Klaus Liebscher: Overview of financial services in Austria

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Global Financial Services Industry 2005 Summit, Vienna, 17 June 2005.

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Ladies and gentlemen,

It is with great pleasure that I accepted the invitation to participate in the Global Financial Services Industry 2005 Summit here in Vienna, and I would like to extend to all of you a warm welcome on behalf of the Oesterreichische Nationalbank (OeNB). In the next twenty minutes I will address some issues regarding the development of the financial services industry in Austria.

First, I would like to highlight the changes in the Austrian economy and financial sector that have taken place since Austria joined the European Union (EU) ten years ago.

Second, I am going to outline how these developments and adaptations have made Austria's financial sector highly competitive, sound and stable.

Third, I will focus on the recent performance of the Austrian financial sector and on the major challenges it will face in the near future.

1. Changes in the Austrian economy and financial sector since EU accession

Austria celebrates a number of important anniversaries this year. We commemorate not only the end of World War II 60 years ago and the signing of the Austrian State Treaty 50 years ago, but also Austria's accession to the European Union ten years ago. EU accession was an important milestone promoting the positive development of the Austrian economy and had - among other things - beneficial effects on economic growth, price stability, the labor market and the country's attractiveness to foreign investors. These effects - paired with the high adaptability and innovative character of the industrial and especially also the financial sector - strengthened Austria's competitiveness in the international arena.

Let me give you a few figures that attest to the favorable economic development in Austria following its accession to the EU:

- Goods exports increased considerably from 25% of GDP in 1995 to 38% in 2004.
- The trade deficit had been widening until 1995, but this trend clearly reversed following EU accession.
- The volume of foreign direct investment from the EU-15 in Austria almost quadrupled from 10 billion euro to 38 billion euro over the last ten years, while the volume of Austrian investments within the EU-15 went up nearly five times from 4 billion euro to 19 billion euro.

Austria's accession to the EU had a considerable impact on the financial services industry and the capital market. In this respect, the EU's common market served as an important catalyst for the increased refocusing and consolidation efforts the Austrian banking sector made in order to become more competitive. Specifically, consolidation efforts resulted in a decline in the total number of Austrian credit institutions from 1,053 at end-1994 to 882 at end-2004 while total assets on an unconsolidated basis increased from 369 billion euro to 653 billion euro over the same period. The unconsolidated return on assets (ROA) improved from 0.33% at end-1995 to 0.46% at end-2004.

The number of credit institutions went down most significantly in particular in the decentralized sectors of the Austrian banking industry (that is savings banks, Raiffeisen and Volksbank credit cooperatives) and to a lesser extent also in the other banking sectors (that is joint stock banks, state mortgage banks, building and loan associations, and special purpose banks). Examples of the consolidation dynamics at the level of large banking groups were the acquisition of the largest Austrian bank - Bank Austria Creditanstalt - by the German HypoVereinsbank as well as the acquisition of P.S.K., the Austrian Postal Savings Bank, by BAWAG, both in 2000. Austria nevertheless retains a high banking and branch office density, with the number of inhabitants per banking office (head offices and branches) amounting to 1,537 in 2003. This compares to 2,113 inhabitants per banking office in

Germany and 2,043 in Switzerland. This means there is still room for further consolidation in the Austrian banking sector.

Another significant development in the last decade was the formation of clusters of smaller banks within a sector that became increasingly tied to central institutions (e.g. Erste Bank, RZB) through cross-guarantee schemes. This development produced a few relatively large banking groups.

To put that into perspective, in a worldwide ranking of banking groups[1], BA-CA occupied rank 99 in 2003, while Erste Bank occupied rank 106 and RZB rank 189. The banks at the head of the sector pyramid provide centralized services and achieve economies of scale in areas such as payment and settlement, liquidity management and funding. Furthermore, the traditional multisector structure of the Austrian banking sector - derived from historical differences in lines of business and ownership - has changed significantly in recent years, and the vast majority of banks now effectively operate as universal banks.

