

This analysis of the conditions and risks for the stability of Austrian financial intermediaries reflects the difficult economic environment. The sluggish pace of the economy in 2002 contributed to a substantial drop in corporate loan demand, while continued stock market weaknesses affected the profitability of both Austrian banks and insurance companies – albeit to a smaller extent than in other countries. Banks' staff costs and administrative expenses advanced moderately, thus preventing cost/income ratios from deteriorating further in the wake of declining operating income. The relatively high costs of customer services, which can in part be explained by the still rather high number of banking offices per inhabitant (at end-2002, 897 Austrian banks operated 4,471 branch offices) leads us to expect further cost-cutting measures and mergers, in particular of small banks.

Austrian banks fare comparatively better than large German banks, which have to face considerable declines in operating profits and a substantial need for loan loss provisioning for current lending. Also in 2002, the successful performance of large Austrian banks' subsidiaries in the CEECs helped improve their parent companies' profitability, contributing 30% to 60% to consolidated group operating profits. Obviously, banks' profitability increasingly depends on the contributions from their subsidiaries in the CEECs.

Austrian banks mastered the difficult conditions prevailing in 2002, with capital ratios remaining largely unchanged at a satisfactory average of over 13%. External rating agencies

still rate the situation of the reporting Austrian banks as robust; only one bank was downgraded in 2002. The assessed risk categories do not indicate any immediate danger to the systemic stability of the Austrian banking sector, either. Market risks remained relatively unchanged, and banks did not increase their interest rate and stock market exposure. As Austrian banks hold only few stocks, the weak stock market developments hardly had an impact on their asset situation. The high volumes of foreign currency loans have a certain risk potential, however, as their regional concentration is high in particular in western Austria.

## **Banks**

### **Business Activity and Profitability**

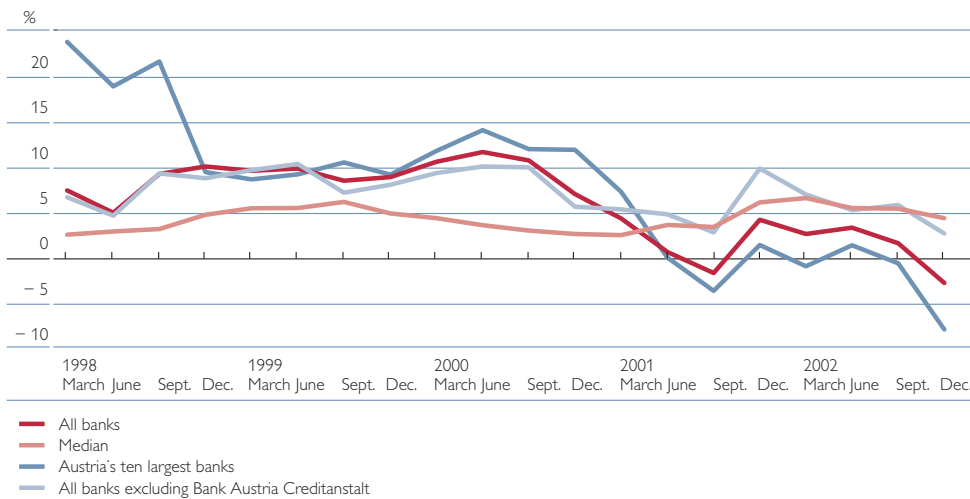
#### **Total Asset Growth Declining**

In 2002, the unconsolidated total assets of Austrian banks recorded a negative growth rate of 2.5% year on year (see chart 7). Among other factors, this development was ascribable to business policy decisions as well as changes and reorganization measures following the merger of Bank Austria and Creditanstalt in August 2002. The total assets of Austrian banks excluding Bank Austria Creditanstalt AG (BA-CA) went up by almost 3% – still a slight decline against previous years, however. This trend is traceable to the difficult economic situation and the ensuing drop in banks' business volume.

The impact of the BA-CA merger also shows in the changes in the total assets of Austria's top ten banks,<sup>1)</sup> which went down by 7.5% year on year, thus accounting for 52.8% of

<sup>1</sup> This calculation is based on the ten largest banks in terms of total assets at end-2002. As a consequence of the merger of Bank Austria and Creditanstalt in August 2002, an additional bank has been included in this group as of end-2002.

Chart 7

**Austrian Banks' Total Assets Growth**

Source: OeNB.

the total assets of all Austrian banks (end-2001: 55.7%). The median<sup>1</sup>) of the total asset growth recorded by all Austrian banks trended downward as well, falling slightly to 4.6% at end-2002 compared to 6.4% in the previous year.

#### Further Growth in Derivatives Trading

In the fourth quarter of 2002, derivatives trading picked up 25%, reaching a volume of EUR 1,388 billion year on year and thus growing significantly faster than total assets. Thus, the volume of derivatives trading recorded by all Austrian banks was 2.4 times higher than banks' total assets at end-2002 (end-2001: 1.9 times higher). As in previous periods, interest rate contracts held the lion's share in derivatives traded (82.4%), with savings banks – among them BA-CA – accounting for 78.2% of all interest rate derivatives transactions. As in

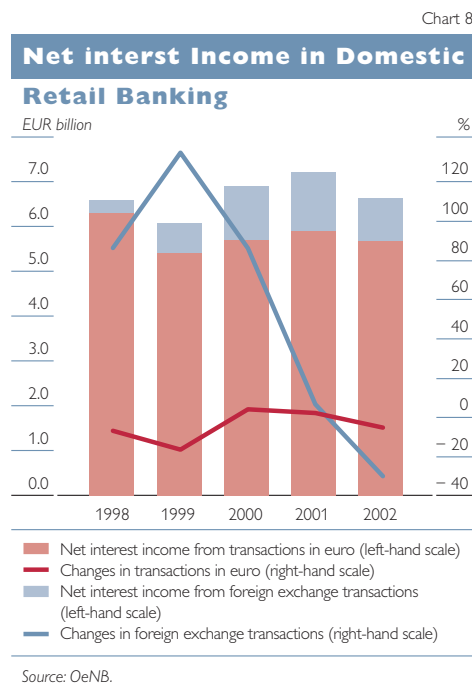
other countries, derivatives trading in Austria is mostly concentrated among the largest banks.

In the monthly return, Austrian banks report derivatives business data as nominal amounts, which is why these data cannot be used directly to assess the riskiness of the derivatives business. However, since the interest rate risk apparently did not increase for Austrian banks (see chapter “Market Risk of Austrian Banks”), one may assume rising volumes to be attributable almost equally to taking on risk positions and performing hedging transactions.

#### Profitability of Austrian Banks Weakens Compared to 2001

As in many other EU countries, the difficult economic environment in 2002, in particular sluggish growth and the turmoil on financial markets also affected Austrian banks, causing

<sup>1</sup> 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 stable against outliers. Special-purpose banks are not included in the calculation of the median.



operating profits to go down. Given the limited role of the mutual fund business and the substantial contribution of Austrian banks' subsidiaries in the CEECs to operating profits, banks' performance is weak, but does not give cause for concern.

Austrian banks' provisional 2002 operating result on an unconsolidated basis<sup>1</sup>) decreased by 7.9% from EUR 4.6 billion to EUR 4.2 billion year on year. Whereas this period saw a decline in operating income by 2.4%, operating expenses remained almost unchanged.

Net interest income, which runs to some 52% of total operating income, remained largely unchanged as well (2001: EUR 7.09 billion; 2002: EUR 7.08 billion). A detailed analysis of the 2002 net interest income in domestic retail banking (see chart 8) reveals a year-on-year decline by 7.9% to EUR 6.6 billion, with the

contribution of foreign exchange transactions to net interest income plummeting by 27.2%, i.e. at a clearly faster pace than that of transactions in euro, which went down by a mere 3.7%. In domestic retail banking, transactions in euro contributed close to EUR 5.6 billion, or 79.6%, to net interest income. Interest margins dropped by 6 basis points from 2.93% in 2001 to 2.87% in 2002.

Accounting for 22% of total operating income, fee-based income is the second most important source of income after interest income. In 2002, this item contracted only slightly, by 1.6% or EUR 3.01 billion (after EUR 3.06 billion in 2001) – the smallest decline since the second quarter of 2001. A breakdown of fee income shows that income from lending operations surged by 28.9%, while income from payment services picked up slightly by 4.6%. The continued weakness of stock markets triggered a decline in the net income from securities transactions by 10.0%. Furthermore, the elimination of currency exchange fees in the wake of the introduction of the euro considerably reduced income from trading in foreign exchange, currency and precious metals by 17.8%.

