Stability of Banking System Further Strengthened

Impressive Performance by Austrian Banks

Total Assets Continue Surging

Since 2003, the unconsolidated total assets of the entire Austrian banking sector have risen almost steadily, peaking at EUR 658.7 billion in January 2005. Compared with the previous year, this represents strong growth of 8.0%. The ten largest banks (excluding special purpose banks) posted growth of 6.8%, thereby accounting for 52.0% of total banking assets. What is striking is that, above all, state mortgage banks, Volksbanken and special purpose banks recorded above-average growth of 19.0%, 12.7% and 12.3%, respectively.

Foreign business, the assets and liabilities sides of which strengthened by 14.2% and 9.3% respectively in January 2005, remains crucially important for the growth of total banking assets. In this connection, the expansion of Austrian banks in Central and Eastern Europe should be highlighted. Loans posted a year-on-year increase of 5.3%, with foreign currency loans, in particular, still basking on a wave of popularity. On the liabilities side, domestic interbank liabilities (+8.0%) and increasing domestic issues (+9.7%) drove the growth of total banking assets. By contrast, domestic nonbank deposits grew by 5.4%, thereby falling short of total asset growth.

In 2004, the number of banking offices continued to drop, standing at 882 head offices (of which 28 foreign banks) and 4,366 branch offices in December 2004. Overall, banking office numbers were down by 49 (14 head and 35 branch offices), with the Raiffeisen and savings bank sector primarily contributing to this development. In addition, full-time equivalent (FTE) employment[16] in the Austrian banking sector as a whole contracted by 3.0% in 2004 (December 2004: 65,421). The ten largest banks accounted for 21,538 or 32.9% of FTE employment in the banking industry. The median[17] was 21, thus mirroring the high share of banks with low FTE employment.

Derivatives Business Continues to Contract

Since April 2004, the nominal value of special off-balance sheet financial transactions pursuant to § 22, Annex 2, Austrian Banking Act (derivatives business) has been going down steadily, amounting to EUR 1,432.6 billion in January 2005. This is 36.4% less year on year and is thus only 2.2 times as high as the total assets of all Austrian banks (January 2004: 3.7). This decline can be traced back to, in particular, the change in business activity of a single major Austrian bank. If one disregards this particular bank's volume, Austrian banks' derivatives business can be said to have experienced modest growth of 2.4%. Overall, interest rate contracts still account for the lion's share (83.1%) of derivatives business, followed by exchange rate and gold contracts (16.2%).

By contrast, off-balance sheet transactions pursuant to § 22, Annex 1, Austrian Banking Act (sureties, guarantees, outstanding loan commitments, etc.) have increased. In February 2005, these transactions, broken down

[16] *For instance, two part-time employees working 50% of a full-time employee correspond to one FTE employee.*

[17] *The median is the midway value, under and above which an equal number of values lie. Special purpose banks are disregarded for the calculation of the median.*

by risk into the categories of high, medium, below-average and low credit risk, amounted to EUR 134.9 billion (+9.1% year on year), accounting for about 20% of total banking assets. Most transactions (equivalent to EUR 66.7 billion carried a low credit risk; followed by those with a medium credit risk (amounting to EUR 35.8 billion), followed by transactions with a high credit risk (amounting to EUR 29.8 billion) and, finally, those with a below-average risk (amounting to EUR 2.6 billion or 2.0%).

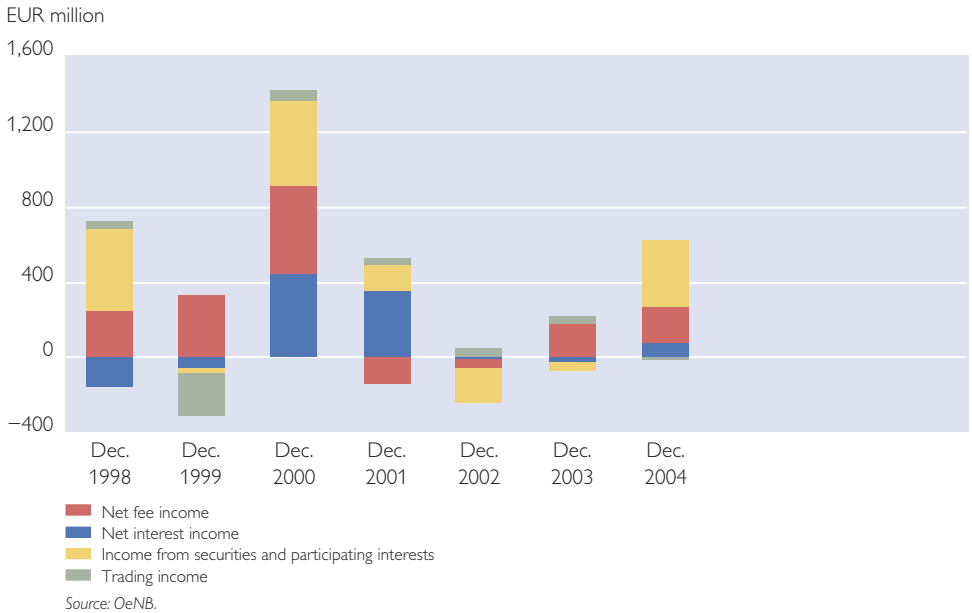
Austrian Banks' Profit Growth Continues Accelerating in 2004

In 2004, profits generated by Austrian banks continued to rise. Although Austrian banking subsidiaries in Central and Eastern Europe made a key contribution to this development, domestic business also posted strong profit growth.

In 2004, unconsolidated operating profits grew by 7.6% (2003: +4.5%). The continued improvement in domestic operating banking business is attributable to the fact that, since early 2003, income has been growing faster than costs. In 2004, operating income and operating expenses were up by 4.3% and 2.7% respectively, year on year. At 67.2%, the cost/income ratio for 2004 was the second best ever at year-end since 1997. The cost/income ratio has been lower only in 2000 (66.6%), primarily owing to high income at the time. By contrast, the reasons for these latest improvements can be found on both cost and income front.

Chart 19

Annual Growth of Income Components



Source: OeNB.

In 2004, income from participating interests and fee-based income made a major contribution to income growth (see chart 19). Income from securities and participating interests rose by 20.7%, largely thanks to dividend payments by foreign affiliates. Fee-based income increased by 6.2%, with, above all, net fee income from securities transactions posting robust growth. Interest income edged up slightly by 1%, and trading income

deteriorated by 1.7%. As chart 20 shows, the rise in net interest income was driven by growth in volume, as the interest margin[18] continued narrowing from 1.27% in 2003 to 1.21% in 2004[19] (end-2001: 1.34%). The ECB's interest rate statistics also confirm the continuing trend in narrowing interest margins. Lending rates on the entire range of outstanding loans are largely dropping, whereas deposit rates are largely rising. Compared with the euro area, consumer lending rates are nowhere more favorable than in Austria, and corporate lending rates also rank among the lowest. On the deposit front, interest rates offered in Austria are in the top third of the euro area. All in all, this means Austria has the euro area's second-lowest interest margin between loans and deposits, according to the ECB's interest rate statistics.

Chart 20

Annual Change in Net Interest Income and Interest Margin

Source: OeNB.

Interest income is becoming less important for Austrian banks. Only 49% of operating income is generated by interest-based business (1995: 61%). By contrast, income from fee-based business and from participating interests is growing in importance: 23% of income is generated by fee-based business and 14% by participating interests. At the end of 2004, the share of trading income remained low (4%). In early 1997, by contrast, it was twice as high (8%). A comparison shows that the higher the contribution of individual categories' income is, the less volatile their growth rates have been, which can be judged positively from the perspective of financial stability. In other words, interest earnings may have lower margins but are a reliable income component for Austrian banks in an unfavorable market environment.

[18] *This analysis is based on the ECB's method, which takes account of differing credit and deposit volumes, but does not reflect different credit and deposit maturity structures. Further details can be found in ECB (2000) "EU banks' margins and credit standards," Frankfurt am Main.*

[19] *A seemingly small change in the interest margin has a significant impact on profits: At the end of 2004, for instance, a 0.1% percentage point lower interest margin would trigger a decline of 8.3% in net interest income.*

At 2.7%, the annual growth in operating expenses is primarily attributable to the increase in staff costs. Whereas administrative expenses remained constant on a year-on-year basis, staff costs rose by 2.5%. In view of reduced employment (measured in FTE) and increased income, the rise in staff costs is likely to be due to profit-related wage components. In addition, staff costs have become more flexible in the last few years. Compared with the EU, however, some leeway still remains as regards staff costs.

