

Austrian Financial Intermediaries Perform Well despite Financial Market Turbulence

Banks' Activities in Central, Eastern and Southeastern Europe Remain an Asset

Sustained Solid Asset Growth

In 2007, Austrian banks' unconsolidated total assets continued to rise sharply. Fueled by the persistently dynamic external business, their total assets increased by around EUR 101.8 billion or almost 12.8% year on year to EUR 899.5 billion, thus topping the corresponding rate in 2006 (+9.9%). The share of the five largest Austrian banks¹ in the unconsolidated total assets continued to drop somewhat and amounted to almost 43% at the end of the year. On a consolidated basis, i.e. also including the data of subsidiaries in Central, Eastern and Southeastern Europe (CESEE), total assets augmented by 15.7% or EUR 145.5 billion to EUR 1,073 billion year on year at the end of 2007, with the share of the five largest Austrian banks¹ rising slightly to 62.5% owing to their strong external business operation.

Buoyant external business boosted external assets by EUR 57.5 billion or 19.6% to EUR 351.0 billion (on an unconsolidated basis) in 2007, which corresponded to a share of 39% of total assets at the end of 2007 compared to 36.8% in 2006. Over the same period, the share of external liabilities fell from 32.5% to 30.4%, which was partly attributable to the decline in foreign currency loans. On the asset side, the higher foreign share is mainly the result of growing claims on foreign nonbanks, which climbed by 28.4% year on year,

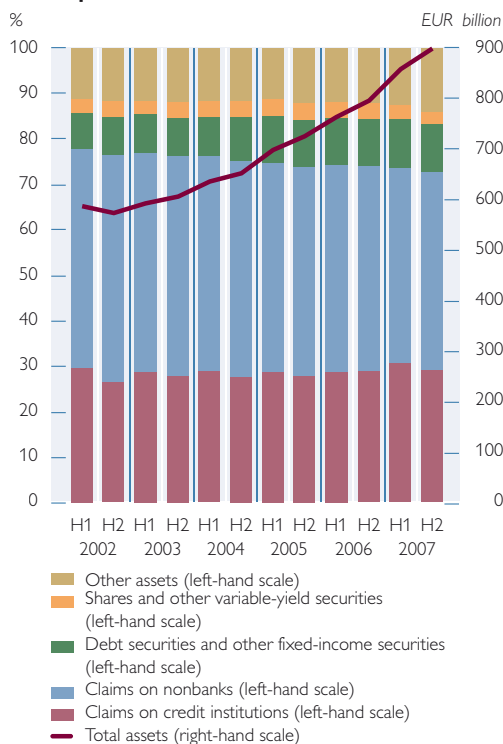
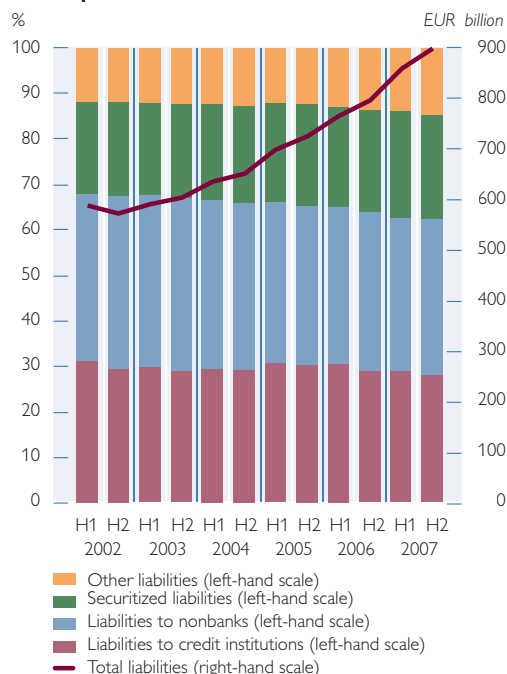
while the claims on foreign banks augmented by 13.7%. The rise in external liabilities was primarily driven by an increase in liabilities to foreign nonbanks by 14.6%.

Domestic business growth was less pronounced in 2007. While in 2006 claims on domestic nonbanks had increased by close to 5%, they augmented by only 3.4% to EUR 287.5 billion up to the end of 2007. On the liability side, liabilities to domestic nonbanks rose by 11.7%, thus significantly stronger than in the same period of 2006 (+4.7%). Despite the fact that all deposit categories of domestic nonbanks recorded gains at the end of 2007, time deposits stood out with an increase by 51.0% year on year, as financial market uncertainty considerably raised the attractiveness of saving products. The growth of direct domestic issues to nonbanks was similarly outstanding: It went up by around 24% year on year compared to 15.4% in the same period a year earlier. Growth was almost equally fueled by the rising number of debt securities issued and other securitized liabilities.

Special off balance sheet transactions (derivatives business) continued to rise visibly, namely by 23.8% year on year to around EUR 2,056 billion in December 2007,² which was basically 2.3 times the amount of total assets. Interest rate contracts (around 82%) as well as exchange rate and gold contracts (16.9%) accounted for the lion's share of these transactions.

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

² As the data are based on nominal values, it is not possible to make any statement about the riskiness. In addition, it has to be noted that this position is highly volatile.

Balance Sheet Structure of the Austrian Banking Sector (unconsolidated)**Development of assets 2002–2007****Development of liabilities 2002–2007**

Source: OeNB.

In 2007, the downward trend in the number of banking offices in Austria was interrupted, as their number went slightly up to 5,156 from 5,150 banking offices existing at the end of 2006.³ Even though this was only a minor net increase, it was the first one since 1992. At the same time, staff numbers increased by around 2.6% to 68,221 employees. While in Austria one bank employee statistically serves 109 inhabitants, the average EU-25 ratio is 152 inhabitants per employee.⁴

External Business Remains Profit Generator

Although the developments in the international financial markets have not left Austria completely untouched, the Austrian banking sector continued to report solid profits in 2007 owing to its pronounced exposure to CESEE. Consolidated operating profits⁵ went up by EUR 1.8 billion or 19.7% to EUR 11.1 billion in 2007 compared with EUR 9.2 billion in the same period of the previous year. Although the operating

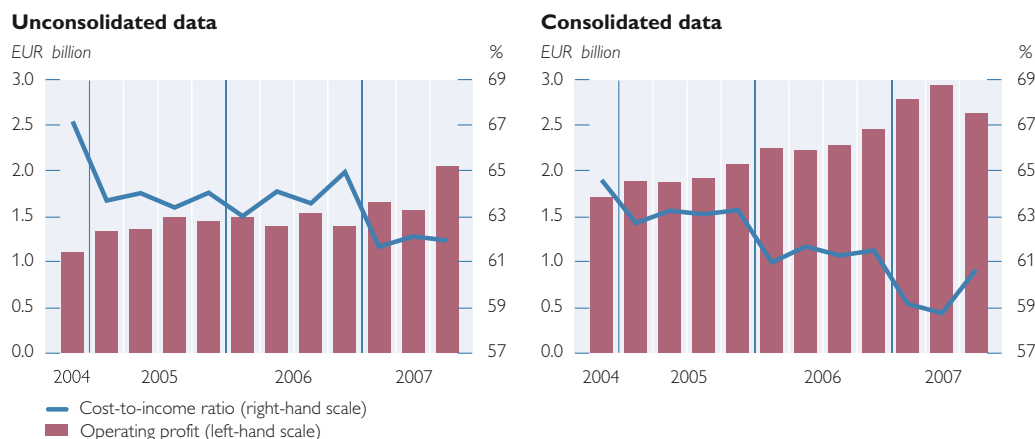
³ At the end of 2007, 5,156 banking offices including 870 head offices and 4,286 branches.

⁴ Source: ECB report "EU Banking Structures," October 2007.

⁵ As banks use different accounting standards, aggregated consolidated data may convey a slightly distorted picture.

Chart 14

Comparison of Unconsolidated and Consolidated Operating Profit



Source: OeNB.

profit margin⁶ was not much higher in 2007 at 1.03% than in 2006, the underlying increase in total assets had been very strong. Reflecting a further improvement in efficiency, banks' consolidated cost-to-income ratio came down from 61.5% at the end of 2006 to 60.7% in December 2007. Consolidated operating income went up by 17.1% – thus more markedly than consolidated operating costs (+15.5%).

Driven by credit expansion in CESEE, consolidated interest income advanced by EUR 3.1 billion or 20.7% to EUR 18.0 billion year on year in 2007, thus already making up about two-thirds of the total growth of consolidated operating income. Consolidated fee income, which rose by even 21.1% year on year, accounted for the remainder. International financial market turmoil reduced the consolidated trading income by almost one-quarter to about EUR 0.8 billion in 2007 compared to the previous year.

On the expenditure side, administrative expenses climbed by 17.6%

against the previous year, thus outpacing staff cost growth (+16.4%). The consolidated end-of-period result decreased by EUR 0.6 billion or 7.8% to EUR 6.9 billion year on year. In December 2007, the consolidated return on assets (ROA) rose to 0.75%.⁷

Domestic Business Profits Have Also Grown Markedly

Despite financial market turmoil domestic profitability developed dynamically in 2007. Unconsolidated operating profit advanced strongly by around 14.5% or EUR 0.9 billion to almost EUR 6.7 billion year on year. Likewise, the unconsolidated cost-to-income ratio improved considerably from 65.0% at the end of 2006 to 62.0% at the end of 2007 as operating profits, driven by fee-based income and income from participating interests, grew markedly stronger year on year (+5.5%) than operating cost (+0.5%), which remained almost at the growth level of the previous year. Yet, financial market turmoil did also surface in Austria: Among oth-

⁶ Consolidated operating profits relative to consolidated total assets.

⁷ In 2006, ROA amounted to 0.94%. One-time effects caused by restructuring within the UniCredit group are the reason for the upward distortion of this value. Adjusted for these effects, ROA comes down to 0.69%.

ers, it had an impact on the net result of financial operations, which contracted by more than half to EUR 0.4 billion in December 2007 against the same period in 2006.

By end-2007, net interest income was up higher than in previous periods: It climbed by around 3.2% or EUR 0.23 billion to close to EUR 7.4 billion against the previous year. This rise is particularly remarkable given that the interest margin was at a historically low level of 0.95% in the last three quarters of 2007. Liquidity shortage in the money market caused by financial market turbulence in 2007 led to a general increase in interbank interest rates, which banks were at least partly able to pass on to their customers as clearly reflected by rising retail interest rates. Given higher refinancing costs, banks are now challenged not to narrow their interest margins any further. The share of net interest income in total operating income moved slightly downward again from 43.1% to 42.3% between 2006 and 2007.

