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AUSTRIA

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and European Departments

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- This Financial System Stability Assessment (FSSA) is based on the work of two Financial Sector Assessment Program (FSAP) missions that visited Austria in October and December 2003. The FSAP findings were discussed further with the authorities during the Article IV Consultation mission in April/May 2004.
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- Austria's financial sector is generally sound and has proved to be resilient to external shocks. It has weathered the recent global slowdown well and enjoys a high level of observance of internationally accepted financial sector standards. The successful expansion in the Central and Eastern European Countries (CEECs) has helped boost the performance of banks, offsetting low profitability in the home market.
- At the same time, the financial system faces a number of, mostly medium-term, challenges including: (i) high bank and branch density, which constrains efficiency and profitability in the home market; (ii) growing exposure in the CEECs, which introduces new risks; (iii) high levels of foreign currency lending to households and associated risks; (iv) a complex deposit insurance system that should be streamlined; and (v) the need to foster a stronger cushion of safety in the insurance sector.
- The main authors of this report are Messrs. Ouanes and O'Brien, with contributions from the rest of the FSAP team.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks specific to individual institutions, such as asset quality, operational or legal risks, or fraud.

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ACRONYMS

AML	Anti-Money Laundering
ATM	Automatic Teller Machine
BCP	Basel Core Principles
CAR	Capital Adequacy Ratio
CFT	Combating the Financing of Terrorism
CHF	Swiss Francs
CIS	Collective Investment Scheme
GDP	Gross Domestic Product
CEEC	Central and Eastern European Country
EC	European Community
EEA	European Economic Area
EU	European Union
FATF	Financial Action Task Force
FMA	Financial Market Authority
FMABG	Financial Market Authority Act
IAIS	International Association of Insurance Supervisors
IAS	Insurance Supervisory Principles
IFRS	International Financial Reporting Standards
IFS	IMF International Financial Statistics
IOSCO	International Organization of Securities Commissions
JPY	Japanese Yen
LLP	Loan Loss Provision
LOLR	Lender of Last Resort
MoF	Ministry of Finance
OECD	Organization for Economic Co-operation and Development
OeNB	Austrian National Bank
OeVAG	Austrian Volksbanken A.G.
PD	Probability of default
RKO	Raiffeisen-Kundengarantiegemeinschaft Oesterreich (Raiffeisen Cross Guarantee System)
ROA	Return on Assets
ROSC	Reports on Standards and Codes
ROE	Return on Equity
RZB	Raiffeisen Zentral Bank
SME	Small and medium-size enterprises
USD	U.S. Dollar

I. EXECUTIVE SUMMARY AND OVERALL STABILITY ASSESSMENT

1. **The banking sector has been going through a period of steady restructuring and consolidation since 1990.** This period has also seen the emergence of relatively large banking groups (e.g., Erste Bank and RZB), as smaller banks clustered together, and became increasingly tied through cross-guarantee schemes to lead banks. Nevertheless, with some 900 (albeit mostly small) banks, Austria retains one of the highest bank and branch densities in the world.
2. **Profitability in the domestic market is low.** This, and the small size of the domestic market, have been two of the factors leading to the major expansion into the Central and Eastern European Country (CEEC) countries by Austrian financial institutions. This eastward looking strategy has been highly profitable to date.
3. **The banking sector has weathered the recent economic slowdown well, and is generally sound and resilient.** Aided by the profits from the successful move into the CEECs, its risk absorptive capacity has remained high with risk-adjusted capital ratios for the system as a whole hovering around 14.4 percent, well above the Basel prescribed norms. Stress tests performed on the banking system as part of the FSAP confirmed the robustness of the system. The insurance sector has also performed relatively well in comparison to insurance companies in many other European countries in recent years, although its cushion for safety has been significantly reduced.
4. **The financial system is, however, facing several areas of potential risk and medium-term challenges.** These include:
 - **Foreign currency lending by banks to domestic customers** is unusually prevalent in Austria, especially for house mortgages. While the risks are well understood and managed by the banks, nevertheless many borrowers are not hedged. Mitigating risks will require continuing efforts to educate customers and ensure that banks—particularly the smaller ones—further improve their risk management.
 - With bank and branch density in Austria remaining high by international standards, and domestic profitability low, there is room for **further restructuring and consolidation** in the banking sector.
 - While **the accession of the CEEC countries** into the European Union will support their growth and stability, the concentration of Austrian bank investments in this region and the growing exposures to clients in these countries nevertheless imply some risks that require continued monitoring and vigilance.
 - The **sectoral deposit insurance system** has worked well. But its complexity and the ongoing consolidation of the Austrian banking system argue in favor of reforming the current system over the medium term to reduce the likelihood of recourse to public funds.

- As in other countries, **new and riskier insurance products** are being developed (particularly as third pillar pension provision and development of local capital markets become more important). The Austrian supervisory authorities will need to ensure that insurance companies' technical reserving methodologies and techniques evolve in parallel.

5. **Austria enjoys a high standard of supervision based on strong institutions and a comprehensive legal framework.** The consolidation of supervision in the new Financial Market Authority (FMA) in 2002 was smooth. Cooperation among the FMA, the Austrian National Bank (OeNB), and Ministry of Finance (MoF) is good; and the FMA's capacity to discharge its mandate is being built quickly and effectively. This is confirmed by Austria's high level of observance of internationally accepted standards in the areas of banking, insurance, securities, and anti-money laundering.

6. **Ongoing reforms and EU directives in the pipeline will address most of the identified gaps in observance of financial sector standards and codes.** In addition, the FSAP team felt that the supervisory authorities should: increase the number of on-site inspections and focus supervisory resources on systemically important banks to a greater extent; further improve governance in financial institutions; and resolve several legal issues, in particular the public liability of supervisors, so that the latter can carry out their mandate more effectively.

7. **The key recommendations stemming from this assessment are summarized in Box 1.** Some of these were already in the process of being implemented by the authorities during the assessment, in particular as regards strengthened supervision of conglomerates.

Box 1. Summary of Key Recommendations

Regulatory and supervisory framework for banking

- Resolve the issue of public liability of supervisors.
- Complete development of the process for supervision of conglomerates.
- Increase the frequency of on-site inspections, especially for the largest institutions.
- Review possible need for a broad provision in the banking law allowing FMA to issue regulations.
- Strengthen the contingency planning framework to deal with systemic problems, should one occur.
- Provide banks with more detailed guidelines for managing risks.
- Continue to closely monitor foreign currency lending by banks to unhedged domestic customers, especially by the small banks most heavily involved in these loans, and ensure that appropriate risk management is followed for these loans.

Deposit insurance

- Review issues of deposit insurance in mortgage and commercial bank pillars, with a view to a possible consolidation of some or all of the different deposit insurance schemes over the medium term.

Securities market regulation

- Consider substantial increase in the sizes of maximum levels of administrative fines.

Insurance and pension issues

- Accelerate FMA's move to risk-based supervision and intensify monitoring of life insurance company solvency.
- Enhance actuarial and auditing role in insurance companies as regards assessing the overall financial position of life insurers, and long-tail liabilities for non-life insurers.
- Address special challenges created by new pension products, including issuance of guidelines to banks to ensure appropriate risk management.

Corporate governance

- Introduce formal fit and proper test for financial institutions' supervisory board members.
- Consider making the Austrian voluntary code of corporate governance mandatory for financial institutions.
- Consider changing the regulatory framework so that the internal audit function for financial institutions reports to the supervisory board.

II. FINANCIAL SECTOR AND REGULATORY CONTEXT

A. Financial Sector Structure

8. **The financial system is dominated by the banking sector.** Banks' total assets represent a higher proportion of GDP (270 percent) than in many other industrialized countries (Table 1). Total loans and deposits of banks are similarly large. Until now, the securities markets have had only a limited role in financing enterprises, with stock market capitalization and outstanding bonds equivalent only to about 20 percent and 80 percent of GDP, respectively, at end-2003. The limited reliance on securities markets is linked in part to the very important role that SMEs play in the economy. Smaller enterprises are less likely to want, or to be able, to access securities markets.

9. **The banking sector retains a multi-pillar structure** deriving from historical differences in lines of business and ownership. There are seven categories, or “pillars,” of banks: joint stock and private banks, savings banks, rural credit cooperatives or raiffeisenbanks, industrial credit cooperatives or volksbanks, state mortgage banks, building societies, and special purpose banks (Table 2). Although the vast majority of banks now effectively operate as universal banks and the state has substantially divested its bank holdings, significant differences remain across the pillars in terms of organizational and ownership structures. Government guarantees for liabilities remain for a few banks but these are being phased out.

10. **Another feature has been the emergence of the relatively large banking groups** (e.g., Erste Bank and RZB) in a tiered structure with smaller banks becoming increasingly tied to lead, or “apex”, banks within their pillars. The lead banks provide centralized services, and thus economies of scale, in areas such as payments and settlements, liquidity management, and some funding activities. The formalization of cross guarantees for liabilities in the tiered pillars has reinforced this trend (Box 2). As a result, many of these smaller banks can be thought of to some degree as operating as bank branches rather than as completely separate banks.

11. **The insurance sector is well developed, with insurance premiums per capita being the 12th highest in the world.** The non-life sector is mature, but the life segment operates at approximately half its potential when compared with peer countries in Western Europe, with a life insurance penetration (total premiums divided by GDP) of only 2.75 percent in 2001.

12. **The sector weathered well the falls in international asset markets, the recent slowdown in Austrian economic activity, and the 2002 floods,** relative to the insurance sectors in a number of other developed countries. This reflected: (i) relatively strong levels of reserves at the onset of the slowdown; (ii) reasonably conservative investment in equity, which have helped limit the impact of the fall in equity prices; (iii) heavy reliance for non-life insurers on reinsurers, especially for natural disasters; and (iv) the timely reduction in the minimum guarantee rate.

Table 1. Main Components of the Financial Sector
(as of end-2003)^{1/}

	Billions of Euro	Percent of GDP
Banking sector		
Gross total assets	605.1	269.8
Domestic credit 2/	275.1	122.7
Insurance sector		
Total financial assets 3/	60.4	27.7
Premium income 3/	12.7	5.8
Pension funds		
Total financial assets	9.1	4.1
Mutual funds		
Total financial assets	111.0	49.5
Stock market valuation	43.2	19.3
Bonds outstanding	186.3	83.1
Memorandum items:		
Other countries, in terms of GDP:		
Belgium bank domestic credit 2/	300.1	112.8
Germany bank domestic credit 2/	3043.3	142.4
Sweden bank domestic credit 2/ 4/	...	109.9
Switzerland bank domestic credit 2/ 3/	...	174.2
United States bank domestic credit 2/ 3/	...	90.8

Sources: OeNB and IFS.

1/ Series are not strictly comparable owing to differences in definition and time period.

2/ From IFS banking survey (national residency).

3/ Data are for 2002.

4/ Data are for 1999.

Table 2. Size of the Banking Sector
(December 2003)

	Number	Total Balance Sheet (euro billions)	Total Balance Sheet (percent of total)
All banks	896	605.1	100.0
Joint stock and private banks	47	94.4	15.6
Savings banks ^{1/}	63	215.4	35.6
Rural credit cooperatives	595	144.0	23.8
Industrial credit cooperatives	69	31.9	5.3
State mortgage banks	9	45.7	7.6
Building societies	5	19.2	3.1
Special purpose banks	108	54.5	9.0

Source: OeNB.

1/ Including Bank Austria-Creditanstalt

Box 2. Sectoral Support Arrangements

Raiffeisen Pillar

Solidarity Association (Solidaritatsverein der Raiffeisen-Geldorganisation): Individual raiffeisen banks, raiffeisen regional banks, and the RZB provide mutual assistance to protect the interests of creditors and ensure the continued existence of the troubled institution. Any financial assistance provided is accompanied by conditions such as changing management to remedy the underlying cause of the financial problem.

Raiffeisen Cross Guarantee System (Raiffeisen-Kundengarantiegemeinschaft Österreich (RKO)): Voluntary membership in regional customer guarantee associations, which in turn participate with the other regional guarantee associations (except for the Carinthia region which has no guarantee association and the Salzburg regional association, which is not a member of the RKO) and RZB. Members are legally bound to a contribution, determined by formula, to cover 100 percent of deposits and securities issued by a member bank, subject to a limit based on size of the contributing bank. The scheme covers about 78 percent of all raiffeisen banks, accounting for about 89 percent of raiffeisen pillar deposits.

Savings Bank Pillar

Cross Guarantee System (Haftungsverbund): Voluntary membership which commits participating savings banks to be jointly and severally liable for all deposits and liabilities of member banks, up to a limit established by a formula. Member banks are required to provide support for other member banks facing financial distress, which could include provision of liquidity, granting of loans, provision of guarantees, capital injections as well as intervention in business policy and changes in management. The provisions are implemented by a company that is empowered to establish and monitor risk management policies and systems for member banks, and to intervene and make executive management decisions in a troubled savings bank. The cross guarantee system includes Erste Bank, the 10 savings banks in which it has a significant equity holding, and 43 other savings banks. Total savings bank assets outside the cross guarantee system amount to about €3.5 billion (about 2 percent of pillar assets).

Volksbank Pillar

Volksbanken Community Fund (Volksbanken-Gemeinschaftsfonds): Funded by all volksbank credit cooperatives, providing a guarantee for all deposits. All volksbanks are part of a centralized quarterly reporting system and group internal audit, and have common risk classification and management systems.

Contingent Capital Fund (Volksbanken-Beteiligungsgesellschaft): Provides capital to a volksbank that is unable to access other equity if needed. When provided, such assistance is accompanied by conditions or technical assistance intended to remedy the underlying problem in the bank.

13. **While all major insurers are associated with local banking groups**, and there are some ownership links, the arrangements cannot be characterized as bancassurance: there is fierce competition between the banks and insurers in the emerging market for individual pension products and alliances do change over time. Rather these linkages involve efficient use of distribution systems, and the banks see fee income from such sources as generating at least 40 percent of gross revenues in the future.

