

# Diplomarbeit

Titel der Diplomarbeit:

Risks and Opportunities for the Austrian Financial  
Service Industry in East- and Southeastern Europe due  
to the Financial Crisis

Verfasser

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# 1 - Introduction

Since the fall of the iron curtain 20 years ago the CEE region has continuously been through change, and has been the main source of substantial and above average growth for the Austrian financial service industry. Austrian bank and insurance companies started to enter the economies and managed to gain the leading position in most major countries of the CEE<sup>1</sup>, SEE<sup>2</sup> and CIS<sup>3</sup> region. They started off in the countries bordering Austria, which due to the close cultural and historical connection has proven to be a successful strategy. After this success their focus was moved further and further into the eastern part of the continent.

## 1.1 – The Crisis

In the fall of 2008 the situation in the financial world in Eastern Europe changed unfortunately. It started off with the write down of sub-prime mortgages in 2007, but the financial crisis officially swept over to Europe with the collapse of Lehman Brothers and the bankruptcy of the banking system in Iceland. Since then exposure in the economies of Eastern Europe has been

considered more risky. Many newspapers and rating agencies like the Wall Street Journal (Figure: “On the Hook”<sup>4</sup>), Business Week<sup>5</sup> and Moody’s thought that the large exposure of Austrian banks and insurance companies in the region will result in higher risk and a possible downgrade in the rating. In November 2008 the situation got worse, and the EU officially fell into a recession for the first time in its history. It was at this point that the first members of the Austrian banking sector started recognizing their higher risk profile, and went to the State to get additional capital. The first one to take the bailout money from the state, was Erste Group. Raiffeisen Zentral Bank, the parent company of

### On the Hook

Ten largest creditors of Europe's emerging-market economies

Austria	\$277.6 billion
Germany	219.9
Italy	219.6
France	155.1
Belgium	136.7
Netherlands	122.2
Sweden	106.5
Switzerland	58.6
U.S.	53.6
U.K.	46.8

Notes: As of September 2008, preliminary; based on loans by banks reporting to the BIS  
Source: Bank for International Settlements

<sup>1</sup> Central and Eastern Europe

<sup>2</sup> South-Eastern Europe

<sup>3</sup> Conglomerate of Independent States (i.e. Ukraine)

<sup>4</sup> Wall Street Journal, Austria's Vulnerable Eastern Flank, 11.3.2009, Christian Ortner

<sup>5</sup> Austria Pinched by Eastern Europe Woes, Business Week 12.3.2009, Rüdiger Falksohn and Walter Mayr

Raiffeisen International, later on also decided to apply for state capital. Even though UniCredit Bank Austria, was planning on taking money from bailout plans both in Italy and Austria, they will most likely divert from these plans. Bank Austria will not be able to receive money from the funds, since the parent company in Italy is planning to get fresh funds from the capital market, which restricts them from the bailout fund in Austria. Additionally they did not like the fact that the Austrian government only wanted to help if they received participation capital that later on could be converted into common stock, and therefore could take influence in the decision making process.<sup>6</sup>

## 1.2 – Focus

The focus of the thesis is to analyze one of the most difficult situations for Austrian financial institutions in their history, and conclude with an outlook on how the industry might adapt successfully. Since Austrian banks and insurance companies have taken a connecting role between western and eastern Europe, the thesis will focus on Austrian institutions that have their home market in the CEE and SEE and CIS region.

Due to the large number of countries in the region, the thesis will focus on a set of countries that provide an overview of the mentioned sub-regions of Eastern Europe. On the other hand the selected countries also play a historic role for the institutions under review by this thesis. The CEE countries (Czech Republic, Slovakia and Hungary) all have had a close historical connection to Austria over the past centuries, which is the reason why the Austrian financial institutions first developed in these markets after the UDSSR collapsed. Due to these factors it was not hard for them to understand the mentality and values of the market. The SEE region was the next step for the Austrian financial institutions. Austrian banks and insurance companies took a substantial stake of the Bulgarian and Romanian market, and therefore successfully exported their CEE knowledge to new markets. After they were present in all Eastern European markets that were either members of the European Union or had prospects to become one, they had to take the next step east towards the CIS region. Even though Russia is the biggest market of the region, it cannot only be

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<sup>6</sup> Bank Austria bleibt übrig; 24.9.2009;  
<http://derstandard.at/fs/1253596392293/UniCredit-holt-sich-Kapital-vom-Markt-Bank-Austria-bleibt-uebrig>

considered European. For this reason, and the fact that Austrian institutions have a large stake in the banking and insurance system, the thesis will focus on the Ukraine.

The thesis focuses on the three biggest Austrian banks, and the two largest Austrian insurers of the region. The banks analyzed will be UniCredit Bank Austria, Raiffeisen International and Erste Group. These three banks are both the biggest<sup>7</sup> banks in Austria, and have the most influence on the Eastern European market. The insurers analyzed are Vienna Insurance Group (VIG) and Uniqa, which are the biggest Austrian insurers, and have large influence in Eastern Europe.

### 1.3 – Research Questions and Hypotheses

The central research question of this thesis will be:

How are the Austrian financial institutions going to adapt in the Eastern European market after the crisis?

In order to answer this complex question several sub-questions will try to give an overall picture of the current risks and opportunities for the industry. The sub-questions will be the following:

- What influence will the large involvement in the Eastern European market have for the Austrian financial institutions?
- How will their Equity have to adapt due to the crisis?
- How influential are cost-cutting programs going to be on development and flexibility?
- How will the strong market position of the Austrian financial institutions develop?
- What role will financial regulation play in the future?

These questions lead to the following hypotheses:

H1: The large involvement of Austrian financial institutions in the Eastern European market bears substantial risks for the Austrian banking and insurance industry.

H2: The countries of the region have enormous differences and therefore cannot be considered a homogeneous region.

H3: The institutions will have trouble coming up with the necessary equity that will be demanded by the regulators, and therefore their room for expansion will be minimal.

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<sup>7</sup> Raiffeisen International considered as part of the Raiffeisen Network

H4: The current market position of Austrian financial institutions in the region will remain after the crisis.

H5: Regulation will become a lot stricter and have a negative influence on growth.

## **1.4 – Sources**

The historical side of this thesis has been well documented in the literature. Both the reformation process of the region after the fall of the iron curtain, and the integration into the European Union have been the topic of books, theses and other research papers. The financial crisis on the other hand has dominated the media for the past two years. Hence there is a lot of current literature about the topic, but a theoretical approach to the situation does not yet exist. For this reason most of the information in this thesis will be provided from business reports, national bank reports and other research papers from consulting agencies and investment banks rather than bound literature.

## **1.5 – Structure**

At first the reader will be provided with an introduction into the thesis paper, and its goals. In the following chapter the focus will be on the historical development of the region, especially on its transformation process in the early 1990's, since this process still poses problems to the current day. Additionally the second chapter covers perspectives of internationally renowned consultants and investment banks, and their general view of the current situation in Eastern Europe, but also specifically looking at the Austrian financial industry.

Chapter three will focus on the state of the countries under review. It will give an overview of the general market situation, and the developments on the financial markets. The focus will be on the state of the financial markets specifically looking at the banking and insurance market.

Chapter four will focus on the institutions under review. At first there will be a short overview of the Austrian banking market, followed by an analysis of the three Austrian banks under review. This analysis will cover their current situation, and then will focus on the individual divisions (Retail and Corporate), and on their subsidiaries in the region. Additionally there will be an overview of their strategy, and perhaps of adaptations that have become necessary due to the financial crisis. The second part

of the chapter will focus on the Austrian insurance industry. At first there will be a similar overview of the Austrian insurance market, and then the focus will shift to the divisions (life, non-life) before giving an overview of the subsidiaries in the countries under review.

Chapter five will provide the empirical analysis for the hypotheses stated earlier. This was done via four open interviews with representatives of Austrian banks (Bank Austria, Raiffeisen International), and insurance companies (VIG, Uniqa). In order to give a balanced view of the situation that is not biased towards the perspective of private institutions an interview with a representative of the Austrian National Bank was also conducted. After providing a summary of the answers to the interview questions, an interpretation and conclusion of these answers will follow. The conclusions from these interviews will then provide the necessary information to answer the research questions.

The final chapter will test the hypotheses due to the information provided by the empirical analysis in chapter five. Additionally there will be a summary of the current situation and an outlook on the future development of the industry within the Eastern European market.

## 2 - A Region of Change

### 2.1 – CEE Conversion Process

In 1989 the entire world was watching Europe and the reform process caused by the collapse of the Soviet Union. The system however was already changing since the 1960's due to the poorly articulated fiscal and financial structure of the communist system.<sup>8</sup> The problem for the consumers was that they only had a limited choice of products, and that the high inflation ate up savings. When the government started to sell its properties, barely anyone had enough money to buy them.<sup>9</sup> Additionally consumers only had limited choice on where to invest, for instance if somebody decided to get a life insurance it would not give them any advantage to depositing their income at a savings bank. This was the case because a life insurance company was only allowed to deposit the premiums with the monopolized savings bank. Hence there was not only a lack of choice for the consumers, but also for companies. For this reason people decided to invest in durable goods like houses and cars, which again were difficult to obtain due to strict rationing by the government. If bought, these goods would at least increase in value enough to compensate for inflation.<sup>10</sup>

This left companies and consumers in a position contrary to any western economy. Due to a lack of competition, banks had an easy job. They were the only source of financing for the local companies. Additionally to the naturally high market share, they would simply give out loans if the formalities were met. It was not necessary to hold any kinds of reserves or have any type of risk assessment, since they could always rely on the government to bail them out. For this reason their portfolios were full of non-performing loans, and nobody had reason to believe that this was a problem.<sup>11</sup> As a matter of fact there was no demand for financial information between

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<sup>8</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 10

<sup>9</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 11

<sup>10</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 12

<sup>11</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 13

the branches of the bank, causing a big problem for the banks once the communist system collapsed.<sup>12</sup>

In late 1989 when most velvet revolutions occurred in the region, the system drastically changed due to the different views of the new leaders. Privatization was the keyword of the region, but it happened at different paces. Some governments like Romania decided to stick closer to the Soviet approach, while others like Czechoslovakia took a free market approach. At that point supranational institutions like the IMF and the European Bank for Reconstruction started to get involved to make sure that the officials of the region exercised fiscal and financial restraint.<sup>13</sup> This control mechanism was necessary, due to large declines in industrial output, which ultimately led to a widening public deficit.<sup>14</sup> Several steps were taken to get these problems under control out of which the most vital one was a region-wide introduction of value added tax.<sup>15</sup>

At this early stage of the conversion process consumers for the first time in over forty years were presented with a choice of which bank they wanted to invest their money in. The national banks began to retreat from their monopoly position as a commercial bank, and started to take the role of a regulator responsible for the monetary stability in the system.<sup>16</sup> The government started to encourage the creation of private banks, but some communist thoughts still remained. The newly formed private banks, or more specifically their customers for example faced taxes on dividends, which were not common to any customer of a state-owned bank.<sup>17</sup>

By 1992 the banks of the region started to feel the effects of the non-performing loans in their portfolios, which forced the governments to step in. They started to buy failing loan portfolios from banks that otherwise would have collapsed. However

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<sup>12</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 14

<sup>13</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 15

<sup>14</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 17

<sup>15</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 18

<sup>16</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 20

<sup>17</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 22

discrimination against private banks remained. Most of the aid was given to state owned banks if they had a low ratio of capital to assets. While trying to get rid of bad debt incurred during communist times, banks also had to start to offer new types of products covering the newly found risk appetite of consumers.<sup>18</sup>

As a conclusion one can say that prior to the velvet revolutions of 1989 the region was unified, even though differences already existed before the fall of the Soviet Union. The reform process took different paths for different countries. Some governments were closer to Soviet ideology, while others had a more radical approach. In general it can be said that the more radical approach was also more successful, and that these advantages remain even 20 years later. Some countries developed quicker than others, but the privatization process gave entrepreneurs all over the region an incentive to make efficient decisions, or at least more efficient ones in the Soviet era.<sup>19</sup>

**2.2 – Government Position**

To completely understand the situation that CEE governments and the firms operating in these countries are in, one has to understand the general developments of the financial crisis and the government reactions that followed. According to a study conducted by Lazard, the financial service sector has recorded around 1 trillion US dollars in write-downs since the third quarter of 2007. In the proposition this was analyzed according to the region and sector where these write-downs took place, which is represented by the following figures.<sup>20</sup>

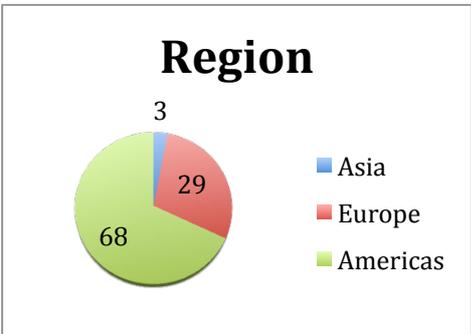


Figure 1

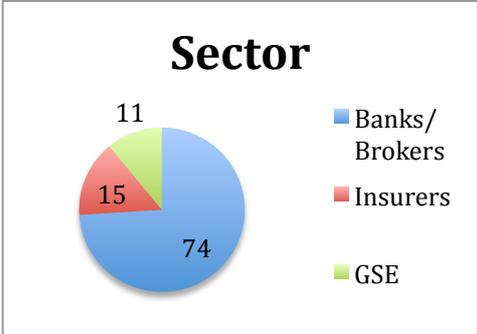


Figure 2

<sup>18</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 26

<sup>19</sup> The Development and Reform of Financial Systems in Central and Eastern Europe, Bonin&Székely 1994; Edward Elgar Publishing Ltd., England; pg. 31

<sup>20</sup> Government Position pg.1; Lazard Group, January 2009

Figure 1 shows that most of the write-downs until the end of 2008 occurred in the Americas region. This ultimately leads to the expectation that the European financial service industry will still have to write-down a substantial part of their assets. Figure 2 shows that most of these write-downs occurred in the banking sector. This goes along with the common belief that the financial crisis is more of a bank than an insurance issue.

These enormous write-downs also led to a large demand for capital by the institutions. According to the Lazard proposition, financial institutions raised an extra 920 billion US dollars from the market since the third quarter of 2007. This was then analyzed according to the region and sector where these capital injections took place.

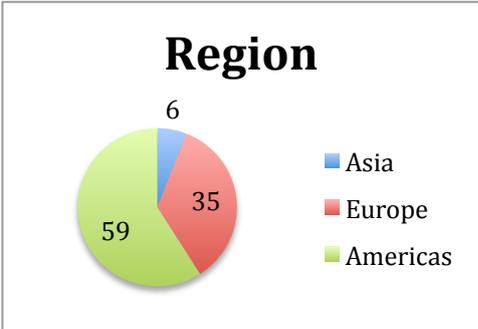


Figure 3

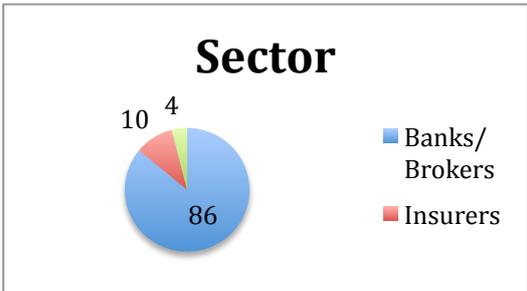


Figure 4

When comparing Figure 3 with Figure 1 it shows that even though there were more write-downs in the Americas, the European financial service industry has raised more capital comparatively. This might either be an indicator that the European financial service industry was not as well equipped with capital in comparison to their counterparts in the US, or that they are already expecting additional problems on the capital markets. Comparing Figure 4 to Figure 2 is yet another indicator that the crisis is a bigger issue for the banking sector. Another interesting fact about these capital raises is its source. Lazard states that during 2008, 40% of all capital raised by financial institutions came from government funds. The worrying trend is that during the last quarter of 2008 following the collapse of Lehman Brothers, this figure reached 67%. This might indicate that there is not enough capital available from investors to cover the needs of the financial institutions. When considering that most of this capital was

raised in the US where there is a large market for equity one might ask how a relatively small European equity market could handle such issues.<sup>21</sup>

These developments forced governments around the world to become active, since they were the only remaining source of capital for the industry.<sup>22</sup> At first their actions considering

- capital
- funding, and
- guarantees

had to be quick, and did not leave them with a lot of time to analyze the possible effects of their actions. Their next step was, and still is to reconsider the make up of the entire industry. Some questions that are currently coming up are whether the world needs that many banks, and how the existing banks can further decrease their leverage without harming the recovery. Leverage in this context is the biggest issue. Most institutions after the booming years were highly levered in order to boost their profitability. However reversing this process has shown to be rather problematic. It leaves the industry in a vicious cycle. The falling confidence leads to higher perceived counterparty risk, which then leads to lower risk appetite and thereby reduced consumption, which then further reduces the confidence and so on. The outcome of this development can either be a mild, and perhaps healthy recession or a depression scenario. In a mild recession there would be a natural sorting out process, causing companies with poor business models to fail, but leaving good companies relatively stable. In a complete depression, banks that are well off could also fail, which would ultimately lead to the collapse of the financial system causing further problems like large unemployment figures and a collapse of asset prices.<sup>23</sup> The most important factor now is that governments and companies work closely together in order to ensure that the new policies created on factors like liquidity and capital do not harm a recovery.<sup>24</sup>

### **2.3 – How long will the banking sector take to recover?**

According to renowned consulting agencies like the Boston Consulting Group the sector will take a long time to recover from these difficult times. According to

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<sup>21</sup> Government Position pg.2; Lazard Group, January 2009

<sup>22</sup> Government Position pg.7; Lazard Group, January 2009

<sup>23</sup> Government Position pg.6; Lazard Group, January 2009

<sup>24</sup> Government Position pg.7; Lazard Group, January 2009

estimates by the IMF, the losses in mature credit markets between 2007 and 2010 were around 3.4 trillion US dollars, which is greater than any loss in world history. For this reason and due to new regulation banks will need fresh capital in order to survive these turbulences.<sup>25</sup> Currently the governments of the world are giving out cheap credit in order to fulfill that need, but nobody is sure if that is going to be enough to get out of this dilemma. Another suggestion would be direct action as for example direct capital injections. However these actions are often feared by the government officials, since it would transfer taxpayer money to the share- and bondholders of these failing institutions, which would not be welcomed by the public during a future election.<sup>26</sup> Another problem is that a lot of banks in the US and Europe are currently holding onto their assets, because realizing their losses would cause them to go bankrupt. This is worrying, since such banks do not give out new loans and therefore do not get the world economy going again. They mention that this is very critical in Europe, since European banks have not written down their assets to the same extent as their US counter parts.<sup>27</sup> Another indicator that European banks are going to give out less loans in the future, are the beliefs of the European Commission that in order for banks to receive state aid, these will have to shrink their balance sheets. Currently due to the cheap money available to banks from the market profits are rising once again, but the profitability of the sector will still be under pressure for years to come.<sup>28</sup>

Another disturbing development for economic growth is the protectionist approach of governments. Since the 1980's there was a trend towards deregulation in the financial sector, but due to the crisis this has been reversed. In 2009 the G-20 nations agreed to become active again in order to protect their national economic interests, and to prevent another financial crisis from happening.<sup>29</sup> However the resources of these governments to stimulate the economy are also limited, especially considering some economies that already prior to the financial crisis had high debt levels. Since capital markets are expecting them to balance their budgets this could cause additional difficulties that might push the world back into a recession.

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<sup>25</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 12

<sup>26</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 13

<sup>27</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 17

<sup>28</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 18

<sup>29</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 37

Unfortunately for some the only possibility will be to cut spending, increase taxes and perhaps seek inflation as a last resort.<sup>30</sup>

One problem for the European banking system is the increase in the regulation for the financial service industry, specifically those companies involved in cross-border business. Many governments are currently pressuring these banks to stop lending outside their home market. When taking into account the situation of most CEE countries, where most of the banks are in the hands of foreigners this trend becomes critical. If these “foreign” banks decrease their lending, it might result in another crisis that according to them might be bigger than the Asian crisis towards the end of the 90’s.<sup>31</sup> Despite the fact that academics agree that protectionism generates less wealth than free trade, the governments of Europe currently have different priorities.<sup>32</sup> Their goal seems to be to have more control over the financial system, which they are trying to achieve through government ownership and more regulation. Unfortunately from a historical point of view, government ownership has not proven to be successful or efficient. It seems unlikely that the governments will step back out of these equity positions once things start going again. Their efforts will be to protect their financial network from foreigners, and through more regulation reduce the high leverage ratios amongst the financial institutions, and constrain the return of speculative investors.<sup>33</sup> However a unified set of regulations, which would be beneficiary to the system seems unlikely, since some countries with a strong financial service industry are not interested in restraining growth in that segment. Unfortunately this additional regulation, which will be different from country to country, will most likely hinder growth prospects.<sup>34</sup>

In the future the world for the financial service industry will be more difficult. One thing that cannot be expected in the near future is a return to the pre-crisis profit levels. Their environment will be less growth friendly. They will have to face lower economic growth as well as stricter regulation from protectionist governments. Additionally in the future companies will only be considered good if they have solid balance sheets, which indicate that increasing leverage to increase profitability will

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<sup>30</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 39

<sup>31</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 47

<sup>32</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 49

<sup>33</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 50

<sup>34</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 51

not be likely in the future.<sup>35</sup> However such a recession is not only negative. Within often lies the opportunity of a lifetime for some companies.<sup>36</sup> Now is the time where a successful business model pays off, and those without one will ultimately exit the market.<sup>37</sup> In a new low-growth environment the acquisition of weaker competitors, will be an important source of growth for many industries.<sup>38</sup> It will be important to focus on core competencies, and perhaps let go of other parts in the portfolio that are not essential.<sup>39</sup>

## 2.4 – Insurance Industry

The European insurance industry despite that it had a smaller amount of write-downs than the banking sector, developed similarly in its share price. However analysts from Deutsche Bank believe that even though the financial turmoil caused both balance sheet and expected earnings levels to erode, the majority of insurance companies still look well capitalized. For this reason new equity issuance still seems unlikely, but with the current volatility of the markets this could change quickly. They believe that this also poses the largest risk for the sector. Since insurance companies are exposed to the developments on the financial markets, another downturn in economic activity could also make stronger capital measures necessary.<sup>40</sup>

In terms of solvency their outlook for the insurance sector depends on which segment an insurance company is covering. The non-life insurers in the market seem to be robustly capitalized, while life insurers are relatively worse off. In general they believe that companies, which have historically shown to be sensitive to capital markets have hedged their position such that further downward movements should not have an effect. The main risk for the solvency ratios now lies with the development of the corporate bond market as the financial crisis has started to affect the real economy.<sup>41</sup>

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<sup>35</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 59

<sup>36</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 61

<sup>37</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 63

<sup>38</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 65

<sup>39</sup> Accelerating out of the Great Recession; David Rhodes & Daniel Stelter, 2010 BCG, USA, pg. 134

<sup>40</sup> European Insurers: The Morning After – Earnings and target prices revised pg.1; Deutsche Bank Global Markets Research, 14.10.2009; Oliver Steel, Spencer Horgan, Paolo Tamagnini

<sup>41</sup> European Insurers: The Morning After – Earnings and target prices revised pg.3; Deutsche Bank Global Markets Research, 14.10.2009; Oliver Steel, Spencer Horgan, Paolo Tamagnini

According to analysts from Bank of America, stock prices of the insurance sector have come under significant pressure following the difficulties towards the end of 2008. However they believe that insurance companies with a focus on the CEE region have not lost their relative valuation premium, despite the fact that the GDP growth gap in comparison to Western Europe is not as big as it used to be.<sup>42</sup> Similar to the Deutsche Bank analysts they have also seen a large deterioration of the solvency ratios, but they believe that the insurance sector has comparatively gotten better through the crisis than the banking counterpart.<sup>43</sup> One problematic issue, considering the new regulation that will most likely increase the equity requirements, is the fact that most European insurance companies have considerably increased their leverage ratios since 2004. With continuous troubles on the financial markets this might still put additional pressure on their solvency ratios.<sup>44</sup>

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<sup>42</sup> European Insurance Sector – A Review: Merrill Lynch pg. 3; 20.4.2009

<sup>43</sup> European Insurance Sector – A Review: Merrill Lynch pg. 4; 20.4.2009

<sup>44</sup> European Insurance Sector – A Review: Merrill Lynch pg. 5; 20.4.2009

### 3 - Countries

This section will be an overview of the developments in the individual countries covered by this thesis. At first there will be an overview of the general macroeconomic environment in order to be able to provide an insight into the current situation of each country. The differences between the countries are very important, since even though they are more or less considered as part of one region, all of them are at different stages in their development.

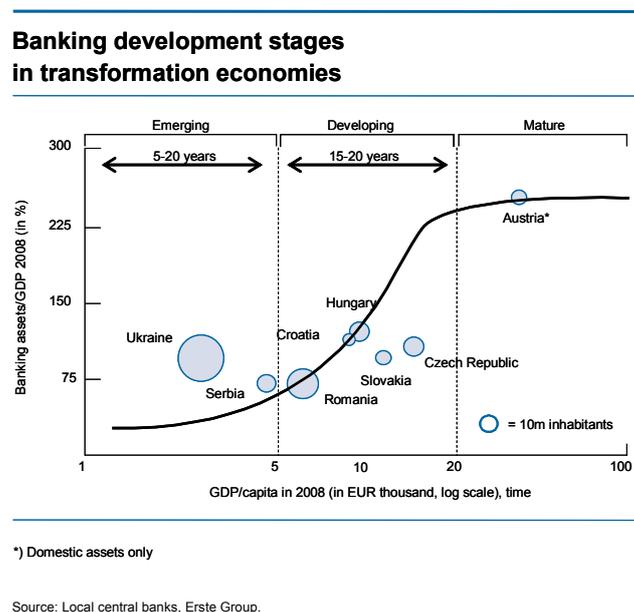


Figure 1<sup>45</sup>

Additionally each one felt different effects from the crisis. While countries like the Czech Republic have been able to remain at a good level in comparison to pre-crisis values, other countries like Hungary have been heavily hit. From Figure 1, one can tell Erste Group's opinion on the development of the economies. The countries in this graph are separated into three sections (Emerging, Developing, Mature) depending on their GDP per capita, their Banking Assets to GDP ratio and the stage in their development. The main point to focus on from this figure is that most of the countries closely around Austria are already classified as developing countries. These countries are also showing demand for more complicated banking products such as mortgages and credit cards, while the Ukraine, which is still an emerging economy, is mainly driven by products like debit cards and current accounts. At this early stage the market basically still has to be "conquered". Due to differences like this, it is

<sup>45</sup> Erste Bank Annual Report 2008, pg. 27

important to differentiate between the countries, since some are closer to western economies while others still have a long way ahead of them.

