**Banks**

**Business Activities and Profitability**

**After a Period of Stagnation,**

**Austrian Banks’ Total Assets Are Up Again**

Following a slight decline in the first quarter and weak growth in the second quarter of 2003, Austrian banks’ total assets recently posted a clear year-on-year rise. Unconsolidated total assets were up 4.2% from EUR 574 billion in August 2002 to a new record high of EUR 598 billion in August 2003. The stagnating growth in total assets in the first half of 2003 was attributable primarily to the persistently adverse economic environment. However, the recent increase might already be the start of a trend reversal. The total assets of Austria’s top ten credit institutions were likewise going up again in August 2003, even though, at 2.4%, their rate of growth was lower than that of all Austrian banks taken together.¹)

The main reason why total assets trended upward in August 2003 was the increase in external assets by EUR 15.3 billion, or 9.5%, year on year. Particularly, claims on foreign credit institutions expanded significantly. During the same period, domestic interbank business also augmented by EUR 5.6 billion or 5.4%.

On the liabilities side, external liabilities were likewise up EUR 8.8 billion or 5.1% compared to August 2002, which was attributable largely to the securitization of liabilities abroad. Overall, external assets worth EUR 176.2 billion contrasted with external liabilities to the amount of EUR 180.4 billion.

An analysis by size shows that the relatively large number of small banks remained unchanged in June 2003. 5 credit institutions had total assets in excess of EUR 20 billion, 4 banks reported total assets between EUR 10 billion and EUR 20 billion, and 43 credit institutions were in the range between EUR 1 billion and EUR 10 billion. The remaining 854 of the total of 906 credit institutions posted total assets of less than EUR 1 billion. The market share held by Austria’s top ten banks shrank continuously between

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¹ This calculation is based on the ten largest banks in terms of total assets as of August 2003. To allow for a meaningful comparison with pre-merger data, an eleventh bank was added to this group for the period prior to the merger of Bank Austria and Creditanstalt in August 2002. Special purpose banks are not included here.
June 2002 and June 2003, from 54.8% to 52.8% of aggregate total assets. In June 2003, the five largest credit institutions accounted for 43.4% of aggregate total assets compared with 46.3% in June 2002.

Steep Rise in Derivatives Trading
In August 2003, the notional volume of Austrian credit institutions’ derivatives business expanded substantially by 101.7% to EUR 2,651.4 billion year on year. Specific off-balance sheet transactions were thus 4.4 times higher than total assets, while in the like period of the previous year, the comparable figure had been 2.3. The most common type of derivatives are interest rate contracts (almost exclusively between banks), which accounted for 87% of total derivatives in August 2003. Among interest rate contracts, interest rate swaps\(^1\) are the most important category. This uptrend in interest rate swaps, specifically short-term EONIA swaps, is mainly attributable to the fact that one of Austria’s major banks makes increased use of this instrument for asset and liability management at the expense of traditional interbank operations with a view to reducing costs and risks (namely capital adequacy requirements and liquidity costs).

Accounting for 12% of Austrian banks’ derivatives business in August 2003, foreign exchange derivatives were the second most important derivatives category after interest rate contracts. All other derivatives, including precious metals and commodity contracts, continue to play only a minor role.

Capital Market Recovery Is the Major Cause of Austrian Banks’ Improving Profitability
After a weak year 2002, the profitability of Austrian banks improved in the first half of 2003. Since the first half of 2002, the unconsolidated\(^2\) operational

\(^1\) Interest rate swaps are contracts between two counterparties involving the exchange of differently structured interest payment flows over a specified period of time without exchanging the underlying principal amount.

\(^2\) The quarterly report (data of June 2003) records the income statement data of banks operating in Austria on an unconsolidated basis, i.e. exclusive of the revenues and expenses of Austrian banks’ subsidiaries in the CEECs.
ing profit of the entire banking sector has gone up by 8.7% from EUR 2 billion to EUR 2.2 billion.

At the end of the second quarter of 2003, operating results augmented by 3.0% (EUR 201 million) year on year, after having contracted by 2.4% at end-2002. This recovery was attributable mainly to income from financial operations, which more than doubled at a rate of 119%. Their share in operating results grew from 2.9% in June 2002 to 6.3% in June 2003. Chart 12 shows that operations involving trading portfolio securities, in particular, contributed significantly to the result of the second quarter of 2003: After hitting a low in the second quarter of 2002 at slightly above EUR 12 million, this income category surged to EUR 199 million year on year. The net result from foreign exchange, foreign currency and precious metal operations contributed EUR 140 million (+20.2%) to income from financial operations, while the balance from other financial operations contributed EUR 92 million (+36.2%).

In the first half of 2003, net fee-based income\(^1\) increased by 2.6% (EUR 39 million) year on year, accounting for more than 22% of overall operating income. In particular, fee-based income from lending operations (+18.2%), payment services (+8.2%) and foreign exchange, foreign currency and precious metal operations (+5.9%) went up against the first half of 2002.

Income from securities and participating interests that are not included in the trading portfolio\(^2\) dropped by 1.6% compared to the corresponding 2002 period. This development is attributable primarily to income from domestic participating interests, which fell by more than 50% from EUR 194 million in the second quarter of 2002 to EUR 94 million year on year. This plunge was compensated partly by income on domestic shares, other participating interests and floating rate securities, which rose by EUR 19 million over this period, as well as by income on foreign securities and participating interests, which surged from EUR 72 million to EUR 143 million.

In the first half of 2003, net interest income declined slightly by 0.6% year on year. The development of interest income and interest expenses reflects the falling interest rate levels: interest income shrank by 9.8% (EUR 1.2 billion), interest expenses by 13.7% (EUR 1.1 billion). Against the second quarter of 2002, the interest margin remained constant at 1.29% for the

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1 Net fee-based income is defined as the difference between fee-based income and fee-based expenditure.
2 Chart 12, by contrast, depicts income from securities actively traded by banks.
entire interest rate business.1) After going down from more than 1.6% to slightly below 1.3% in the period from 1997 to 1999, the interest margin has been hovering around 1.3% since early 1999.

