FOR AGENDA

SM/08/156
Correction 1

June 11, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Austria—Financial System Stability Assessment—Update**

The attached corrections to SM/08/156 (5/23/08) have been provided by the staff.

Factual and Typographical Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 13, Table 3, last three columns, row 1: for " 5.8 9.1 14.2"
read "20.4 25.3 34.1"
row 2: for "46.9 88.4 144.5"
read "64.4 90.6 114.0"

Page 22, para. 30, line 2: for "The FSA" read "The FMA and the OeNB"

Questions may be referred to Mr. Hardy, MCM (ext. 38490).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

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Department Heads

Table 3. Austria: Banking Sector Financial Soundness Indicators (concluded)
(In percent; end of period)

	2004	2005	2006	2007	2007 Quartiles		
					25	50	75
Liquidity							
Liquid assets/total assets	28.9	27.4	27.6	26.8	20.4	25.3	34.1
Liquid assets/short-term liabilities	73.8	68.0	68.6	67.0	64.4	90.6	114.0
Foreign currency-denominated liabilities/total liabilities	20.3	20.5	20.0	17.2	2.7	7.0	12.5
Deposits/assets	66.1	65.3	63.8	62.6	...	...	...
Loans/deposits	113.9	112.9	115.8	116.3	...	...	...
Sensitivity to market risk							
Off-balance sheet operations/assets	224.6	207.5	208.1	200.2	...	...	...
of which: interest rate contracts	190.1	171.9	170.7	187.8	...	...	...
forex contracts	33.1	33.1	35.1	38.6	...	...	...
other derivatives	1.3	2.4	2.5	2.2	...	...	...
Duration of assets/total assets							
Less than 3 months	51.2	61.1	59.3	62.4	...	...	...
Between 3 months and 1 year	14.7	13.7	12.2	13.4	...	...	...
Between 1 and 5 years	13.9	12.4	11.5	10.7	...	...	...
More than 5 years	8.2	8.3	8.1	7.6	...	...	...
Duration of liabilities/total liabilities							
Less than 3 months	49.1	58.6	54.4	56.9	...	...	...
Between 3 months and 1 year	12.7	13.4	13.5	14.6	...	...	...
Between 1 and 5 years	16.6	14.8	14.0	12.4	...	...	...
More than 5 years	9.2	9.1	8.9	10.0	...	...	...
Net open position in foreign exchange/capital	2.1	3.3	3.8	1.5	0.1	0.9	3.3

Source: OeNB.

1/ Data as of end-2006.

2/ Data as of 2007Q3.

5. **Almost all the large Austrian banking groups now have major subsidiaries in several CESE countries and some CIS countries.** Often, these subsidiaries are large relative to the host countries' financial systems. Austrian exposures to the CESE are far larger (relative to GDP) than those of its European peers: in 2006, the total assets of the six largest Austrian banks in the CESE region were equivalent to over 60 percent of GDP (a fifth of total banking assets or 3 times regulatory capital), and generated about 40 percent of banks' profits. This total is roughly evenly divided between the CESE countries that joined the EU in 2004, and the remainder.

6. **Some segments of the nonbank financial sector have experienced significant growth in recent years.** Occupational pension fund assets, non-term life insurance, and *Zukunftsvorsorge* pension accounts have grown, but Austrians still rely substantially on state-provided pensions. Austrian insurers are active in the CESE region, in part in reaction to slow growth in the domestic non-life business. Austria's investment funds market has expanded rapidly in recent years, and is ranked eighth in Europe in terms of assets under management. The stock of bonds outstanding and equity market capitalization have increased substantially since 2003, in part due to the expansion of many listed companies into CESE

markets. The Vienna Stock Exchange (VSE) has various cooperation agreements with exchanges in CESE countries.

7. **Managerial failings and/or fraud have led to a few episodes of difficulties in certain financial institutions.**[3] Common features of these cases include failure to reveal relevant material to internal auditors or supervisory boards, conflicts of interest, and the withholding of information from supervisors and the public. The cases do not appear to have persistently weakened confidence in the system, but in one case the authorities felt compelled to provide a guarantee to creditors, though it was not called upon.