The drop in operating income is largely attributable to the 9.8% decline in other operating income (mostly from noncore activities and nonbank activities) and to income from securities and equity interests, which account for a considerable share of 13% in operating income. As a result of the difficult stock market situation, income from securities and equity interests shrank by 9.6% to EUR 1.8 billion year on year, which

<sup>1</sup> The quarterly report (data of December 2002) records the income statement data of banks operating in Austria on an unconsolidated basis. Revenues and expenses of foreign subsidiaries, in particular, are thus not included.

in turn was largely ascribable to a reduction in income from stock transactions and – given current integration measures – from equity shares in affiliated enterprises.

Out of total operating expenses, which in 2002 posted the lowest growth in five years, staff costs rose moderately by 2.1% – an increase which basically no more than reflects the annual valorization of salaries and wages. Other administrative expenses even decreased by 0.4%, after having climbed continuously in recent years in the wake of Y2K-related computer projects, the introduction of the euro and the expansion of electronic banking. The low rise in operating expenses also indicates that cost-cutting measures initiated to improve banks' profitability are beginning to show first results. The clear rise in the depreciation of tangible fixed assets and intangible assets by 8.8% reflects the vivid investment activities of recent years.

As profitability went down, the cost/income ratio deteriorated to 69.3% in 2002, compared to 66.6% in 2000 and 67.4% in 2001. Compared to other EU Member States, the cost/income ratio of Austrian banks is relatively high. The mean cost/income ratio of the ten largest banks (taking into account the BA-CA merger in mid-2002) jumped from 65.1% in 2001 to 70.8% in 2002, which is also attributable to the 9.9% slump in income, given that

expenses went down by 2.1%. 10% of Austrian banks report a cost/income ratio of 82.4% or worse (90% quantile).

Banks operating in Austria expect to close the 2002 business year with an operating result (before taxes) of EUR 4.2 billion, a year-on-year decline of 7.8%. At EUR 2.0 billion, loan loss provisions are expected to be almost 8% lower than the exceptionally high figure recorded in 2001. Since transfers to provisions for securities and participations are higher than transfers from these items, their balance will have to be factored into expenses also in 2002. In previous years, by contrast, this – at times considerable – balance had always been factored into revenues. For 2002, a strong downtrend is expected in particular for income from the realized sale of securities and equity interests.

For a comprehensive assessment of bank profitability in Austria, the unconsolidated results based on banks' quarterly reports have been refined with the consolidated results based on their reports of condition and income. Taking account of the consolidated financial statements of the various banking groups prepared in compliance with the Austrian Commercial Code or using the IAS format ensures that the results adequately reflect the income earned and expenses incurred by each banking group as a whole (including subsidiaries abroad).

Table 4

<b>Cost/Income Ratio</b>					
	1998	1999	2000	2001	2002
	%				
Mean of the ten largest banks	64.6	71.1	66.9	65.1	70.8
50% quantile (median)	70.6	70.2	64.8	67.7	68.3
10% quantile	58.1	57.4	52.1	54.9	54.4
90% quantile	84.7	83.1	77.8	81.4	82.4

Source: OeNB.

On the whole, the consolidated profitability data broadly match the unconsolidated results. At year-end 2002, both the consolidated and the unconsolidated operating income in percent of total assets were below the comparable results of the previous years. Interest income remained fairly stable, as in recent quarters, whereas noninterest income fell markedly short of the 2001 result, reflecting the difficult situation in the securities markets. As a result, operating income in percent of total assets declined. While costs in percent of total assets did not deteriorate, the poorer operating income result caused the cost/income ratio to worsen to a similar extent from a consolidated and from an unconsolidated perspective.

Risk provisions tended to remain slightly below the record highs of 2002, also from a consolidated perspective. That the relative credit risk costs were lower at the end of 2002 than at year-end 2001 above all reflects the release of a high percentage of loan loss provisions. The fact that the profit for the year fell visibly short of the 2002 result, both from a consolidated and an unconsolidated perspective, can be attributed above all to the lower amount of income derived from the release of provisions for securities and participating interests.

### **Credit Risk of Austrian Banks**

#### **Economic Slowdown Dampens Loan Growth**

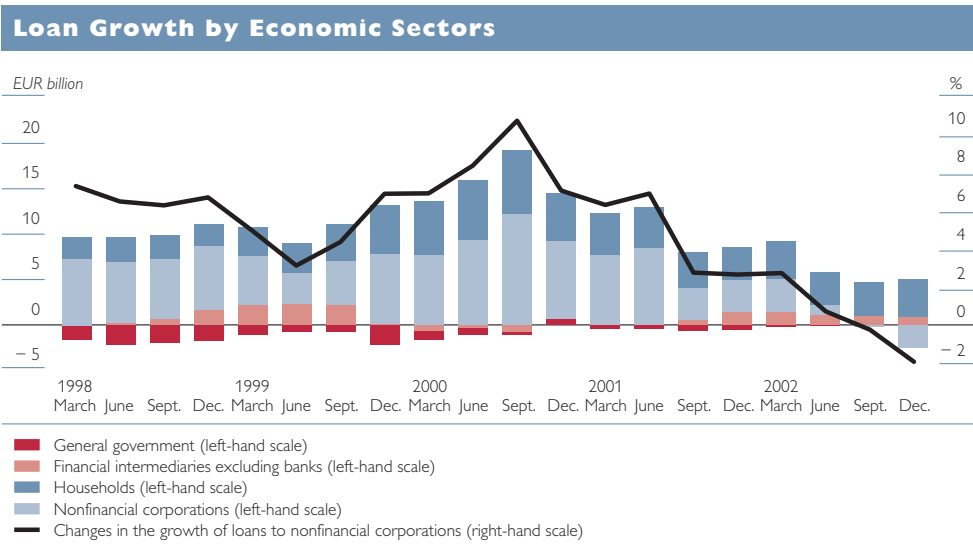
The downturn in both the national and international economy affected Austrian banks' lending activities in 2002, slowing down loan growth in spite of falling interest rates for commercial and personal loans. At the end of the fourth quarter of 2002, loan growth stood at 1.2%, compared to

3.5% in the last quarter of 2001. The ten largest banks recorded a 2.3% decline, following a 3.0% rise in the fourth quarter of 2001. The median of annual growth came to 3.8%, a slight reduction against the 4.5% recorded in the previous period.

For the second half of 2002, a breakdown of banks' lending by economic sectors (see chart 9) shows stable developments in particular in lending to households and financial intermediaries (excluding banks), with both sectors recording relatively constant year-on-year growth rates. In the second half of 2002, by contrast, changes did occur in the government and nonfinancial corporations sector. Lending to the general government went up slightly. Over the previous periods, the general government had cut back its loans from banks, partly by changing its financing strategy (notably by issuing more bonds) and partly owing to the fact that provincial governments substantially reduced their level of indebtedness. At the beginning of the second half of 2002, lending to the general government picked up again for the first time in quite a while, albeit only slightly. This rise, however, rather indicates short-term financing requirements toward the end of 2002 than a trend reversal in general government borrowing.

Moreover, lending to the corporate sector went down considerably and has even posted negative growth rates since the third quarter of 2001. At end-2002, the annualized growth rate stood at -1.8% (see chart 9, right-hand scale). Although this drop is in line with decelerating corporate loan growth in the EU in general, it is a lot more pronounced than the rate observed for the whole euro area (+3.5% according to ECB data).

Chart 9



A similar decline in corporate loan growth in Austria was last recorded in 1992 and 1993, when the economic situation was comparably problematic. Thus, the rough economic conditions are probably one of the chief reasons for Austrian banks to steer a more careful and risk-sensitive course in borrowing. Furthermore, nonfinancial corporations currently seem to postpone their investment plans (and, subsequently, their demand for loans) or to opt for other forms of financing, in particular for debt securities (see above all chapter “The Real

Economy and Financial Markets in Austria”). A long-term analysis reveals that while at present, the slowdown in corporate loans is problematic in terms of growth, it does not entail risks for financial stability.