On the cost side, banks continued their cost-cutting policies. In the first half of 2003, operating expenses increased by no more than 0.6% year on year. Considering an inflation rate of 1.1% in June 2003, operating expenses in real terms actually went down. After an annual growth rate of 0.25% at end-2002, the current rate is the second-lowest rate observed in the past five years. Other administrative expenses even contracted by 1.1% year on year. At 2.4%, staff costs grew at a very moderate rate, reflecting the effects of reduced expenditure on wages and salaries and increased expenses for statutory social charges, higher retirement benefits and allocations to pension fund reserves.

As operating income went up while operating expenses remained stable, the entire banking sector’s cost/income ratio improved, on balance, from 70.1% in the first half of 2002 to 68.4% in the first half of 2003 – without, however, reaching the value of 65.4% recorded in the first half of 2000. Even though the ten largest banks trimmed their cost/income ratio from 72.5% to 70.0%, they are still trailing the remaining banks, which managed to reduce their cost/income ratio from 68.5% in the second quarter of 2002 to 67.3% in the second quarter of 2003 (see table 5).

At the end of June 2003, Austrian banks expected annual operating results of EUR 3.9 billion for the 2003 fiscal year – 1.9% less than forecast in June 2002. Based on these expectations, the balance on loan loss provisions and income from the release of loan loss provisions would fall by 13%, thus reducing expenses. Based on the forecast for 2003, the balance on transfers to provisions for securities and income from the release of such provisions would turn negative and thus increase income. Taking into account expected taxes and expected extraordinary income, the profit for the year is predicted to amount to EUR 1.8 billion – rising by 17.1% year on year.

An analysis of consolidated income,2) which permits a more comprehensive assessment of the Austrian banking sector, confirms the positive

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1 This margin is calculated using the ECB method, which accounts for different volumes on the assets and liabilities sides. However, this method does not take the different term structures of assets and liabilities into account. For details see the ECB study “EU banks’ margins and credit standards” published in December 2000.

2 The consolidated approach considers the consolidated financial statements of major banks prepared in compliance with the International Accounting Standards (IAS) and the requirements of the Austrian Commercial Code. It thus captures the revenues and expenses of banking groups as a whole (including their foreign subsidiaries).
development indicated by the trend in unconsolidated income. Interest income, which in this case, however, includes income from securities and participating interests, rose by 1.8% to EUR 5.6 billion in the first half of 2003. Fee-based income was up 5.8% and trading income 52.6%. The entire banking industry reported a consolidated operating income of EUR 8.3 billion in the first half of 2003, climbing 5.6% year on year.

Consolidated staff costs grew at a rate of 2.5% in the second quarter of 2003, largely at the same pace as unconsolidated staff costs, while consolidated other administrative expenses edged up slightly by 0.4% in contrast to unconsolidated figures. Overall, at a rate of 2.3%, administrative expenses rose more slowly than operating income.

As a result, the cost/income ratio of the consolidated banking sector improved from 71.1% in the second quarter of 2002 to 68.9% in the second quarter of 2003. Taking into account extraordinary income, taxes and minority interests, the consolidated result for the first half of 2003 runs to EUR 1.3 billion, thus rising by 30% above the corresponding figure for the same period in 2002.

In an EU-wide comparison, however, the Austrian banking sector ranks only in the lower middle range with a consolidated return on assets (ROA) of 0.38%\(^1\) and a consolidated cost/income ratio of 68.9%. This position leaves some potential for further improvement in income and costs, which could be achieved by further structural consolidation, e.g. of banking offices.

**Credit Risk of Austrian Banks**

Loan Growth Remains Slow

The relatively slow growth in lending reported already in 2002 continued throughout the first half of 2003. Credit growth slowed down significantly, which was attributable primarily to the slumping national and international economy. In mid-2003, the Austrian banking sector as a whole for the first time recorded a decline (by 0.1%) in loan volume (see chart 13). In July and August 2003, however, loan growth turned positive again, possibly indicating a trend reversal. The decline in lending volumes was traceable mainly to the fact that the ten largest banks recorded a change of –3.0% in their loan volume at end-June. However, as in previous periods, the median\(^2\) of loan growth remained positive at 2.7% as at the end of June 2003.

At mid-2003, all banking sectors except state mortgage banks and special purpose banks registered a decline in loan volume growth. While in most sectors this slowdown appears to be only a short-lived phenomenon, new lending of the building and loan sector seems to be showing signs of a more persistent weakness. Since September 2002, this sector has been reporting a cut-down on lending, with loan growth hitting a low in June 2003 at a rate of –3.37% (June 2002: 1.85%).

One of the reasons behind this weakness in building and loan sector lending in recent months appears to

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1 Consolidated period result as a percentage of consolidated total assets, annualized.
2 The median is the middle value in a set of data arranged in order of decreasing or increasing magnitude, with half the scores being above, the other half below the median. In contrast to the arithmetic mean, the median has the advantage of being more stable against outliers. Special purpose banks are not included in the calculation of the median.
be the competition by other banks offering foreign currency loans. As under Article 9 of the Act on Building and Loan Associations (Bausparkassengesetz, BSpG) these credit institutions are required to avoid taking on any currency risks, they are unable to provide foreign currency loans for home financing. Savers wishing to use foreign currency loans for this purpose therefore have to turn to other banks. Moreover, the weak economy has hit the building and loan sector more massively than other sectors since at times of economic uncertainty consumers are, as a rule, even more reluctant to make long-term big-ticket purchases than to buy less costly consumer goods.

Household consumption is, however, generally quite sluggish, as reflected by the slowdown in the growth of loans to households over recent months. At end-June 2003, the growth rate stood at 2.6% compared with 3.6% at the same time in the previous year. Loans to nonfinancial enterprises contracted at a slower pace than in previous periods, stabilizing at a growth rate of around −2.0% at the end of June 2003 (see chart 14).

While the volume of loans to financial intermediaries (excluding banks) remains expand at a stable rate,
loans to the general government subsided again in the first half of 2003 after a brief period marked by a slight uptrend.