II. The Banking Sector

A. Regulation, Supervision, and Enforcement

Reform of the supervisory architecture

8. **The FMA is the integrated regulator and supervisor for the financial system.** It was created in 2002 with the aim of enhancing supervision of cross-sector linkages and concentrating financial sector expertise under one roof. The OeNB until now has undertaken most of the on-site and some off-site bank supervision. The Federal Finance Ministry (BMF) retains responsibility for certain legislative matters. Coordination is promoted through a Financial Sector Committee. Larger banks host a so-called State Commissioner, who takes part in supervisory board meetings in order to monitor compliance with laws and regulations. In addition, the authorities rely upon external auditors, not only to certify data but also to check compliance with regulation. The banks in some sub-sectors have systems for mutual monitoring.

9. **Following the episodes of banking difficulties in the past few years, the authorities have amended legislation to shift more responsibility for the conduct of banking supervision to the OeNB.** The main change was to give the OeNB sole responsibility for on-site supervision from January 2008. The FMA now determines, with the OeNB, the schedule of regular inspections (currently, major banks are to be inspected annually, and medium-sized banks every two years), and in addition, both agencies and the BMF are able to request follow-up or ad hoc inspections. For off-site supervision, a joint OeNB-FMA database is being established, but the OeNB is tasked with analysis. The FMA retains licensing and enforcement powers, and all responsibilities for NBFIs. In addition,

[3] The most prominent case was that of Bawag, Austria's fourth-largest bank. The discovery of a fraud and a subsequent U.S. lawsuit triggered a deposit run in early May 2006, which was successfully stemmed (see SM/07/112, especially paragraphs 11 and 26). Other recent cases involved a financial service provider and nonbank affiliates of a bank; in both cases malfeasance appears to have been present.

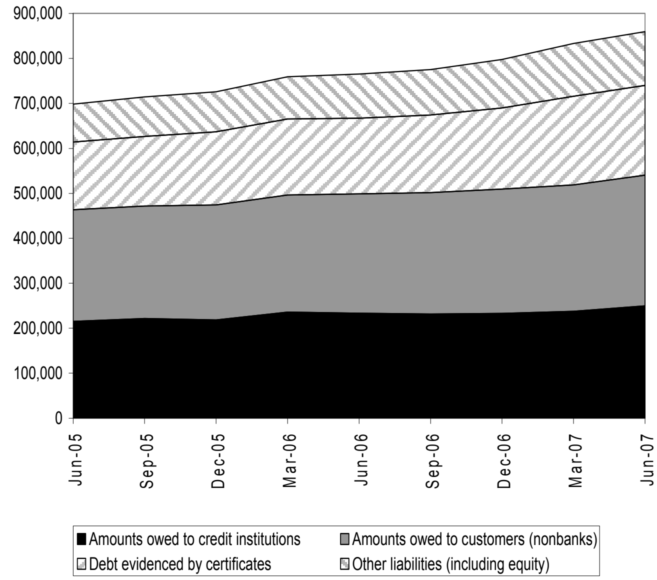
Box 1. Financing Sources and Exposures to CESE Countries

The funding structure of Austrian banks appears to be stable (Figure 1). The same holds for their foreign subsidiaries, where local deposits contribute a rising share of funding, especially local currency funding (Figure 2). Interbank loans from parents account for 10 percent of total funding, with other types of lending from parents representing another 10 percent. The balance comprises mainly equity and debt issuances by the foreign subsidiary.

Parents' exposure to CESE countries, via lending to their foreign subsidiaries and direct loans into those countries, has remained relatively flat in absolute terms since 2005. Given the continuing rise in parents' total assets, exposure has declined as a proportion of their assets.