A breakdown by industrial sectors reveals that loan growth is going down above all in sectors sensitive to cyclical fluctuations. At the end of 2002 for instance, annual loan growth came to  $-7.9\%$  in the energy sector,  $-10.2\%$  in the transportation sector,  $-4.0\%$  in the basic materials sector and  $-1.5\%$  in construction.<sup>1)</sup>

### Bank Lending Survey for the Euro Area – Results for Austria

As the results of the second round of the new bank lending survey indicate, Austrian banks reacted to the higher risk resulting from the less favorable economic environment by pursuing a more cautious lending policy in the first quarter of 2003. Banks were more hesitant to approve loans or credit lines especially to enterprises than in 2002. At the same time, they tightened their terms and conditions for such loans, first and foremost by widening their margins for riskier loans.

The surveyed banks reported that demand for loans sagged as well, again reflecting above all the weak cyclical conditions. Overall, the recent pronounced slowdown of credit growth thus appears to have been caused by both demand-side and supply-side factors, though whether banks’ tightening of standards is stronger than warranted for cyclical reasons alone cannot be judged yet, as only the data from the first two surveys have become available.

<sup>1</sup> This breakdown of industrial sectors is in line with the ECB’s classification of industrial sectors and may deviate from other types of classification, such as ÖNACE.



*Obviously, Austrian banks considered the risk profile of households to have changed less amid the economic slowdown, because they did not tighten their standards and conditions for loans to retail customers as much as for those to the corporate sector. This divergent assessment of corporate and retail customers is further reinforced by the slight rise in household loan demand reflected by the survey results.*

*Quite basically, lending by banks is a key aggregate in cyclical developments. Hence, the situation on the credit markets is a crucial factor in implementing monetary policy. To enhance the Eurosystem's knowledge of financing conditions for companies and households in the euro area, the Eurosystem (the ECB and the national central banks which have adopted the euro) launched a bank lending survey at the beginning of 2003. This survey requires 86 leading banks from all euro area countries – 5 of which are Austrian banks – to fill out a questionnaire four times a year. The first two surveys on euro area lending were conducted in January 2003 and April 2003 and were able to provide significant insights into the latest euro area lending developments.*

*In the U.S.A., where the Federal Reserve has been conducting bank lending surveys since 1967, and in Japan, such surveys have proved to be a valuable instrument and contribute importantly to the assessment of current and future lending conditions.*

#### Continued Uptrend for Foreign Currency Loans to Households

While the share of foreign currency loans in total corporate loans outstanding has stabilized at just under 20% since the beginning of 2001, households' foreign currency financing keeps gaining importance. At the end of 2002, foreign currency loans accounted for 65% of the annual growth of household borrowing, with well over half of all loans granted to households in 2002 falling in this category. By the end of 2002, the foreign currency share of total claims on households had thus augmented by almost 2 percentage points to 25% compared to the previous year; Austrian banks' claims on domestic customers totaled EUR 44.5 billion (or 18.7% of total loans), with corporations accounting for almost EUR 25 billion, households for EUR 16.7 billion, and the general government and nonbank financial intermediaries for the remainder. The number of foreign currency loans outstanding doubled since mid-1999, coming to almost 300,000 at end-2002. Whereas financing in Japanese yen had surged in the past few years, borrowers have

started to opt for Swiss franc-denominated loans again since mid-2002. At the end of 2002, 55% or EUR 25.7 billion of total foreign currency loans were denominated in Swiss francs and 37% or EUR 17.4 billion in Japanese yen.

Home and home improvement loans constitute a major part of foreign currency loans to households. At the end of the fourth quarter of 2002, the foreign currency share in the total volume of residential construction loans outstanding came to 17% or EUR 8.2 billion. During this period, foreign currency loans accounted for around three quarters of the annual growth in home loans. Also commercial real estate financing saw a rise in foreign currency loans.

#### Regional Concentration of Foreign Currency Loan Exposure

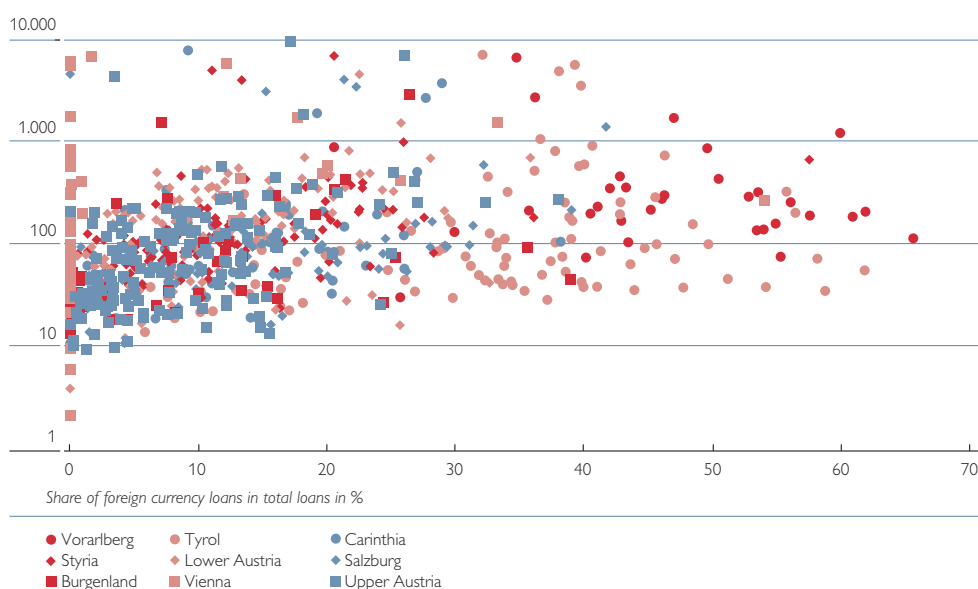
Taking out foreign currency loans entails a number of risks for borrowers, above all, for example, the exchange rate risk, i.e. the risk that interest rate or principal repayments go up as the foreign currency appreciates. Even though a foreign currency loan may provide an interest rate advantage of

Chart 10

### Share of Foreign Currency Loans in Total Loans and Total Assets of Austrian Banks – Broken Down by Provinces

Data for the fourth quarter of 2002

Total assets in EUR million (logarithmic scale)



Source: OeNB.

Note: Banks with total assets of over EUR 10 billion are not included in this chart. Foreign currency loans account for between 5% and 20% of the total loan volume of these banks. Branch offices of foreign banks and banks without relevant lending operations were not included in this calculation.

several percentage points, exchange rate fluctuations may render this type of loan much more expensive at the end of the day than a comparable euro-denominated loan. Moreover, foreign currency loans have, in general, variable interest rates and are thus exposed to interest rate and/or spread risks, i.e. the risk that the interest rate goes up in the foreign currency and/or that the interest rate spread against euro rates narrows. In addition, foreign currency loans constructed as repayment vehicles<sup>1)</sup> are exposed to the so-called repayment risk. This term comprises the entire range of risks, which are related to the performance of the repayment vehicle and may cause the capital saved up in the repayment vehicle to be

insufficient to redeem the loan. As long as banks observe the principles of matching maturities and currencies in refinancing their foreign currency loans, the above risks are in principle borne by the borrower.

Since borrowers of foreign currency loans incur higher risks, banks' default risk goes up as well. Generally banks hedge against higher default risk by demanding higher collateral. However, we may presume that collateral provided by households, in particular, is of a certain homogeneity. Mostly, household collateral will consist of mortgages on real estate properties which may be located in more or less the same area with respect to individual regional banks.

<sup>1</sup> These are foreign currency loans that are fully repaid at maturity and where the principal is saved up during the time to maturity in the form of a repayment vehicle (e.g. a life insurance policy, mutual fund, etc.).