The refocusing of efforts aimed at raising financial sector competitiveness in the run-up to Austria's EU accession resulted, among other things, in the expansion of some large Austrian banks (RZB, BA-CA, Erste Bank) into Central and Eastern Europe (CEE), a region sharing historical ties with Austria. At the beginning of the transition period in CEE, the financial sectors of these economies showed inefficiencies, instabilities and a low degree of financial intermediation. For this reason, Austrian banks' strategic move into this region not only benefited the respective banks, but also helped stabilize the financial sectors in these economies and improved the penetration of banking services.

The successful cross-border diversification strategy of several Austrian banks has contributed substantially to their positive profit development, since margins in CEE are still relatively high. Austrian banks today account for a market share of approximately 20% in CEE (except Russia), and Erste Bank, BA-CA and RZB are among the major players in this region. In our neighboring countries Austrian credit institutions reach market shares ranging from 32% in the Czech Republic to 44% in Slovakia in 2004. 42% of net profits of Austria's five largest banks stem from operations in Central and Eastern European countries. Not least owing to the accession of many CEE countries to the EU in May 2004 and the subsequent boost in economic growth as well as the harmonization of the legal framework, this positive impact on profitability is expected to continue, although probably on a less pronounced basis as margins adapt to EU level and therefore are expected to decline. The positive experience from operations in CEE are now being transferred to upcoming markets, especially in the Southeastern European countries, with Austrian banks increasingly taking the lead in this region as well.

As I have shown by taking the Austrian banking sector as an example, European integration has been a success story. In this respect, Economic and Monetary Union (EMU) - and especially the adoption of a common currency for 12 EU Member States - certainly marked a historic and successful milestone of the integration process.

EMU is based on the efficient interplay of three main factors embodied in the stability architecture: first, a monetary policy with the primary goal of maintaining price stability in the medium term; second, sustainable public finances; and third, structural policies that support growth and global competitiveness. Price stability is of high importance for safeguarding consumers' purchasing power and promoting secure and stable planning conditions for enterprises. Price stability, however, can only be maintained if a solid financial policy is pursued. Moreover, structural reforms are necessary to overcome frictions in the labor and product markets as well as in the service sector; they are also important when it comes to improving the resilience of economies against shocks by making them more flexible. These three mutually supportive factors are responsible for the success of EMU and are prerequisite for economic stability, sustainable growth and employment. Therefore, some of the recent public discussions about a dissolution of EMU are totally absurd.

Regarding price stability, moderate wage increases in Austria in the last ten years and low inflation, which remained below 2% annually after 1999, have contributed to the positive development of the economy and supported Austria's competitiveness in the euro area as well as internationally.

[1] Source: The American Banker.

However, since the beginning of 2005 inflation in Austria has been higher than 2%, which is mainly attributable to growing pressures from energy prices, the services sector and increasing rents.

2. Stability and soundness of the Austrian financial sector

The fact that Austria's financial institutions proved to be highly adaptable to the changing macroeconomic environment has strengthened the stability and soundness of the Austrian financial sector. This was confirmed by the International Monetary Fund during its Financial Sector Assessment Program (FSAP)[2] in 2004 and reconfirmed during its yearly consultation finalized in May 2005.

The key conclusions of the IMF assessment are as follows:

- Austria's financial sector is generally stable and resilient to external shocks.
- The stability of the banking sector was confirmed by detailed stress tests conducted by the IMF in cooperation with the Oesterreichische Nationalbank.
- The Austrian insurance sector has performed relatively well compared with that of many other European countries.
- Austria enjoys a high standard of prudential supervision based on strong institutions and a comprehensive legal framework. Financial supervision was integrated in the Financial Market Authority (FMA) in 2002, and the cooperation between the FMA and the Oesterreichische Nationalbank, which continues to be strongly involved in banking supervision, works smoothly.
- This framework results in a high level of compliance with internationally accepted standards in the areas of banking, insurance, securities and the prevention of money laundering.

This highly favorable IMF assessment reflects, among other things, the strategic foresight of Austrian banks with respect to the opportunities in Central and Eastern Europe and the innovative potential and adaptability of Austria's financial intermediaries. The strong competitiveness of the financial sector is furthermore supported by high business and regulatory standards as well as effective and stringent banking secrecy rules.

