1 The Expansion of Austrian Banks to CESEE

Austrian banks started to enter the Central, Eastern and Southeastern European (CESEE) markets as early as in the mid-1980s, thus being among the first to move into the region. This step was primarily motivated by the wish to provide services to domestic corporations that had expanded to CESEE. In addition, it gave domestic banks the opportunity to gain a foothold in markets that – mainly for geographical and historical reasons – had close links with Austria. By the early 1990s, three Austrian banking groups had established subsidiaries in neighboring countries and also in Poland and Russia. Chart 1 shows the presence of the major Austrian banking groups in CESEE and in the Commonwealth of Independent States (CIS) in terms of the number of local subsidiaries.

During the recessions that struck most CESEE countries in the 1990s, Austrian banks and their subsidiaries – contrary to many state-owned banks – stayed clear of default, as at that time the subsidiaries were almost exclusively greenfield.

![Diagram showing the presence of six major Austrian banks' subsidiaries in CESEE and the CIS over time.]

Source: OeNB, banks’ websites.

1 Banks included: UniCredit Bank Austria AG, Erste Bank der österreichischen Sparkassen AG (Erste Bank), Raiffeisen Zentralkreditbank Österreich AG (RZB), Volksbank AG (VBAG), Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG (BAWAG P.S.K.), and Hypo Group Alpe Adria (HGAA) or their respective predecessors.

2 Serbia and Montenegro (CS) until 2005, from 2006 Montenegro (ME) and Serbia (RS).

---

Gerald Krenn, Claus Puhr

---

1 Oesterreichische Nationalbank, Financial Markets Analysis and Surveillance Division, gerald.krenn@oenb.at and claus.puhr@oenb.at. The authors would like to thank Markus Hameter, Johannes Pann, Thomas Reiningger and Zoltan Walko (all OeNB) for their support and the provision of data. We also acknowledge valuable research assistance by Gregory Ivanov.

2 See also Kager’s contribution “A Banker’s Take on Twenty Years of CEE Banking Sector Developments” in this issue.
operations with less risky loan portfolios than many state-owned banks that struggled with bad loans inherited from Communist times. While the restructuring and refinancing of state-owned banks proved costly and led many CESEE governments to proceed with full or partial privatization, more Austrian banks expanded into CESEE in the second half of the 1990s (see Barisitz, 2006). That period was marked by a significant departure from the banks’ formerly homogeneous business models as their strategies diversified. Some banks continued to concentrate on their initial greenfield operations and a strategy of organic growth, whereas others acquired stakes in large state-owned banks in the first wave of privatization to accelerate their expansion.

At the turn of the millennium, the economic environment in most CESEE countries stabilized and banking activities entered a path of sustained expansion, boosted by robust economic growth and the anchor or prospect of EU accession (see Barisitz, 2006). EU-15 banks began to enter the markets in significant numbers, taking advantage of further large-scale privatizations. Apart from a few large domestically-owned national players or state-owned banks, the banking markets in CESEE were dominated by EU-15 banking groups at that time. As the CESEE countries began to prosper and EU membership negotiations started, in particular three Austrian banks (UniCredit Bank Austria, Erste Bank, and RZB) had already seized the opportunity of an early expansion into the region. They are now among the largest foreign investors in terms of total banking assets in CESEE.

In addition, the CIS started to become more important for Austrian banks at the turn of the millennium. With many of the CESEE markets passing on to a more mature stage of development, the CIS offered an opportunity for Austrian banks to prolong their strategy of pioneering expansion.

2 Current Exposure of Austrian Subsidiaries in CESEE

The recent past has been characterized by both an increase in market shares that Austrian subsidiaries hold in CESEE and the CIS and a rise in the region’s importance for the Austrian banking system. Regarding market shares, disaggregated data on the subsidiaries of the 11 Austrian banking groups active in the region reveal that these subsidiaries hold considerable cumulated shares in CESEE that come to or exceed 30% in six countries (see chart 2). For the entire region (excluding Russia), Austrian subsidiaries’ market share recently dropped by 1 percentage point to 22% at year-end 2008. Including Russia, this share stands at 15%.