Fee-based income developed favorably: In spite of a slightly weaker growth in the last two quarters of 2007, net fee-based income increased by 9.5% against the previous year. With its share in operating income climbing to 26.9% – this was an increase by 1 percentage point against the previous year – fee-based income remained a key driver of growth; it accounted for 45.7% of total growth in unconsolidated operating income. In the wake of volatile financial markets the conditions for generating fee-based income will, however, become more difficult in the future.

Income from equity shares and participating interests picked up by 22.3% against the same period a year earlier.

On the expenditure side, administrative expenses climbed above-average, namely by 5.3%, whereas the rise of staff costs (+0.3%) remained at almost the same level as in the previous year. The latter can mainly be explained by the release of pension fund reserves as wages and salaries augmented by around 5.6% against 2006.

Box 1

Financial Market Turmoil Has Had Little Impact on Austrian Banks

In the summer months of 2007, high default rates on U.S. subprime mortgages triggered strong turbulence on international financial markets which spread out in several waves. Initially, the disruptions were primarily limited to the market for structured products based on U.S. subprime mortgages; over time, however, rising uncertainty about individual banks' exposure to the resulting losses caused liquidity constraints in the money market. Upon publication of third-quarter operating results it became obvious that other segments of the structured credit market had also been strongly affected, which in turn led to further value adjustments and an increase in credit default swap (CDS) spreads. The next wave spilled mainly over to U.S. bond and credit insurers, whose top ratings were questioned given the high insurance commitments they had incurred for structured credit products. Finally, the turmoil also caused leverage to decline more strongly in large parts of the financial system, with negative effects on the liquidity in various markets. The situation relaxed somewhat once the takeover of a large U.S. investment bank initiated by the U.S. authorities had worked out and the accompanying monetary policy measures were in place.

So far, current financial turbulence has most heavily hit banks, particularly those in the U.S.A., Switzerland and Germany. The effects on the banks in these countries are primarily the result of their direct and indirect exposure to the U.S. subprime market, their refinancing patterns and their "originate and distribute"¹ strategy.

¹ See footnote 2.

Owing to their relatively little exposure to the U.S. subprime market, Austrian banks have remained largely unscathed. By and large, the effects translated into increased value adjustments for structured credit products, shrinking trading income and higher refinancing cost. In 2007, Austrian banks had to write off EUR 1.1 billion of their investments in structured credit products according to an OeNB survey. The fact that Austrian banks were comparatively little affected is mainly attributable to their “originate and hold”² strategy and to their focus on activities in CESEE.

Overall, turbulence of the past months revealed various vulnerable spots of the international financial system. In order to eliminate these vulnerabilities, the Financial Stability Forum (FSF), which is set up at the BIS, drafted on behalf of the G7 finance ministers recommendations aimed at enhancing the resilience of the global financial system. These include strengthening the liquidity and risk management as well as the prudential oversight of off balance-sheet activities, enhancing transparency and valuation, reforming credit rating process for structured products, rendering the implementation of the findings more effective as well as harmonizing crisis management cooperation internationally.

² “Originate and hold” stands for a business model in which the bank granting a loan generally also holds it to maturity, whereas banks implementing “originate and distribute” strategies sell the loans to other market participants.

In the event of continued strain on international financial markets, the profitability of Austrian banks might also be affected by the ensuing adverse effects despite their limited exposure to the U.S. market. Apart from the need for further value adjustments and declining dynamics in fee-based income, it is primarily the medium-term impact of financial turmoil on the real economies of Austria and CESEE which constitute a potential threat.

Stable Lending Despite Difficult Financial Market Conditions

In view of the current financial turmoil, the question arises to what extent it affects Austrian banks’ lending activities. Up to now, the credit volume has hardly been touched. By end-2007, the total loan volume growth of Austrian banks reached 5.6%. A look at the economic sectors shows that lending⁸ to businesses remained stable with an annual growth rate of 5% in December

2007, whereas the growth of loans to households⁹ reached 5.6% and was clearly above the level of the previous year.

A long-term comparison shows that the loan volume of Austrian banks has somewhat declined since the beginning of 2006. This rather moderate decline may come as a surprise, given that Austrian banks have raised their retail interest rates for new loans in the wake of current financial market difficulties. Particularly housing loans became more expensive in the course of 2007 with interest rates for new business climbing by almost 1 percentage point from 4.28% in December 2006 to 5.27% in December 2007 (interest rates for consumer loans rose from 5.84% in December 2006 to 6.56% in December 2007). In 2007, businesses had to pay an interest rate of 5.5% for new loans of less than EUR 1 million (2006: 4.55%), and 5.1% for loans of more than EUR 1 million (2006: 4.24%).

⁸ The growth rate is calculated on the basis of data reported by credit institutions, which are required to report their asset positions according to annex A1a of the unconsolidated balance sheet statement (pursuant to article 1 paragraph 1 of the regulation on the Report of Condition and Income Regulation).

⁹ In this context, the economic sector “households” also comprises “nonprofit institutions serving households (NPISH)”.

Following the increased sale of loans and the strong growth in new business at some banks, the credit volume development of Austria's largest banks varied considerably in the second half of 2007. It is therefore not possible to make out a uniform trend for the individual institutions of Austria's five largest banks; at an aggregated level their loan volume growth amounted to 5.3% at the end of the year. The median growth of the Austrian banks' outstanding loans totaled 4.1% in the same period.

A look at the development of the lending activities in the individual banking sectors shows that joint stock banks performed below-average in the second half of 2007, while at the same time state mortgage banks and Raiffeisen credit cooperatives posted above-average annual growth as the change in the loan volume amounted to 18.3% and 14.2% respectively in December 2007.

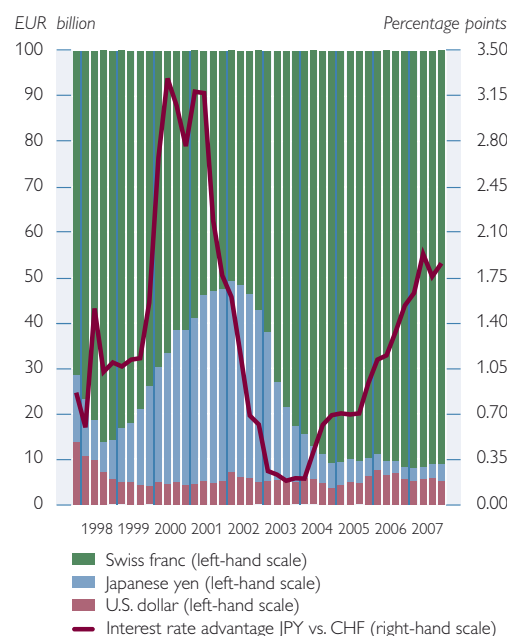
Dwindling Interest in Foreign Currency Loans

In 2007, the popularity of foreign currency loans continued to decline. Whereas at the end of 2006 around 18.7% of all claims on domestic nonbanks were still denominated in a foreign currency, this figure dropped to just 16.2% in December 2007 and the volume shrunk by around EUR 5.4 billion to close to EUR 46.7 billion. For the first time since 1996, the share of foreign currency loans in lending to nonfinancial corporations fell below 10% and amounted to 8.1% at the end of 2007. Similarly, the share of foreign currency loans to households came down to 27.5%, which also represents a pronounced decline compared with the historical peak of 31.5% in June 2006. Both developments point to borrowers' heightened risk awareness.

Contrasted with 2006, the currency composition of foreign currency loans remained almost unchanged. By end-2007, the Swiss franc (CHF) was still the dominant currency, even though its share of 90.8% in the previous year had dropped slightly to the current 88.7%. Around 5% of all foreign currency loans were denominated in U.S. dollar (USD), another 3.6% in Japanese yen (JPY). The first half of 2007 saw dynamic growth in loans denominated in Czech koruna (CZK) caused by currency speculations and low interest rates. But as this trend did not last throughout the second half of the year, only about EUR 0.9 billion or 2% of all loans to domestic nonbanks were denominated in Czech koruna at the end of 2007.

Chart 15

Foreign Currency Lending by Austrian Banks – Shares of Currencies



Source: OeNB, 3-month interbank interest rates (Bloomberg); included currencies: CHF, USD, JPY.

At the end of 2007, around 79% of all foreign currency loans to domestic households and nonfinancial corporations were bullet loans. Out of these, 77.8% were backed by repayment ve-

hicles. A distinction between household and nonfinancial corporations shows that households held a significantly higher share of foreign currency-denominated bullet loans, namely 85.0%, than nonfinancial corporations, whose share amounted to merely 60.0%. The difference was even more pronounced for loans involving repayment vehicles. Whereas 87.2% of all households

backed their bullet loans by repayment vehicles, only 34.5% of the nonfinancial corporations did.¹⁰

Although the share of foreign currency loans in total lending has declined, exchange rate risks and performance risks of repayment vehicles remain particularly significant for households given that markets are still volatile.

Box 2

Reform of Financial Market Supervision in Austria

At the end of 2007, the Austrian parliament adopted a reform of financial market supervision, which went into effect on January 1, 2008. Under the new regime, the organizational concept of a “dual” supervisory system that comprises the Financial Market Authority (FMA) and the OeNB was maintained, but the latter’s competences in banking supervision were broadened. The reform was designed to improve the allocation of competences and to strengthen the FMA’s and OeNB’s shared responsibility for overall financial market supervision.

The FMA has retained its status as an independent and autonomous integrated financial supervisor and remains the authority in charge of banking supervision. The OeNB has become responsible for all on-site inspections and all off-site analyses of banks. As a basis for on-site inspections, the FMA and the OeNB draw up an annual inspection program. In principle, the FMA continues to issue inspection mandates to the OeNB. However, the OeNB is entitled and obliged to request the FMA to extend ongoing inspections or initiate inspections not envisaged in the inspection program if necessary. The FMA must decide on such requests by the OeNB without delay, at the latest, however, within a week. Furthermore, the OeNB is entitled to conduct on-site inspections on its own initiative for “macroeconomic reasons.”