Chart 11

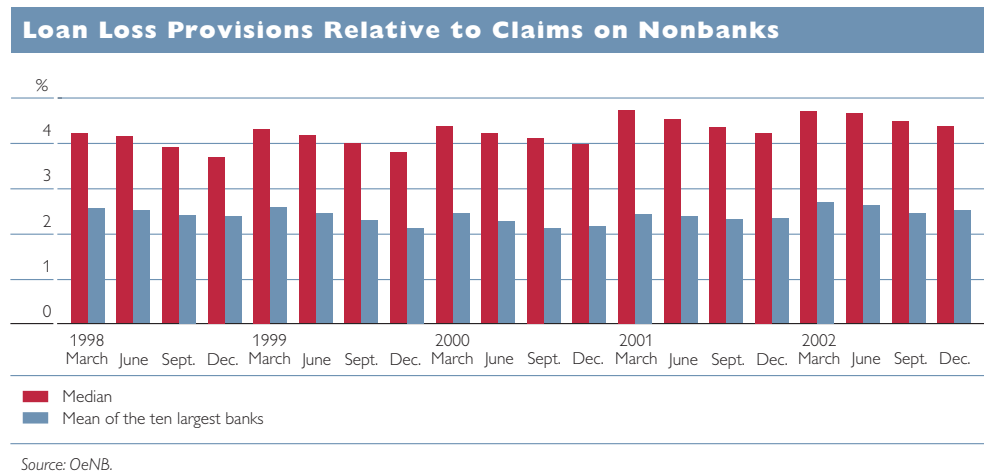


Chart 10 shows the share of Austrian banks' foreign currency loans in total claims on nonbanks. For 106 (or some 13%) of the 800 banks<sup>1</sup>) analyzed, foreign currency loans account for over 30% of outstanding claims; for 23 banks (or close to 3%) this share is even higher than 50%. Banks with a very high share of foreign currency loans are almost exclusively small and medium-sized regional banks in western Austria. In individual cases, up to around 50% of total assets are based on foreign currency loans. Should several private borrowers become insolvent because of rising exchange rates, the simultaneous and complete realization of the above-mentioned collateral would considerably dampen the price to be achieved. Banks with a very high percentage of foreign currency loans thus incur a concentration risk which, as soon as collateral is to be realized, might especially endanger the stability of some regional banks in western Austria with a high share of foreign currency lending. From the perspective of financial market stability, the high share of foreign currency loans in Austria therefore harbors a certain risk potential;

the risks involved thus need to be closely monitored.

#### Loan Loss Provisions Do Not Indicate Any Marked Deterioration of Credit Quality

Given the difficult economic environment and the resulting slight rise in the number of insolvencies, loan loss provisions went up moderately as well (see also chapter "The Real Economy and Financial Markets in Austria"). At end-2002, loan loss provisions relative to claims on nonbanks amounted to 3.3%, after 3.1% in the previous year. A breakdown by sectors reveals that loss provisions relative to claims on nonbanks grew from 3.5% to 3.9% for savings banks and from 4.4% to 4.8% for Volksbank credit cooperatives, while joint stock banks recorded a decline of loan loss provisions relative to claims on nonbanks from 2.9% to 2.7%.

The mean value of loan loss provisions relative to claims on nonbanks of the ten largest banks also went up slightly from 2.3% to 2.5% (see chart 11). As in previous periods, the figure for the ten largest banks was clearly lower than the median, which picked up somewhat from 4.3% to 4.4%.

<sup>1</sup> See note to chart 10.

With respect to the development of loan loss provisions relative to claims on nonbanks over several years, 2002 recorded no substantial changes in credit quality compared to the previous year.

### Market Risk of Austrian Banks

#### Exposure to Interest Rate Risk

##### Remains Stable

As of December 31, 2002, all Austrian banks have been required to compile and report quarterly interest rate risk statistics.<sup>1)</sup> These statistics comprise items sensitive to interest rate fluctuations (such as fixed-income securities and variable rate securities, savings deposits, loans or interest rate derivatives) and serve as a basis for deriving interest rate risk measures. A risk measure used by the Basel Committee on Banking Supervision is the ratio of the decline in a bank's economic value as a result of a potential interest rate shock of 200 basis points in relation to its eligible own funds. A group of 13 banks, accounting for 37% of Austrian banks' total assets at year-end 2002, started compiling and reporting these statistics as of December 31, 2001, without making use of the granted transitional period. Starting from a somewhat higher level, the average ratio reported by these banks dropped to 7.0% by mid-2002 and picked up slightly to 7.8% in the third quarter. At end-2002, it stood at 7.3%, which is clearly below the critical value (20%) specified by the Basel Accord. As of the third quarter of 2002, the group of reporting banks has included

the 32 largest Austrian banks, which together account for as much as 73% of total assets (as at end-2002). The average ratio of these large to medium-sized banks ran to 9.3% in the third quarter of 2002 and to 8.9% at year-end, a rise by some 1.5% against the comparable measure of the first group of reporting banks. In both cases, however, the interest rate risk follows the same trend, showing a slight decline as of late. Chart 12 shows the distribution of ratios for the 32 large to medium-sized banks.

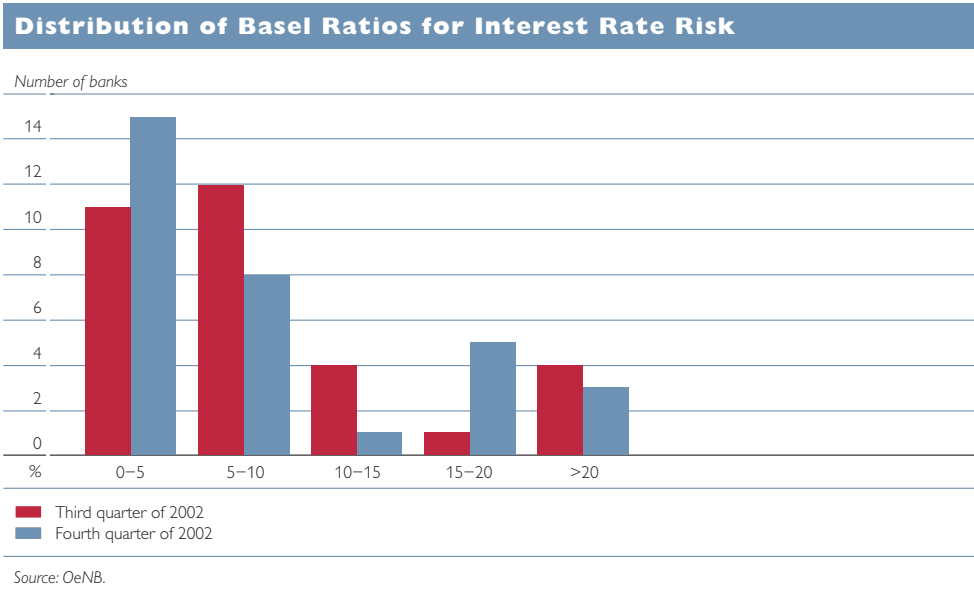
As chart 12 shows, most of the large to medium-sized banks use a rather conservative strategy with regard to the interest rate risk in their banking books. It should be pointed out, however, that there are some banks that would exceed the 20% threshold in case of an interest rate shock of 200 basis points; their number is going down, however.

Banks with large trading book exposures need not include trading book items in their statistics on the interest rate risk. Therefore, the capital required to cover the position risk of interest rate instruments serves as the basis for assessing the interest rate risk of trading book items.<sup>2)</sup> These data do not indicate any rise in the interest rate risk in the trading book throughout 2002. Since the third quarter of 2001, the respective values have remained almost unchanged at a relatively low level.

From the data reported for the interest rate risk in banking and trading books one can conclude that Austrian banks did not build up any additional interest rate risk in 2002.

<sup>1</sup> Branch offices operating in Austria under freedom of settlement are exempt from these reporting requirements.

<sup>2</sup> To this end, the results of the standardized calculation of capital requirements are combined with banks' internal value-at-risk data.



#### Exchange Rate Risk Edging Up

The capital requirements for open foreign exchange positions<sup>1)</sup> may serve to assess the risk exposure of Austrian banks to exchange rate fluctuations. These data again combine the results of standardized and value-at-risk calculations. Chart 13 shows how capital requirements for open foreign exchange positions developed. It reveals that Austrian banks' current level of open foreign exchange positions is rather low. Moreover, the chart indicates relatively high fluctuations in the past, which are mostly ascribable to the exposure of individual large banks. After reaching a historic low of EUR 64 million at end-2001, this type of capital requirement has been edging up again, standing at EUR 80 million at end-2002; a stabilization of this value has been observed over the past one and a half years.

It is possible to allocate the exchange rate risk to individual currencies by means of the monthly peaks of the open foreign exchange posi-

tions. The total sum of the absolute amounts of all banks' peak values shows that at end-2002, Austrian banks' highest exposures were vis-à-vis the U.S. dollar (EUR 887 million), the Swiss franc (EUR 800 million) and the Japanese yen (EUR 718 million). Exposures vis-à-vis the Danish krone (EUR 192 million), the Australian dollar (EUR 156 million) and the pound sterling (EUR 143 million) were significantly lower.