However, the IMF critically mentioned the low domestic profitability and efficiency of Austrian banks. For one thing, these factors are traceable to strong competitive pressures given the high banking and branch office density. For another, banks still retain a rather unfavorable cost-income ratio, with some banks still absorbing the costs of recent domestic consolidation, of expansion into Central and Eastern Europe as well as of major investments into upgrading information technology platforms and risk management systems.

Furthermore, the IMF expressed concerns regarding the high level of foreign currency loans taken out especially for house mortgages. The Oesterreichische Nationalbank had already raised the same concerns earlier on. In the first quarter of 2005, foreign currency loans accounted for 19.3% of all loans issued to domestic nonbanks and for about 30% of all loans to households. From the European perspective, loans granted by Austrian banks accounted for approximately 3% **of all euro area loans** to nonbanks while foreign currency loans accounted for 18% **of all euro area foreign currency loans** granted to nonbanks at end-2004[3]. Nearly 90% of all foreign currency loans issued to nonbanks in Austria are denominated in Swiss francs while the importance of the Japanese yen currently stagnates at a low level, equaling the volume of loans denominated in U.S. dollars.

This high amount of foreign currency loans is tightly monitored by the Austrian authorities and has already entailed a number of supervisory actions, including the introduction of a set of recommendations called "Minimum Standards of Granting and Managing Foreign Currency Loans."

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[2] FSAPs are designed to assess the stability of a financial system as well as to identify and remedy weaknesses in a country's financial sector structure.

[3] Swiss francs 42%, Japanese yen 19%, U.S. dollars 2%.

3. Economic and financial sector performance in 2004 and in the first months of 2005

Turning to my third issue, I would now like to give you a brief glance on the development of the Austrian economy and financial sector in 2004 and the first months of 2005.

Austria encounters the current challenges and reform requirements with a forward-looking economic policy. The pension reform contributes to a sustainable retirement system that is financially secure in the long term. The corporate and income tax reform add to making Austria an attractive business location and supports the real income of households. Austria's current account surplus amounted to 0.3% of GDP in 2004 and is expected to improve further in the course of this year.

Mainly on the back of strong exports, Austria's GDP grew by 2% in 2004, thus being clearly higher than in the two previous years but in line with the euro area average. The OeNB recently forecast real GDP to grow by 2.0% in 2005 and 2.2% in the next two years. Supported mainly by exports, the second stage of the tax reform also constitutes an important impetus for domestic demand. Austria's economy, however, cannot fully withstand the current economic slowdown in the euro area.

Austria's deficit according to Maastricht amounted to 1.2% of GDP in 2004, which is considerably less than the euro area average. The 2005 tax reform is expected to raise the deficit to 1.8% in 2005. However, Austria's most recent Stability Program sets the target of reaching a balanced budget as well as a debt ratio of below 60% of GDP by 2008.

The stability of the **banking sector** strengthened further in 2004 and the first quarter of 2005. In March 2005, total assets of the banking sector amounted to 678 billion euro on an unconsolidated basis (+3.9% qoq).

In other words, total banking sector assets grew by 3.9% compared to the fourth quarter of 2004, which is among other things attributable to a rise in international business. The cost-income ratio improved to 64% on an unconsolidated basis owing to reduced costs and higher income. The unconsolidated operating profit increased in the first quarter of 2005 by 13% year-on-year to 1.34 billion euro. The capital ratio, which relates banks' capital to their risk-weighted assets, remained well above the minimum requirement and stood at 14.6% on an unconsolidated basis, giving Austrian banks ample capital buffers in case of stress scenarios. (Year-end 2004 data: consolidated ROA 0.6%, consolidated capital ratio 12.2%).

The **insurance industry** experienced a positive development in 2004 as well. A total of 52 insurance undertakings (except small mutual associations) were operating in Austriain 2004. Their total assets came to 68 billion euro in 2004, which constitutes an increase of 7% year on year. Their total premium volume rose by 7% to around 14 billion euro in 2004, which was mainly attributable to a further increase in the demand for retirement-related products. Insurance penetration expressed as a ratio of total insurance premiums to GDP stood at 7.2% in Austria in 2004[4].