As part of its responsibility for off-site analyses, the OeNB is obliged to make all analysis results and any relevant information available to the FMA and to inform the FMA without delay if there is a substantial change in the risk situation or if there is reason to suspect a breach of regulatory provisions. Moreover, the OeNB must carry out specific off-site examinations or provide further explanations of analysis results on the FMA’s request. The OeNB also has to draw up expert opinions in approval procedures for all risk management models, has to conduct economic assessments of business models in the course of mergers/demergers¹ (consultation procedure) and has the right, jointly with the FMA, to propose the conclusion of memoranda of understanding by the Federal Minister of Finance.²

In addition to the reform, the OeNB’s financial stability mandate was explicitly established in Article 44b of the Federal Act on the Oesterreichische Nationalbank (Nationalbank Act). Accordingly, the OeNB shall, in the public interest and based on extended data access rights, monitor all circumstances that may affect the maintenance of financial stability in Austria. These enhanced competences entail the obligation that the OeNB inform the Federal Ministry of Finance and the FMA of any findings of a principal nature or of particular importance to financial stability. Upon request, the OeNB must produce the necessary technical explanations, make documents available and deliver opinions.

¹ In the course of licensing procedures, the OeNB had to be heard already before the reform.

² To guarantee the efficiency of the supervisory process, the FMA shall whenever possible draw on the OeNB’s inspections, expert opinions and analyses as well as on the data available in the joint database the OeNB operates with a view to ensuring a common level of up-to-date information.

¹⁰ Contrary to foreign currency loans, only 28% of all euro-denominated loans to domestic households and nonfinancial corporations were bullet loans in December 2007; out of these around 11.6% were backed by payment vehicles.

Credit Quality: Banks Rate Customers' Creditworthiness Favorably

Specific loan loss provisions for claims on nonbanks recorded by resident banks in their unconsolidated balance sheets shrank by EUR 1 billion to EUR 9.6 billion over the course of 2007, while net claims on nonbanks increased by EUR 32 billion to EUR 392 billion.¹¹ Declining from 2.86% to 2.39%, the ratio of specific loan loss provisions to claims on nonbanks thus decreased more rapidly in 2007 than in the previous three years (end-2003 level: 3.31%). This reduction is due partly to external claims – the loan loss provision ratio for external claims shrank at a faster pace than that of domestic claims¹² and the share of external claims in total claims on nonbanks increased from 23% at end-2006 to 27% at end-2007 – and partly to developments at major banks: the five largest banks' aggregate loan loss provision ratio dropped by 0.87 percentage points to 1.93% in 2007, which contrasts with a mere –0.22 percentage points to 2.67% for all other banks combined.

Since loan loss provisions are reserves banks allocate to cover expected

losses from lending, it follows from the above figures that banks' assessment of credit quality continues to improve. Today's historically low level of loan loss provisions could, however, become a problem for banks' profitability should the credit cycle take an adverse turn.

To ascertain whether in the past loan loss provisions built up in a given year correlated to the defaults observed in the subsequent year, chart 16 contrasts the annual change in Austrian businesses' actual average default rates¹³ with the annual change in loan loss provision ratios.^{14, 15} The linear relationship between the changes in default rates and in loan loss provision ratios inferable from the chart underscores the predictive power of loan loss provisions vis-à-vis expected losses.

The data series represented in chart 16 start in 1997; the default rate for 2008 was extrapolated from the first quarter. The sample thus comprises 11 data points. There could be several reasons why the relationship is not more pronounced: e.g. default figures only include a small share of households but households are fully accounted for in the loan loss provision ratios,¹⁶ banks'

¹¹ Data are sourced from the report of condition and income. Claims in this context are defined as loans and unlisted debt securities.

¹² The loan loss provision ratio for external claims sank by 0.67 percentage points to 1.13% in 2007, while that for domestic claims contracted by 0.32 percentage points to 2.84%.

¹³ Based on data provided by Kreditschutzverband von 1870.

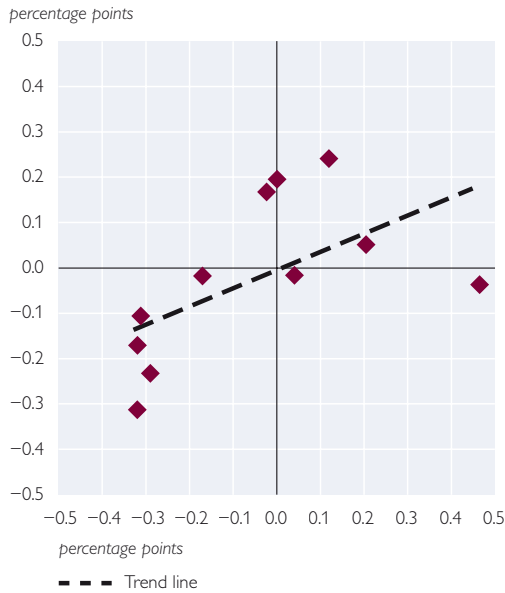
¹⁴ The loan loss provision ratios refer to year-end figures. Using annual changes rules out distortions that could arise from seasonal patterns in specific loan loss provisioning.

¹⁵ Under accurate loan loss provisioning, a change in the loan loss provision ratio implies, under certain conditions, a proportionate change in the default probabilities estimated by banks and should thus, on average, also be reflected by a proportionate change in actual default rates. It is fair to assume that said conditions, i.e. constant estimation of loss given default (LGD) and a constant portfolio structure, are in reality not fulfilled completely but still to such an extent that the linear relationship between the changes in loan loss provision ratios and default probabilities is approximately valid.

¹⁶ Specific loan loss provision data refer to overall claims on nonbanks and are not available for subaggregates, such as households.

Chart 16

Annual Change in Average Default Rate and Loan Loss Provision Ratio for Domestic Claims on Nonbanks



Source: OeNB, Kreditschutzverband von 1870.

x-axis: Annual change in Austrian businesses' average default rate
y-axis: Annual change in loan loss provision ratio for domestic claims on nonbanks

estimates of LGDs are not constant over time or the portfolio structure changes over time.¹⁷

Significance of Market Risk Remains Low

Market risk continues to affect banks operating in Austria to a lesser extent than credit risk. The unconsolidated regulatory capital requirement for position risks¹⁸ came to around 4% of total capital requirements (credit risk: 90%,

operational risk: 6%) at end-January 2008, i.e. the first binding reporting date under the new Basel II framework. Capital requirements for the market risk inherent in interest rate instruments increased by over 30% in the first half of 2007, but grew at a slower pace in the second half. As a result, averaged out over 2007, the increment in this category came close to 50%, driving up the capital requirement to EUR 1,083 million. The capital requirement for equity positions more than doubled in the first six months of 2007 before contracting slightly again. Overall, this translated into an increase of some 80% to EUR 181 million in 2007.¹⁹ By contrast, the capital requirement for open foreign exchange positions remained unchanged at about EUR 75 million throughout 2007.

Banks are also faced with market risk arising from interest rate risk in the banking book. In the absence of explicit regulatory capital requirements applicable to this risk category, the second pillar of Basel II nevertheless calls on banks to also pay heed to the interest rate risk in the banking book in ensuring capital adequacy. Under the supervisory reporting system, banks calculate the Basel ratio of interest rate risk, an indicator that relates potential losses arising from the interest rate risk in the banking book to unconsolidated eligible assets. Measured by this ratio, interest rate risk in the banking book²⁰

¹⁷ The fact that a 1 percentage point change in the average default rate goes hand in hand with a change in the loan loss provision ratio of less than 1 percentage point (0.4 percentage points according to the trend line in chart 16), points to an LGD of below 100%.

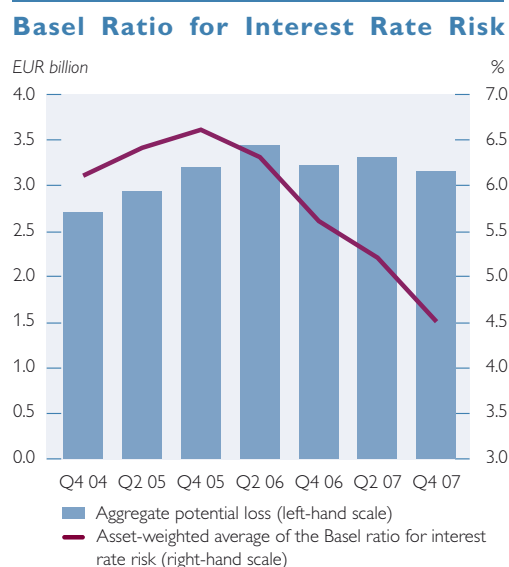
¹⁸ Position risks refer to the risk of value changes triggered by stock price and interest rate fluctuations in the case of positions in the trading book and of value changes arising from exchange rate and commodity price fluctuations in the case of all bank positions.

¹⁹ The increase in the capital requirements for both interest rate instruments and equity positions during the year 2007 may be traceable to the new reporting requirements, since mutual fund shares are possibly subsumed under the underlying risk categories.

²⁰ The loss potential is defined as the change in the present value of the banking book that would follow in the wake of a parallel yield curve shift of 200 basis points for all currencies.

decreased noticeably in 2007, in a repeat of 2006. The asset-weighted average of the Basel ratio for interest rate risk of all banks diminished by more than 1 percentage point to a historical low of 4.5% in 2007. As is evident from chart 17, mounting eligible assets were driving this development because the aggregate potential loss resulting for the Austrian banking system from the assumed interest rate shock continues to be pegged at slightly more than EUR 3 billion.

Chart 17



Source: OeNB.

Austrian Banks' Liquidity Situation Remains Sound in the Face of Global Market Turbulence

Liquid claims (with maturities of up to three months) and liquid assets (e.g. government bonds) held by Austrian banks at year-end 2007 amounted to 110% of short-term liabilities (with maturities of up to three months). In other words, Austrian banks are in a position to absorb even an unexpected negative liquidity shock (such as a further tightening of refinancing conditions in the euro money market).

Analyzing the cumulative net funding gap produces a similar picture. The

net funding gap is calculated based on data reported for the residual maturity statistics, where 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 inevitably negative, given the pivotal role of the banking system, namely maturity transformation. In 2007, this indicator rose slightly from 11.7% of total assets to 14.4% from the second quarter to year-end. Banks insure against liquidity risk that comes with a negative cumulative funding gap by holding liquid assets. As a matter of fact, the Austrian banking system's coverage of the cumulative net funding gap stood at a comparatively sound 127% at year-end 2007. However, euro money market developments have pushed up liquidity risk somewhat, considering that coverage had still stood at 162% in the second quarter 2007.

