VIENNA
As a Financial Centre

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Video on FT.com

Neil Buckley talks about prospects for the city and region

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Reflection of strength: the Austrian capital has become a popular location for international companies, among them Heineken and Lukoil, the Russian oil company, to base regional headquarters Dreamstime

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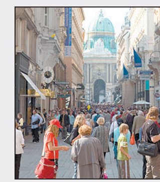

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Worries ease on exposure to east

As emerging Europe's financial hub, the city suffered during the crash. But the region is now growing at 4 per cent.
Chris Bryant reports

Vienna is famed for its abundance of charming cafés where one can while away hours, with a coffee, cake and newspaper.

But, fixing a time to meet a professional contact in one of these places for a *Melange* (Viennese milky coffee) is not always straightforward.

Frequent visits to the ski slopes are one reason for the unavailability of bankers, insurers, estate agents and lawyers in the winter months; so, too, the wealth of distracting cultural attractions in Austria's capital.

But the primary reason for frequent absences is the demands of business trips to subsidiaries or client meetings in central and eastern Europe.

These markets form the foundation on which the city has built a reputation as a small but influential centre of regional financial expertise.

Following the fall of the iron curtain, Austrian companies were among the quickest to seize on the once-in-a-lifetime opportunity to deepen financial intermediation in the region.

The country's banks – particularly UniCredit/Bank Austria, Raiffeisen Bank International and Erste Group – led the way.

In their wake followed insurance companies (Vienna Insurance Group, Uniqa), energy groups (OMV), telecoms companies (Telekom Austria), real estate firms (CA Immo, Conwert, Immofinanz), as well as a host of consultancy, legal and ancillary services providers.

As its regional footprint has grown, Vienna has become a sought-after location for non-Austrian companies to base their regional headquarters: among them Heineken, the Dutch brewer and Lukoil, the Russian oil company.

Josef Pröll, finance minister, speaking before a recent illness, said: "We're the door to central and eastern European countries. We're really successful in these markets and have a lot of experience."

When the crisis struck, analysts speculated that Vienna's embrace of eastern Europe could become its yoke.

Most economies in emerging Europe suffered deep recessions, requiring painful adjustments that caused unemployment to soar and left banks nursing large portfolios of problem loans.

The crisis also exposed a variety of weaknesses in eastern Europe's economic model, above all its high reliance on foreign capital flows, and foreign-currency denominated credit.

But with the region expected to grow by about 4 per cent this year – twice the rate of the eurozone – those who wrote off eastern Europe and with it the financial centre of Vienna have been proved wrong.

Local economists acknowledge that the region's recovery is less dynamic than other emerging markets and by no means homogeneous.

An export-led recovery is driving growth in the Czech Republic and Slovakia. Poland was the only member of the European Union to avoid a recession during the crisis.

But in south-eastern Europe, growth is more sluggish and domestic demand weaker. Meanwhile, in Hungary unorthodox government policy is creating investor uncertainty.

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Altered economic backdrop prompts rethink of tactics

Banks

Robert Anderson says the focus is now on steady organic growth and 'underbanked', less risky countries

Austria's three big banks have survived the global financial crisis without tipping into full-year losses, despite warnings about their heavy exposure to some of the most troubled markets in central and eastern Europe.

The three – Bank Austria (part of UniCredit of Italy), Erste and Raiffeisen Bank International – are cautiously optimistic as economic growth revives.

Yet questions remain about the health of smaller banks and the impact of tighter regulation.

After the collapse of Communism, the big banks built impressive networks in neighbouring CEE countries, motivated by the region's economic growth prospects and its underdeveloped banking markets.

However, this exposure appeared a serious weakness when the financial crisis forced Ukraine, Romania and Hungary, among others, to seek help from the International Monetary Fund.

The Austrian government injected equity into the country's banks (Bank Austria refused) to cushion the rise in bad assets and restore international confidence so they could continue to tap funding.

In return, it has now imposed a banking levy that costs the sector about €500m ($711m) a year.

Non-performing loans are now expected to peak in the first half of this year but banks are planning to expand their loan books again, if not to the same extent as before the financial crisis.

"Now we are all on the growth path again," says Gianni Franco Papa, head of UniCredit's CEE division.