Although some markets account for a significant share in Austrian banks’ overall exposure to the CESEE and CIS markets – in terms of subsidiaries’ aggregate total assets, the largest exposure is vis-à-vis the Czech Republic (more than EUR 50 billion), followed by almost equally large exposures to Croatia, Slovakia, Romania, Russia, and Hungary (around EUR 30 billion each) – no single country contributes more than 20%.

In response to the increasing importance of CESEE operations for the entire domestic banking system, the OeNB started to collect data on the subsidiaries that primarily operate under host country supervision. At the beginning (i.e. in 2002), these data included basic balance sheet information, which were later augmented by more detailed, risk-related information. Section 2 is mainly based on data from these reports that have been available over the entire reporting horizon.

Albania, Bosnia and Herzegovina, Croatia, the Czech Republic, Romania, and Slovakia.
The recent rise in subsidiaries’ total assets (see chart 3) was mainly boosted by two driving forces: acquisitions, the bulk of which took place outside the EU Member States that joined in 2004, and annual loan growth rates that persistently exceeded 20% in virtually all organically developing entities and were even considerably higher in several cases. Nevertheless, the CESEE-10 account for roughly two-thirds of Austrian subsidiaries’ total assets in the region. Outside the CESEE-10, Croatia is the most important market for Austrian banks’ subsidiaries, closely followed by Russia, the largest market in the entire region.

On an aggregate level, these two markets gained further weight with the restructuring that followed the 2007 takeover of HVB Group (then Bank Austria’s parent bank) by the Italian UniCredit Group (its current parent bank). The latter, also a pioneering institution in the region, put its Austrian subsidiary, henceforward UniCredit Bank Austria, in charge of the entire group’s CESEE segment.8

Even on the aggregate level, this transaction had a significant impact on the Austrian banking system’s overall exposure to the region. Given the fact that EU membership has always been cited as a major stabilization factor, this transaction notably increased the share of assets outside the CESEE-10 (from 25% at end-20067 to 34% at end-2007). However, there are many other, more refined ways to assess subsidiaries’ risk positions, amongst which external sources such as bank or sovereign ratings play an important role. Up to early 2008, rating outlooks for the region were consistently positive, and up to mid-October 2008, actual downgrades were limited to sovereigns which are of only marginal importance to Austrian banks.8 From October 2008 on, however, the large rating agencies issued qualitative analyses some of which described the outlooks as deteriorating both at bank and sovereign level. Shortly after, the first downgrades relevant to Austrian

---

1 CESEE-10 refers to the eight CESEE countries that joined the EU in 2004 (CESEE-8: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia) plus the two that joined in 2007 (CESEE-2: Bulgaria and Romania).

2 The sale of the Polish Bank RPH (which became necessary as the Polish subsidiary reports directly to the Italian parent bank) and of the Croatian Splitska banka (which was required based on competition rules) was more than offset by the acquisition of Bulbank (BG), Živnostenská banka (CZ), Zagrebačka banka (HR, the largest local bank), UniCredit Bank (IV), UniCredit Tiriac Bank (RO), IMB (RU) and Unibanka (SK). In addition, UniCredit Bank Austria took control of the 40% stake in the Turkish joint venture Yapı Kredi.

3 If one includes the exposure to Bulgaria and Romania already in the CESEE-10 category.

4 For instance, Standard & Poor’s downgraded the ratings of Kazakhstan and Lithuania.
banks followed. Nevertheless, at year-end 2008, more than one-half of Austrian subsidiaries’ total banking assets in the region were still held in countries with investment grade ratings.