Austrian banks are highly resilient to liquidity shocks, as was again made evident by the results of stringent liquidity stress testing conducted under the IMF's FSAP update. The resilience is above all attributable to the very solid financing structure of Austrian banks by international standards, where customer deposits play a greater role than in other banking systems. In Austria, 46% of households' financial assets take the form of bank deposits, which is substantial in an international comparison. Amid the financial market turbulence, bank deposits became even more important for Austrian households. At EUR 11.6 billion, they accounted for the lion's share (62%) of the increase of financial assets in 2007. This took some of the edge off the tougher refinancing

conditions in the euro money market and curbed dependence on more volatile money market financing sources. The cumulative net funding gap vis-à-vis other banks is a mere 4.4% of total assets in Austria, and its coverage through liquid assets runs to some 420%.

Austrian banks must comply with the liquidity regulations laid down in Article 25 of the Austrian Banking Act. The liquidity ratio relates liquid assets to the corresponding liabilities. According to Article 25 of the Austrian Banking Act and the Fourth Liquidity Regulation of the Austrian Federal Minister of Finance, a minimum ratio of 2.5% applies to liquid resources of the first degree (cash ratio) and of 20% to liquid resources of the second degree (quick ratio).²¹

An analysis of individual bank data likewise attests to Austrian banks' solid liquidity situation. The average minimum level for aggregate first-degree liquidity (LI 1) came to about EUR 4.9 billion from January to March 2008, while the actual LI 1 level was 5.6 times higher at some EUR 27.1 billion. The average minimum value of aggregated liquid resources of the second degree (LI 2) amounted to EUR 52.4 billion during that period. At EUR 112 billion, the actual LI 2 level outperformed the target value by 2.1. In light of the conditions in the euro money market since August 2007, the OeNB has intensified the monitoring of Austrian banks' liquidity situation and its communication with market participants.

Upscaling from TARGET to TARGET2 – Another Important Milestone toward a Harmonized Market Infrastructure

TARGET, short for Trans-European Automated Real-time Gross settlement Express Transfer system, interlinked the national payment systems of the euro area central banks for the real-time processing of interbank payments. On November 19, 2007, it was succeeded by the second-generation system TARGET2, which runs on a single shared platform (SSP). The central banks of the euro area each operate their own TARGET2 component system; Austria's TARGET2-OeNB and the OeNB's Home Accounting Module HOAM.AT, the successor to ARTIS used exclusively to process domestic payment transactions, were included in the payment systems statistics in November 2007.

TARGET2-OeNB and HOAM.AT were the most significant payment systems in Austria in terms of the value of transactions processed (some EUR 6,857 billion) in the second half of 2007, which underlines their importance for the economy as a whole. The largest number of transactions (about 133.5 million) was again settled via direct debit payment systems (with Maestro/POS leading the charge). In the second half of 2007, retail payment systems supporting credit transfers registered a clear increase both in the number (+28.4%) and in the value (+33.9%) of transactions processed compared with the first half of the year, with this uptrend essentially attributable to one payment system. By contrast, in sync with overall financial market trends, securities settlement systems posted considerable declines in the number (-31.5%) and the value (-26.5%) of

²¹ *Federal Law Gazette II No. 14/1999.*

transactions processed. International payment systems have been attracting a steady stream of Austrian banks as new participants. The large-value payment system EURO1 remained the most important international payment system for Austrian banks in terms of the value of transactions processed (around EUR 837 billion). In the same vein, the retail payment system STEP2 continued to process the largest number of transactions initiated by Austrian participants (about 8.9 million).

As to system security, the second half of 2007 saw a total of 17 system disruptions, which, however, exclusively affected relatively small infrastructure providers and had no repercussions for the Austrian financial system.

Central, Eastern and Southeastern Europe Continues to Gain in Importance²²

The subprime crisis set in motion a global repricing of risk in financial markets.²³ From July 2007 to April 2008, (almost) all financial marketplaces, including the CESEE stock exchanges, suffered in part considerable losses. Comparing equity price developments in CESEE with those in Austria or in the whole of Europe reveals above all a marked difference between the performance of the leading indices in Central Europe²⁴ on the one hand and South-

eastern Europe²⁵ on the other (see chart 18). Given the divergent macro-economic developments,²⁶ banks are now attaching greater importance to country specifics when assessing the investment risk associated with a particular region.

Chart 18

Stock Price Developments on European Stock Exchanges



Source: OeNB, Bloomberg.

The consolidated CESEE business segment reports of the five major Austrian banks active in the region²⁷ bear testimony to another successful year. Not least due to UniCredit's restructuring of its CESEE business operations, aggregated total assets increased by 46.5% to around EUR 275.3 billion in the CESEE segment, reaching a share of no less than 25.7% at year-end 2007 (2006: 20.3%²⁸) in Austrian banks' consolidated total assets. Pretax profit

²² Mainly on the basis of quarterly reports on condition and income submitted by Austrian banking groups since early 2002. These reports contain selected items from the consolidated financial statements of parent banks and their fully consolidated subsidiaries abroad. Additional sources, like annual reports or market research data, supplement the analysis where indicated.

²³ See also the section "General Repricing of Risk Affects Stock Prices of Major Austrian Banks" in this issue.

²⁴ The CECE EUR Index of Wiener Börse includes the Czech Republic, Hungary and Poland.

²⁵ The SETX EUR Index of Wiener Börse includes Bulgaria, Croatia, Romania and Slovenia.

²⁶ See also the box "Banking Sectors in Central, Eastern and Southeastern Europe: Generally Robust Credit Growth, Largely Stable Performance" in this issue.

²⁷ Bank Austria, Erste Bank, Hypo Alpe Adria International, ÖVAG and RZB.

²⁸ Then still including BAWAG P.S.K.

climbed by merely 22.1% to EUR 4.0 billion, though, mainly as a result of one-off effects of the financial year 2006. When these effects are factored out, the share of the CESEE segment as at year-end 2007 edges up 3.9 percentage points to 42.6% in Austrian banks' consolidated pretax profit.

In total, 12 Austrian banks with 73 fully consolidated subsidiaries operated in this market as at December 31, 2007. 31 of these subsidiaries are situated in the new EU Member States that joined in 2004 (NMS-2004²⁹), 7 in the EU Member States that joined in 2007 (NMS-2007³⁰), 24 in other Southeastern European countries (SEE³¹) and 11 in the Commonwealth of Independent States (CIS),³² where primarily acquisitions made by Bank Austria in Kazakhstan, Kyrgyzstan and Tajikistan broadened the geographical scope. Add to this the not fully consolidated joint venture run by Bank Austria in Turkey, which still does not qualify for consideration on account of reporting requirements. Even without this Turkish subsidiary, Austrian banks have already come to assume a share of some 15.3% of the entire CESEE banking market (see chart 19), which rises to about

22.7% when Russia is taken out of the equation.

A look at the data reported by the fully consolidated subsidiary banks in CESEE³³ shows an ongoing clear focus on the new EU Member States. With the share of aggregated total assets coming to 49.8% in the NMS-2004 and to 15.9% in the NMS-2007 at the end of 2007, more than EUR 150 billion have been generated within the EU (see chart 20); 18.9% (about EUR 43.9 billion) of total aggregate assets are in SEE countries and 15.4% (about EUR 35.7 billion) in CIS countries.

The aggregated total assets of all CESEE subsidiary banks thus mounted by about 46% on the previous year; yet again we have to bear in mind that growth rates were considerably distorted by UniCredit group's restructuring of its CESEE business operations, which was first reflected in the reporting data in 2007. This reorganization significantly exceeded the distortions normally associated with acquisitions.³⁴ Taking these effects into account confirms the recent observation that the greater the geographical distance to Austria, the faster the rate of growth of subsidiary banks.

²⁹ NMS-2004: the Czech Republic (CZ), Hungary (HU), Latvia (LV), Poland (PL), Slovakia (SK) and Slovenia (SI).

³⁰ NMS-2007: Bulgaria (BG) and Romania (RO).

³¹ SEE: Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME) and Serbia (RS).

³² CIS: Belarus (BY), Kazakhstan (KZ), Kyrgyzstan (KG), Russia (RU), Tajikistan (TJ) and the Ukraine (UA).

³³ Based on data from the unconsolidated reports filed under the supervisory reporting system.

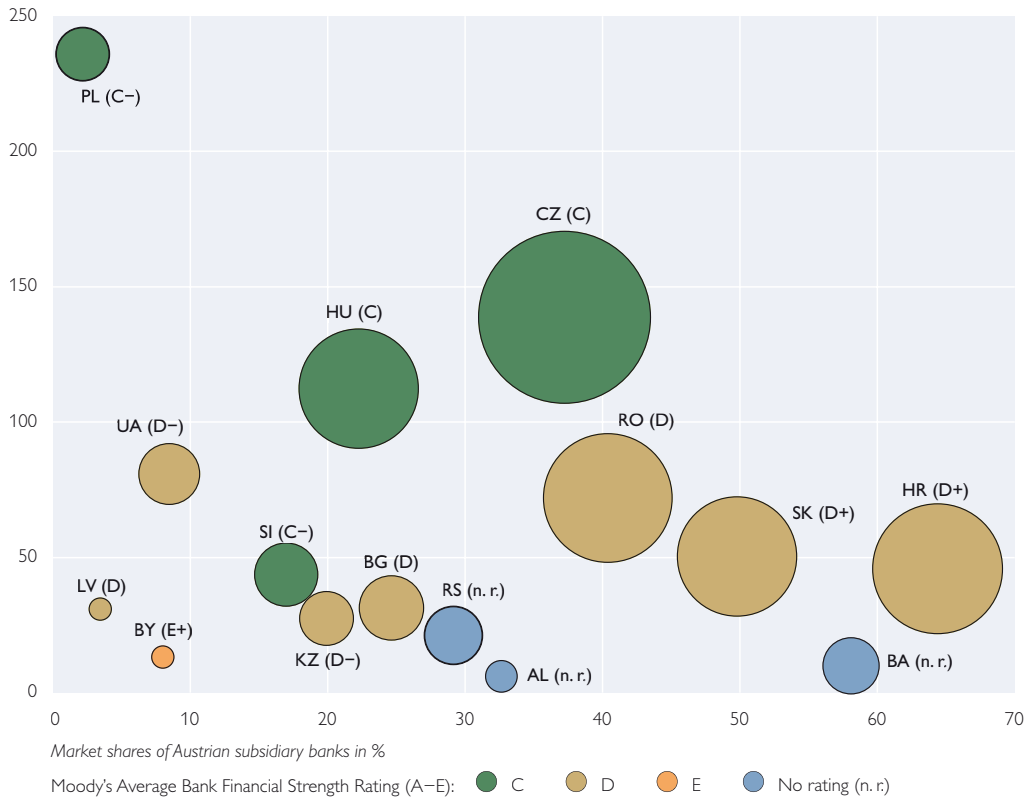
³⁴ See OeNB. *Financial Stability Report 14*, p. 51–55.