B. Profitability and Efficiency

14. **Domestic profitability and efficiency of Austrian banks have been low compared to other major European countries.** This reflects the competitive pressures arising from

one of the highest bank and branch densities in the world, with about 900 banks in a country with a population of a little over 8 million, and about one bank branch per 1,500 people. Austrian banks also have one of the highest cost-to-income ratios in Europe (Table 3).¹ While banks in many other European countries have reduced cost-to-income ratios over the past decade, Austrian banks have witnessed a slight increase, although the ratios have improved since 2001. Some banks are still absorbing the costs of recent domestic consolidation, foreign expansion and major investment in upgrading information technology platforms and risk management systems; it will take some time to reap the benefits of these investments. The cooperative nature of part of the banking system, and a consequent greater focus on provision of services than on profitability, may also have played a role.

Table 3. Austria and Other European Countries: Selected Banking Sector Performance Indicators, 1992–2001

	1992		2001	
	Return on Assets	Cost to Income Ratio	Return on Assets	Cost to Income Ratio
Austria	0.28	0.64	0.50	0.67
Belgium	0.15	0.68	0.47	0.63
Finland	-2.67	1.90	2.83	0.38
France	0.17	0.67	0.58	0.62
Germany	0.22	0.65	0.15	0.70
Italy	0.37	0.66	0.60	0.55
Netherlands	0.41	0.67	0.47	0.69
Norway	-0.28	0.60	0.78	0.61
Spain	0.82	0.60	0.76	0.55
Sweden	0.21	1.46	0.88	0.64
Switzerland	0.38	0.52	0.53	0.60
United Kingdom	0.14	0.66	0.75	0.57

Source: OECD

Note: For U.K. and Sweden, figures of commercial banks are reported.

15. **Overall profitability has, however, been reasonable due to the successful expansion by the major banks, and to a lesser extent insurance companies, into the CEEC markets.** As of mid-2003, total assets of Austrian banks in the CEECs amounted to about €9 billion, equivalent to about 10 percent of consolidated total assets. The Czech Republic accounts for the lion's share (around 40 percent) of Austria's expansion in the region, followed by the Slovak Republic, Croatia, Poland and Hungary. These investments have been highly profitable, helping to offset the sluggish domestic returns. Banks in the CEECs generated a 1.1 percent return on assets on average in 2002 compared with

¹ The savings bank pillar performs slightly worse than the other pillars. This can be explained by the rigid cost structure for many of these banks and their lower spreads, both of which reflect a focus on service provision. Joint stock banks are the most profitable on average, possibly reflecting stronger pressures to perform.

0.37 percent domestically. Thus, even though CEEC activities account for only 10 percent of consolidated total assets, they provided as much as 26 percent of pre-tax operating income.²

16. **Ongoing consolidation and restructuring should in due course help banks to address their high cost structures.** The strong regional focus and the legal form and ownership of some banks in some of the tiered pillars has not been a major impediment to cross-pillar and within-pillar consolidation; since 1990, about 23 banks have exited the market on average each year, largely through mergers. Only four of the largest ten banks in existence in 1990 still remain and government ownership has been reduced drastically. Consolidation has also been happening to a degree through the clustering of small banks around apex banks in some pillars in a tiered structure. As already noted, however, the results have yet to be seen in terms of reduced cost-to-income ratios.

17. **The introduction of risk-based pricing through Basel II may enable banks to justify pricing loans better and thereby improve margins.** Basel II will be particularly relevant as regards small- and medium-sized enterprise (SME) lending, albeit in several different ways. Loans to most SMEs could be classified under the “retail customer” category, which requires lower capital requirements than currently. Nevertheless, while some SMEs may benefit from lower interest rates, others could face an increase in loan costs.

C. Foreign Currency Lending

18. **The high level of foreign currency loans by local banks to domestic customers is a notable phenomenon in Austria.** In other EMU countries, for example, typically less than 5 percent of loans to households and corporations are in foreign currency; in Austria the share exceeds 20 percent. Further, while Austria accounts for about 3 percent of total lending within the euro area, its shares of loans in Swiss francs and Japanese yen in the region are 36 and 34 percent, respectively.

19. **In addition to low interest rates, demand for these loans appears to have been driven by several Austria-specific factors.** The loans initially became popular in the west of the country, where many borrowers had natural hedges in Swiss francs (e.g., through being employed in Switzerland and paid in Swiss francs). Publicity that many of these early borrowers had made major savings due to low interest rates and the absence of adverse exchange rate movements spread demand throughout the country. Financial advisors may also have played a role by marketing the benefits of these loans heavily. While the loans are now common throughout the country, they are particularly concentrated in the smaller banks and in the western region of the country.

² Foreign ownership of the Austrian banking sector has also grown over recent years, with foreign (mainly EU) controlled bank subsidiaries and branches now having a total market share of about 25 percent. Most of this is accounted for by the German bank HypoVereinsbank which in 2001 took control of Bank Austria (which subsequently merged to form Bank Austria Creditanstalt), the biggest bank in Austria.

D. Safety Net

20. **Safety net arrangements include a deposit insurance framework and systemic liquidity arrangements that meet the standards that have been agreed for Eurosystem members** (Box 3). Observed bank failures have been rare. In part due to the existence of the sectoral support arrangements, only the deposit insurance scheme in the joint stock banks pillar has had to make payouts.

Box 3. Safety Net and Systemic Liquidity

Deposit insurance

The system of deposit insurance for banks is compulsory and organized by pillar, with five separate schemes, each of which meets the minimum EU standards. Each scheme is administered by the respective trade association in the pillar and operates shared early warning systems. Funding is *ex post* and member banks from the affected pillar are required to contribute only when a guarantee event occurs. Contributions are based on the proportion of the covered deposits in each pillar, subject to an annual ceiling of 0.83 percent of the risk-weighted assets of the contributing bank. Payouts in excess of the ceiling spill over to the other pillars and, if the shortfall persists, the originally affected pillar can issue bonds to raise external funds. The federal government has the legal right, but not the obligation, to guarantee such bonds. To date, there has been no occasion on which these second or third layers of the deposit insurance framework have been accessed.

Systemic liquidity arrangements

Liquidity management is carried out through the Eurosystem, to which the OeNB belongs. Mechanisms are in place to provide emergency lender-of-last-resort (LOLR) assistance to an illiquid but solvent institution should that prove necessary. The Eurosystem has established two principles for LOLR assistance: first, the provision of such assistance is primarily a national responsibility. Second, any potential liquidity impact deriving from the provision of emergency liquidity assistance would have to be managed in a way consistent with the maintenance of the unified monetary policy stance. The National Bank Act requires that the OeNB lend to banks only against collateral, even in emergencies. The OeNB does, however, have flexibility in the collateral that it would be prepared to accept. Beyond that, the Austrian authorities consider that it would not be appropriate to predetermine and publicly announce detailed rules for the provision of temporary liquidity in the event of a systemic liquidity crisis both because of potential moral hazard and also because the particular circumstances giving rise to a problem can vary.

III. STABILITY ISSUES

21. **Austria has performed well in recent years relative to its main EU partners, the short-term outlook is positive, and the financial system appears generally sound and resilient to shocks.** As noted in the accompanying Article IV Consultation Staff Report, growth is expected to average 1.6 percent this year and 2½ percent in 2005. The financial soundness indicators presented in Table 4 are all in a comfortable range. In particular, the tier I and II risk-weighted capital adequacy ratio (CAR) for the banking system as a whole has consistently exceeded 13 percent in recent years and non-performing loan levels have been about 1.3 percent.

Table 4. Financial Soundness Indicators, 1998–2003
(In percent, year-end, unconsolidated basis)

	1998	1999	2000	2001	2002	2003
Capital Adequacy						
Regulatory Tier I, II, III capital to risk-weighted assets	14.3	13.9	13.8	14.6	14.1	14.7
Regulatory Tier I, II capital to risk-weighted assets 1/	13.5	13.0	13.3	13.7	13.3	14.4
Regulatory Tier I capital to risk-weighted assets	9.8	9.4	9.1	9.5	9.1	9.9
Banking sector asset composition and quality						
Total assets (Euro billions)	480.9	524.6	562.7	587.7	573.3	605.1
Sectoral distribution of loans (in percent of total)						
Nonbank financial institutions	4.4	4.1	3.8	4.2	4.4	4.6
Nonfinancial enterprises	47.2	46.7	46.3	46.2	44.8	44.0
Private households	20.6	21.1	21.4	22.1	23.3	23.7
Public sector	12.7	10.9	10.4	9.9	9.8	10.2
Nonresidents	15.1	17.3	18.2	17.6	17.6	17.5
Geographical distribution of loans (in percent of total)						
Domestic	84.9	82.7	81.8	82.4	82.4	82.5
Cross-border	15.1	17.3	18.2	17.6	17.6	17.5
Nonperforming loans to total gross loans	2.6	1.7	1.9	1.3	1.3	...
Nonperforming loans net of provisions to capital	9.0	-4.5	-0.2	-12.3	-15.3	...
Large exposures to capital	133.6	190.0	201.2	171.7	160.5	145.7
Deposits (excluding interbank) to loans	80.6	77.3	74.4	76.8	76.3	78.3
Foreign currency denominated loans to residents to total claims on residents	12.3	15.7	17.5	18.1	18.7	18.3
Foreign currency-denominated loans to households to total claims on households	10.2	18.1	21.3	23.2	25.0	26.6
Foreign currency-denominated loans to corporations to total claims on corporations	15.4	16.9	18.7	19.1	19.2	17.9
Foreign currency-liabilities to total liabilities	35.4	27.4	27.6	27.6	23.3	21.3
Earnings and Profitability						
ROA	0.35	0.33	0.42	0.48	0.25	0.36
ROE	7.13	6.94	9.43	9.80	5.36	7.23
Interest margin to operating income	52.7	52.0	49.8	50.4	51.6	50.9
Operating expenses to operating income	68.1	70.6	66.6	67.4	69.3	68.2
Personnel expenses to noninterest expenses	51.8	51.5	49.8	49.4	50.3	50.1
Spread between average lending and deposit rates	1.58	1.45	1.49	1.56	1.49	1.42
Liquidity						
Liquid assets to total assets 2/	34.8	31.9	30.4	31.5	30.3	30.2
Liquid assets to total short-term liabilities 3/	81.6	72.7	71.1	74.5	78.7	77.9
Sensitivity to market risk						
Duration of assets (in percent of total)						
Less than 3 months	36.2	33.9	32.4	33.2	32.6	32.3
Between 3 months and 1 year	13.8	13.7	13.6	13.6	12.7	11.7
Between 1 year and 5 years	22.9	23.7	22.9	22.2	23.1	24.0
More than 5 years	27.1	28.7	31.1	31.0	31.6	31.9
Duration of liabilities (in percent of total)						
Less than 3 months	46.0	47.7	46.6	46.4	42.2	42.5
Between 3 months and 1 year	12.7	11.5	11.7	11.2	11.3	10.3
Between 1 year and 5 years	21.3	19.7	20.0	20.3	22.8	23.1
More than 5 years	20.1	21.1	21.7	22.1	23.7	24.1
Net open position in foreign exchange to capital	3.2	4.4	2.3	2.7	2.7	2.2
Net open position in equities to capital	3.8	5.4	4.9	3.7	3.8	3.4

Sources: OeNB and staff estimates.

1/ Tier I+Tier II capital adequacy ratio was used in the stress tests.

2/ Liquid assets consist of interbank and 50 percent of nonbank assets with residual time to maturity of up to three months (excluding utilized current account overdraft facilities), cash reserve, debt instruments admitted for refinancing with the central bank, and listed bonds and equities.

3/ Short-term liabilities consist of interbank and nonbank liabilities with residual time to maturity of up to three months.

A. Macroeconomic Risks

22. **The financial system is exposed to a range of macroeconomic risks, chief amongst which are a possible recession in Austria, the major banks' exposures to the CEECs and the high levels of unhedged foreign currency borrowing by Austrian households and enterprises.** The FSAP team looked at each type of risk in depth, including in the context of the stress tests which are reported in Section C below, and found none to be of major concern at the present time.

23. **While the outlook for the economy is viewed as positive, a protracted recession, should one occur, would be expected to impact on banks' balance sheets through higher levels of non-performing loans.** Mitigating against this risk is that households and enterprises in Austria are traditionally not highly leveraged. While the SMEs which are so important to the economy tend to have high debt ratios, this is to some extent due to tax regime and other reasons. The majority of the borrowings by these enterprises tends to be from their owners rather than from banks.

24. **Similarly, adverse macroeconomic developments in one or more of the CEECs where Austrian banks have invested heavily would result in increasing non-performing loan levels.** The accession of many of these countries to the European Union will support growth and stability, and thus lessen this risk. Nevertheless, the concentration of Austrian bank investments in this region and the growing exposures to clients in these countries both give rise to the potential for problems. In many cases, the Austrian parent would be insulated to some extent from such an eventuality because the investments are via subsidiaries rather than branches. However, there would still be a direct impact on the parent banks' balance sheets and there could be a significant impact on overall group profitability on an ongoing basis.

25. **As is well known from the experience in other countries, problems can easily arise for banks in respect of foreign currency loans to domestic customers even where the banks themselves are fully hedged.** Significant adverse exchange rate movements will impact on the borrowers' solvency, and thus on their ability, and sometimes their incentives, to repay. The banks are in general well aware of these risks and seem to be monitoring and controlling them adequately. It is notable that there are typically features of these loans in Austria that limit the risks involved, especially for the lenders. Banks generally require among other things: a greater degree of collateral than they would on a euro loan; the ability of the borrower to service a loan of the same amount in euros; and an option of unilaterally switching the loan to euros if there is sufficient movement in the underlying exchange rate. Another mitigating factor is that the likelihood of substantial defaults in the short term is not that high, since households are generally not highly leveraged, and many of these loans are long-term mortgages that could be restructured if necessary (e.g., maturities lengthened). Also, similarly to the lending banks, borrowers often have an option to redenominate loans in euros on interest rate reset dates thus enabling them to limit any foreign exchange losses.

26. The authorities have reviewed the foreign currency lending issue in detail.³

While they feel that the risks are generally well known, monitored and adequately controlled by the banks, they have nevertheless taken a number of preventative measures, including issuing guidelines to the banks on lending in foreign currency and on loans involving repayment vehicles.⁴ They have also mounted a publicity campaign to raise borrowers' awareness of the risks from these loans and are introducing a legal amendment to strengthen consumer protection provisions. While these measures together with the recent significant switch from the more volatile yen denominated loans to Swiss franc loans should help control the risks arising from these loans, ongoing vigilance by the authorities will be needed to ensure that banks, especially some small banks which are relatively heavily exposed to these loans, are managing these risks appropriately.

