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Bank Industry Risk Analysis: Austria (Republic of)

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Executive Summary

In Standard & Poor's view, the Austrian banking system--despite its structural weaknesses--is strong enough to withstand the economic downturn, which has reduced economic growth rates to low levels since 2001.

The Austrian economy, which ranks among the most prosperous in the world, has been one of the least volatile among rated sovereigns. Although Austria is closely tied to the Eurozone and particularly to its largest trading partner, Germany, GDP growth has repeatedly outpaced that of Germany since 1992 and unemployment rates have remained well below the EU average. Due to its geographic proximity and historically strong ties Austria is expected to be among the main beneficiaries of the EU enlargement. Due to the global economic downturn, economic growth has declined sharply since 2001 and signs of a quick recovery have not yet emerged. Furthermore, demographic characteristics will require reforms of the public health care and pension systems. Nevertheless, Standard & Poor's expects the relative stability of the economic and social environment to continue to have a stabilizing effect on the banking system.

Privatization, consolidation, and refocused strategies on extended home markets have been the key characteristics of the Austrian banking sector over the past decade. At year-end 2002, the combined market share of the five largest institutions by total bank assets amounted to 46%, whereas the respective market share of the four largest German banks accounted for only 16%, by comparison. Although room for further consolidation on a larger scale is limited, consolidation among the smaller institutions, such as cooperative and savings banks, is expected to continue. Whereas public sector ownership used to be a characteristic of Austrian banking, providing state-guaranteed institutions with superior credit ratings, today--following the privatizations of Bank Austria Creditanstalt AG (BA; A-/Negative/A-2) and Postsparkasse (PSK; Postal Savings Bank; not rated)--it is essentially limited to a number of small regional savings and Landeshypothekenbanks. Moreover, on Jan. 21, 2003, the European Commission (EC), in a formal decision, requested the Austrian government to phase out state guarantees benefiting Austrian banks.

Nevertheless, despite the consolidation process, with almost 900 banks and almost 5,400 outlets serving a population of about 8 million, Austria remains one of the most competitive and overbanked markets in Europe. Furthermore, whereas BA and Erste Bank der oesterreichischen Sparkassen AG (Erste Bank; --/--/A-2) are institutions, which aim for profit maximization, the combined market shares held by less profit-driven cooperative banks, savings banks, state-owned banks, and the trade-union-controlled Bank für Arbeit und Wirtschaft (BAWAG; not rated) are significant. This unique industry structure has, in Standard & Poor's view, contributed to a slow adaptation to change, low risk-adjusted margins, and unfavorable cost levels. Consequently, consolidation has not translated into higher profitability levels in the Austrian banking market and earnings have remained low by international standards.

The lack of growth potential, competitive pressures, and persistently low margins at home prompted Austrian banks early on to look at cross-border opportunities in neighboring Central and Eastern Europe (CEE) countries based on strong historical, commercial, and cultural ties in the region. Through organic growth and acquisitions BA, Erste Bank, and RZB are now firmly established in the region and rank among the primary competitors in CEE countries, and particularly in the EU accession countries. Although the three banks have been successful in coping with the additional credit, operational, and legal risks, and transforming their operations in CEE countries into profitable ventures, they will be challenged to avoid excessive exposure and reliance on these promising, but still more volatile markets.

Economic Risk

The Austrian economy is characterized by high living standards; a stable economic and social environment; a modern, diversified, and competitive export-oriented economy with strong ties to the EU and neighboring CEE countries; progress in fiscal consolidation that is gradually decreasing public debt levels; low inflation and unemployment; and also a low level of economic volatility. The key economic challenges result from Austria's demographic characteristics of an ageing society, which are putting further strains on the social security system, and the heavy tax burden. Furthermore, given the high degree of economic openness, Austria's growth prospects remain closely intertwined with that of its largest trading partners in the EU, particularly Germany, whose GDP growth has been below the EU average since 1993. Due to its geographic proximity and historically strong ties, Austria is expected to be among the main beneficiaries of the EU enlargement, however.

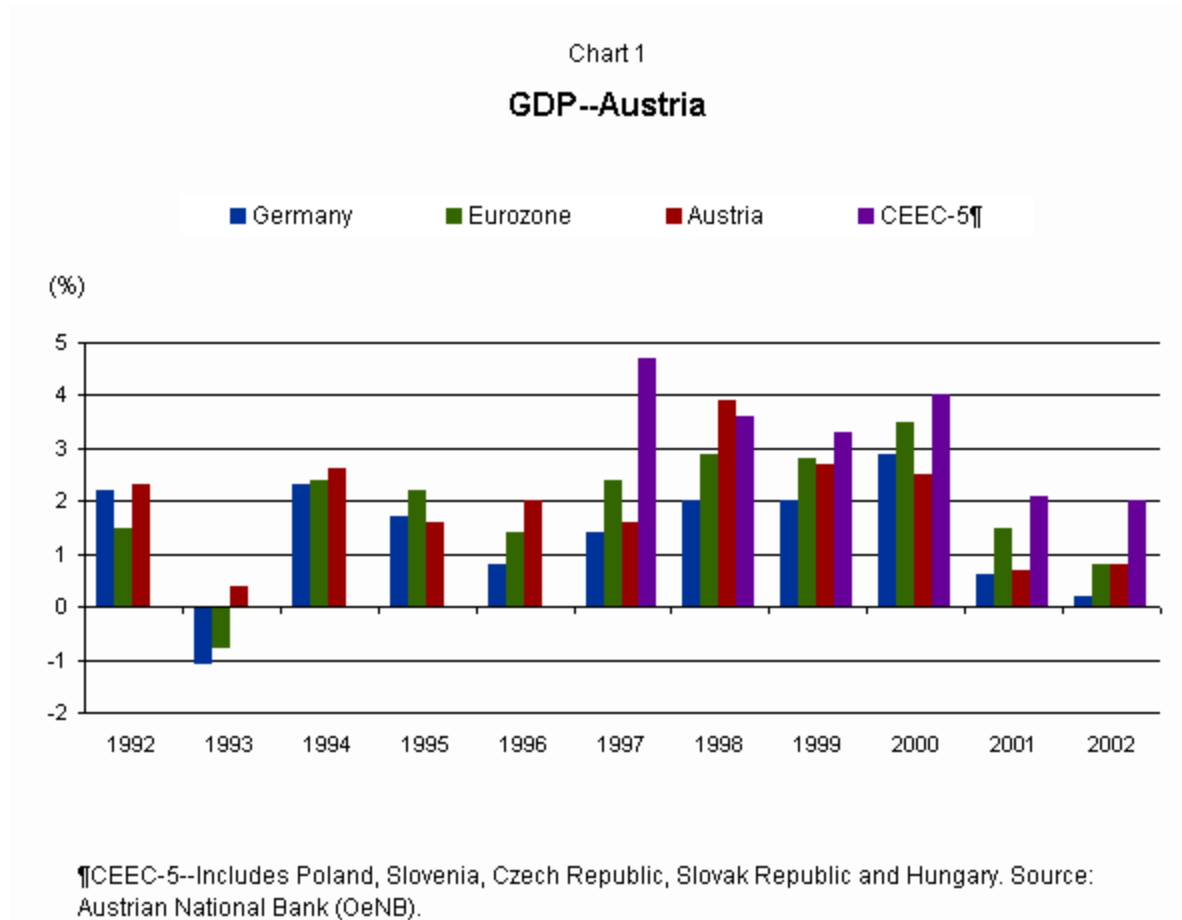
Standard & Poor's evaluates the possible or existing problems for every banking system where banks are rated, by estimating the potential level of gross problematic assets (GPAs) in a financial system in a reasonable worst-case economic scenario, expressed as a percentage of domestic credit to

private sector and nonfinancial public enterprises in the coming year. The assumptions behind these scenarios are severe, and therefore unlikely, although not impossible. To this end, Standard & Poor's monitors several leading indicators to spot adverse trends, which in the case of Austria do not indicate system stress at present. There are six categories of potential GPAs. For the Austrian banking system, in the event of a severe economic downturn, Standard & Poor's estimates that GPAs could range from 10%-20%, which is the second strongest category.

Overall, Standard & Poor's expects the stability of the economic environment to continue to have a stabilizing effect on the Austrian banking system, which itself is characterized by low profitability levels, however.

Business cycle/structural problems.