In addition to improved operating business, the burden from both credit risk and securities risk also weakened in 2004. Expected net credit risk provisions contracted 8% year on year. Anticipated net loss provisions for both securities and participating interests even boosted profits by EUR 560 million. This is largely due to a one-off effect from increasing hidden reserves for participating interests. In 2003, this item only added EUR 46 million to the operating profits of Austrian banks.

Taken together, this generates profits on ordinary activities, which were up 35% year on year. Including extraordinary income and tax, annual net profits grew by 44% to EUR 2.98 billion, with the above-mentioned one-off effect significantly contributing to this rise. At 0.47%, ROA[20] in 2004 was much higher than in the previous year (0.35%), thereby matching its peak in 2001.

Consolidated Profits Reflect Business Activity in Central and Eastern Europe

The uptrend in unconsolidated profits is mirrored by consolidated profits, which benefited above all from the business activity of Austrian banks in Central and Eastern Europe. On a consolidated basis, net interest income rose by 13.3% year on year (including income from securities and participating interests), while fee-based income increased by 15.9%. In contrast, trading income fell by 3.7% from the high level recorded in 2003. In relation to total assets (which grew by 12.8% in 2004) operating profits stood at 2.6%, same as in 2003.

The expansionist activities of Austrian banks in Central and Eastern Europe are also reflected in the growth in costs. Overall costs rose by 10.9%, with staff costs increasing by 7.5%, administrative costs rising by 12.8% and write-downs jumping by 19%. At the same time, operating expenses as a ratio of total assets remained more or less unchanged from 2003. Including risk provisions – which also reflect the above-mentioned one-off valuation effects from individual Austrian banks' participations – and tax, Austrian banks' consolidated annual profits jumped by close to 50% to more than EUR 3.7 billion in 2004. ROA for the banking industry as a whole thus reached 0.6% in 2004.

Depsite robust growth in profits and contributions from business in Central and Eastern Europe, Austrian banks are still not very profitable compared with their EU peers. This is primarily due to fierce competition inducing relatively low interest margins. At the same time, low-margin interest earnings also account for a comparatively high share of income. The contribution of income from fee-based business is small by euro area standards. As already mentioned, however, it is becoming an increasingly important income component for Austrian banks.

[20] *Annual net profit relative to average total assets.*

Chart 21

Annual Loan Growth of Austrian Banks

Source: OeNB.

Loans Expand As Loan Loss Provisions Decline Slightly

Steady Growth in Bank Lending

Compared with 2003, when bank lending trends were sluggish owing to a lackluster economic environment, domestic loans in Austria soared throughout 2004. In the second half of 2004 as well, growth in Austrian bank lending was higher than in previous periods. At the end of 2004, the annual loan growth of all Austrian banks amounted to 5.1% (see chart 21). By contrast, it was only 1.6% at the end of 2003. In addition, preliminary figures for 2005 indicate further annual growth (January 2005: 5.3%).

Compared with previous periods, moreover, it is striking that the loan growth of Austria's ten largest banks (in terms of total assets) also accelerated sharply, outperforming in the second half of 2004 growth in the median value of all Austrian banks for the first time since 2002. In January 2005, annual loan growth generated by the big ten was 5.8%. However, this group's steep loan growth in fall 2004 can be traced back to the lending of a single major Austrian bank, in particular. The median value for lending exhibits a comparatively steady growth. In the second half of the year, it hovered around 4%, which it reached in January 2005 as well.

All in all, lending therefore increased in an economically more benign climate and against a backdrop of favorable interest rate developments.

A breakdown by banking sector shows that, in particular, Volksbanken, state mortgage banks and the Raiffeisen sector all posted robust annual loan growth of around 7%. The joint stock bank sector, where lending even dropped from August to November[21] 2004, posted a poor performance, as did the building and loan association sector, which had already reported a rather muted financing performance in previous periods.

An analysis of loan growth by economic sectors shows that corporate lending continued to accelerate compared with previous years. In December 2004, annual corporate loan growth was 2.7%.[22] This corresponds to the more buoyant investment activity of Austrian enterprises in the second half of 2004.

Furthermore, household lending staged a recovery. At the end of 2004, annual household loan growth was 8.4%. A comparison of total household lending by lending purpose shows that the share of home loans as a percentage of total loans increased to the detriment of consumer loans. Since September 2004, home loans have accounted for more than 60% of total household loans. In early 2005, consumer loans accounted for some 30% of total household loans.

Likewise, loans to nonbank financial intermediaries grew sharply on a year-on-year basis. In January 2005, annual growth was 11.4% (2004: 7.1%). By contrast, loans to general government grew at a below-average rate, posting annual growth of only 2.7% in January 2005.

[21] *Since Bank Austria's reclassification to a new sector in the reporting system in December 2004, only data to November 2004 can be used for the time being.*

[22] *Data on loans to households and nonfinancial corporations are inclusive of foreign currency loans. Since the relevant repayment vehicle and thus accompanying "hypothetical" loan repayment rates cannot be included for technical reasons, the numbers are maxima.*

Alternative Corporate Financing

The last few years have seen numerous initiatives by economic policy actors and banks to promote and propagate alternative financing instruments for enterprises – in particular, small and medium-sized enterprises (SMEs). The recent period has also seen academic studies and surveys published on the importance and potential of alternative forms of financing in Austria. Their results[23] are presented below by way of a brief description and explanation of the individual financing instruments.

According to a survey[24] on medium-sized enterprises, ***leasing financing*** *is the most frequent source of financing used by enterprises after traditional bank loans: about 45% of respondents said they used leasing. From a financing perspective, the rental or leasing of movable or immovable economic goods has the advantage of both improving the balance sheet structure and committing less capital, thereby facilitating greater flexibility in planning investments.*

Apart from leasing financing and subsidized financing (e.g. subsidized export financing), other alternative forms of financing are currently only of minor importance for raising funds. Only 6% of respondents said they used mezzanine financing, widely promoted by financial institutions and development agencies. ***Mezzanine capital*** *is a hybrid of equity and debt capital in three ways. First, it pays interest and is to be repaid like a loan. Second, it offers the provider of capital the possibility of participating in the enterprise value, and, third, it represents subordinate capital compared to the other debt capital components. As a rule, repayment and interest of mezzanine loans depend on growth in both cash flow and profits generated by the enterprise, thereby facilitating greater financial flexibility. Moreover, collateral is not generally required. However, interest rates on mezzanine financing are, for the most part, much higher than on traditional bank loans, and market norms require a minimum financing amount of EUR 500,000. A similarly hybrid form of financing are* ***dividend warrants****, for which funds with a minimum maturity of ten years are provided by several investors to an enterprise requiring capital. In addition,* ***factoring*** *and* ***forfaiting****, which are used by a mere 1% of respondents, are currently forms of financing that both have – at best – future potential. In the case of these two instruments, enterprises sell part of their assets at a discount mainly to banks or specialist financial institutions. As a rule, the latter assume the economic risk since the seller is not liable for the servicing of the debt. In addition to an inflow of liquidity and a freeing up of funds, enterprises using this form of financing therefore also benefit from the transfer of risk. However, this instrument is hardly used – a fact that is probably due to the high costs of factoring and forfaiting.*

In the case of ***asset-backed securitization*** *(ABS), bonds backed by a pool of assets (e.g. trade receivables, loans or bonds) are issued. In this way, hitherto illiquid assets are converted into instruments that can be traded in financial markets. As with factoring and forfaiting, the advantages of ABS are the freeing up of funds and rapid injections of liquidity. However, the minimum total financing amount of an ABS transaction is EUR 20 million under current market conditions.*