Chart 19

Market Shares of Austrian Subsidiaries in CESEE

As at December 31, 2007

Aggregated national total assets of banks in EUR billion



Source: OeNB, national central banks, Moody's.

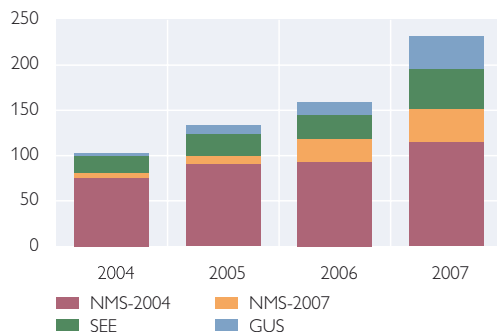
Note: The chart shows the individual countries according to the Austrian subsidiaries' market share (x-axis) and the aggregated total assets of the national banking industry (y-axis). The size of the circle corresponds to the total exposure of Austrian banks to the respective country. The country color code corresponds to Moody's average Bank Financial Strength Rating (BFSR). Because the Russian banking sector is so large (around EUR 583 billion as at year-end 2007), the chart does not show Russia, where Austrian subsidiaries held a market share of 3.8%. Apart from this, the chart shows all countries where Austrian subsidiaries record aggregated total assets of at least EUR 1 billion. Recent acquisitions in CIS countries (with the exception of Kazakhstan) and in Montenegro are thus not reflected.

Chart 20

Total Assets of Austrian Subsidiaries in CESEE

As at December 31, 2007

EUR billion



Source: OeNB.

Even in a conservative interpretation of the data (for the reasons stated above), the aggregated operating profit of CESEE-based subsidiary banks shows a similar uptrend, having jumped by nearly two-thirds to around EUR 4.7 billion in 2007. As in the case of aggregated total assets, the subsidiaries established outside the EU grew at a more dynamic pace than their EU-based counterparts, which is why the share of the non-EU subsidiaries in the operating profit advanced by 5 percentage points, while that of the EU-based subsidiaries dropped just below two-thirds.

Moreover, the cost-to-income ratio³⁵ of fully consolidated subsidiary banks in CESEE improved by nearly 3 percentage points to 54.0% in December 2007 year on year.

Similarly, the credit exposure³⁶ of Austrian banks to CESEE reflects the dynamic growth and the prominent role of this region. Of the total lending volume of EUR 146.7 billion, EUR 93.3 billion are attributable to the new EU Member States (NMS-2004: 48.5%, NMS-2007: 15.1%), which corresponds to a growth rate of close to 40% (see chart 21). This contrasts with much faster growth evident both in the SEE countries, which in the meantime account for EUR 26.7 billion of the indirect lending volume, and in the CIS countries, where subsidiary banks have extended loans to the tune

of EUR 26.6 billion. Both regions thus account for a share of some 18.2% each in Austrian subsidiaries' total lending in CESEE. Once again – especially with regard to CIS – the caveat applies that growth rates were driven by restructuring and acquisitions.

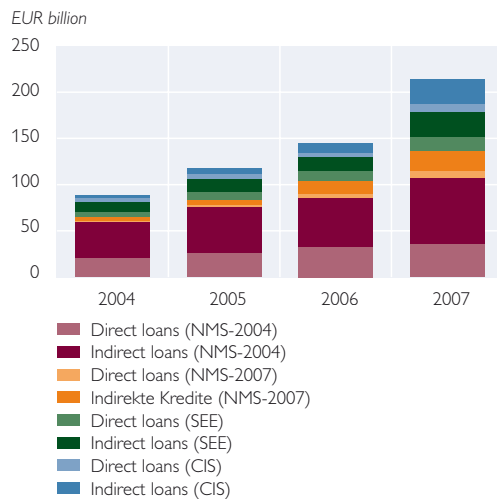
The new EU Member States also play a dominant, if diminishing, role in subsidiary banks' direct loans³⁷ extended to CESEE.³⁸ Their share in the total lending volume of EUR 67.0 billion stands at almost two-thirds (see also chart 21). Unlike in the case of subsidiary banks, the growth rates for direct loans may be interpreted; these rates, however, took a path that differs substantially from that of indirect lending. While the growth rate of direct loans to the NMS-2004 dropped from 22.6% in 2006 to 11.6% in 2007, the respective growth rate recorded by the NMS-2007 nearly doubled to 65.5%. Thus, direct credit exposure to the NMS-2007 grew even more quickly than that to the SEE countries (to EUR 15.3 billion or +39.2%). Only direct lending to CIS countries advanced at a more dynamic pace (to EUR 8.5 billion or +78.0%). The divergent growth rates are, however, also partly due to different starting levels.

To quantify the risk associated with Austrian (subsidiary) banks' credit exposure to CESEE, the OeNB regularly conducts stress tests that capture the impact of a number of different shocks on the Austrian banking system. The FSAP update of late 2007 led to a further refining of the stress testing meth-

Chart 21

Credit Exposure to CESEE Countries

As at December 31, 2007



³⁵ Ratio of administrative costs to operating income before deduction of net risk provisioning in the lending business.

³⁶ Loans extended locally by subsidiary banks in other countries.

³⁷ Loans granted by Austrian banks to borrowers resident in other countries.

³⁸ These data comprise more countries located in this region than those listed in footnotes 29 to 32.

Table 8

Average Ratings of CESEE Banking Systems and Selected Subsidiaries

As at April 14, 2008

Country	Bank	LT deposit rating	BFS rating	Outlook
Bulgaria	Raiffeisenbank Bulgaria	Baa2	D	–
		Baa3	D+	stable
Kazakhstan		Ba1	D–	–
Croatia	Zagrebacka Banka	A2	D+	–
		Ba1	D+	stable
Latvia		Ba1	D	–
Poland		A1	C–	–
Romania		A3	D	–
	Banca Comerciala Romana	Baa3	D	stable
	Raiffeisen Bank	Baa3	D	stable
Russia		Baa2	D–	–
	ZAO Raiffeisenbank	Baa2	D+	under review
Slovakia		A1	D+	–
	Slovenska Sporitelna	A1	C–	stable
	Tatra Banka	A1	C–	stable
Slovenia		A1	C–	–
Czech Republic		Aa3	C	–
	Ceska Sporitelna	A1	C	stable
Turkey		A3	D+	–
	Yapi ve Kredi Bankasi	B1	D+	stable
Ukraine		Ba1	D–	–
	Raiffeisen Bank Aval	B2	D	under review
Hungary		Aa3	C	–
	Erste Bank Hungary	A2	D+	stable
Belarus		Ba1	E+	–

Source: Moody's Investors Service.

Note: LT: long-term, BFS: bank financial strength.

odology, in particular with respect to CESEE.³⁹

The latest results of the standard stress tests⁴⁰ introduced in the Financial Stability Report 13 were still satisfactory. At year-end 2007, the capital adequacy results came in slightly higher than in the previous year in light of improved capital levels. One has to bear in mind that these sensitivity analyses

exceed historical worst-case scenarios, since the nonperforming loan (NPL) ratios over the sum of all loans to non-banks are extremely low given recent financial market developments. For this reason, the calculations are based on the higher losses caused by an absolute and a relative deterioration, the extent of which depends on the local risk assessment. In absolute terms, the shock

³⁹ See also Boss, M., G. Fenz, G. Krenn, J. Pann, C. Puhr, T. Scheiber, S.W. Schmitz, M. Schneider and E. Ubl (2008), *Stress Tests for the Austrian FSAP Update 2007: Methodology, Scenarios and Results*, in this issue.

⁴⁰ See also Boss, M., G. Krenn, C. Puhr and M.S. Schwaiger (2007), *Stress Testing the Exposure of Austrian Banks in Central and Eastern Europe*, *Financial Stability Report 13*, p. 115–134.

fluctuates around NPL ratios that worsened by 5 to 10 percentage points, while in relative terms, the ratios increased by 1.5 to 2 times.

In a worst-case scenario, the shock affects all countries of the region simultaneously; additionally, the revenues of Austrian banks, especially of those in CESEE, are not used to cover the losses. Against this backdrop, the decrease in the consolidated capital ratio recorded by the entire banking system at year-end 2007 from 12.0% to 10.6% (2006: from 11.6% to 10.5%⁴¹) may be well be viewed as positive. The major Austrian banks proved resilient to shocks also at the level of individual banks. Contrary to the previous year, all five major banks active in the region stayed above the mandatory capital ratio of 8%. In addition to internal analyses, external sources such as bank ratings provide qualitative information on the risk position of the respective banking markets in general and of Austrian subsidiaries in particular (see table 8).

The largely positive results of internal and external analyses notwithstand-

ing, the higher profitability of these markets is inexorably linked with increased risk. In the presence of macro-economic imbalances in some countries, the banks active there are faced with the risk of marked profitability losses in the event of sudden corrections. These banks must therefore pursue a dual approach: first, in the light of the region's dynamic credit growth, they must endeavor to prevent the accumulation of hidden credit risks and, second, they must continuously adjust their capital buffer in sync with this buoyant growth. At the same time, risks arising from the legal and institutional framework are partly offset by the fact that most Austrian (subsidiary) banks' CESEE activities are still focused largely on EU Member States. Besides, the long-term perspective for both the economy and the banking sector in this region is positive thanks to the ongoing catching-up process. In the face of prevailing imbalances, growth may nevertheless decline or even plummet in the short run despite the region's integration into the EU.

Box 3

Banking Sectors in Central, Eastern and Southeastern Europe: Generally Robust Credit Growth, Largely Stable Performance

In 2007, year-on-year growth in domestic lending to private nonbanks as a percentage of GDP was especially strong in Slovenia, Bulgaria and Romania. Compared with the other CESEE countries, these three countries also saw the most marked credit expansion in 2007 against that of 2006. In Bulgaria and Romania, this development reflected the lifting of various measures aimed at dampening credit growth at the start of 2007 and, in the case of Romania, the effect of the currency depreciation on the amount of total lending (calculated in national currency), which had a clear impact because of the substantial share of domestic credit denominated in a foreign currency. Croatia was the only country where credit expansion was slower in 2007 than in 2006.