**Asset Quality Deteriorated Slightly in the First Half of 2003**

Data from the external auditor’s annual prudential reports, available since mid-2003, allow for assessing credit quality and thus the credit risk Austrian banks were exposed to in 2002. In assessing credit quality, the report distinguishes between nonaccrual and nonearning claims, nonperforming claims, and irrecoverable claims on nonbanks.1) Quite generally, the prudential reports state that Austrian banks’ credit quality was satisfactory in 2002 and that there were no developments since 2001 that would have given reason for concern. The 95% quantile2) even improved against 2001 across all three categories mentioned above (see table 6). Currently, for 95% of all Austrian banks nonaccrual and nonearning claims account for less than 3.1% of banks’ loan portfolios, while in the previous year this figure stood at 3.5%. The share of nonperforming claims even dropped from 9.3% (2001) to 8.2% (2002), while irrecoverable claims declined somewhat from 4% in 2001 to 3.8% in 2002.

Likewise, the median remained quite stable for the three categories, although irrecoverable loans rose slightly from 0.5% in 2001 to 0.6% in 2002. It is interesting to note that only the ten largest banks posted an above-average year-on-year increase in irrecoverable loans from 0.4% in 2001 to 0.6% in 2002. In the other categories and where loan loss provisions are concerned, however, the credit quality of large banks is better, as a rule, than that of smaller banks.

The level of loan loss provisions that Austrian banks report in their

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1) Claims on nonbanks that are not expected to make payments in the near future are rated as nonaccrual and nonearning assets. Nonperforming claims are claims that are expected to default. Irrecoverable claims are claims that have already defaulted at the time of data compilation.

2) The 95% quantile divides an ordered set of data into the lower 95% and the upper 5%. This means that 95% of credit institutions recorded values that are below the level of the 95% quantile.
monthly returns may serve to examine their credit quality during the year. This figure shows the risk provisions created with respect to loans that are likely to be irrecoverable. The predominant part of loan loss provisions is set up for claims on nonbanks, while loan loss provisions for claims on credit institutions typically tend to be rather low.

In the first quarter of 2003, loan loss provisions relative to claims on nonbanks amounted to about 3.6%. This percentage declined to about 3.5% in the second quarter and came to 3.4% in August 2003. As loan loss provisions reported at the beginning of the year are usually higher than those reported at year-end, which creates a seasonal effect across the year, assessments are best made year on year. Such a year-on-year comparison shows that the loan loss provisions reported in August 2003 were the highest since 1999, reflecting the difficult economic environment in which the Austrian banks are currently operating.

In August 2003, the risk provisions made by the multi-tier sectors of the Austrian banking system, which traditionally report a higher level of provisioning, were slightly up against August 2002, running to 5.1% for Volksbank credit cooperatives, 3.8% for savings banks and 4.2% for Raiffeisen credit cooperatives. At 2.8%, loan loss provisions reported by joint stock banks had also increased. The traditionally very low provisioning levels of building and loan associations rose likewise, from 0.4% in August 2002 to 0.6% in August 2003. By contrast, in the period under review state mortgage banks reduced their loan loss provisions from 2.7% to 2.3% of claims on nonbanks, thus — after a period of increased provisioning — approaching the level recorded in 2000.

The loan loss provisions of the ten largest Austrian banks developed along similar lines, albeit at a lower level than in 2001 and 2002. In August 2003, loan loss provisions relative to claims on nonbanks stood at 2.7%, thus exceeding the percentage recorded at the same time of the previous year. In August 2003, the median level of loan loss provisions for claims on nonbanks was 4.6%.
Innovative Financial Instruments for the Transfer of Credit Risk

The Impact of Securitization on Financial Stability

The international capital markets have seen a growing trend towards the securitization of assets, driven primarily by the search for new refinancing sources and for possibilities to reduce regulatory capital requirements and by targeted credit risk transfer. Recently, this trend has given rise to a broad debate at the international level, which has focused mainly on the question of whether, overall, the transfer of credit risk within the banking sector as well as from the banking sector to other financial market participants has a stabilizing or a destabilizing effect on the financial system.

Against this background, the Oesterreichische Nationalbank (OeNB), in fulfilling its task of maintaining and safeguarding financial market stability, organized a panel discussion on the effects of securitization on financial stability, bringing together experts from supervisory authorities and academia as well as practitioners. One of the conclusions of this event was that the impact of these instruments currently cannot be fully assessed and that opinions on this matter differ strongly. The debate will therefore continue both at the international and the national level.

Survey on the Use of Innovative Instruments for the Transfer of Credit Risk

In cooperation with the Financial Market Authority (FMA), the OeNB is currently conducting a survey on the use of innovative instruments for the transfer of credit risk. In the course of this survey, which was initiated by the European Central Bank (ECB), selected credit institutions in the EU Member States are asked to provide both quantitative and qualitative data on these innovative instruments.

Some initial results of the survey reveal that Austrian credit institutions “invest” some amounts in these instruments, thereby assuming additional credit risk. The reasons given for these purchases are, in particular, the opportunity to generate additional income and to diversify credit risk. The ratings assigned by the established rating agencies usually play a significant role in the selection and valuation of the transactions. Austrian banks mainly buy shares in tranches and products with high credit ratings. The credit institutions surveyed have indicated that they wish to continue operating in this market segment and thus further actively take on credit risks.

Austrian credit institutions currently only to a limited extent engage in the selling of credit risks by securitizing their own assets or using credit derivatives. The narrow use of credit derivatives is largely attributable to the structure of Austrian banks’ loan portfolios, which are dominated by medium-sized corporate borrowers. The liquidity of the credit derivatives market for such borrowers is currently rather low owing, mainly, to a lack of external ratings. Only few Austrian banks currently securitize their own assets because of too low transaction volumes as well as high transaction costs. The instrument is, however, considered to offer interesting potential as an alternative refinancing option and for the transfer of credit risk.

Shift from Japanese Yen- to Swiss Franc-Denominated Loans Reduces Risk Potential of Foreign Currency Loans

Since around mid-2002, both the volume of Austrian banks’ foreign currency claims on domestic nonbanks and the share of foreign currency loans in total lending have stabilized. Following a slight downturn in the first half of 2003, another rise took place in August 2003, however, to an aggregate level of EUR 44 billion. Foreign currency loans now account for 18.5% of total loans, still remaining significantly below the record high of 19.2% witnessed in August 2002.