The second part of the country analysis will focus on the stability of the financial sector. The combination of the real economic situation, and the stability of the financial system will provide an overview of the situation that Austrian financial institutions are currently facing.

### 3.1 – Czech Republic

The country has not been hit hard by the economic crisis in 2008, but never the less it is facing the effects ever since. For this reason the analysts of the Czech National Bank (CNB) expect a negative development of the GDP for 2009, while they estimated a slight recovery for 2010.<sup>46</sup> However all of these estimates remain very vague, since no one is able to foresee the effects the crisis will still have. In total it has to be mentioned that in comparison to other countries of the region, the Czech Republic is considered as stable and well off.

The officials, similarly to a lot of governments in the western world, have been trying to conquer the problems of decreasing economic activity through lowering the interest rate.<sup>47</sup> They believe that the real interest rates, especially in the corporate sector are still too high to foster growth.<sup>48</sup> However these adaptations in monetary policy are not the ultimate solution, since there are several other risks not under the influence of the Czech government as for instance the value of the currency. Another factor that has a negative impact on a possible recovery is the deterioration of the creditworthiness of non-financial corporations (see Figure 1) and the increase in bankruptcies.<sup>49</sup> Additionally there is also rising credit risk in the household sector. If there was a 10% decrease in nominal income a lot of households would not be able to manage to repay their debt.<sup>50</sup> A lot of this debt has been issued to finance houses, which became the collateral for these loans, which again results in a decrease of property prices and thereby makes these issues even more critical for banks.

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<sup>46</sup> CNB Financial Stability Report 2008-2009, pg. 18

<sup>47</sup> CNB Financial Stability Report 2008-2009, pg. 19

<sup>48</sup> CNB Financial Stability Report 2008-2009, pg. 20

<sup>49</sup> CNB Financial Stability Report 2008-2009, pg. 26

<sup>50</sup> CNB Financial Stability Report 2008-2009, pg. 31

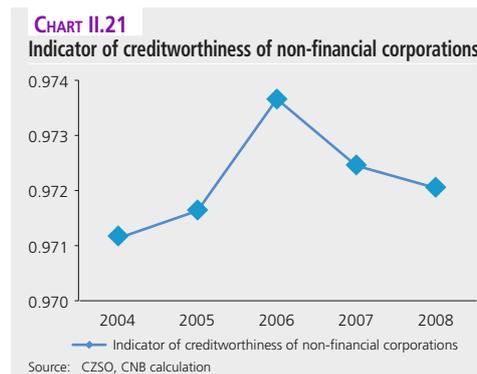


Figure 1<sup>51</sup>

The financial sector performed well in 2008, and managed to maintain its comparatively high profitability levels. As one of the few countries in the OECD, the Czech Republic was not induced to increase the solvency level in their banking sector, but rather increase the deposit insurance limit, which was similar to most Western-European economies.<sup>52</sup> Hence the banking sector remains in a very good position, but there has been a major effect on the behavior of these players. Nowadays customers have to face tougher credit standards than a couple of years ago, but this development seems completely adequate. After all the Czech banking sector cannot pull itself out of the international connections with the banking industry. The insurance sector was hit harder, and had to face losses due to the devaluation of toxic assets in their portfolios.<sup>53</sup>

The banking sector only suffered small losses from the revaluation of toxic assets. Their net profit decreased by 3%, to 45.7 billion CZK in comparison to 2007. By the end of 2008 it became clear that some countries in the CEE region are going to need external financing, and are going to have problems covering the foreign loans in the economies. The Czech Republic however only has a small share of foreign loans, and generally banks are independent of external financing. It seems strange that a country where a lot of banks are in the hands of foreign investors is independent of external financing, but in this case it is easily explained. Due to the low loan to deposit ratio in their portfolios, Czech banks are basically financed from primary deposits (see Figure 2). The loans in foreign currencies can basically be neglected (see Figure 3). In comparison to other countries of the region, this strategy has

<sup>51</sup> CNB Financial Stability Report 2008-2009, pg. 26

<sup>52</sup> CNB Financial Stability Report 2008-2009, pg. 48

<sup>53</sup> CNB Financial Stability Report 2008-2009, pg. 49

proven to be a very successful. It limits the dependence on factors not under the control of the host country.<sup>54</sup>

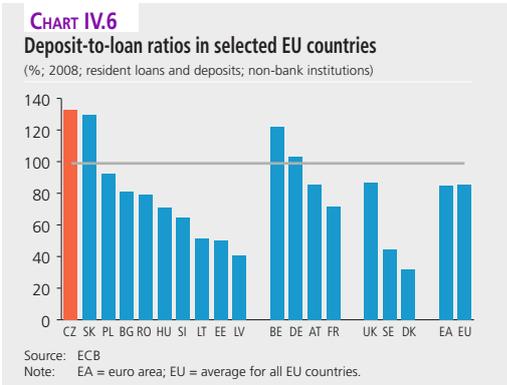


Figure 2<sup>55</sup>

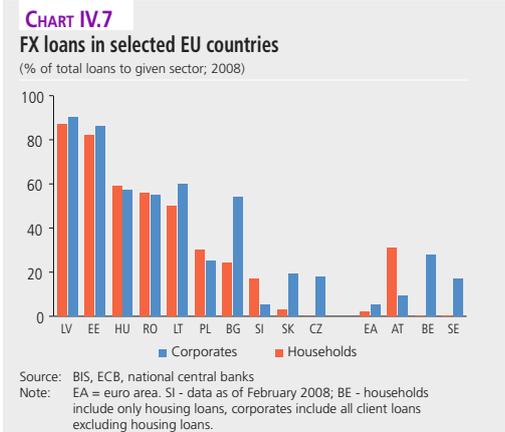


Figure 3<sup>56</sup>

The amounts of loans outstanding draw another awkward picture. Despite the fact that most European economies are facing lower demand for loans, the Czech Republic still has relatively high growth rates (16.4% at the end of 2008). However it can be expected that this demand for new loans is going to depreciate. First of all due to the increasing non-performing loans ratio (NPL) (3.8% in Q12009, in comparison to 3.1% in Q42008), the interest rates paid by borrowers are also going to increase, since it has to be expected that more borrowers default in their payments. Another reason is that the banks operating in the Czech Republic are going to tighten their non-interest regulations, as for example increasing the amount of collateral requested to secure a loan.<sup>57</sup> All together it can be concluded that Czech banks are well off, since they are liquid with a Tier 1 capital ratio well over 10%, and are merely facing a situation of declining profitability due to the increase in non-performing loans.<sup>58</sup>

The insurance sector in contrast was facing more difficult times during 2008. Their growth rate of premiums written decreased from 8.9% to 5.2% in comparison to 2007, which was largely caused by the decline in growth of the life insurance segment (see Figure 4). However the equity-linked life insurance, in comparison to other declines in the EU has not been the main reason with a growth rate of 17.4 % in 2008. Unfortunately for the insurance sector the claim settlement costs have gone

<sup>54</sup> CNB Financial Stability Report 2008-2009, pg. 50  
<sup>55</sup> CNB Financial Stability Report 2008-2009, pg. 50  
<sup>56</sup> CNB Financial Stability Report 2008-2009, pg. 50  
<sup>57</sup> CNB Financial Stability Report 2008-2009, pg. 52  
<sup>58</sup> CNB Financial Stability Report 2008-2009, pg. 54

up due to terminations and settlements of contracts. This might indicate a decrease in the demand for life insurance products.<sup>59</sup> For 2009 the Czech insurance industry is looking at lower premium growth rates due to the decline in demand for products like life-, motor-vehicle- and industrial insurance. This effect is worsened by having to face higher costs in claim settlement, and higher capital requirements according to Solvency 2. Never the less, all insurance companies operating in the Czech Republic remain well-capitalized despite the fact that the average solvency ratio declined from 335% to 235% in 2008.<sup>60</sup>

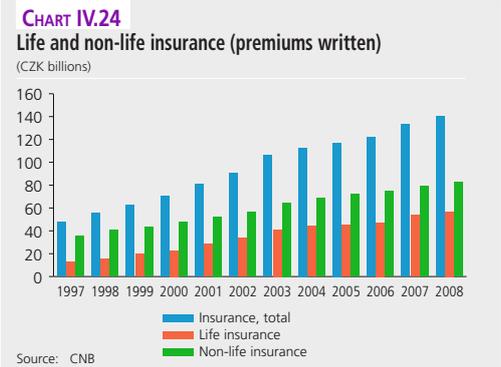


Figure 4<sup>61</sup>

### 3.2 – Hungary

Out of the EU countries covered in this thesis Hungary was perhaps one of the most severely hit by the effects of the financial crisis. This was to a certain degree caused by the very negative sentiment that investors showed towards the economy. They viewed the country as being in too much external debt, and in combination with the lower risk appetite caused by the financial crisis, the country was perhaps doomed more by the international community than necessary. The external debt actually is a very big issue that needs to be addressed by the government, but this is no different to many other countries of the EU. The only problem is that the level of external debt was already very high prior to the crisis, and therefore will always look large in a regional comparison (see Figure 1).

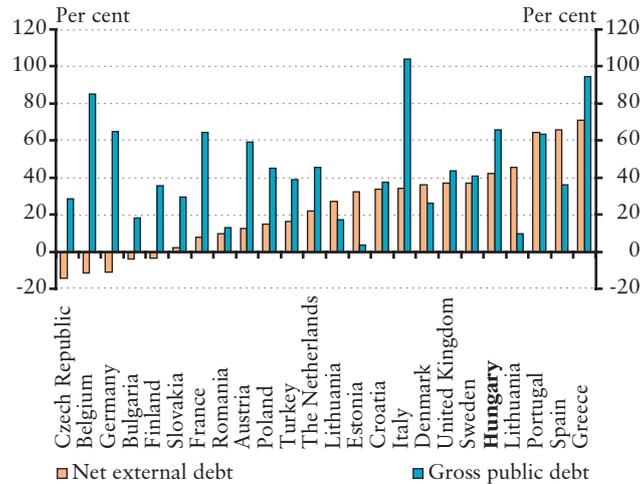
<sup>59</sup> CNB Financial Stability Report 2008-2009, pg. 56

<sup>60</sup> CNB Financial Stability Report 2008-2009, pg. 57

<sup>61</sup> CNB Financial Stability Report 2008-2009, pg. 56

### Net external debt and gross government debt as a proportion of GDP

(as of 31 December 2007)



Source: IFS, Eurostat.

Figure 1<sup>62</sup>

Another reason why Hungary is having problems was the low growth rate of the GDP during the booming years. Fortunately when the crisis unfolded the country was saved by external aid provided by organizations like the IMF. The credit line of twenty billion Euros that was given to Hungary significantly lowered the perception that it was going to have difficulties refinancing its external debt. Additional help came from parent companies, providing their Hungarian subsidiaries with sufficient liquidity to withstand the consequences of the crisis. Parent companies have become essential to the Hungarian banking sector, since without their assistance many subsidiaries would have faced liquidation during the last quarter 2008. Many risks unfortunately remain in the region, which is reflected by the increase in risk premium of all CEE nations.<sup>63</sup>

The deteriorating European macroeconomic environment also had a significant effect on the Hungarian economy. The country faced deteriorating exports, while the domestic demand was unable to compensate these issues.<sup>64</sup> The decline in demand of households stems from the difficulties of the corporate sector to maintain its profitability. Despite these issues, the decline in external demand is a much larger

<sup>62</sup> Financial Stability Report April 2009 MNB, pg. 25

<sup>63</sup> Financial Stability Report April 2009 MNB, pg. 19

<sup>64</sup> Financial Stability Report April 2009 MNB, pg. 22

threat to the economy. A delayed global recovery therefore would cause larger problems for the government than the decrease in domestic demand.<sup>65</sup>

Credit risk as with most other countries in the region poses a significant risk to the banking sector. Banks are facing decreasing growth in their portfolios (see Figure 2), which is mainly caused by the decrease in risk appetite, and on the other hand their portfolio quality seems to be continuously decreasing. This development is very harmful to the economy, since banks in these difficult times are seeking deposits, and since corporations are unable to finance their investments through lending they have to rely on their deposits.<sup>66</sup> Another possible threat is the Hungarian Forint, which has shown to be very volatile in difficult times. This left credit institutions with enormous foreign currency positions. All of these additional risks led to a tightening of credit standards, and a reduction in the supply of loans specifically for short-term loans.<sup>67</sup>

One country specific problem of Hungary is the large debt of firms in Swiss Francs. This makes up approximately 30% of all FX positions held by corporations even if some of them are not even exporting products to Switzerland. These small firms have the highest exposure in this risk, and unfortunately in most cases are not hedged against it.<sup>68</sup>

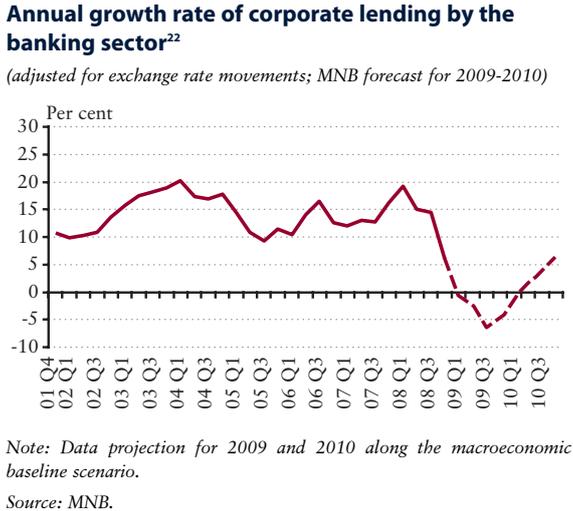
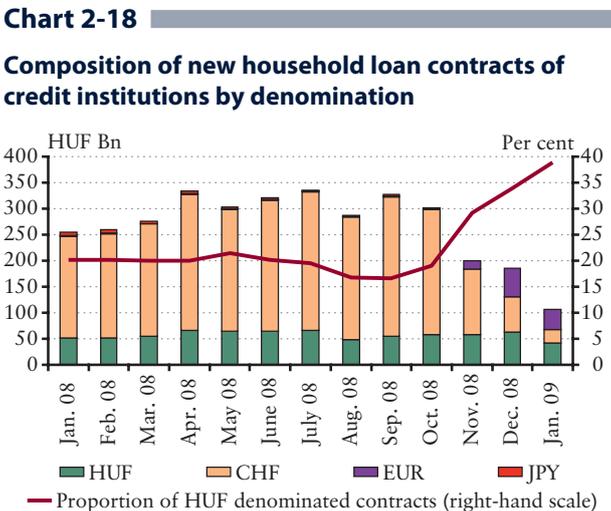


Figure 2<sup>69</sup>

<sup>65</sup> Financial Stability Report April 2009 MNB, pg. 23  
<sup>66</sup> Financial Stability Report April 2009 MNB, pg. 30  
<sup>67</sup> Financial Stability Report April 2009 MNB, pg. 31  
<sup>68</sup> Financial Stability Report April 2009 MNB, pg. 34  
<sup>69</sup> Financial Stability Report April 2009 MNB, pg. 32

The household sector’s situation seems to be improving. Even though the indebtedness is rising it remains far below western European levels.<sup>70</sup> Additionally the Hungarian households currently face difficulties concerning the weak forint. It disables them to take foreign currency loans, and on the other hand the local interest rate remains high making it expensive to take on debt in local currency. Similar to the corporate FX loan situation, the household debt portfolio also mostly consists of Swiss Frank loans (~80%). This causes similar problems, but since banks have stopped lending in Swiss Franks, the time horizon of this problem seems limited. All of these factors resulted in a general decrease in demand for credit by households.<sup>71</sup> However the portfolio started to focus more on forint-based loans (see Figure 3), which is a positive trend in terms of financial stability.<sup>72</sup>



Source: MNB.

Figure 3<sup>73</sup>

The liquidity risk of the banking sector was a major problem for Hungary. Liquidity injections from the MNB and parent banks have become more important to the well-being of their subsidiaries, and significantly increased the trust in the banking system. The dependence on external funds of the Hungarian banking market remains relatively high due to a high loan to deposit ratio.<sup>74</sup> In order to reduce their dependency on foreign capital injections, they either have to increase their deposits or reduce lending activity. This trend seems to be present throughout the CEE region, as well as the EU. The question that remains is how drastic these actions will

<sup>70</sup> Financial Stability Report April 2009 MNB, pg. 36  
<sup>71</sup> Financial Stability Report April 2009 MNB, pg. 37  
<sup>72</sup> Financial Stability Report April 2009 MNB, pg. 38  
<sup>73</sup> Financial Stability Report April 2009 MNB, pg. 38  
<sup>74</sup> Financial Stability Report April 2009 MNB, pg. 42

have to be in order to improve the situation, considering that the access to international capital markets is becoming increasingly expensive.<sup>75</sup>

The financial position of the banking sector declined in 2008, and is supposed to further decline in 2009 due to the unfavorable economic situation. Currently the MNB views the sector as being well capitalized as a whole, but at individual level there certainly are deficits. In order to withstand possible future shocks, the MNB suggests that banks should keep their capital adequacy ratio above 10%. Despite the fact that profitability is on the downside, it remains well above the levels of the parent banks home countries.<sup>76</sup> The situation of the current loan portfolio might suggest that capital injections have become necessary, since non-performing loans are on the rise. Consequently parent banks are likely to play a more important role if the situation turns for the worse.<sup>77</sup> which not only causes impairments, but also is the reason for soaring loan provision. In total the current environment has reduced the income generating capacity of the sector, with pre-tax profit expected to have declined from 350 billion Forint in 2008 to 100-200 billion Forint in 2009.<sup>78</sup>

The insurance sector in Hungary also suffered significantly due to the financial crisis, and is looking at a similar deterioration of their portfolio as the banking sector. They are losing their capability to produce positive yields, which is specifically the case with unit-linked insurance products. However the insurance business tends to react slower than the banking world. This is for example indicated by relatively favorable profit figures despite the difficult situation. However these figures might also suggest that insurers have already adjusted their premiums in order to compensate for the effects of the financial crisis. It could unfortunately also point out that the consequences will still be felt once the real economy starts to react to the financial turmoil with high unemployment.<sup>79</sup> In total 2008 was a bad year for the life insurance market, since they faced negative yields on their investments. This was as largely influenced by the downfall of unit-linked insurance. One fact that might explain this development is that in difficult times, households tend to shift towards other investments as for example deposits, since they have immediate access to it.

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<sup>75</sup> Financial Stability Report April 2009 MNB, pg. 43

<sup>76</sup> Financial Stability Report April 2009 MNB, pg. 49

<sup>77</sup> Financial Stability Report April 2009 MNB, pg. 51

<sup>78</sup> Financial Stability Report April 2009 MNB, pg. 50

<sup>79</sup> Financial Stability Report April 2009 MNB, pg. 56

Another reason might be that, banks are giving out less loans, and therefore the insurance companies are losing the ability to sell these bank customers unit-linked insurance products with these loans.<sup>80</sup>

All together it can be said that the years ahead are going to be difficult for all kinds of financial institutions. Austrian financial institutions have always had a strong link to the Hungarian market, and are therefore going to continuously show their commitment. The current halt in growth still does not speak against the enormous growth potential, which remains in the country. One indicator would be the insurance density of life and non-life insurance in Hungary at the end of 2009 which was at 501.40 USD, whereas in Austria the figure lies at 2,865.80 USD, and that is by no means the top of the latter.<sup>81</sup>

### 3.3 – Slovakia

Slovakia is yet another country that was not immediately hit by the financial crisis in 2007, but as a very small and open economy is now feeling the consequences of the global financial turmoil. The financial, and especially the banking system held very close ties to the domestic economy with a conservative business approach. Through this commercial banking approach, the banks were able to finance loans largely through local deposits, and on the other hand were not hurt in their balance sheets by the fall of asset prices on the international markets. One major factor helping the Slovak economy through 2008 was that the introduction of the Euro in January of 2009. This gave the country stability in terms of currency as well as a low dependence on foreign funds. Additionally this indicated that the country was doing relatively well throughout the crisis, since otherwise the introduction of the Euro would have not been confirmed by the ECB.<sup>82</sup> However it seems unreasonable to believe that the Slovak economy is going to be able to stay out of the most horrific financial crisis the world has ever seen. Perhaps the introduction of the Euro and the integration into the European Union will also cause a delayed recovery.<sup>83</sup>

The banking system has to face the consequences of a small and open economy, which in the booming years was focused on export. The Slovak economy will

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<sup>80</sup> Financial Stability Report April 2009 MNB, pg. 57

<sup>81</sup> Swiss Re, Sigma Nr. 3/2008 Assekuranz Global 2007

<sup>82</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 7

<sup>83</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 45

ultimately face a downward trend, since the domestic-based firms in the economy will not be able to offset the external shocks produced by the market.<sup>84</sup> This decrease in economic activity manifests itself in a decrease of GDP growth, as well as a reduction in investment activity and domestic consumption towards the end of 2008.<sup>85</sup> In the medium run the situation poses substantial risks to the Slovak economy. The export-based industry will not be able to be replaced by the domestic demand. This also limits the government's possibilities, since in a small and open economy using fiscal policy only shows little effect when trying to boost economic activity.<sup>86</sup>

In 2008 the Slovak banking sector faced a decline in profits of roughly 10%. However this was influenced by the bad results of one specific bank, since otherwise there would have been a positive growth of 6%. Specifically banks operating as branches of foreign banks achieved higher profitability.<sup>87</sup> The major source for the banking sectors revenues was the interest income, which showed significant growth in the household sector (+21%), as well as the corporate sector (+17%). However, due to the financial crisis, there was a decreasing amount of new loans towards the end of 2008. The provisions that had to be created grew by more than 340% to 311 million Euros. This is influenced by the increase in non-performing loans, and is an indicator for difficult times ahead.<sup>88</sup> However according to the NBS all banks at the end of 2008 had sufficient capital to withstand the situation. These capital stocks were generally bolstered up with profits from the successful previous periods, which was necessary due to higher capital requirements of 27%.<sup>89</sup> When looking at the connection between the institutes, especially considering the high influence of one bad result, it should be mentioned that the systemic risk is low on the Slovak market due to low volumes of deposits and loans on the interbank market.<sup>90</sup>

A favorable development in the banking sector was the reduction of the loan to deposit ratio(see Figure 1). This gives the banking sector the chance to continue financing loans by increasing customer deposits, while not being dependent on

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<sup>84</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 8

<sup>85</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 39

<sup>86</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 44

<sup>87</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 62

<sup>88</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 9

<sup>89</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 64

<sup>90</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 69

volatile market developments. As you can see from Figure 2 and 3 the increase in deposits took place both in the household and the corporate sector. These developments were specifically present during the last quarter of 2008, and are certainly linked to the introduction of the Euro. However even though more deposits give the sector a chance to finance more projects there are many factors upsetting this possibility. One example of this would be the tightening of credit standards, which have become necessary to keep up a low risk portfolio. Due to the negative developments on the markets, the lending growth was more affected by the fall in demand than additional regulations.<sup>91</sup>

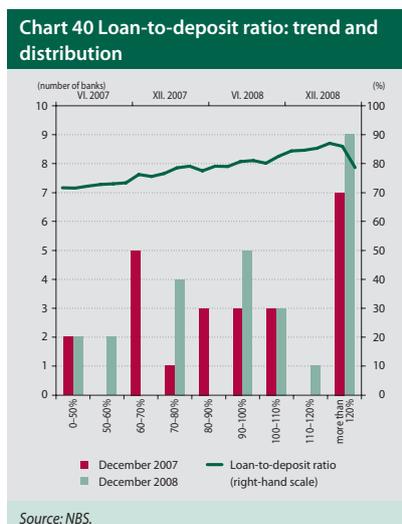


Figure 1<sup>92</sup>

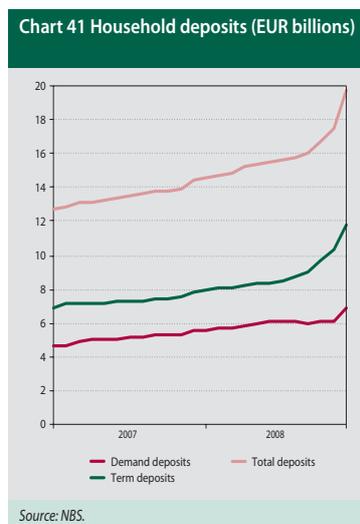


Figure 2<sup>93</sup>

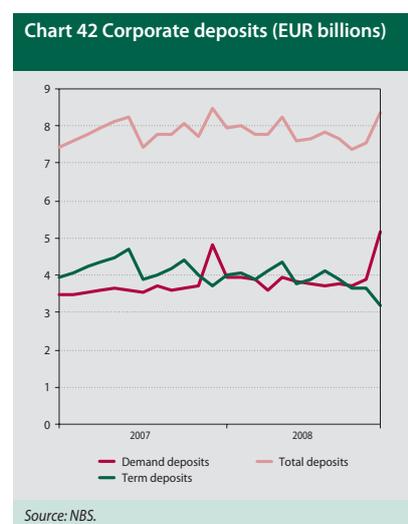


Figure 3<sup>94</sup>

The retail segment showed a positive growth at the beginning of 2008, but in the second half of the year these growth rates shrank considerably. One factor that had large influence on the development of the situation of households was the real estate market. The price increase during the period of 2007 until the beginning of 2008 is now causing problems for many households facing decreasing disposable incomes. They are not able to repay their loans, which were generated with high loan to value ratios on properties that were worth more back then than they are now.<sup>95</sup>