The Austrian banking system's exposure to foreign exchange risk can be assessed as relatively stable, showing a slight uptrend as of late. Exposure is strongest vis-à-vis the U.S. dollar, the Japanese yen and the Swiss franc. When taking into account the historical volatilities of exchange rates, the U.S. dollar and the Japanese yen present the highest exchange rate risk.

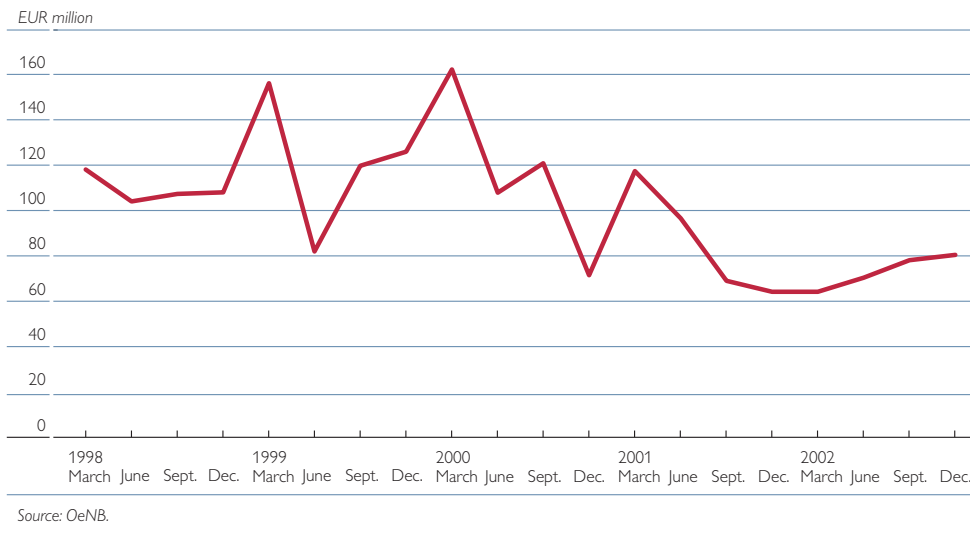
#### Exposure to Equity Price Risk Remains Low

The percentage of equity shares in Austrian banks' securities portfolios, i.e. in their holdings of debt securities

<sup>1</sup> This type of capital requirement refers to the bank as a whole, i.e. to both the banking and the trading book.

Chart 13

### Capital Requirements for Open Foreign Exchange Positions



and other fixed-income securities, mutual fund shares and stocks, remained low. Based on book values, equity shares accounted for 2.5% of banks' securities portfolios at the end of 2002. While in the previous year, this share had come to 2.9%, it declined continuously in the course of 2002. This drop is attributable to stagnating equity portfolio volumes in Austria, accompanied by the continued – albeit less pronounced – growth in the volume of debt securities and other fixed-income securities in the second half of the year. The market values of banks' equity portfolios declined by 3% year on year. As a consequence, the equity shares in the Austrian securities portfolio hardly contain any revaluation reserves: The book-to-market ratio, which had stood at 90% at the end of 1999, climbed to 98% by the end of 2002, thus reaching about the level of 1997.

The share of domestic equity in the equity portfolio remained stable over the last two years, coming to

53% at end-2002. The percentage of listed shares, by contrast, continuously declined over the same time, falling from 77% at the end of 2000 to no more than 56% at the end of 2002, with the share of listed domestic issues clearly exceeding that of foreign issues.

The capital required to cover equity positions in the trading book<sup>1)</sup> also illustrates that Austrian banks did not expose themselves to any additional equity risk in 2002. At the end of 2002, the capital required to cover equity price risk in proprietary trading even fell clearly below the long-year average.

It can be concluded that – in the face of the continued uncertainty on the stock markets – Austrian banks' stock market activities were hesitant in 2002. There is no evidence for any significant shift of business toward investment in equities such as to compensate for loss of business in traditional areas.

1 These data combine the results of both internal value-at-risk models and standard calculations.

### Risks Incurred Through Business in Central and Eastern European Countries

Several Austrian banks, notably large banks like BA-CA, Erste Bank der oesterreichischen Sparkassen AG and Raiffeisen Zentralbank Österreich AG, have by now gained a strong foothold in a number of Central and Eastern European markets. Following the strategy of “enlarged local community markets,” these banks took up business in various new markets at an early stage, relying on the advantage of geographical vicinity and existing historical ties.

By now, Austrian banks’ subsidiaries in the CEECs have become stabilizing factors in terms of operating profits. This trend prevailed throughout 2002, with CEE subsidiaries attributing over 30% – in one case even over 60% – to group results. The prospering economy in most of the CEECs (see section “Central and Eastern Europe” in chapter “International Environment”) and the intense prepa-

rations for EU accession in the candidate countries provide for a positive economic climate. However, we must take into account that the profitability of Austrian banks’ increasingly depends on markets that have so far proved to be a lot more volatile than the Austrian market. What is more, several CEECs have by now largely completed the catching-up process in the financial services sector, and the pressure on the hitherto excellent profit margins increases in tandem with fiercer competition.

Austrian banks continue their commitment in the privatization of financial services in the CEECs, setting up long-term business relations based on their strong background in retail banking. Examples of this approach are the acquisition, by BA-CA, of Splitska Banka (Croatia) and Commercial Bank Biochim AD (Bulgaria) with their 70 and 160 branch offices, respectively. Adequate risk management will become more and more important as lending to small and

Table 5

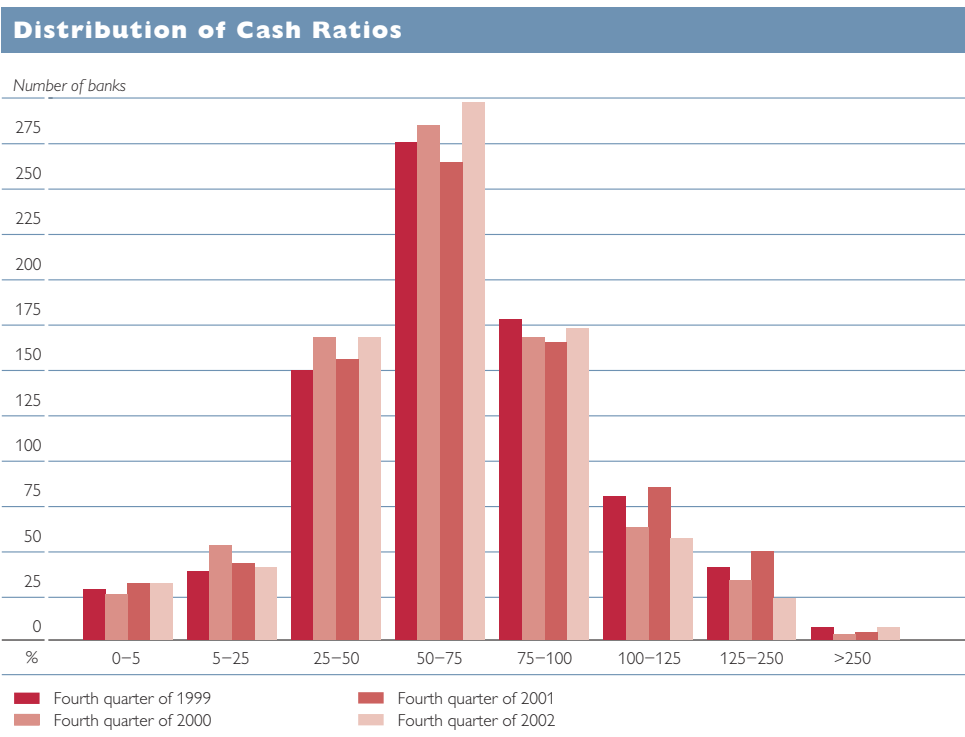
### Key Ratios of Central and Eastern European Commercial Banks Majority-Owned by Austrian Banks<sup>1)</sup>

	Total assets EUR million	Operating profit	Risk costs	Market share %	ROE	Staff Number	Banking offices
<b>Croatia</b>							
December 2001	3.855	90	– 8	18	38	2.108	81
December 2002	8.168	146	– 36	36	26	4.845	256
<b>Slovak Republic</b>							
December 2001	8.507	115	– 1	40	21	8.851	566
December 2002	10.751	147	– 32	46	16	10.207	583
<b>Slovenia</b>							
December 2001	944	13	– 5	5	3	413	15
December 2002	1.639	20	– 8	..	16	723	33
<b>Czech Republic</b>							
December 2001	21.159	272	– 87	25	11	15.486	756
December 2002	22.715	364	– 21	27	18	15.634	753
<b>Hungary</b>							
December 2001	5.742	98	– 16	15	17	3.455	160
December 2002	7.221	90	– 22	16	13	3.726	179
<b>Total</b>							
December 2001	40.237	588	– 115	x	x	30.313	1.578
December 2002	50.494	767	– 119	x	x	35.135	1.804

Source: OeNB.