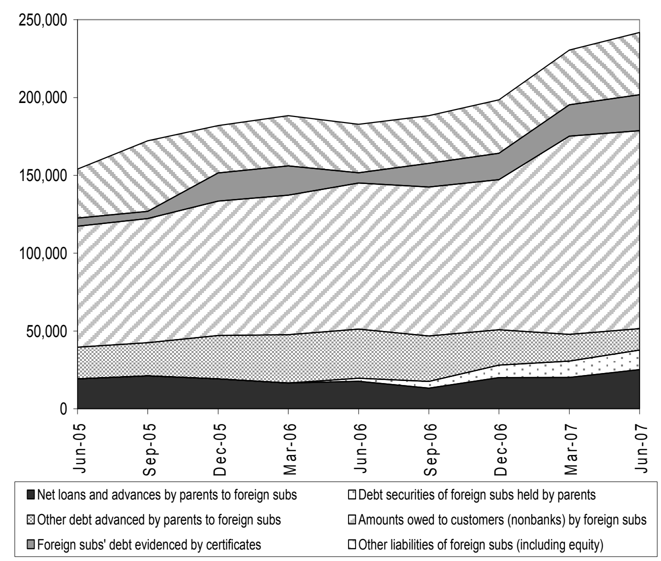
However, strong growth in local lending to nonbanks by foreign subsidiaries has driven up the banking groups' total exposure to emerging European countries. Subsidiaries' rising investment in securities has also increased group exposures. Rising local deposits represents the main source of funding in most markets. Meanwhile, OeNB data suggest that direct lending by Austrian parents to non-subsidiaries in emerging Europe have remained relatively stable in aggregate, although there has reportedly been an increase in direct lending to larger corporates in some markets, in part in response to administrative measures taken by those countries authorities to slow credit growth.

Figure 1. Austria: Funding Sources of the Banking System*
(In millions of euro)



Source: OeNB.
* Figures obtained from unconsolidated balance sheet.

Figure 2. Austria: Funding Sources of Banks' Foreign Subsidiaries*
(In millions of euro)



Source: OeNB; and IMF staff estimates.
* Some data are derived from differences between consolidated and unconsolidated balance sheets.

29. **Banking system soundness is supported by the balance sheet strength of the domestic non-financial sector; the main outstanding concern is the foreign exchange exposure of some borrowers.** (Table 4). Household indebtedness relative to income is comparatively low, and corporate leverage has been falling. Real estate prices have been much steadier than in many European countries. Consistent data on the financial position of the corporate and household sectors in markets abroad where Austrian banks operate were not available.

Table 4. Austria: Non-Financial Soundness Indicators
(In percent)

	2003	2004	2005	2006	2007
Corporate sector					
Total debt as a percentage of equity 1/	251.0	206.5	119.1	114.4	112.9
Total debt as a percentage of GDP	84.1	81.2	82.9	83.7	...
Profitability (return on equity) 1/	24.8	23.3	14.6	14.7	15.0
Number of applications for protection from creditors (number)	2,957	2,972	3,203	3,084	3,023
Household Sector					
Total debt as a percentage of GDP	48.4	50.6	54.2	53.4	53.1
Financial saving ratio as a percentage of GDP	6.6	7.2	7.8	7.2	7.3
Savings rate	8.7	8.9	9.3	9.7	...
Real estate sector					
House price inflation	0.4	-2.7	4.8	3.1	5.1

Source: OeNB.
1/ Break in series in 2005.
2/ 2007Q3.

30. **The recent financial markets turmoil does not appear to have had a major impact on Austrian banks.** The FMA and OeNB acted expeditiously in compiling information on banks' exposures to affected asset classes and off-balance sheet risks (including special investment vehicles, asset-backed commercial paper and sub-prime mortgages), which turned out to be modest; write-downs reported to date were easily absorbed in strong 2007 profits. Banks have not made extra use of central bank financing. Furthermore, one major bank was recently able to raise additional capital to support its expansion in CESE, and demand for private placement of securities and Pfandbriefe (a form of covered bond) has reportedly held up relatively well. Hence, the impact of higher funding costs will be phased in, and currently does not appear to be more severe than what was seen in past tightening cycles.

Market-based indicators

31. **Market-based indicators, which the authorities have begun to monitor, suggest that the exposure of Austrian banks to CESE and CIS countries is perceived as generating higher returns but also higher risks.** However, the broader exposure brings also diversification benefits. The major Austrian banks have posted strong positive stock price performances in recent years, although they have been affected by the recent turmoil in global financial markets (Figures 3 and 4). On a risk-adjusted basis—using the Sharpe