Black spots remain – notably Ukraine and particularly Kazakhstan, where Bank Austria had to write down the value of its business by another €199m last month – but most of the region is out of intensive care and its troubles have been overshadowed by those of the Eurozone periphery.

"This region is perceived to be much less risky than some parts of the western world," says Franz Hochstrasser, deputy chief executive of Erste Bank.

Analysts question if Bank Austria and Raiffeisen – which are both widely distributed across the region compared with the more focused Erste – might decide to sell one of their struggling foreign banks, but both deny this is an urgent topic of discussion.

"We are thinking of increasing our capital allocation towards CEE," says Mr Papa, dismissing speculation that UniCredit's new management could downgrade the region.

He points out that Bank Austria plans to open 900 branches, largely in Romania, Turkey and Hungary.

But tactics are being rethought in this changed economic environment. "We are refocusing our activity; the name of the game is changing," he adds.

After two years of battening down the hatches, the strategy is now steady organic growth, focused on the most "underbanked" or least risky countries, and on particular segments in each market, rather than on overall market share.

None are planning any big acquisitions either,

> 'Sooner or later we will clearly raise capital but there is no desperate need'

though Raiffeisen recently agreed to buy a second bank in Poland, to become the sixth biggest financial institution there in terms of assets.

While the big banks are back on the growth track, Austria's smaller ones are still wrestling with the legacy of past mistakes in an environment that remains challenging.

During the financial crisis, Hypo Group Alpe Adria, the sixth largest, and Kommunalkredit, a municipal lender, were nationalised after loans and risky investments went bad.

Both are being nursed back to health and should eventually be reprivatised.

Before that, Volksbanken, the fourth largest bank, is looking to sell its loss-making international arm to repay €1bn of state capital.

For the smaller institutions, margins are tight because of fierce competition, financing is still stretched because of the credit crisis, while capital adequacy appears weak by European standards.

Consolidation looks inevitable, if only to meet the higher capital requirements demanded by the Basel III international banking regulations.

"Austrian banks' continued below average capital adequacy compared with the rest of the world represents a challenge – particularly in respect of future regulatory requirements," the central bank pointed out in its financial stability report in December.

Basel III is also putting the bigger banks under pressure to raise equity.

Both Erste and Raiffeisen want to repay the government's equity before the interest rate goes up in 2013, but they hope to do this from retained earnings as profits revive.

Raiffeisen – which merged its domestic and international operations last year – looks the most likely to raise equity in the next couple of years.

Patrick Butler, Raiffeisen's head of investment banking, says: "Sooner or later we will clearly raise capital but there is no desperate need."

None of the big three is expected to struggle to pass the next round of Eurozone-wide stress These measure banks' resilience to a credit crisis. Even if the crisis in the Eurozone periphery worsens, the banks hope to remain partly protected by the ongoing recovery in central and eastern Europe.

Propped up: Hypo Group Alpe Adria was nationalised

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Raiffeisen Bank International

Watchdog tackles unhappy legacy of lax supervision

Investigations

The financial collapse brought problems to light. **Eric Frey** reports

Austria's transformation from a sleepy financial backwater to a promising market for corporate and individual investors after 2000 has resulted in a number of banks and investment companies being investigated for taking advantage of lax supervision and inexperienced customers for their own benefit.

When the financial crisis hit in 2007 and 2008, several investment schemes collapsed and resulted in a series of scandals and judicial investigations.

These include two once-popular real estate funds and a private bank that acted as a big feeder fund for Bernhard Madoff's US-based Ponzi scheme.

Only a few of these cases resulted in formal charges against bankers, and even fewer in convictions.

While the court cases drag on, there is a growing debate on whether Austria's image as a financial marketplace has been seriously tarnished.

For Michael Buhl, joint chief executive of the Vienna Stock Exchange, the impact has been limited to domestic business.

"We definitely have frustration from Austrian retail investors," he says.

International investors, however, "see this as something that happens in all markets. There is little international spillage."

Much press criticism in Austria has focused on Karl-Heinz Grasser, finance minister from 2000 to 2007.

He has been mentioned in connection with some of these scandals, including the 2008 collapse of Hypo Group Alpe-Adria, a regional bank.

Mr Grasser is under judicial investigation for his role in the privatisation of a real estate company where questionable kickbacks were paid, but has denied any wrongdoing.