The Austrian economy, which accounts for only 3% of the Eurozone output, has been one of the least volatile among rated sovereigns. Austria last recorded negative output growth as far back as 1981. High levels of competitiveness, flexibility, and diversification contribute to the country's economic wealth, with income per capita at \$25,260 in 2002 and unemployment rates that are significantly below the EU average. The economy is very export oriented, with exports accounting for more than one-half of national production. Austria's GDP growth has repeatedly outpaced that of its largest trading partner, Germany, since 1992. Nevertheless, after eight years of solid GDP growth the Austrian economy slowed sharply in 2001 and 2002.



The EU enlargement envisaged in 2004 is expected to improve Austria's growth prospects in particular, due to its close historic ties with these CEE countries, four of which border Austria. Standard & Poor's expects modest GDP growth in 2003, however. Fiscal consolidation reduced the debt burden to 62% in 2002 and the general government budget was broadly in balance in 2001, for the first time in three decades. In the longer term, demographic patterns could dampen growth rates and further reforms of the public health care and pension systems will be necessary.

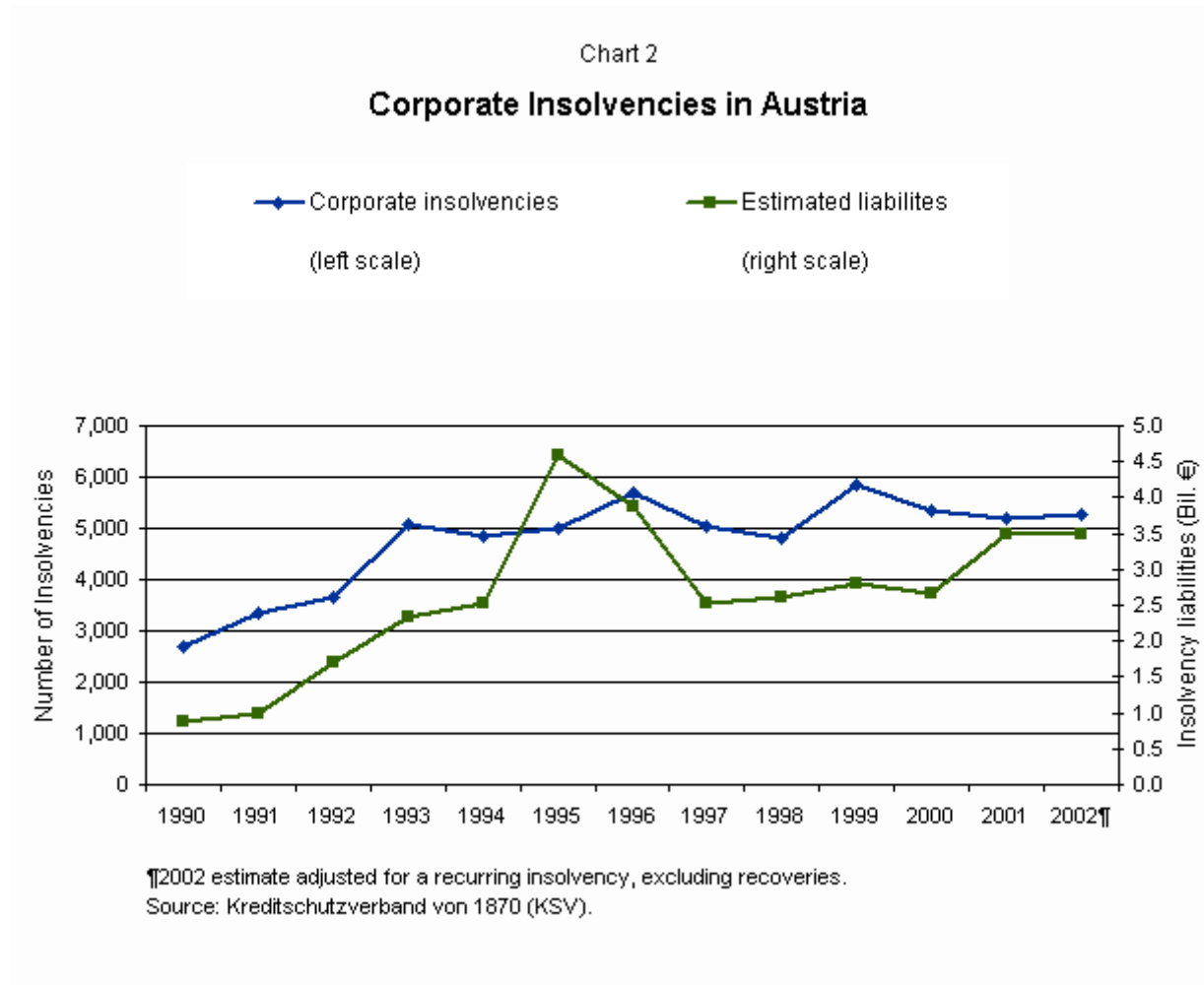
Lending risk.

The credit growth of Austrian banks remains moderate compared with that of other European countries' banking systems. Loans to domestic nonbanks rose 29% between year-end 1996 and year-end 2002, and by only 1.1% in 2002. Total domestic credit to the private sector and nonfinancial public enterprises rose to 109% in 2002, from 97% in 1996, but remained well below Germany's 121%. Although private sector indebtedness has increased, lending growth does not pose an imminent risk to the financial system in Austria.

Corporate sector.

Corporate lending accounted for 54% of domestic loans to nonbanks in 2002. Corporate funding is dominated by bank loans, as Austrian debt and equity capital markets are underdeveloped.

The number of corporate insolvencies fluctuated within a narrow band of 5,000-6,000 between 1993 and 2002, and, despite the economic downturn, did not increase significantly between 2000 and 2002. This compares favorably to other European countries, particularly Germany, which saw an increase of about 16% in corporate insolvencies in both 2001 and 2002. However, outstanding insolvency liabilities in Austria rose 31% to €3.5 billion in 2001 and remained at this high level in 2002, mainly reflecting the insolvencies of a few larger companies. Insolvency liabilities have remained below the previous peaks, which occurred in 1995 and 1996, however.



The Austrian corporate sector is dominated by small and midsize enterprises (SMEs) as well as the self-employed, which comprise the majority of corporate lending in Austria. Austrian SMEs are usually only modestly capitalized, with 51% having less than 20% capital and only 25% more than 30%, making them susceptible to the current dampened economic climate. This has led to rising provisioning needs in this segment. Furthermore, intense price competition in the SME segment from cooperative and savings banks means that interest margins are low by international standards. Consequently, risk-adjusted returns have been unsatisfactory. Consolidation among the

larger institutions, increased pressure to generate shareholder value, and capital constraints have made listed institutions more reluctant to tolerate low returns, which might lead to more prudent pricing policies in the large corporate sector.

Whereas the large banking institutions were predominantly affected by the insolvencies of large companies in 2001, the effect of the cyclical downturn and the 2001 floods in Northern Austria on SMEs is likely to increase provisioning needs for smaller regional banks as well.

There are two peculiarities of the Austrian market in contrast to other European markets:

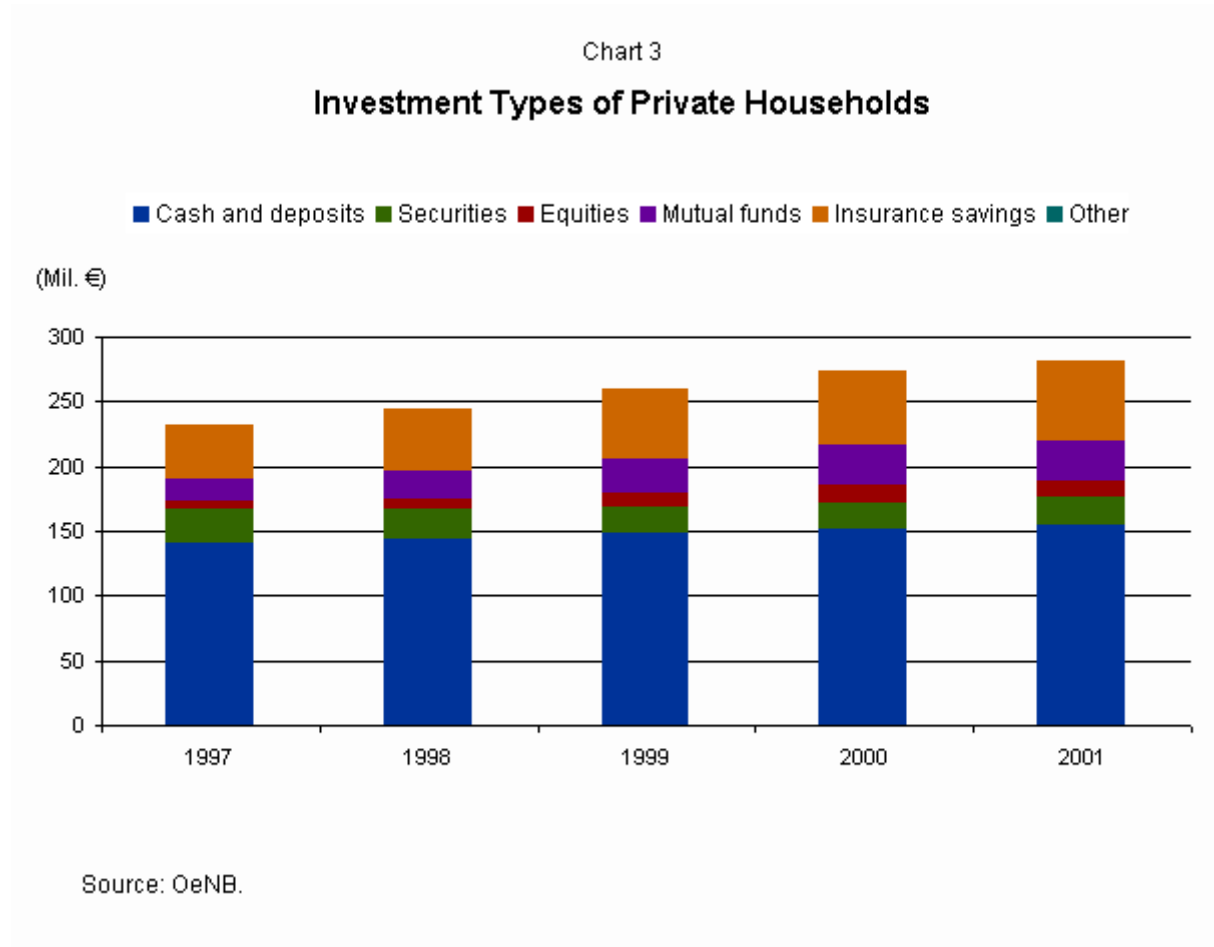
- First, due to their geographic proximity, the exposures of Austrian banks' to CEE countries is comparatively high. Raiffeisen Zentralbank Österreich (RZB; --/--/A-1) and BA were among the first western European institutions to enter these markets, and Erste Bank has gained significant market shares in two countries through its recent acquisitions. The credit loss records of both banks have been good so far, as a result of cautious lending policies and the favorable economic development in these countries, or in the case of Erste Bank, due to significant risk protection from the respective governments during the privatization process. Whereas the banks' credit business had focused on foreign investors, the public sector, or larger and often state-owned domestic enterprises in the past, increased price competition is forcing the banks to expand their lending business with SMEs and private customers. This is a potential source of higher revenues, but also results in increased provisioning needs in the future.
- Second, Austrian banks have a relatively high proportion of foreign-currency-denominated lending. Since 1995 this share increased at rates of about 30% per year, resulting in a 19.4% share of total lending to nonfinancial institutions at mid-2002, with Swiss francs accounting for 52% and Japanese yen accounting for 42%. Although the banks' customers have benefited from low interest rates in these countries, they are exposed to foreign currency risk, which they might not fully comprehend. Standard & Poor's welcomes the fact that banks have adapted their lending criteria and require higher collateral to cover for currency valuation changes.

Private households.

Loans to private customers accounted for 28% of domestic loans to nonbanks in 2002. Although the gross indebtedness of private households--measured as

a percentage of disposable income--continued to increase to almost 50% at mid-year 2002 compared with 30% at the end of the 1980s, the ratio continues to be much lower than Germany's 112% in 2001. In addition, Austrian household wealth was at 220% of disposable income, making private households net lenders to the economy. The personal savings ratio, however, has steadily decreased to about 6% in 2002, from about 11.8% in 1995.

As Austrian private households have only started to switch into more sophisticated products in recent years, the majority of savings is still invested in cash and sight deposits (see Chart 3). Therefore, the wealth of private customers has been less affected by the slump in equity markets. Furthermore, unemployment continued to be well below the EU average in 2002. Overall, Standard & Poor's does not consider lending to private customers an area of concern.



Asset price inflation.

In contrast to Germany, the Austrian economy has not shown any signs of overheating in the stock or real estate markets in the past decade.

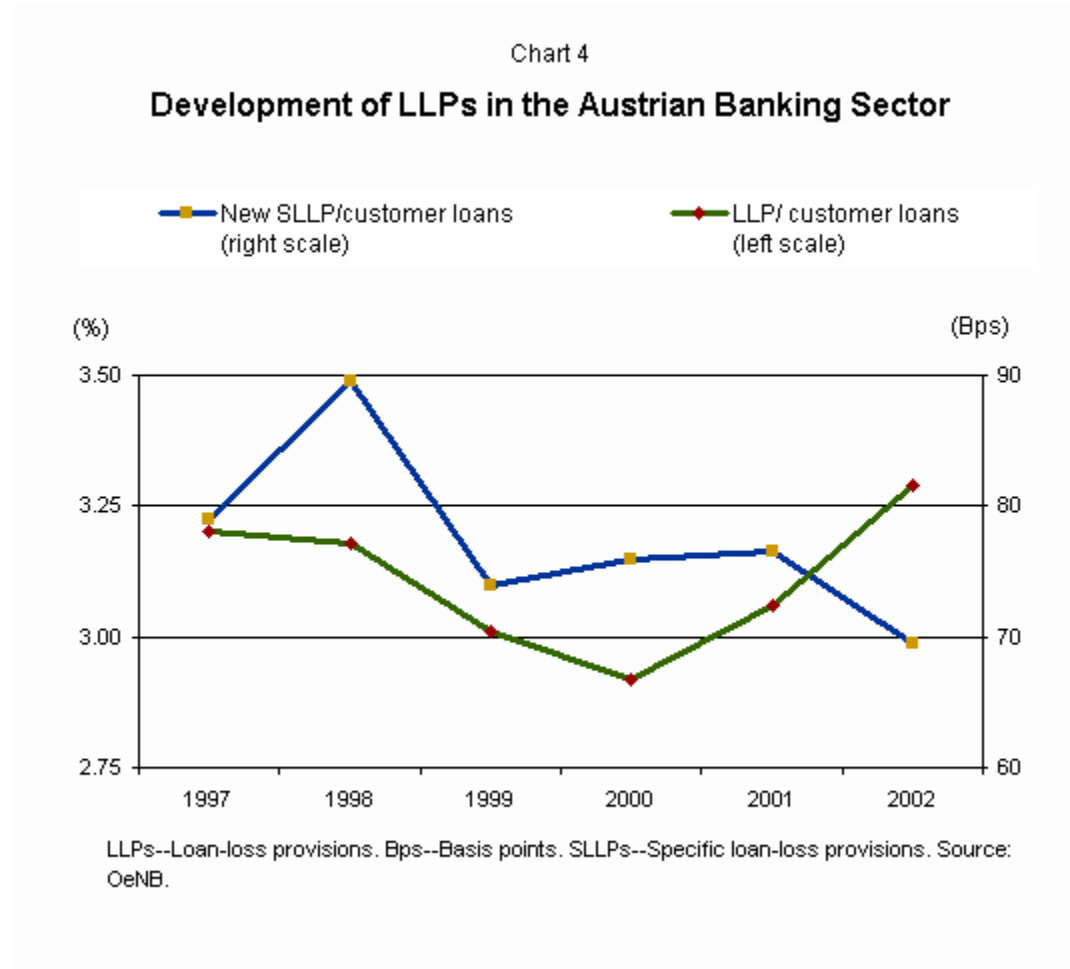
Moreover, as the small Austrian stock exchange has not experienced the high volatility of other European stock markets, and, given that the proportion of equity investments is low, the effect on private households of bearish stock markets has been very limited. Consequently, unlike their cross-border competitors, Austrian banks are less affected by declining commission income or the reduced wealth of their customers.

Similarly, real estate prices have remained at relatively stable levels throughout the 1990s and are therefore less susceptible to market swings, although commercial real estate in Austria's capital and economic center, Vienna, has suffered from the economic downturn.