Within the framework of capital market financing, the last few years have increasingly seen, in addition to traditional bonds and equity issues, instruments designed to open up access to capital markets for SMEs as well. The key forms of financing in this area are venture capital and private equity. ***Venture capital*** *(VC) is primarily used for financing early stages of innovative start-ups. The provider of capital does not only supply capital but generally also has a consulting and supporting role vis-à-vis management.* ***Private equity*** *(PE), by contrast, is more appropriate for mature enterprises requiring capital for specific purposes (stock market flotation, expansion, management buyouts). In this case, the provider of capital has a more reserved role vis-à-vis management. According to a recent survey,[25] 5% of medium-sized enterprises currently intend to use VC/PE financing in the future. According to enterprises, their scant interest is due to the say investors would potentially have in the management of the enterprise. However, 31% of medium-sized enterprises are unfamiliar with this instrument.*

[23] *Cf. Industriewissenschaftliches Institut (2005), Mittelstand und Kapitalmarkt, Ergebnisse einer Befragung nichtbörsennotierter Unternehmen in Österreich, Vienna. See also: http://www.aktienforum.org/218.html.*

[24] *This survey on "Banking Relations with Austrian Medium-Sized Enterprises" was carried out by Schwabe, Ley & Greiner Ges.m.b.H. at 4,833 Austrian enterprises (response rate: 7.57%) and the results were made available to the Oesterreichische Nationalbank (OeNB). In this survey, medium-sized enterprises are defined as all enterprises with sales between EUR 7 million and 40 million.*

[25] *See footnote 23.*

Slight Decline in Ratio of Specific Loan Loss Provisions to Claims on Nonbanks

The ratio of specific loan loss provisions to claims on nonbanks[26] registered a slight year-on-year decline of 0.14 percentage point to 3.4% in January 2005. This downtrend, which has been visible since early 2004, reflects the improving economic climate. Likewise, new credit risk provisions registered a further decline in 2004 after decreasing in 2002 and 2003. Adjusted for the release of loan loss provisions, net provisions for the Austrian banking sector as a whole in fact declined by 8% in 2004 after having already fallen by 7% in 2002 and by 14% in 2003.

In sectoral terms, however, a different picture[27] can be seen. At state mortgage banks, for instance, the ratio of loan loss provisions to claims on nonbanks was down by 0.2 percentage point to 2.04% in January 2005, as were those at building and loan associations (–0.05 percentage point to 0.58%) and special purpose banks (–0.16 percentage point to 0.68%). At Volksbanken too, the ratio of loan loss provisions to claims on nonbanks fell by 0.28 percentage point to 4.98%. By contrast, the ratio at Raiffeisen banks remained almost unchanged (4.46%). In January 2005, joint stock banks reported a year-on-year rise in the ratio from 0.37 percentage point to 3.37% while savings banks registered a decline of 0.16 percentage point to 3.93%.[28] In January 2005, foreign bank branches reported a ratio of loan loss provisions to claims on nonbanks of 3.73%.

The mean ratio of loan loss provision to claims on nonbanks at the ten largest Austrian banks (excluding special purpose banks) also declined slightly, standing at 2.83% in January 2005. This means that, as in previous years, the mean ratio of these banks is still lower than the value for all Austrian banks, although this gap has narrowed in the last few years. In January 2005, the median of all Austrian banks, which has steadily been at least 1 percentage point above the value of all Austrian banks since 2000, was 4.66%, thus remaining almost unchanged on a year-on-year basis. Overall, the number of banks (excluding special purpose banks), which had ratios of loan loss provision to claims on nonbanks exceeding 15% year on year, increased from 16 to 17. However, these banks are, without exception, small, systemically unimportant banks.

Foreign Currency Loans Remain Increasingly Popular

Since the mid-1990s, financing in Swiss francs and Japanese yen has grown increasingly important for both households and enterprises in Austria. At EUR 48.5 billion, the total amount of foreign currency loans issued to domestic nonbanks peaked in January 2005, accounting for 19.2% of all loans issued to Austrian nonbanks.

Household borrowing, in particular, is responsible for this development. Steady growth since mid-2003 in the share of foreign currency loans in all household loans has continued

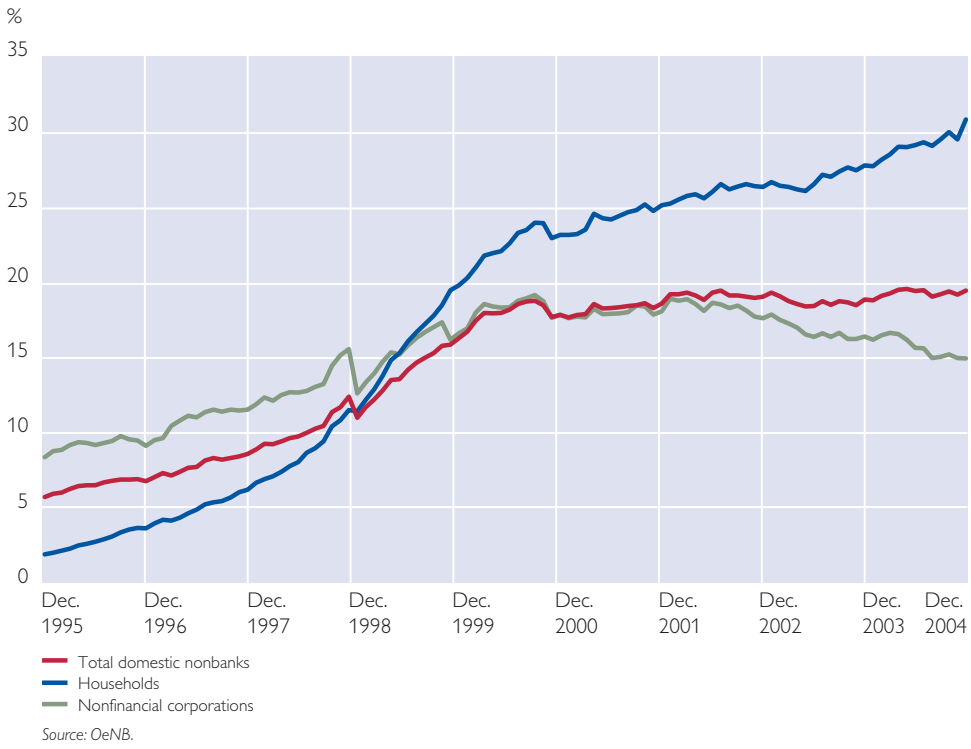
[26] *As experience shows, provisions for interbank loans are rather low and thus not taken into account in the following analysis. Specific loan loss provisions for outstanding claims on nonbanks are recorded in the monthly reports sent by banks to the OeNB and represent provisions for possible losses on loans, for which the borrower's solvency is in doubt.*

[27] *Multi-tier sectors traditionally have higher ratios of specific loan loss provisions to claims on nonbanks.*

[28] *However, these figures are influenced by the reclassification of BA-CA from the savings bank sector to the joint stock bank sector; hence, the figures are not fully comparable.*

Chart 22

Share of Foreign Currency Loans in Overall Loans to Domestic Nonbanks



Source: OeNB.

undiminished, peaking at 30.4% in January 2005. At 14.8% (at last count), exposure to foreign currency loans continued to decline slightly for nonfinancial corporations (see chart 22).

With a share of 89.1% of all foreign currency loans issued to nonbanks in January 2005, the Swiss franc maintained its position as the dominant currency. The Japanese yen's importance is currently stagnating at a low level, on a par with the volume of loans in U.S. dollars.

The foreign currency loan volumes indicated here are maximum values since no data are available on contributions made toward the repayment vehicles created for these loans. While the savings accrued under the repayment vehicle schemes lower the loan volumes, these volumes remain relatively high by euro area standards. Moreover, it should be borne in mind that, whereas repayment vehicles diminish some of the credit risk underlying foreign currency loans, the foreign currency risk and thus the resulting indirect credit risk are reduced only if the repayment vehicle matches the currency in which the loan is denominated. From the perspective of financial stability, this means that the absolute and relative level of foreign currency borrowing should also be closely monitored in future.