The corporate segment showed an increase in lending of 14% in 2008. However when comparing this with the past, it shows that the growth in this market segment is also starting to stagnate. This is also enforced by the negative economic outlook,

<sup>91</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 9

<sup>92</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 57

<sup>93</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 58

<sup>94</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 58

<sup>95</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 66

which caused the banks to tighten their credit standards. Similarly to the retail segment this decrease in growth is also highly influenced by a decrease in demand for loans by the firms. Even though there is a negative outlook the credit quality of the overall corporate loan portfolio remained unchanged in 2008. Currently the segment is generating profits and hence remains in a liquid position.<sup>96</sup>

For insurance companies 2008 was a difficult year in comparison to the previous booming period between 2003 and 2007(see Figure 4). Their profit was down by 50% to 108 million Euros, which shows the drastic decrease in profitability of the firms acting in the market. According to the NBS this difficult situation in the sector has three main reasons:

1. The firms faced an enormous decline in the values of their assets
2. a lower technical result in non-life insurance
3. an increase in surrenders of life insurance policies<sup>97</sup>

The deterioration in profit was basically a result of the bad financial result. It only accounted for 30% of the total profits in 2008 in comparison to 70% the year before.<sup>98</sup> One big surprise was the performance of the life insurance segment, which showed the largest growth since 2002 despite the financial crisis. This was the result of the performance of unit-linked insurance. However while the life insurance segment soared and its technical account showed a positive balance, the non-life insurance segment had difficulties and decreased in comparison to the previous years.<sup>99</sup> The claims incurred also increased by 115 million to 872 million Euros, which was largely caused by an increasing number of life insurance surrenders. Despite all difficulties the Slovak insurance companies were able to meet the required minimum solvency ratios.<sup>100</sup>

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<sup>96</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 10

<sup>97</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 11

<sup>98</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 73

<sup>99</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 74

<sup>100</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 75



Figure 4<sup>101</sup>

### 3.4 – Bulgaria

The Bulgarian economy suffered significantly from the consequences of the financial crisis. Being one of the two youngest EU members it is facing one of the most delicate situations, which is evident through the involvement of the IMF. The liquidity problems, which arose in October 2008 due to the collapse of Lehman Brothers, have consequently forced the country to seek outside aid. Even though the GDP was still growing by 6% in 2008 the problems only really started during the last quarter of that year. Ever since the middle of 2008 the country was facing decreasing exports and imports. Additionally the liquidity released through the IMF was not directly used to boost the economy, since there was also a lack in demand by firms and households.<sup>102</sup> Overall the industry shows mixed signals. Certain industries like manufacturing and construction have been hit more severely than others. On the other hand financial intermediaries have shown growth even during these difficult times. They grew by 3.6% in 2008 mostly due to an increase in efficiency.<sup>103</sup> The inflation in the economy has slowed down in 2008 to 7.2% in comparison to 11.6% in 2007. Even though this is a positive signal the inflation still remains relatively high in comparison to other countries of the region.<sup>104</sup>

The banking sector has been influenced by several outside factors contributing to an already negative environment. For instance lending to households and firms slowed

<sup>101</sup> Financial Stability Report 2008, National Bank of Slovakia, pg. 74

<sup>102</sup> Annual Report BNB 2008, pg. 10

<sup>103</sup> Annual Report BNB 2008, pg. 18

<sup>104</sup> Annual Report BNB 2008, pg. 19

down significantly towards the end of the year. Additionally due to a lower risk appetite the banks ran a strategy that was based on growth in deposits rather than in lending. The national bank however was able to stabilize the situation in the banking sector by reducing the minimum reserve rate, and thereby creating additional capital for the banks to work with. This should not be considered as an additional risk, since the minimum rates in Bulgaria still remain well above the EU average. Overall it seems like the environment could change rather quickly, but when regarding the market share of the five largest banks in the market it becomes clear that it has not. Their market share remained at 57.1%. However it also became clear that during these difficult times the involvement of more developed economies within the EU has become greater (see Figure 1).<sup>105</sup>



Figure 1<sup>106</sup>

The main issue that threatened financial stability during this period was credit risk. Banks were facing portfolios build up during booming years, which were not feasible during a crisis. For this reason most of them changed their risk appetite, and paid closer attention towards the quality of the assets under management. Additionally banks got problems with financing the growth strategy from previous years. Due to the lack in external financing they had to substantially increase deposits. All of these factors lower the flexibility of the system, which perhaps still will be necessary in a consistently volatile environment.<sup>107</sup>

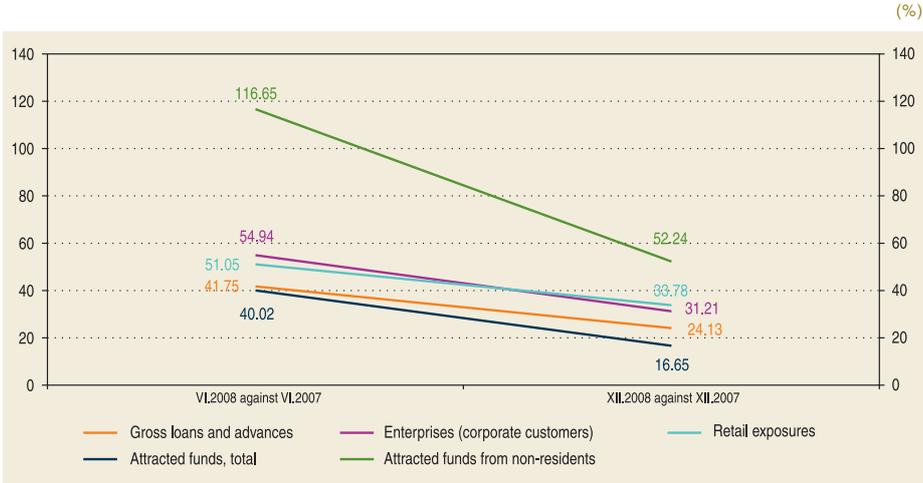
<sup>105</sup> Annual Report BNB 2008, pg. 38

<sup>106</sup> Annual Report BNB 2008, pg. 39

<sup>107</sup> Annual Report BNB 2008, pg. 41

The asset quality has remained relatively good, even though there are negative trends as seen by the increase in non-performing loans. The cushion of provisions, which as of end-2008 stood at 114% of the non-performing loans, seems adequate to cover negative shocks. The financial results of the sector were still positive during 2008, but were showing a constant downward trend in terms of growth. Therefore it seems unreasonable to expect that the growth in profits continue like it did in 2008, when it climbed to 1,374 million BGN in comparison to 1,151 million BGN in 2007.<sup>108</sup>

Dynamics of Selected Balance Sheet Indicators



Source: BNB.

Figure 2<sup>109</sup>

As one can see from Figure 2 both the household and the corporate sector faced an enormous drop in lending growth during the second half of 2008, standing at 33.7% and 31.2% respectively.<sup>110</sup> Overall the market still has enormous potential and still is growing, but in comparison to the booming period of the previous 5-6 years the picture has changed, and some business models might have become obsolete.

### 3.5 – Romania

During the last two years Romania has seen a sharp decline in economic activity as well as a very difficult economic situation. The main problems are the high level of external debt, which mostly is short term. This problem was caused during the booming period, since at that time it was not difficult to get external financing, especially when considering the enormous outside influence in Romania’s banking system. Now the outside members of the market are less willing to provide the capital, since they themselves face difficulties and have a higher risk aversion. The

<sup>108</sup> Annual Report BNB 2008, pg. 11

<sup>109</sup> Annual Report BNB 2008, pg. 39

<sup>110</sup> Annual Report BNB 2008, pg. 39

once main source of growth has become the biggest vulnerability of the economy.<sup>111</sup> Additionally the current levels of outside liabilities and assets for households and companies in foreign currency indicate that the situation is rather getting worse than better. In Romania it has shown that economies, which face large-scale economic growth during one period, also face large contractions during another.<sup>112</sup>

These difficult times on the Romanian market also forced the banking sector to rethink its strategy. Factors like liquidity risks are on the upside. However in comparison to the situation of the entire economy, the banking sector has managed to deliver good financial results making it seem capable to withstand additional shocks. Unfortunately it seems as if the sector is already expecting additional problems, and it also should regarding the large deterioration of the credit portfolio during 2008 and the beginning of 2009. The reaction was to bolster up the provisions dedicated to non-performing loans at an above average level in comparison to other CEE economies. Another indicator of difficult times ahead is that the Bulgarian national bank has urged banks even though capital adequacy currently seems fine, to maintain a solvency ratio of at least 10% to be able to withstand strong shocks.<sup>113</sup> However new members like the Royal Bank of Scotland still enter the market<sup>114</sup>, and there is a general increase in the number of business outlets.<sup>115</sup> It is clear that the foreign parent companies that currently own the top nine banks of the country are showing a commitment towards the economy, which in turn gives the market additional stability.<sup>116</sup> This commitment however could cost them, since the Tier 1 capital ratio has hit a six-year low towards the end of 2008, and they agreed to keep the solvency ratio equal to or above 10%. This should be followed closely by the government, since it poses a real threat to the banking sector and thereby the entire economy.<sup>117</sup>

Loan growth was down in 2008 especially in the private sector where the growth rate got reduced by 50% in comparison to 2007. Another disturbing tendency in the private sector is that loans denominated in local currency faced an even steeper

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<sup>111</sup> Romania Financial Stability Report 2009, pg. 7

<sup>112</sup> Romania Financial Stability Report 2009, pg. 8

<sup>113</sup> Romania Financial Stability Report 2009, pg. 9

<sup>114</sup> Romania Financial Stability Report 2009, pg. 17

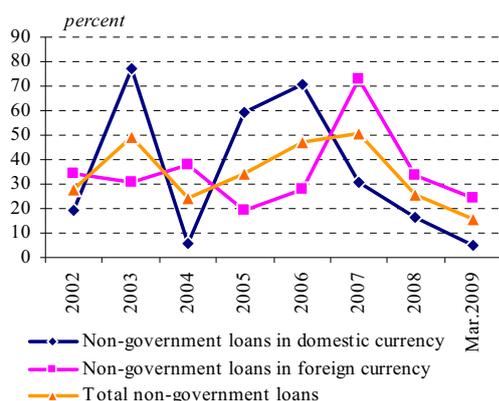
<sup>115</sup> Romania Financial Stability Report 2009, pg. 18

<sup>116</sup> Romania Financial Stability Report 2009, pg. 25

<sup>117</sup> Romania Financial Stability Report 2009, pg. 26

downturn, which in turn means that the ratio of foreign liabilities is still growing (see Figure 1). The loans were mainly financed from customer deposits, since the banks could not rely on foreign capital anymore.<sup>118</sup> The negotiations with the IMF however reduced the additional risk faced by deterioration of the leu. The help package made available to the country stabilized the leu, which reduced the risk mentioned before.<sup>119</sup> Foreign currency risk was most common in the corporate sector, and therefore might still add to the bad situation.<sup>120</sup> Unfortunately deposit growth in both the household and the corporate sector was slower than in previous periods.<sup>121</sup> One cause for the slowdown in growth for loans might be the difficult liquidity situation a lot of banks faced due to the lack of external financing. This trend has been persistent for the last five years, and is yet another reason for the government officials to worry. Whether this issue will also be cured by the involvement of the IMF is yet to be determined.<sup>122</sup>

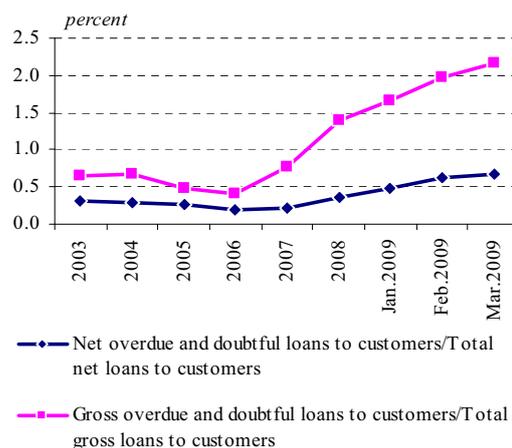
**Chart 3.2.22 – Real growth rate of non-government loans – total and by component**



Source: NBR

**Figure 1**<sup>123</sup>

**Chart 3.2.28 – Credit quality in the banking system**



Source: NBR

**Figure 2**<sup>124</sup>

The quality of the credit portfolio deteriorated during 2008 (see Figure 2), with a significant rise in overdue loans mostly denominated in local currency.<sup>125</sup> This caused the amount of provisions held to cover these non-performing loans to go up. It does not seem like something special when compared to the trends within the CEE region or even the EU, but it has been taking place at a higher rate, which is a reason for

<sup>118</sup> Romania Financial Stability Report 2009, pg. 21

<sup>119</sup> Romania Financial Stability Report 2009, pg. 34

<sup>120</sup> Romania Financial Stability Report 2009, pg. 45

<sup>121</sup> Romania Financial Stability Report 2009, pg. 23

<sup>122</sup> Romania Financial Stability Report 2009, pg. 42

<sup>123</sup> Romania Financial Stability Report 2009, pg. 35

<sup>124</sup> Romania Financial Stability Report 2009, pg. 38

<sup>125</sup> Romania Financial Stability Report 2009, pg. 37

concern.<sup>126</sup> Therefore with the increase in caution in lending by banks in order to hold “safe” loans in their portfolio, and the following slowdown in growth for loans, the situation of the economy should stabilize.

In contrast to all indications mentioned above, the banking sector was still able to present good financial results for 2008. The net aggregate profit increased by 73.9% in comparison to 2007 reaching 4,681.9 million leu.<sup>127</sup> The operating income also showed good results, and was mainly driven by the net interest income (46.2%) and the net income from commissions (28.1%).<sup>128</sup> Due to the crisis and the increasing amount of non-performing loans the provisions grew by 65% in 2008, which describes the deterioration of the credit portfolio held by the institutes.<sup>129</sup>

The insurance market, as it is still in a convergence period, still showed significant growth in 2008 (see Figure 3). However it did feel the effects of the financial crisis, and is facing higher risks in both non-life and life insurance. In terms of development both market segments (life and non-life) grew at a similar pace. The auto- and credit-insurance segments are of specific concern. The developments in these areas specifically hurt the technical result of non-life insurance especially in the case of auto insurance. It grew to become the major part of non-life products, but currently is also facing an enormous increase in claims. The development of the life insurance segment was similar. It still showed significant growth, but on the other hand there were more redemptions, which were mainly the result of the financial crisis.<sup>130</sup> Also as a result of the financial crisis the profitability of the insurance sector declined.<sup>131</sup> Overall the insurance market in Romania is showing increasing volatility due to the difficulties on the financial markets. For life insurers the situation seems less risky than for non-life insurance companies, since they can transfer some of the risk held to their clients.<sup>132</sup>

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<sup>126</sup> Romania Financial Stability Report 2009, pg. 40

<sup>127</sup> Romania Financial Stability Report 2009, pg. 46

<sup>128</sup> Romania Financial Stability Report 2009, pg. 47

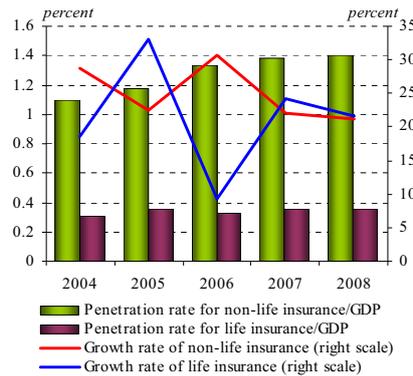
<sup>129</sup> Romania Financial Stability Report 2009, pg. 48

<sup>130</sup> Romania Financial Stability Report 2009, pg. 53

<sup>131</sup> Romania Financial Stability Report 2009, pg. 54

<sup>132</sup> Romania Financial Stability Report 2009, pg. 55

Chart 3.3.11 – Insurance market developments



Source: ISC, NBR

Figure 3<sup>133</sup>

### 3.6 – Ukraine

The Ukraine has the biggest problems out of the selected countries. Their crisis stems from both internal as well as external problems. They have been hit hard by the financial crisis, and additionally they are lacking a stable and consequent political system, which would be necessary to resolve the problems ahead. The government has failed to adjust its policy according to the situation, and therefore even though the Ukraine has returned on a growth path in 2009 the country is still looking at a deficit of 9-10% of the GDP. The presidential race of January 2010, which was won by the pro-Russian candidate, is not expected to bring in the long-awaited political relief.<sup>134</sup>

The country has been lacking a clear economic policy for quite some time. It has been very pro-cyclical. This worked as long as the large GDP growth was covering up the real problems of the country, which are a soaring inflation and unemployment rate as well as increasing external debt. The combination of delayed policy decisions, an unfriendly business environment, and a severe recession towards the end of 2008 painted a rough path through the crisis. At the end of 2008 the internal and external demand for products slumped, and with the enormous deterioration of the Ukrainian hryvnia (-60%) all banks faced a very delicate situation. The banking sector was forced to react to large capital outflows, and a difficult financing situation due to the liquidity crisis caused by the Lehman collapse. This emergency situation that almost

<sup>133</sup> Romania Financial Stability Report 2009, pg. 54

<sup>134</sup> RZB Research Strategy Ukraine December 2009, pg. 1

caused the market to collapse, forced the authorities to seek help from the IMF, which was approved in November 2008.<sup>135</sup>

The money lent by the IMF has managed to keep the market relatively stable, and most importantly re-earn the trust of the market members. This led to increasing willingness of foreign banks to inject capital into their Ukrainian subsidiaries. Gradually the exchange rate returned to normal levels, the inflation rate fell and demand also started to pick up again. Never the less, the Ukraine remains a troublemaker. Their continuous conflict with Russia about the gas-transit routes to Europe, the populist promises made by the government and their lacking ability to make the necessary reforms keeps the IMF on its feet. Since the agreement between the super-national institution and the country, the disbursement of the loan tranches has already been postponed twice.<sup>136</sup>

Despite the improving economic situation, the banking sector is still looking at difficult times. The non-performing loans are on the rise, and the pro-cyclical stand of the country remains to this day. This causes the Ukraine to be very dependent on global economic trends. The long-term strategy can only be to increase the domestic demand and thereby reduce the dependency of global trends.<sup>137</sup> With this significant amount of hurdles in the way, the country still has a long way to go, but most certainly keeps its enormous potential. The improving export conditions might be of help for a recovery, but in a historic context it might also be a potential risk. In the early 2000's the Ukraine has managed to keep its exports high through an artificially low valued currency, and thereby gave the government only limited possibilities to react. Private consumption is most likely still going to suffer from the outcomes of the financial crisis due to lower wages, an increasing unemployment rate, and little credit available from the banking sector.<sup>138</sup> Looking forward analysts believe that the Ukraine will possibly have to continuously rely on the IMF to bridge its finance gaps, even though the organization has already pumped 4.8 billion USD into the market, which accounts for roughly 4% of the countries GDP.<sup>139</sup>

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<sup>135</sup> RZB Research Strategy Ukraine December 2009, pg. 3

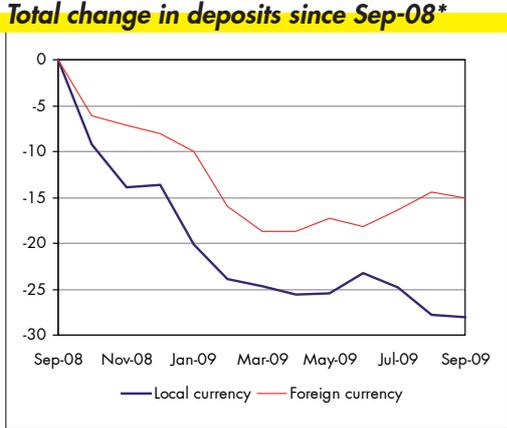
<sup>136</sup> RZB Research Strategy Ukraine December 2009, pg. 4

<sup>137</sup> RZB Research Strategy Ukraine December 2009, pg. 5

<sup>138</sup> RZB Research Strategy Ukraine December 2009, pg. 7

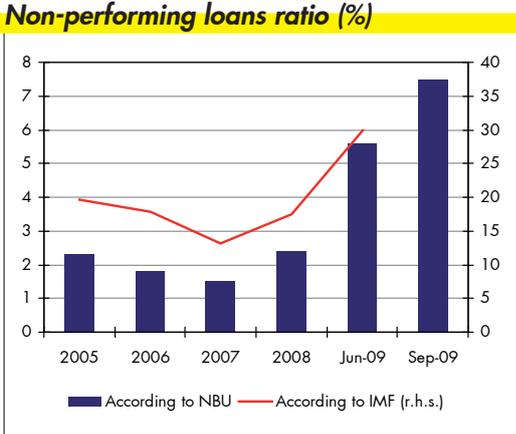
<sup>139</sup> RZB Research Strategy Ukraine December 2009, pg. 9

The banking sector was one the countries' success stories of the early 2000's, and even after the financial crisis remains one the driving forces in the domestic economy. The continuous unhedged FX lending in combination with the worsening economic situation and exchange rate, caused several bank runs towards the end of 2008 causing a capital outflow of nearly 25% of the deposit base. The enormous outflow of deposits becomes clear when looking at Figure 1 below. Even though the situation has gotten better, foreign exchange risk still remains very high, since most foreign currency loans were given to people without income in foreign currency. Hence a volatile and low-valued local currency makes it close to impossible for borrowers to repay their credit. This situation contributes to a rising non-performance loans ratio (see Figure 2), and thereby to an increased need for provisions making it harder for the banks to produce profits.<sup>140</sup>



\* %, cumulative  
Source: National Bank of Ukraine, Raiffeisen RESEARCH

Figure 1<sup>141</sup>



Source: National Bank of Ukraine, IMF

Figure 2<sup>142</sup>

The additional lack of liquidity in the market has caused most of the market members to stop their lending activity. Some banks still lend to already existing clients, but overall one can say that credit is basically not available. Even though the government is trying to keep the stability within the system in tact by buying stakes of insolvent companies, relaxing capital requirements and an increase in the maximum deposit insurance the easy times seem to be over. The banking sector will have to adapt to a new business model, which is completely different than the one in tact, but similar to approaches in other countries of the region. Banks will have to focus on lending activity in local currency, which will be financed via domestic deposits.<sup>143</sup>

<sup>140</sup> RZB Research Strategy Ukraine December 2009, pg. 16  
<sup>141</sup> RZB Research Strategy Ukraine December 2009, pg. 17  
<sup>142</sup> RZB Research Strategy Ukraine December 2009, pg. 17  
<sup>143</sup> RZB Research Strategy Ukraine December 2009, pg. 17

## 4 – Companies

This section will provide an insight on the operations of the companies reviewed by this thesis. These were selected, since they are the largest players on the Austrian market, and have the highest influence in the region under review. In order to give a balanced picture of the Austrian financial service industry the thesis concentrates on both the banking and the insurance market (see Figure 1).

<b>Market Position</b>	<b>Bank</b>	<b>Insurance</b>
<b>1</b>	UniCredit Bank Austria	Vienna Insurance Group
<b>2</b>	Raiffeisen International	Uniqa
<b>3</b>	Erste Group	

Figure 1<sup>144</sup>

The individual sub-chapters for each institute will be divided into two parts. At first there will be a general description of their situation and strategy, followed by a description of the subsidiaries in the countries under review.