3 Direct Cross-Border Lending by Austrian Banks to CESEE

In addition to the assets of local subsidiaries, Austrian banks hold substantial exposures to CESEE and the CIS in the form of direct cross-border loans. From year-end 2002, credit to nonbanks more than quadrupled to EUR 67.4 billion. On an aggregate basis, direct lending to CESEE and the CIS grew at a steadily increasing pace, but local and regional differences are quite significant (see chart 4). In terms of total (i.e. direct and indirect) cross-border lending to nonbanks in the region, the relative importance of direct cross-border lending remained constant at just under one-third of the total volume.

Regarding cross-border credit extended to customers resident in the CESEE-10, direct lending to the CESEE countries that joined the EU in 2004 increased at a fairly steady pace of about 20% per year to EUR 36.2 billion, whereas direct lending to Bulgaria and Romania grew at a significantly faster rate of more than 50%
to EUR 10.7 billion at year-end 2008. Together, the two regions account for a steady share of slightly over two-thirds of overall direct lending to CESEE and the CIS countries.

In contrast to indirect cross-border lending to CESEE and the CIS, customers from Croatia (with a share of 17%), Poland (13%), the Czech Republic, Hungary and Romania (12% each) were the leading recipients of credit from Austrian banks at year-end 2008. In Romania, and to a lesser extent also in Bulgaria, direct cross-border lending has grown faster than in all other countries since 2002. This development to some extent mirrors the trend of indirect lending to the entire region, which has also been expanding rapidly in the CESEE-8 (and also SEE and the CIS) – at the expense of the relative weight of the CESEE-2. This would suggest that, by and large, direct lending activities of Austrian banks have accompanied the expansion of indirect lending.

However, the co-movement of direct and indirect lending is far from ubiquitous. In Russia, for example, indirect loans expanded rapidly through both organic growth and acquisitions, whereas the relative importance of direct lending decreased markedly. The same applies e.g. to Slovenia and Ukraine. As a consequence of the ongoing financial crisis and the associated reassessment of the risk posed by the regional credit exposure, the dynamics of credit expansion lost momentum across the region in the second half of 2008. Notwithstanding differences among the countries, growth almost came to a standstill at year-end with as yet no sign of a recovery.

So far, the analysis was restricted to aggregate data, so that the large Austrian banking groups dominated observations. But direct cross-border lending to CESEE has become important for small and medium-sized banks, as well. Puhr et al. (2009) show that these banks, particularly in the eastern provinces of Austria, tend to extend loans to borrowers from immediate CESEE neighbors.13

Chart 5 shows a breakdown by province of aggregate direct cross-border lending to Austria’s four CESEE neighbors at year-end 2008 (represented by the light

---

13 Austria’s immediate CESEE neighbors are the Czech Republic, Hungary, Slovakia, and Slovenia.
blue slices within each circle). Moreover, the chart provides information about the respective customers’ countries of residence (represented by the columns next to each blue slice). The two measures indicate the influence of geographic proximity on whether Austrian banks extend loans to the region at all and if they do, where to. The dominance of the Czech Republic in the north, Hungary in the east, and Slovenia in the south indicates that geographic proximity is indeed a significant factor in the choice of destination for direct cross-border lending by Austria’s small and medium-sized banks.

4 The Impact of the Expansion to CESEE on the Austrian Banking System

As shown in the previous two sections, the staggering organic growth of established subsidiaries, further acquisitions, as well as surging direct lending have contributed to an increase in the exposure of Austrian banks to CESEE and CIS markets. To assess the impact of this rapid expansion of the Austrian banking system’s activities in CESEE as a whole, we need to take a look at the consolidated level.

Unfortunately, systematic reporting with a breakdown by regions of balance sheet and profit and loss data was only implemented in 2008. However, the business segment reports of the six major Austrian banks active in the region have shown a steep relative increase in total assets and an even steeper relative rise in pretax aggregate profits. In the second half of the decade, the share of total

---

14 All Austrian provinces are included in chart 5 with the exception of Vienna. Home to all large Austrian banking groups except HGBA, Vienna more or less reflects the aggregate Austrian banking systems’ geographic diversification of direct cross-border lending.