In corporate lending, the share of foreign currency loans fell from its 20.1% peak of April 2002 to 18.3% in August 2003. The share of foreign currency loans in loans to households continued to expand unabatedly until end-2002. It was only in the first half of 2003 that this share stabilized somewhat at around 25%. By August 2003, though, foreign currency loans had reached a share of almost 26% in total lending.
This renewed rise in foreign currency loans was attributable primarily to an increased demand for loans denominated in Swiss francs. In addition, the trend to replace Japanese yen loans by Swiss franc-denominated loans, which has been observed since mid-2002, intensified further in the first half of 2003. The share of Japanese yen loans in total foreign currency loans outstanding fell from its June 2002 high of 42.0% to 18.5% in August 2003, while Swiss franc loans surged from about 50.1% to almost 73.7% over the same period.

The phenomenon of foreign currency loans observed in Austria is still unique across the euro area: While Austria’s share in total euro area lending was 3.1% in June 2003, its share in Swiss franc- and Japanese yen-denominated loans came to 36.3% and 34.4%, respectively.

The main reason for this shift into the Swiss franc is the fact that the interest rate spreads between the euro and both the Swiss franc and Japanese yen have increasingly been converging since early 2002, coming to around 2 percentage points in September 2003 (in terms of three-month money market rates). In addition, exchange rate developments may also have played a role: While positive economic indicators have been exerting mounting upward pressure on the Japanese yen since mid-2003, the Swiss franc was trending downwards in the first half of 2003.\(^1\)

From the perspective of financial stability, the trend of shifting from the Japanese yen to the Swiss franc has to be regarded as positive, as the Swiss franc proved to be two to three times less volatile than the Japanese yen over the past decades. We may therefore conclude that the exchange rate risk — and thus the concentration risk for banks with a particularly high share in foreign currency loans — is lower for loans denominated in Swiss franc than for Japanese yen loans.

Nonetheless, even financing denominated in Swiss franc carries a nonnegligible exchange rate risk, which is augmented by interest rate risks and, where the common repayment vehicles are used, by additional risks associated with these repayment vehicles. Therefore, given the high share of foreign currency loans in total loans, potential risks to the stability of Austrian financial markets continue to exist, even though mitigated by the shift from the Japanese yen into the Swiss franc.

Hence, in the first half of 2003 the OeNB collaborated with the Financial Market Authority (FMA) in drawing up a questionnaire which is to help collect data on foreign currency loans that are not included in the monthly returns in order to gain insight into the risk management practices of the individual banks. Based on an analysis of the findings of this questionnaire, the FMA drew up the “FMA Minimum Standards for Granting and Managing Foreign Currency Loans” and the “FMA Minimum Standards for Granting and Managing Loans with Repayment Vehicles” in October 2003. Both sets of standards are addressed to the Austrian banking sector.

\(^{1}\) On the recent development of the exchange rates of the Japanese yen and the Swiss franc see chapter “Economic Developments and Financial Markets.”
hypothetical decline in the bank’s economic value in response to an interest rate change of 200 basis points in relation to its eligible own funds. Since end-2002, all Austrian credit institutions have reported this ratio; 32 of these – and almost exclusively the largest banks in terms of total assets – have even been reporting banks since before this date. From a risk perspective, these 32 banks, which together accounted for 73% of the aggregate assets of all Austrian banks in mid-2003, went through a positive development in the first half of 2003, as their average Basel ratio for interest rate risk declined from 8.9% to 7.9%. The distribution of Basel ratios of the above-mentioned 32 large to medium-sized banks in chart 16 shows that the number of banks with a higher exposure to interest rate risk (above 15%) has declined. However, two institutions still exceed the critical value of 20% set by the Basel Committee.

Across the entire Austrian banking system, the average Basel ratio for interest rate risk was relatively high at 12.0% at end-2002, but fell to 9.7% during the first half of 2003. As this ratio has only just been introduced, however, the figures may still be somewhat lacking in precision and should therefore be interpreted with due caution.

For banks running a large trading book, interest rate risk-sensitive positions of the trading book are not included in the Basel ratio. The capital requirements for covering the position risk of interest rate instruments, however, do not indicate an increase in this type of risk for the first half of 2003. The corresponding values have retained their historically low levels.

1 In the following, this ratio, which was proposed by the Basel Committee on Banking Supervision, shall be referred to as the Basel ratio for interest rate risk (or Basel ratio). Eligible own funds comprise tier 1 capital plus tier 2 capital minus deductible items.
Exchange Rate Risk:
Stress Tests Show only Modest Risk
As at end-2002, when assessing the relevance of reported exposures to foreign currencies for the Austrian banking system, we can identify three groups of currencies at mid-2003: major exposures in excess of EUR 500 million exist vis-à-vis the Swiss franc, the U.S. dollar and the Japanese yen; medium-sized exposures (between EUR 40 million and EUR 200 million) vis-à-vis the Australian dollar, the Danish krone, the Norwegian krone and the Canadian dollar; and minor exposures (between EUR 10 million and EUR 30 million) vis-à-vis the New Zealand dollar, the Hong Kong dollar and the South African rand.

The following findings of a stress test for June 2003 serve to assess the risk arising for Austrian banks from open foreign exchange positions. The scenario used in the test assumed exchange rate changes against the euro of 20%. The loss of market value resulting from the materialization of the exchange rate risk is interpreted as a burden on capital. Accordingly, the stress test compares the current (unconsolidated) regulatory capital ratio of a bank with its stress-tested capital ratio, computed by deducting the calculated loss in market value from a bank’s eligible capital.\(^2\)

When applying this stress scenario to all Austrian banks (with the exception of special purpose banks), the average capital ratio goes down by 14 basis points from 17.23% to 17.09%, with small credit institutions showing a weaker decline. In the stress test, the average capital ratio of credit institutions with total assets of less than EUR 100 million was found to contract by only 9 basis points, whereas that of credit institutions with total assets between EUR 100 million and EUR 500 million went down by 19 basis points and that of banks with total assets of more than EUR 500 million by 27 basis points. Only 14 of the 800 banks covered by the stress test saw their capital ratio fall by more than 1%; none of these were large banks. The maximum decline in the capital ratio of a single credit institution was 2.10%.