### 4.1 – UniCredit Bank Austria

#### 4.1.1 – Overview & Strategy

UniCredit Bank Austria is currently Austria's biggest bank in terms of assets, and holds a market share of approximately 19% making it the market leader<sup>145</sup>. They are not only the biggest bank in Austria, but are also taking the leading position in the CEE region. They currently hold 139 billion Euros of assets, and serve around 24 million customers in 18 different countries. This service is brought to the customers through a network of roughly 2,824 branches that are run by 57,000 employees. Even though it is part of one of the biggest banks of Europe, Bank Austria plays a special role for Eastern Europe. Since the beginning of 2007, they became a sub-holding company responsible for all group activities in the region except for Poland and the Ukraine. That they are doing a great job is shown by the 50% increase in profit before taxes to over 2 billion Euros in 2008 despite the economical situation.<sup>146</sup>

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<sup>144</sup> Author's investigation

<sup>145</sup> UniCredit Group – leading in Central and Eastern Europe Brochure, June 2008, pg. 7

<sup>146</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/central-eastern-europe-cee-division.html>

The strategy which has been in place since they were promoted to be the sub-holding company for the CEE region, involves three different approaches:

- A regional focus on large and quickly growing economies where the group enjoys a strong market position, as for example Romania.
- A divisional approach on retail banking, in order to be able to foster the expansion of their lending network through funds from local deposits.
- A cross-regional approach that ensures communication among all segments of the company to increase product quality (i.e. offering investment banking products and knowledge through local branches).<sup>147</sup>

For them the crisis is not only viewed as a threat, but also as an opportunity to align the structure within the company. This includes the concentration on high net worth individuals in private banking handled by Pioneer Investments, which is responsible for all the asset management activities.<sup>148</sup> Another effort will be to combine the corporate banking segment with the knowledge in the investment banking division, and thereby create a useful knowledge-platform for the customer. They believe that their strategy of organic growth, and a focus on retail banking is successful and does not have to be changed. However it is mentioned that due to the current economical situation the capital involvement in the subsidiaries will be minimal.<sup>149</sup>

Their retail banking division was not able to escape the difficult market situation and could not keep up with figures reached in previous years, which is one reason for the service-quality focus currently implemented in retail banking.<sup>150</sup> In corporate banking they further implemented their strategy to bundle their individual knowledge groups and thereby create a segment, which is only responsible for the activities of large and multi-national companies. This is supposed enable them to serve their largest clients

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<sup>147</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/central-eastern-europe-cee-division-2.html>

<sup>148</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/strategy-confirmed-by-crisis-3.html>

<sup>149</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/strategy-confirmed-by-crisis-4.html>

<sup>150</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/retail-division.html>

at a faster and more efficient rate.<sup>151</sup> Despite all that the corporate banking section will also have to increase its productivity due to the difficult economic situation.<sup>152</sup>

#### 4.1.2 – Region

In Bulgaria, Bank Austria has control over UniCredit Bulbank. They are the market leader with a market share of roughly 15%, and are serving 1.2 million customers through a network of 263 branches. However the bank as of 2006 focused on being the top provider of loans on the once rapidly growing mortgage market as well as small businesses and leasing segments. These segments tend to be the ones facing the largest difficulties in the crisis.<sup>153</sup> In 2008 the subsidiary managed to increase its total revenues by 7.1% to 611.9million BGN, as well as increasing its net operating income by 5.7% to 352.7 million BGN. Unfortunately their deposits declined by 4.9%, while their loans increased by 38.4%. This clearly is opposed to their strategy mentioned before.<sup>154</sup> They increased their retail and corporate banking revenues by 19% and 20.6% respectively despite the difficult economic situation. In total the Bulgarian subsidiary is in a good position for 2009, but they will have to focus their efforts on increasing their customer deposits.<sup>155</sup>

UniCredit Bank Czech Republic is currently the 4<sup>th</sup> largest bank on the market with a market share of 7%, and a total asset value of 11.6 billion Euros. They are serving more than 568,000 customers through 63 branches.<sup>156</sup> The retail segment faced a decrease in deposits of 2% in 2008, while their loan portfolio increased by 8%. However they believe that the strategy of focusing on small and affluent business customers is the right approach in a troubled economic environment. In the corporate segment the bank has successfully focused on the SME business. Additionally they bring improvements to large international customers by being able to serve them through a multinational network.<sup>157</sup> Despite all these positive facts analysts have a negative outlook for 2009 due to the financial and economic crisis.<sup>158</sup>

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<sup>151</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/corporates-division.html>

<sup>152</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/central-eastern-europe-cee-division-2.html>

<sup>153</sup> UniCredit Group – leading in Central and Eastern Europe Brochure, June 2008, pg. 18

<sup>154</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/bulgaria.html>

<sup>155</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/bulgaria-2.html>

<sup>156</sup> UniCredit Group – leading in Central and Eastern Europe Brochure, June 2008, pg. 22

<sup>157</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/czech-republic.html>

<sup>158</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/czech-republic-2.html>

In Hungary UniCredit Bank holds the 7<sup>th</sup> position on the market with a market share of approximately 6%, and a total asset value of 6.1 billion Euros. They are serving approximately 238,000 customers through 83 branches.<sup>159</sup> Despite the troublesome times the country itself is facing, the branch has managed to show record braking results. This was however partially a result of selling their holdings of the Budapest Stock Exchange. In the retail segment the branch is operating very successfully both in the lending and deposit business. They managed to increase their retail loans and deposits enormously in 2008 (47% and 49% respectively). The corporate segment has also managed to maintain its high profitability, and a market share of 9.1% both in the lending and the deposit business.<sup>160</sup> The focus of the Hungarian subsidiary in 2009 is to maintain the successful corporate business with an emphasis on mid-market clients, and to further increase its retail operations.<sup>161</sup>

In Romania the group is represented by the Tiriac Bank, which holds the fourth position on the Romanian banking market. They are holding a market share of 5.3% in deposits and 6.2% in loans, with a total asset value of 17.5 billion RON. Their network includes 242 branches, which distribute to its 606,000 customers. The subsidiary was under constant change during the last couple of years due to three mergers. This of course resulted in a high employee turnover. Never the less they managed to increase their revenues and net operating profit by 31% and 41% respectively. In their retail segment they managed to increase their loan portfolio to private individuals (+46%), and focused on developing a strong connection to small and medium businesses. In their corporate segment they managed to increase their loan portfolio by 52% while increasing their deposit portfolio by 57%. In total they managed to increase their revenue by 36% in comparison to 2007. For the near future the goal of the Tiriac bank will be to increase their efficiency and profitability while only allowing moderate growth.<sup>162</sup>

In Slovakia, UniCredit Bank holds the 4<sup>th</sup> position on the market, with a market share of around 8%.<sup>163</sup> For Slovakia the Bank has a comparatively large network of 86

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<sup>159</sup> UniCredit Group – leading in Central and Eastern Europe Brochure, June 2008, pg. 24

<sup>160</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/hungary.html>

<sup>161</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/hungary-2.html>

<sup>162</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/romania.html>

<sup>163</sup> UniCredit Group – leading in Central and Eastern Europe Brochure, June 2008, pg. 38

branches, which is serving its 183,000 customers. In 2009 their main goals were to prepare for the euro inauguration, while facing the effects of the crisis. They increased their net profit by 33% to 71.8 million Euros. Their current portfolio holds 2.6 billion Euros in loans and 2.7 billion Euros in deposits, which goes along with their strategy. In the retail segment there was an increase in loans of 16.1%, which is larger than the growth in deposits (+10%). However the deposits remain three times as high in total value (1.2 billion Euros). In the corporate segment the company is facing a different situation. In 2008 there was a decrease in loan volume to 2.2 billion Euros due to the effects of the crisis, but an increase of 4.7% in deposits to 1.6 billion Euros. From this one can tell that this subsidiary is doing relatively well, but in 2009 will still have to focus on resolving the effects of the crisis.<sup>164</sup>

## 4.2 – Erste Group

### 4.2.1 – Overview & Strategy

Erste Group owns companies in five of the seven countries under review by this thesis. They are one of the major players in the region, is currently operating under a different strategy than the other two banks in this report. It is the only one that began to concentrate on its core segment, retail banking. They are not focusing on niche products, but rather on a broad portfolio of standard and simple banking products offered to a wide range of possible customers.<sup>165</sup> Due to the financial crisis the group has focused on countries that, "...had a realistic prospect of EU membership,"<sup>166</sup> while limiting their exposure in countries that are facing higher risks. Without the crisis their portfolio would be more balanced, but in difficult times it seems reasonable to concentrate on countries that have back up from the EU. In total Erste Group offers their products to 17.2 million customers through approximately 3,200 branches in eight countries (see Figure 1) across the CEE region.<sup>167</sup>

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<sup>164</sup> <http://geschaeftsbericht.bankaustria.at/2008/gb/en/unicredit-group-at-a-glance-/slovakia.html>

<sup>165</sup> Annual report Erste Group 2008 pg. 26

<sup>166</sup> Annual report Erste Group 2008 pg. 3

<sup>167</sup> Annual report Erste Group 2008 pg. 25

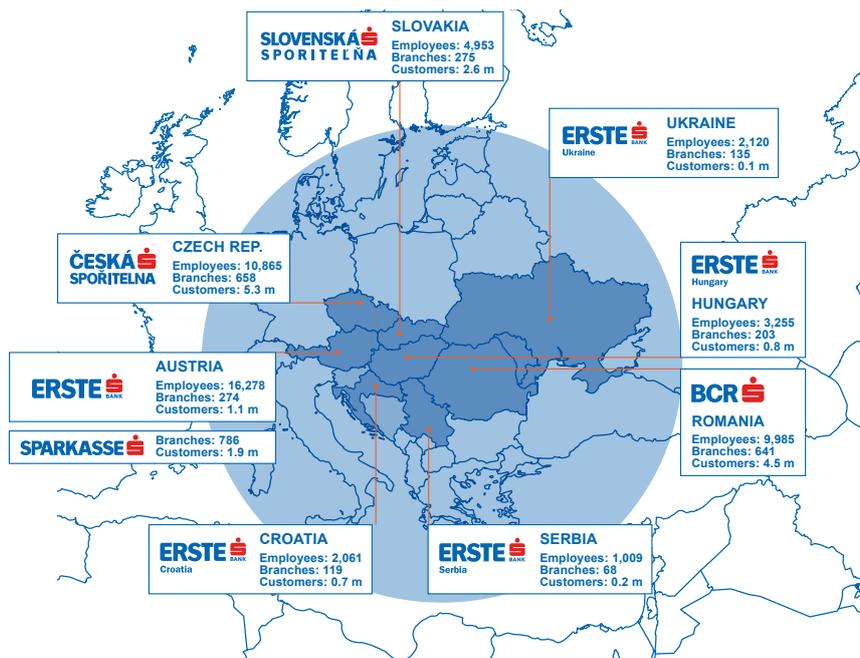


Figure 1<sup>168</sup>

Erste Group's first move towards Eastern Europe was in the late 1990's when they realized that their future was dependent on whether they found sufficient possibilities outside of Austria. Simply cost-cutting at home would have just made the company a potential target for larger players on the market. For this reason they started to enter Austria's neighboring countries via selected acquisitions, and thereby extend their home market.<sup>169</sup> In the last couple of years, Erste Group has faced several structural changes as for example selling their insurance business section to VIG for 630.8 million Euros. This action specifically boosted their balance sheet in 2008 giving them the possibility to soften the effects of the financial crisis. Even though they sold most of their insurance business, they agreed with VIG that the local subsidiaries would continue to hold five percent of the insurance companies in addition to a mutual sales agreement.<sup>170</sup> This way Erste Group has managed to focus on its core segment retail banking, but is still taking part in the upside of the insurance business. Another structural change in their business model was that they standardized several activities as for example; debt capital markets, treasury, equity capital markets, real estate, corporate banking etc, and established the Global Markets and the Group Corporate Investment Banking divisions.<sup>171</sup>

<sup>168</sup> Annual Report 2008 Erste Bank, pg. i.v. 3

<sup>169</sup> Annual Report 2008 Erste Group, pg. 25

<sup>170</sup> Annual Report 2008 Erste Group, pg. 30

<sup>171</sup> Annual Report 2008 Erste Group, pg. 26

The financial data for Erste Group in 2008 look good considering the effects of the crisis. Their operating profit in 2008 increased by 19.3%, while the general administrative expenses only rose by approximately 10%(see Figure 2). This results in a record breaking operating result increase of 19.3% and a good cost/income ratio of 57.2%, which compares favorably to the competition.<sup>172</sup> The total assets of the group only rose by 0.5%, which was influenced by the sale of the insurance unit (if adjusted it would have been a 4.7% increase).<sup>173</sup> Despite these positive results Erste Group also had to face the effects of the financial crisis when for instance they had to deal with the negative overall result from financial assets, which was at -570.6 million Euros in 2008. This devaluation took place even though there was no deterioration in the performance of the underlying assets, and was influenced by the troubles in Iceland and the collapse of Lehman Brothers.<sup>174</sup>

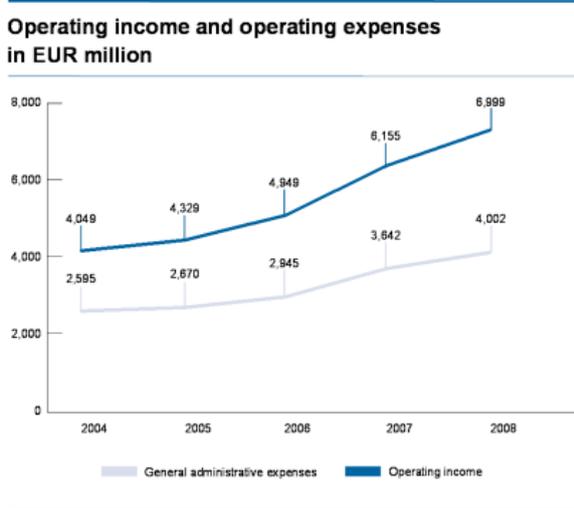


Figure 2<sup>175</sup>

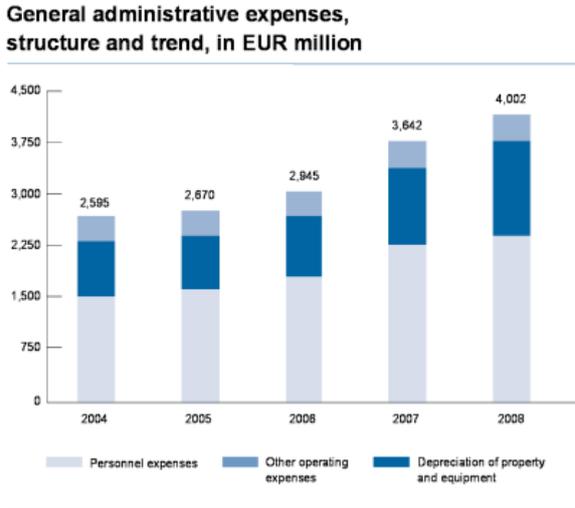


Figure 3<sup>176</sup>

As you can tell from Figure 3, the increase in general administrative expenses is mostly a result of depreciation, and not an increase in personnel expenses. This represents a big change in comparison to the preceding years, where the increase in personnel expenses was the most influential factor. This shows the effects of the crisis, since the expansion process becomes more selective and therefore slows an increase in employees.

<sup>172</sup> Annual Report 2008 Erste Group, pg. 31  
<sup>173</sup> Annual Report 2008 Erste Group, pg. 32  
<sup>174</sup> Annual Report 2008 Erste Group, pg. 34  
<sup>175</sup> Annual Report 2008 Erste Group, pg. 31  
<sup>176</sup> Annual Report 2008 Erste Group, pg. 33

The crisis also resulted in an increase in non-performing loans of 2.9% in the fourth quarter of 2008 in comparison to Q3. Additionally the level of risk provisions increased from 3.3 billion Euros to 3.8 billion Euros. However customer deposits increased by 9.2% from 100.1 billion to 109.3 billion Euros, whereas loans increased by 10.7% from 114 to 126.2 billion Euros in 2008 resulting in a strong loan to deposit ratio of 115.4% in 2008. While Erste Group in comparison to many competitors was able to increase their tier 1 capital to approximately 7.4 billion Euros<sup>177</sup>, their solvency ratio reduced to 10.1%. This is still comfortably above the 8% minimum requirement, but never the less 0.4% below the value of 2007.<sup>178</sup>

Since modern, western retail banking was not existent in the region up to a couple of years ago; it seemed reasonable for Erste Group to focus on the retail segment.<sup>179</sup> This also apparently is one reason why the CEE region was initially not as affected by the financial crisis. The growth was not a sign of an overheating economy, but rather of a lot of to catch up potential. This becomes clear when regarding the wealth management segment, which is another focus of Erste Group. They see enormous catch up potential (see Figure 4), which is the reason why they expanded the share of its fund management activities to 20%, hence dominating the market. However with the current crisis, it is difficult to project at what point the wealth management segment is going to become important. They argue that based on historic trends, many countries in the CEE region are close to breaking a barrier of GDP per capita at which wealth management gains relevance.<sup>180</sup>

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<sup>177</sup> Annual Report 2008 Erste Group, pg. 35

<sup>178</sup> Annual Report 2008 Erste Group, pg. 36

<sup>179</sup> Annual Report 2008 Erste Group, pg. 27

<sup>180</sup> Annual Report 2008 Erste Group, pg. 28

Funds/capita in CEE (2008) in EUR thousand

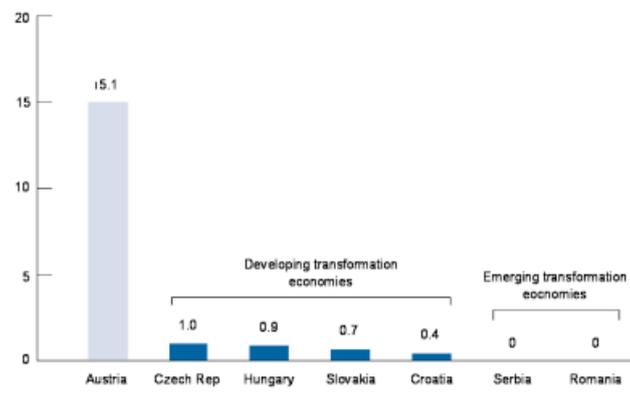


Figure 4<sup>181</sup>

#### 4.2.2 – Region

In the Czech Republic Erste Group is represented by Česká spořitelna and its subsidiaries. It currently holds the top position on the retail market and the second place in terms of total assets. In 2008 they were serving about 5.3 million clients through a network of 658 branches.<sup>182</sup> In 2008 they managed to increase their deposits by 19.3%, while the loan growth slowed down to 12%. The slow down was primarily driven by a decrease in mortgages where Erste Group holds the leading position. They faced a decrease in their trading result due to currency devaluation towards the end of 2008. Additionally there was an increase in administrative expenses of 17.6%, and an increase in risk provisions of 66.3% to 116.6 million Euros. However despite the negative development of the currency and the economy, there was still an increase in the operating result of 41.7% to 773.8 million Euros.<sup>183</sup> All of this resulted in a total exposure 28.6 billion Euros, which was equal to 13% of Erste Group's total exposure.<sup>184</sup>

Banca Comercială Română (BCR) currently represents Erste Group in Romania, which was the market leader on the Romanian banking market in 2008, serving 4.5 million customers through a network of 641 branches. Even though they were able to sustain their leading position on the market, they most certainly faced strong competition and hence a decreasing market share. This was the case, because many other competitors had highly levered portfolios, and were therefore

<sup>181</sup> Annual Report 2008 Erste Group, pg. 29

<sup>182</sup> Annual Report 2008 Erste Group, pg. 47

<sup>183</sup> Annual Report 2008 Erste Group, pg. 48

<sup>184</sup> Annual Report 2008 Erste Group, pg. 49

aggressively competing for low margin deposits. Since BCR's portfolio was already carefully balanced before the crisis, they did not have to compete in this price war. Their goal is to maintain their leading position through cutting costs, and a continued to expansion of their network.<sup>185</sup> The operating result of the Romanian operations more than doubled in 2008, reaching 547.7 million Euros in comparison to 270.8 million Euros in 2007. Meanwhile there was also an increase in net interest income of 45.2%, which resulted from a strong rise in customer loans. On the other hand there was a 11.5% decline in administrative expenses due to less employees and lower restructuring costs. All together it caused the cost to income ratio to significantly improve to 45.5% from 65.6% in 2007. However the financial crisis resulted in rising risk provisions as well as an increase in the non-performing loans ratio (+1.8%). The Romanian operations in 2008 had a total exposure of 13.2 billion Euros, which is equal to approximately 6% of Erste Group's total exposure.<sup>186</sup>

Erste Group is currently represented by Slovenská sporiteľňa (SLSP) in Slovakia. They are a formerly state owned savings bank that currently serves around 2.6 million customers through a network of 275 branches. They currently hold the number one position in retail banking, asset management, leasing and factoring.<sup>187</sup> Their intension is to maintain that leading position in the retail market. That is of specific importance when considering the introduction of the Euro, which caused a large increase in deposits of 37%. There was also significant growth in the loan portfolio of 24% primarily driven by housing loans,<sup>188</sup> which led to an increase of net interest income of 14.9% to 334.8 million Euros in 2008. All of this led to an increase in the operating result of 20.9% to 216.3 million Euros. However due to the introduction of the Euro there was also an increase in administrative expenses of 13.3%, since it created the need for a new core banking system. The exposure of the Slovak market as of 2008 was 8.5 billion Euros, or approximately 4% of Erste Groups total exposure.<sup>189</sup>

Erste Bank Hungary was the second biggest bank in terms of clients in 2008. It serves approximately 800,000 clients through a network of 200 branches.

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<sup>185</sup> Annual Report 2008 Erste Group, pg. 50

<sup>186</sup> Annual Report 2008 Erste Group, pg. 51

<sup>187</sup> Annual Report 2008 Erste Group, pg. 52

<sup>188</sup> Annual Report 2008 Erste Group, pg. 53

<sup>189</sup> Annual Report 2008 Erste Group, pg. 54

Additionally they have a strategic partnership with the Hungarian Post enabling them to access 327 online post offices.<sup>190</sup> Due to the financial crisis the strategy of Erste Bank Hungary had to be reorganized, since many parts of the business plan were not feasible anymore. For example they had to completely remove their FX lending in Swiss Francs, which has become unpopular due to the deterioration of the local currency. This decline in FX lending also had the effect that the real estate market shrank, which presented an opportunity to the group. Many market-members were not able to finance projects anymore, and therefore the group had the possibility to hand pick the best-looking projects. When regarding the financial statement, Erste Bank Hungary managed to increase both their net interest income as well as their net commission income by 19.8% and 7.4% respectively. Their administrative expenses grew by 8%, which was a result of the expansion process, and an increase in risk provisions by 15.7%. In total the operating result of the operations in Hungary increased by 18.6%. Overall the development was successful considering the worsening market conditions, which is indicated by the improvement of the cost to income ratio to 52.1% in 2008.<sup>191</sup> The group's total exposure in the market was 8.5 billion Euros, or 4% of the total exposure of Erste Group.<sup>192</sup>

Erste Bank Ukraine (EBU) currently only takes the position of a start up operation since it was only opened at the beginning of 2007. As of 2008 they were managing roughly 65,000 clients through a network of 135 branches. Due to the small involvement in the market, the subsidiary only ranked 23<sup>rd</sup>, which equals a market share of approximately 1% in most product categories.<sup>193</sup> The main goal of the operation at the current time is to improve the position in retail banking. However this goal due to the financial turmoil has to be reached differently than it was planned at the start of the operations in 2007. At the moment it is simply not reasonable to enlarge their network through acquisitions, or as a matter of fact increase the involvement in the market at all. In 2007 they planned on playing a role in the housing market, which does not seem to be a smart thing to do in the current situation. Never the less EBU managed to double its loan portfolio to 600 million Euros despite the fact that the market was coming to a halt at the end of 2008.<sup>194</sup>

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<sup>190</sup> Annual Report 2008 Erste Group, pg. 54

<sup>191</sup> Annual Report 2008 Erste Group, pg. 56

<sup>192</sup> Annual Report 2008 Erste Group, pg. 57

<sup>193</sup> Annual Report 2008 Erste Group, pg. 61

<sup>194</sup> Annual Report 2008 Erste Group, pg. 62

Deposits quadrupled, but remain at a low level of 45 million Euros in 2008. They managed to increase their operating result to 45.1 million Euros, which was mainly driven by the increase of net interest income (+312.5%). On the other hand the administrative expenses increased to 56.2 million Euros due to expanding the branch network and increasing the number of employees, which resulted in a loss after minorities of 28.7 million Euros. However when regarding the Ukrainian market it has to be said that this market only represents 0.4% of the total exposure of the group at 747 million Euros.<sup>195</sup>

## **4.3 – Raiffeisen International**

### **4.3.1 – Overview & Strategy**

Raiffeisen is a banking conglomerate with a lot of influence in Austria, despite that in terms of banking assets it lacks behind UniCredit Bank Austria. Raiffeisen International is a subsidiary of Raiffeisen Zentralbank (RZB) responsible for their business in Eastern Europe. By the end of 2008 the company was operating in 17 markets (see Figure 1) serving more than 14.7 million customers through 63,376 employees in 3,231 business outlets. The subsidiaries run mutually exclusive from each other, and thereby do not create systemic risk within the company. Their successful business model has brought seven of their subsidiaries into the top three banks of their country.<sup>196</sup>

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<sup>195</sup> Annual Report 2008 Erste Group, pg. 63

<sup>196</sup> Raiffeisen International Annual Report 2008, pg. 30



Figure 1<sup>197</sup>

Unfortunately with the recent crisis their business focus also had to adapt. Now their strategic focus is on the expansion of deposits, and on the quality of their assets rather than expanding their already large market positions through acquisitions. The firm is currently holding back from merger opportunities due to the unfavorable environment, since the capital might become necessary in other areas.<sup>198</sup>

The financial situation of the bank was exceptionally well in 2008, especially considering that most rating agencies and the IMF expected banks with strong involvement in CEE region to face difficult times. In 2008 Raiffeisen International's profit from operating activities grew by nearly 40% reaching 2,247 million Euros.<sup>199</sup> Their general administrative expenses grew by 21% to 2633 million Euros, which was influenced by a large increase in staff costs of 18%. Due to the large increase in operating income this meant a favorable development in the cost to income ratio by 3.6% to 54% in 2008. These developments ultimately also put the profit before taxes at a record level, but the first difficulties started to come up.<sup>200</sup>

<sup>197</sup> Raiffeisen International Annual Report 2008, pg. 4

<sup>198</sup> Raiffeisen International Annual Report 2008, pg. 24

<sup>199</sup> Raiffeisen International Annual Report 2008, pg. 55

<sup>200</sup> Raiffeisen International Annual Report 2008, pg. 56

The provisioning for impairment losses increased by 119% to 780 million Euros, and therefore caused a relatively lower increase in profit before taxes in comparison to the operating profit. Due to this the risk to earning ratio also climbed from 14.8% to 24.1%. Geographically speaking the largest part was allocated in the CIS region, specifically the Ukraine. In this region the risk to earning ratio grew by 28%. The CEE region's ratio grew by 26%, while the lowest growth came from South-Eastern Europe with 17%.<sup>201</sup>

The profit after taxes and minorities increased by 17% to 982 million Euros in 2008. Without the valuation losses due to currency fluctuations the profit would have easily crossed the one billion Euro barrier. The Ukrainian hryvnia and the currencies of several other currencies were under pressure during the period, which resulted in a total valuation loss of 873 million Euros during 2008.<sup>202</sup> In order to meet the increasing demand for capital Raiffeisen International has started a cost cutting program. The expansion of the branch network will be postponed, or at least will be bound to strict conditions. Additionally no new employees should be further recruited in 2009, and the number of employees in the CIS region will be reduced.<sup>203</sup>

For the near future the bank sees difficult times ahead of them. The recession in the Western world is also lowering the demand for CEE export goods, and reducing the direct investment from these developed economies. Through this the financing costs are increasing, which is ultimately going to limit credit growth and thereby slow down a recovery. The governments will focus on the soaring budget deficits and the interest payments rather than promoting growth.<sup>204</sup> Despite these threats, Raiffeisen International believes that the region's potential has remained. The only thing that has changed is that the focus will be on deposits, rather than on loan growth.<sup>205</sup>

The corporate customer division showed strong growth in 2008 with an increase in profit before tax of 32% to 884 million Euros. The growth in the operating income was 34% reaching 1,678 million Euros. Unfortunately the provisions for impairment losses