Pension funds (Pensionskassen) managed assets to the amount of approximately 10 billion euro in 2004, which means an 11% increase year on year. Pension funds thus further strengthened their position as important institutional players in Austria's financial sector. The Austrian market for pension funds is highly concentrated, with the three major players accounting for a market share of approximately 70%. The performance of pension funds exceeded 7% on average in 2004, thus continuing the positive trend of the previous year.

The **mutual fund** sector enjoyed a strong year-on-year growth of 13% in 2004, which can be attributed to the positive economic environment, the launch of new retirement-related saving products as well as the good performance of the Vienna stock exchange, Wiener Börse AG. Total assets of the mutual fund sector amounted to 125 billion euro in 2004. 2,021 funds of domestic mutual fund management companies and 3,378 funds of foreign mutual fund management companies are licensed in Austria.

The **Vienna stock exchange** performed strongly in 2004 and has continued to do so in 2005, with the ATX outperforming major international indices. Stock market capitalization amounted to 74 billion euro in April 2005, reaching approximately 30% of GDP. While market capitalization can still be considered rather low compared with other advanced economies, the ATX showed a strong growth of

[4] U.K.: 14.8%, Switzerland: 13.4%.

approximately 33% year on year at end-April 2005, or of 140% when comparing end-2000 with April 2005.

Having demonstrated the positive performance of the Austrian financial sector as well as its stability and soundness, I would now like to outline some major challenges that financial institutions face in the near future.

These challenges result not only from the continuing integration process of the EU financial services sector, but also from the development of new products and techniques that shape the financial industry.

Continuing financial integration in the euro area is - from the perspective of a central bank - conducive to the effective implementation of monetary policy. Moreover, the economies of the euro area should become more efficient owing to an improved allocation of financial resources and a reduction of financing costs. However, the impact of financial integration on financial stability is more complex. Deeper financial integration may increase diversification and reduce certain vulnerabilities, while possibly raising contagion risk. Close cooperation between supervisors and central banks especially in the euro area therefore seems warranted.

Faster and more efficient legislative procedures on the European level are important in order to keep pace with rapid technological changes and financial innovations. In this respect, the so-called Lamfalussy regime, which was developed in the securities business, was extended to comprise the entire financial services sector in 2004. The Committee of European Banking Supervisors (CEBS), which consists of high-level representatives of national supervisory authorities and central banks, has become the most important advisory body supporting the European Commission in supervisory matters. The CEBS not only aims to ensure a consistent implementation of EU directives across member countries, but develops standards and guidelines to harmonize supervisory practices in the EU.

In order to achieve further financial integration in the EU and a single market in financial services, the European Commission launched the Financial Services Action Plan (FSAP) in 1999. One of the last and most prominent open issues on the agenda of the FSAP is the proposal of a new capital adequacy directive to implement the New Basel Capital Accord (Basel II) in the banking sector.

Basel II is regarded a necessary instrument to meet the fundamental changes in the banking industry, which includes the emergence of new financial products and advances in risk management practices. Basel II aims to enhance the stability of the financial system via more risk-sensitive capital requirements.

Austrian banks are considered to be well informed of, and prepared for, the changes induced by Basel II. The Oesterreichische Nationalbank is closely involved in the Basel II process and currently conducts a road show on this topic to improve the level of know-how especially among small and medium-sized enterprises (SMEs) in Austria.

While completing the EU initiatives especially with a view to the new capital requirements, Solvency II, and the Legal Framework for Payments, the European Commission has announced that in the post-FSAP era, its activities will rather focus on the effective implementation and enforcement of regulations issued in recent years. Any new initiatives will be subject to rigorous impact assessments, and the European Commission will continue its consultation activities with the industry. One of the priorities in this respect will be the further integration of the retail financial market.

Ladies and gentlemen,

Given the limited time frame I was only able to touch upon some cornerstones of the financial services industry in Austria. By way of conclusion, however, let me say that I am convinced that, based on its solid background, the Austrian financial sector is in an excellent position to meet both current and future challenges.

Thank you very much for your attention.