⁴¹ These figures deviate slightly from those published in *Financial Stability Report 13* because later updates of the risk assessment for individual countries were, for comparability, factored into the year-end 2006 calculations.

Domestic Credit to Private Nonbanks

	2004	2005	2006	2007	2004	2005	2006	2007
	Year-end change, % of GDP				Real rate of change at year-end, %			
Bulgaria	11.9	10.7	9.3	25.7	43.2	23.4	17.5	45.7
Croatia	7.2	9.5	13.6	9.9	11.0	13.4	20.7	8.8
Poland	1.7	2.5	6.5	9.6	2.1	8.5	22.3	26.2
Romania	4.7	6.6	9.4	13.8	26.2	33.7	46.4	50.1
Slovakia	2.0	7.8	7.3	7.7	1.3	23.5	18.5	19.2
Slovenia	9.4	11.3	13.9	20.3	19.9	21.5	22.5	26.2
Czech Republic	3.7	6.4	7.3	10.5	10.6	19.2	20.1	21.8
Hungary	7.2	8.1	7.9	9.8	12.5	15.1	9.5	10.7

Source: Eurostat, national central banks, OeNB.

Note: The real rate of change is derived by HICP adjustment.

At end-2007, the foreign currency share in outstanding domestic lending to enterprises and households was highest in Croatia (including loans indexed to foreign currencies), Hungary, Romania and Bulgaria. Against end-2006, this share again decreased sizeably in Croatia and declined moderately in Poland, mainly because of measures implemented by their respective central banks. In contrast, it increased sharply in Hungary, Romania and Bulgaria, which was partly due to exchange rate developments in the first two countries.

Domestic Foreign Currency Loans to Private Nonbanks

	2003	2004	2005	2006	2007
	Year-end, % of total domestic loans to private nonbanks				
Bulgaria	43.6	48.2	47.3	45.1	50.0
Croatia	76.6	77.0	77.8	71.7	61.4
Poland	30.6	25.3	25.9	27.0	24.2
Romania	55.4	60.8	54.7	47.4	54.3
Slovakia	18.8	21.5	22.5	20.0	21.3
Slovenia	27.1	43.1	55.7	63.4	7.3
Czech Republic	12.8	11.2	10.0	10.4	9.1
Hungary	33.7	39.0	45.9	49.6	57.2

Source: National central banks, OeNB.

The foreign currency share in outstanding loans to households at end-2007 was especially high in Croatia, Hungary and Romania. Notably in Bulgaria, but also in Slovakia and the Czech Republic, the foreign currency share was considerably lower for loans to households than for loans to enterprises. One reason for the rising share of foreign currency loans recorded in Hungary and Romania was probably the relatively large yield gap against loans denominated in the national currencies. Some borrowers might also have been motivated by the appreciation of the Hungarian forint and the Romanian leu in the first half of 2007.

Domestic Foreign Currency Loans to Households

	2003	2004	2005	2006	2007
	Year-end, % of total domestic loans to households				
Bulgaria	8.9	11.0	15.4	19.0	20.0
Croatia	81.2	79.4	80.0	77.7	67.3
Poland	..	27.2	28.4	30.9	27.9
Romania	29.3	45.9	44.1	41.2	53.1
Slovakia	..	0.6	1.1	1.7	3.0
Slovenia	1.0	22.5	37.4	41.7	15.2
Czech Republic	0.5	0.3	0.3	0.2	0.2
Hungary	4.6	12.9	29.2	42.7	55.0

Source: National central banks, OeNB.

A high share of foreign currency lending constitutes a risk to financial stability, as unfavorably developing exchange rates together with increasing foreign interest rates could have a negative effect on borrowers' solvency, particularly since households and small and medium-sized enterprises (SMEs) might not be appropriately hedged against such risks.

The profitability of banks in CESEE in terms of return on equity (RoE) after tax was highest in Poland, Bulgaria and the Czech Republic and lowest in Romania and Croatia. The most pronounced change was seen in Poland, where the RoE declined, albeit at a high level, and in Hungary.

Nominal Return on Equity

	2003	2004	2005	2006	2007	H1 06	H1 07
	%						
Bulgaria	14.8	16.6	18.0	19.7	21.5	18.1	20.6
Croatia	14.5	16.1	15.6	12.4	11.1	14.7	12.0
Poland	5.5	17.4	24.0	27.2	22.0	28.0	27.6
Romania	17.7	17.7	15.1	11.6	11.5	14.2	12.5
Slovakia	10.5	12.3	13.4	17.6	14.8	16.4	16.6
Slovenia	11.9	12.5	12.7	15.1	..	..	..
Czech Republic	17.8	18.1	18.4	17.1	18.7	19.2	18.7
Hungary	17.2	22.5	21.7	21.4	16.6	23.1	21.3

Source: National central banks, OeNB.

Note: Based on profits after tax. Data are not comparable across countries.

At end-2007, banks' capital adequacy ratio ranged from 10.4% in Hungary to 15.4% in Croatia; it declined markedly in Romania against end-2006, probably reflecting rapid growth in corporate and retail lending.

Capital Adequacy Ratio¹

	2003	2004	2005	2006	2007	H1 06	H1 07
	%						
Bulgaria	22.2	16.6	15.3	14.5	13.8	16.0	14.4
Croatia	16.2	15.3	13.4	14.0	15.4	12.9	15.0
Poland	13.8	15.4	14.5	13.2	12.4	14.1	12.5
Romania	21.1	20.6	21.1	18.1	12.7	17.8	15.0
Slovakia	21.7	19.0	14.8	13.0	12.4	14.3	13.5
Slovenia	11.5	11.8	10.5	11.1	..	..	..
Czech Republic	14.5	12.6	11.9	11.4	11.5	11.5	11.7
Hungary	12.3	12.8	12.0	11.5	10.4	10.8	11.6

Source: National central banks, OeNB.

¹ Ratio of regulatory capital to risk-weighted assets.

Note: Data are not comparable across countries.

The share of nonperforming loans in total loans at end-2007 was around 2% to 3% in most countries. Only in Poland and Romania were the shares significantly higher according to these countries' classification methods. Against end-2006, however, this share diminished in Poland in particular and also in the Czech Republic and in Slovakia, whereas it expanded sizeably in Romania. Remarkably, the share of nonperforming loans did not rise in Hungary despite slower economic growth. In countries with fast credit growth, however, there is a general risk that these shares give an overly positive impression of portfolio quality.

Nonperforming Claims

	2003	2004	2005	2006	2007	H1 06	H1 07
	(% of total claims)						
Bulgaria	4.2	3.6	2.8	2.2	2.0	2.7	2.2
Croatia	5.1	4.6	4.0	3.2	3.1	3.6	3.3
Poland ¹	21.2	14.7	11.0	7.3	5.2	9.4	6.3
Romania	8.3	8.1	8.3	7.9	9.7	8.4	7.9
Slovakia	9.1	7.0	3.7	3.3	2.5	3.7	3.1
Slovenia	6.5	5.5	4.8	4.2	..	..	..
Czech Republic	5.0	4.2	4.1	3.8	2.9	3.8	3.2
Hungary	2.7	2.7	2.5	2.5	2.4	2.4	2.5

Source: National central banks, OeNB.

¹ Poland: Data comprise both nonperforming and so-called irregular claims.

Note: Data are not comparable across countries.

Capital Ratio Remains Stable

Banks' capital ratio, one of the key indicators for assessing their risk-bearing capacity, draws heightened public attention in times of financial turmoil. At the end of 2007, the consolidated capi-

tal ratio (i.e. the ratio of banks' capital to their risk-weighted assets – the assessment base)⁴² of all Austrian banks came to 12.1% (see chart 22). Overall, Austrian banks' capital adequacy on a consolidated basis thus improved

⁴² As new capital requirement provisions became effective at the beginning of 2007, banks now directly report their capital requirement for credit risk pursuant to Article 22a to 22h of the Austrian Banking Act instead of providing information on risk-weighted assets. Based on the statutory 8% minimum capital adequacy ratio, risk-weighted assets and the assessment base can be calculated by multiplying the capital requirement for credit risk by the factor 12.5.

slightly against the previous year (December 2006: 11.6%) and clearly exceeds the statutory 8% minimum capital adequacy ratio required by Basel II.⁴³

Chart 22

Austrian Banks' Consolidated Capital Ratio



Source: OeNB.

The capital ratio of the five major Austrian banks is somewhat below the capital ratio reported for all banks. Averaging 10.9% in December 2007, it almost equaled that of major European banks⁴⁴ (10.97%).

The value for the 5% quantile, which represents the banks with comparatively low capital ratios, also developed favorably: Not only did it climb to 9.6% in December 2007 (against 9.2% in December 2006) but throughout

2007, in a longer-term comparison, it also exceeded the values recorded in earlier years. No Austrian bank reported a capital ratio that was below the statutory 8% threshold.

As for the core capital ratio, which relates tier 1 capital (core capital) to the assessment base, the consolidated total of all Austrian banks also reached satisfactory levels, coming to 8.7% in December 2007.

Accommodating their continued strong growth in CEE in their medium-term strategic capital planning remains a challenge for Austrian banks, however.

FSAP Stress Tests Confirm Austrian Banking Sectors' Good Resilience to Shocks

During the December 2007 update of the Austrian Financial Sector Assessment Program (FSAP), a number of different stress tests were carried out for the Austrian banking system. Aside from sensitivity analyses regarding market and liquidity risk as well as the indirect credit risk of foreign currency lending, two macroeconomic stress tests were performed over a three-year horizon. The underlying crisis scenarios assumed a regional macroeconomic shock in CESEE that generated spillover effects for the domestic economy on the one hand and a slowdown in global economic growth causing a prolonged recession in Austria on the other.⁴⁵ The results of these stress tests reconfirmed the Austrian banking sec-

⁴³ From the introduction of the New Basel Capital Accord (Basel II) in Austria on January 1, 2007, to end-2007, Austrian banks had the option, according to Article 103e no. 16 of the Austrian Banking Act, to calculate their regulatory capital either according to the provisions of Basel I or according to those provided for under the Standardised Approach to Credit Risk (Article 22a Austrian Banking Act). As at end-2007, around 10% of Austrian banks reported their regulatory capital according to the standardized approach. Data on capital requirements according to Basel II for all Austrian banks will only be available in the course of 2008.

⁴⁴ ECB, *Financial Stability Review*, June 2008.

⁴⁵ For a detailed discussion, see the contribution "Stress Tests for the Austrian FSAP Update 2007: Methodology, Scenarios and Results" in the Special Topics section of this Financial Stability Report.