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<sup>201</sup> Raiffeisen International Annual Report 2008, pg. 57

<sup>202</sup> Raiffeisen International Annual Report 2008, pg. 58

<sup>203</sup> <http://ar2008.ri.co.at/ereport.asp?fCompanyID=14&fAction=SHOWREPORT&fLangID=1&freportid=116&fpageid=3333>

<sup>204</sup> Raiffeisen International Annual Report 2008, pg. 79

<sup>205</sup> <http://ar2008.ri.co.at/ereport.asp?fCompanyID=14&fAction=SHOWREPORT&fLangID=1&freportid=116&fpageid=3335>

also doubled to 269 million Euros. The general administrative expenses in this division on the other hand only grew by 18%, thereby improving the cost to income ratio to 31.3%. With its highest profit in history, and all of the positive developments, the corporate division has further increased its stake of total earnings to 62%.<sup>206</sup> However during the final months of 2008 the picture began to change. The division's strategy was adapted to attract mid-market customers in order to improve the diversity in the portfolio keeping the focus on deposits and cash management.<sup>207</sup>

The retail customers division did not witness such positive developments. The profit before tax fell by 11% to 435 million Euros, and additionally there was a 133% increase in provisions for impairment losses of 507 million Euros. The branch expansion program further increased the general administrative expenses by 22% to 1,876 million Euros. However there were also some positive developments. For instance they managed to increase the operating income by 25% to 2,819 million Euros, and despite high expenses they decreased the cost to income ratio by 1.7% to 66.6%. All together the retail division has felt the crisis more significantly, which is also indicated by the drop in the division's share of the total earnings (-9%). Nevertheless the division feels it has a strong position throughout the region, and when the growth picks back up so will the profit margins. Similarly to the corporate division, their main goal will be to increase the amount of deposits.<sup>208</sup>

#### 4.3.2 – Region

Raiffeisen International divides their subsidiaries into three regions:

- Central Europe – CE
  - Czech Republic, Hungary, Slovakia
- Southeastern Europe – SEE
  - Bulgaria, Romania
- Commonwealth of Independent States – CIS
  - Ukraine<sup>209</sup>

In the CE region the profit fell by 2% to 442 million Euros. Therefore the region has remained dominant in terms of assets (43%), but in terms of earnings it is lacking

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<sup>206</sup> Raiffeisen International Annual Report 2008, pg. 108

<sup>207</sup> Raiffeisen International Annual Report 2008, pg. 109

<sup>208</sup> Raiffeisen International Annual Report 2008, pg. 110

<sup>209</sup> Raiffeisen International Annual Report 2008, pg. 82

behind the CIS and the SEE region.<sup>210</sup> This slowdown can be explained by higher provisioning for impairment losses.<sup>211</sup> Due to this negative trend the risk to earnings ratio increased by 11% to 25.9%. The net fee and commission income grew by 21%, out of which the largest growth was registered in the Czech Republic and Poland. Their general administrative expenses grew by 18% to 930 million Euros. This was highly influenced by a staff increase of 10% and 40 new outlets, which were opened during 2008. All together the region's cost to income ratio developed favorably, decreasing by 1.9% to 56.8%.<sup>212</sup>

In Slovakia Raiffeisen has control over Tatra banka, the third largest bank of the country. As of the end of 2008 they had 3,885 employees, which served 744,000 customers through 162 business outlets. This subsidiary is adapting successfully to the new strategy, which is easily seen by the large increase of deposits (+34.6%). The large increase to 7.5 billion Euros in deposits in comparison to a total of 6.2 billion Euros in loans is very favorable. The good development of the subsidiary is also seen through the development in the cost to income ratio, which decreased to 53.3% in comparison to 56.2% in 2007. This decrease is comparatively larger than the regions average (-1.9%), and also leaves the country with a lower than average cost to income ratio.<sup>213</sup>

In the Czech Republic, Raiffeisen currently has a market share of roughly 4%, which puts them into the top 5 largest banks of the market. Their 2,654 employees are serving 411,000 customers through 107 business outlets. Their development of the loan to deposit ratio was not quite as favorable as in Slovakia. The deposits increased by 18.7% to 4.2 billion Euros, but unfortunately their loan portfolio grew faster (+25.6%) hitting 5.5 billion Euros. Nevertheless the subsidiary has managed to become more efficient, which is clearly shown by the 8% decrease in the cost to income ratio, but it still remains above the region's average of 56.8%.<sup>214</sup>

Hungary is one of the largest subsidiaries of Raiffeisen International. They currently are the 5<sup>th</sup> largest bank on the market. With 3,960 employees they are serving

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<sup>210</sup> Raiffeisen International Annual Report 2008, pg. 83

<sup>211</sup> Raiffeisen International Annual Report 2008, pg. 84

<sup>212</sup> Raiffeisen International Annual Report 2008, pg. 85

<sup>213</sup> Raiffeisen International Annual Report 2008, pg. 89

<sup>214</sup> Raiffeisen International Annual Report 2008, pg. 86

657,000 customers through 164 business outlets. The loans increased by 13.3% to 7.2 billion Euros while the deposits rose by 16.4% to 5.7 billion Euros, hence the loan to deposit ratio developed favorably. This ratio still has to be improved concerning their strategy, but it is already on the right path. Their cost to income ratio unfortunately increased during the period from 55.9% to 58.5% showing a decrease in efficiency.<sup>215</sup>

In the SEE region the profit before tax showed an increase of 12% reaching 534 million Euros. This strong increase was largely influenced by the increase in net interest (+29%) and net fee and commission income (+20%).<sup>216</sup> The allocations for provisions from impairment losses showed an excessive growth of 171% to 159 million Euros, but they started from a very low level. When comparing it with the other two regions it still remains the lowest level. The regions non-performing loans increased to 2.26 percent, showing the increasing uncertainty on the financial markets. Their general administrative expenses grew by 20% to 773 million Euros. One factor that had a large influence in this was the increase in the workforce of 21% in comparison to 2007. In total the region is doing very well with a low cost to income ratio of 51.9%<sup>217</sup>, and the second highest profit of all regions.<sup>218</sup>

In Bulgaria Raiffeisen has been part of the banking market since 1994. They are currently fourth on the market, serving 653,000 customers through a network of 3,700 employees in 197 outlets. Their loan portfolio increased by 32.5% to 3.4 billion Euros, while their deposits only grew by 20.7% to 2.2 billion Euros. This development is not in line with the group's strategy to increase customer deposits. The subsidiary's cost to income ratio improved from 53.2% to 47.4% in 2008, indicating an increase in efficiency.<sup>219</sup>

In Romania Raiffeisen is the third largest bank on the market. In 2008 they had 6,899 employees serving approximately 2 million customers through 557 business outlets. The loan to deposits ratio did not develop favorably. While the deposits remained at 3.5 billion Euros, the loan portfolio grew by 30.1% to 4.6 billion Euros. The cost to

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<sup>215</sup> Raiffeisen International Annual Report 2008, pg. 87

<sup>216</sup> Raiffeisen International Annual Report 2008, pg. 91

<sup>217</sup> Raiffeisen International Annual Report 2008, pg. 92

<sup>218</sup> Raiffeisen International Annual Report 2008, pg. 83

<sup>219</sup> Raiffeisen International Annual Report 2008, pg. 95

income ratio improved to 53.3% during the period, which reflects the strong centralization of all business processes.<sup>220</sup>

The CIS region, despite facing many problems at the time, had the largest increase in profit before tax (+50%). With 665 million Euros it became the biggest contributor on the earnings side.<sup>221</sup> A large part of this development was caused by the enormous increase of 41% in net interest income reaching 1,297 million Euros in 2008. In addition the net fee and commission income as well as the net trading income grew by 64 million and 47 million Euros respectively. Unfortunately the provisioning for impairment losses also doubled to 356 million Euros in 2008. The general administrative expenses rose by 23% to 853 million Euros. Nevertheless the cost to income ratio improved significantly by 6.5% to 45.1% in 2008.<sup>222</sup>

In the Ukraine, Raiffeisen Bank Aval as of the end of 2008 was the second biggest bank of the country. With 17,368 employees they were serving more than 4.7 million customers through 1,134 outlets. The loan to deposit ratio unfortunately increased in the country. While the loan portfolio was still increasing by 2.7% to 5.3 billion Euros, the deposits declined by 20.6% to 2.4 billion Euros. As a consequence Raiffeisen has begun strong cost cutting efforts in the country. On the top of their list of cost reductions stands the large number of employees, which got reduced by 412 in 2008 and will most likely be reduced further.<sup>223</sup>

## 4.4 – Vienna Insurance Group

### 4.4.1 – Overview & Strategy

Vienna Insurance Group (VIG), is Austria's biggest insurance company in terms of total premium, and has the largest involvement in the CEE area. It is currently operating in 23 countries, out of which six are under the review of the thesis (see Figure 1). Additionally all subsidiaries, except for Hungary, are part of the top 3 insurers in their country.

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<sup>220</sup> Raiffeisen International Annual Report 2008, pg. 98

<sup>221</sup> Raiffeisen International Annual Report 2008, pg. 100

<sup>222</sup> Raiffeisen International Annual Report 2008, pg. 101

<sup>223</sup> Raiffeisen International Annual Report 2008, pg. 104

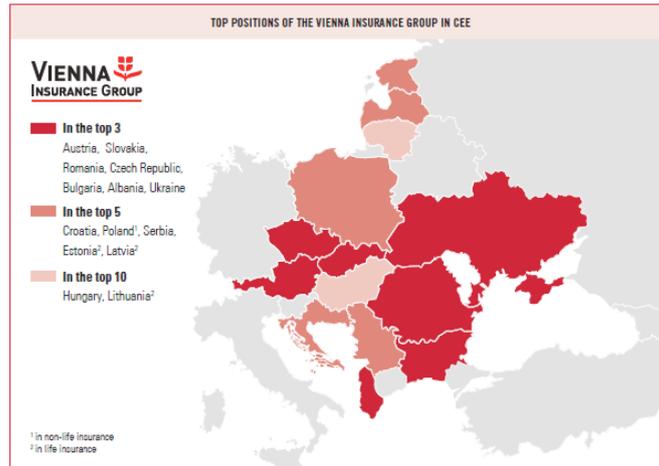


Figure 1<sup>224</sup>

Figure 2 shows that VIG managed to increase its premium volume by 14.3% to 7,898.87 million Euros in 2008. This suggests that the growth opportunities in the unsaturated economies of the CEE markets are easing the effects of the crisis. Currently VIG generates around 50% of its premiums in the CEE region. It contributed 61.7% of the non-life segment, and 38.9% of the life insurance segment.<sup>225</sup> The organic growth realized from the acquisition of the insurance part of Erste Bank<sup>226</sup> and thereby also securing an additional distribution channel, is threatened by the high volatility of the markets and their currencies.<sup>227</sup> This threat causes the management of the VIG Group not to be able to make a forecast for the year 2009.<sup>228</sup>

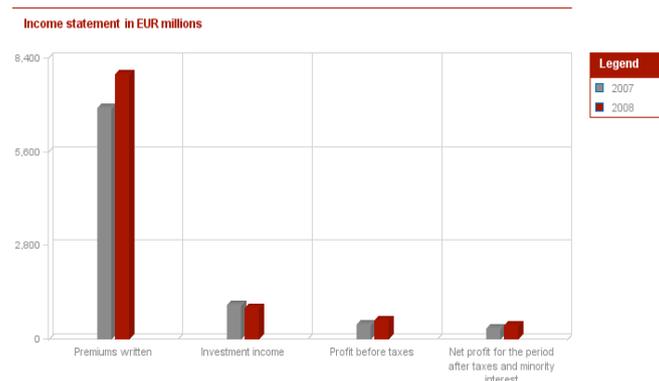


Figure 2<sup>229</sup>

<sup>224</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandeasterneurope.html>

<sup>225</sup> <http://vig.online-report.eu/2008/ar/performance2008/businessdevelopment.html>

<sup>226</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/groupactivities/viginternational.html>

<sup>227</sup> <http://vig.online-report.eu/2008/ar/outlookfor2009/viennainsurancegroup.html>

<sup>228</sup> <http://vig.online-report.eu/2008/ar/outlookfor2009/insurancemarket.html>

<sup>229</sup> <http://vig.online-report.eu/2008/ar/servicepages/keyfigurescomparison.html>

Due to the financial crisis, VIG had to drastically reduce their expenses. In the beginning of March 2009, their CEO announced a cost reduction program of 100 million Euros. These reductions will primarily reduce the number of employees. Additionally they will manage to reduce costs by consolidating the IT Terminals in Poland, Rumania and Slovakia.<sup>230</sup> VIG is currently facing increasing costs. The expenses for insurance claims increased by 11.4%, and the operating expenses by 16.1% compared to 2007. However it is more important whether these increases in costs caused by growth, are smaller than the growth in premium income. VIG as a matter of fact has increased their profit before taxes by 23.7%, to 540.8 million Euros. This however was influenced by extra income generated from the sale of Unita to Uniqa in Romania. In total it shows that the Group's strategy of keeping each individual daughter company under a combined ratio of 100% is successful. Currently the group's combined ratio is at 96.4%.<sup>231</sup>

VIG has been actively engaged in the CEE region for many years. They had a first mover advantage, but they were also the first to face the difficulties resulting from a formerly centrally planned economy.<sup>232</sup> They managed to overcome these difficulties, and successfully become the leader of their core markets as you can tell from Figure 1 in the previous chapter.

The first product segment that became important for VIG In the CEE region was motor vehicle insurance. Due to the European standard that motor vehicle liability insurance is mandatory this segment proves to be relatively crisis resistant, since people tend to not want to give up their mobility. After they became a major motor-vehicle insurer in the region, VIG focused on life insurance, since this is the area with the most growth potential in the region. One reason for this high potential is the low average insurance density in the countries at the moment compared to the EU-15 countries as you can tell from Figure 3.<sup>233</sup>

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<sup>230</sup> Presse: 4.3.2009, Christian Höller

<sup>231</sup> <http://vig.online-report.eu/2008/ar/performance2008/businessdevelopment.html>

<sup>232</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/thebusinessmodel/ceefocus.html>

<sup>233</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandesterneurope/growthpotential.html>

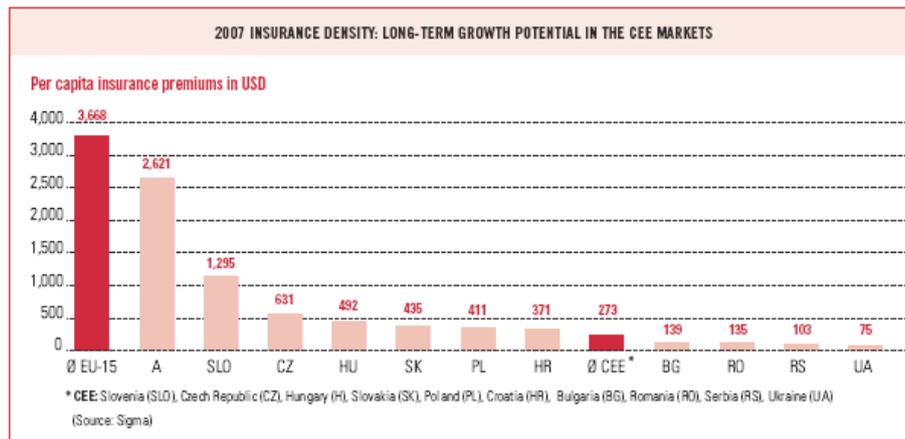


Figure 3<sup>234</sup>

People from this region are more concerned about reserves for retirement than in western countries, since the local governments in most cases cannot provide financial safety. However this trend only becomes important with additional income, and therefore growth could be offset by the financial crisis. VIG has recently announced that they want to start offering private health insurance in the CEE region, and thereby becoming a first mover in a segment they consider as being very important in the future.<sup>235</sup> Another initiative from VIG was to incorporate their knowledge about the region in a reinsurance company. By 2009, VIG Re has already managed to reach their premium targets of 2011, which is yet another sign of the specialist position VIG has within the region.<sup>236</sup>

#### 4.4.2 – Region

In the Czech Republic VIG is the second largest insurer with a market share of 31.4%. Due to the acquisition of s-Versicherung they also became a leading insurer in the life insurance segment with a market share of 27.4% in 2008.<sup>237</sup> In total VIG owns two composite insurers, and one insurance focusing on the life segment. Out of these companies, Kooperativa is the most important as it is the largest insurance company held outside of Austria. They offer their life insurance products through a close cooperation with Ceska Sportelna, which has more than five million clients. Additionally they also started to sell their products via telephone, in addition to

<sup>234</sup> <http://vig.online-is-report.eu/2008/ar/strategymarketandactivities/centralandeasterneurope/growthpotential.html>

<sup>235</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/thebusinessmodel/productdemand.html>

<sup>236</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/groupactivities/viginternational.html>

<sup>237</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandeasterneurope/marketposition/czechrepublic.html>

internet sales.<sup>238</sup> The business development for VIG during 2008 was positive concerning the current problems. Their premium volume increased by 25.6%, which was highly influenced by the life insurance segment. It increased by 49.5%, in comparison to an increase of 17.3% in the non-life segment. The group managed to increase their profit before taxes by 45.6% to 107.45 million Euros. The combined ratio of the group's operations in the Czech Republic was reduced by 1.5 percent, and now stands far below the 100% barrier at 92.2%.<sup>239</sup>

In Slovakia VIG was the second largest insurance company in 2008 with a market share of 31.3%. They were both the leading life, and motor-vehicle insurer of the country.<sup>240</sup> VIG owns one composite, one non-life, and three life insurance companies. The firm in the non-life segment is the third biggest motor-vehicle insurer. This strengthens the core product segment that is covered by VIG in the CEE region so far. The successful development of the life insurance segment was partially caused by the multi channel distribution system. These channels cover everything from brokers, agents and a bancassurance partnership with the largest bank of the country. This gives VIG access to 2.5 million potential clients.<sup>241</sup> As for the financial facts the total premiums in Slovakia increased by 22.5% in 2008, which was influenced by the large increase in life insurance (+39.2%). The non-life segment is more saturated, and therefore only was increased by 11.3%. The operating expenses increased by 14.7%, which is considerably lower than the increase in premium. However the expenses for insurance claims were very high in 2008 due to the conversion process of the formerly state owned monopoly insurer. Due to this fact, and the difficult situation on the capital markets, the companies operating for VIG in Slovakia decreased their profit before taxes by 83.5% to 4.99 million Euros. The combined ratio for the country still is below the barrier of 100%, but increased to 93.3% in 2008 in comparison to 92.9% in 2007.<sup>242</sup>

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<sup>238</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/czechrepublic/vigcompanies.html>

<sup>239</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/czechrepublic/businessdevelopment.html>

<sup>240</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandesterneurope/marketposition/slovakia.html>

<sup>241</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/slovakia/vigcompanies.html>

<sup>242</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/slovakia/businessdevelopment.html>

Even though VIG had to sell UNITA to Uniqa, they managed to increase their leading position on the Romanian market with a market share of 30.6% in 2008. Benefiting from the organic growth caused by the acquisition of s-Versicherung they became one of the Top 3 life insurers of the country. They sustained their market leadership in their core segment motor-vehicle insurance with a market share of 35.4%.<sup>243</sup> Currently they are in control of three composite insurers: Omniasig, Asirom and BCR. The first two are the largest motor vehicle insurers of the country. The non-life products are offered through direct sales, agents and brokers. Life insurance products are also sold through agents, but since the opening of the life insurance branch of BCR, a bancassurance arrangement also came into play.<sup>244</sup> VIG Romania managed to increase its premiums by 47.1% in 2008, which is influenced by the increase in the non-life segment (+42.3%). Even though the increase in the life insurance business was much greater (+187.1%) it only contributes a small part in terms of total premiums (~6%). The premium growth caused an increase in operating expenses and expenses for insurance claims of 89.7% and 50.6% respectively. The profits before taxes of the group's operations were highly influenced by the sale of Unita, and therefore were increased by 52.9 million Euros to 57.46 million Euros in 2008. Problems in the country are indicated by the 4.7% increase in the combined ratio. This puts Romania above the 100% barrier at 104.7% in 2008.<sup>245</sup>

VIG plays a dominant role on the Bulgarian insurance market. In 2008 they reached a total market share of 17.9%.<sup>246</sup> The group currently owns four composite insurers with both life and non-life operations. The biggest out of which is Bulstrad non-life, which in 2008 was the largest insurance company of the country.<sup>247</sup>

In the Ukraine, VIG currently is part of the top 3 companies operating on the insurance market. This was primarily reached through the acquisition of UIG in

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<sup>243</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandesterneurope/marketposition/romania.html>

<sup>244</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/romania/vigcompanies.html>

<sup>245</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/romania/businessdevelopment.html>

<sup>246</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandesterneurope/marketposition/othercee.html>

<sup>247</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/otherceemarkets.html>

2007.<sup>248</sup> VIG Ukraine currently is controlling four insurance companies. Three of these companies primary goal is to strengthen VIG's market position in the motor-vehicle segment. Jupiter is the only life insurance operation in the Ukraine, which cooperates with Erste Bank as a bancassurance distribution partner.<sup>249</sup>

In Hungary, VIG does not play a large role in comparison to other CEE countries. Currently it is the eighth biggest insurance company on the market, and therefore far off from the top 5 status the company normally seeks.<sup>250</sup> Currently VIG runs the composite insurer Union, and the recently acquired Hungarian Erste life insurance branch ESB. The products of ESB are distributed through a bancassurance agreement with Erste Bank.<sup>251</sup>

Since Bulgaria, Hungary and the Ukraine are not part of the VIG core markets the group did not publish the business development separately for each country. Classified as other CEE countries they increased their total premiums by 29.3% in 2008, which was influenced by the increase in non-life insurance. The premiums grew in non-life and life insurance 33.1% and 21.6% respectively. This stands in contrary to the general development of the region, where the growth is often more influenced by the life insurance segment. Even though the expenses for insurance claims and the operating expenses only rose by 27.6% and 19.5% respectively the group still suffered a loss of 14.41 million Euros in 2008. This was largely due to the deteriorating situation of these markets. It is also reflected by the combined ratio of 105.8%, which is considerably above the group target of 100%.<sup>252</sup>

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<sup>248</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandasterneurope/marketposition/othercee.html>

<sup>249</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/otherceemarkets.html>

<sup>250</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandasterneurope/marketposition/othercee.html>

<sup>251</sup> <http://vig.online-report.eu/2008/ar/strategymarketandactivities/centralandasterneurope/marketposition/othercee.html>

<sup>252</sup> <http://vig.online-report.eu/2008/ar/performance2008/geographicsegmentreporting/otherceemarkets/businessdevelopment.html>

## 4.5 – Uniqa

### 4.5.1 – Overview & Strategy

Uniqa is Austria's second biggest insurance company in terms of total Premiums. As a composite insurance group they offer non-life, life and health insurance products to the public. In recent years Uniqa has taken product innovation as one of their goals. With products like “safe-line” auto insurance where the driver can “click” for help in case of an accident, they tried to distinguish themselves from the classic and dull insurance products offered by the competition. Within this section the reader will get an overview of their current situation, their market activities in the pre-specified region, and their strategy in eastern and southeastern Europe.