B. Risk Management by Banks

27. The large systemically important banks have made major strides in implementing evolving best practices in risk management. Three of the large banks have adopted, with the approval of the FMA and subject to rigorous ongoing validation requirements, internal value-at-risk models for market risk exposures. All the banks are well advanced in their preparations for Basel II. However, the process needs to be monitored on an ongoing basis.

28. The tiered pillars provide some advantages in stability and soundness. Each pillar has developed a self-supervision system combining internal audit support, external audit, an early warning system and the statutory deposit insurance system. The risk management standards and information technology systems of the smaller banks have been aligned with international standards through centralized provision of services by the relevant apex banks. More important, the financial and reputation risk exposure to other members of the pillar, should an individual bank fail, encourages prompt action within the pillar to address emerging problems.

C. Stress Tests

29. The FSAP team undertook a range of stress tests in conjunction with the Austrian authorities aimed at assessing the extent of credit, market, liquidity and

³ See, for example, *Financial Stability Report 4*, Austrian National Bank, Vienna, 2002.

⁴ Repayment vehicles can be associated with mortgage loans where the principal is repaid in a single payment on maturity of the loan, rather than by instalments over the term of the loan. In some cases of such loans, the borrowers make regular payments into an investment fund or other repayment vehicle during the term of the loan so as to have generate funds to repay some or all of the loan on maturity. The use of such vehicles gives rise to risks for the borrower depending on *inter alia* the kinds of investments made with the funds invested in them, and the assumed rates of return at the outset. If the actual rate of return turns out to be lower than was assumed, the amount available on maturity will be lower than expected.

interbank contagion risks facing the banking system.⁵ Specific tests were carried out to assess the banking system's exposure to credit risks arising from: (a) the impact on borrowers of a possible protracted recession in Austria; (b) possible adverse developments in the CEEC economies; and (c) the high levels of foreign currency lending in the domestic market. The tests covered the banking sector as a whole, the major pillars (joint-stock banks, savings banks, the Raiffeisen banks, and others) and groupings chosen in response to specific stress test scenarios (e.g., systemically important banks, regionally active banks, and banks with high exposure to foreign currency lending).

30. **Overall, the stress tests confirm the resiliency of the Austrian banking system to large but plausible shocks (Box 4 and Table 5).** In large part, this reflects the high level of capitalization, which stood at 14.4 percent for the system as a whole as at end-December 2003. Credit risk was found to be the most important risk facing the banking system (market and liquidity risks were modest). Even so, credit risk was not high. The combined impact of the three credit risk scenarios described above resulted only in a 9.4 percent decline in banks' capital, so that CARs remained well above 8 percent for virtually all banks. The exceptions related to a limited number of small banks significantly exposed to the CEEC countries or to foreign currency lending. Even in these cases, CARs did not fall far below 8 percent.

D. Supervision and Regulation

31. **Austria enjoys a high standard of supervision based on strong institutions and a comprehensive and modern legal framework (Box 5 and Annex).** The consolidation of supervision in the new Financial Market Authority (FMA) in 2002 has taken place smoothly.⁶ The FMA is a young organization, and faces the challenge of building institutional capacity with the benefit of not being bound by a pre-existing structure. This should prove a benefit as the FMA implements a process to coordinate banking and insurance supervision in the oversight of financial conglomerates.

⁵ Due to the large number of banks in Austria, only the results related to the sample of 15 systemically important banks are presented in Table 5. Confidentiality considerations meant that the actual testing computations were conducted by a working group of OeNB staff with FMA participation. The FSAP team designed the shocks used in the stress tests in consultation with the working group. All tests were run on a bank-by-bank basis, so as to compute minimum and maximum impact statistics, however the results were reviewed with the FSAP team on a summary basis, so that no individual information was revealed. All tests were conducted initially on the basis of end-September 2003 data and subsequently updated to end-December 2003.

⁶ Information on the creation and legal structure of the FMA is provided in SM/02/211, p. 16.

Box 4. Stress Tests Results

Credit risk

- *Domestic credit risk* was estimated by simulating the impact of a protracted low growth environment in Austria. This scenario was simulated using the OeNB's macroeconomic model and assuming that the low GDP growth rates experienced between 2001 and 2003 are further scaled back so as to yield a cumulative reduction of GDP of 3 percent in 2003. The impact of this economic slowdown on credit quality was estimated using econometric regressions linking Probabilities of Default (PDs) and Loan Loss Provisions (LLPs) to key macroeconomic variables. In both approaches, the impact of this prolonged slowdown appears relatively small, with a maximum reduction of 5.8 percent of regulatory capital, observed in the LLP model.
- *CEEC credit risk* was estimated by simulating a cyclical and a structural shock, that respectively assume the worst deterioration in LLPs observed in each CEEC since 1997 and an increase of LLPs of Austrian subsidiaries to the average level observed in each CEEC. Both scenarios have a small impact of 1.6 percent of regulatory capital, which largely reflects the so far relatively modest share of CEEC lending, estimated at 13 percent of Austrian banks' consolidated lending. Simulations were also run on a subsample of regionally active banks representing 44.3 percent of total banking sector assets and resulted in a 3.3 percent decline in the sample's average CAR.
- *Foreign currency lending.* A 10 percent appreciation of the Swiss franc (CHF) and a 20 percent appreciation of the Japanese yen (JPY) were considered and were converted to equivalent deterioration of servicing capacity of borrowers. The cumulative effect of both scenarios reduces banks' CAR by 3 percent, with two thirds of the effect coming from CHF loans. While the aggregate impact appears to be relatively mild, simulations on a sub-sample of banks largely exposed to foreign currency lending and representing 15 percent of banking sector assets shows an 8 percent decline in the sample's average CAR. This shock translates in 8 small banks representing 0.3 percent of total banking sector assets, going under the 8 percent limit in these scenarios.

Market risk

- *Interest rate risk.* The scenarios assume four different shocks to the yield curve: a parallel upward shift, a parallel downward shift, a steeply declining twist and a flattening twist. (These shocks were run on Euro interest rates and were also repeated for the U.S. dollar, the Japanese Yen and the Swiss Franc) The impacts of those scenarios are small, representing less than 0.4 percent of regulatory capital, with the only exception of the 130 basis point Euro parallel shift, which results in a 4 percent decline in regulatory capital.
- *Equity price risk.* The exposure of Austrian banks to equity prices was tested by simulating a 30 and a 35 percent decline in the local and the foreign stock markets respectively. The very small exposure of Austrian banks to equity prices (0.5 percent of total assets) explains why the cumulative impact is only 2.6 percent of regulatory capital.
- *Exchange rate risk.* Movements in the U.S. dollar, the Swiss franc, the Japanese yen and CEEC currencies were simulated separately and were cumulated in a "worst case" scenario, assuming the worst combination of exchange rate changes. This adverse scenario does not reduce regulatory capital by more than 1 percent, which reflects the generally modest net open position in foreign currencies, estimated at 2.2 percent of capital at end-December 2003. This is due to the fact that foreign currency lending by Austrian banks is generally financed by borrowing in the same currency.

Liquidity risk: The stress test simulated the impact on banks' liquidity of large withdrawals of customer and interbank deposits as well as of large decline in the value of important liquid assets like government bonds. The impact on banks' liquidity ratios is generally small.

Interbank contagion risk: This risk was investigated by using a model previously developed by the OeNB to assess the potential for contagion in the Austrian interbank market arising from the specific event of insolvency of a single bank. The results show that the risk of this form of contagion is minimal.

Table 5. Summary of Stress Test Results
(end-December 2003)

Scenario/Risk Considered	Size of Shocks			Average CAR	Effect on Capital Adequacy Ratio				
				All banks	Min. CAR Sample	Max. CAR Sample	Average Sample		
				(Unless Otherwise Indicated)					
Credit Risk				<i>Percent change</i>		<i>Percent change</i>			
Baseline				14.4	...	9.0	18.8	...	
Total credit risk				13.1	-9.4	-8.9	
Of which									
Domestic credit risk	3-yr. recession scenario; LLP approach			13.6	-5.8	8.6	18.5		
	3-yr. recession scenario; PD approach			14.1	-2.6	8.8	18.6	-2.2	
Credit risk in CEECs ^{1/2/}	Cyclical shock			14.2	-1.6	7.9	16.9	-3.3	
	Structural shock			14.2	-1.5	7.5	17.4	-3.1	
Credit risk related to forex loans ^{3/}	10 percent appreciation CHF			14.2	-1.9	8.9	18.7	-4.9	
	20 percent appreciation JPY			14.3	-1.1	9.0	18.8	-2.9	
Interest Rate Risk									
Baseline									
Shock to Euro yield curve	short term	medium term	long term						
Parallel upward shift	130	130	130	13.8	-4.2	8.1	17.6	-4.1	
Parallel downward shift	-130	-130	-130	15.2	5.0	10.0	21.9	4.9	
Steepening twist around 3 yrs.	-70	0	30	14.4	-0.4	8.9	18.4	-0.3	
Flattening twist around 3 yrs.	70	0	-30	14.6	1.2	9.3	20.2	0.9	
Shock to USD yield curve									
Parallel upward shift	110	110	110	14.4	-0.2	9.0	18.9	-0.3	
Parallel downward shift	-110	-110	-110	14.5	0.3	9.0	18.8	0.4	
Steepening twist around 3 yrs.	-60	0	40	14.4	-0.1	9.0	18.8	-0.2	
Flattening twist around 3 yrs.	60	0	-40	14.5	0.1	9.0	18.8	0.1	
Shock to CHF yield curve									
Parallel upward shift	150	150	150	14.4	-0.3	9.0	19.0	-0.4	
Parallel downward shift	-50	-150	-150	14.5	0.2	9.0	18.8	0.2	
Steepening twist around 3 yrs.	-50	0	80	14.4	0.0	9.0	18.8	0.0	
Flattening twist around 3 yrs.	90	0	-40	14.4	-0.1	9.0	18.9	-0.1	
Shock to JPY yield curve									
Parallel upward shift	130	130	130	14.5	0.3	9.0	18.9	0.6	
Parallel downward shift	-20	-40	-130	14.4	-0.4	9.0	18.8	-0.8	
Steepening twist around 3 yrs.	-20	0	110	14.5	0.3	9.0	18.8	0.5	
Flattening twist around 3 yrs.	80	0	-50	14.4	-0.1	9.0	18.9	-0.3	
Equity Price Risk									
Domestic stock market crash	30% decline			14.3	-1.1	9.0	18.8	-1.2	
International stock market crash	35% decline			14.2	-1.5	9.0	18.8	-2.3	
Foreign Exchange Rate Risk									
USD	Appreciation			15%	14.5	0.1	9.0	18.8	0.1
	Depreciation			15%	14.4	-0.1	8.9	18.9	-0.1
CHF	Appreciation			10%	14.4	0.0	9.0	18.8	0.0
	Depreciation			10%	14.5	0.0	8.9	18.9	0.0
Yen	Appreciation			20%	14.4	-0.1	9.0	18.9	-0.1
	Depreciation			20%	14.5	0.1	9.0	18.8	0.1
Euro	Worst case ^{4/}			10%	14.3	-1.0	8.9	18.8	-0.8
CEECs currencies	Baseline			9.0	17.5	...	
	Worst case ^{4/}			15%	9.0	17.4	-0.3
Liquidity Risk				Effect on liquidity ratio ^{5/}					
Baseline				1.1	...	0.6	3.3	...	
Decline in value of bonds				10%	1.0	...	0.6	3.2	...
Decline in value of equities				20%	1.1	...	0.6	3.2	...
Withdrawal of short-term interbank deposits				20%	1.1	...	0.6	3.5	...
Withdrawal of short-term nonbank deposits				20%	1.1	...	0.5	3.6	...

Source: OeNB and Fund staff calculations

Note: Minimum and Maximum CAR refer to a subsample of 15 banks considered systemic (unless otherwise indicated)

1/ Total assets of banks going under the 8 percent limit are less than 2 percent of total banking sector assets.

2/ The subsample considered here covers regionally active banks and represents 44.3 percent of banking sector assets

3/ The subsample considered here covers banks largely exposed to forex lending and represents 15 percent of banking sector assets

4/ Worst case scenarios simulate an adverse exchange rate change for each currency.

5/ The liquidity ratio is defined as the ratio of liquid assets (maturity < 3 months) to short term liabilities.

Note: All interest rate risk scenarios are designed in such a way that negative interest rates are avoided.

Box 5. Main Conclusions from the Standard Assessments

BCP: Austria has a high overall level of compliance with the Core Principles. It would be beneficial if more detailed and specific prudential guidance was provided to banks. Onsite inspections and offsite analysis are of a high standard, and there is a generally high and increasing awareness of good risk management practices among Austrian banks. Area of recommended action include: (i) introduce a pre-notification requirement for major investments/acquisitions in entities other than credit institutions; (ii) increase frequency of on-site inspections, especially of the largest institutions; and (iii) strengthen the prudential rules for connected lending

IAIS: Austria has a well defined regulatory and supervisory structure and resources are currently adequate in the insurance sector. There is also a strong auditing and legal/judicial framework in place. The actuarial profession is potentially strong but needs to upgrade its practices. There is the need to (i) develop detailed regulations/guidelines on internal control and procedure and enhance on-site inspections; (ii) improve technology for both non-life, long tail technical reserves and life insurer overall prudential management; and (iii) strengthen the supervisory unit responsible for the Pensionskassen (second pillar of the pension system).

IOSCO: The overall quality of the supervisory framework for securities markets in Austria is very good, but there are some aspects of enforcement that could be further improved. Most of the gaps in the areas of international cooperation and market manipulation will be removed with implementation of the Market Abuse Directive in October 2004. Other recommendations include (i) making the FMA responsible for the depositing of prospectuses for public offering and (ii) giving consideration to raising the size of administrative fines which can be imposed by the FMA

AML/CFT: Austria has made significant progress in the past few years in bringing its anti-money laundering and combating the financing of terrorism (AML/CFT) regime into compliance with international standards, and the overall legal and institutional framework currently in place is comprehensive. Nevertheless, Austria's AML/CFT regime would benefit from certain improvements, such as (i) more clarity in the legal provisions defining suspicion of money laundering and the obligation to screen unusual transactions; (ii) further guidance to financial institutions on AML/CFT duties, in particular on the identification of customers; (iii) enhanced monitoring of compliance by the supervisors in all sectors subject to AML/CFT obligations, including through on-site inspections; (iv) sustained supervisory attention during the process of phasing out anonymous passbooks.