In general, neither rapid credit growth nor asset price inflation is putting stress on the Austrian financial system.

Trend in loan-loss provisions.

The development of loan-loss provisions (LLPs)-to-customer loans mirrors the benign economic environment until 2000 and the deterioration since then. LLPs-to-customer loans had declined to 2.9% in 2000, but increased to 3.3% in 2002, which is slightly above the 1997 level. New LLPs have remained markedly stable in absolute terms since 2000, although at high levels, and even decreased relative to average customer loans in 2002 to 70 basis points (bps) from their peak of 90 bps in 1998. As signs of a quick economic recovery have not yet emerged, Standard & Poor's expects no relief in provisioning needs in 2003.



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Nominal GDP (Bil. €)	2,160	2,276	2,371	2,450	2,511	2,614	197	207	212	216
GDP (Bil. \$)	186	199	235	231	206	211	210	192	190	204
Real GDP (% chg.)	0.42	2.61	1.62	2.00	1.59	3.52	3.70	3.53	0.67	0.90
Population (Mil.)	7.99	8.03	8.05	8.06	8.07	8.08	8.09	8.11	8.13	8.14
GDP per capita (\$)	23,236	24,821	29,212	28,703	25,505	26,134	25,942	23,640	23,338	25,080

Real GDP per capita (% chg.)	(0.71)	2.09	1.37	1.87	1.47	3.42	2.47	3.35	0.37	0.78
CPI (% chg.)	3.60	2.95	0.51	1.73	1.20	0.79	0.49	1.95	2.30	1.80
Unemployment rate (%)	4.2	3.7	3.8	4.3	4.4	4.5	4.0	3.7	3.6	4.1
Exchange rate, year-end (€/\$)	12.14	11.10	10.09	10.95	12.63	11.75	1.00	1.07	1.13	0.95
Total domestic credit to private sector & NFPEs (Bil. €)	2,019	2,086	2,229	2,377	2,596	2,716	198	214	225	233
Total domestic credit to private sector & NFPEs/GDP (%)	93.47	91.66	94.01	97.02	103.38	103.90	100.62	103.13	106.31	107.93
NFPE--Nonfinancial private enterprise.										

Industry Risk - Business Dynamics

Competitive dynamics.

Privatization, consolidation, and refocused strategies on extended home markets have been the key characteristics of the Austrian banking sector over the past decade. At year-end 2002, the combined market share of the five largest institutions by total bank assets amounted to 46%. This compares, for example, with the respective market share of the four largest German banks, which accounted for only 16%.

The structure of the Austrian banking industry became radically more concentrated in 1997 when BA (ranked number one at the time) acquired Creditanstalt (ranked two), and Erste Bank was created through the merger of GiroCredit Bank (ranked three) and Die Erste Österreichische Spar-Casse (known as First Austrian). Moreover, in 2000, the state sold PSK to BAWAG, creating a new sizable domestic competitor, and increasing concentration among the large banks. With BA owned by Bayerische Hypo- und Vereinsbank AG (HVB; A-/Negative/A-2), and Erste Bank and RZB deeply rooted in their respective banking sectors, the room for further consolidation on a larger scale is limited. Nevertheless, consolidation among the smaller institutions, such as the cooperative and savings banks, is expected to continue. Although public-sector ownership used to be a characteristic of Austrian banking, providing state-guaranteed institutions with superior credit ratings, today--following the privatizations of BA and PSK--it is essentially limited to a number of small regional savings and Landeshypothekenbanks. Further, on Jan. 21, 2003, the European Commission (EC), in a formal decision, requested the Austrian government to phase out state guarantees benefiting Austrian banks. Therefore state support is set to diminish going forward.

Nevertheless, despite the consolidation process, with almost 900 banks and

almost 5,400 outlets serving a population of about 8 million, Austria remains one of the most competitive and overbanked markets in Europe. Furthermore, whereas BA and Erste Bank are institutions that aim for profit maximization, the combined market shares held by less profit-driven cooperative, savings, and state-owned banks, and the trade-union-controlled BAWAG are significant. This unique industry structure has, in Standard & Poor's view, contributed to low risk-adjusted margins and unfavorable cost levels. Consequently, consolidation has not translated into higher profitability levels in the Austrian banking market and earnings have remained low by international standards.

The lack of growth potential, competitive pressures, and persistently low margins at home have prompted Austrian banks early on to look at cross-border opportunities in neighboring CEE countries, based on strong historical, commercial, and cultural ties in the region. Through organic growth and acquisitions, BA, Erste Bank, and RZB are now firmly established and rank among the primary competitors in CEE countries, particularly in those that are EU accession countries. Although the three banks have been successful in coping with the additional credit, operational, and legal risks and in transforming their operations in CEE countries into profitable ventures, they are challenged to avoid excessive exposure and reliance on these promising, yet more volatile markets.

Operating flexibility.

Although the legal and regulatory environment provides a reasonable level of operating flexibility, Austrian banks have generally been slow to adapt to changes and competitive pressures in the past. The industry structure, with the relative lack of pressure from shareholders, has contributed to this trend. Although fully licensed banks are generally free to conduct all kinds of banking business and set lending and/or deposit rates, as well as fees and commissions for other banking services, competition has reduced profitability to low levels by international standards. For example, Austrian labor laws are less restrictive than in Germany; however, the number of employees in the domestic banking system has remained almost static since 1998. Notable exceptions are BA, which has been reducing domestic staff and containing cost growth as a result of its merger, and to lesser extent Erste Bank, both of which are under greater shareholder pressure to improve returns.

Retail banking customers in particular are protected by a set of consumer protection laws, which in recent years have focused on preventing banks from providing misleading advice or counseling to consumers and have resulted in an increasing administrative burden for the banks. Against the background of growing harmonization within the EU, this burden is likely to increase further. Although Austria's tax burden is among the highest compared with other 'AAA'

rated countries, Austrian banks were able to reduce their tax rates to less than 20% of pretax profits on average between 1998 and 2001.

Franchise: depth and diversity.

The Austrian banking system is dominated by universal banks, which are entitled to engage in a wide range of banking activities. Specialized subsidiaries, such as mortgage banks (Hypothekenbanken), building savings banks (Bausparkassen), investment funds (Kapitalanlagegesellschaften), and insurance companies complement their range of products. In addition, the larger commercial banks have also built up extensive foreign operations through networks of branches and subsidiaries.

Physical branch networks are expected to remain the cornerstone of customer relationships despite a growing acceptance of Internet banking in recent years. This protects the position of banks from potential new market entrants in the domestic banking market. Apart from HVB's acquisition of BA, foreign banks are mainly active in niche markets, such as investment banking, public finance, and consumer finance and leasing.

Austria is likely to remain a highly intermediated market, with banks expected to maintain their dominant role in the financing of the economy, as capital markets are still underdeveloped.

On the deposit side, threats to the intermediation role of banks within the economy, through shifts from deposits to alternative investments, is also limited because banks manage the vast majority of mutual funds. Furthermore, unfavorable capital markets have reversed this trend.

Deregulation.

The effects of deregulation in the past, the entry of Austria into the EU in 1995, and the privatizations of BA and PSK have already been reflected in the business and risk profiles of banks. Regulation and supervision have been strengthened to bring both in line with the EU financial sector directives and international best practices. However, organizational changes for financial market supervision in 2002 are fairly new, and effective implementation will take some time. Passbooks can no longer be opened without identification and since June 2002 anonymous deposits or withdrawals are no longer permitted. The abolition of anonymous passbooks had no tangible impact on institutions rated by Standard & Poor's. Major forthcoming changes are the introduction of IAS accounting in 2005 and Basle II in 2006. These changes are welcomed by Standard & Poor's as they might promote improved risk-adjusted pricing and capital allocation as well as disclosure and transparency.

Ownership structures.

The Austrian National Bank distinguishes between the banking sectors described below:

Commercial and private banks (Aktienbank und Bankiers).

The 59 commercial banks are privately owned. Shares of those that operate as joint-stock companies are typically not listed or have limited shares in free float due to the dominance of large, stable shareholdings. Their market share by total assets amounted to 16% at year-end 2002. Prior to its merger with BA in 2002, Creditanstalt was included in this segment. The largest institution in this sector is now BAWAG, which is 53% owned by Österreichische Gewerkschaftsbund (ÖGB; Austrian Federation of Trade Unions), and 46% owned by German Bayerische Landesbank (AAA/Negative/A-1+).