Figure 1<sup>253</sup>

Uniqa currently operates in 20 markets throughout Europe (see Figure 1) with a total Premium volume of 5.8 billion Euros. Eastern Europe plays a very important role in the strategy of Uniqa. The subsidiaries in the region provide 22% of the total premiums, and the plan is that one-day Eastern Europe and the other international subsidiaries should provide more than half of the premium volume.<sup>254</sup> Additionally their goal is to increase their market shares in their non-life and life insurance companies to 6% and 3% respectively. One factor that will continue to help them develop in the underdeveloped insurance markets of Eastern Europe is the preferred

<sup>253</sup><http://ar2008.uniqa.com/ereport.asp?fCompanyID=8&fAction=SHOWREPORT&fLangID=1&fReportID=119&fPageID=3544>

<sup>254</sup><http://ar2008.uniqa.com/ereport.asp?fCompanyID=8&fAction=SHOWREPORT&fLangID=1&fReportID=119&fPageID=3544>

partnership with Raiffeisen International. This bancassurance agreement currently covers 13 countries in the region, and is hence supposed to give both participants a chance to achieve above average growth ratios.<sup>255</sup> Uniqa additionally receives support from the European Bank for Reconstruction and Development. This support grew from 70 million Euros in 2007 to 150 million in 2008, and is therefore an important factor in the growth strategy for the CEE region.<sup>256</sup>

Despite the difficulties in 2008 Uniqa managed to increase its total premiums by 10.4%, which was highly influenced by the growth in the Eastern European subsidiaries (+56.7%). Despite the large growth rates the forecasts for the medium term have been postponed due to the increasingly more difficult situation on the financial markets.<sup>257</sup> However with the third profit improvement program running out in 2010, Uniqa will be able to lower its cost ratios, compress structures, eliminate redundant work and save resources through outsourcing.<sup>258</sup>

As already mentioned the premiums grew by 10.4% in 2008. When broken up into life and non-life insurance, their premiums were split up into 41.2% non-life insurance (2007: 41.7%), 42.5% life insurance (2007: 41.1%) and 16.3% health insurance business (2007: 17.2%). There was a slight movement from health insurance towards life insurance, but overall the balance was similar to 2007. More importantly Eastern Europe was responsible for 22% of the total group premiums. Nevertheless the operating expenses draw a bit of a different picture. These grew by 17.2% in 2008 reaching 1,237 million Euros. Then additionally the group had to cover higher acquisition costs (+6.7%), and other operating expenses. In total this increased their cost ratio, which compares total expenses with the premiums earned, from 22% to 22.5% in 2008.<sup>259</sup>

The crisis manifested itself the strongest in investments. Even though the total investments decreased only slightly by 0.9% to 21,342 million Euros, the net income from these investments reduced drastically by 80.2% from 955 million Euros in 2007 to 189 million in 2008. This also had a direct effect on the profit on ordinary activities

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<sup>255</sup> Uniqa Group Annual Report 2008, pg. 6

<sup>256</sup> Uniqa Group Annual Report 2008, pg. 7

<sup>257</sup> Uniqa Group Annual Report 2008, pg. 4

<sup>258</sup> Uniqa Group Annual Report 2008, pg. 7

<sup>259</sup> Uniqa Group Annual Report 2008, pg. 37

which was set back to 90 million Euros from 340 million in 2007. Additionally the worsened economic situation also caused a decline of the cash flow on ordinary activities to 267 million Euros from 846 in 2007. Despite all these negative figures the group has managed to keep total equity at 1,459 million Euros, which is mere reduction of 73 million to 2007.<sup>260</sup>

The non-life segment was developing favorably in the difficult environment of 2008. The premiums increased by 9.3% to 2,401 million Euros, which was influenced by the above average increase in premiums from Eastern Europe (+33.1%). The Eastern European operations already contribute 29.2% of the total premiums earned in this segment (see Figure 2). Uniqa is an insurance company with an international focus, which is best represented by the fact that 46.1% of the premiums earned in this segment in 2008 came from international subsidiaries. Additionally the retained insurance benefits increased by 12.8%, which is large in comparison to the increase in premiums. Operating expenses in this segment rose by 22.6% causing the cost ratio to rise to 33.4% from 32.6% in 2007. The net income from investments at - 83.7%, was above the total average reduction mentioned earlier. This ultimately led to a reduction in profit on ordinary activities from the non-life segment to 113 million Euros in comparison to 238 million in 2007.<sup>261</sup>

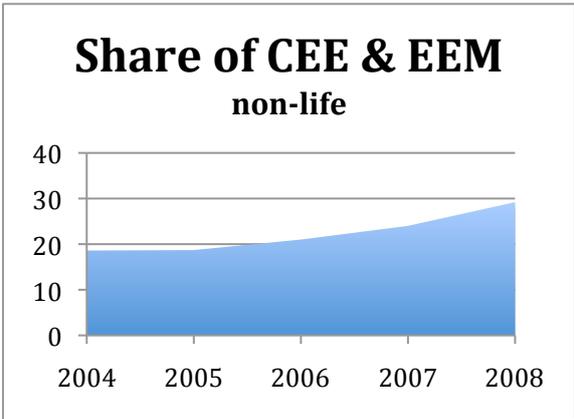


Figure 2<sup>262</sup>

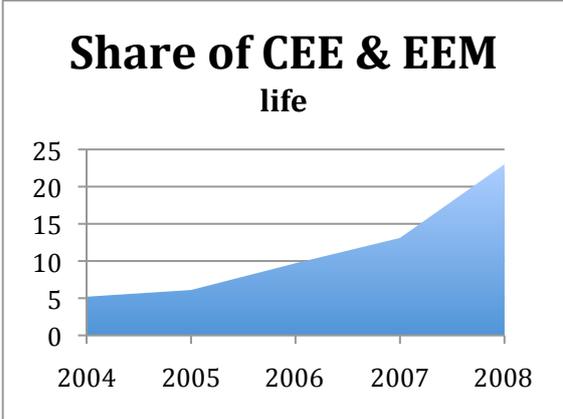


Figure3<sup>263</sup>

The life insurance operations of Uniqa were expanding during 2008. The total premium volume grew by 14.1% to 2,476 million Euros.<sup>264</sup> The premiums of the Eastern European subsidiaries have doubled, and already contribute 23% to the total

<sup>260</sup> Uniqa Group Annual Report 2008, pg. 38

<sup>261</sup> Uniqa Group Annual Report 2008, pg. 39

<sup>262</sup> Author's Investigation; Data Source: Uniqa Group Annual Report 2008

<sup>263</sup> Author's Investigation; Data Source: Uniqa Group Annual Report 2008

<sup>264</sup> Uniqa Group Annual Report 2008, pg. 40

life insurance premiums. This is lower than the figure in non-life insurance, but the growth rates are much larger in this segment (see Figure 3). This can be explained by the fact that a lot of Eastern European economies are still lacking behind in life insurance penetration. Unfortunately this insurance segment has shown to be more problematic during difficult times. Retained insurance benefits decreased by 13.5% in total, but in the CEE markets they grew by 325.5% due to the growth in premiums. Operating expenses on the other hand have also grown by 13.1%, as well as acquisition expenses (+9.2%), and other operating expenses (+30.8%). However due to the growth in premiums, the cost ratio of this segment remains at 15.5%, which is a slight decrease in comparison to 2007 (-0.2%). Net income on investments decreased by 76.4% to 133 million Euros, which is a bit below the total average of 80.2%. Nevertheless there was a loss of 27 million Euros in this segment in comparison to a profit of 5 million Euros in 2007.<sup>265</sup>

#### 4.5.2 – Region

As for the region under review by this thesis Uniqa is operating in all of the chosen markets. In Bulgaria Uniqa has control over one life and one non-life insurance company. The non-life company currently is the 6<sup>th</sup> largest on the market, and offers all lines of non-life insurance products.<sup>266</sup> The life insurance company is the 5<sup>th</sup> largest on the market, and offers the full range of life insurance products.<sup>267</sup> Both companies offer their products through a countrywide sales network of employees and agents.

In Slovakia the group has control over the composite insurer Uniqa poisťovňa. It is one of the leading insurance companies on the market and offers all types of life and non-life insurance products through a countrywide network of offices, agents, brokers and car dealers. However even though all type of products are offered the focus remains on motor and life insurance.<sup>268</sup> The Czech subsidiary runs under the same name and principle. It acts as a composite insurer, and is currently one of the top 10 insurance companies on the market. The products are also offered through a similar sales network.<sup>269</sup>

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<sup>265</sup> Uniqa Group Annual Report 2008, pg. 41

<sup>266</sup> [http://www.uniqagroup.com/uniqagroup/cms/eng/group/group\\_companies/uniqa\\_insurance\\_plc.jsp](http://www.uniqagroup.com/uniqagroup/cms/eng/group/group_companies/uniqa_insurance_plc.jsp)

<sup>267</sup> [http://www.uniqagroup.com/uniqagroup/cms/eng/group/group\\_companies/uniqa\\_life\\_insurance\\_plc.jsp](http://www.uniqagroup.com/uniqagroup/cms/eng/group/group_companies/uniqa_life_insurance_plc.jsp)

<sup>268</sup> [http://www.uniqagroup.com/uniqagroup/cms/eng/group/group\\_companies/uniqa\\_poisťovňa.jsp](http://www.uniqagroup.com/uniqagroup/cms/eng/group/group_companies/uniqa_poisťovňa.jsp)

<sup>269</sup> [http://www.uniqagroup.com/uniqagroup/cms/eng/group/group\\_companies/uniqa\\_pojistovna.jsp](http://www.uniqagroup.com/uniqagroup/cms/eng/group/group_companies/uniqa_pojistovna.jsp)

The Hungarian subsidiary has been part of the group since 2003. It is currently the sixth largest insurance company on the market. As a composite insurer it offers all types of non-life and life insurance products through a sales network of more than 850 agents.<sup>270</sup>

The acquisition of UNITA insurance in Romania has been a large step in the prospectus Romanian market. It is currently the 6<sup>th</sup> largest property insurer with a market share of 7.1%. Hence with this acquisition Uniqa has already met the target market share for markets in this region. The company has roughly 950 employees, and is offering their products to approximately 250,000 customers through a network of agents, branch offices and brokers.<sup>271</sup>

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<sup>270</sup>[http://www.uniqagroup.com/uniqagroup/cms/eng/group/group\\_companies/uniqa\\_biztosito.jsp](http://www.uniqagroup.com/uniqagroup/cms/eng/group/group_companies/uniqa_biztosito.jsp)

<sup>271</sup> Image Report Uniqa 2008, pg. 21

## 5 – Empirical Analysis

In order to provide the necessary information to value the stated hypotheses several interviews were conducted. The people interviewed were all managing officers, or have just recently retired, and hence have large insight into the firm's operation throughout the reviewed region. In total there were five interviews. Two interviews were conducted with representatives from the banking industry (UniCredit Bank Austria and Raiffeisen International), as well as two interviews with representatives from the insurance industry (VIG and Uniqa). In order for the empirical analysis not to be biased towards the view of the private sector, an interview with an official from the Austrian National Bank was also conducted. By adding the view of the regulators, the analysis paints a more realistic picture.

Due to the fact that the financial crisis still has strong effects on the world markets, and in order to get better answers, the people interviewed were made anonymous in order to be able to guarantee that no negative effects would be brought on them. For the further analysis I will use the following names for the interview partners:

- Mr. Smith – UniCredit Bank Austria, recently retired
- Mr. Jones – Raiffeisen International
- Mr. Brooks – VIG
- Mr. Terry – Uniqa
- Mr. Charles – Austrian National Bank

In order to get good results the interview was conducted through open questions in order to give the people interviewed the possibility to give a complete picture of their firm's current situation. This way they were able to express different factors influencing their situation, which are impossible to put into numbers. It also gave the interview partners a possibility to add a different perspective not intended by the interviewer.

The questionnaire on, which the interviews were based on, was in German. Even though this was not essential, since all people interviewed are perfectly capable to hold an interview in English, it was done this way to make the interviewed as comfortable as possible. All interviews were held in Vienna between October 2009

and January 2010, and took from 30 to 60 minutes. Due to the length of these interviews, a transcript would have outdone the length of the thesis itself. For this reason the recorded interviews were only transferred into key points by the interviewer. The German questionnaire reads as follows (translated into English below):

### *Interviewleitfaden*

#### *Region / Umfeld*

- 1. Wie wird sich ihrer Meinung nach das Umfeld der österreichischen Banken und Versicherungen in der Region Osteuropa in den nächsten 3 bis 5 Jahren entwickeln?*
- 2. Wie stehen sie zu der Auffassung, dass Finanzdienstleister die sich primär auf Osteuropa konzentrieren in Zukunft auf Grund der Finanz- und Realwirtschaftskrise in Turbulenzen geraten könnten?*
- 3. In welchen osteuropäischen Ländern sehen sie stärkere Wachstumschancen?*
- 4. Gibt es ihrer Meinung nach Länder die sich bereits an die Werte Westeuropas annähern? Ist es für diese bereits weitentwickelten osteuropäischen Länder möglich, die Werte auch während und nach der Finanzkrise zu halten?*
- 5. In welchen Regionen sehen sie in den nächsten 24 Monaten auf Grund der Finanz- und Realwirtschaftskrise eine große Gefahr eines Wachstumseinbruchs, welcher nicht Währungsbedingt ist? Gibt es Segmente die besonders von der Krise getroffen sind?*

#### *Eigenkapital*

- 6. Welche Eigenkapitalquoten in Relation zu den gesetzlichen Minimalerfordernissen empfinden sie als notwendig um über dem Durchschnitt des Marktes in Osteuropa zu wachsen?*
- 7. In wieweit könnten sich die gesetzlichen Eigenkapitalerfordernisse in der Zukunft ändern?*
- 8. Sehen sie in den nächsten 24 Monaten auf Grund der Realwirtschaftskrise eine weitere Welle an Staats bzw. Entwicklungshilfen um entweder die Finanzwelt der Region zu stützen bzw. die Unternehmen die darin tätig sind?*

#### *Kosten*

- 9. In welchen Märkten und Bereichen sehen sie das größte Potential an Kosteneinsparungen für ihr Unternehmen(z.B. Personal, IT, Vertrieb, Administration, Synergien)? Könnten sich diese auch auf den Handlungsspielraum ihres Unternehmens auswirken?*

#### *Markt & Marktposition*

- 10. In welchen Märkten sehen sie Gefahren, dass die gewonnene Marktposition der österreichischen Banken und Versicherungen in Osteuropa im heutigen Ausmaß nicht gehalten werden kann?*

11. Sehen sie in einem 5 Jahreszeitraum in dieser Region eine konkrete Chance die Marktposition zu erweitern?

### Regulierung

12. Sehen sie mit den neuen Eigenkapital Vorschriften (Basel 2 / Solvency 2) eine stärkere lokale bzw. europaweite Regulierungswelle in Folge der Krise?

13. Wird ihrer Meinung nach in Zukunft stärker reguliert werden oder wird sich mit dem Abklingen der Krise auch das Niveau der Regulierung auf dem heutigen Level einpendeln?

14. In wiefern halten sie eine Umstrukturierung der europäischen Finanz-Regulierungsbehörden für notwendig um einheitliche Spielverhältnisse für alle Marktteilnehmer zu schaffen, und zukünftige Krisen zu vermeiden?

It is divided into the following five sections to be able to provide the information necessary to test the stated hypotheses:

- **Region (H1 / H2)**
  1. How will the surrounding of the Austrian Banks and Insurance companies in the Eastern- European region evolve in the next 3 to 5 years?
  2. Do you believe that Banks or Insurance companies that are currently concentrating on the Eastern-European market are going to face turbulences due to the financial and real- economy crisis?
  3. Which countries currently provide strong growth potential?
  4. In your opinion, are there any countries already getting close to western values? Will these countries be able to maintain that position throughout the crisis?
  5. Do you see a region where there might be another non-currency related turmoil in the next two years that is related to the financial or real economy crisis? Are any segments especially hurt due to the crisis?
- **Equity (H3)**
  6. How much Equity will be necessary in comparison to the regulatory minimums to grow above the market?
  7. How will the equity requirements adapt in the future?
  8. Are there going to be any more rescue packages during the next 24 Months to either stabilize the financial markets or bail out important companies?
- **Cost (H3)**
  9. In which market and company segments do you see the greatest cost-cutting potential (i.e. HR, IT, Sales, Administration, Synergies)? Could this cost cutting also influence the flexibility of your firm?
- **Market Position (H4)**
  10. Do you currently see the dominant market position of the Austrian financial service industry at risk in Eastern Europe?
  11. Do you see an opportunity to enlarge your market position in the region during the next five years?

- **Regulation (H5)**

**12. Concerning the new requirements that have to be met by banks and insurers (Basel 2/Solvency 2) do you see more local or Europe-wide regulation due to the crisis?**

**13. Do you believe that in the future there will be a general trend towards stricter regulation, or will this trend ease again once the current crisis is in the past?**

**14. Do you think that the European regulatory system has to be reformed in order to create a “unified codex” which applies to all market players, and do you think that future crisis scenarios can be prevented this way?**

In the following analysis of the answers provided by the interview partners, the questions and answers were translated into English. This will be followed by a summary of the results for the individual questions.

## **5.1 – Interviews**

### **1. How will the surrounding of the Austrian Banks and Insurance companies in the Eastern- European region evolve in the next 3 to 5 years?**

Mr. Smith from UniCredit Bank Austria replied that the most important thing to keep in mind is that this is not a homogeneous region. Each country has different problems, and is at different levels in their development. While the next barrier for some countries is the Euro, other countries have not even entered the European Union. When for example comparing the ratio of bank assets to the GDP, you can still see enormous potential in the region due to a very low bank penetration. The actions of the ECB and the FED resolved the liquidity crisis, which was a huge problem in the second half of 2008. However, he believes that the biggest write-down's for the institutions are still coming up in 2010 and 2011. The rising unemployment rate is another worry in his eyes.

From Mr. Jones' perspective the problem is very similar to Mr. Smith's view. He also believes that the most important fact is that the region is not homogeneous. Some countries have problems, while others are doing well. Some economies would have also been hit hard despite the crisis. The Ukraine for example is a political nightmare, with a lot of corruption. Hungary was also hit hard, however their problems also do not stem from the crisis, but rather from the soaring deficit. Other countries like the

Czech Republic and Slovakia are doing very well, and our subsidiaries have only showed a small decrease in profits. Although these countries are also going to do well in the future, he believes that there might be a time lag in the NPL ratio. For this reason he also states that the pre crisis levels will only become possible again three to five years from now. However at that point the growth in the region will be stronger than anywhere else in Western Europe.

Mr. Brooks from the Vienna Insurance Group suggested that during 2010 and 2011 all countries of Eastern Europe (although Western-Europe is going to have similar issues) are going to have problems resulting from high unemployment rates. He believes that some factors are going to improve in individual countries, but not region-wide. He sees this situation as an opportunity for the Austrian Financial Service Industry to improve their situation through good customer relationships.

Mr. Terry states that the markets in the CEE region during the next three years are going to be catching up quicker to pre-crisis levels than most western economies. In eastern and southeastern Europe the growth will depend on the debt situation of each economy, since large debt burdens also result in restricting public spending and also slow down growth. Growth will also largely depend on foreign investment from the West, since the state will not be able to provide the capital without having to fear large restrictions by the IMF. Mr. Terry sees this conflict in a lot of economies in the region as for example the Ukraine, Romania, Bulgaria and Hungary.

Mr. Charles from the Austrian National Bank says that in the second half of 2008 the situation was very critical, and that everybody was fantasizing about how the modern financial system is going to collapse. Almost all of the analysts made the mistake of thinking of Eastern Europe as a homogeneous region. The only thing that unites this region, the national bank representative says, is that geographically seen it lies east of us, and not even that is true when looking at Prague. Throughout all countries there are major differences in the political systems, the economic stability and stage of development. He believes that despite all the bad media, the region will remain the growth source of Europe in the long term. After all there is catch up potential in all financial indicators. He believes that the Austrian banks and insurance companies

have a long-term commitment to the region, and that this will also bring them sufficient growth in the future.

**2. Do you believe that Banks or Insurance companies that are currently concentrating on the Eastern-European market are going to face turbulences due to the financial and real- economy crisis?**

Mr. Smith actually believes that the opposite is the case. He states that even though Eastern Europe has definitely felt the consequences of the financial crisis, there is still enormous growth potential in the markets when compared to Western Europe. He also says that these countries are more used to dealing with crisis situations than any other region. The people are easily motivated even in rough times, which in part is a consequence of the enormous catch up potential.

The Raiffeisen representative believes that to a certain degree all banks are facing problems, and that this is not limited to Austrian banks. Also it depends on how a problem is defined, since Raiffeisen International up to date has never recorded a loss neither annually nor quarterly. During the liquidity crisis immediately after the Lehman Brothers collapse, Raiffeisen was having difficulties like everyone else. He also states that if banks default it is mostly due to liquidity reasons, and not due to lacking capital. Eastern Europe has felt the effects of the financial crisis more than any other emerging market, and therefore will also most likely take the longest to recover. However he believes that the region still has enormous catch up potential, and growth opportunities in the long run.

Mr. Brooks believes that all the concerns about the Austrian financial service industry and its involvement in the CEE region also have an economic background from speculators. When comparing Eastern Europe with Western Europe it is clear that the West has bigger problems. Off course the situation is not easy to manage, but relatively speaking they are better off. Especially when taking into account, that the region is far behind in its economical development in comparison to Western Europe. It is important to keep in mind that this region did not get the western banking system into trouble, but rather the other way around. When only looking at the insurance industry everything seems to be pretty calm at the moment. The only country where there are problems are in the Ukraine, but that is the same for all other providers of financial services.

Mr. Terry says that especially during the beginning of the financial crisis, the media switched their impression of the involvement of the Austrian financial service industry from what was at first considered as enormous potential in Eastern Europe into massive negative exposure in the region. Large investors nowadays tend to act more rapidly after negative press statements especially in the U.S., and this might have also been one reason for the over-reaction of the market. However he also mentions, that once new entry possibilities at a reasonable price open up these investors will also re-enter these markets relatively quickly. Additionally he mentions that in general the entire situation is more of a banking than an insurance problem, as for instance in the case of foreign currency loans denominated in Swiss Franks that have caused a lot of problems for Austrian banks. For the insurance industry this crisis also results in lower growth rates, but these will pick up once the situation recovers.

Mr. Charles thinks that currently the involvement of the financial institutions is seen as a risk, whereas in the past it was considered an advantage, but he believes that the media in most cases only tells half the story. Actually the Austrian Banks are highly diversified throughout the region, which should be considered an advantage according to portfolio theory. Swedish banks for example only got involved in the Baltic states, and are now facing much larger problems due to the lack in diversification. Additionally Austrian Banks have specialized on the classic banking business, which does not stem that much risk.

### **3. Which countries currently provide strong growth potential?**

Mr. Smith believes that in general there is still a lot of growth potential in the entire region. Currently there are countries that are more problematic, as for example Rumania, Bulgaria, Hungary and the Ukraine. However these economies will also grow again when the crisis is over, and then most likely at a much faster pace than Western Europe.

Mr. Jones also believes that due to the transformation process there is strong growth potential in the entire region, but investments from abroad will remain necessary. The large volatility in the markets will also remain in the near future. When taking the historical context of the region into account and comparing it to Western Europe this

also seems logical. After World War 2, the Western European nations also were only able to prosper due to the enormous investment from the US, and the last war in the Balkans was only in 1999. Another issue that Mr. Jones wanted to express was that in the future it will be more important for Raiffeisen to serve their current customer base with more products rather than gaining additional market share. Such “wide” customers are also more profitable to the bank, and it is also easier to determine their risk.

The VIG representative believes that there is enormous growth potential in all countries of the region. He mentions that when you compare the insurance density of for instance Bulgaria with Austria you can tell the enormous difference. In Bulgaria the current insurance density is 168 USD per year, whereas in Austria the value is at approximately 3000 USD per year. And that is by far not the end of the scale. Due to this comparison he believes that strong growth is to be expected in the future. The countries have been disturbed in their growth pattern due to the crisis, but when it is over the growth will be far above average. The insurance industry similarly got halted in its growth. It will take a bit longer, but the growth pattern will continue. However the situation will be different from country to country.

Mr. Terry also shares the belief that in the medium to long run all countries of the region have enormous potential due to the lack in insurance penetration. He believes that from the countries under review by this thesis the Czech Republic and Slovakia are the most attractive markets.

Similarly to all other interview partners, Mr. Charles from the Austrian National Bank also thinks that enormous growth opportunities remain in the entire region despite the crisis. He also again urges that the region is heterogeneous, and therefore everything will depend on the country. For some countries like the Ukraine and Romania, he believes that the political situation is very critical and could have an adverse effect on the growth of these economies.

**4. In your opinion, are there any countries already getting close to western values? Will these countries be able to maintain that position throughout the crisis?**

The Bank Austria representative believes that especially the countries surrounding Austria, except for Hungary, are in a good position. Slovakia and the Czech Republic are in comparison to other countries in the region relatively close to western standards, and this will also stay that way throughout the crisis. In Slovakia there unfortunately is one factor that might still disturb this picture, and that is the high influence of the automotive industry on the GDP. If the automotive industry has problems recovering from the recession, this might also put pressure on the Slovak economy.

Mr. Jones smiled when asked this question, and stated that even though some countries got through the crisis quite well there is still a lot of catch up potential when looking at Western Europe. This growth potential is also the reason why they focused their operations on this region.

The VIG representative believes that from the countries under review, the Czech Republic is furthest along. However their insurance density is also just one fifth of Austria, hence there still is a lot of growth potential. In the insurance industry, Mr. Brook states, there is something similar to Maslow's pyramid. In this case the lowest layer are non-life insurance products, as for example motor-vehicle insurance. The following level is related to unfortunate personal situations, as for example accident insurance. The last layer of the "insurance pyramid", are insurance types like life, health and pension plans. These products are aimed at clients that are planning ahead financially. Eastern Europe is still at the first stage of that pyramid, and therefore still has a long way to go.

Mr. Terry states that even though some countries have gotten closer to Western standards they still remain behind. From his opinion the Czech Republic is the furthest along. They currently have a good mix between living standard and national debt, which gives them an advantage to other countries in the region like Hungary. Other than that he also believes that Slovakia has developed fairly well. However similarly to the UniCredit representative he also sees the enormous dependence

from investments in the automotive industry. The country has a big advantage due to the introduction of the Euro, since it is not the target of currency speculations, but if the investments in the auto industry slow down significantly compared to pre-crisis levels it could cause difficulties.

**5. Do you see a region where there might be another non-currency related turmoil in the next two years that is related to the financial or real economy crisis? Are any segments especially hurt due to the crisis?**

When asked this question Mr. Smith at first mentioned what would happen if the Euro was used as a “save haven” for weak economies. Slovakia is one example where the economy gained stability due to the introduction of the Euro. However the next extension of the Euro zone will take a while, since most countries in the current situation are far from being ready to introduce the Euro, and if they were to enter this would destabilize the entire union. All segments of the bank will feel the pressure of credit defaults. One problematic product that was largely caused by Austrian institutions, are foreign currency loans, often denominated in Euros or Swiss Francs. Due to the large currency devaluations and increasing unemployment in the region the repayment of these types of loans became more and more difficult. Other segments currently facing problems are real estate loans and small to medium enterprises.

Mr. Jones also sees some problems in almost all segments. The corporate and retail segments for example were hit really hard due to the crisis, while the treasury department was already doing well again in 2009. The retail segment was hurt specifically, since there are a lot of fix costs in this segment that cannot be reduced when difficulties come up. In general the business activity declined in many segments due to very low to no growth in interest income. He says that some products are hurt more than others. Foreign currency loans are a specific issue. Here the regulators from his perspective are playing the wrong cards, since this product is especially important for house builders. An adaption of the product according to him would make more sense. One example is that in the past these loans were classified due to their loan to value ratio, whereas other factors like the payment rates in comparison to the salary, or whether the person taking the loan also live in the house have higher influence on whether the loan is repaid.

Mr. Brooks believes that the situation is dependent on the individual countries and their governments. It depends whether the state aid has been enough to ensure a working market, and if budget deficits are going to indirectly constrain the growth through additional taxes for example. In general life insurance is going to be hurt more than non-life insurance, since this covers the basic needs of a growing economy as for example motor-vehicle insurance. Mr. Brooks also mentions some additional factors that might have a strong influence on the market. For instance during the crisis there were a lot of people that moved back home from abroad, and hence caused additional consumption. Since their reserves are getting less this might also cause a decline in the non-life segment. The Ukraine has often been in the media for facing a difficult situation, but this is a “bank-problem”, that is largely influenced by political instability. The insurance side of the market is also causing problems, but is comparatively less developed.