32. **The OeNB continues to undertake some aspects of on-site supervision on behalf of the FMA.** Supervision also relies heavily on banks' own auditors. The FMA is gradually building up its on-site supervisory capacity. The Financial Market Committee, which comprises representatives of the FMA, the OeNB and the MoF, provides a formal basis for high level interagency communication, and the "Coordination Forum" has been effective in coordinating on-site supervision. The FMA also cooperates effectively with supervisors in other countries (both European Community and third countries) in supervising the licensing and activities of Austrian banks in those countries and of their banks in Austria.

33. **The main areas where the FSAP team felt that the supervision and regulatory framework could be further strengthened relate to a need for: (a) more detailed or specific prudential guidance to financial institutions in some areas; and (b) a strengthened focus on on-site inspections, especially for the most systemically important institutions.** Ongoing reforms and EU directives in the pipeline will address most of the

team's recommendations. In addition, the team felt that the supervisory authorities should seek to resolve several outstanding legal issues, in particular the public liability of supervisors, and further strengthen the AML/CFT regime. The team also felt that the FMA should be given a broader regulation-making authority to expeditiously deal with issues not foreseen in the drafting of legislation. This would permit issues to be addressed without either a legislative amendment or reliance on non-binding guidelines.

On-site inspection program

34. **The program of on-site examinations can be further enhanced through coordinated implementation of the planned increase in supervisory resources.** Given the involvement of both the OeNB and FMA in on-site work, it will be important to develop a clear plan for the future division of this work, ensuring that the supervisory resources are domiciled in the most appropriate institution and consistent with the legal mandate of each institution. Maintaining or even enhancing the current high level of coordination and cooperation between the FMA and OeNB will be important in continuing to demonstrate that the involvement of two institutions is not an impediment to effective supervision. The FMA also needs to build adequate capacity and depth in this area, while still effectively leveraging on the experience of OeNB. Moreover, given the large number of banks, the allocation of supervisory resources needs to be carefully prioritized.

35. **The systemically important banks, whether part of a tiered pillar or not, should be the principal focus of on-site programs.** At the same time, of course, all banks should be inspected at some stage.

Conglomerates

36. **There are important linkages between the banking and insurance sectors.** The mapping exercise completed by the FMA is extremely valuable in identifying the extent of ownership linkages, many of which occur in the structure of very complex groups. Other linkages may be even more important. For example, the many life insurance companies are highly dependent on the associated banks as a distribution channel, making the companies more dependent on the bank relationship than a simple look at ownership stake would suggest. In this context, the FMA quite rightly intends to use a broad definition of "financial conglomerate" for supervisory purposes. The decision by the FMA to introduce a new "integrated supervision" department in early 2004, to be responsible for the supervision of financial conglomerates as well as monitoring the linkages between different parts of the financial sector, is welcome.

Securities markets

37. **The overall quality of the supervisory framework for securities markets in Austria is very good, but there are a few areas that could be further improved.** The FMA relies heavily on external auditors to undertake supervision. Although there is no evidence that this approach results in inadequate standards of supervision, additional staff would enable the FMA to take a more direct approach. As with other areas of financial

market supervision in Austria, the size of administrative fines which can be imposed by the FMA are relatively low, which tends to limit their role as a regulatory tool. It is difficult, however, to increase the size of fines as they are required under Austrian law to be in line with other administrative fines and cannot currently be higher than criminal penalties. The supervisory framework could also be strengthened by broadening the definition of price manipulation, and increasing maximum fines.

Governance issues

38. **Governance in the financial sector should continue to be enhanced in line with emerging international best practices.** The voluntary code of corporate governance, which is mandatory for listed companies on the stock exchange, could be made fully mandatory for financial institutions; the role of the internal audit function would be further strengthened if it reported to the supervisory board rather than the management board, and a formal fit and proper requirement should be introduced for supervisory board members.

AML/CFT issues

39. **Austria has made significant progress in the past few years in bringing its anti-money laundering and combating the financing of terrorism (AML/CFT) regime into compliance with international standards.** The overall legal and institutional framework currently in place is comprehensive, and Austria has achieved a good level of compliance with the FATF 40+8 Recommendations. Though there has been significant progress overall, the assessment identified several areas that could be strengthened, including the need for: further guidance to financial institutions on AML/CFT duties, in particular on the identification of customers, and greater clarity in some of the related legal provisions; enhanced monitoring of compliance by the supervisors; and sustained supervisory attention during the process of phasing out anonymous passbooks.

IV. MEDIUM-TERM CHALLENGES

A. Profitability in the CEECs

40. **Banks' margins in the CEECs countries would be expected to narrow with greater market access and competition following their integration with the rest of Europe.** Offsetting this, financial deepening will continue to occur in the CEECs, since bank asset to GDP ratios are still significantly lower than in the EU, thus contributing to banks' profits. The Austrian banks are well aware that this situation requires continued monitoring and vigilance. Further consolidation and increased efficiency in domestic Austrian operations will be important to offset any reduction in CEEC profitability, and the banks are taking steps to achieve these goals.

B. Phasing Out of State Guarantees

41. **In contrast to the situation in Germany, the impact of the phasing out of state guarantees agreed with the European Commission (EC) will be relatively small, with**

only the Hypo banks (mortgage banks) being materially affected. The funding cost advantage arising from the guarantees, which market participants estimate in the range of 10 to 50 basis points, will disappear. These banks have already responded by seeking a legal amendment allowing the establishment of a funding vehicle (*Pfandbriefstelle der Oesterreichischen Landes-Hypo*) to permit issuance of instruments covered by low risk (e.g., sovereign risk) assets, which will thus be rated highly. The overall low proportion of Austrian bank assets affected by the removal of the state guarantee, the long phase out period envisaged, and the adjustment underway mean that the stability implications of the EC decision will be manageable. Nevertheless, future recourse to covered bonds would engender increased risk albeit small to the system, mainly reflecting the pledging of the lowest risk assets in the system in support of the bond issues (Box 6).

C. Deposit Insurance

42. **Ongoing change in the banking sector may require changes to the sectoral approach to deposit insurance in the medium term.** It would be difficult to deal with a large problem bank quickly under the current framework, as effectively every bank in Austria would have to be consulted, likely resulting in widespread public knowledge of the financial distress. This would increase the probability of a decision to use public funds to support a quick and non-disruptive solution, such as an assisted merger or recapitalization and to avoid the initial problem becoming a systemic banking crisis. A revised deposit insurance system could help to resolve these potential difficulties in dealing with financial distress in a large problem bank. Moving over the medium term to a single system-wide scheme would avoid some of the complications and uncertainties of the current sectoral system.

43. **In the more immediate future, however, some consolidation may be appropriate for the Hypo and commercial bank deposit insurance schemes at least.** The phasing out of the state guarantees for the Hypo banks will increase the probability of deposit insurance claims in the unlikely event of a Hypo bank failure. With only nine members of the Hypo bank deposit insurance scheme, the cost of deposit insurance claims could be relatively high for the other members, thus quite possibly exceeding the assessment cap for these members, in which case the costs would spill over into other the other pillars' deposit insurance schemes.

44. **Deposit insurance could also become an issue in the commercial bank pillar as there are several factors that differentiate this scheme from those for the other banking pillars.** One of the members of the commercial bank deposit insurance scheme is very much larger than the other members. Another factor is the absence of a centralized oversight of the pillar by the scheme.

Box 6. Existing System of State Guarantees

According to the provisions of the Savings Bank Act (for the savings banks) and the Statutes (in case of mortgage or Hypo banks), liabilities of these institutions benefit from a guarantee from the regional (Federal Provinces) or local authorities (communities). The guarantees, which are neither limited in duration nor to a certain amount, take the form of an obligation for the State (at a regional or municipal level) to step in should the bank become insolvent. Thus, the bank's creditors have a direct claim against the respective province or municipality. The guarantor (the respective province or municipality) can, however, only be called upon should the assets of the bank prove insufficient to satisfy all creditors (*deficiency guarantee*).

In line with an agreement reached earlier with Germany, the EC adopted a formal decision in January 2003 proposing Austria phase out state guarantees. This decision affected 22 municipal savings banks and 7 mortgage banks, which together account for less than 10 percent of the assets of credit institutions in Austria. The regional mortgage banks affected account for less than 7 percent of the balance sheet of credit institutions, while the savings banks affected represent only less than 3 percent

There are four key provisions to the agreement with the EC on the deficiency guarantees:

- Liabilities existing at the time of the agreement (April 2, 2003) continue to be covered until their maturity.
- New liabilities incurred during the transitional period (from April 2, 2003 to April 1, 2007) will be covered by the deficiency guarantees provided that their maturity does not go beyond September 30, 2017.
- All new liabilities undertaken starting on April 1, 2007 will not be covered.
- Austria is committed to amend its laws and adopt by end-September 2004 proposals for the necessary legal measures abolishing state guarantees in the Austrian banking sector.

D. Issues in Insurance and Pensions

45. **While the insurance sector has performed well relative to those in many other developed countries in recent years, the sector's cushion for safety has nevertheless been significantly reduced.** Further, the sector now faces new financial pressures, and in the case of the life segment, thin margins. While the closer monitoring by the FMA of the most affected segment of the industry and the decision to further reduce, effective January 2004, the minimum guaranteed crediting rate (the interest rate offered on investment type insurance policies) to 2.75 percent are important steps in the right direction, more is needed to provide the sector with a desirable margin of safety.

46. **Consideration should also be given to:** (i) accelerating the move that is already underway in the FMA to risk-based supervision of the insurance sector, including enhanced monitoring of solvency, so as to ensure that insurance companies' methodologies and techniques evolve in parallel with the development of new and riskier insurance products; (ii) improving reserving and pricing for the long-tail non-life classes, while working with the MoF to ensure that the tax regime does not present a disincentive for technical reserve strengthening; and (iii) enhancing and upgrading the actuarial and the auditing professions as

regards assessments of the overall financial position of life insurers, and long-tail liabilities for non-life insurers.

47. **Several steps should be taken to address some weaknesses in the second pillar occupational pension plans (the *Pensionskassen*).** In particular, there is a need to:

(i) improve smoothing of reserves, which are currently low following a number of years with negative returns; and (ii) move away from investing defined benefit, defined contribution, and retiree funds in the same investment pool, since this practice goes against the lifecycle stage of the members, despite efforts to apply asset allocation policies which “average” the needs to the various constituencies. The FMA is aware of these issues and has taken some steps to more closely monitor the capital adequacy of the *Pensionskassen*.

48. ***Zukunftsvorsorge*, a new state-sponsored savings product, has recently been introduced to promote the Third Pillar and boost the local capital market.** From the investor point of view the product has many attractive features, including a government subsidy in the form of a premium, a guaranteed return, a tax incentive, and a relatively short lock-in period (10-year term). From the financial sector point of view, however, the *Zukunftsvorsorge* carries some risks for the issuing institutions, and possibly for the system as a whole. The risks emanate from: (i) the need to provide the guarantee; (ii) the relatively short lock-in period; and (iii) the requirement that 40 percent of the contributions be invested in securities listed on an eligible exchange in the European Economic Area with capitalization below 30 percent of GDP.⁷

49. **The FMA has appropriately issued a regulation requiring insurance companies** either to establish additional reserves or hedge contingent liabilities to investors arising from the new savings product through an external capital guarantor. The intention to issue a similar regulation to banks in 2004 is welcome.

E. Payment System

50. **Improvements may also be possible to the efficiency of the payment system, which would in turn support improved profitability.** The institution of the nationwide ATM network to which all banks belong has been a successful initiative. Consideration could also be given to whether a greater degree of centralization in the system for domestic payments would be more efficient than the current system of bilateral correspondent accounts.

⁷ At the time the FSAP was undertaken, only the Vienna Stock Exchange met this criterion. From May 1, 2004, however, exchanges in other countries that joined the EU on that date also qualified, but it is not clear how attractive they will be compared with a local investment in the Vienna Stock Exchange.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

The annex contains summary assessments of international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system.

The following detailed assessments of financial sector standards were undertaken: the Basel Core Principles for Effective Banking Supervision (BCP) by Messrs. Michael Andrews (IMF-MFD Consultant) and Göran Lind (Sveriges Riksbank); the IAIS Insurance Core Principles assessed by Mr. Rodney Lester (insurance supervision expert, World Bank) on the basis of the new IAIS Methodology approved in October 2003; the IOSCO Objectives and Principles of Securities Regulation assessed by Ms. Susanne Bergsträsser (securities expert, German Financial Supervisory Authority); and the FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations on Combating the Financing of Terrorism (FATF 40+8 Recommendations) by Messrs. Kiyotaka Sasaki (IMF, MFD), Mr. Peter Csonka (IMF, LEG), and Kent Madstedt (Chief District Prosecutor, Economic Crimes Bureau, Sweden).

Austria enjoys a high standard of supervision based on strong institutions and a comprehensive legal framework. The consolidation of supervision in the new Financial Market Authority (FMA) in 2002 has taken place smoothly. The FMA is a young organization, and faces the challenge of building institutional capacity with the benefit of not being bound by a pre-existing structure.

REPORT ON OBSERVANCE OF STANDARDS AND CODES: BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

General

51. The assessment of implementation of the Basel Core Principles for Effective Banking Supervision (BCP) was conducted within the framework of the Financial Sector Assessment Program for Austria. A BCP assessment requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision. The assessment team⁸ received the full cooperation of its counterparts and all information required.

Institutional setting

52. The Financial Market Authority (FMA) is the agency responsible for the prudential supervision of banks. The Austrian National Bank (OeNB) has a number of legal responsibilities in the field of banking supervision and therefore has an important role, e.g., mandatory on-site examinations of credit and market risk upon the authorization of the FMA (these examinations are performed by the OeNB on its own accountability and in its own name), data collection and processing, and rendering expert opinions.

⁸ Michael Andrews (IMF-MFD Consultant) and Göran Lind (Sveriges Riksbank).