Table 9

Results of the Standardized SRM Simulations Based on End-2007 Data

	Total risk		Credit risk		Market risk		Contagion risk	
	Mean	95% quantile	Mean	95% quantile	Mean	95% quantile	Mean	95% quantile
	%							
Baseline scenario: Simulation without crisis scenario	-1.8	0.9	-1.6	0.6	-0.1	1.1	-0.0	-0.0
Doubling of domestic default probabilities	-0.1	2.6	0.1	2.4	-0.2	1.1	-0.0	-0.0
Increase of euro interest rates by 120 basis points	-0.4	2.1	-1.6	0.6	1.2	2.0	0.0	0.0

Source: OeNB.

Note: The figures represent the mean and the 95% quantile of the loss distribution corresponding to the respective risk category over the first quarter of 2008 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.

tor's good resilience to shocks that had already been established during previous stress tests.

Table 9 shows the results for the aggregate Austrian banking system derived from the standardized Systemic Risk Monitor (SRM)⁴⁶ simulations of the baseline scenario and of two crisis scenarios, based on end-2007 data. It displays the mean values adjusted for credit risk provisioning and the related 95% quantiles of the loss distributions for the first quarter of 2008 relative to eligible capital. For credit risk, contagion risk in the interbank market and total risk, a negative value means that the related provisions banks have created are higher than the expected losses.⁴⁷ For market risk, no risk provisions were taken into consideration; a negative value corresponds to an expected profit for the first quarter of 2008.

In the baseline scenario the means of the loss distributions for total risk

and credit risk are sufficiently covered by existing provisions. For total risk, the 95% quantile, i.e. the amount of loss with a 95% probability of not being exceeded, stood at 0.9% of eligible capital. With regard to market risk, for the first quarter of 2008 an average profit of 0.1% of eligible capital is expected. As for contagion risk in the interbank market, losses in the mean and the 95% quantile are not to be expected – neither under the baseline scenario nor under the stress scenarios. A doubling of domestic default probabilities results in expected credit risk losses exceeding the corresponding risk provisions by 0.1% of eligible capital. With a view to total risk, however, expected market risk gains still fully cover expected credit risk losses. At the same time, however, the 95% quantile goes up to 2.6% of regulatory capital. A rise in euro interest rates by 120 basis points has noticeable effects on market risk, with the average loss coming to 1.2%

⁴⁶ For details on the methodology underlying 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*, Financial Stability Report 11, OeNB, p. 83–95.

⁴⁷ See note to table 9.

Table 10

Ratings of Selected Austrian Banks

As at April 14, 2008

	Deposit rating		Bank Financial Strength Rating	
	Long-term	Outlook		Outlook
Bank Austria	Aa2	stable	C+	stable
BAWAG P.S.K.	Baa1	stable	D	stable
Erste Bank	Aa3	stable	C	stable
Hypo Alpe-Adria	A2	positive	D-	positive
Hypo Tirol	Aa1	stable	C	stable
Investkredit	A1	stable	C	stable
Kommunalkredit	Aa2	stable	B-	stable
Oesterreichische Kontrollbank	Aaa	stable	..	..
ÖVAG	Aa3	stable	C	stable
RZB	Aa2	stable	C	stable
Raiffeisenlandesbank Oberösterreich	Aa3	stable	C	stable
Vorarlberger Landes- und Hypothekenbank AG	Aa1	stable	C	stable

Source: Moody's Investors Service.

of capital. But looking at total risk, losses are not expected to exceed risk provisions even under this scenario.

Since 2003, the OeNB has been carrying out stress tests to assess the indirect credit risk of foreign currency loans. These stress tests have now been improved on the basis of the additional information on foreign currency loans that has been available from foreign currency loans statistics since early 2007. An important additional risk factor for many foreign currency loans is the performance risk related to the funding plan (life insurance, equity fund, etc.) used to repay the respective loan at the end of its maturity. Around 79% of Austrian foreign currency loans are bullet loans, 77.8% of which are combined with a corresponding repayment vehicle. To allow for the preponderance of these loans, the chosen stress scenario assumes a 15% deterioration

in the performance of the repayment vehicle for all bullet loans⁴⁸ on top of a 10% appreciation of the Swiss franc.⁴⁹ On an aggregate level and excluding any existing risk provisions, this scenario resulted in a loss amounting to 3.7% of eligible capital. In a semi-annual comparison, the respective risk thus abated slightly by 0.8 percentage points.

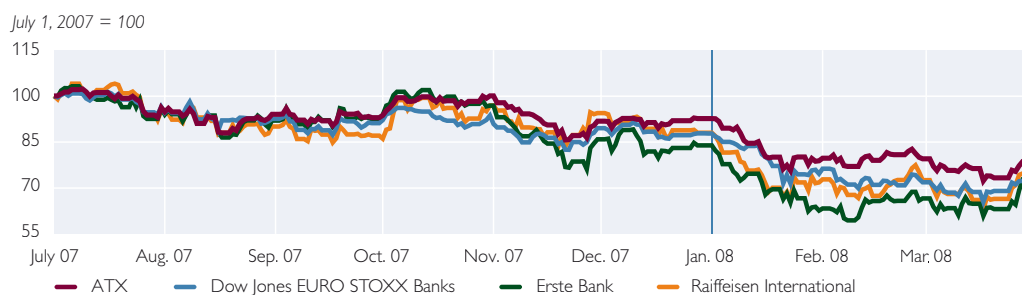
Ratings of Austrian Banks Remain Stable

Aside from supervisory reporting data, various market indicators such as stock price developments and ratings serve to assess financial stability. Moody's long-term deposit rating and bank financial strength rating (BFSR) are examples of such market indicators. Neither has changed substantially for Austrian banks over the first few months of 2008.

⁴⁸ Bullet loans without repayment vehicle can be expected to be subject to an implicit repayment vehicle risk related to the performance of the capital earmarked for loan repayment.

⁴⁹ As loans denominated in Japanese yen have become less and less important over the past few years (with only 3.6% of all foreign currency loans being denominated in Japanese yen at the end of 2007), the respective results will not be reported here.

Stock Price Developments – Austrian Banks and European Bank Indices



Source: OeNB, Bloomberg.

The introduction of the Joint Default Analysis methodology by Moody's in early 2007 led to changes in ratings for almost all Austrian banks;⁵⁰ any subsequent changes have been minor. After Cerberus took over BAWAG P.S.K., for example, BAWAG P.S.K.'s rating for long-term liabilities was lowered from A3 to Baa1, while its BFSR was upgraded from E+ to D. Moreover, the rating outlook for Hypo Alpe-Adria-Bank International AG was changed from stable to positive in May 2007 on news about its takeover by Bayerische Landesbank.⁵¹ In addition, recent analyses by Moody's of end-March 2008 confirmed the stable rating outlook for Erste Bank and RZB.

General Repricing of Risk Affects Stock Prices of Major Austrian Banks

The uncertainties in the financial sector triggered by the U.S. subprime crisis of July 2007, have put banks' stock prices under pressure around the world. High uncertainty regarding banks' subprime exposure as well as frequent reports on subprime-related losses at

some banks caused a general slump in stock prices, which seriously impaired market confidence. The two major Austrian banks that are listed on the stock exchange⁵² also felt the impact of these developments, although their subprime exposure is relatively low. The subprime crisis, however, sparked a wave of risk repricing on the international financial markets during which the spreads on *credit default swaps (CDS)* increased sharply in almost all CESEE countries.⁵³ Similar observations were made for the CDS spreads of the two listed Austrian banks. Owing to the negative correlation between stock prices and CDS spreads, implications for Austrian banks' stock prices have begun to materialize: In particular since mid-October 2007, relatively pronounced price corrections have occurred, and the downward trend in stock prices continued until March 2008.⁵⁴

In total, Austrian bank shares have been developing roughly in line with the Dow Jones EURO STOXX Banks index, although the reasons behind these price developments (exposure to

⁵⁰ See *Financial Stability Report 13 of June 2007*.

⁵¹ See *Financial Stability Report 14 of December 2007*.

⁵² Erste Bank and Raiffeisen International.

⁵³ CDS spreads mirror market participants' assessment of country risk.

⁵⁴ In January 2008, a general stock market crisis additionally supported this trend.

CESEE countries vs. subprime exposure) must be weighted differently for Austrian banks and for large international banks.⁵⁵

The implied volatilities of Erste Bank's at-the-money call options surged

by around 70% from mid-November 2007 to end-February 2008, while Raiffeisen International, the ATX and the Dow Jones EURO STOXX Banks index recorded markedly weaker increases.

Box 4

Favorable IMF Assessment of Austrian Financial Market

The regular review of the Austrian financial market under the Financial Sector Assessment Program (FSAP), which the International Monetary Fund (IMF) applies to member countries around the globe, took place at the end of 2007. This exercise was an update of the initial assessment program the IMF had carried out in Austria in 2003; based on an analysis of strengths and weaknesses, it mainly serves to illustrate the priorities to be set for the further development of the financial system.

The IMF's preliminary FSAP results signal a positive assessment of the Austrian financial system; these findings were confirmed, in general, by the IMF's annual Article IV consultation of March 2008, which also covered current developments. In particular, the IMF pointed to the continued further strengthening of the Austrian financial system and acknowledged its shock resilience – two factors that were also confirmed by the complex stress tests that had been performed. Given their sound holdings of deposits and their “originate and hold” strategy, Austrian banks had felt relatively little impact from the recent financial turmoil. Moreover, the IMF stated that Austria had been agile in seizing the opportunities resulting from the opening-up of CESEE markets, which are now paying off in terms of earnings and an improved risk diversification. At the same time, however, the IMF pointed out that the risks resulting from transactions on CESEE markets required close observation and that not least for this reason, the international cooperation of supervisory authorities should be further promoted.

While the IMF recognized further improvements in the regulatory and supervisory framework, which had already conformed to a high standard, it pointed out that, nevertheless, there was still room for improvement in some areas such as the further strengthening of corporate governance principles. Moreover, the IMF considered it necessary that Austria limit its extensive public liability provisions, clearly define the responsibilities of external auditors and further promote their independence. In general, the IMF also demanded higher staffing levels in supervision, the further extension of on-site inspections of financial institutions and the performance of cross-border simulation exercises and intensive stress tests also with insurance companies and pension funds. As the last few years have seen the implementation of extremely complex new regulatory provisions and a reform of financial market supervision, the IMF also deemed appropriate a longer period of consolidation of the supervisory and regulatory framework.