Moderate Market Risk Trends

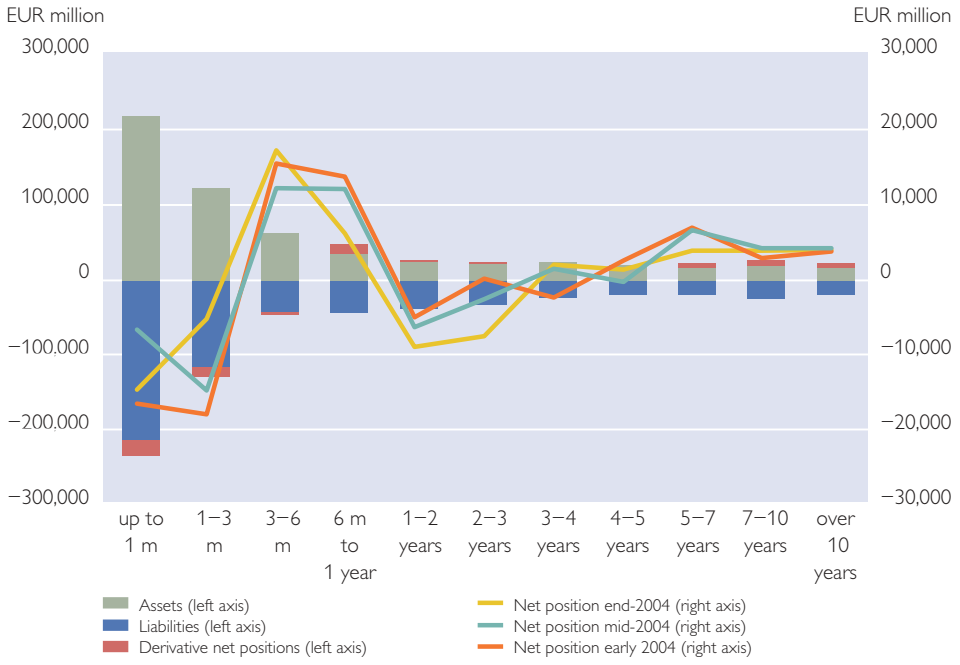
In addition to credit risk, market risk is another key risk category for any banking system. An important aspect of market risk is that changes in risk factors such as interest rates, equity prices or exchange rates can trigger losses in value of the on- and off-balance sheet positions held by banks.

Key Features of Interest Rate Risk Profile Unchanged, Interest Rate Risk in the Banking Book Down

The key features of the interest rate risk profile of the Austrian banking system as a whole did not fundamentally change in 2004.[29] Interest rate fixation periods of up to three months show net liability positions, followed by net asset positions in the band up to one year, followed by net liabilities in fixation periods of up to three years, and, finally, by net asset positions for longer terms. This can be seen from chart 23 where net interest rate positions – determined for all currencies[30] – are broken down by the term to the next interest rate fixing for the start, middle and end of 2004 (see chart 23).

Chart 23

Breakdown of Interest Rate-Sensitive Positions by Term to Next Interest Rate Fixing (Determined for All Currencies)



Source: OeNB.

Negative effects on the banking system from interest rate changes due to this exposure depend on how the yield curve as a whole is moving. In commonly used risk assessment scenarios, a parallel shift in the yield curve is assumed. Accordingly, a parallel yield curve shift for all currencies by 200 basis points is applied for calculating the Basel ratio for interest rate risk.[31]

[29] *This analysis is based on the data of the interest rate risk statistics and does not comprise trading book positions of banks running a large trading book. Included in the description are all interest rate-sensitive on- and off-balance sheet positions as well as non-interest rate-sensitive on-balance sheet positions whose performance banks assess on the basis of market interest rates.*

[30] *The resulting net interest rate positions are largely attributable to the euro area.*

[31] *The Basel ratio for interest rate risk indicates the percentage decline in a bank's eligible regulatory capital as a result of an interest rate shock such as this.*

In 2004, the average of the Basel ratio – determined for all Austrian banks by weighting by total assets – shrank relatively sharply from 7.8% to 6.1%. On the basis of these data and this assumed scenario, it can therefore be concluded that the interest rate risk in the banking book was reduced in the Austrian banking system as a whole in 2004.

However, Austrian banks' capital requirements for position risk of interest rate instruments of the trading book continued to increase – as they have since mid-2003 – in the second half of 2004 as well (from EUR 515 million to EUR 610 million). Although these figures lag behind those of 2000 (average: EUR 865 million), the trend in increased trading activity with interest rate instruments seems to be lasting.

Following an uptrend in the first half of 2004, stagnation in equity trading emerged in the second half of the year. At the end of 2004, the capital requirement for equity position risk in the trading book was EUR 43 million (EUR 52 million after the first six months of the year, EUR 28 million at the start of the year). The exposure of the Austrian banking system to equity price risks is deemed to remain limited (see also results of the related stress tests).

In 2004, capital requirements for open foreign exchange positions remained almost unchanged (EUR 53 million at the end of the year vs. EUR 55 million at the start of the year). The US dollar and Swiss franc continue to be the most important currencies in which open positions were held.

Payment and Securities Trading, Clearing and Settlement Systems Ensure System Stability

In 2004, 17 payment and securities trading, clearing and settlement systems, through which some 380 million transactions worth approximately EUR 8,700 billion were processed in total, were in operation in Austria. In terms of volume, about 99% of aggregate transactions was processed by retail payment systems,[32] of which most (around 190 million transactions) were processed by direct debit[33] payment systems. In terms of value, ARTIS/TARGET[34] accounted for roughly 97% and securities trading, clearing and settlement systems for about 2% of transactions processed. Steady growth in transaction processing was observed in almost all payment systems. Striking growth rates (+34%) were also seen in systems with e-money functionality, which so far have been relatively insignificant. In 2004, 13 Austrian banks participated in international payment systems. With approximately 6 million transactions, STEP2, which is operated by the European Banking Association (EBA), was the most used payment system, indicating its growing acceptance as a pan-European retail payment system by Austrian market participants. With some EUR 940 billion, the highest transaction values were processed by EURO1, the larger value payment system also operated by the EBA.

[32] *Payment systems with direct debit, cash electronic money, charge and credit functions that are used to transfer retail payments.*

[33] *Payment systems with a direct debit function enable point-of-sale payments that are offset against the payer's account at the earliest possible value date.*

[34] *ARTIS: Austrian Real Time Interbank Settlement System; TARGET: Trans-European Automated Real-time Gross settlement Express Transfer System.*

None of the 36 disturbances in system operation[35] or in system participation recorded in 2004 had an adverse impact on the Austrian financial system. These disturbances were largely due to software problems, network breakdowns or unplanned IT maintenance work. None of the payment systems was subject to multiple system disturbances. ARTIS, the securities trading, clearing and settlement systems and the key infrastructure facilities of the *Austrian Payment Services Ges.m.b.H. (APSS)* proved to be resilient to disturbances in particular.

The Importance of Secure Payment and Securities Trading, Clearing and Settlement Systems for Financial Stability

Liquidity of more than EUR 1,500 billion flows into the Eurosystem's wholesale payment systems on a daily basis. This is equivalent to 25% of the euro area's annual gross domestic product. The volumes in the systems used to settle securities transactions are no less significant. In addition to their importance for settling transactions within and between financial markets, the abovementioned systems are an essential transmission mechanism for the Eurosystem's monetary policies. A possible system failure would have not only a direct impact on the liquidity of the monetary and financial markets but could be expected to have a knock-on effect on other areas of the economy as well. This potential threat, which is described as a system risk, consists in a chain reaction triggerable even by a sole system participant, due to credit and liquidity risks as well as operational risks. Central banks therefore need to focus on the stability of these financial infrastructures and their resilience to crises. However, they also need to secure systems and instruments that are used for retail payment purposes since people's confidence in the security and reliability of these systems and instruments stands in direct proportion to their confidence in the currency per se.

For central banks, therefore, payment system oversight is a prerequisite for fulfilling their core tasks. As far as EU legislation is concerned, the legal foundations underpinning payment system oversight are Article 105 (2) of the Treaty Establishing the European Community, Articles 3 and 22 of the ESCB statutes and, in Austria's own case, Article 44a of the Federal Act on the Oesterreichische Nationalbank. Within the framework of the Eurosystem, the OeNB accordingly collaborates in developing legal, financial, organizational and technical standards for ensuring system security, whereof it monitors compliance in Austria. These requirements that are considered essential to guarantee system security are originally based on ECB Council Resolutions and are published in the OeNB's so-called oversight standards.[36] The smooth functioning of the Austrian systems and the participation of Austrian banks in international systems are also monitored by an oversight system for reporting statistics (payment system statistics) on an ongoing basis.