Savings banks.

Although the savings bank sector today consists of Erste Bank as the central institution and 62 local savings banks, the national banking statistics continue to include BA for historical reasons. Therefore, the market share of the savings bank sector by total assets, amounting to 37% at year-end 2002, is overstated. BA is a joint-stock company fully owned by Germany-based HVB group, and, with total consolidated assets of €148 billion, is by far the largest Austrian bank accounting for 22% of total bank assets as a whole.

Erste Bank, also a joint-stock company, is the second-largest bank in Austria, with total consolidated assets of €94 billion at Sept. 30, 2002, reflecting its acquisitions in CEE countries in 2000 and 2001. Erste Bank's major shareholders are: Die Erste Anteilsverwaltungsparkasse (AVS), which holds 35.6%, and the Austrian savings banks, which hold 8.6%.

Consolidation has reduced the number of savings banks to 62 from 80 in 1994. Savings banks operate under the Austrian Savings Bank Act (Sparkassengesetz), last amended in 2001. The savings banks' owners typically cannot participate in the banks' equity or profits, that is, they are restricted from injecting or withdrawing capital. There are two types of savings banks: "Gemeindesparkassen" and "Vereinsparkassen".

Gemeindesparkassen are savings bank founded by a municipality and are in many ways similar to a publicly owned institution, and account for 62% of the savings banks. As they typically benefit from a deficiency guarantee of the municipality, Gemeindesparkassen were also covered by the EC's decision to phase out state guarantees. The remaining savings banks are Vereinsparkassen or foundation savings banks, which are savings banks founded by benevolent associations, such as a credit association. Banks in this category are similar to mutual institutions. Since the 1993 amendment to the Savings Bank Act, savings banks have also been permitted to operate in

the form of joint-stock savings banks, a move that finally paved the way for new, external owners in the sector. Apart from BA and Erste Bank, more than one-half of the savings banks already operate in this legal form.

Cooperation and cohesiveness has been significantly strengthened since Erste Bank became the central institution in 1997 for the savings bank sector. On Sept. 26, 2001, the Austrian savings banks and Erste Bank signed an agreement aimed at further strengthening the cooperation and mutual support among members of the savings banks sector, and the security of customer deposits. The new protective scheme became effective on Jan. 1, 2002, and comprises the overwhelming majority of savings banks, which account for about 95% of customer deposits. Due to the introduction of the protective scheme, Erste Bank consolidates all member institutions and recorded consolidated assets of €125 billion at Sept 30, 2002, (see section entitled "Deposit insurance schemes" in this report).

Credit cooperatives.

In contrast with Germany, the Raiffeisen and the Volksbanken cooperative sectors are separated. The two sectors accounted for 23% and 5%, respectively, of total bank assets at year-end 2002.

The Raiffeisen cooperative banking sector has a three-tier structure. It consists of 599 local banks, nine regional central banks (Raiffeisenlandesbanks), with RZB as the central bank. With total consolidated assets of €110 billion, the Raiffeisen banking sector is the largest banking sector--although smaller than BA--with a market share by assets of 23% at year-end 2002. It operates the largest branch network, with 2,328 outlets, and employs more than 20,000 staff. Consolidation has reduced the number of independent local banks to 599 from more than 800 back in 1992. These local banks, whose business profiles are similar to those of the savings banks, offer a full range of banking services, but concentrate on retail customers and small businesses. They have about 1.7 million members, who are customers and owners of local banks. The sector's strong position in domestic retail banking is reflected in its market shares: 26% of domestic customer deposits and 22% of domestic customer loans.

Raiffeisenlandesbanks, which are owned by the local banks, provide services that cannot be carried out by the independent local banks. These services include: payment and foreign transactions; securities business; technological support; and advisory functions. Furthermore, they act as liquidity centers and commercial banks. RZB, which is 88%-owned by the Raiffeisenlandesbanks, acts as the central institution of the sector, the liquidity center for the Raiffeisenlandesbanks, and also operates as a commercial bank. The sector offers a complete range of financial services through specialized entities,

including insurance products, mutual funds, building savings products, and leasing. Solidarity within the sector has been traditionally strong and was further strengthened through the introduction of explicit customer protection schemes at the central and regional level in November 2000 (see section entitled "Deposit insurance schemes" in this article).

The Volksbanken sector has a two-tier structure; there are no regional banks. At the base level are 67 Volksbanken, and at the top level is the central bank of the sector, Österreichische Volksbanken AG (ÖVAG). ÖVAG is a joint-stock company, of which 60% of the shares are owned by the local cooperatives, and 25% is held by DZ Bank AG Deutsche Zentral-Genossenschaftsbank (DZ Bank; A-/Negative/A-2), the central institution of the German cooperative banking sector. The Volksbanken operate their own deposit protection scheme.

Landeshypothekenbanks.

Founded by the state governments, these eight regional banks account for about 7% of total Austrian bank assets at year-end 2002.

Landeshypothekenbanks originally specialized in mortgage financing and the issuance of mortgage-backed bonds (Pfandbriefe), but are now universal banks with a strong focus on local SME lending and retail customers. In addition, they continue to serve as banker to their respective states and usually assist in promoting the local economy. Landeshypothekenbanks were traditionally organized as institutions under public law with the respective states acting as owners and deficiency guarantors. Today, the banks operate in the form of joint-stock companies and have been partly privatized to form strategic alliances. All but one, however, still benefit from deficiency guarantees from their respective state owner, for which they pay a relatively small fee. On Jan. 21, 2003, the EC, in a formal decision, requested the Austrian government to phase out state guarantees benefiting Austrian banks by the end of 2004, although indicated that a longer transition period might be agreed upon if necessary, however.

The counterparty credit ratings on the five rated Landeshypothekenbanks are based on the ultimate deficiency guarantee (Ausfallsbürgschaft) of the state owners, under which the states are liable to the banks' creditors if, under a liquidation scenario, the creditors are unable to obtain full payment from the banks' assets. These are:

- HYPO TIROL BANK AG (AAA/Negative/A-1+);
- Landes-Hypothekenbank Steiermark AG (AA/Negative/A-1+);
- Niederösterreichische Landesbank Hypothekenbank AG (AA+/Negative/A-1+);

- Oberösterreichische Landesbank AG (AAA/Negative/A-1+); and
- Vorarlberger Landes-und Hypothekenbank AG (AAA/Negative/A-1+).

The negative outlooks on these banks reflect, however, that existing state guarantees will be phased out over a transition period, and that in the absence of explicit state guarantees, future counterparty credit ratings are expected to be lower.

Although the EC stated that guaranteed obligations of Landeshypothekenbanks will continue to benefit from state guarantees until maturity, Standard & Poor's negative outlooks on guaranteed debt ratings reflect that the existing deficiency guarantees do not ensure timely payment. Although Standard & Poor's expects that an agreement with the EC will allow timely payment if certain conditions are met, Standard & Poor's relies on the commitment of guarantors to make payments in a timely fashion, should this ever become necessary. However, the commitment of the guarantors might change over time, for example, in the case of a privatization.

Building savings banks (Bausparkassen).

The five Austrian building savings banks accounted for about 3% of total bank assets at year-end 2002 and offer medium-term and interim homeowner financing. Potential borrowers are required to build up savings over a certain period before receiving financing in the form of a second mortgage, which usually matches their savings at guaranteed low interest rates. Three of the building savings banks act as specialists for their respective banking sector.

Banks with special functions.

There were 81 special-purpose banks at year-end 2002, which in their majority comprise investment management companies that are not allowed to pursue any banking activity other than investment fund business. The two largest institutions, which are both jointly owned by the major Austrian banking groups, are Oesterreichische Kontrollbank AG (ÖKB; AAA/Stable/ A-1+), which provides state-sponsored export financing and acts as securities clearing house and settlement agency, and Investkredit (not rated), which mainly provides long-term financing to Austrian companies.

Financial Trends

Performance.

The levels of profitability at Austrian banks have been low by international standards, mainly because of low margins and high costs, and due to ownership structures, which have not demanded higher returns. Although a

far keener focus on raising earnings is penetrating much of the Austrian banking sector, achieving progress in the saturated and highly competitive Austrian market has been difficult and slow. Whereas Austrian banks have aimed to improve market shares by driving down margins in the past, the increasing focus of major banks on shareholder value and capital allocation might eventually lead to efficiency improvements and a more prudent risk-adjusted pricing policy, particularly in corporate lending. Standard & Poor's expects this process to be gradual, however.