The results of this stress test suggest that direct exchange rate risk has only a limited impact on the Austrian banking system’s ability to bear risks. However, this test does not examine potential indirect foreign exchange risks — such as the deteriorating credit quality of foreign currency loans or of portfolios held by subsidiaries of Austrian banks in the Central and Eastern European countries (CEECs) as a result of adverse exchange rate developments.

Exposure to Equity Price Risk Remains Low
As in 2002, the percentage of equity shares in Austrian banks’ securities portfolios also declined in the first half of 2003.\(^3\) Based on book values,\(^4\)...

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1 A bank’s exposure is determined on the basis of the monthly peaks of open foreign exchange positions. It is calculated as the total sum of the absolute amounts of all Austrian banks’ peak values.

2 The capital ratio refers to the capital eligible as credit risk cover under the Austrian Banking Act (tier 1 capital plus tier 2 capital minus deductible items) as a percentage of the assessment base.

3 The average capital ratio must not be confused with the capital ratio of all banks referred to under “Austrian Banks’ Risk-Bearing Capacity.” The latter relates the total sum of eligible capital to the total sum of assessment bases. As a number of small special purpose banks have very high capital ratios, the average capital ratio is also higher.

4 In this context, equity shares refer only to stocks that are not held in the form of participations or shares in affiliated companies. Shares held through mutual funds are likewise not included.
equity shares accounted for 2.3% of banks’ securities portfolios at mid-2003, down from 2.5% at the end of 2002. (Apart from equity shares, securities portfolios comprise debt securities, other fixed-income securities and mutual fund shares).

The regulatory capital required to cover equity positions in the trading book went up slightly during the first half of 2003 (from EUR 20.5 million to EUR 25.0 million). Given the typical fluctuations prevailing in this area, this rise may be considered moderate; the capital required to cover equity positions remains at historically low levels.

Legal Liquidity Holdings Remain Stable
In the second quarter of 2003, all Austrian banks fulfilled the stipulations under Article 25 of the Austrian Banking Act, governing liquid resources of the first and second degree,1 with the poorest cash ratio coming to 2.6% and the poorest current ratio to 20.3%. 28 banks posted a cash ratio of between 2.5% and 5%, compared to 31 banks at end-2002. However, the 5% quantile2 for the cash ratio fell from 11.5% in the second quarter of 2002 to 7.1% in the second quarter of 2003, thus still outperforming the corresponding value of 6.1% recorded at end-2002. At 66.9%, the median hardly changed against the mid-year levels of previous years. The ratio for the entire Austrian banking industry3 slightly deteriorated to 24.2% against 26.4% in 2002, but the banking system holds sufficient cash to meet liquidity requirements pursuant to Article 25 of the Austrian Banking Act. Second-degree liquidity holdings have slightly improved: In the second quarter of 2003, the 5% quantile stood at 28.2% (second quarter of 2002: 27.35%), while the median came to 53.1% (second quarter of 2002: 50.9%).

Risks Incurred Through Business in Central and Eastern European Countries4
In the first half of 2003, consolidated total assets of Austrian banks’ subsidiaries operating in the CEECs again expanded vigorously by 4.9%, even though growth slowed down somewhat compared with previous years (growth in 2002: +16%). In absolute terms, consolidated total assets grew by EUR 3.4 billion to EUR 71.2 billion, with EUR 918 million stemming from acquisition activities. The share of unsecuritized assets in total assets decreased slightly between end-2002 (66.2%) and mid-2003 (65.7%).

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1 Austrian banks are required to retain highly liquid assets to the amount of at least 2.5% of their short-term liabilities in euro (cash ratio) and sufficiently liquid assets to the amount of at least 20% of their longer-term euro liabilities with residual or agreed maturities of up to three years (current ratio). Central institutions have the obligation for covering at least 50% of the deposits other institutions may use to meet their cash ratio.
2 The 5% quantile, which indicates the liquidity ratio exceeded by 95% of all banks, may serve as a measure for less liquid banks.
3 Total liquid resources of the first degree of all banks as a percentage of their total short-term liabilities.
4 This subsection covers all CEECs in which Austrian banks have fully consolidated subsidiaries. This group of countries includes, among others, also Bulgaria, Serbia and Montenegro, and Russia. This subsection focuses exclusively on the business relations of the Austrian banking sector (including subsidiary banks) with and within these countries, while the chapter “Central and Eastern Europe” explores the development of the entire banking sectors in the individual Central European Countries, including Croatia. As the two sections draw on different data sources, figures on banking statistics are not directly comparable.
Detailed Analysis of 2002 Results
Underlines the Region’s Importance

The profitability of the Austrian banking sector, which is currently comparatively weak by international standards, largely relies on the positive trends in banks’ business activities in the CEECs (see table 7). While at end-2002, business in the CEECs accounted only for about 10% of banks’ consolidated total assets, it earned 22% of their operating results (interest, fee-based and trading income) and even 26% of the result before tax. Banks’ ROA before tax for business in the CEECs comes to 1.1% against only 0.37% for activities in Austria and the rest of the world, which is primarily attributable to higher margins in interest income, fee-based and trading income, and a more favorable cost structure. For instance, the interest income generated by Austrian banks’ subsidiaries in the CEECs accounts for 3.0% of total assets, while income on business in Austria and the rest of the world comes to 1.56%. The cost/income ratio for the CEECs is 67.0%, while for Austria and the rest of the world it comes to 71.2%.

Substantial Credit Exposure to Central and Eastern Europe

The Austrian banking system’s credit risk exposure to Central and Eastern Europe is twofold: first, lenders resident in Austria make loans to borrowers in this region (direct cross-border loans), second, subsidiaries of Austrian banks operating in this region act as lenders (indirect loans). To illustrate the relative share of the entire Central and Eastern European region as well as of individual countries in Austrian banks’ credit exposure, table 8 lists the volumes of direct and indirect loans to nonbanks.