General preconditions for effective banking supervision

53. Austrian banks have benefited from a domestic economy characterized by sound macroeconomic policies. Despite the recent slowdown, unemployment rose only slightly, reflecting in part the benefits from increasing Austrian investment in the growing transition economies in Central and Eastern Europe Countries (CEECs). These opportunities have been particularly important for Austrian banks, as the income in the mature and over-branched domestic market has been relatively low.

54. Government infrastructure is well developed. There is a broadly appropriate body of commercial and banking law, and respected judiciary. Accounting standards established by the Austrian commercial code are consistent with the European Union accounting directives. The larger banks, and also many of the larger commercial companies, have voluntarily adopted International Accounting Standards (IAS) for their consolidated statements. Those listed on the senior board of the Vienna Stock Exchange are required to use IAS.

55. The principal components of the safety net are the deposit insurance schemes of each pillar of the banking industry, and the mutual support arrangements in place for the tiered pillars. Deposit insurance to a limit of €20,000 is provided on a sectoral basis, with banks being legally required to belong to the deposit insurance scheme for their pillar, and being assessed after the fact on a formula based on their size for any required deposit insurance payments. In addition, there are mutual guarantee agreements in the savings bank and cooperative pillars that make the individual member banks jointly and severally liable for the deposits of all banks in the pillar. The law provides the supervisory authority with a full range of tools and sanctions for dealing with problem banks.

Main findings

56. Austria has a high overall level of compliance with the Core Principles. Some legal amendments are required to reach full compliance, and in several areas it would be beneficial if more detailed and specific prudential guidance was provided to banks. The FMA and OeNB coordinate and cooperate well, and despite being a young organization, the FMA has made a strong start in building supervision capacity. On-site inspections and off-site analysis are of a high standard, and there is a generally high and increasing awareness of good risk management practices among Austrian banks.

Objectives, autonomy, powers, and resources (CP 1)

57. There is a generally appropriate body of banking laws and regulations. Both the FMA and OeNB enjoy operational independence, and have mandates clearly defined in law, as well as legal provisions for coordination and information sharing. The banking law provides a range of available remedial powers, and there is legal protection for individual supervisors discharging their duties in good faith. One particular concern is a recent court decision finding the federal government liable for losses in a bank failures due to shortcomings of an external auditor performing supervisory duties prescribed in the banking act. This potentially

makes government (or possibly the FMA) liable for all losses in bank failures. The role of supervision is to ensure orderly exit of weak banks, not to prevent all failures and losses. Only in the case of gross dereliction of duty should the supervisory authority (or government) be potentially liable for depositor and creditor losses in bank failures.

Licensing and structure (CPs 2–5)

58. The licensing regime is well developed and appropriate, as is the process for review of change in ownership of significant shareholdings in banks. One shortcoming in this group of principles is the lack of a pre-notification requirement for major acquisitions and investments of credit institutions in entities other than credit institutions. Such a requirement is not intended to substitute the supervisor's commercial judgment for that of bank management, but would ensure that the supervisor could prohibit legal structures likely to inhibit effective supervision, or investments where the supervisor is not satisfied that sufficient information will be provided on an ongoing basis to permit proper evaluation of the risks to a banking group arising from nonbank activities.

Prudential regulations and requirements (CPs 6–15)

59. There is a generally high level of compliance with these principles, but in several instances the supervisory regime would be strengthened by the promulgation of more detailed guidelines for banks in managing risks, including prevention of the use of banks by criminal elements. The *Banking Act* (BWG) provides good high level guidance regarding the responsibilities of the management and supervisory board, but more specifics regarding the minimum standards banks must meet for internal processes and controls would be helpful to banks, and also to external auditors by clearly establishing the yardstick by which banks should be assessed. The definition of parties related to a bank should be expanded to include significant shareholders. The role of the supervisory board, and qualifications of its members, should be enhanced by making the *Austrian Code of Corporate Governance* fully mandatory for credit institutions—substantial parts of the Code are already mandatory as they are covered in various laws, primarily the *Austrian Joint Stock Companies Act* and the *Act on Companies with Limited Liability*. It would also be better if banks' internal audit functions were required to report to the supervisory board (or a committee thereof) rather than to the management board, although this would require amendment to company law more generally as well as the banking statutes.

Methods of ongoing supervision (CPs 16–21)

60. There is a well structured off-site analysis function and the depth of risk analysis of on-site work is greater than might be suggested by the bare provisions of the legal framework. The external auditors' bank supervision annual report is a crucial part of the supervisory framework. The current plan of conducting an FMA or OeNB on-site examination of one large bank each quarter provides insufficient coverage, and resources should be increased to permit examination of all systemically important banks on a one-to-two-year cycle in addition to the external auditor's annual report.

61. A formal process is needed within the FMA to coordinate banking and insurance supervision with respect to conglomerates, and to systematically assess the risks to banking groups from nonbank activities. This need should be addressed by the new Integrated Supervision Department which was created in the FMA in January 2004 to be responsible for financial conglomerates and risk transfer.

Formal powers of supervisors (CP 22)

62. A broad range of remedial powers is provided by law to the FMA, including explicit requirements to take prompt action in serious cases such as insolvency. However, in less obvious but important cases, the legal system puts a high burden of proof on the supervisor before action, which may subsequently be challenged in court. This could conceivably lead to a tendency for the supervisory authority not to take remedial action until all possible evidence has been gathered. In practice, however, there is no evidence of undue delays.

Home-host supervision (CPs 23–25)

63. Austria has a sound regime for home and host country supervision, including memoranda of understanding with many foreign supervisory authorities, a program of explicit evaluation of the risks to Austrian banks from their foreign establishments, and periodic on-site examinations conducted abroad.

Table 6. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
CP 5: Investment Criteria	<ul style="list-style-type: none"> • Introduce a pre-notification requirement for major investments/acquisitions in entities other than credit institutions (for which pre-notification already exists in the case of qualifying participations).
CP 10: Connected Lending	<ul style="list-style-type: none"> • Establish a requirement for transactions with related parties to be undertaken on market terms and conditions. • Explicitly require banks to have dedicated credit administration for related party transactions. • Include significant shareholders in the legal definition of related parties.
CP 13: Other Risks	<ul style="list-style-type: none"> • Introduce guidelines on interest rate risk, operational risk and the ability to require capital to be held against risks in addition to credit and market risk.
CP 15: Money Laundering	<ul style="list-style-type: none"> • The recent promulgation of the guidelines on AML/CFT to banks is an important step forward, which should be used as the yardstick for verification by external auditor and in on-site examinations. It is also important to build on this step through additional guidelines and follow-up.
CP 16: On and off-site Supervision	<ul style="list-style-type: none"> • Increase frequency of on-site inspections, especially of the largest institutions.

Reference Principle	Recommended Action
CP 20: Consolidated Supervision	<ul style="list-style-type: none"> • Establish procedures and structure within FMA to coordinate banking and insurance supervision for conglomerates, including cases falling outside the EU conglomerate definition. The creation of the new Integrated Supervision Department should fulfill this recommendation. • Routinely assess the risks to banking groups from nonbank activities, including those undertaken in insurance and non-financial affiliates.

Authorities' response

64. The Austrian Ministry of Finance, the Financial Market Authority and the Oesterreichische Nationalbank are grateful for the fruitful discussion with the IMF and appreciate the IMF conclusions and results which point out that the Austrian financial sector is stable and sound, as verified by the comprehensive stress tests carried out commonly by IMF and OeNB, and that it is overall supervised in compliance with the Basel Core Principles for Effective Banking Supervision.

65. **Investment criteria.** In reaction to the IMF's recommendation, the MoF has drafted a bill amending the Austrian Banking Act (BWG) stipulating that a special involvement of the FMA via a permission or notification is needed if a bank undertakes a relevant investment (acquisition surpassing a certain threshold of voting rights or share capital) in an entity other than a credit institution. This proposal is currently under discussion.

66. **Guidance and on-site supervision.** In autumn, the FMA already introduced minimum standards for the management of foreign currency loans. Currently, the FMA prepares minimum standards (for Internal Audit and for Credit Business) and guidelines on AML/CFT (Internal control and procedures as well as suspicious transactions reporting). The FMA and the OeNB jointly work on a series of Best Practice Papers ("Leitfäden") in various fields (i.e., Risk Management of Securitization, Rating Models and Validation, Credit Risk Management, Credit Risk Mitigation Techniques).

67. The FMA and the OeNB plan to increase the total number and frequency of on-site inspections, starting with the inspection plan for 2004. The FMA has also highly increased the number of Management Discussions with the senior management of banks.

68. **Consolidated supervision.** As of January 1, 2004, FMA has created a new department, "Integrated Supervision" to take fully into account the linkages between the banking and insurance sector, among others. This department will be responsible for financial conglomerates and risk transfer within the group. This goes much beyond simply developing a formal internal process. Furthermore Austria is currently transposing the EC Directive on Financial Conglomerates into Austrian Law; the provisions will enter into force from January 1, 2005.

IAIS INSURANCE CORE PRINCIPLES

General

69. This assessment was carried out between October 22 and October 31, 2003 within the framework of the Financial Sector Assessment Program for Austria. The IAIS Methodology approved earlier in October 2003, together with an IMF/World Bank Template based on this Methodology, was employed in preparing this assessment.

70. The assessment reviews the compliance of Austrian insurance law (including supporting regulation and rules) with modern insurance supervisory concepts, which rely on a multi-pillar approach involving prudential supervision, corporate governance and transparency of the markets. In addition, it examines the effectiveness of the supervisory body, which in Austria's case is the Insurance and Pensions Supervisory Department of the Austrian Financial Markets Authority (FMA). This department carries out most insurance supervisory activities, although certain legal and enforcement issues are dealt with in another department of FMA, and direct supervision of intermediaries lies with another arm of federal government and local government. Governing insurance law is the responsibility of the Ministry of Finance (MoF).

Institutional and macroprudential setting

71. The Austrian insurance sector has 54 locally licensed players and two non-EEA branches (ignoring the relatively tiny rural mutual insurers) which actively compete. Following a bout of consolidation in the 1990s it has recently demonstrated a remarkable level of stability in its industry structure with five insurers tending to dominate. Two of these are overtly foreign (one Italian and one German) and two have links to other German institutions through shareholdings in associated banks.

72. All major insurers are associated with local banking groups, although the arrangements could hardly be characterized as bancassurance: there is fierce competition between the banks and insurers in the emerging market for individual pension products and alliances have changed in the recent past. Rather these linkages involve efficient use of distribution systems, and the banks see fee income as generating at least 40 percent of gross revenues in the future.

73. The non-life sector is mature, but the life segment operates at approximately half its potential when compared with peer countries in Western Europe. A life insurance penetration (premiums divided by GDP) of 2.75 percent in 2001 places Austria at 29th position in the world, behind Portugal. This no doubt reflects the relatively generous social insurance system currently operating in Austria. A voluntary supplementary second pillar employer-based pension system established in the early 1990s engages a separate class of institution, called Pensionskassen (pension companies), which are joint stock companies mainly owned by banks or insurers, but with characteristics very similar to life insurance.

74. The insurance industry has historically produced adequate profits, but a combination of natural disasters (the 2002 floods), price competition in the non-life sector and falling asset markets and returns have introduced new financial pressures and, in the case of life insurers, seen a significant reduction in safety margins. There is some evidence that long tail classes such as motor bodily injury third party and medical malpractice show chronic poor run-off patterns and there appear to be grounds for improving reserving and pricing technology for these classes. However, a tax regime which does not allow full deductibility of non-life technical reserve strengthening could inhibit the implementation of such technology.

75. While Austrian traditional life insurance products have similar characteristics to those sold in other countries influenced by the German model (that is minimum guaranteed bonus rates), Austrian life insurers have fortunately adopted a relatively conservative investment policy over the last decade. The minimum guaranteed crediting rate was increased from 3 percent to 4 percent only in 1995, and the reduced again to 3.25 percent in mid-2000. Thus, while the life insurance sector performed poorly in 2002, it did so to a lesser extent than was the case in some other jurisdictions.

76. A new third pillar pensions contract involves some difficult technical issues and the FMA, with MoF support, has required that insurers writing the product set up special reserves using a VAR methodology, unless the risk is laid off to a bank. In practice, most of the market risk has to date been transferred to the banking sector.

Main findings

77. Austria has performed well against the new, much more demanding, IAIS assessment methodology.

Conditions for effective insurance supervision

78. There is a strong auditing and legal/judicial framework in place. The actuarial profession is potentially strong but needs to upgrade its role to cover the overall financial position of life insurers and to at least opine on long tail liabilities for non-life insurers. This will require further strengthening of the professional infrastructure and updating and broadening of the training process. Domestic capital markets are currently rather thin and are the subject of an active development program.

The supervisory system

79. Austria has a well defined regulatory and supervisory structure and resources are currently adequate in the insurance (but not pensions) supervisory arm of the FMA, although the industry levy being charged appears low by international standards. However the FMA, while a young organization, has already been faced with the implications of the legal interpretation of its responsibilities in the courts and has had to maintain relevant liability insurance coverage.

The supervised entity

80. Austria satisfies most requirements under this heading. The bicameral board structure creates some issues in applying the governance CP. However the introduction of a voluntary Code of Corporate Governance in Austria has pointed to a growing role for the supervisory board of an insurer in monitoring risk.

Ongoing supervision

81. Austria meets most ongoing supervision requirements.

Prudential requirements

82. Prudential requirements are somewhat stronger than EU minima, and a form of asset-based stress testing for life insurers has been introduced. However the technical reserving methodologies and techniques currently being used are unlikely to be adequate in an increasingly risky market involving more complex life insurance product structures and greater exposures to volatile assets. In addition, there has in recent years been some mild forbearance for life insurers on both asset and liability sides of the balance sheet, although the life industry still appears to satisfy statutory solvency requirements at the aggregate level.

83. Early intervention mechanisms are specifically anticipated by the law, however these tend to be applied on an ad hoc basis: there are no written statements as to how this process will operate in practice. Documenting the process would help to ensure consistency and transparency.

Markets and consumers

84. While formal supervision of intermediaries does exist in Austria, the insurance supervisor has only an indirect overview of agents and brokers, through its supervision of insurers. Consumer protection also tends to be handled through separate law and agencies, although the FMA is able to receive complaints and attempt to resolve them. However it has no formal powers in this regard.