Strategies to improve earnings often center on exploiting opportunities in neighboring CEE markets. BA, Erste Bank, and RZB have been leaders and are now well established, which has increasingly allowed them to reap the benefits of their geographic expansion. CEE countries, with the exception of Poland, have continued to show robust economic growth, unlike the Austrian economy, which, following a period of solid GDP growth between 1998 and 2000, deteriorated in line with its largest Western trading partners, particularly Germany. Consequently, the three banks recorded acceptable earnings on a consolidated basis despite the economic slowdown, as profit contributions from CEE operations continued to grow. However, with CEE countries accounting for pretax profit of 50% and above in 2002, these three banks will be challenged to avoid excessive reliance on their foreign operations and to improve profitability levels in Austria, as growing competition and declining interest rates are likely to reduce profit margins in these countries. Competitive pressure will also necessitate a broadening of their customer bases and the prudent build-up of lending business with SME and private customers, as lending to the public sector and the large companies has become less lucrative, which could augment the business risks and capital strains involved with their expansion strategies.

According to Austrian National Bank statistics, which are based on the unconsolidated accounts of the banks, excluding profits from foreign subsidiaries, the projected earnings of Austrian banks for 2002 are expected to be sharply depressed, as a result of the economic downturn and the still high level of provisioning needs, reduced profits from the sale of or release of reserves for available-for-sale securities and participations, and reduced interest income due to the low interest rate environment. Net income-to-average Tier 1 capital is expected to drop to about 5% in 2002, from about 10% in 2001 and 2000, and from above 7% between 1997 and 1999. High costs remain a key challenge, but most banks have remained reluctant to rigorously address inefficiencies. Consequently, the industry's average cost-to-income ratio has remained almost unchanged since 1990 at about 70%. Standard & Poor's expects a continuation of weak performance in the Austrian market in 2003.

Lending and Asset Quality

Asset quality in the Austrian banking system is satisfactory, as it benefits from the relative robustness of the Austrian economy and the wealth of its population. Until 2000, asset quality had also benefited from the benign economic environment and the absence of unsound asset price inflation. Whereas the cyclical increase of domestic insolvency liabilities, due to some larger corporate insolvencies, mainly hit the larger institutions in 2001, provisioning needs appear to be more widely spread in 2002. The total new risk provisions of the banking system have remained markedly stable and even decreased relative to risk assets to 71 bps, based on preliminary results in 2002, from 80bps in 1997. The key problem remains the lack of discipline with respect to risk-adjusted pricing in the Austrian market, which makes lending less attractive. This has prompted many banks to increase opportunistic lending via credit surrogates, such as corporate bonds and asset-backed securities, to benefit from higher margins and lower origination costs. Preliminary data from the Austrian National Bank suggest that write-downs on such loans increased, thus aggravating the pressure on the earnings of banks in 2002.

Foreign assets accounted for 28% of total bank assets in 2002. This somewhat underestimates the foreign exposures of Austrian banks, as the National Bank's statistics are based on unconsolidated figures. With respect to the largest institutions, BA, Erste Bank, and RZB, and with the exception of the Russian crisis in 1998, provisioning needs in CEE countries have often been lower than in Austria or could be more easily absorbed due to better risk-adjusted pricing. This contrasts with their international exposures outside their extended home markets, particularly in Asia, and more recently, in the U.S. Improving profitability in CEE countries will reduce the pressure to seek higher-yielding assets outside their home markets, however.

Funding.

The funding of Austrian banks is generally well diversified, with a significant share of domestic customer deposits funding about 80% of domestic customer loans. The funding structure at year-end 2002 shows customer deposits accounting for 38% of the balance-sheet total, complemented by 30% interbank funding and 23% in own issues. Funding profiles vary significantly between predominantly retail-funded savings and cooperative banks and the larger institutions with a significant wholesale business.

The current increase in customer deposits in 2001 and to a lesser extent in 2002, as a result of weak capital markets, does not indicate that the underlying trend toward financial disintermediation has halted. In addition, customers are increasingly demanding higher-yielding investment products in view of the persisting low interest rate environment. Austrian customers have

historically been conservative and banks control the largest domestic mutual funds, however. Operations in the less-mature CEE markets often provide a good opportunity to source customer deposits, which reduces the need to increase wholesale funds. Nevertheless, the use of excess liquidity from CEE countries in other markets is limited by the depths of cross-currency swap markets.

Capital.

Although the Austrian National Banks' statistics suggest that the general capitalization of the Austrian banking system appears to be strong on average and has been markedly stable in recent years, Standard & Poor's regards the capital strengths of the system as only adequate. The reasons for this are as follows:

- The capital ratios based on unconsolidated accounts overstate capitalization due to the double leverage as a result of the ownership structures of the cooperative and savings bank sectors.
- The higher level of credit and operational risk of the equity stakes of Austrian banks' in banks and nonbanks is not adequately reflected in the ratios.
- The profitability levels of the system are moderate and compare unfavorably by international standards.

However, Standard & Poor's does not foresee any threats to the overall solvency of the banking system.

Total reported equity-to-total assets amounted to 4.8% at year-end 2002, which compares favorably with Germany's 4.0%.

The regulatory Tier 1 ratio of Austrian banks has always been above 9% on average in recent years, but declined to 9.2% in 2002, from 9.5% in 2001. With Tier 1 ratios well above 9% and capital-to-assets close to 6%, the average capitalization of the cooperative Raiffeisenbanks and Volksbanks appears to be strongest, whereas the Landeshypothekenbanks average Tier 1 ratio of 6.8% and capital-to-asset ratio of 3.3% remained well below average. The overall issuance of hybrid Tier 1 capital, which Standard & Poor's considers a weaker form of capital, has generally been limited. Erste Bank is a notable exception. The banking system's total regulatory ratio declined to 14.1% in 2002 from 14.6% in 2001.

Ratios on a consolidated basis are lower and better reflect the capital strengths of the banking sectors. For example, the consolidated Tier 1 ratio of

the Raiffeisen banks amounted to a still satisfactory 7.5% at year-end 2001, and that of the savings banks was 6.1% at year-end 2002. BA's Tier 1 ratio was 6.8% at year-end 2002. Furthermore, in its analysis, Standard & Poor's places more weight on the overall strength of purer measures of capital, provided by its adjusted common equity-to-risk assets ratio, and deducts the book value of goodwill, intangibles, and equity stakes in unconsolidated bank subsidiaries from capital. Finally, Standard & Poor's also considers that core capital should provide a cushion for all kinds of banking risks other than market and credit risk, and includes qualitative factors, such as the prudence of a bank's strategy, management, and risk tolerance, in its analysis.

Regulatory Environment.

The Finanzmarktaufsicht (FMA)--created on April 1, 2002--acts as primary supervisor for banking, insurance, pensions, and capital markets. The FMA is supported by the Austrian National Bank (OeNB), which conducts on-site inspections and collects regular reports from the banks and reports of external auditors to the supervisors. The creation of the FMA as a public entity with legal independence is a result of the 2001 Financial Market Supervisory Act and responds to the changing and increasingly complex requirements for prudent supervision. However, as only 100 staff were transferred from the Ministry of Finance and the Austrian Securities Authority, the FMA is challenged to manage the transition process and to deal with the more extensive supervisory requirements. The OeNB will continue to play an important role to ensure that all banks will be inspected periodically. Nevertheless, further recruiting and training will be required to improve cross-sector supervision and to cope with the additional workload following the implementation of Basle II in 2006.

Standard & Poor's welcomes the ongoing improvements to the Austrian Banking Act (BWG) and reporting requirements for the banks subject to this statute.

The legal basis for banking supervision is the BWG, last amended in 2002. Nearly all kinds of financial services that are offered commercially have to be approved by the FMA and are subsequently regulated. The Act is aimed at safeguarding the viability of the banking industry by protecting creditors and regulates, for example: capital and liquidity requirements; surveillance of the lending business as well as market and interest rate risk management; information requirements and audits; licensing; and enforceability and sanctions. Supplementary laws also exist, notably the Savings Bank Act, the Building Savings Banks Act, and the Investment Companies Act.