The high proportion of loans granted by Austrian banks’ subsidiaries in the CEECs in total indirect lending reflects their local concentration in Central and Eastern Europe: Of the global volume of indirect loans (EUR 32.7 billion), 91% originated from this region (EUR 29.8 billion), with the acceding countries accounting for 74% of this amount. Of the

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1 The data set used in this subsection draws on the reports of those Austrian banking groups that are most active in the CEECs (Bank Austria-Creditanstalt AG, Erste Bank der oesterreichischen Sparkassen AG, Raiffeisen Zentralbank Österreich AG, Österreichische Volksbanken-AG, Bank für Arbeit und Wirtschaft AG/Österreichische Postsparkasse AG, Hypo Alpe-Adria-Bank AG) on the results of their local subsidiaries (segment information) as well as on Austrian banks’ consolidated data. Data under “Austria and the rest of the world” are calculated as the difference between consolidated data and the key financial figures of the subsidiaries of the above-mentioned six banking groups in the CEECs and thus also include the parent banks’ cross-border transactions with the region.

2 Result before tax as a percentage of total assets.

3 Administrative expenses relative to total operating income including provisioning for lending operations.

4 Loans discussed in this subsection do not include securities positions held by banks.

5 A distinction must be made between these direct cross-border loans and the direct loans covered under “Credit Risk of Austrian Banks.” The latter are loans that are not granted under a securitization scheme.

6 This includes exclusively unsecuritized loans to the amount of the exposure. Since only loans to nonbanks have been taken into account, there are no distortions resulting from intra-group interbank transactions. Of all direct and indirect loans granted to, or originating from, respectively, Central and Eastern Europe, 67% are loans to nonbanks. As the data source used for direct loans is the Major Loans Register (reporting threshold per bank and borrower: EUR 350,000), not all direct loans are included. However, since in cross-border lending larger volumes tend to predominate, it can be assumed that a sufficient amount of loans is covered. The volumes of indirect loans – i.e. loans extended by subsidiaries – are weighted according to the equity held by the Austrian parent institute.
loans extended directly from Austrian banks to foreign borrowers (volume: EUR 50.7 billion), the proportion going to the CEECs is lower, by comparison, than the proportion of these countries in indirect loans. 29% of direct cross-border loans were granted to borrowers in the CEECs, with borrowers in the acceding countries accounting for 70% of this share. Taken together, direct cross-border loans and indirect loans granted by subsidiaries add up to EUR 83.5 billion in foreign lending exposure. Of this amount, Central and Eastern Europe accounts for 53% (EUR 44.5 billion), with the acceding countries representing almost three quarters of this share (72.8%). This underlines the outstanding importance of Central and Eastern Europe – and here again of the acceding countries – for the Austrian banking system.

The largest credit exposure of the Austrian banking system to a single country – measured as the sum of direct and indirect unsecuritized loans to nonbanks – is the one to the Czech Republic at EUR 12.8 billion or 15.3% of total foreign exposure. Among the CEECs, the Czech Republic accounts for the highest exposure both in direct cross-border loans (EUR 3.3 billion) and in indirect loans (EUR 9.5 bil-

Table 7

**Selected Earnings Ratios of Austrian Banks in 2002**

<table>
<thead>
<tr>
<th></th>
<th>Total Austria and the rest of the world</th>
<th>CEECs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>%</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA (before tax)</td>
<td>0.45</td>
<td>0.37</td>
</tr>
<tr>
<td>Cost/income ratio</td>
<td>70.40</td>
<td>71.20</td>
</tr>
<tr>
<td>Interest income as a percentage of total assets</td>
<td>1.71</td>
<td>1.56</td>
</tr>
<tr>
<td>Fee-based income as a percentage of total assets</td>
<td>0.58</td>
<td>0.51</td>
</tr>
<tr>
<td>Trading income as a percentage of total assets</td>
<td>0.14</td>
<td>0.10</td>
</tr>
</tbody>
</table>

Source: OeNB.

1) Broken down by origin of contribution.

Table 8

**Credit Exposure to Central and Eastern European and Selected Other Countries**

As of June 30, 2003

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Austria</th>
<th>Other countries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country rating</strong></td>
<td>Aaa</td>
<td>A1</td>
<td>A1</td>
</tr>
<tr>
<td>EUR billion</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct loans2)</td>
<td>214.1</td>
<td>163.4</td>
<td>50.7</td>
</tr>
<tr>
<td>%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign share</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EUR billion</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indirect loans3)</td>
<td>32.7</td>
<td>32.7</td>
<td>22.1</td>
</tr>
<tr>
<td>%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign share</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EUR billion</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: OeNB, Moody’s Investors Service.

1) Rating of foreign currency-denominated government bonds (as of September 5, 2003).
2) Unsecuritized loans extended to foreign nonbanks by Austrian banks.
3) Unsecuritized loans extended to nonbanks by foreign subsidiaries of Austrian banks.
The second largest total exposure (direct and indirect lending) within the CEECs is vis-à-vis Croatia, which does not belong to the acceding countries. Next in line are Hungary, Poland, Slovakia and Slovenia. Further details are set out in table 8, which for comparison also includes the three countries that account for Austrian banks’ largest credit exposure outside the CEECs. The category “Other CEECs” – which denotes those nonacceding CEECs where Austrian banks are represented by fully consolidated subsidiaries – in table 8 includes the three countries of this region with the largest share in total exposure.

### Austrian Banks’ Risk-Bearing Capacity

**Capital Ratio Remains Stable**

Against the background of a difficult business cycle environment, the question arises to what extent banks are able to absorb risks even over longer periods of economic weakness. An analysis of capital adequacy shows that despite persistent economic gloom Austrian banks have kept the level of their capital ratio stable over recent periods. In mid-2003, the unconsolidated capital ratio of all Austrian banks stood at 13.9% and was thus only slightly below the rate recorded at the same time in the previous year (June 2002: 14.2%, see chart 17). Austrian banks’ capital ratio thus substantially exceeds the minimum legal requirement of 8%.

As in most of the preceding periods, the capital ratio of the ten largest banks (in terms of total assets) is slightly higher than the median value (see chart 17). In June 2003, the ten largest banks reported an average capital ratio of 13.3%, which was slightly below the previous year’s ratio of 13.6%. The median as of June 2003 remained unchanged year on year at

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1 In this context, the capital ratio refers to the capital eligible as credit risk cover under the Austrian Banking Act (tier 1 capital plus tier 2 capital minus deductible items) as a percentage of the assessment base (according to Article 22 paragraph 2 Austrian Banking Act). The result of this calculation may differ from the capital ratios quoted in other OeNB publications, which usually also include tier 3 capital and are therefore obviously higher. However, as tier 3 capital is subordinated capital that may only be used as capital charge for market risk, it was not included below for the purpose of assessing capital adequacy in relation to credit risk.
12.6%. These developments show that both large banks and average Austrian banks keep their capital ratios stable over the business cycle and are apparently able to adequately absorb risks even in economically difficult times. Banks with comparatively low capital ratios have not exhibited any deterioration in their ability to carry risk, either: In June 2003, the value for the 5% quantile stood at 8.9%, which means that at mid-year 95% of Austrian banks had a capital ratio of over 8.9%. This value even increased slightly year on year.