<sup>1)</sup> National totals (rounded); excluding Poland for data protection reasons; provisional figures for 2002.

Chart 14



medium-sized enterprises and households expands.

In December 2002, the total assets of Austrian banks' subsidiaries in the CEECs ran to EUR 68 billion, corresponding to some 12% of total domestic assets. At almost 16%, subsidiaries' total asset growth against the previous year clearly lagged behind the comparable figure for 2000 and 2001, but still indicates continued acquisition activities in 2002, notably in Croatia (Rijecka Banka, Splitska Banka).

A breakdown of total assets by countries reveals the highest score for Austrian banks' subsidiaries in the Czech Republic (EUR 23 billion), in Poland (EUR 12 billion) and in the Slovak Republic (EUR 11 billion). Total assets in Croatia and Hungary came to EUR 8 billion and EUR 7 billion, respectively, but remained below EUR 1.7 billion in the other

countries under review. By means of their subsidiaries, the large Austrian banks engage in a wide range of activities, including some areas of focus, across a number of countries. This approach reduces their dependence on the business developments and profitability performance in individual countries and lowers the potential impact of regional slumps in profits on their overall profitability. Austrian banks hold a particularly high market share in the Slovak Republic (46%), Croatia (36%), the Czech Republic and in Bosnia and Herzegovina (27% each). Meanwhile, CEE commercial banks owned by Austrian banks operate some 3,000 banking offices with over 57,500 employees.

As at December 2002, banks' profitability also showed an upward trend. Coming to EUR 767 million, banks' total operating results in the countries presented in table 5 clearly



exceed the value recorded in 2001 (EUR 588 million), with risk provisions remaining largely unchanged despite a clear rise in total assets.

### Assessment of Other Risks

#### Legal Minimum Liquidity Requirements More Than Fulfilled

Liquidity shortfalls that prevent banks from servicing called liabilities pose a high risk of contagion to the entire banking sector. Article 25 of the Austrian Banking Act stipulates that banks must ensure that they are able to meet their payment obligations at all times. As a minimum requirement, banks must retain liquid resources of the first and second degree.

In order to maintain liquidity of the first degree, banks must retain highly liquid assets to the amount of at least 2.5% of their short-term liabilities (cash ratio).<sup>1)</sup> Maintaining the liquidity of the second degree requires holding sufficiently liquid assets relative to liabilities with residual or agreed maturities of up to three years (current ratio). The current ratio must at least come to 20%.

At end-2002, all banks met the cash ratio requirements, after two banks had failed to do so in 2001. The cash ratio of 31 banks ran to between 2.5% and 5%. Seven banks even held liquid resources a hundred times in excess of the minimum requirements. The 5% quantile, which indicates the liquidity ratio exceeded by 95% of banks, may serve as a measure for less liquid banks. In the past three years, this quantile remained unchanged at 6%; the median fluctuated just slightly

around 63%. The ratio for the entire Austrian banking industry amounts to 22%.<sup>2)</sup> The banking sector thus holds sufficient cash liquidity.

The overfulfillment of minimum requirements for the current ratio is not as pronounced as for the cash ratio. At the end of 2002, ten banks posted a ratio of over 200%. At 26%, the 5% quantile remained almost unchanged over the past four years, just like the median value (53%). The ratio for the entire Austrian banking industry amounts to 48%. The banking sector thus holds sufficient assets to meet the current ratio requirements and is very stable in this respect.

#### Operational Risk from the Perspective of Payment Systems Oversight

As electronic payment systems are becoming increasingly important for the functioning of financial systems – and with a view to the mandate of the European System of Central Banks (ESCB), stipulated in the Treaty, to promote the smooth functioning of payment systems – the Oesterreichische Nationalbank (OeNB) has been entrusted with payment systems oversight as of April 1, 2002. This duty comprises inspecting the systemic stability of payment systems with a view to legal, financial, organizational and technical risks as well as, subsequently, the operational risks linked to the operation and systemically important participation in payment systems.

When dealing with payment systems, operational risk is in general defined as “the risk that operational

1 The central institutions of individual sectors have an additional obligation for covering 50% of deposits that may be used by other banks to meet their cash ratio.

2 Total liquid resources of the first degree of all banks in relation to their total short-term liabilities.

factors, such as technical malfunctions or operational mistakes, cause or exacerbate credit or liquidity risks.”<sup>1)</sup>

A major system failure thus induced might truly endanger the stability of the financial system. What is more, implementing the monetary policy of the euro system would not, or only within limits, be possible without properly functioning payment systems.

Within the OeNB’s responsibility for payment systems oversight, monitoring operational risk is one aspect of the OeNB’s duties pursuant to Article 44a of the Central Bank Act. The obligatory inspections comprise collecting information, according to the respective guidelines, from system operators and systemically important participants on measures taken to safeguard systemic stability and to ensure safe participation as well as on-site investigations, if necessary. This information is then evaluated according to the defined oversight standards stating the substantive requirements for system security. If necessary, measures are initiated to remedy any deficiencies detected.

#### **Austrian Banks’ Risk-Bearing Capacity Capital Ratio Remains Satisfactory Despite Slight Decline**

Given the clouded economic outlook and unsatisfactory price developments at the international stock exchanges, banks’ capital is gaining importance when it comes to absorbing risks.

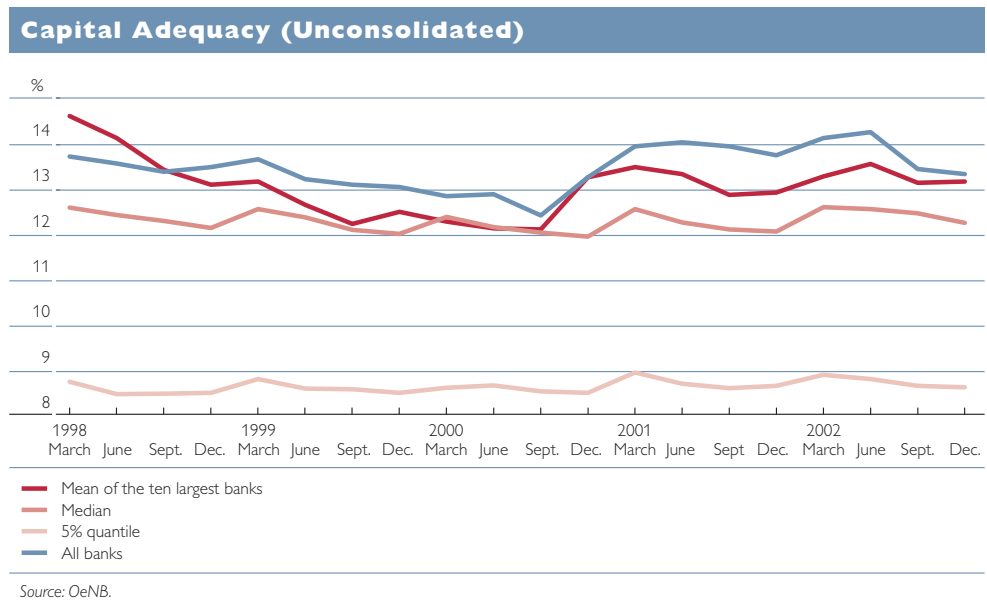
Despite the currently tight economic framework, the eligible capital of banks operating in Austria remains good, even if it edged down 1% in December 2002 year on year. At the end of 2002, the unconsolidated capital ratio<sup>2)</sup> of all Austrian banks, which serves as an indicator of a significant part of banks’ risk capacity, stood at 13.3%. Although this means a slight reduction against the comparable 2001 figure of 13.7%, this ratio clearly remains above the legal minimum requirement of 8%. We also observed a slight decline in the tier 1 capital ratio, i.e. core capital as a percentage of the assessment base. At the end of 2002, the unconsolidated tier 1 capital ratio reached 9.1%, after having stood at 9.5% in the comparable month of 2001. In absolute terms, core capital (tier 1) came to EUR 26.8 million at end-2002, against EUR 27.4 million at end-2001, while supplementary capital (tier 2) remained unchanged year on year at EUR 13.5 million. Austrian banks thus have a capital buffer at their disposal in case economic conditions and, as a consequence, borrowers’ creditworthiness deteriorate even further.