Banks are generally required to meet the capital requirements according to

BWG, whereas only banks operating internationally with significant foreign exposures are also required to meet the Bank for International Settlements (BIS) guidelines. Although Austria's regulatory regime with regards to the risk weighting of assets is generally in line with the BIS guidelines, the regulatory approval of hybrid capital instruments as Tier 1 capital differs. Since October 1998, the BIS rules limit the inclusion of dated hybrid capital instruments in Tier 1 to a maximum of 15% of Tier 1 capital. In contrast, the BWG distinguishes between perpetual hybrids without step-up provisions that can qualify for up to 30% of consolidated Tier 1 as well as perpetual hybrids with step-up provisions that only become eligible up to 15%. Standard & Poor's considers that hybrid capital instruments represent lower quality capital and is concerned that financial institutions could increasingly substitute common equity with hybrid capital instruments that will weaken the financial strength of institutions individually, as well as the industry as a whole. However, the use of such instruments has been limited so far.

Liquidity is measured by two ratios:

- First, the regulatory liquidity ratio gives the proportion between a narrow definition of liquid assets available on demand and up to one month, and a certain percentage of payment obligations callable up to six months; and
- Second, the liquidity ratio gives the proportion between a broader definition of liquid assets and a certain percentage of payment obligations callable up to 36 months.

The liquidity of the institution is deemed to be adequate if its liquidity ratio does not fall below one. Refined instruments are needed for prudent liquidity management, however.

Crisis Management.

The BWG provides the FMA with the power to take preventive action in times of stress. The FMA can, for example:

- Request information from, inspect, and initiate external audits on an institution any time at its discretion;
- Prohibit any capital measures, including dividend payments in cases where the funds of creditors might be endangered;
- Revoke an institution's or management's licence; and
- Close an institution.

If a general political or economic crisis could lead to a systemic crisis for the

economy or the payment systems, the federal government has the power to temporarily stop payment transactions.

There have been relatively few bank failures in Austria, partly because problems have been resolved through collective action within the cooperative or savings bank sectors without regulatory intervention. A recent example is Tiroler Sparkasse, which was taken over by Erste Bank in December 2001, and is currently being restructured. In 2000, Bank Burgenland (not rated) was close to failure. The bank, however, received support from its guarantor and main owner, the respective state government.

Deposit insurance schemes.

The regulatory environment in Austria, in connection with the established individual deposit-insurance systems operated by the various bank sectors, is well positioned to safeguard the well-being of the banking sector as a whole and to resolve smaller problems that might arise at individual banks. The protective schemes operated by the Raiffeisenbanks and the savings banks, in particular, go well beyond legally required provisions and aim to protect the solvency of institutions. Nevertheless, investors should not rely on regulators adopting a "too-big-to-fail" approach and should take into consideration that even protective schemes might, at the least, experience timeliness problems, particularly when the resources of these schemes are strained in times of stress.

Following Austria's entry into the EU and the revision of the BWG, the EU deposit-protection directive has been implemented. Austrian deposit institutions must be a member of one of the five deposit-protection schemes of the respective banking sectors. Deposit-protection facilities were established as separate legal entities and guarantee repayment of deposits up to €20,000 for each depositor within three months should a member institution become unable to pay. Deposits of legal entities are only 90% protected within the limit of €20,000 each.

Protective scheme of the Raiffeisen banking group.

Unlike in The Netherlands and in France, the Raiffeisen banking sector is not linked by a cross-guarantee scheme. The sector has demonstrated cohesiveness and solidarity in the past on a voluntary basis, however, and has been successful in preventing bankruptcies and losses for creditors and member shareholders. In November 2000, the sector introduced explicit customer protection schemes at the central and regional level, funded by contributions from the member banks according to the proportion of each bank's protected liabilities. About 78% of all the Raiffeisenbanks, representing about 82% of deposits, are participating in the scheme. At the central level, the scheme is managed by an association (Raiffeisen-

Kundengarantiegemeinschaft Österreich; RKÖ), of which RZB and the regional Raiffeisen banking associations are members. Both report to RKÖ on their present and future financial situations on a quarterly basis. The amount available to absorb losses was €3.3 billion at year-end 2001.

The agreement falls short of a strong and timely cross-guarantee, however, because it does not guarantee all claims, includes certain limits with regard to member banks' obligations to provide financial support for distressed members, and becomes effective only if a member bank commences insolvency proceedings. Nevertheless, the interdependence of the member banks means that the incentive and willingness to prevent bankruptcies remains very strong and is even enhanced by the new scheme.

Protective scheme of the Austrian savings banks.

The protective scheme is operated by a newly established special-purpose company (Haftungsgesellschaft; HG), which is 51%-owned by Erste Bank. Member banks are obliged to furnish HG with financial information on a regular and timely basis to detect potential problems at an early stage. HG will also decide about the necessity, form, and implementation of support for troubled member banks, ranging from advice to capital contributions. According to the agreement, financial support will be funded by the member banks, which is capped at the overall limit of 1.5% of risk assets and 75% of expected pretax profit on a combined basis. For the participating savings banks, excluding Erste Bank, this limit amounted to about €450 million at Sept. 30, 2002. Owing to the uncertainties of the implications of Basel II proposals on the amount of risk assets permissible for banks, the member banks will be allowed to renegotiate these limits in 2004.

Although the protective scheme falls short of a cross-guarantee system because of certain limitations, it demonstrates the overall strengthened cooperation and stronger cohesiveness within the sector and Erste Bank's commitment to fulfill its function as the central institution of the sector. Although the savings banks on average are better capitalized than Erste Bank, the positive rating implications for Erste Bank are (beside the limitations of the scheme) further limited, as the savings banks are much smaller than Erste Bank. At Sept. 30, 2002, Erste Bank had consolidated assets of €94 billion compared with €125 billion of the members of the HG, including Erste Bank. Nevertheless, Standard & Poor's considers the scheme as a positive rating factor, as it strengthens Erste Bank's ability to absorb losses and its role within the sector, as the banks have also agreed on uniform business strategies, IT and controlling systems, production, processing, and marketing. The savings banks have also committed themselves to continue to deposit up to 14% of their deposits with Erste Bank, which they are currently obliged to do, irrespective of potential legislative changes.

Accounting Policies

The lack of transparency in the financial reporting of Austrian banks remains an area of dissatisfaction and disclosure continues to fall short of that of many of its international peers. The reason for this is that creditor protection is the overriding rule in Austrian accounting. A proposal made by the EU calls for compulsory reporting under International Accounting Standards (IAS) by 2005 for listed companies or banks that have debt instruments quoted on an exchange. The largest institutions already report their consolidated results in line with IAS--a trend that is very much welcomed by Standard & Poor's. As this limits the ability of banks to smooth earnings, it will lead to a more volatile earnings performance, a consequence to which customers and investors will have to become accustomed. In addition, the market will have to cope with the confusion caused by banks applying different accounting standards over the next few years.

The most important differences between Austrian accounting and IAS affect the following areas:

Securities portfolio.

Austrian accounting rules differentiate between three types of securities: trading, liquidity, and investment securities. Trading securities are allowed to be and liquidity securities must be valued at the lower of cost or market principle, while investment securities are valued at cost or below cost if a value depreciation is considered permanent. The classification is, to a certain degree, at the discretion of management. IAS, on the other hand, distinguishes between trading securities, investment securities, and securities available for sale. Trading securities and available-for-sale securities are marked-to-market. Investment securities must be valued at cost or below cost if a value depreciation is considered permanent. Unrealized gains and losses on financial assets and liabilities, including available for sale securities, which had to be remeasured at fair value with the introduction of IAS 39 in 2001, are generally shown in equity until their disposal.

Risk provisions.

The almost complete lack of meaningful insight into the asset quality and provisioning policy of Austrian banks has always been a point of criticism and will probably continue to be the case for some time. Banks can, and do, compensate the net evaluation result of their liquidity security portfolio--which includes all securities that are not classified as trading or investment securities--with the evaluation of their credit risks. This makes it difficult to interpret the resulting net figure for risk provisions in the profit and loss statement. Attempts to draw comparisons over time or between banks remain subject to certain assumptions and can sometimes be misleading. Neither are Austrian banks required to report, for example, their credit losses, level of risk

provisions, or nonperforming loans (NPLs).

Under IAS, provisions for credit risks have to be segregated and broken down by gross new specific provisions, release of specific provisions (which are no longer needed), and the use of specific provisions.

In contrast to many other countries, there are currently no mandatory regulatory requirements regarding LLPs; that is, there is no classification of NPLs, loans past due, or restructured loans. Regarding specific provisions, the somewhat vague guidelines state that doubtful debts are to be shown at their realizable value and that bad debts must be written off; however, it is up to the banks and their auditors to decide when a loan becomes doubtful. The fiscal authorities decide each case on its own merit.