Anti-money laundering, combating the financing of terrorism

85. Apart from Section 18a of the Insurance Supervision Act, there are few regulations, guidelines, guidance or manuals issued by the FMA or the Insurance Association regarding AML/CFT requirements. The latest circular by the FMA for the life insurance sector (October 2003) added some substance, however as yet there is no manual for inspections to review the compliance with the requirements for AML/CFT.

Table 7. Recommended Actions to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Conditions for effective insurance supervision	
i.e., CP 1	Upgrade role of responsible actuary to include reporting overall financial position of life insurers. Institute relevant standards and professional development.
The supervisory system	
i.e., CPs 2–5	Clarify the legal liability of staff. Develop a more stable and adequate basis for funding the pension company supervisory team. Examine the long term viability of the insurance levy in light of the demands which will emerge from the rapid development of foreign subsidiaries of Austrian insurers and the immediate and medium term pressures on the life insurance sector.
The supervised entity	
i.e., CPs 6–10	Consider introducing positive fit and proper criteria related to an understanding of the business, or at least financial market matters. Suggest, or ideally require, that all substantive insurers observe the new Austrian Code of Corporate Conduct.
Ongoing supervision	
i.e., CPs 11–17	Strengthen the supervisory unit responsible for Pensionskassen. Introduce a more explicit set of rules on the circumstances under which early intervention will occur. Fines should be increased to meaningful levels.
Prudential requirements	
i.e., CP 18–23	The Supervisory Board of an insurer should be required to have an overview role with regard to underwriting policy. Technology needs to be strengthened for both non-life long tail technical reserves and life insurer overall prudential management (including DST where AML issues exist). A watching brief for the underwriting of risk through credit instruments, either on the liability or the asset sides of insurer balance sheets, should be maintained.
Markets and consumers	
i.e., CPs 24–27	A half way house claims resolution process, sitting between the FMA and the courts, should be introduced. The FMA should be given more direct influence over the licensing of intermediaries, particularly those selling complex pension products.
Anti-money laundering, combating the financing of terrorism	
i.e., CP 28	Develop detailed regulations/guidelines on internal control and procedure at insurance companies as well as enhancing on-site inspections. Consider developing an inspection manual for insurance companies in addition to those for banks and securities firms that are already planned.

Authorities' response to the assessment

86. As with the assessment of banking supervision, the assessment procedure and its outcome led to a very positive result as regards the insurance supervision system and the Austrian insurance market. This process was particularly challenging since Austria was the first jurisdiction to undergo an FSAP based on the new IAIS Insurance Core Principles. We appreciated very much the intensive discussions during the mission and the recommendations which will further strengthen the effectiveness of the Austrian Insurance Supervision system. The FMA also welcomed the proposals on how to maintain good quality supervision in a more risky environment.

87. The FMA is already working on the implementation of certain recommendations. In particular, the FMA is actively taking steps to strengthen the actuarial profession, to look more closely into the adequacy of long-tail provisioning and—more generally—to accelerate the shift toward a more risk-based supervision system.

IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

General

88. The assessment of the IOSCO Objectives and Principles of Securities Regulation was conducted in October 2003 within the framework of the FSAP for Austria. The assessment used for reference the February 2002 version of the Objectives and Principles of Securities Regulation together with the Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation adopted in October 2003 by IOSCO.

89. The assessment focuses on the powers and responsibilities of the FMA, which were assumed on April 1, 2002, under the Financial Market Authority Act (FMABG). Under this Act, the FMA is an integrated financial supervisory authority directly responsible for banking, insurance and pension funds, securities and stock exchange supervision (compliance with take-over rules is supervised by a separate authority, the Take-Over Commission, which is not the subject of this assessment). All supervisory tasks with regard to securities markets were transferred from the Austrian Securities Authority to the new supervisory body. The reform has established the FMA as an institution under public law, and its independence is secured by constitutional provision.

90. The assessment was based on: (i) a detailed self-assessment by the FMA, using the high-level questionnaire prepared by IOSCO; (ii) extensive documentation provided by the FMA including: all relevant legislation, ordinances and guidance, the annual report of FMA and relevant statistical data; and (iii) meetings with market participants including credit institutions, investment service providers, the stock exchange and industry associations.

Capital market and structural overview

91. There are five capital market segments in Austria based on type of product, transparency and disclosure requirements, and extent of market commitment. These are: (i) the equity market, which is further subdivided into a prime market and a standard market; (ii) the bond market, mainly for government, bank, and corporate bonds; (iii) a derivatives market; (iv) warrants; and (v) other listings.

92. As of end-2002, there were 91 domestic publicly listed companies. Stock market capitalization was €30.4 billion, or about 14 percent of GDP, and annual stock market turnover was about 42 percent. Compared to most other advanced countries, capitalization is low. The total volume of debt securities outstanding was €178.9 billion, or 82.5 percent of GDP. About 58 percent of all bonds outstanding are federal government issues, while nearly 39 percent are bank issues. The *Kontrollbank* acts as the clearing house for the Vienna Stock Exchange, and is the central securities depository and settlement agency.

93. Also as of end-2002, there were 339 investment service providers, providing advice concerning client funds, managing client portfolios and brokering the acquisition or sale of various financial instruments. As of August 2003, there were 23 operators of collective investment schemes managing €6.2 billion. There were 1,391 funds, of which 481 were funds of funds. In addition, there were 578 special funds; special funds are open to a maximum of ten institutional investors, and are usually tailored to the specific needs of a single investor. There were also 3,202 foreign funds from other EU states and globally that were eligible to be marketed in Austria.

General preconditions for effective securities regulation

94. The general preconditions for effective securities regulation in Austria are in place. There are no discernible barriers to entry or exit from markets or for products. Austrian accounting standards are good and comprehensive. The law permits the use of International Accounting Standards; companies listed on the prime market are obliged to prepare the financial statements according to IAS (or US-GAAP). Auditing is regulated through a mix of law and self regulation. A greater degree of supervision of the application of accounting standards by auditors by an Austrian authority would nevertheless be desirable, especially given the key role external auditors play in the supervision of credit institutions and investment services providers.

95. According to an EU-Directive on the Application of IAS (adopted 2002), all EU Companies listed on a regulated market as well as those preparing to be listed have to draw up their consolidated accounts in line with the IAS/IFRS-International Financial Reporting Standards by 2005 at the latest. For Austria that means they have to implement the 41 new accounting rules and establish an effective supervisory structure for supervising the application of the IAS/IRFS.

Main findings

96. **The overall quality of the supervisory framework for securities markets in Austria is very good, but there are some aspects of enforcement that could be further improved.**

97. **Principles relating to the Regulator (Principles 1–5).** The FMA is the single authority responsible for the regulation of securities markets and their participants in Austria. The tasks and competences of the FMA are defined in the various relevant laws. According to the FMABG, which has the standing of constitutional law, the FMA performs its tasks without being bound by any instructions from other parties. Any interference—either from the political or the commercial side—would be unlawful. The Minister of Finance (MoF) can, however, commission the FMA to conduct audits of financial institutions. While this is seen as being part of the accountability framework covering the FMA, it does appear somewhat inconsistent with the FMA’s independent status. The MoF also has the right to nominate the exchange commissioner who has supervisory responsibilities concerning exchange trading. Consideration could be given to shifting this responsibility to the FMA.

98. As with other areas of financial market supervision in Austria, the size of administrative fines which can be imposed by the FMA as administrative sanctions are relatively low, which tends to limit their role as a regulatory tool. The legislator is, however, limited in its ability to increase the size of fines as they are required under Austrian law to be in line with other administrative fines and cannot currently be higher than criminal penalties.

99. **Principles of Self Regulation (Principles 6–7).** There are no self-regulatory organizations in the securities markets in Austria.

100. **Principles for the Enforcement of Securities Regulation (Principles 8–10).** The FMA is provided with necessary inspection, investigation and surveillance powers. The FMA has the power to require the production of information and to carry out inspections of business operations. Suspicion of violation of the law is not a prerequisite to make use of these powers. The FMA can also conduct investigations and take all measures to counteract the abuse of inside information. The FMA relies heavily on external auditors to undertake supervision. Although there is no evidence that this approach results in inadequate standards of supervision, additional staff would enable the FMA to take a more direct approach.

101. **Principles for Cooperation in Regulation (Principles 11–13).** The FMA and the stock exchange which is responsible for real time, on-the-spot, surveillance of exchange trading and for exchange listing admission can exchange confidential information. The FMA has the authority to share public and confidential information with other national authorities, including on an unsolicited basis. In insider trading cases it is clear that the FMA can exchange non-public information. In other cases it is not entirely clear how far the competences extend, and they may not include market manipulation which was until recently not covered by an EU directive.

102. **Principles for Issuers (Principles 14–16).** Austrian legislation embodies international best practice regarding requirements: for full, accurate and timely disclosure of financial results and other information that is material to investors' decisions; that holders of securities in a company should be treated in a fair and equitable manner; and that accounting and auditing standards should be of a high and internationally acceptable quality.

103. **Principles for Collective Investment Schemes (Principles 17–20).** The supervision of collective investment schemes and their operators is generally of a high standard. Licenses are required for marketing a collective investment scheme (CIS) or for operating a CIS. Unit certificates may only be offered in Austria if a comprehensive prospectus has been published and deposited with the Kontrollbank. The Investment Funds Law sets out the rules governing the legal form and structure of collective investment schemes and the requirements in respect of the valuation of CIS assets. Governance will be strengthened when the quality standards which have been set up by the industry become fully compulsory in early-2004 (at present parts of the standards are compulsory under various other laws) as this will minimize any possibility of conflicts of interest leading to the disadvantage of investors in a CIS.

104. **Principles for Market Intermediaries (Principles 21–24).** The supervisory system is also of a high standard in this area. Investment services providers must be licensed by the FMA, with minimum capital requirements which vary depending on the type of business being undertaken. The FMA can refuse a license to an applicant if the authorization qualifications laid down in law are not fulfilled. Credit institutions and investment services providers must be properly organized, have appropriate internal control systems and adequate security precautions for electronic processing. Intermediaries have to act with the necessary expertise, diligence and conscientiousness in the best interest of the customers and minimize conflict of interests; cold calling is forbidden under Austrian law. However, commodity futures are currently outside the current scope of supervision regulation in Austria. This will be rectified with the implementation of the new EU directive which has been adopted (April 30, 2004).

105. **Principles for the Secondary Market (Principles 25–30).** Exchange operating companies require approval, have to fulfill requirements concerning initial capital and the fitness and propriety of the management, and undergo ongoing supervision by the FMA. Regulations are in place which promote the transparency of trading and also which aim to ensure the proper management of large exposures, default risk and market disruption. While the supervisory framework appears to have been effective, it relies in part on self-supervision by the exchange operating company which has some potential to give rise to conflicts of interest. The supervisory framework could also be strengthened by broadening the definition of price manipulation, and increasing maximum fines. With implementation of the EU Market Abuse Directive these gaps will be addressed.

106. Systems for clearing and settlement of securities transactions are subject to regulatory oversight, to ensure that they are fair, effective and efficient, and reduce systemic risk.

Table 8. Recommended Plan of Actions to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principles Relating to the Regulator (P 1–5)	Consideration could be given to whether the MoF should continue to be able to commission the FMA to conduct audits, and also whether the MoF's right to nominate the exchange commissioner who has supervisory responsibilities concerning exchange trading should be shifted to the FMA.
Principles for the Enforcement of Securities Regulation (P 8–10)	Additional staff would enable the FMA to take a more direct approach to supervision, particularly as regards to the inspections of firms. Consideration should also be given to raising the size of administrative fines which can be imposed by the FMA.
Principles for Cooperation in Regulation (P 11–13)	The rule concerning international cooperation should allow full cooperation in all matters that FMA is responsible for, including the conducting of investigation on behalf of a foreign authority.
Principles for Issuers (P 14–16)	The FMA should be responsible for the depositing of prospectuses for public offering as the competent authority in securities supervisory matter in Austria.
Principles for Collective Investment Schemes (P 17–20)	The FMA should impose an explicit obligation to disclose any pending legal proceedings involving the fund, the operator or its management which may be material to the decision to invest.
Principles for Market Intermediaries (P 21–24)	Commodity futures are outside the current scope of regulation in Austria but this will be addressed with the implementation of the new EU-Financial Investment Markets Directive which has been adopted by EU as of end-April 2004.
Principles for the Secondary Market (P 25–30)	The possibility for conflicts of interest arising from self-supervision by the exchange operating company could perhaps be addressed by giving the surveillance department of the exchange an independent status. The FMA should then also have the right to give instructions to this department.

Authorities' response

107. The Austrian Ministry of Finance and the Financial Market Authority are grateful for the interesting discussion with the IMF and appreciate the IMF conclusions and results which point out that the Austrian securities sector is of high quality, and that it is overall supervised in compliance with the international Standards and Codes for effective supervision.

108. First of all, we would like to stress that all major comments of the IMF will be addressed through implementation of the Market Abuse Directive, Prospectus Directive and the "new ISD" Directive in Austria.

109. **Comments to the Principles for the Enforcement of Securities Regulation (P 8–10).** We would like to stress that the increase of the maximum size of administrative fines is currently one of the main topics of discussion between the FMA and the MoF, especially regarding the implementation of the Market Abuse Directive in October 2004.

110. **Comments to the Principles for Cooperation in Regulation (P 11–13).** We would like to point out that all gaps that refer to international cooperation and market manipulation will be removed with implementation of the Market Abuse Directive in October 2004.

111. **Comments to the Principles for Collective Investment (P 17–20).** We do not see an urgent need, as the disclosure requirements in a CIS' prospectus as well as its annual and semi-annual reports are in full consistency with the relevant EU Directive (on UCITS, 85/611, as amended) and state that a "prospectus shall include all information required for investors to be able to make an informed assessment of the investment offered to them." Also, "Major changes in the overall conditions which may influence the assessment of the unit certificates shall be published without delay." However, the FMA can see the benefit of a more explicit obligation and will discuss this recommendation with the MoF as the authority responsible for any legal changes to the Investment Fund Act.