Trial calculations based on consolidated data result in a clearly lower capital ratio (11.3%) than trial calculations based on unconsolidated data. This value improved slightly compared to the previous year and is thus also clearly above the legal minimum requirement of 8%.

1 *Committee on Payment and Settlement Systems. 2001. Core Principles for Systemically Important Payment Systems. Report of the Task Force on Payment System Principles and Practices. CPSS Publication 43. Basel: Bank for International Settlements. January 2001, p. 5.*

2 *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. The capital ratios published in the OeNB’s monthly return and Financial Stability Report 2 (2001) also include tier 3 capital, which results in higher values. As tier 3 capital is subordinated capital that may only be allocated against market risk, it was not included here so as to produce a conservative capital adequacy assessment.*

Chart 15



The capital ratio of the ten largest banks (in terms of total assets) amounts to 13.2%, which is almost 1% higher than the median value of 12.3% (see chart 15), and is thus perfectly in line with past trends. Even banks with a comparatively low capital ratio remained above the minimum requirement of 8%. The value for the 5% quantile, indicating the banks with the lowest capital ratios, came to 8.7% at end-2002.

Banks' current capital ratios appear sufficient to meet future changes in capital requirements in the wake of the New Basel Capital Accord (Basel II). In the third Quantitative Impact Study (QIS 3), which was carried out at the beginning of the year to provide banks around the world with an opportunity to test the impact of the new capital requirements on their

current assets, Austria achieved quite satisfactory results.<sup>1)</sup> When applying the standardized approach,<sup>2)</sup> the figures for capital requirements go up slightly, while internal ratings-based approaches indicated a reduction of capital requirements. Although the results of the QIS 3 test still need to be viewed with caution as discussions on the new capital adequacy framework have not yet been concluded, Basel II in its present form does not create an immediate need for Austrian banks to increase their capital ratios to meet future capital requirements.

#### Ratings of Large Austrian Banks Essentially Unchanged

Credit quality assessments and ratings are formal methods to evaluate credit risks. Each rating grade corresponds to a statistical probability of default

1 See also the contribution "Basel II, Procyclicality and Credit Growth – First Conclusions from QIS 3" by Redak and Tscherteu in this issue.

2 In principle, banks have two options to assess the creditworthiness of their customers: the standardized approach, where a customer is rated by an external rating agency, or the internal ratings-based (IRB) approach, where banks rate their customers themselves.

Table 6

## Ratings of Austrian Banks

	Moody's Investors Service – Deposit Rating				Standard & Poor's – Deposit Rating		
	LT <sup>1)</sup>	ST <sup>2)</sup>	BFSR <sup>3)</sup>	Outlook financial strength	LT <sup>1)</sup>	ST <sup>2)</sup>	Outlook
Bank Austria Creditanstalt AG	A2	P-1	B–	stable	A	A-2	negative <sup>4)</sup>
Erste Bank der oesterreichischen Sparkassen AG	A1	P-1	C+	stable		A-2	
Raiffeisen Zentralbank Österreich AG	A1	P-1	C+	stable		A-1	–
Oesterreichische Kontrollbank	Aaa	P-1	–		AAA		–
Österreichische Postsparkasse AG	Aa3	P-1	C+				
Raiffeisenlandesbank Oberösterreich reg. GenmbH	A1	P-1	B–				
Landes-Hypothekenbank Oberösterreich AG					AAA	A-1+	negative <sup>4)</sup>
Landes-Hypothekenbank Niederösterreich AG					AA+	A-1+	negative <sup>4)</sup>
Landes-Hypothekenbank Steiermark AG					AA	A-1+	negative <sup>4)</sup>
Landes-Hypothekenbank Tirol AG					AAA	A-1+	negative <sup>4)</sup>
Landes-Hypothekenbank Vorarlberg AG	Aa		C		AAA	A-1+	negative <sup>4)</sup>
Hypo Alpe-Adria-Bank AG	Aa2	P-1	C+	stable			
Österreichische Volksbanken-AG	A2	P-1	C+				
Bank für Arbeit und Wirtschaft AG	Aa3	P-1	C+				
Kommunalkredit Austria AG	Aa3	P-1	C+				
Investkredit Bank AG	A1	P-1	C–				

Source: Moody's Investors Service, Standard & Poor's.

<sup>1)</sup> Long-term.

<sup>2)</sup> Short-term.

<sup>3)</sup> Bank financial strength rating.

<sup>4)</sup> A negative outlook indicates a potential downgrade within the next two to three years.

with respect to repayment obligations.<sup>1)</sup> In addition to the traditional bank deposit ratings for savings, sight and time deposits and for interbank business, Moody's Investment Service provides a Bank Financial Strength Rating (BFSR). This assessment system evaluates banks according to their own financial strength, irrespective of any support by a parent company or third party, e.g. in the form of a deficiency guarantee.

International rating agencies judge the Austrian banking sector to be stable because of its sustained, predict-

able performance and its growing commitment in CEE markets, which continue to show good growth potential.

In Austria, 16 large banks subject themselves to issuer credit ratings assessing their general financial strength and overall ability to meet payment obligations. An important aspect of these ratings is to raise the confidence of investors and customers, as a favorable rating both opens access to large-scale deposits and helps reduce refinancing costs.

With the exception of BA-CA, the issuer credit ratings of Austrian banks

1) Probability tables give the respective default probabilities for each rating, distributed over the years. The probability that an AAA-rated bond is not serviced in one year is 0%; the probability that it is not serviced in 15 years is rated at 1.06%. For a BBB rating, the 15-year probability amounts to 4.2%, for a CCC rating it stands at 42.96% (Source: S&P Corporate Default Study, August 1998).

were not downgraded in 2002. The rating agency Moody's Investors Service, however, downgraded both long-term and subordinated liabilities of BA-CA in July 2002 and then again in January 2003 by one grade each,<sup>1)</sup> quoting structural problems of the parent company Bayerische Hypo- und Vereinsbank AG as the reason for this downgrade.

In their current ratings of five regional mortgage banks, Standard & Poor's already take into account the long-discussed phase-out of state guarantees by adding the rating "Outlook negative," which means that the next two to three years may see a downgrade. At the beginning of April 2003, the European Commission and Austria reached an agreement on the existing system of state guarantees for Austrian banks.<sup>2)</sup> The phase-out schedule provides for a transitional period: New instruments that are covered by state guarantees may only be issued until April 1, 2007, and existing guarantees may remain in place for operations maturing on September 30, 2017, at the latest. This means that the issuer credit ratings of regional mortgage banks are in danger of future downgrades.

## **Insurance Companies**

### **Weak Business Activity in the Insurance Industry**

The continued volatile development in investment markets had a sustained effect on the income of Austrian insurance companies for 2002 in general and in particular on life insurance companies – a fact which will also bear on bonus payments for 2002. In-

surance companies are likely to further cut profit share payments to between 4.25% and 5.5%. Moreover, the volume of life insurance premiums trended downward for the first time in five years, decreasing by around 2%. Surprisingly, the number of equity-linked life insurance policies went up despite unfavorable stock market developments. In the property/casualty insurance segment, premiums augmented by 6% according to the Austrian Association of Insurance Companies. Claims payments, however, went up twice as fast as premium income, which is in part attributable to payments related to the floods of summer 2002. A total of around EUR 368 million in flood damage claims were made on Austrian insurers, EUR 305 million of which were covered by reinsurance plans. Moreover, insurance companies registered a steep increase in claims payments for fire insurance, which came to around EUR 454 million.

In 2002, the number of domestic insurers reporting to the OeNB went down to 62, as 3 institutions were closed. There are three Austrian insurance groups – the current market leaders – that are listed at Wiener Börse AG. At just under EUR 200 million, however, the market value of their trades remained rather low.