Goodwill.

Whereas Austrian banks have the option to deduct acquired goodwill directly from equity or amortize, IAS requires that a purchased goodwill be written off over five to 20 years, thereby adversely affecting bottom-line profitability each year. Standard & Poor's, however, deducts goodwill and intangibles from adjusted common equity.

Treatment of provisions for pension fund liabilities and other.

Whereas under Austrian accounting rules the calculation of these obligations is strongly influenced by the treatment for tax purposes, the implementation of IAS will result in the disclosure of "hidden expenses". In contrast to Austrian rules, IAS uses a market rate as a discount factor and accounts for future increases in salaries and retirement benefits, resulting in a one-off expense at introduction and more volatile annual contributions, presumably at higher levels.

Other differences between Austrian accounting rules and IAS exist in the areas of:

- Consolidation of a wider range of subsidiaries under IAS;
- Tax accounting with the capitalization of deferred taxes under IAS in contrast to tax-based accounting under Austrian GAAP;
- Depreciation, irrespective of tax considerations under IAS, in contrast to tax-based depreciation under Austrian GAAP;
- Stricter limitations on the formation of provisions for future expenses under IAS (for example, restructuring expenses);
- Specific rules on hedge accounting under IAS 39; and
- The detail of notes under IAS, for example provided on certain balance-

sheet items and the profit and loss account.

Appendix 1: Basic Data: Austrian Banking System

Number of banks.

At year-end 2002, there were 897 authorized banks in Austria, of which 679 are cooperative banks (609 Raiffeisen and 70 Volksbanken), 64 savings banks, 59 private banks, nine Landeshypothekenbanks, with the remainder split between building savings banks and other, special-purpose banks. The international network of Austrian banks as a whole comprises 25 subsidiaries and 45 representative offices in other countries. There are 19 banks in Austria with foreign bank or nonbank majority ownership.

System deposits.

The total deposits of Austrian residents--enterprises and private individuals, excluding public sector households--held in domestic banks and building savings banks amounted to €175 billion at year-end 2002, according to Austrian central bank data.

Deposits per capita.

€23,150 at June 30, 2002.

Form of regulation.

The Finanzmarktaufsicht (FMA)--created April 1, 2002--acts as the primary supervisory body for banking, insurance, pensions, and capital markets. The FMA is supported by the Austrian National Bank (OeNB), which conducts on-site inspections and collects regular reports from the banks and reports of external auditors to the supervisors. All banks licensed in Austria must be audited annually and auditors have to be changed every six years. Detailed reports and information must be submitted to the regulators on a regular basis. The FMA supervises banks under the Austrian Banking Act (BWG) and several supplementary laws, notably the Building Savings Bank Act, Savings Bank Act, and the Investment Companies Act. Almost all kinds of financial services that are offered commercially have to be approved by the FMA and are subsequently regulated.

Bank superintendent.

The presidents of the FMA are Prof. Dr. Andreas Grünbichler and Dr. Kurt Pribil.

Appendix 2: Republic of Austria - Sovereign Ratings

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Outstanding ratings: AAA/Stable/A-1+

Rationale

The ratings on the Republic of Austria are supported by:

- A modern, highly diversified, and competitive export-oriented economy;
- The rapid progress in fiscal consolidation and a gradually declining debt burden; and
- Its stable and stress-tested democratic institutions based on consensus building and predictability in economic policy orientation.

Austria's economy is characterized by high living standards, based on a high level of productivity and the innovative capacity of its corporate sector. Markets are flexible and react swiftly to economic shocks. As a result, unemployment is significantly less than levels observed across most of Europe, and the economy has been among the least volatile of rated sovereigns. The resilience of Austria's economy is underpinned by its tradition of wage moderation and responsible social partnership. A consensus favoring responsible macroeconomic policies and a modernizing microeconomic reform agenda has gained strength, and many recent reforms relating to liberalization and deregulation now appear irreversible. The willingness of authorities to tackle even the most contentious areas of economic reform--such as parametric changes to promote the financial viability of state pensions--has increased. Nevertheless, a significant reform agenda still needs to be addressed, notably with a view to reducing the heavy tax burden and simplifying the complex tax system while safeguarding a balanced budget. Rationalizing the costly public health care and pension systems has become ever more important as the population ages. GDP is expected to grow just 0.90% in 2002, but the economy will recover from the current slowdown to grow at a rapid 3.00% in 2003 and along its long-term growth path of 2.25%-2.50% thereafter.

Austria has succeeded in becoming a European leader in terms of fiscal consolidation. Although the debt burden remains high, at 61.8% of GDP in 2002, the turnaround since 1998, when Austria had the highest general government deficit among EU sovereigns, has been remarkable. The general government was broadly in balance in 2001, for the first time in three decades. Although specific circumstances facilitated the achievement of a balanced budget, the structural balance also improved significantly. In 2001-2003, Austria's structural balance will be in a small surplus, following an average structural deficit of 2.5% of GDP during 1998-2000. Sustaining broadly balanced budgets over the medium term should reduce the general government debt burden to 52.2% by 2005.

Outlook

The ratings on Austria remain secure against virtually all foreseeable medium-term downside economic and political risks. Austria's typical 'AAA' sovereign credit profile takes into account its stable political system, high levels of economic wealth and diversity, and flexible market institutions. EMU membership shields Austria effectively from balance of payments-related pressures. None of these factors is likely to change over the coming years, and Austria's structural features provide ample potential to deal with virtually all realistic downside scenarios. Prudent policy-making will prevail, irrespective of the outcome of the general election due in October 2003. Standard & Poor's expects a continuation of the successful fiscal stabilization process despite the temporary and mild slippage seen in 2002, which was due to weak economic growth. There is no tangible threat to the consensus endorsing stable and predictable macroeconomic policies and a cutback in government debt over the medium term.

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Appendix 3: Insurance Outlook

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On Jan. 21, 2003, Standard & Poor's Ratings Services revised its outlook for rated Austrian insurers to stable from negative, indicating that insurer financial strength ratings are more likely to remain the same than to be lowered or raised.

Although negative rating activity has been evident in the Austrian market over the past two years, due to continued weak earnings, the insurance market's profitability appears to have stabilized and the rating environment seems to be slowly improving.

During 2001, there were six downgrades in the Austrian insurance market, representing one-third of Standard & Poor's ratings coverage in the region. Rating actions slowed in 2002, with only one downgrade, which was based on the stand-alone characteristics of market participants and unrelated to any group impact. Nevertheless, although ratings in the market appear to be reaching a more sustainable level, the uncertain economic environment remains a threat, with any further investment market shocks likely to pressure ratings.

Consolidation in 2001 and 2002 will contribute to the stabilization of the

market, following mergers between Volksfürsorge-Jupiter and Wüstenrot in 2001, and, in 2002, between Montanversicherung AG and Wiener Städtische, and Winterthur and Zurich Kosmos. Announced at the end of last year, the sale of AXA Versicherung AG (Austria) to UNIQA Versicherungen AG (A/Negative/--) will be a further boon to the stabilization of the market. Nevertheless, although consolidation will assist the recovery of the market and a return to profitability over the long term, improvements in the operating performance of companies will be slow.

Following premium growth above the rate of inflation in 2001, the non-life sector saw a significant seven-percentage-point improvement in its combined ratio--the main indicator of an insurer's underwriting profitability--to 111.5%. Nevertheless, there remains some way to go before the sector reaches the 100% break-even point.

Despite an improved technical result in the non-life sector in 2001, there is unlikely to be any significant improvement in profitability for 2002. The summer 2001 floods in Northern Austria, losses from hail storms, and difficult operating conditions in the industrial sector are likely to limit the level of profitability for the sector.

Premium growth in the life sector in 2001, although modest at 8.2%, also remained above inflation. Most notably, strong sales of unit-linked products belied poor investor confidence in other European markets, up 17.6% on 2000.

The life sector is unlikely to experience exceptional results in 2002, however, with earnings expected to be similar to those in 2001, largely due to the poor investment environment. Growth in the Austrian life market will depend on insurers' ability to maintain confidence among policyholders. Although domestic equity markets remain stable compared with those of other European countries, Austria's life insurers also have exposure to other European markets and there is already talk that life policy bonuses will be cut.

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