112. **Comments to the Principles for Market Intermediaries (P 21–24).** We would like to stress that with the implementation of the Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments ("new ISD"), which has just been adopted, a license from the FMA will be required for providing investment services regarding commodities futures.

113. **Comments to the Principles for the Secondary Market (P 25–30).** We would like to point out that within the scope of the implementation of the Market Abuse Directive, there has been discussion with the MoF regarding the surveillance department of the exchange. As a result, the FMA should be able to give instructions to this department.

FATF RECOMMENDATIONS FOR ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

Introduction

114. This Report on the Observance of Standards and Codes for the FATF *Recommendations for Anti-Money Laundering and 8 Special Recommendations Combating the Financing of Terrorism* was prepared by a team composed of staff of the International Monetary Fund and an Independent AML/CFT Expert (IAE). The IAE, who was not under the supervision of Fund staff, was selected from a roster of experts in the assessment of criminal law enforcement and non-prudentially regulated financial activities and conducted an assessment of the implementation of the criminal law enforcement elements of the

AML/CFT Methodology.⁹ *Throughout this report, portions of the assessment attributable to the IAE are shown in italicized text.*

115. The report provides a summary of the level of observance with the FATF 40+8 Recommendations, and provides recommendations to strengthen observance. The views expressed in this document are those of the assessment team and do not necessarily reflect the views of the government of Austria or the Board of the IMF.

Information and methodology used for the assessment

116. In preparing the detailed assessment, Fund staff reviewed the relevant AML/CFT laws and regulations, and supervisory and regulatory systems in place to deter money laundering and financing of terrorism among prudentially regulated financial institutions. The IAE reviewed the regulatory systems in place for other non-prudentially regulated sectors that may pose an AML/CFT risk, specifically bureaux de change, money remitters, lawyers, notaries, high-value good dealers and casinos, as well as the capacity and implementation of criminal law enforcement systems. The assessment is based on the information available at the time it was completed in November 2003 and takes into account subsequent discussions and additional information provided through May 2004.

Main findings

117. Austria has made significant progress in the past few years in bringing its anti-money laundering and combating the financing of terrorism (AML/CFT) regime into compliance with international standards. The overall legal and institutional framework currently in place is comprehensive, and Austria has achieved a good level of compliance with the FATF 40+8 Recommendations.

118. The main public sector institutions involved in AML/CFT activities in Austria are the Financial Market Authority (FMA), the Ministry of Finance (MoF), the Austrian National Bank (OeNB), the Federal Ministry of the Interior (BMI), the Federal Ministry of Justice (BMJ), the Federal Crime Office (BKA), the Austrian Financial Intelligence Unit (FIU), the Federal Agency for State Security and Counterterrorism (BVT) and the Federal Ministry of Economy and Labor (BMwA). The private sector, in particular larger internationally active banks, also participates in these efforts through the Austrian Chamber of Commerce (WKO). The FMA is the primary financial regulatory and supervisory body, which is also responsible for monitoring AML/CFT compliance by credit and financial institutions, insurance and investment service provider firms.

⁹ The AML/CFT team consisted of Mr. Abdessatar Ben Ouanes (Mission Chief, MFD), Mr. Peter Csonka (LEG), Mr. Kiyotaka Sasaki (MFD), as well as the independent AML/CFT expert, Mr. Kent Madstedt (Chief District Prosecutor, Economic Crimes Bureau, Sweden).

119. Though there has been significant progress overall, the assessment identified several issues that need addressing and might require legal amendments. These issues concern the definition of suspicion and the obligation to screen unusual transactions, the provision of further guidance to financial institutions on AML/CFT duties, particularly in relation to customer identification, intensifying supervision of AML/CFT compliance across the financial sector, including the monitoring of the phasing out of anonymous passbooks, and increasing resources for the financial supervisors and the FIU.

Criminal justice measures and international cooperation

Criminalization of ML and FT

120. **Austria has ratified all international treaties related to money laundering and financing of terrorism, with the exception of the Palermo Convention, and has accordingly criminalized money laundering and financing of terrorism in line with the international standards.** The main ML offense (Section 165 of the Criminal Code) extends to all (serious) crimes and recent amendments further enlarged the range of predicate offenses. However, some aspects of the ML offense, i.e., the knowledge requirements and the penalty regime, need revisiting. Moreover, legal persons cannot be held liable for ML at present, though a legal reform is being considered. An amendment to the Criminal Code in 2002, effective October 1, 2002, introduced FT as a separate criminal offense (Section 278d of the Criminal Code). FT is also a predicate offense to ML and included in the list of criminal offenses subject to domestic jurisdiction regardless of the laws where the act occurred. Convictions have been obtained so far in 13 cases for ML but none for FT.

121. Austria is a party to the UN Drug Convention and the Council of Europe Convention. In December 2000, Austria signed, but has not yet ratified, the Palermo Convention, which has recently entered in force internationally. Austria ratified the UN International Convention for the Suppression of the Financing of Terrorism on April 15, 2002. Austria is a member of the FATF and the Austrian FIU is a member of the Egmont Group.

Confiscation of proceeds of crime or property used to finance terrorism

122. **The value-based confiscation system broadly follows international standards and allows confiscation of any criminal proceeds and provisions exist to enable the forfeiture of property of organized crime or terrorist groups.** Austrian criminal law provides for two different avenues—introduced in 1996—to confiscate proceeds or property in criminal proceedings: value-confiscation of profits (Sections 20 and 20a) and criminal forfeiture (Sections 20b and 20c). Neither of the two requires a conviction. Confiscation applies generally to economic benefits derived from any criminal offense, whereas forfeiture only to property being at the disposal of a criminal organization (Section 278a) or a terrorist group (Section 278b). The decision of confiscation or forfeiture can be made either as part of the main criminal trial (if any) or separately. Significantly, the forfeiture provision allows partial reversal of the onus of proof but in practice evidentiary issues remain. Both avenues

are underutilized in practice. Other issues include that instrumentalities cannot be confiscated and there is no forfeiture fund.

123. The Code of Criminal Procedure provides broad authority to prosecutors and the police to identify, freeze and seize criminal proceeds and terrorist assets under judicial control. Adequate legal provisions exist for the protection of bona fide third parties.

124. *The collection of statistical data needs to improve, in particular with regard to the amount of property frozen, seized or confiscated. Apart from statistical data kept by the FIU on transactions blocked, there is no centralized system to keep statistics on predicate offenses to ML, disclosures, freezing or confiscation orders. There is regular training for law enforcement personnel, including prosecutors, on ML legislation and trends.*

The FIU and processes for receiving, analyzing, and disseminating financial intelligence

125. **The Austrian FIU is a police-type unit with robust investigative but limited analytical capability and full access to police information.** The FIU, formerly known as EDOK, was established in 1994 within the Federal Ministry of the Interior on the basis of the Banking Act, but in 2002, it was absorbed as one section within the newly established Austrian BKA. The FIU continues to serve as the central repository of suspicious transaction reports and is responsible for analyzing and disseminating disclosures related to ML and FT. Its main function however is the investigation of ML offenses, for which the FIU has access to police data and a host of databases. Its access to financial information is subject to judicial authorization, unless the information relates to an STR, and its financial analytical capability is limited. Bank secrecy does not apply in cases when banks and other financial institutions are required to report suspected money laundering or financing of terrorism. Such cases may be subject to instructions of the authorities (i.e., FIU) with regard to processing such transactions. The FIU can order the temporary blocking of transactions, but has no freezing power.

126. *The FIU has 13 staff and can pool resources from other parts of the BKA as necessary or rely on local police forces for conducting investigation on its behalf. The FIU entered into an MOU with the Federal Agency for Security and Counterterrorism (BVT) under which it has to transfer disclosures related to FT to the BVT. The FIU receives an average of 300–350 suspicious transaction reports a year. It provides information on typologies through training seminars, but is reluctant to issue written guidance on suspicious transactions. The FIU regularly organizes training and awareness-raising seminars in partnership with private sector entities.*

Law enforcement and prosecution authorities, powers and duties

127. **The police and prosecutors have adequate powers to investigate and prosecute ML-cases**, including searches, wiretaps and undercover operations. Further clarity as to the application of controlled delivery has been recently provided with the consolidation of police powers in the Code of Criminal Procedure, which also contains specific provisions on police

observations, undercover operations and pseudo-purchases. For accessing bank information, the conditions of obtaining disclosure orders under Section 145a of the Code of Criminal Procedure are restrictive at the stage of the FIU's intelligence work, and only if justified can judges lift bank secrecy for ML or FT—related investigations. *Both police officers and prosecutors are well-trained and equipped, but a staff increase may prove necessary if the number of STRs increases. As prosecutors at times face legal challenges in proving the predicate offense, a lighter burden of proof and task-force type investigations may help improve results.*

International cooperation

128. **Austria is a party to numerous bi- and multi-lateral MLA and extradition treaties and is able to offer assistance on the basis of domestic law.** Austria ratified all Council of Europe treaties on MLA and extradition, and concluded supplementary agreements with a number of jurisdictions. It can also provide assistance without a treaty on the basis of its Extradition and Mutual Legal Assistance Act, provided reciprocity is guaranteed. Dual criminality is a general condition under this Act as well as under the European Convention on Mutual Assistance in Criminal Matters, which may be an issue in ML cases involving different mens rea (knowledge) standards. The principle of double criminality is, however, partly being abandoned. Austrian law does not enable the extradition of Austrian nationals, but prosecutors have an obligation to prosecute mandatorily crimes that are committed by Austrian citizens. Austria has not enacted legislation that provides for sharing of confiscated assets with other governments, but bilateral mutual legal assistance treaties can be used as an alternative vehicle.

129. *Statistics are not kept on MLA requests, nor on information exchange, given the direct communication channels that exist in Europe for MLA requests. The Ministry of Justice does not centralize MLA and relies to a large extent on courts to deal with requests.*

Preventive measures for Financial Institutions

(Prudentially-regulated sectors)

General framework

130. Austria's principal AML/CFT legislation concerning credit and financial institutions is contained in Sections 40 and 41 of the Banking Act, which sets out the measures to prevent money laundering and financing of terrorism. Further, a general duty of diligence is contained in Section 39 paragraph 3 of this Act, which imposes a requirement to pay attention to any transaction which in the credit institution's opinion strongly suggests that it may be connected to money laundering or financing of terrorism. These AML/CFT provisions of the Banking Act, which came into force on January 1, 1994, and were since amended a number of times, apply to a host of banking and other monetary activities, the definition of "credit institutions" (Section 1 paragraph 1) being broader than banks, as well as

to financial institutions (Section 1 paragraph 2), which cover for example leasing. Bureaux de change and money remittance services are covered by these AML requirements.

131. By referring back to the Banking Act, identical AML requirements apply to investment service providers under the Securities Supervision Act (Section 21) and to life insurance companies under the Insurance Supervision Act (Section 18a).

132. AML/CFT-related supervision is part of general supervisory activity in Austria and for a large portion of the financial sector it is carried out by the FMA, which has been designated as the single supervisory authority under the FMA Act as from April 1, 2002. Under the sectoral Acts (banking, insurance and securities) the FMA, in its capacity as general financial supervisory authority has, among other things, assumed the task of supervising compliance with requirements for AML/CFT. With regard to the banking sector, FMA supervision however relies to a large extent on the operational involvement of the OeNB, since the OeNB can be entrusted with on-site inspections in general, and regularly is entrusted with the bulk of on-site inspections, currently. Since its establishment, the FMA inspected one bank specifically for AML/CFT in a targeted inspection, while it conducted 25 inspections of investment service providers which also covered AML/CFT. The FMA plans to strengthen on-site inspections of banks with focus on AML/CFT for 2004 and has developed an inspection manual for that purpose in the 1st Quarter of 2004. However, the manual will be for internal use for the FMA inspectors and will not be made public.

133. Under the FMA Act, the FMA has the authority to issue ordinances and, to enhance the enforceability of supervisory measures, the FMA is vested with the power to impose administrative penal sanctions and enforce its supervisory rulings (for bureaux de change and money transmitters these powers are in force as from January 1, 2004). The FMA also issues circulars to the Chamber of Commerce that are distributed to member CIs, FIs, insurance companies and investment service providers. The circulars include information on the latest NCCT list of the FATF and the results of the FATF plenary meetings.

134. However, the FMA has been cautious in providing guidance or instructions to the financial industries regarding the details of the AML/CFT-related requirements in the relevant laws. Although internal controls for AML/CFT compliance could be addressed in the context of the risk management by each firm and could be different from firm to firm, the FMA should verify and ensure the effectiveness of internal controls at each firm. As an important step forward in this respect, **the FMA has been enhancing supervisory oversight for the AML/CFT compliance, in particular, for banks by issuing, in April 2004, a guideline regarding internal controls and procedures, and suspicious transaction reporting requirement for AML/CFT. Similar guidelines for insurance companies and investment service providers are in preparation. The FMA should follow this up with further guidance, e.g., on customer identification requirements and enhance its on-site inspections using the inspection manuals that have been developed in the first quarter of 2004.**

Customer identification

135. While anonymous accounts are not expressly prohibited in Austrian law, the Austrian authorities argued that by virtue of the customer identification requirements being imposed on credit and financial institutions, such accounts logically are not allowed. However, dormant anonymous savings passbooks continue to exist, but can only be accessed after prior identification and a waiting period accompanied by reporting to the FIU above a certain threshold (€15,000). **Further, the authorities have recently put in place a proactive program of monitoring not yet identified passbook accounts in accordance with the strengthened internal controls mandated for these accounts. In order to ensure that all anonymous passbook holders are identified and that Austria eventually eliminates the system of anonymous savings passbooks completely, the authorities need to continue monitoring the phasing out of the remaining accounts and may, in addition to the measures already taken, wish to explicitly prohibit anonymous accounts and reduce the general closure term of 30 years foreseen for dormant accounts to a more limited period of time.**

136. For the moment, Austrian law does not require that credit and financial institutions, including money remitters, include accurate and meaningful originator information on funds transfers and related messages and that such information remain with the transfer or related message through the payment chain (FATF SR VII). Austria strongly favors a common EU regulation on this matter to achieve a uniform EU standard and such a regulation should be proposed, according to the EC, in 2004. Although there is no regulation, among Austrian banks, money transfer to overseas are often limited to those customers who have already accounts at banks or in practice, charges higher for walk-in customers. However, **with the proposed EU regulations, requirements should be in place that will comply with SR VII.**

Suspicious transactions reporting

137. The level of suspicion required by the Banking Act for reporting (“reasonable suspicion”), as interpreted in practice, seems too high, which results in a relatively low number of STRs. This interpretation may be partly corrected by the FMA Guideline on Internal Controls and Procedures and Suspicious Transaction Reporting for AML/CFT, which was issued in April 2004. In addition, this guideline contains an express requirement to detect unusual and large transactions. In order to ensure that disclosures are in practice made in all cases of “reasonable suspicion,” the FMA will need to monitor closely the level of reporting and take further corrective action as necessary.