Banks Driven Strongly by Booming CEE Business[37]

The business activities of Austrian banking subsidiaries in Central and Eastern Europe continue to post stable growth in terms of both total assets and profitability. In all, sixteen major global banking players operate in this market. Of these, five are Austrian banks with a significant commitment and strong representation in the new EU Member States, in particular. In addition to Erste Bank, which is the second-biggest international bank by total assets in this market after Belgium's KBC, BA-CA (in fourth place after

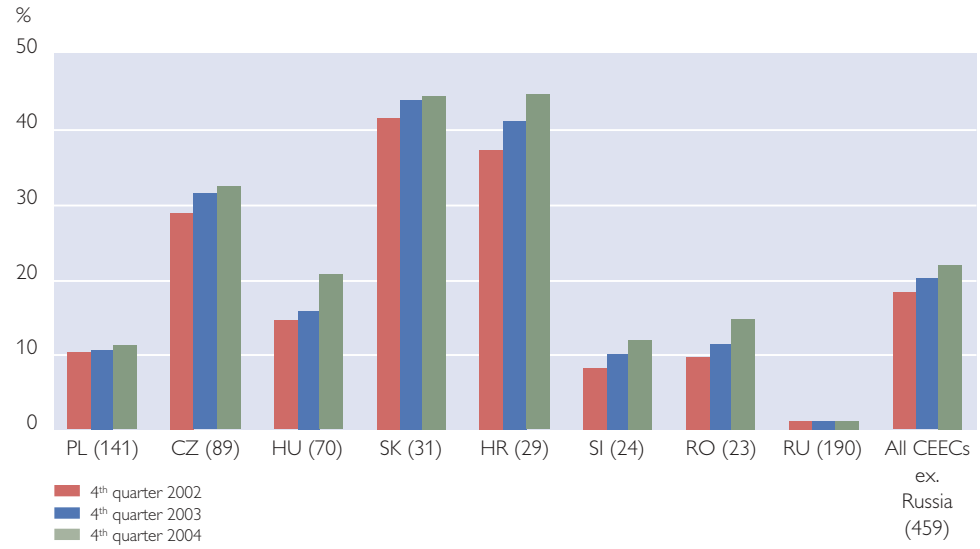
[35] *System disturbance is defined as any system standstill exceeding 30 minutes during operating hours and is induced by the payment system, or any standstill due to system disruption during the last 30 minutes preceding settlement cut-off.*

[36] *The abovementioned documents are located at http://www2.oenb.at/rel/zsa_p.htm.*

[37] *The source is the financial and income statement Austrian banks have published on a quarterly basis since early 2002. This publication contains selected items from the consolidated annual reports of parent banks and their fully consolidated subsidiaries abroad.*

Chart 24

Market Share of All Austrian Banking Subsidiaries in Central and Eastern Europe[1])



Source: OeNB.

[1]) Figures in parentheses are the total assets of the aggregate banking system in the relevant countries in EUR billion.

UniCredit), RZB – the pioneer in the Central and Eastern European banking market – Hypo Alpe Adria and ÖVAG are also represented in this region. Austrian banks now account for around 20% of the banking market as a whole in Central and Eastern Europe (see chart 24). Italian banks rank second with a share of almost 12%.

The number of fully consolidated Austrian banking subsidiaries in Central and Eastern Europe increased from 50 to 53. The aggregate total assets of all fully consolidated foreign subsidiaries in these markets were approx. EUR 102.6 billion at the end of December 2004, which is equivalent to a rise of 34% year on year. Compared with the previous year's period, however, growth can be said to have further accelerated (2003 growth: + 13%).

Claims on nonbanks[38] in Central and Eastern Europe grew broadly in line with total assets. This development is reflected in the increase in the "claims on nonbanks" balance-sheet item in the period between the end of 2003 and the end of 2004, with growth of 35% and an increase in total assets of 34%. In the previous year's comparable period, these two items had grown 23% and 13%, respectively.

In 2004, the aggregate operating profits of Central and Eastern European banking subsidiaries grew by 34% year on year to EUR 1.8 billion. The cost/income ratio improved from 64% in 2002 to 62% in 2003 to 59% in 2004. This is basically due to operating income growing at a faster pace than operating expenses. Furthermore, the subsidiaries represented 22% of their ten parent banks' aggregate total assets and generated just above 40% of their aggregate operating profits. It should be borne in mind that Austrian banks are becoming increasingly dependent on growth in markets (that have so

[38] These are loans issued by Austrian banking subsidiaries operating in CEE countries (indirect loans).

far been volatile). On the one hand, the still satisfactory economic situation in most CEECs and the preparatory measures adopted by further potential accession candidates will offer positive conditions and contribute to a stable economic environment. Furthermore, the service sector's still continuing catch-up process in less tapped markets will last for years owing to the tiny degree of market penetration by financial services particularly in Eastern and Southern European countries, thereby offering banks and other financial institutions continued stable growth prospects in the longer term. On the other hand, the catch-up process for financial services is already fairly well advanced in some of the new Member States and the related growing competition will squeeze margins.

Table 4

Key Figures of Austrian Banking Subsidiaries in 13 CEECs

	Total assets (EUR million)	Operating profits (EUR million)	Loan loss provisions (% of claims on nonbanks)	Cost/income ratio (%)	ROA after tax (%)
2002	67,827.5	1,175.5	6.3	63.7	1.05
2003	76,579.2	1,379.3	4.5	61.8	1.28
2004	102,645.1	1,853.6	3.4	58.7	1.32

Source: OeNB.

Another Record Year for National Banking Sectors in Central and Eastern Europe[39]

In 2004, GDP growth in all the countries under review (with the exception of Croatia) accelerated, partly due to stronger investment growth. This development led to higher growth (adjusted for inflation) in corporate and household loans in Slovenia and the Czech Republic. Loan growth in Bulgaria and Romania remained very high (+30% to 40% year on year). Hungary and Croatia also enjoyed robust growth (around +10%) whereas Poland and Slovakia continued to experience sluggish levels despite economic recovery and increased household loans. This was attributable to weak (in Poland, even falling) demand for corporate loans. In Poland, this is due to the particularly healthy corporate profit situation.

Despite loan growth, the share of nonperforming loans[40] as a percentage of the entire loan book continued to decline in all the countries under review during 2004. However, the steep loan growth should be taken in account when assessing this decline. Moreover, difficulties in servicing this strong expansion in loans are not likely to be fully assessable until at a later stage.

[39] *In this section, developments in the aggregate banking sector in the Czech Republic, in Hungary, Poland, Slovakia, Bulgaria, Croatia and – to a limited extent due to the data situation – in Romania are examined and not only those of the Austrian banking subsidiaries established in these countries.*

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

Although Central and Eastern European banks have small open foreign currency positions,[41] their relatively high share of foreign currency loans to both domestic enterprises and households (excluding general government and banks) represents a credit risk. This is attributable to the fact that households and some enterprises are insufficiently hedged against a weakening of their local currency relative to the loan currency. Foreign currency loans play an important role, above all, in Bulgaria (48.1% of all loans to domestic enterprises and households), Romania (60.8%), Croatia (9.3%; moreover, almost 65% of loans are indexed to the exchange rate performance relative to the euro), Hungary (39.0%) and Slovenia (33.1%). The share of foreign currency loans continued to climb relatively steeply in 2004 in these countries (with the exception of Croatia, where it remained broadly stable).

Banks' earnings improved or remained stable at a high level. Net interest income was boosted in several countries, partly as a result of robust loan growth. Both an improvement in the cost/income ratio and, in many countries, a corporate tax cut had a beneficial impact on banks' net profits.

Nominal Return on Equity

%

	2001	2002	2003	2004	H1 03	H1 04
Bulgaria	18.9	14.6	14.8	17.1	20.8	18.5
Croatia	6.6	13.7	14.5	n. a.	17.9	17.9
Poland	12.8	5.3	5.5	15.7	10.3	17.1
Slovak Republic	7.9	11.5	10.5	13.0	11.6	13.8
Slovenia	0.6	8.5	8.2	8.7	n. a.	n. a.
Czech Republic	16.6	27.4	23.4	23.3	22.7	22.4
Hungary	16.0	16.1	18.7	23.7	21.9	25.8

Note: Based on profits after tax. Intrayear data are annualized linearly.