From Mr. Terry’s perspective especially countries that have problems with their debt levels will face additional difficulties as for example restrictions by the IMF. Due to this the recovery in these markets will also take longer and become more difficult. However all the people of the region have had more crisis training than Western Europe, and therefore are also more stable in these types of situations. For the insurance industry the crisis has resulted in reduced growth in all segments. In non-life insurance for instance the auto-insurance product showed lower growth due to the low number of new cars being bought. The life insurance segment was hit even harder, since people have a lower saving tendency due to the crisis. They currently need their money to survive rather than to save. The products most brutally hit are equity-linked life insurance policies, which show a strong correlation to the development of the stock indices and the disposable income of an economy, as well as the life insurance policies linked to credits. In this area the insurance industry is also dependent on credit growth, which is difficult when there is no liquidity on the market. Once this liquidity returns this product will also come back on a growth path.

Mr. Charles mentions that 75% of the exposure of the Austrian banks is in EU member countries, and therefore relatively safe. However he once again mentions that some of the countries are politically unstable. Especially when two parties are

campaigning for an upcoming election, as in the case of the Ukraine, they often make populist statements. These statements in a very delicate situation like the current crisis, have an enormous effect on the markets and the payout schedule of the rescue packages. In such times strong governments that are able to push forward the transformation process would be necessary. Unfortunately in a lot of countries in the region that is currently not the case.

#### **6. How much Equity will be necessary in comparison to the regulatory minimums to grow above the market?**

Mr. Smith said that Austrian banks currently have no problems with capital requirements, but the exact amount of equity that is necessary cannot be derived through an equation. It depends very much on the business branches of each institution. He believes that currently the core tier 1 ratio should be greater than 9%, which is the case for most of the competitors even if they used state capital to get to that level. Bank Austria in comparison did not take state money, which is the reason why their core tier 1 ratio currently only is at 7.7%. This will change when they receive 2 billion Euros from the capital expansion of their Italian parent company. Mr. Smith believes that those 9% are also just an assumption by the market, since most banks are currently trying to stay over that level in order to have a competitive advantage. In his eyes the impairment problem is going to be much bigger in the future. This is going to be the case for market members that bought firms very late, and at an expensive price. Since currently they are not able to remain within their budgets, they will eventually have to write down their participation in these subsidiaries. In total it is important not to have a certain amount of equity, but relatively more than the other market players. If that is not the case the company's financing costs are going to rise, since they are going to be regarded as more risky than the competition.

Mr. Jones has a slightly different perspective on this matter than the UniCredit Bank Austria representative. Mr. Jones says that there are currently a lot of discussions going on about the topic, and that many things are still unclear. He also believes that the core tier 1 ratio will rise, but he sees it between 6-7%, and that Raiffeisen International with its current core tier 1 ratio of 8% should be well off.

The VIG representative believes that the equity requirements set by the regulators will have to be met, but otherwise this should not be a concern. Solvency 2 on the other hand can become difficult for Austrian insurers, since it is highly influenced by the strategy of large international insurance companies.

Mr. Terry similarly to the VIG representative states that the current system is actually fine, and he also forecasts possible threats to the Austrian insurance industry due to Solvency 2. He believes that this new regulation is an over-reaction from the regulators due to populist statements by politicians. Too many factors at the moment are still unclear to make assumptions about the future capital requirements.

Mr. Charles thinks that it is important to distinguish between the regulatory requirements, and the expectations of the market. The regulatory requirements, especially the tier1 capital ratio will probably be increased. However it is much more important for the Austrian banks to have an equity ratio, which is higher than the competition. This way they would send out a positive signal to the capital markets, and thereby reduce their refinancing costs.

## **7. How will the equity requirements adapt in the future?**

Mr. Smith believes that the equity requirements are going to rise in general, and that this increase will also remain throughout the crisis. He specifically believes that certain types of loans will have to be covered by different amounts of equity. For example he believes that when banks do business for their own books in the future it will have to be covered by 100% equity in order to shut down that part of the business. This would contain one of the reasons for the crisis, because if banks had not been able to trade for their own books, the high volumes would have not been possible.

From Mr. Jones' perspective several changes in the regulatory system will occur in the near future. The requested core tier 1 ratio will rise to somewhere between 6-8%. Another indicator that might become part of the regulation is the leverage ratio. However he believes that all these changes only make sense if they are done globally. If the system is only going to change on the European market, this would subsequently bring comparative advantages to the US and Asia. The real problem

from his perspective is not the over-regulated banking market, but the unregulated segments like the hedge fund market.

Mr. Brooks believes that this factor is critical to the development of the entire insurance market. He believes that the requirements should not be adapted in a way, that only large multinational insurers are able to follow them. Everything is also very dependent on who conducts the analysis of the region. He believes that this is very critical, since outsiders taking the region under review have failed in the past. One thing not to forget is the fact that many Eastern European countries have comparatively low debt ratios. Romania's debt ratio for example is below 50%, while Austria's currently is around 80%.

The Uniqa representative sees harsh times ahead for the industry, since regulators are going to ask for more capital from the insurance companies even though their business volume has not changed. It is also hard for him to imagine where that additional capital should come from. He states that if the regulation changes as drastically as currently displayed there would be an additional demand for capital from banks and insurance companies of approximately 700 million Euros. The big question is where should that capital come from. The firms would be asking for huge amounts of additional capital without having expanded their business. For this reason the only way to be able to get that kind of capital in one step would be to sell far below value, and thereby probably harm the companies even more. From his perspective it would be necessary to base the capital requirements on the industry the company is in, and the business model, which varies a lot between banks and insurance companies. One way to make this process acceptable for the insurance industry would be to increase the time-span. Such an increase in capital base cannot be achieved over night in a small equity market like Europe. If the regulators would give insurance companies a time frame of five years, which is similar to an approach taken in the Swiss insurance industry, it would make the switch in regulation more reasonable.

Mr. Charles currently sees a development towards higher equity requirements, but the details still remain unknown due to the large differences in the regulatory systems around the globe. Especially the differences between the US and European

accounting systems are hard to overcome. Mr. Charles also believes that by only increasing equity requirements, future crises cannot be prevented. According to him it would be important to split up certain banks that became too big, and therefore have large influence on the entire system. If these huge conglomerates were split up it would be easier to let one part of the firm file for bankruptcy in difficult times, instead of having to worry about the future of the entire conglomerate, and thereby in some cases even the stability of the entire system.

**8. Are there going to be any more rescue packages during the next 24 Months to either stabilize the financial markets or bail out important companies?**

Mr. Smith believes that the current rescue packages already took their effect to ease the situation, and that these should be sufficient. The trust has been rebuilt, and there is enough liquidity on the market. However the banks that took the bail out money will try to repay it quickly, since it is expensive in most cases. If the situation were to get worse, there is enough capital available from supranational institutions like the IMF. However he also sees the current situation as a missed opportunity for the EU. If there would have been a quick European solution, Europe could have manifested itself as crisis stable in comparison to the US. Even though all of the packages offered by the individual countries are similar, there are minor differences. For example he mentions his frustration that the Austrian participation capital model was continuously adapted. When Bank Austria wanted to file for the participation capital, the government suddenly wanted a conversion right, which it did not regard as necessary for the other banks. Mr. Smith believes that this was an advantage granted to the local banks.

From the point of view of the Raiffeisen International representative there is of course the possibility that other rescue package will become necessary, however he also believes that due to the help provided by the EU and the IMF, the situation is relatively safe and no country will have to default. Currently the situation might turn out to be a W-type recession, and that therefore the adaptation in the regulation, specifically concerning the core tier 1 ratio has to be done at the right time in order not to upset growth. Growth is the most important factor for getting out of a crisis, and comparatively has a much larger effect on the deficit than cutting down public spending. He mentions that for instance the big administrative reform in Austria,

which has been planned for more than 20 years, would bring the government 3 billion Euros, while 0.5% more growth would have the same result. Off course it is important to raise the equity requirements, also considering that it is a clear G-20 goal for 2012. The timing however is crucial, since it might end up in an artificial prolongation of the crisis. For that reason the time horizon of this process might have to be adapted.

The VIG representative believes that increasing unemployment is going to be the major priority of Eastern European governments in the next two years. However he also believes that the current rescue packages are going to be enough to keep the markets stable, but the governments should be aware of the risks that come along with a high debt balance. The insurance industry itself will not need any state aid, as it has not done so far.

Mr. Terry believes that in several economies further east than the CEE region with the exception of Hungary, some help packages might still be necessary. However this international help would also give the governments less flexibility, since they would have to follow strict rules given by the IMF. Growth in countries like Romania, Hungary or the Ukraine will be more dependent on the capital from foreign investors. Unfortunately these investors will only return to the markets if there are reasonably priced acquisition possibilities, and that is currently not the case. Many that invested just before the crisis are currently not exiting with losses, but would rather wait for times to change.

Mr. Charles believes that the current stimulus packages should be enough, since the risk appetite of the market members has already increased, and thereby caused a recovery. Unfortunately in times of a crisis a country can also have problems financing their debt, which is also partially due to the large stimulus packages. New rescue packages would also not be a problem according to Mr. Charles. He said that the IMF, similarly to the other super-national institutions, has bolstered up its capital base to withstand shocks like that. Even though it still remains a fragile situation, Mr. Charles believes that the current rescue packages and the commitment of the banks will be enough to stabilize the markets.

**9. In which market and company segments do you see the greatest cost-cutting potential (i.e. HR, IT, Sales, Administration, Synergies)? Could this cost cutting also influence the flexibility of your firm?**

Mr. Smith states that even though cost cutting is going to play a role in the future, Bank Austria will remain a universal bank in the Eastern European region offering products in all segments. The effects will however be felt in the outlet expansion program, which was put on hold until further notice. Originally the plan was to create 1000 additional outlets in the region. Additionally the firm is currently reducing employees, especially in Eastern Europe. However even though it is necessary to cut costs in the current situation, Bank Austria still expects a positive result in the first six months of 2009.

Cost cutting in the eyes of Mr. Jones currently is a very important topic. Raiffeisen International is trying to cut costs wherever it can. By keeping the costs below the budget constraint they were able to push the results during the last period. The biggest cost cutting measurements were in the retail segment, especially by decreasing the number of employees. For Mr. Jones' the best example is the Ukrainian subsidiary. Raiffeisen International bought a former soviet bank, and naturally there were too many employees for the job that was done. This problem occurs in a lot of the former-communist countries, and hence the number of employees can be reduced without losing quality. In total Mr. Jones believes that the factors, which limit the possibilities of a bank are the market and capital rather than the areas where costs are currently cut. Hence the bank should not lose any flexibility due to cost cutting.

Mr. Brooks states that the highest potential for cost cutting is in the administration. The firm is currently running a 100 million Euro cost-cutting program, that is focused on the improvement of back-office processes. However he does not believe that this is going to have any influence on the opportunities of the company.

Mr. Terry sees the biggest cost cutting potential in the smaller markets in Eastern Europe. He believes that there is a lot of potential in the area of cross border services if focused on areas that are not highly populated. This centralization process of the rural areas cuts down a lot of back office costs for Uniqa. Additionally he mentions

that the population in these areas is also highly educated, and would work for relatively low wages if they were not forced to move to the West or other financial centers where living costs are significantly higher. Despite all these possibilities these cost-cutting programs do not work over night. The effort today is to switch fixed into variable costs in order to be able to react better in a crisis.

**10. Do you currently see the dominant market position of the Austrian financial service industry at risk in Eastern Europe?**

The Bank Austria representative said that due to relatively large barriers to entry the Austrian position in the region is pretty safe. They have gained significant market share, which will also remain due to synergy effects and the opening of new outlets. For Bank Austria he sees advantages in comparison to other Austrian Banks. For example they standardized the brand, and their IT operations to reduce costs, whereas Erste Bank for example does not have a unified brand in Eastern Europe.

Mr. Jones says that overall he believes the Austrian institutions will be able to hold their current market position in the region, but there are going to be some markets where that is not going to be the case. In Rumania and all countries surrounding Austria this should not be a problem, but specifically in the CIS region he sees some issues. He believes that if a bank were to concentrate on that specific region it would become a Russian bank, which could be a problem due to the enormous size of the market. Additionally this would result in an unbalanced portfolio, and in respect to the current crisis this could not be considered a positive development.

The VIG representative believes that the market has already been divided, and therefore a new market entry will be difficult and expensive for outsiders. However with the current crisis it is possible. From his perspective the market position of the Austrian companies in the region will not change drastically due to the crisis.

Mr. Terry similarly to the other interview partners believes that the market position in Eastern Europe is not going to change. He thinks that unless Western European or U.S. funds take a stake in an Austrian holding company, as in the case of Bank Austria, the situation is going to remain unchanged. That currently seems unlikely, but if the crisis blooms up for a second time or the equity expectations from the

regulators continue to rise, the situation could become more critical. Nevertheless with the current expectations of a recovery this should not become an issue.

Mr. Charles also shares the belief that there are significant barriers to entry especially in the retail segment. He however forecasts lower profits in the future. The success of the individual firms will depend on how successful their business models are. If it is successful there is also no need to change anything. However he also mentions the fact that most of these firms run on different strategies, and therefore their results will also vary. Although he currently sees no equity problems in the industry, additional difficulties in the markets that cause a deterioration of the credit portfolio might make international partners a welcome source of capital.

**11. Do you see an opportunity to enlarge your market position in the region during the next five years?**

Mr. Smith thinks that it is possible that an M&A wave might happen due to the crisis. However he believes that it will still be difficult for outsiders to enter the market, due to the large market shares of the current players. Another reason why expanding their operations might become difficult, is that the competitors that bought firms on the market during the booming period, bought at high prices. Due to this they are currently not able to sell off these subsidiaries at a profit. This also to a certain degree is a reason for the enormous demand for equity. All market members want to be well capitalized in order to be able to use good acquisition possibilities, but these might come at a price.

Mr. Jones believes that in the current situation growth in market share is only relatively important. It is much more important to connect with the current customers, and sell them more products. He believes that this will create more profitable customers, and that their risk will be easier to determine. One possible source of growth for Raiffeisen International is the close cooperation with Uniqa. Through their bancassurance agreement, Raiffeisen is also able to profit from the underdeveloped insurance market in Eastern Europe.

The VIG representative once again mentioned that this is different in every country of the region. In some countries like the Czech Republic and Slovakia the group is not

able to expand anymore, since it is already at the border of the EU competitive market regulation. Even though VIG would definitely be interested in good takeover opportunities, in some countries like Rumania and Bulgaria there are currently no real acquisition opportunities. In other words Mr. Brooks does not necessarily believe in an M&A wave due to the crisis. The goal of the group will be to grow organically rather than through acquisitions.

Mr. Terry sees a general trend during the next three to five years towards organic growth. He believes that this way the companies can also realize growth in market share, since market shares in these emerging markets are not frozen like in Western developed economies. He also mentions that even if Uniqa was looking for acquisition possibilities, there are currently no realistic ones on the market. People are still expecting high prices, even though the foreign buyers are only willing to buy at low ones. Additionally there is the factor that due to the new high equity requirements, investors have become more careful with acquisitions.

**12. Concerning the new requirements that have to be met by banks and insurers (Basel 2/Solvency 2) do you see more local or Europe-wide regulation due to the crisis?**

Mr. Smith thinks that it would be better to have European guidelines, but currently this seems highly unlikely. There are a large number of national guidelines that just got put into place, and therefore it is going to be hard to make a set of rules that guides the entire region. However Mr. Smith thinks that this crisis should also be seen as an opportunity to reform the regulatory system, in order to improve it for future crises.

Mr. Jones has a similar point of view to the Bank Austria representative. He thinks that European wide regulations would be better for the system, and would save a lot of costs. Considering that the individual national banks would have to give up some of their rights this currently seems very unlikely.

Mr. Brooks believes that the Austrian system is already very good, and that there are too many things still unclear with Solvency 2. He believes that it would be important to take the situation of each insurer into consideration. One fact that specifically worries him is that the definition of equity capital still is unclear. It also is still unknown

whether, or to what degree, hybrid capital can be considered as equity. Another factor is whether the group as a whole has to meet the equity requirements or each subsidiary by itself. He states that in general the equity requirements definitely should go up, but the regulators also have to keep the current situation in mind. If they put the equity requirements too high, they could do more harm than good. Mr. Brooks believes that the politicians and the IFRS board are lacking the understanding for the current situation of some companies.

Mr. Terry sees a development towards more European regulation, which from his perspective is not bad if it would concern the coordination process. However he believes that if the EU tries to increase the equity requirements too much, this could cause a lot of problems for the development of the region, and pro-long a recovery.

Mr. Charles sees a strong tendency towards a more European regulation with independent authorities. As an example he mentions the current discussions about a banking and insurance authority. He also mentions that it is important for the European regulators to act quickly, since some countries are only cooperative for a certain timeframe. He sees this as an important step for the European financial system. In his eyes it is necessary to regulate on an international level when the market players are also acting and thinking on an international basis. The only problem that he sees is that such a system could probably not be created with the current EU constitution, and therefore it might take some time to develop. Currently there is a compromise, where the members of the regulating authority meet and discuss the issues with the corporations operating in their country. For this reason Mr. Charles believes that the current system should differentiate between regional and international banks, and that the execution should for now remain at a regional level.

**13. Do you believe that in the future there will be a general trend towards stricter regulation, or will this trend ease again once the current crisis is in the past?**

Mr. Smith believes that there is generally going to be stricter regulation beyond the crisis. The core tier 1 ratio requirements for example are definitely going to be raised. From his point of view there is also no reason why that should change after

the crisis. However he again mentions that the important part for a bank is not to meet the requirements in absolute terms, but to have a relative advantage over the competition.

Mr. Jones thinks that stricter regulation definitely makes sense, especially in the current situation. After all the system should learn from its history. However he believes that if this stricter regulation is brought about at the wrong time it might have a very negative effect. The worst thing that could happen would be that through this new regulation the growth is slowed down, and that the recovery would therefore take longer. He also mentions that currently there are big discussions about how to change the system, and that not everything turns out as presented by the media.

Mr. Brooks says that there is definitely a trend towards stricter regulation. However he does not believe that it is going to be as strict as often stated from the press. Nevertheless this stricter regulation will also remain after the crisis. Warning systems, as for example stress tests will become more important, since the goal must be to prevent such an event.

The interview partner from Uniqa said that the regulators are still acting in a state of shock, which was caused by the strong accusations from politicians. Now they are trying to avoid these situations in the future via large capital requirements. Unfortunately this also causes several problems. For example the foreign investment is becoming lower, and this is necessary for the growth of the region. If these strict capital requirements are put into place, they also most likely are going to stay, which makes it even more important to formulate them exactly. From his perspective this over-regulated environment is going to have negative effects on the business over the next decade. Due to the fact this entire situation is highly influenced by populist political statements, the trend will also not be easily reversed.

Mr. Charles states that most certainly if stricter regulations are put into place they will also remain there. Another factor that definitely hints towards stricter regulation that will also remain after the crisis, are the beliefs of the G-20 members. They agreed that in the future there will be stricter regulations for the financial systems. However

they also said that they do not necessarily want to cause an over-regulated environment, but rather a better system.

**14. Do you think that the European regulatory system has to be reformed in order to create a “unified codex” which applies to all market players, and do you think that future crisis scenarios can be prevented this way?**

Mr. Smith thinks that there will always be a future crisis even though this one has definitely been above average. He believes that this crisis is an opportunity for the regulators to improve the system. The regulatory system should be conducted centrally in order to recognize risks earlier. This would not prevent a crisis from happening, but it could deal better with the consequences. If the crisis had not happened, there would have also been no incentive to improve the system, which could have later on resulted in even bigger problems.

Mr. Jones definitely sees himself on the pro side of this argument. A new regulation with the same set of rules for everyone would save a lot of money. Unfortunately most national banks believe that it is better to regulate locally, and that their competence to judge the economic situation of their country is better than of a European authority. For this reason he believes that even though it is a great idea, such a European authority will lack the necessary competences to actually make a difference.

According to the VIG representative this has already become more than necessary. It would be important to form European criteria and guidelines that have to be followed by the companies. For instance the regulators at the headquarters of a company should play an important role, and also an assisting role in all countries where the company has subsidiaries. However he also mentions that new regulation alone cannot prevent another crisis from happening. Through new criteria and rules companies can be made more stable in shock situations, but trying to do more than that would be counterproductive. Rather than tightening the standards for firms even more, a European rating agency should be created. This way there would finally be the possibility to receive ratings from experts that actually understand the region.

Mr. Terry believes that a unified regulation, especially for the coordination process, would be something good. However if the EU simply tries to take responsibilities from the local national banks and move them to Brussels or another financial center, this will not be successful. They should focus on the coordination process. In the U.S. for example the authorities are also not all unified. Mr. Terry believes that making the entire process too strict would result in a disadvantage in terms of flexibility for Europe.

Mr. Charles thinks that a united European regulatory system would definitely benefit the market. One thing it would definitely do is reducing the regulatory arbitrage. The only problem is that such steps have to be coordinated globally, because otherwise the EU would have a disadvantage to other financial centers.

## 5.2 – Results

### **Question 1:**

Both Banking representatives share the view that the region is completely heterogeneous, and therefore the problems lie in different areas for each country. Unfortunately they also forecast another downturn.

The insurance representatives believe that the recovery process in the region will be quicker than in Western Europe. However they mention that this varies from country to country. The interview partner from Uniqa specifically mentions that the amount of foreign investment is critical for the development of the region.

The national bank representative similarly to all other interview partners believes that the region is not homogeneous. There are large differences in the development of the individual countries, but Eastern Europe will remain the growth source of the European continent.

### **Question 2:**

Both interview partners from the banking industry believe that there is still enormous catch up potential in Eastern Europe, and that the region will also play a large role in the future. However both of them mention that the industry has most certainly faced difficulties due to the economic crisis, especially following the collapse of Lehman Brothers.

The interview partners from the insurance side believe that the large volatility on the markets is caused by the behavior of speculators. These nowadays tend to move more rapidly due to messages of the media. The VIG representative additionally mentions that the crisis originated in the west and then moved eastwards, and not the other way around.

The national bank representative believes that the Austrian financial institutions are highly diversified, and therefore in a relatively safe position according to theory.

**Question 3:**

All interview partners for this question shared the same belief. They see large catch up potential in the entire region, but the situation varies for each country and is dependent on the amount of foreign investment.

**Question 4:**

All interview partners share the belief that the countries surrounding Austria are the furthest along, specifically the Czech Republic. However they also mention that there still is a significant gap to western levels, and therefore not even these economies can be considered developed markets.

**Question 5:**

Both banking representatives agree that there are problems in all product segments, but foreign currency loans have so far been the biggest issue. Another factor mentioned by the Bank Austria representative is that the Euro despite seeming like a safe haven against currency volatility should not be used as such, since it would risk the stability of all other Euro countries.

Both interview partners from the insurance side similarly see problems in all product segments, but both agree that the life insurance side has been more affected. Both also believe that the situation is dependent on the country. The Uniqa representative additionally mentions that countries under restrictions by the IMF will take longer to recover due to stricter regulation.

The national bank representative sees the biggest issue in political instability. He believes that an unstable government, or populist statements by politicians can have a big effect on the future development of the country. Despite that he sees Austrian financial institutions to be safe, since most of their operations are in EU countries.

**Question 6:**

Both banking representatives believe that currently the capitalization is not a problem for the Austrian institutions. They also believe that the core tier 1 ratio will be raised due to the financial crisis, but they have different thoughts on how much. While the Bank Austria representative believes that it will have to be around 9%, the Raiffeisen International representative believes that it will be between 6-7%.

The interview partners from VIG and Uniqa both believe that currently there are no issues for Austrian insurers concerning the solvency ratio, but Solvency 2 might be problematic. They both believe that it is largely influenced by large multi national insurers, and therefore will be difficult for others to fulfill.

The national bank representative thinks that it is most important to differentiate between the regulatory and the market requirements, since these often play a larger role for banks.

**Question 7:**

All interview partners believe that the equity requirements will rise, and that this will also remain after the crisis. However it is still unclear how the new regulation will look, and therefore the interview partners mentioned that it is important to create a global set of rules that applies to everyone and does not only consider the interests of a few. One interesting fact mentioned by the Uniqa representative is that he does not see where all the additional capital should come from with a relatively small equity market in continental Europe.

**Question 8:**

While the Bank Austria, the VIG and the Austrian National Bank representative believe that the current help packages should be enough, the Raiffeisen International and the Uniqa representative still see difficult times in the future. Despite the fact that

they have different beliefs concerning the necessity of a new help-package, they all believe that there are more than enough funds to conduct such a package if it becomes necessary. The Raiffeisen International and the Uniqa representative however also believe that such additional help packages will also cause additional regulation, which will hinder the growth opportunities of these countries.

**Question 9:**

Cost cutting plays a similar role amongst all interview partners. All companies are currently running cost cutting programs that specifically focus on the efficiency of back office processes. Despite the fact that all are trying to improve the performance through cost cutting, none of them believe that this is going to affect the flexibility of their companies.

**Question 10:**

All interview partners believe that the market position of the Austrian financial service industry in the region is going to remain the way it is throughout the crisis. They believe that there are significant barriers to entry in these markets and therefore they see their market position as relatively safe. The only option for an external player to enter the market according to the Uniqa representative is to take a stake in an Austrian holding company, since an entry in the Eastern European markets seems close to impossible.

**Question 11:**

The interview partners all shared the thought that the future goal will be to grow organically rather than through acquisitions. However this is not the case because the companies are not interested in acquiring competitors as the VIG representative mentioned. He states that currently there are basically no opportunities on the market, since most of the potential sellers bought shortly before the crisis. For this reason the price expectations are still too high, but if that factor changes it might trigger an M&A wave in the region.

**Question 12:**

All interview partners share the belief that there is a trend towards European guidelines, which is a good development if implemented correctly. However they also

believe that such developments are very difficult on a European level, because all individual countries have their own interests and that will ultimately slow down the process according to the banking industry representatives. The interview partners from the insurance side see different problems due to the new regulation. They believe that an over-regulated environment as it is currently planned, will in the medium to long run do more harm than good. The national bank representative additionally is worried that if the EU does not act quickly on the reformation of the regulatory system the window of opportunity might close due to a recovery.