15 The six major Austrian banking groups (see footnote 1 of chart 1) increasingly published business segment reports as part of their annual reports. For those who did not, the OeNB drew that information from bilateral surveys.
assets in CESEE and the CIS rose by approximately 10 percentage points to just over one-quarter at year-end 2007. At the same time, the contribution of the CESEE and CIS business to pretax profits improved to more than 40%, thus significantly outpacing the growth of the regions’ share in Austrian banks’ total assets.

At end-2008, the 40 banking groups subject to this new reporting standard held more than 30% of Austrian banks’ total consolidated assets in CESEE and the CIS. At the same time, they hauled in EUR 2.9 billion in pretax profits, which helped to offset the losses incurred domestically and in the rest of the world. Again, subsidiaries played an important role (see chart 6), which can be partly explained by an observation made by Liebeg and Schwaiger (2007): They show that in CESEE – contrary to other emerging markets – foreign ownership had a positive effect on interest margins. They attribute this to the fact that for subsidiaries, refinancing is cheaper than for their domestic peers, as the subsidiaries have access to the internal capital market of the holding group and profit from implicit guarantees by the parent institution.

In the same study, Liebeg and Schwaiger confirm the assumption that interest rate margins in CESEE are the lower, the more developed an economy is. Thus, they provide evidence of a fact that is one of the main incentives for banks to move further east to less developed markets, where, however, higher profits have gone hand in hand with higher risks. Although financial deepening, and therefore a benign climate for banks, is expected to resume in CESEE and the CIS in the long run, the short- and medium-term outlook is less positive. Still, Austrian banks have on numerous occasions confirmed their intention to support local subsidiaries through these harder times.

While financial markets are already factoring in the region’s economic downturn, the risk positions in bank balance sheets as well as the data reported reflect this development with a lag. In view of the adverse developments, profit contribution can be expected to shrink notably in the near future, and total asset growth in the region can be expected to decelerate (or even turn negative), at least in the

---

10 In 2008, business segment reports were formally introduced as part of the OeNB’s regulatory reporting requirements.

---
short term. After all, expanding lending without providing for additional own funds would inevitably lead to lower capital ratios, and investors are currently demanding higher capital ratios, which they consider a sign of a bank’s higher risk-bearing capacity.

In their assessment of the impact of the crisis on Austria’s financial sector, Schürz, Schwaiger and Übeleis (2009) claim that “judged by the sequence of events in previous crisis episodes, at the current juncture, the brunt of the feedback of the real economic downturn on the banking sector is yet to come.” Accordingly, the risk emanating from the Austrian banking system’s CESEE and CIS exposure was partially reflected in the size of Austria’s bank package, which was comparatively large by EU standards. The political will in Austria, but also internationally, should instill confidence regarding the long-term success of Austrian banks’ expansionary business model. But as events are still unfolding, it would be premature at this point to attempt a final assessment of the impact the global crisis will have on Austrian banks and of the role their CESEE and CIS business will play in that ongoing story.

References

17 In the second half of 2008, growth rates of direct and indirect cross-border lending decelerated significantly. They remained slightly positive on aggregate, but decreased in individual countries.
18 Capital ratios decrease when risk-weighted assets (the denominator of the ratio) increase — independently of whether this rise stems from an expanding loan book or higher risk weights as part of portfolio migration to worse rating classes at the turn of the credit cycle.
19 In a comparison of bank packages, Posch, Schmitz and Weber (2009) find that the Austrian bank package, together with the Irish bank package, is at the upper end in terms of size measured as a ratio of GDP.
20 According to Schürz, Schwaiger and Übeleis (2009), the financial assistance provided by the EU and the IMF has helped to avoid bleak scenarios in CESEE and the CIS.