An analysis of banks’ capital ratio by banking sector shows that at the end of June 2003 special purpose banks still boasted a high capital ratio of 18.6%, followed by the savings banks sector’s 14.6%. Building and loan associations reported the lowest capital ratio (9.8%).

Another ratio used in assessing the Austrian banking system’s ability to bear risks is the core capital ratio, which relates tier 1 capital (core capital) to the assessment base. At the end of June 2003, the unconsolidated core capital ratio for all Austrian banks was 9.5%. The tier 1 ratio was thus slightly below the ratio of 9.9% reported one year earlier. While the core capital ratio of building and loan associations and state mortgage banks has been on the decline, the remaining banking sectors are keeping their core capital ratios broadly stable (see chart 18).

Overall, Austrian banks have maintained highly stable capital ratios over recent periods and hold adequate capital buffer even during economic downturns.

Ratings of Austrian Banks by Agencies and International Organizations
In the first half of 2003 international rating agencies (Moody’s Investors Service, Standard & Poor’s, and Fitch IBCA) hardly changed their assessment of the Austrian banking sector and the outlook remained stable. Among the 16 major banks for which issuer ratings are provided, the following changes were observed in the period under review until September 2003: Fitch IBCA upgraded both Erste Bank der oesterreichischen Sparkassen AG (from C to B/C) and
Kommunalkredit Austria AG (from B/C to B). In June 2003, Standard & Poor’s rated Hypo Alpe-Adria-Bank AG at AA (long-term).

In spring 2003, rules were adopted governing the expiry of the Austrian regional and local governments’ guarantees for the debt of state mortgage banks and local authority savings banks. The required legal changes have to be implemented by September 30, 2004, with transition periods being provided up to the year 2017. In Austria, 7 state mortgage banks and 21 local authority savings banks are affected by the abolition of these guarantees, of which only 5 state mortgage banks have been rated by international agencies. Since 1999, the European Commission has put increased pressure on the Austrian authorities to end government guarantees, which prompted rating agencies to downgrade their “outlook ratings” immediately from stable to negative. The partly excellent ratings are currently on the watch list.

The IMF Financial Sector Assessment Program (FSAP)

In a joint effort, the International Monetary Fund (IMF) and the World Bank in May 1999 launched the Financial Sector Assessment Program (FSAP) as a pilot project for 12 countries; since then the scope of the program has been continuously expanded. Work under the FSAP is conducted by IMF and World Bank experts, supported by national and international institutions, authorities and experts. A wide range of countries, including industrialized countries such as the United Kingdom, Canada, Switzerland and Germany, has so far voluntarily taken part in the program.

The FSAP aims to identify the vulnerabilities of a country’s financial system to avoid crises and to determine the priorities for developing the financial sector as well as to enhance financial system efficiency. The comprehensive assessment of the strengths and vulnerabilities of a country’s financial system is to help the early identification of potential issues of concern and the timely implementation of corrective measures. Another aim of the FSAP is to improve communication with national authorities.

The FSAP exercises focus on three key issues:

- financial sector stability (a systematic analysis of the macroeconomic environment which takes into account a number of indicators, the results of stress tests, etc.);
- compliance with the relevant international standards and codes in the banking, insurance and securities sectors as well as in the fields of payment systems, money laundering and the fight against the financing of terrorist activities, etc.;
- financial market reform and essential changes (adequacy and efficiency of the supervisory framework, adequacy of the legislative framework, etc.).

To facilitate the preparation and implementation of the FSAP exercise in Austria, the Financial Market Committee in spring 2003 established a joint FSAP secretariat, in which one representative each of the Federal Ministry of Finance, the Financial Market Authority and the OeNB work as coordinator and contact person for all Austrian and foreign institutions involved (FSAP-Austria@fma.gv.at).

Two working visits of IMF delegates to Vienna, which include meetings with experts from the Federal Ministry of Finance, the Financial Market Authority and the OeNB as well as from Austrian banks, insurance companies, interest groups, external auditors, etc., are scheduled for October and December 2003. At the end of the second visit, the IMF delegates will submit a draft report, which will be discussed with representatives of the three involved institutions. The FSAP for Austria will be concluded in the course of the regular IMF Article IV Consultation in the first half of 2004. The results of the FSAP are planned to be published in an abridged final report.
Insurance Companies
Market Developments
and Business Activity

After years of falling revenues, insurance companies both at the European and at the Austrian levels seem to be regaining some ground, which has also been mirrored by the upward trend of the DJ EURO STOXX Insurance Index since the beginning of 2003. Although certain rating agencies maintain that the financial situation of (particularly German) life insurance companies has not been showing signs of improvement, the company data of the 50 largest European life insurers indicate that a slight recovery has been underway. Gross premium income, for instance, increased, implying that there is renewed optimism in the industry. The stock market turmoil seen over the past few years severely affected the life insurance business. However, now that capital markets have been picking up, investment returns have also been improving. Still, it must be noted that sliding stock prices had prompted investors to shift their portfolio compositions towards lower-risk instruments; having thus reduced the share of stocks in their portfolios, insurers can now reap only part of the advantage from the stock markets’ recovery. With bond yields at low levels, investment in lower-risk securities is not considered too promising either. The brighter outlook for premiums notwithstanding, it would therefore be too early to speak of a sustained recovery of the European insurance business.

Claims from natural disaster, corporate bankruptcy and asbestos victims weighed heavily on European nonlife insurers. This branch of the insurance industry, however, was able to adjust more easily to market developments through premium hikes. Also, it benefited from increased demand for insurance products.