Net Interest Income

% of annual average bank assets

	2001	2002	2003	2004	H1 03	H1 04
Bulgaria	4.2	3.9	4.7	4.8	4.6	4.9
Croatia	3.6	3.3	3.4	n. a.	3.4	3.1
Poland	3.7	3.4	3.1	3.2	3.1	3.2
Slovak Republic	2.5	2.7	2.9	n. a.	2.9	2.9
Slovenia	3.6	3.7	3.2	2.9	3.4	2.9
Czech Republic	2.5	2.4	2.1	2.3	2.1	2.2
Hungary	4.2	4.3	4.0	4.3	3.9	4.0

Note: Data between countries not comparable. Intrayear data are annualized linearly.

[41] *Official data on both on-balance sheet and off-balance sheet open foreign currency positions reveal few open positions for Bulgarian, Croatian, Polish, Czech and Hungarian banks (less than 1% of total assets). Slovak banks had an on-balance sheet net short position of some 5% in December 2004, and Slovenian banks an on-balance sheet net short position of 1.3% at the end of 2003.*

Current Operating Costs

% of current operating income

	2001	2002	2003	2004	H1 03	H1 04
Bulgaria	64.1	63.5	63.0	57.8	60.7	55.4
Croatia	65.6	59.3	57.3	n. a.	54.9	55.5
Poland	62.4	63.5	68.7	65.3	66.4	64.8
Slovak Republic	65.7	57.9	64.6	56.3	58.9	56.6
Slovenia	65.2	59.7	62.5	60.8	62.7	57.8
Czech Republik	53.4	51.4	52.6	47.2	49.4	49.0
Hungary	66.7	64.7	60.1	53.1	57.6	49.8

Net Change in Loan Loss Provisions

% of current operating income

	2001	2002	2003	2004	H1 03	H1 04
Bulgaria	−8.7	1.3	3.7	8.9	−9.0	6.2
Croatia	13.7	6.6	7.0	n. a.	8.0	4.5
Poland	18.9	22.9	15.2	7.9	11.2	7.0
Slovak Republic	−33.4	−9.8	−12.5	−10.4	−13.1	−14.2
Slovenia	25.9	19.8	16.6	16.0	12.2	17.1
Czech Republic	22.8	9.3	0.8	10.0	16.1	11.1
Hungary	4.3	4.7	−5.5	−7.5	−4.3	−8.7

Nonperforming Loans

% of all loans

	2001	2002	2003	2004	H1 03	H1 04
Bulgaria	4.5	3.6	4.2	3.5	4.5	2.4
Croatia	7.3	5.9	5.1	n. a.	5.5	5.1
Poland	18.4	21.6	22.1	15.2	22.6	17.9
Slovak Republic	21.0	11.0	9.1	7.0	10.5	7.8
Slovenia	7.0	7.0	6.5	5.5	6.8	6.0
Czech Republic	14.1	8.5	5.0	4.1	6.5	4.6
Hungary	3.6	3.7	3.0	2.9	3.3	3.4

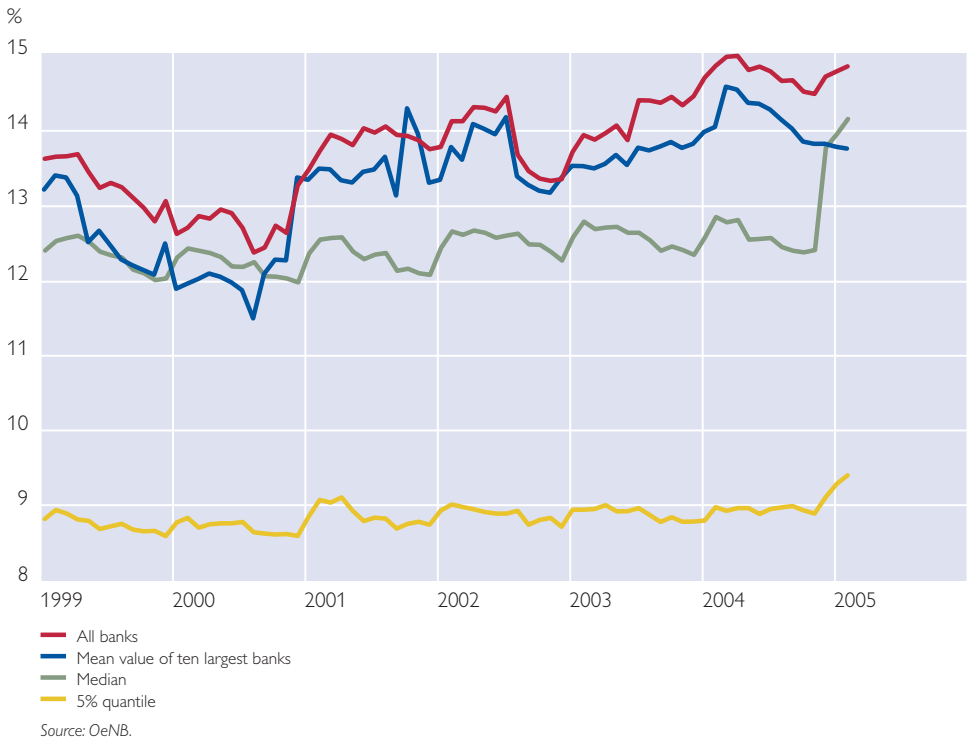
Banks' Risk-Bearing Capacity Still Guaranteed

Capital Ratio Remains High

The capital ratio, which is a key indicator for banks' risk provisions, is used to assess the risk-bearing capacity of Austrian banks. In January 2005, the unconsolidated capital ratio, relating banks' capital to their risk-weighted assets, was 14.8% for all Austrian banks (see chart 25). At the end of 2004, the consolidated capital ratio amounted to an equally comfortable 12.2%. This means Austrian banks' capital ratios remain at a very high level, clearly exceeding the required minimum capital ratio of 8%. Austrian banks therefore have a sizeable capital buffer, should stressful or crisis scenarios arise.

Chart 25

Capital Ratio of Austrian Banks (Unconsolidated Capital Ratio)



Source: OeNB.

Latterly, these high capital ratio trends can be tracked by the median value, in particular. In January 2005, the median value of all Austrian banks[42] came to 14.0% on an unconsolidated basis and has, for the first time in a while, exceeded the mean value of Austria's ten largest banks in terms of total assets. Although these largest banks have seen a slight deterioration in capital adequacy, their average capital ratio of 13.8% in January 2005 remains at a comfortable level.

An improvement in risk provisioning can also be seen by the value for the 5% quantile, which represents banks with relatively weak capital ratios. In early 2005, the value for the 5% quantile increased from 8.8% in January 2004 to 9.3% in January 2005. From the perspective of the last few years, this value represents a record high.

[42] *Special purpose banks are not included in determining the values for the ten largest banks and the median.*

The individual banking sectors do not show any striking developments. Owing to BA-CA's switch (for reporting purposes) from the savings bank sector to the joint stock bank sector, the joint stock bank sector (aside from special purpose banks) now boasts the highest capital ratio (January 2005: 15.8%).

As to the core capital ratio, which by relating tier 1 capital (core capital) to the assessment base also measures the capital adequacy of banks, the industry total of all Austrian banks on an unconsolidated basis was high compared with previous years (January 2005: 10.2%).

All in all, Austrian banks have a strong risk-bearing capacity.

Risks for Banking System Look Limited According to Stress Tests

Stress tests, which are used to assess the Austrian banking system's risk-bearing capacity as regards credit and market risks, were recomputed for the end of 2004.[43] Table 5 shows a summary of the results.

Table 5

Stress Test Results for the Aggregate Austrian Banking System

		%			capital ratio
Current capital ratio (dec. 2004)					14.71
Credit risk					
Domestic credit exposure					
Increase in the ratio of loan loss provisions to loans outstanding by			+30		13.79
Credit exposure in Central and Eastern Europe					
Increase in the ratio of loan loss provisions to loans outstanding by			+40		14.44
Foreign currency loans					
Appreciation of the Swiss franc against the euro by			+10		14.41
Appreciation of the Japanese yen against the euro by			+20		14.64
Accumulated credit risk					
Consideration of all three credit risk components at the same time[1])					13.32
Market risk		basis points			capital ratio
Interest rate risk		short	medium	long	
EUR	Upward parallel shift of the yield curve	130	130	130	14.36
USD	Upward parallel shift of the yield curve	110	110	110	14.65
CHF	Upward parallel shift of the yield curve	150	150	150	14.70
JPY	Downward shift of yield curve[2])	−20	−40	−130	14.68
Equity price risk		%			capital ratio
Domestic stock market crash, decline in ATX by			−30		14.55
International stock market crash, decline in international stock indices by			−35		14.50
Exchange rate risk					
Worst case estimate[3]), appreciation/depreciation of the euro by			±10		14.62

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

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

[2]) In the case of the Japanese yen, there was no parallel downward shift in the yield curve so as to avoid a negative interest rate scenario.

