political Economy of Financial Market Regulation: The Dynamics of Inclusion and Exclusion*. Cheltenham, U.K. Edward Elgar. pp. 214–246.