The final results of the FSAP have been available since June 2008.

⁵⁵ Other reasons for stock price losses despite favorable business data might be the clouded economic outlook for the next few years, the above-mentioned uncertainty in the banking sector and the general pessimism prevailing at the stock exchanges.

Outlook for Other Financial Intermediaries Clouds Over Slightly

Insurance Companies Report Subdued Business Activities

The Impact of the Global Financial Market Turmoil on Austria Appears Manageable

Against the backdrop of a favorable real economic and financial environment, European insurance companies continued on their relatively positive course throughout 2007. Despite claims events induced by natural disasters in some parts of Europe, the overall profitability of the insurance sector went up, which was attributable, in part, to favorable investment results in the first half of 2007. Further improvements in the capital structure combined with higher profitability have increased the overall risk-bearing capacity of the European insurance sector. Given the changes in the perception of risk as well as the higher uncertainty on financial markets it cannot be ruled out, however, that lower investment results affect insurance companies' profitability even though an increasingly risk-adequate pricing of risks assumed and favorable developments with regard to loss events should have a cushioning effect.

On the whole, the Austrian insurance sector also performed well during 2007. Insurance premium income advanced by 1.9%⁵⁶ to EUR 15.9 billion year on year. At a rate of 0.4%, growth in the life insurance segment was weaker than in the health insurance and the property/casualty insurance sectors (3.2% and 3.1%, respectively). Compensating the decrease in one-off payments and pension insurance contributions, booming unit-linked life insur-

ance plans (+25%) and subsidized personal pension schemes (+17%) played a substantial role in sustaining demand in the life insurance sector. This development shows that investment risk is increasingly passed on to insurance holders. Winter storms at the beginning of the year, floods in early summer and maturing life insurance policies impacted insurance companies' claim payments in 2007. Claim payments by property/casualty insurance companies climbed by 1.3% to EUR 4.8 billion against the previous year. The Austrian Association of Insurance Companies expects premium growth in the life insurance segment to continue to lag the health and property/casualty segments in 2008. In the first few months of 2008, claims events reflected winter storms; moreover, investment results tended to be less favorable. The sale of an insurance company that was part of a large banking group intensified the concentration in the Austrian insurance market, while it reduced the potential for intragroup contagion effects between the group's insurance and banking branches. Austrian insurance companies continued to expand their CESEE activities and, in general, significantly improved their business performance and profitability.

In 2007, Austrian insurance companies' total assets⁵⁷ grew by EUR 5.1 billion to EUR 88 billion; at 6.2% in June 2007, the annual growth rate was below the comparable figure for 2006 (8%). The increase in assets can be attributed to a large extent to *foreign debt securities* (EUR 1.9 billion or +9.3%), other external assets (EUR 1.8 billion or +54.4%) as well as *domestic equity securities and other domestic securities* (EUR 0.9 billion or +3.8%). Accord-

⁵⁶ Press release by the Austrian Association of Insurance Companies of February 21, 2008.

⁵⁷ Excluding reinsurance business; based on quarterly reports (OeNB insurance statistics).

ing to the Austrian Financial Market Authority (FMA), asset-backed securities accounted for 2.6% of Austrian insurance companies' overall investment portfolio; some 99 % of these asset-backed securities have an investment grade rating.

Market indicators for both the European and the Austrian insurance sectors reflect higher uncertainty, which is attributable to the financial turmoil on the one hand and to potentially weaker income dynamics on the other. Since the publication of their 2007 annual accounts, which showed that risk provisions for U.S. subprime securities were lower than expected, insurance company's shares have outperformed bank shares. At end-May 2008, the rating outlook for the large Austrian insurers was stable and positive, respectively. The stock prices of insurance companies listed on the prime market segment of Wiener Börse AG went down slightly between October 2007 and May 2008.

Threats to the profitability and stability of the insurance sector do not only originate from shocks in the financial markets (i.a. losses in the market value of structured products) and the higher frequency of major claims events, but also from the underestimation of longevity risk, the continued low performance of the investment portfolio of life insurance companies that hold a high share of policies with a guaranteed minimum yield and from inadequate risk pricing in the face of increasing competition.

Risk of Contagion Remains Low

Year on year, the total exposure of Austrian insurance companies to domestic

banks went up slightly by 2.1% to EUR 11.5 billion (13% of total assets) in December 2007, with *debt securities issued by domestic banks* accounting for the lion's share (EUR 8.6 billion) along with cash in hand and deposits other than overnight deposits with domestic credit institutions (EUR 2.3 billion). Insurance companies' investments with domestic credit institutions thus decreased to slightly more than 1% of Austrian banks' consolidated total assets. Owing to the positive business and profit performance and the moderate level of exposure, the risk of contagion between the banking and insurance sectors is still low.

Financial Market Turmoil Decelerates Mutual Fund Growth

The European mutual funds market continued to expand in 2007, although growth dynamics have clearly moderated since the onset of the financial market turbulence in August 2007. Assets under management by European mutual funds⁵⁸ went up by 4.9% to EUR 7,925 billion in 2007. The net outflows recorded in the third and fourth quarters of 2007 were basically attributable to investors' reduced risk appetite, which had the strongest effect on bond and equity funds; both segments recorded net outflows for 2007 as a whole. In this environment, funds with a typically more defensive investment strategy (e.g. balanced funds and money market funds) were able to attract investor capital. Against the backdrop of higher financial stability risks in Europe and investors' reduced risk appetite, the outlook for the European mutual funds sector is uncertain.

⁵⁸ Here, mutual funds comprise undertakings for collective investment in transferable securities (UCITS) and non-UCITS.

Outflows of Austrian Mutual Funds Causes Decline in Assets under Management

Overall developments in the Austrian mutual funds sector were weak in 2007. Assets under management by Austrian mutual funds (including fund-of-fund investments) decreased by 1.9% to EUR 165.6 billion. While valuation gains easily compensated outflows in the first half of 2007, reduced valuation gains, a higher profit distribution and a clear rise in outflows in the second half caused assets under management to shrink for the first time since the introduction of the OeNB's mutual fund statistics in 1998. Combined with investors' reduced risk appetite, higher interest on bank deposits and the increasing popularity of structured products might have contributed to this moderate development. In 2007, mutual funds tended to reduce their holdings of debt securities, foreign stocks and equity securities and to expand their holdings of mutual fund shares as well as their real estate and tangible assets positions. Domestic stocks and equity securities continued to account for 2.3% of assets under management. The capital-weighted average total performance of all Austrian mutual funds in 2007 was 1.9% (against 4.4% in 2006). At 0.95%, fixed income funds showed the comparably weakest performance, while real estate funds' performance went up by 4.6%.

The high volatility and adverse financial market developments in the first quarter of 2008 continued to create an unfavorable environment for Austrian mutual funds. According to the FMA, four of the about 7,900 (domestic and foreign) mutual funds registered for operation in Austria are still subject to a temporary suspension. One

of these four funds had been set up by an Austrian investment company. The suspended redemption of shares is connected to the drying up of parts of the credit market.

The business and profit performance of Austrian investment companies, which are largely owned by Austrian banks, continued to be positive in 2007, with operating profits rising by a significant 29%. The risk investment companies pose for Austrian banks is limited, however, and consists mainly of a possible future worsening of their profitability.

Claims on Severance Funds Continue to Rise

In the fourth quarter of 2007, nine severance funds were licensed to manage severance claims in Austria. In 2007, the vested rights to future severance payments climbed from EUR 1.1 billion to EUR 1.6 billion (+43.4%). Eligible capital, by comparison, went up by 9.8% from EUR 22.3 million to EUR 24.5 million and thus exceeds capital requirements calculated at EUR 4 million.

At end-2007, the number of employers that had signed severance fund agreements came to 375,036.⁵⁹ Compared to the previous year (345,914 agreements), the number of agreements climbed by 8.4%. The three largest providers have been able to secure their market position; as measured by the number of agreements with employers, they hold a market share of 75% (2006: 75%). In 2007, severance fund agreements established around 5.8 million vesting periods for 2.4 million people, corresponding to a rise by 28.8% and 14.3%, respectively, against the previous year. The number of vesting periods not assigned to any of the severance

⁵⁹ Source: Main Association of Austrian Social Security Institutions.

funds went up from 54,508 in 2006 to 102,411 in 2007. Severance funds' nominal performance averaged 2% in 2007 after deduction of asset management costs (0.45% to 0.7% of investment groups' assets) – a figure that remained below the 2.2% HICP inflation rate recorded in 2007.⁶⁰ The performance of individual severance funds ranged from 0.14% to 3.1% in 2007. From 2004 to 2007, according to severance funds' data, the average nominal performance was 4% per annum, with average inflation coming to 2% per annum over the same period.⁶¹ The cumulative performance of the individual severance funds for the period from 2003 to 2007 ranges between 16.6% and 28.6% in nominal terms.⁶² For a better assessment of investment returns, it would be desirable that severance funds publish performance benchmarks for investment groups in advance. This might help render the market more transparent.

Since the new severance pay scheme was introduced, the share of investment returns in investment groups' as-

sets has climbed from –0.1% to 4.4%. At end-2007, the majority of these assets (95.6%) still consisted of contribution payments (minus severance payments made). This situation not only reflects the lackluster investment performance, however, but also the fact that prospective beneficiaries must bear the costs associated with the product; these costs are independent of the funds' investment performance. In relation to investment returns, total costs (administrative costs, asset management costs, deposit costs, transfer costs) accounted for around 40% of investment returns from 2004 to 2006. In 2007, beneficiaries received benefit payments of EUR 66 million (2006: EUR 23 million).⁶³ The fact that returns have remained below the legislator's expectations (6% per annum in nominal terms) may be attributed to the structure of the new severance pay scheme (capital guarantee and entitlement to severance pay after three years of contributions under certain circumstances; administrative, asset management and deposit costs).

⁶⁰ Source: Severance funds platform; OeNB.

⁶¹ The annual returns data published by the severance funds platform date back to 2004. Relevant calculations do not consider investment income tax, as severance funds are exempt from investment income tax. Return on investment (ROI) must be differentiated from return on contributions. While ROI is calculated on the basis of invested capital, the return on contributions takes administrative costs into account and is calculated on the basis of contributions (without prior deduction of administrative costs). Severance funds do not publish their return on contributions, which is typically lower than the ROI.

⁶² Source: Severance funds.

⁶³ Source: Severance funds platform.