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

[43] *The methodology on which the stress tests are based is described in Financial Stability Report No. 7.*

Marginal increases in the loss potential (implied by the assumed scenarios) for the aggregate Austrian banking system relative to the stress tests for mid-2004, for the interest rate risk in Japanese yen, for the domestic equity price risk, and for exchange rate risk are offset by a reduction in the loss potential for interest rate risk exposure in the euro area, for domestic credit risk, for credit risk vis-à-vis Central and Eastern Europe, and for credit risk of loans to domestic nonbanks in Japanese yen. The Austrian banking system's resilience to shocks can be positively assessed using the results of the stress tests.

The Analytical Framework in Austrian Banking Supervision

In Austria, off-site analysis plays a particularly important role in the supervisory process, as on-site analyses cannot be carried out very frequently owing to the country's high degree of banking density. In addition to long applied, proven tools of analysis, subject to recalibration and updating at regular intervals, supervision also relies on new tools that were developed on a scientifically sound basis and are state of the art even by international standards. The key models are listed in the table below:

Tool of Analysis	Scope of analysis	Key Result	New Devlpt.
Logit model	Total risk scenario	Probability of defined event (PD)	Yes
Cox model	Total risk scenario	Distance to defined event (DtD)	Yes
Structural model	Total risk scenario	Value at Risk (VaR)	Yes
Systemic risk monitor	Total risk scenario	Probability of defined event (PD)	Yes
CAMEL	Total risk scenario	Ranking	No
Filter system	Total risk scenario	Conspicuous cases identified	No
Interest rate risk outlier	Aspect of total risk	Yes/No	No
Infringements of the Austrian Banking Act	Aspect of total risk	Yes/No	No
Profitability	Aspect of total risk	Relative profitability	No
Problem loan cover	Aspect of total risk	Relative amount of credit risk	Yes
Overall MLR analysis	Aspect of total risk	Conspicuous cases in MLR portfolio	Yes
Rating consistency	Aspect of total risk	Yes/No	Yes

Furthermore, great importance is also attached to providing a clear presentation and collation of the different quarterly analyses so that a meaningful overall picture of the Austrian banking scenario can be formed from the many individual analyses. To offer all market participants and interested parties in the financial arena an insight into the analytical tools used in Austrian banking business analysis, the OeNB and FMA have produced a joint publication entitled "Die Analyselandschaft der österreichischen Bankenaufsicht" ("The Analytical Framework in Austrian Banking Supervision").

Ratings of Major Austrian Banks Remain Stable

In addition to data from the reporting system, on which most of the analyses on the banking sector's performance and stability are based, publicly available data on the major banks, in particular, also provide insights into the Austrian banking sector's health. These data include the ratings and stock pri-

ces of banks. Long-term ratings, covering savings, sight and term deposits as well as interbank business and subordinated liabilities, remain stable, having changed only minimally in recent months. In January 2005, Investkredit was downgraded by Moody's by a single notch from A2 to A1. The U.S. rating agency justified this move by citing that Investkredit's future ownership structure was unclear owing to ÖVAG's announcement that it intended to fully acquire Investkredit. ÖVAG has since acquired the participating interests held by BAWAG-PSK, Erste Bank and Wiener Städtische in Investkredit, in which it now has a 45.5% interest since February 2005. Further talks will be held with BA-CA and RZB, which have participating interests in Investkredit of 28.1% and 18.3%, respectively. Moody's fear is that ÖVAG's takeover of Investkredit could have an adverse impact on ÖVAG's capital ratio. Furthermore, the rating agency anticipates minimal synergy effects and additional costs for ÖVAG and downgraded its Bank Financial Strength Rating from C+ to C in January 2005 following the announcement of this takeover bid. In January 2005, Moody's corrected its outlook for BA-CA's long-term deposit rating from stable to negative. As a result, there are currently signs that the long-term rating could deteriorate from a current A2 in the next few years. According to the rating company, the predicted deterioration is due to the recent downgrading of the credit rating outlook of BA-CA's parent HVB (current deposit rating: A3). Using similar economic-arguments, rating agency Standard and Poor's (S&P) downgraded BA-CA to Creditwatch, with baleful implications of a potential downward correction.

Successful IPO of Raiffeisen International Bank-Holding AG

On April 25, 2005, RZB floated its Eastern European subsidiary, Raiffeisen International Bank-Holding (RI), on the stock market. Further bank acquisitions in Eastern and Southern Europe are to be financed with the flotation proceeds, which came to a total of EUR 1.11 billion including greenshoe. Refinancing via the stock market will enhance RI's financial scope.

RI is a fully consolidated subsidiary of the RZB banking group, acting as a holding company and management entity for the group's companies in Central and Eastern Europe. Currently, RI operates in 15 Central and Eastern European markets with more than 900 bank branches and operates as a universal bank in this region.

The post-flotation free float is 24%. With a current stake of 70%, RZB remains the controlling shareholder. Prior to flotation, RZB held a stake of 86%, followed by the Raiffeisen regional banks with a stake of 6%, and the European Bank for Reconstruction and Development (EBRD) as well as the International Financial Corporation (IFC) with 4% each. In the wake of the flotation, the Raiffeisen regional banks disposed of their interest completely. World Bank subsidiary IFC and the EBRD now hold a stake of 3.2% and 2.8%, respectively.

RI's flotation is a major new issue for Vienna as a financial center and has helped strengthen the Vienna stock exchange. It was admitted to the ATX leading index at the end of April 2005.

Market Performance of Austrian Banks

The ATX Prime Market, which currently consists of 39 securities, includes four bank stocks (BA-CA, Erste Bank, RI and Investkredit), with a joint

market capitalization of EUR 25.8 billion as at April 30, 2005. Compared with September 2004, this amount increased by EUR 8.9 billion, or 52.3%. Between September 30, 2004 and April 30, 2005, ATX Prime Market's total market capitalization increased by EUR 18.1 billion to EUR 66.4 billion (+40%). As at the end of April 2005, the abovementioned four bank stocks accounted for close to 40% of ATX Prime's total market capitalization.

Other Financial Intermediaries Show Positive Developments

Insurance Companies Benefit from Favorable Climate on the Financial Markets

Private Pension Plans Drive Growth in the Life Insurance Segment

The recovery of the European insurance industry's profitability is continuing, driven primarily by positive developments on the financial markets – in particular, price gains on the equity and bond markets. However, given the low key interest rates and low risk and liquidity premiums on the markets, existing life insurance contracts with a guaranteed minimum return are also putting pressure on insurance companies' profitability.

Austrian insurers enjoyed an upward trend in operational business in 2004, due in part to the dynamic growth in Central and Eastern Europe, and were also able to benefit from positive developments on the capital markets. Insurers recorded rising premium income in both the life insurance and non-life insurance segments. Increasing awareness of the importance of private pension plans is apparent in the figures for annuities and state-subsidized personal pension plans, which are chiefly responsible for the positive trend in the life insurance segment. While stock prices of insurance companies in Europe remained largely unchanged, the insurance stocks listed on the Vienna stock exchange's prime market segment outperformed comparable European benchmarks.

Foreign Fixed-Income Securities and Domestic Equity Securities Dominate Assets

Insurance companies' total assets (excluding reinsurance transactions) grew EUR 5.4 billion to EUR 68.3 billion in 2004. As in 2003, this growth was mainly attributable to the rise in investments in foreign fixed-income securities (up EUR 2.7 billion to EUR 15.6 billion) and, albeit to a lesser extent, an increase in domestic equities and other domestic securities (up EUR 2.3 billion to EUR 17.5 billion) as well as foreign equities (up EUR 843 million). Loans saw the largest decline (EUR 734 million) in terms of value on the assets side. The chief reason for this drop can be traced to the maturing of loans that had been granted to the Austrian federal government. Deposits with Austrian banks rose again in the second half of 2004. At EUR 2.5 billion, they were up 19% year on year. Further increases in fixed-income securities from domestic banks and loans to domestic banks have boosted insurance companies' exposure to banks to EUR 9.7 billion. With a share of 14.2% of insurance companies' total assets, this exposure is somewhat above the average for the past nine years. As investments with credit institutions by insurance companies merely correspond to some 1.5% of the total assets of Austrian banks, the contagion risk posed by the insurance industry for the banking sector is still low.