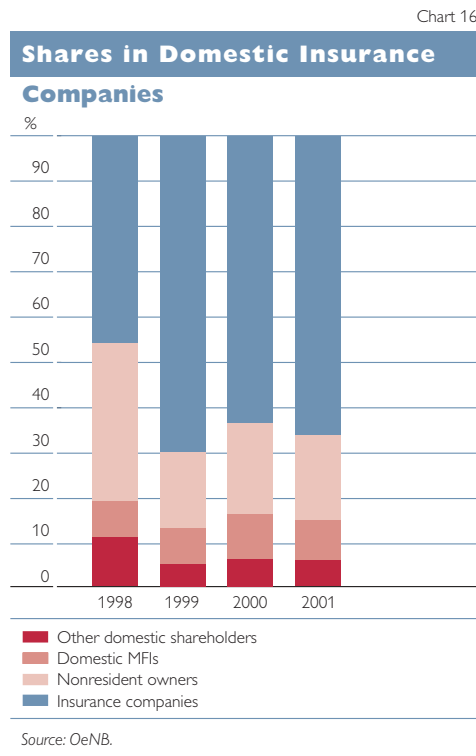
The total assets of the Austrian insurance industry (excluding the reinsurance business) came to EUR 58.3 billion at end-2002, up 5.8% against the previous year. This means that growth continues to slacken – a trend observed since end-1999 – albeit at a slower pace.

- 1 *These ratings fall in the category of "good financial condition and soundness," which means that in case of unfavorable macroeconomic conditions negative effects on the respective enterprise cannot be ruled out.*
- 2 *This agreement affects seven regional mortgage banks, for which the respective regional authorities provide guarantees, and 20 municipal savings banks, for which the respective municipality is liable.*

### No Spillover Effect Evident for the Austrian Banking Industry

Austrian insurance companies clearly tended to invest more in domestic assets in 2002. At end-2002, investment in equity securities and other domestic securities recorded the strongest growth since 2000 (+15% year on year); moreover, having expanded to 26% of total investment, this category has become the second most important investment category for insurers. Investment in domestic equity capital went up fastest, at a rate of +29%. This rise, however, is essentially attributable to the conversion of shares into equity capital as well as to additional contributions by shareholders at a couple of insurance companies. Accounting for 27% of total assets, external assets remain the most important investment category, with investment volumes also going up in 2002. As in previous years, lending continued to slow down, mainly because government borrowing subsidised further. Investment in domestic debt securities, which had shown a clearly slackening tendency over the last few years, appears to have stabilized for the time being. With investment coming to EUR 7.7 billion, this category accounts for 13% of total investment assets.

Insurance technical reserves, which reflect insurers' liabilities vis-à-vis their subscribers, account for the lion's share of liabilities. They comprise premium reserves and other technical provisions. The amount of required premium reserves is calculated according to actuary principles; it is the amount the (life) insurer must have at its disposal to be able to fulfill its payment obligations. In the fourth quarter of 2002, insurance technical reserves amounted to EUR 53.5 billion, thus accounting for around 85%



of total liabilities. Life insurance companies hold the largest share (close to 77%) of these reserves, namely EUR 41.3 billion, while property/casualty insurance accounted for 18% and health insurance for 5%.

Despite its poor profitability and the resulting impact in particular on the life insurance segment, the domestic insurance industry does not constitute an immediate risk factor for financial stability. Domestic insurers were able to partly replenish the reserves they had released in 2002 in order to compensate reduced income from financial assets and to meet payment obligations. This was possible due to low interest rate levels and the ensuing profits in the bond segment, which helped compensate the reduction of reserves in equity. In particular insurance companies with a strong real estate backing show high reserve ratios.

There is no evidence that the current weakness of the insurance industry



constitutes any additional burden on the profitability of the Austrian banking sector in particular. On the one hand, the volume of loans granted to insurance companies is low. Although at the beginning of 2002, lending increased compared to previous years, banks' claims on insurance companies and pension funds merely accounted for around 1% of eligible capital in the fourth quarter of 2002. On the other hand, linkages between banks and insurance companies (in the form of financial conglomerates) are relatively rare in Austria. Cross-majority ownership does not exist between domestic banks and insurers and even though there are cases of majority ownership between banks and insurers, no single large bank holds a majority stake in a large insurance company. Chart 16 shows that the majority of stakes in insurance companies are held by other insurance carriers. Since the end of the 1990s, these stakes have obviously gone up at the expense of equity interests held by foreign or other domestic owners. Domestic insurance companies have majorities in investment companies, severance funds, real estate companies or other direct investment enterprises or funding organizations. In December 2002, one of the leading domestic insurance holding companies was the first Austrian insurer to establish a credit institution.

### **Other Financial Intermediaries**

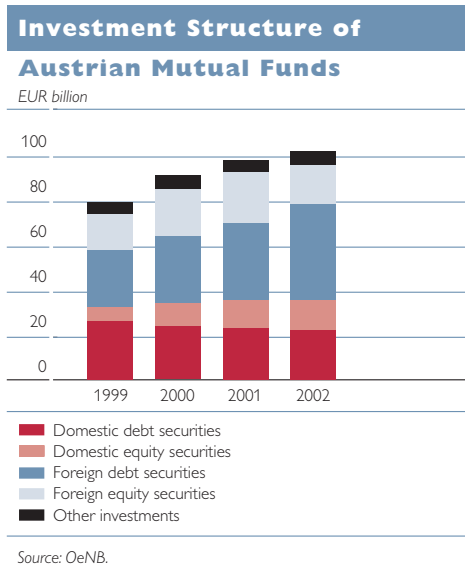
#### **Mutual Funds Boost Low-Risk Investment**

Forthcoming changes to the applicable legal framework are going to have consequences for the future business of Austrian mutual funds. By August 2003, two directives<sup>1)</sup> will have to be transposed into national law through amendments to the Mutual Funds Act and the Banking Act. Among other things, the directives ensure equivalent market access rules and operating conditions for management companies through the issuance of a "European passport." Taking into account market developments of previous years, they also provide for a wider range of investment options for mutual funds.

Despite uncertainties about economic developments and the continued weakness of the stock markets, private and institutional investors bought mutual fund shares worth EUR 10.6 billion in the course of 2002. This drove up the volume of funds managed by the 22 Austrian investment companies to EUR 102.7 billion at end-2002 – an increase by around 4% (compared to 2001) which largely relied on foreign debt securities (see chart 17).

1 Directive 2001/107/EC of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with a view to regulating management companies and simplified prospectuses, and Directive 2001/108/EC of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with regard to investments of UCITS. See also OeNB. 2002. *Financial Stability Report* 3. p. 45.

Chart 17



The continued weakness of capital markets is reflected, however, in the performance of Austrian mutual funds. The major part of equity funds and balanced funds recorded negative performance results in 2002 owing to the decline in stock prices, while as many as 87% of fixed income funds reported positive results. The trend toward low-risk investment continued in 2002. Compared to the previous year, the share of debt securities in the volume of total investment increased further to around 64%, while shares and equity securities went down from a share of 20% at end-2001 to 14% in 2002. Investment in mutual fund shares also declined from previously 18% to around 16%.

### Weak Stock Markets Affect the Performance of Pension Funds

Like other financial intermediaries, Austrian pension funds<sup>1)</sup> suffered from the prolonged weakness of the stock markets in 2002. According to preliminary calculations for 2002 by the Oesterreichische Kontrollbank, Austrian pension funds reported a negative investment return of 6.2%. As a result, supplementary contributions were required. These payments remained moderate by international comparison, however, as the majority of Austrian externally managed pension funds rely on defined contribution schemes.<sup>2)</sup> Those European enterprises, however, which largely rely on defined benefit plans will increasingly be under pressure as weak stock markets will cause solvency ratios to fall below the prescribed level.

Assets held by Austrian pension funds amounted to EUR 7.9 billion at end 2002 (see chart 18). In the last quarter of 2002, investment assets resumed an upward trend for the first time in two quarters, climbing by around 3%. The majority of assets continue to be invested in securities of domestic issuers; accounting for around 91% of total investment assets, mutual fund shares continue to be the most important category.

1 For further information on pension funds, see section "Private Pensions in Austria and Their Role in the Capital Market" in the chapter "The Real Economy and Financial Markets in Austria".

2 These pension schemes rely on predetermined contributions, with the actual amount of retirement benefit payments depending on an annuity paid on the assets accumulated in the pension fund, on the interest accrued and on the actuarial profit/loss. Defined benefit plans by contrast clearly define the amount of future retirement benefit payments, calculating the amount of ongoing contribution payments on the basis of this predetermined amount.

Chart 18