**Question 13:**

All interview partners believe that there will be stricter regulation due to the crisis, and that once it is in place it will also remain. However they also believe that the timing for this reformation process is critical. It could possibly have a severe effect on the growth opportunities of the region, and thereby prolong a recovery.

**Question 14:**

All interview partners favor a new European regulatory system. They believe that after a crisis like the current one, a reformation of the regulatory system is a logical step. However they also believe that it currently seems unlikely. The power of local national banks is still very high, and these will probably block any progress that might change this. Additionally they also mention that additional restrictions to the financial markets can only be done globally, since otherwise it would cause a comparative disadvantage for the EU. They believe that an adaption of the old system is necessary, since it has proven to be inefficient. However an over-reaction of the regulators from their perspective might be problematic. On the one hand it could cause a disadvantage for the entire EU in comparison to other financial centers. On the other hand they also believe that new crises will always happen and cannot be prevented. The only thing that should be done is to make the individual companies more stable in critical situations.

## 6 – Conclusion and Outlook

The following section will at first provide answers to the research questions followed by a test of the hypotheses stated in Chapter 1. The conclusions were drawn from the information provided by the interview partners during the empirical analysis. This will provide the reader with an overview of the current situation of the Austrian financial institutions as well as an outlook according to the views of managing directors in the individual firms.

The research questions were the following:

- What influence will the large involvement in the Eastern European market have on the Austrian financial institutions?

According to the answers provided by the interview partners the Austrian financial service industry should not have difficulties in the region due to the effects of the financial crisis. Actually the broad diversification of the Austrian banks and insurance companies throughout the region provide them with additional stability if a shock were to occur in one of the countries. All of them shared the perspective that the crisis originated in the West, and that the media miss this fact a lot of the time. The region has of course felt the consequences of the financial crisis, but it is still not in such a bad condition. Another important factor that stood out during the interviews is that the region is heterogeneous. For this reason the region in total is unproblematic, but while some countries like the Czech Republic, which is considered to be the furthest along in their development, are well off others like Hungary are facing enormous difficulties. Nevertheless the recovery throughout the region should start earlier and at a higher pace than in the Western world. Due to the enormous catch up potential it will therefore reach pre-crisis levels quicker. However none of them believe that the crisis is already over. There is still a lot of factors that can severely harm the future economic development of the region, as for instance political instability and over-regulation. For this reason the interview partners are also split up on whether there will be an additional wave of rescue packages. Fortunately all of them are certain that the funds for such actions would be available, whether they are necessary or not.

- How will their Equity have to adapt due to the crisis?

A general increase in equity requirements that will also remain after the crisis is to be expected by the entire financial service industry. For banks the core tier 1 capital ratio is going to be the biggest concern. The interview partners expect it to rise to somewhere between 6.5-9%. Another question is how much equity will be necessary to operate in which segment. A lot of factors currently remain unclear, since the reformation of the regulation is only at the start. This is even more the case in the insurance industry. Both of the interview partners stated that they were still very uncertain on what effect the new regulation will have on their business. Despite all of these uncertainties in the regulation, all of the interview partners including the Austrian National Bank representative believe that it is most important to look at the equity levels in comparison to the competition. On the current volatile and extremely sensitive markets it is important to remain at a relatively higher equity level than the competitors in order to keep a comparative advantage.

- How influential are cost-cutting programs going to be on development and flexibility?

Despite the fact that cost-cutting programs are the headlines of most newspapers, they will most likely not have a lot of influence on the development of the reviewed companies. All of them have programs running that are mostly focused on reducing back-office costs, but all interview partners stated that this will have little influence on the opportunities undertaken by the institutes. Increasing efficiency will however remain at the top of the agenda, specifically concerning the fact that the new regulation might make it difficult to perform in the current situation.

- How will the strong market position of the Austrian financial institutions develop?

All of the interview partners believe that they are going to remain in their current market positions if not expand them. They believe that the Austrian banks and insurance companies operating in the region entered the market early enough to get a substantial market share. Through this development, which already began before the fall of the iron curtain, significant barriers to entry were created. Due to these barriers all interview partners including the national bank representative believe that the market position will remain untouched throughout the crisis. Due to their large

market shares they might even be able to grow despite the fact that there are currently almost no acquisition possibilities on the market. Since market shares tend to show more movement in emerging markets than in developed economies, a growth in market share can also be caused by organic growth, which will most likely be the main goal for most institutes operating in the region.

- What role will financial regulation play in the future?

The adaptations in regulation are most likely going to have the largest influence on the future development of the Austrian financial service industry. All interview partners see the financial crisis as a window of opportunity for the regulators, but these would have to act quickly. The individual national banks are only going to be willing to pass part of their power to a European authority when times are bad. Once the recovery starts they will most likely start to focus on their individual interests again. A step towards a European set of regulations would be positive but only if implemented correctly, and this is where most of the interview partners see the problem. The interview partners from the insurance side showed special concern about the new regulation (Solvency 2), since they think that it is strongly biased towards the interests of a few large multi-national insurers. If that is the case they feel that an adaptation in the regulation might not be a good step. Nevertheless both the banking and the insurance side think that the financial world will have to learn a lesson from the current crisis. The only question that remains is at what point. According to them the timing of this process is crucial to the future development of the region. They believe that an over-regulated environment will possibly harm growth opportunities, and in the end the new guidelines could therefore do more harm than good without good timing. Overall they believe that it is time for adaptations in this area, but due to the already mentioned issues it seems unlikely. On the one hand there are powerful national banks that follow the goals of their country, and on the other such switches in regulation would have to be done globally. Otherwise it could cause a severe disadvantage for the EU in comparison to the United States and Asia. After all none of them believe that future crises can be prevented by stricter regulation and that should also not be the goal of the regulators. New and stricter regulation in its best form can make companies more stable, but trying to prevent a future crisis through this method would harm economic growth severely.

These research questions led to the following hypotheses:

*H1: The large involvement of Austrian financial institutions in the Eastern European market bears substantial risks for the Austrian banking and insurance industry.*

As one can tell from the answer of the first research question, there is not one interview partner that shared the beliefs of some correspondents of the international press. They all see the Austrian financial service industry as being highly diversified in a very heterogeneous region, and therefore hypothesis 1 is proven to be false.

*H2: The countries of the region have enormous differences and therefore cannot be considered a homogeneous region.*

While the media was considering the risk of the entire region, all of the interview partners considered the problems of the individual countries. According to them it makes an enormous in which one of the reviewed countries a bank or insurance is operating in. There is also considerable difference between the banking and insurance industry, which is often combined by the press as the financial service sector. For instance while the Ukraine is currently a difficult country for banks the insurance density still is at a very low level, and therefore makes it less problematic in their portfolio. Due to the enormous differences between the countries and the sectors of the financial service industry this hypothesis has proven to be true.

*H3: The institutions will have trouble coming up with the necessary equity that will be demanded by the regulators, and therefore their room for expansion will be minimal.*

This hypothesis showed different results for many of the interview partners. Some believed that their current equity ratios will be sufficient to deal with any problems still ahead, while others believed that these will still have to be increased. Due to this difference in the judgment of the capital situation of Austrian financial institutions there was also a difference in the beliefs on whether the capital resources on the European market will be able to match the increased demand due to new regulation. The uncertainties considering the new financial regulation where a specific issue for the judgment of the situation. Due to these uncertainties the hypothesis has only proven to be partially true. Additionally it seems as if the limited possibilities in the expansion process are caused by the lack of reasonable acquisition possibilities on the market.

*H4: The current market position of Austrian financial institutions in the region will remain after the crisis.*

All interview partners gave similar answers to the questions asked about this area. All of them believe that the Austrian financial service industry will remain at its leading position in the region. Parts of the reason are large barriers to entry that were built up after their early entry into the markets of the region. Due to their dominant position it is close to impossible for newcomers to successfully enter the market and gain significant market share. For this reason this hypothesis has proven to be true.

*H5: Regulation will become a lot stricter and have a negative influence on growth.*

All interview partners share the thought that the financial regulation is going to become stricter due to the financial crisis. The banking side of the interview partners believes that their capital should be sufficient to meet any new regulation, while the insurance side sees difficulties with the new system. The negative outlook on growth due to the stricter regulation is however only confirmed by the insurance side of the interview partners, while the banking side still sees sufficient growth in the future. However there is still large uncertainty on how the system is effectively going to change. Many definitions still remain unclear, which makes it hard for the managers of these corporations to forecast the future development. The most important factor however came from the national bank representative. He pointed out that the system is only going to change significantly if the regulators use the window of opportunity. Therefore due to the large uncertainties considering the development of the regulation this hypothesis can only be considered partially true.

The outlook in terms of growth for the region seems relatively stable. Some countries are going to witness problems, while others recover faster. From the countries under review by this thesis the Ukraine and Hungary have proven to be most problematic. However their problems stem from different reasons than the financial crisis. The public indebtedness of Hungary already was an issue prior to fall 2008 and just got intensified through the liquidity crisis. The problems in the Ukraine mostly stem from the political instability. Without a clear direction from the government it becomes severely difficult for an economy to recover from a crisis. Fortunately for these two economies they were rescued by the IMF. Due to the membership in the European Union the situation was not as difficult for Hungary as it was for the Ukraine. However

both of them will have to follow the strict rules set up by these institutions. If they do not comply the financial aid process is stopped, and therefore their flexibility in policy will be limited in the future.

The Austrian banks and insurance companies under review by this thesis have so far not shown big problems. Most certainly their profit margins declined, but in contrast to the common belief presented by the media they did not come close to a collapse. They felt the effects of the financial crisis, specifically following the collapse of Lehman Brothers, but due to their diversified portfolio throughout the region their business has remained relatively stable.

The reason why the general outlook on the banking and insurance sector can be regarded as slightly negative is the uncertainty that lies in the new regulation. At the moment nobody is 100% certain on how the new regulations (Basel 2 and Solvency 2) are going to affect their business. The definition of equity itself is one of the most problematic issues. The classification of equity classes as for instance to what extent hybrid capital can be accounted as such makes an enormous difference on the future opportunities of the industry. Some areas of business might become extinct due to the new regulation, but none are going to remain untouched. The interview partner from Bank Austria for instance mentioned that he believes that banks will probably not be able to trade on their own books in the future, which would ultimately change the current business model. Additionally new taxes are to be expected either on a European wide or individual country basis. All together it draws a grim picture on the growth possibilities of the industry. The question that causes the most uncertainty is whether the new regulation will throw the European continent or the Eastern European region back into a recession, or as a matter of fact whether such new regulation will actually be effective. The national bank representative was specifically worried that new regulation has to be implemented fast in order for it to be effective. The focus on their own interests of the individual national banks will return once the recession eases, and therefore a change in the regulatory system will become very difficult.

In total the future development of the Austrian banks and insurance companies will not be as much dependent on the development of the countries under review, but

rather on the development of the financial regulation. Due to the diversified portfolio of the companies, difficulties in some countries are balanced out by outperformance in others. European regulation on the other hand cannot be avoided as easily. Stricter regulation might cause restructuring in some firms, while others are going to remain relatively unchanged. However it is going to play a key role on the development of the financial service industry globally. Austrian banks and insurance companies therefore will have to adapt their current business models to the new regulation, which might cause difficulties and limit the room for an expansion process, but if this is done successfully the future of the industry should remain a success story.

## 7 – Executive Summary

The Austrian financial service industry due to the financial crisis has often been projected to be at risk by the media. Especially after the collapse of Lehman Brothers in the fall of 2008 the entire banking world faced the biggest liquidity crisis in its history. It was also at this point that the financial crisis swept over to Eastern Europe. At that time all Austrian banks and insurance companies were projected to be highly risky due to their exposure in these Eastern European markets. The reasoning behind that implication was often vague and directed at the entire Eastern European region rather than focusing on the problems of individual countries. This thesis is therefore supposed to show a more differentiated view of the risks and opportunities that the Austrian banks and insurance companies are currently facing in Eastern Europe due to the financial crisis.

The countries under review by this thesis are the Czech Republic, Slovakia and Hungary in the Central Eastern Europe (CEE) region; Bulgaria and Romania in the Southeastern European region, and the Ukraine as part of the Conglomerate of Independent States (CIS). This selection to a certain extent also represents the historic development of the Austrian financial service industry. The companies started expanding to the countries bordering Austria, and then the corporations started to move further into the SEE and CIS regions. The first focus of the thesis is on the financial stability of the individual countries under review. The picture received was far more differentiated than often projected by the media. While some countries like the Czech Republic only started to feel the effects of the crisis, others like Hungary and the Ukraine came to the brink of collapse. However the countries that felt the effects of the crisis more than others already had problems before hand. Prior to the collapse of Lehman brothers Hungary for instance was facing large problems concerning their external debt and their lack of GDP growth during the booming period between 2003 and 2008. Fortunately for them they were saved by the IMF, which granted a twenty billion Euro credit line and thereby secured the liquidity on the market. Another factor that helped Hungary and almost all other countries under review by this thesis was the large dedication of the parent companies towards their subsidiaries. Specifically Austrian institutions have shown that they want to keep Eastern Europe as their home market, and that they are not planning on retrieving

due to the current difficulties. One problem that Hungary shares with many countries of the region is the currency risk. The currencies of emerging markets have shown to be even more volatile during a crisis, and therefore have caused difficulties for the banks and insurance companies operating in them. The only country that has basically avoided this problem was Slovakia, which entered the Euro area in the beginning of 2009.

Another negative factor that arose due to the volatility in the currency markets were foreign currency loans. This specifically became a problem concerning loans denominated in Swiss Franks in Hungary and several other countries across the region. Unfortunately this product was largely offered by Austrian banks, and therefore they now have to carry the burden of a product that once was a cash cow and now became illegal. Overall the development on the currency markets also led to an adaptation in the business model. While during the booming years they would finance the growth in loans by any means, they will now focus on financing it through local deposits. Deposits in general will play a more dominant role in the future of the banking industry.

The markets across the region as already mentioned have mixed tendencies. The problems mentioned above are more dominant in some countries while others have not started to feel the effects of the crisis yet. For instance the banking sector in the Czech Republic and Slovakia has not been as severely hit by the financial turmoil. In these economies the industry was still showing positive results. Of course they started to feel the pressure considering their portfolio quality, but overall the effects of the crisis will most likely not be as severe as in other countries. The insurance industry on the other hand is currently facing more difficult times due to their deterioration in the value of financial assets. In the selected markets their results were always largely influenced by the turmoil on the financial markets, while their core business was still doing relatively well due to the convergence process in the region. However it has to be mentioned that none of the Austrian insurance companies have so far applied for financial help from the state.

The companies under review were both the largest Austrian banks and insurance companies. The banks selected were: UniCredit Bank Austria, Raiffeisen

International and Erste Bank. The insurance companies selected were Vienna Insurance Group (VIG), and Uniqa. These firms were chosen, since they are both dominant players on the Austrian as well as the Eastern European market.

Bank Austria was the biggest bank under review, and is currently acting as the sub-holding company of UniCredit, one of the biggest banks in Europe. Despite the crisis they showed a large increase in profits for the holding company and each one of the subsidiaries under review. They see the financial turmoil as a possibility to restructure and thereby become more efficient. Bank Austria is managing five of the six countries under review (ex Ukraine), and has similar aims in all its subsidiaries. One focus is on keeping the loan to deposit ratio as low as possible preferably financing loan growth through new deposits. The other focus is on the profitability and efficiency of the subsidiaries.

Raiffeisen International is the subsidiary of Raiffeisen Zentral Bank responsible for the operations in Eastern Europe. As of 2008 they were the second biggest Austrian bank in the region. Since their start the bank was following an aggressive growth path. This business model however had to be adapted due to the effects of the crisis. Now the focus lies on increasing deposits to finance loan growth in the subsidiaries, whereas prior to the crisis the focus was on growing as much as possible. Despite the change in business model they still showed a record breaking profit in 2008. However the profit could have been even higher without currency devaluations. The subsidiaries under review, with the exception of some country specific issues, did relatively well despite the difficulties on the financial markets. Except for Romania and the Ukraine they all managed to decrease their loan to deposit ratio, while also increasing the efficiency in most subsidiaries.

Erste Bank is the third biggest Austrian bank operating in the region, but runs under a different business model than the other two banks under review. Their focus always was on the retail segment in order to be able to offer a broad portfolio to a wide audience. They also limited their regional focus to the EU region, which provides them with additional stability in difficult times. Their strategy has so far proven to be successful, which is indicated by the increase in operating profit. However this profit similar to the other institutions under review was negatively influenced by the

financial result. They are currently operating in five out of the six countries under review, and with the exception of the Ukraine, which represents a start-up operation; all of them have already reached a significant market share. Their focus is to increase deposits and the efficiency while remaining in the leading position on the market.

Vienna Insurance Group as Austria's biggest insurer also takes an important position on the Eastern European market. They are operating in all countries under review, while taking a Top 3 position in five out of the six markets. Despite the crisis they managed to increase their total premiums. This was to a large extent caused by the growth in Eastern Europe, which already provides approximately half of the total premiums earned. Their focus in Eastern Europe has been on motor-vehicle insurance, which has proven to be successful in times of a crisis, since people are mostly not willing to give up their mobility. The region still has a very low insurance density, and therefore despite the difficulties there are still a lot of growth opportunities for VIG. Due to the financial crisis the profitability of the subsidiaries under review during 2008 was not exceptional. Only the subsidiaries in Romania and the Czech Republic showed increases in profits, while others had more difficulty to remain profitable.

Uniq is Austria's second biggest insurance company, and has also taken a dominant role in the Eastern European market. Their Eastern European subsidiaries contributed to the increase in premiums despite the difficult times, and as of 2008 was already responsible for 22% of the total premiums generated. Their goal is to further increase this ratio in the future, so that at some point the Eastern European subsidiaries contribute more than half of the total premiums. Due to the difficulties on the financial markets, which had a severe effect on the value of their assets, their profit on ordinary activities was only one third of the previous value.

In order to be able to test the stated hypotheses four interviews with managers of the Austrian financial service industry were conducted. Two interview partners were from the banking sector (UniCredit Bank Austria, Raiffeisen International), and two interview partners came from the insurance sector (VIG, Uniq). The interviews were conducted according to a questionnaire that covered five different areas of

interest (Region, Equity, Cost, Market Position, Regulation) that could possibly affect the future of these companies. In order to provide a point of view that was not biased towards the private sector an additional interview with a representative from the Austrian national bank was conducted to provide the point of view of the regulators.

According to the answers provided during the interview process, the individual representatives believe that the future of the Austrian financial service industry still is going to be very bright despite the effects of the crisis. Most certainly the companies under review felt the consequences of the liquidity crisis in fall of 2008, but they have managed to adapt their business models where necessary, and have remained profitable up till this day. Their first mover advantage in this region has put them into strong market positions across the region, which ultimately created large barriers to entry for other contenders.

All interview partners agreed that the regulators currently have the biggest influence on the future of the entire industry. It is up to them to reform the failed system successfully. However they should keep in mind that over-regulation, which reduces growth, should not be the ultimate goal. In the end all interview partners agreed that a future crisis cannot, or to a certain extent should not be prevented by a regulatory system. The goal of the new system should be to make corporations more stable in times of a crisis rather than hinder growth through over-regulation. However another factor that the interview partners agreed upon was that such a new system would have to be put in place quickly in order to be successful, and that unfortunately seems to be the catch. Whether or not the individual national banks will give up some of their rights to a European authority is questionable, and the implementation of such a system seems even more problematic.

In total the future development of the Austrian banks and insurance companies will not be as much dependent on the development of the countries under review, but rather on the development of the financial regulation. This will ultimately affect the entire financial world around the globe. Austrian banks and insurance companies therefore will have to adapt their current business models to the new regulation, which might cause difficulties and limit the room for an expansion process, but if this is done successfully their future should remain bright.

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## 9 – Abstrakt

Die österreichische Finanzindustrie war während der Finanzkrise oft im Fokus der Medien. Speziell in der Liquiditätskrise nach der Lehman Brothers Pleite im Herbst 2008 wurde das einstige Osteuropapotential der Finanzdienstleister plötzlich als enorme Risikoquelle dargestellt. Die vorliegende Diplomarbeit hat es sich zur Aufgabe gemacht die Risiken und Möglichkeiten der österreichischen Banken und Versicherungen in ausgewählten Ländern der Region Ost- und Südosteuropa auf Grund der Finanzkrise näher zu analysieren. Es wurden Hypothesen über die Entwicklung verschiedener Bereiche (Region, Eigenkapital, Kosten, Marktposition, Regulierung) erstellt, die nach einer ausführlichen Umweltanalyse durch einen Interviewprozess getestet wurden.

Die ausgewählten Länder (Tschechien, Slowakei, Ungarn, Bulgarien, Rumänien, Ukraine) sind sowohl repräsentativ für die einzelnen Subregionen (Zentraleuropa, Südosteuropa, CIS) als auch für die historische Entwicklung der heimischen Banken und Versicherungen. Die ersten Expansionsschritte wurden in unmittelbar angrenzenden Ländern getätigt, da hier auch ein historischer Zusammenhalt besteht, was einen erfolgreichen Markteintritt vereinfachte. Mit zunehmendem Erfolg expandierten die Unternehmen schließlich immer weiter und schneller Richtung Osten, was auch mit der Hauptgrund für den enormen internationalen Erfolg der österreichischen Finanzindustrie war. Aufgrund der Finanzkrise besteht nun allerdings die Frage, wie man sich von einer wachstumsorientierten Strategie zu einer Krisenstrategie entwickelt.

Der erste Fokus der Arbeit liegt auf einer Analyse der Finanzstabilität der behandelten Länder. Die Informationen hierfür wurden vorwiegend von den Veröffentlichungen der individuellen Nationalbanken bezogen. Die Analyse zeigt auf, dass es sich um eine äußerst heterogene Region handelt, in der es eine große Anzahl verschiedener Risiken gibt. Die größten sind unter anderem eine hohe Staatsverschuldung, Währungsrisiken sowie eine abnehmende Höhe der Investitionen aus dem Ausland. Allerdings haben diese Risiken in den behandelten Ländern unterschiedliche Gewichtungen. Während einige Länder stark unter den Folgen der Krise leiden, wie zum Beispiel Ungarn, hielten sich manche Länder, wie Tschechien, während der größten Probleme wacker. Während sich die Slowakei

durch den Euro Beitritt im Januar 2009 keine Gedanken mehr über die Währungsstabilität machen muss, haben andere Länder der Region stark damit zu kämpfen.

Die Arbeit behandelt sowohl die Aktivitäten der drei größten Österreichischen Banken (UniCredit Bank Austria, Raiffeisen International, Erste Bank) als auch der zwei größten Versicherer (Vienna Insurance Group, Uniqa). Diese Institute zählen sowohl zu den einflussreichsten Finanzdienstleistern in Österreich als auch in Zentral- und Osteuropa. Die Analyse der Unternehmen beinhaltet einen Überblick der unterschiedlichen Geschäftsmodelle, der momentanen finanziellen Lage und der Entwicklung der Länderportfolios.

Um die anfangs aufgestellten Hypothesen zu testen wurden in Rahmen der Diplomarbeit fünf Interviews sowohl mit leitenden Mitarbeitern der jeweiligen Unternehmen, als auch eines Mitarbeiters der OeNB -um die Objektivität der Analyse zu bewahren- geführt. Daraus ergab sich eine für den Ernst der Lage relativ positive Sicht der Dinge. Sämtliche Interviewpartner befanden, dass die Region noch enormes Wachstumspotential sowohl auf Banken- als auch Versicherungsseite aufweist. Weiters wird sich die dominante Position der österreichischen Finanzdienstleister in der Region kaum in Folge der Wirtschaftskrise ändern, da in den behandelten Märkten bereits große Eintrittsbarrieren bestehen. Allerdings ist die Lage in der Region trotz dessen, dass die österreichischen Banken und Versicherungen grundsätzlich gut aufgestellt sind weiterhin mit Vorsicht zu beobachten. Die Lage bleibt auf Grund der labilen Weltwirtschaft weiter angespannt.

Die Zukunft der österreichischen Finanzdienstleister wird eher von der Entwicklung der Regulierung abhängig sein, da die Unternehmen auf Grund der heterogenen Region ein gut diversifiziertes Portfolio besitzen. Durch eine striktere Regulierung könnte es zu großen Nachteilen für die Finanzdienstleister, kommen falls die Regeln nur innerhalb Europas zu einem standardisierten Markt führen. Laut den Interviewergebnissen kommt es vor allem darauf an, möglichst schnell ein gesundes Maß an Regulierung zu finden, um die Finanzmärkte in Krisensituationen stabiler zu machen ohne einen möglichen Aufschwung zu verhindern oder zu verlangsamen.

# CURRICULUM VITAE

## Alexander Klien

### School Training:

1992 – 1996 **Elementary School Knollgasse**  
1996 – 2004 **American International School, Vienna**  
Austrian Matura with IB Credits (Economics, English, French, Math)

### Academic Career:

10/2004 – 9/2010 **International Business Studies**  
University of Vienna, BWZ (Business Centre)  
Specialization: Financial Services, Corporate Finance

### Internships:

03-06/2005 **Raiffeisen Zentralbank**  
**Vienna**  
Economics and Financial Market Research, Investment Banking,  
Global Treasury and Markets, Global Financial Institutions &  
Sovereignty

07-08/2005 **Raiffeisen Zentralbank**  
**Singapore**  
Credit Risk and Management, Treasury, Corporate Finance Asia,  
Commodity Finance

07-08/2006 **SCOR Vie**  
**Paris**  
Introduction into Life Reinsurance, Analysis about CEE region

07-09/2007 **Hoffman La Roche Inc.**  
**Nutley NJ**  
Treasury Intern, Pension Plan Investment Opportunities,  
Bloomberg training

**Languages:** fluent in German and English, working experience in French (+IB)

**EDP:** applications of MS Office and ample skills in other standard  
programs as well as ADONIS, SQL, mySQL, PHP, HTML, Java,  
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