Insurance technical reserves in the life and health insurance segments grew at a rate of 8%, by EUR 3.3 billion to EUR 44.4 billion and by EUR 196 million to EUR 2.7 billion, respectively, in 2004. In the far smaller property/casualty insurance segment, actuarial provisions were up 16.3% or EUR 33 million.

Hedge Funds and Financial Stability

On April 4, 2005, renowned representatives from consulting firms, prime brokers, hedge funds and foreign supervisory agencies spoke at an all-day workshop on the link between hedge funds and financial stability, which was held at the OeNB. The rapid growth of hedge funds in the past few years has led to concern about its possible impact on financial stability. One risk caused by hedge funds is the contagion risk they pose for other financial intermediaries. For example, there is a close relationship between hedge funds and the banking system due to banks' role as prime brokers, which take care of back office activities but also grant loans, and due to banks' own investments in hedge funds. Pension funds and insurance companies have also increased their exposure to hedge funds considerably over the past few years. Additional risks arise from the direct influence that hedge funds have on money markets, capital markets and commodity markets. Hedge funds can move significant volumes given their potential high leverage. If investors were to suddenly sell off their hedge fund shares, it could force the early liquidation of very large positions, which in turn could put individual market segments under heavy price pressures and increase their volatility. Possible spillover effects could carry these trends over into the market as a whole. In the light of the current very low risk and liquidity premiums on the financial markets, the question also arises as to what extent the massive increase in hedge fund volumes is linked to this trend and to what extent it contributes to the creation of imbalances.

However, hedge funds can also have ***positive effects*** *on the stability and functioning of the financial markets. For example, they help improve liquidity in tight market segments. Their contribution to promoting financial innovations and to improving the efficiency of risk sharing among financial market players, for whom hedge funds provide additional options for diversification, is also undisputed. Hedge funds' arbitrage strategies improve pricing information on the markets. (Investment) banks have been able to increase their options for diversification by (partially) outsourcing their proprietary trading to hedge funds, although this outsourcing also entails a loss of control and thus possibly considerable risks.*

In a nutshell, despite all the criticism, hedge funds represent an innovative contribution to financial intermediation. However, greater transparency is needed on the hedge fund market to allow early identification of possible risks and their impact on financial stability. Of particular importance in this respect is the corrective action that can be taken by prime brokers or other contractual partners, who should have incentive to exercise a certain monitoring function in order to avoid potential damage to their own reputations in the event of a crisis.

Positive Trend in Mutual Funds Continues

The favorable situation on the financial markets, greater propensity to invest and investors' positive response to new products were chiefly responsible for the 12.9% increase in the assets under management (incl. fund-of-fund investments) to EUR 125.3 billion as of the end of 2004. While payouts were down 2% to EUR 3.1 billion, due in part to the low interest rates, new investments were up 84.5% or EUR 10.4 billion. The upward trend on the financial markets boosted the capital-weighted total performance of all Austrian mutual funds[44] from 5.5% in 2003 to 6.0% in 2004.

Among Austrian retail funds, bond funds accounted for 59.2%, followed by balanced funds with 18.7% and

[44] *Retail funds and institutional funds.*

equity funds with 17.9%. At 3.1%, money market funds still accounted for only a small share of the total retail fund volume, although interest in this segment is growing steadily. Two new fund categories, *real estate funds* and *alternative funds*, have been well received by the markets. Real estate funds have been available since the fourth quarter of 2003 and accounted for a 0.5% share of the retail funds market as of the end of December 2004. The amendment to the Mutual Funds Act that entered into force on February 13, 2004, introduced the option to establish alternative funds, which quickly achieved a share of 0.7%.

While the volume invested by mutual funds in foreign stocks and equities increased at a below-average rate of 9%, to EUR 17.2 billion, holdings of domestic stocks and equities shot up 73.7% – supported by strong price gains of the domestic stocks listed on the Vienna stock exchange – and now account for 1.4% of total assets under management.

Severance Funds – Volumes Develop Dynamically, Yields Fall Short of Expectations

The legal basis for the operation of severance funds is the Act governing employee retirement and severance pay (*Betriebliches Mitarbeitervorsorgegesetz* – BMVG[45]), which entered into force on July 1, 2002, and applies to employment relationships that were established after December 31, 2002, and are based on a private-law agreement. The law has a variety of objectives that are not always congruent, namely to eliminate hindrances to labor market mobility resulting from the severance pay provisions in effect through 2002, to promote private pension plans and to strengthen the Austrian capital market. As of the start of the employment relationship, employers must transfer 1.53% of their employees' monthly remuneration (plus special bonuses) to the appropriate health insurance provider, which is then to forward the amount to the relevant severance fund.

Besides oversight by the Austrian Financial Market Authority (FMA) and specific regulatory provisions that are modeled on the Austrian Pension Fund Act, a guarantee of the capital invested is mandatory. In addition to the required own funds, 5% of the administrative costs are to be allocated to reserves that are earmarked for the fulfillment of the capital guarantee until they reach 1% of the vested rights to future severance payments.

In 2004, nine severance funds in Austria had the requisite license. Of these, seven are directly or indirectly owned by banks and insurance companies, one is owned by an industrial company and the ninth is a public-law corporation.

As of the reporting date of December 31, 2004, the vested rights to future severance payments, i.e. severance pay contributions, totaled some EUR 363 million, up 147.2% on the December 31, 2003, reporting date. This sharp rise is ascribable to the recent introduction of severance funds (2003) and the contribution-based funding principle. The majority of the severance funds' investments are indirect investments (74.5%), i.e. severance funds invest primarily in mutual funds. Foreign currencies account

[45] *Federal Law Gazette I 100/2002.*

for 1.4% of the assets invested. As of December 31, 2004, 2.08 million vesting periods had been established for 1.32 million individuals from 205,000 employers.[46] For 11.5% of the vesting periods, no severance fund agreements have yet been entered into.

Administrative and asset management costs are governed by Article 26 of the Act governing employee retirement and severance pay. Severance funds are permitted to retain between 1% and 3.5% of the severance pay contributions received to cover ongoing administration. In addition to the cash expenditures, which may be passed on fully, an asset management fee for the management of the investment returns may be retained (up to 1% of the invested severance pay assets). The severance pay assets as such must not be diminished by any deductions. Asset management costs amount to between 0.5% and 0.7% of the invested severance pay assets, which corresponds to a share of 8.3% to 17.5% at a nominal investment yield of 4% to 6%.

Lawmakers sought to achieve a severance pay amount equivalent to the annual salary that would be earned after 37 to 38 years' employment.[47] In mathematical terms, this entails an implicit average annual return of around 6% before costs (assuming an annual increase of salaries of 2%). However, many severance funds assume a nominal yield of 4% to no more than 6% before costs in their long-term estimates and achieved lower yields in 2004 (severance fund average: around 4.6%). Investment yields are calculated monthly by the Oesterreichische Kontrollbank (OeKB) according to a method that is uniform for all severance funds. Market transparency is an important precondition for the stability of the financial system. Regular publication of the investment yields of the severance funds would increase market transparency.

Because all employers are required by law to join a severance fund and because of the contribution-based funding principle, the investment volume is guaranteed to grow. The minimum administrative costs stipulated under the law, market concentration[48] and the single license principle also limit the intensity of competition, thus ensuring stable income for the owners of the severance funds (primarily banks and insurance companies). This, in conjunction with the fact that the capital market risk is largely transferred to the vested individual, will in future contribute to the profitability and stability of the financial intermediaries.

[46] *Source: Association of Austrian Social Security Institutions. One individual can have multiple vesting periods.*
[47] *Official record of the 106th session (June 12, 2002) Federal Minister Martin Bartenstein, p. 52.*
[48] *The three market leaders account for 74.5% of all employer agreements and 73.6% of all vesting periods.*