In line with developments at the European level, the Austrian insurance industry has recorded improving results recently. According to the semiannual reports of the major Austrian insurance companies, premium income in both the life insurance and the nonlife insurance segments rose in the first few months of 2003 against the same period of the previous year. The property/casualty sector on the one hand benefited from increased premium income in the auto insurance sector and on the other hand faced more claims because of the severe storms and hail of spring 2003. The development of stock prices of the Austrian insurers listed on the Vienna exchange has been broadly stable since the beginning of 2003.

Austrian insurance companies’ assets (excluding reinsurance transactions) expanded by 2.2% to EUR 60.6 billion in the second quarter of 2003 against the previous quarter, which marks another increase after the 1.7% rise recorded in the first quarter.

For the domestic market leaders, their activities in Central and Eastern Europe have been playing an increasingly important role. The subsidiaries and participations abroad posted – partly remarkable – increases in premium income, contributing up to 28% to total premium income. After enlargement, the Central and Eastern European markets are expected to hold a large growth potential particularly for life and health insurers. Apart

from expanding their own distribution networks, insurance companies are likely to seek closer cooperation with partners in the banking industry.

**No Spillover Risks for the Austrian Banking Sector**

Austrian insurers’ investment patterns continue to show a preference for domestic assets. Deposits other than overnight deposits with Austrian banks expanded by a remarkable 83% against the previous quarter. Thus, the share of bank deposits in insurance companies’ total assets has doubled to 6% since end-2002. Investors apparently opted mainly for quasi-money market instruments, owing to uncertain capital market developments and low bond yields.

Investment in debt securities issued by Austrian banks expanded by 4%; the increase in this category thus clearly trailed the 13% rise recorded in the first quarter of 2003. At EUR 8.5 billion, domestic debt securities account for 14% of total investment assets. Investment in domestic equity interests was also on the rise (by some 11%). Accounting for 26% of total investment assets, external assets continue to be the most important investment category, even though its amount has hardly changed since the end of 2002. The second largest investment category, representing a share of 24%, are equity securities and other domestic securities, which, however, have recorded a slight downturn since the beginning of 2003. As in previous years, lending continued to slow down, mainly because government borrowing subsided further.

Insurance technical reserves, which reflect insurers’ liabilities against their subscribers, account for the lion’s share of liabilities. In the second quarter of 2003, insurance technical reserves amounted to EUR 55.6 billion, thus representing around 85% of total liabilities. Life insurance companies held the largest share (close to 77%) of these reserves, namely EUR 42.8 billion, the share of property/casualty insurance came to 18%, while health insurance accounted for 5%.

The capital market recovery seen so far this year as well as increasing premium income have contributed considerably to stabilizing the situation of the Austrian insurance industry. Appropriate supervisory measures were
an additional positive impetus. The Maximum Interest Rate Regulation\(^1\) provided for the reduction of the maximum interest rate for calculating technical reserves for life insurance contracts from 3.25% to 2.75%. Hence, there is no evidence that the insurance industry constitutes a burden on the profitability of the Austrian banking sector in particular. With loans to the Austrian insurance industry totaling EUR 1.6 billion (accounting for a share of less than 1% of total large exposures), banks are not exposed to heightened credit risk, which is also confirmed by banks’ very good credit ratings for insurance companies. Equally, the increased use of financial instruments to transfer credit risk between the banking and the insurance sectors does not pose a major threat to financial stability in Austria. At the European level, the stepped-up use of credit derivatives is considered to be a major cause for concern, in particular because market participants lack experience with this instrument. However, credit derivatives have not been traded extensively in the Austrian market. Moreover, their use is subject to supervisory law.\(^2\)

**Other Financial Intermediaries**

**Pension Funds**

The unfavorable economic environment of the years 2001 and 2002 has presented the greatest challenge to Austrian pension funds since they were established, putting them under massive pressure. According to the Austrian occupational pension fund association investment performance averaged \(-6.3\%\) in 2002. In reaction to the changed economic conditions, pension funds reduced their equity shares and increasingly invested in low-risk bonds and structured products.

Legislators also took account of the new environment and in summer 2003 adopted a reform of the Austrian Pension Fund Act. The main aspects of the amendment include a change in the system of capital grants for premium reserves to continuous grants for pensions, the establishment of a minimum yield reserve according to the capital requirements of the EU Directive\(^3\) under which pension funds are obliged to build up reserves for securing the accrued rights to benefits of active and retired pension plan members, and the introduction of new valuation methods in accordance with international standards. Moreover, the Financial Market Authority may determine by regulation maximum percentage rates for the assumed interest rate for new pension contracts and will thus be prepared to respond more flexibly to future capital market developments.

After the low yields of the past few years, a rebound is expected for 2003, which is mainly attributable to new dynamics in the financial markets. Whereas investment performance was weak at the beginning of 2003, it picked up considerably in the first half of the year; by mid-2003, the investment performance of

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1 This Regulation enters into force on January 1, 2004. The new interest rate is applicable to new insurance contracts only and not to index adjustments in existing contracts. Furthermore, it is applicable to conventional life insurance contracts only and not to unit-linked life insurance contracts.

2 Credit derivative trading by insurance companies is subject to the regulation of the Financial Market Authority on investment for the coverage of insurance technical reserves by insurance companies.

Austrian pension funds ranged between 3% and 4.5%. Despite relatively modest growth over the past few years, demand for occupational pension schemes persists. By May 2003, another 300 companies had introduced pension plans, thus the number of active and retired pension plan members has increased by about 5%.

Total assets under management by Austrian pension funds augmented to EUR 8.6 billion by mid-2003. An increase of around 6% against the previous quarter means a continuation of the upward trend which began at the end of 2002.

Whereas the share of domestic issuers’ debt securities denominated in euro decreased by about 30%, the position “other securities of domestic issuers” recorded a marked increase of approximately 170%. Although this investment category displayed a high degree of volatility in the past, the increase is remarkable and may be attributable to the recovery of the stock markets. Deposits also posted a decline of around 6% against the previous quarter. In addition to falling interest rates in all deposit categories, institutional investors’ renewed confidence in international financial markets is likely to be responsible for the shift in investment strategies.

The majority of assets continue to be invested in securities of domestic issuers; accounting for around 93% of total investment assets, mutual fund shares continue to be the most important category.