Internal control, compliance and audit

138. Internal auditors and external auditors are required by the relevant laws to review the effectiveness of internal control for the AML/CFT compliance. The assessments by external auditors are included in the supervisory reports that are submitted to the FMA and the OeNB twice a year. However, the current template of the supervisory reports is not sufficient for the

FMA to identify weakness of AML/CFT internal control at each firm. **The FMA should, in consultation with external auditors, ensure that the supervisory report produced by external auditors provides the FMA with sufficient information on the effectiveness of or weaknesses in the AML/CFT internal controls of individual entities. This might require issuing guidance on external auditing in AML/CFT audits.**

Enforcement powers and sanctions

139. The FMA's enforcement powers and sanctions are adequate, but its on-site inspections are under-resourced. The FMA is planning to conduct targeted inspection of banks with focus on the AML issues in 2004. The inspection manuals have recently been developed, with the one for the banking sector being completed, while insurance supervision intends to develop a manual and the existing one for the securities sector is to be revised based on the banking one. **The FMA needs to enhance on-site inspections to ensure compliance with the AML/CFT requirements in the financial sector, including increasing its resources as well as continuing to develop inspections manuals.**

Co-operation between supervisors and other competent authorities

140. The FMA has created an internal Task Force on Money Laundering which consists of experts from all units involved in the fight against money laundering, mainly banking (regulatory, legal, on-site examination, off-site analysis) insurance, securities, international and legal, to exchange information, establish a common policy and ensure an effective, consistent approach from all angles. The FMA also has ad hoc meetings with other agencies to discuss the issues of the FATF, legal amendments for AML/CFT, which are composed of the Ministry of Finance, OeNB, Chamber of Commerce (plus individual banks), the Ministry of Justice (where necessary) and the Ministry of Interior (where necessary) and acts as a national coordinator on AML/CFT issues.

141. The MoF and the FMA have concluded a number of MoUs with foreign counterparts in the field of exchange of supervisory information and on-site inspections. However, **it is unclear to what extent these are relevant for exchange of information regarding AML/CFT matters.**

Non-prudentially regulated sectors

142. As a result of the amendment of the Banking Act in June 2003, **bureaux de change** are currently defined as credit institutions under Section 1(1) of the Banking Act and as such are subject to licensing requirements and supervision by the FMA as of January 1, 2004. They were previously supervised by the Ministry of Trade. The relevant AML requirements under the Banking Act will thus also apply to bureaux de change. After the introduction of the Euro, the number of bureaux de change has already been reduced and further decline is expected due to the new licensing requirement by the FMA. All the existing bureaux de change in Austria (under 50 in total) have been contacted by FMA to make them aware of the

new requirements and the timeframe for submitting a license application, which ends on June 30, 2004.

143. Like bureaux de change, **money remitters** are also included in the Banking Act as business of credit institutions as from January 1, 2004, and are subject to licensing requirements and supervision by the FMA. Money remitters were encouraged by the FMA, and formerly by the Ministry of Finance, to use banks (credit institutions) as agents in order to ensure the AML requirements for banks are eventually applied to their money remittance business as well. However, the amendment of the Banking Act in June 2003 has made remittance business explicitly subject to the AML/CFT requirements under the Banking Act. All three remittance firms present in Austria will either be subject to AML/CFT requirements and supervision by FMA, or will need to stop operating by June 30, 2004.

Summary assessment against the FATF recommendations

144. The assessment shows that Austria has achieved a good level of compliance with the FATF 40+8 Recommendations for AML/CFT. However, shortcomings have been identified in several areas. The Austrian AML/CFT regime would therefore benefit from improvements, such as more clarity in the legal provisions defining suspicion of money laundering and the obligation to screen unusual transactions; further guidance to financial institutions on AML/CFT duties, in particular on the identification of customers; enhanced monitoring of compliance by the supervisors in all sectors subject to AML/CFT obligations, including through on-site inspections; permanent supervisory attention during the process of phasing out the remaining anonymous passbooks; and more resources for the supervisors and the FIU. *In addition, the robustness of the suspicious transaction reporting regime could be strengthened, as the level of disclosures and resulting investigations seems low. This may stem, inter alia, from the FIU's limited resources and the legal provisions defining suspicion.* Actions needed to comply with the FATF 40+8 Recommendations are in Table 9, while other recommended actions are in Table 10 below.

Table 9. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
40 Recommendations for AML	
General framework of the Recommendations (FATF 1-3)	Revisit Section 145a of the Code of Criminal Procedure so as to enable easier FIU access to bank information.
Scope of the criminal offense of money laundering (FATF 4-6)	Introduce an effective system of liability for legal persons involved in ML or FT.
Provisional measures and confiscation (FATF 7)	Enable the confiscation of instrumentalities used in or intended for use in the commission of ML or predicate offenses for ML.
General role of financial system in combating ML (FATF 8-9)	
Customer identification and record-keeping rules (FATF 10-13)	

Reference FATF Recommendation	Recommended Action
Increased diligence of financial institutions (FATF 14-19)	The authorities should make sure that “reasonable suspicion” is interpreted by the various institutions and professions required to report STRs in a similar manner and that this embraces an obligation to report at least “any <i>fact</i> which might be an indication of money laundering” as required by Directive 91/308/EEC as well as more general suspicions “that funds stem from a criminal activity” (FATF 15).
Measures to cope with countries with insufficient AML measures (FATF 20-21)	
Other measures (FATF 22-25)	
Implementation & role of regulatory and other administrative authorities (FATF 26-29)	
Administrative Cooperation – Exchange of general information (FATF 30-31)	
Administrative Cooperation – Exchange of information relating to suspicious transactions (FATF 32)	
Other forms of cooperation – Basis & means of cooperation in confiscation, mutual assistance, and extradition (FATF 33-35)	
Other forms of cooperation – Focus of improved mutual assistance on money laundering issues (FATF 36-40)	Ensure that the conditions for obtaining bank records under 145a of the Code of Criminal Procedure do not unnecessarily limit the ability of foreign authorities to obtain such disclosures for ML or FT investigations, nor delay the related MLA procedure.
8 Special recommendations on terrorist financing	
I. Ratification and implementation of UN Instruments	
II. Criminalizing the financing of terrorism and associated money laundering	
III. Freezing and confiscating terrorist assets	
IV. Reporting suspicious transactions related to terrorism	
V. International Cooperation	
VI. Alternative remittance	
VII. Wire transfers	With the proposed common EU regulations, the requirements that oblige financial institutions to include accurate and meaningful originator information in wire transfers needs to be established.
VIII. Non-profit organizations	

Table 10. Other Recommended Actions

Reference	Recommended Action
Criminalization	<p>Ratify the Palermo Convention as a matter of priority.</p> <p>Reexamine the knowledge requirements under Section 165 to ensure their full conformity with those of the Vienna Convention.</p> <p>Consider easing the burden of proof on prosecutors in ML-related prosecutions as well as raising the penalty level for simple ML offenses so that all ML offenses are “crimes”.</p>
Confiscation/seizure	<p>Alleviate further the burden of proof on the prosecution in forfeiture cases brought under Section 20b of the Criminal Code.;</p> <p>Consider empowering the FIU to have easier access to bank information and, if justified, to freeze bank accounts, subject to subsequent prosecutorial control.</p> <p>Set up an asset forfeiture fund.</p> <p>Finalize and implement EU Framework Decision on asset-sharing and enable asset-sharing with non-EU jurisdictions.</p> <p><i>Additional statistics should be developed on the amounts of property frozen, seized and confiscated, relating to ML, the predicate offenses and also FT.</i></p>
FIU and Law enforcement and prosecution authorities, powers and duties	<p>The FIU should provide, on its own or in partnership with professional associations, written, practical and updated guidance to reporting entities on suspicious transactions to help them meet their reporting obligations under the law.</p> <p>The FIU should have increased analytical capability and easier access to information subject to bank secrecy; it should be provided with appropriate resources, whether in terms of software or financial analysts, to gather and analyze intelligence; the legal requirements for disclosure orders under Section 145a of the Code of Criminal Procedure should be made easier, for example by empowering the FIU to issue on its own right such orders, subject to subsequent prosecutorial authorization.</p> <p>Procedures for reporting STRs should be further described in regulation or guidance to clarify the general requirements under the law. The authorities should also provide standard templates for reporting STRs in order to facilitate reporting by the obliged entities.</p> <p>FIU-FIU information exchange should be further facilitated and supported by bilateral MOUs, in particular with administrative (non-police) type FIUs.</p> <p>Make use of investigative powers now regulated in a comprehensive manner in the Code of Criminal Procedure.</p> <p><i>The authorities should carefully examine what are the causes of the actual number of STRs and of the divergences in the number and spread of reporting by the different credit institutions, other entities and professionals. These tendencies to produce reports or refrain from reporting should be further analyzed. Additional statistics should be developed and published.</i></p> <p><i>The evidentiary requirements for ML prosecutions should be reviewed and, if necessary, guidance or legislative amendment be issued in order to ensure that prosecutors do not need to prove the predicate offense to the usual criminal standard.</i></p>

	<p><i>Further resources should be allocated to prosecutors and the FIU as necessary. Task forces could be further developed in ML investigations.</i></p>
<p>International cooperation</p>	<p>Dual criminality should not constitute an obstacle to MLA if the request concerns a behavior that is at least an administrative offense under Austrian law. The authorities may wish to issue an official interpretation of the dual criminality principle in that sense (e.g., that it should be applied “<i>in abstracto</i>”). Consideration should also be given to granting assistance in cases of negligent ML and self-laundering.</p> <p>Should there be any indication of potential gaps in Austrian extradition practice as a result of the prohibition of extraditing nationals, the authorities should include explicitly in Section 12 of the Extradition and Mutual Legal Assistance Act an obligation to submit the case without undue delay to the competent authorities for the purpose of prosecution if extradition is refused on the basis of the person’s Austrian nationality.</p> <p><i>Further steps ought to be taken in order to abandon the principle of double criminality.</i></p> <p><i>Additional statistics should be developed on all MLA requests and other requests that are made or received, relating to ML, the predicate offenses and FT, including details of the nature and result of the request.</i></p> <p><i>Additional statistics should be developed on information exchange with foreign law enforcement authorities, including records of the number, source and purpose of the request for such information exchange, as well as its resolution.</i></p>
<p>Preventive Obligations</p>	<p>The FMA ensures that financial institutions establish a procedure for high standards for hiring new employees.</p> <p>The Declaration of Due Diligence of the Austrian Banking Industry and the Standard Compliance Code of the Austrian Credit Industry needs to be reviewed and updated to accommodate developments in international standards relating to AML/CFT compliance.</p> <p>The FMA should enhance its supervisory oversight to ensure compliance by financial institutions’ with AML/CFT requirements, including developing further detailed regulations/guidelines as well as enhancing on-site inspections based on the inspection manual that has been developed by the FMA.</p> <p>In order to implement the FMA’s plan to enhance on-site inspections focusing on AML/CFT, the regime of on-site inspections need to be strengthened, including the increase in resources, developing further inspection manual, upgrading skill and expertise of inspectors.</p> <p>Developing inspection manual for insurance companies as planned, in addition to those for banks and securities firms that have been developed, incorporating the FMA’s internal criteria for assessing internal control for AML/CFT at insurance companies.</p> <p>Consider publishing Inspection manual, when completed, from the perspective of transparency and accountability of the FMA’s supervision as well as to encourage the financial industry to take further steps to enhance internal control for AML/CFT compliance at individual firm.</p>

	<p>The FMA should, in consultation with external auditors, ensure that supervisory report by external auditors could provide the FMA with sufficient information on the effectiveness or weakness in AML/CFT internal control at individual entity, including issuing guidance on external auditing approach for AML/CFT audit.</p> <p>More specificity regarding the exchange of information relating to ML and FT cases in the MoUs would be helpful.</p>
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Authorities' response

145. Austria thanks the IMF, the Assessment Team and the experts for the good cooperation and interesting discussions within this assessment.

146. As mentioned in the report, the creation of the new independent integrated supervisor, the FMA, the international developments in FATF, and finally the self-assessment and the assessment process have provided an important impetus for Austria to review and enhance its AML/CFT regime substantially in the last few years.

147. Many of the recommendations in the report are already being actively implemented in Austria. Further guidance for the obliged entities is being developed by the FMA. The FIU shares practical typology knowledge in a very pro-active policy of seminars and “awareness raising meetings” with the obliged entities, and the on-site inspections programme has been both enhanced and increased. Also, Austria, as part of the EU, is actively working on a common implementation of the new 40 Recommendations (2003), to improve its system further, together with the whole European Union.

148. On specific items in the report, we would like to mention:

- We are pleased to inform you that the parliamentary process of **Ratification of the Palermo Convention** is already completed. The publication in the Federal Law Gazette and the formal deposition of the instrument of ratification will take place as soon as possible, at any rate in 2004.
- As to **Section 145a of the Code of Criminal Procedure (access to bank records)** we would like to point out that—in addition to the possibilities provided for the FIU under the Banking Act—providing information under Section 145a para. 1 n. 1 and 2 of the Code of Criminal Procedure (personal data related to accounts) is obligatory in all cases where it appears to be necessary for investigating an offence, which is punishable by imprisonment of more than 1 year. More detailed information (on specific transactions) and on the continued control of transactions under Section 145a para. 1 n. 3 of the Code of Criminal Procedure require the suspicion of a connection with the commission of a criminal offence or with possible confiscation of profits or possible forfeiture. The same relation is required for other interferences with privacy and property (e.g., house search, seizure or provisional injunction). Such rules are based on the principle of proportionality which is guaranteed under constitutional law by Article 8 of the European Human Rights Convention.