The first investment scheme that went awry in the summer of 2007 was Meinl European Land, a high-flying real estate fund registered in Jersey that was launched by the venerable Meinl Bank. As the stock price collapsed, authorities accused company and bank of misleading investors and breach of trust, which they denied.

Bank chairman Julius Meinl V, the scion of a coffee-making family, was arrested and then freed on a record €100m ($142m) bail in April 2009.

Mr Meinl has not been indicted, although several prosecutors are working on the case and dozens of civil suits were filed against the bank by aggrieved investors. Still, the question of whether Meinl Bank was just the victim of the market crash or had violated any laws remains effectively unresolved.

Another case is that of Immofinanz, an aggressively marketed real estate fund engineered by Karl Petrikovics, who also ran a private bank, Constantia Privatbank.

When the bank collapsed in 2008 and was rescued by a consortium of banks, Mr Petrikovics resigned.

Prosecutors have accused him of breach of trust and balance sheet fraud in relation to his running of Immofinanz, although Mr Petrikovics has repeatedly denied any wrongdoing.

The most prominent case is that of Austrian banker Sonja Kohn, whose Vienna-based Bank Medici had allegedly channelled $9bn to Mr Madoff over the course of two decades.

A criminal investigation in Austria against Ms Kohn is still in its early stages, but in December, the US bankruptcy trustee responsible for recovering money for Mr Madoff's victims filed a $19.6bn lawsuit against Ms Kohn in New York for "masterminding a vast illegal scheme".

Ms Kohn denied that accusation and claimed she was also a Madoff victim.

Most civil suits related to the case in Austria are directed against UniCredit/Bank Austria, which held a 25 per cent stake in Bank Medici and marketed Madoff-related funds under its own name. The bank denies any wrongdoing.

The only prominent money manager to be convicted is Wolfgang Auer Welsbach, who received an eight-year jail sentence this year for defrauding 12,500 investors of a total of €450m through his investment vehicle AvW.

In all these cases, the Finanzmarktaufsicht (FMA), the financial market watchdog, came under criticism for ignoring early warning signs and tolerating questionable business strategies. However, Kurt Pribil, head of the FMA, says most cases go back to a time before his agency became operational in 2002.

In the past, supervision was conducted by a handful of civil servants in the finance ministry. The current structure, with the FMA and the national bank jointly supervising banks and markets, was set up only in late 2008.

A staff of 500 is split between the two organisations. "Now that an effective integrated watchdog is in place, we have actually uncovered quite a number of the bad apples ourselves," Mr Pribil says.

Staff were also added in the prosecutor's offices, although critics say the public attorneys are overwhelmed by the complexity of cases and outgunned by the highly paid law firms that represent the accused.

The FMA sees current laws and regulations as adequate, but would like to impose higher fines for market manipulation and is pushing for tighter publication requirements.

Vienna's image can only improve the more cases the FMA pursues, Mr Pribil says. "Whether we take up a case or not is unrelated to the impact on the reputation of the market. The fact that we uncover misbehaviour will pay off."

Cold war city of spies has become a city of big spenders

Russian visitors

The rouble is making waves in finance, commerce and property, writes **Chris Bryant**

The excited chatter of Russian voices on Kohlmarkt, Vienna's most exclusive shopping parade, is hard to ignore on high-season weekends.

The pricey boutiques that adorn the streets of the "first district" are sustained by a constant flow of wealthy Russian visitors who have made the flight from Moscow – by private jet when available.

"All the expensive shops in the first district, including the big labels, live off Russian customers, the rich Russians. They all say that if the Russians didn't come, it would be very sad indeed," says Nataly Holzmüller, organiser of the Russian Ball, a high point of Vienna's ball season.

But, increasingly, the rouble is making waves in Vienna beyond the shopping arcades, in finance, commerce and property. And Russian companies are providing lucrative work for Viennese lawyers, realtors, consultants and tax advisers.

Russians' close affinity for the city dates back several centuries and reached its zenith after the second world war, when the city – situated near the then dividing line between east and west – became an international spy hub.

Even after the fall of the iron curtain, countless Russian agents are thought to have remained in Vienna, drawn by the high quality of life and presence of international organisations, including the UN, the Organization of the Petroleum Exporting Countries and the International Atomic Energy Agency.

"The Russians, for whatever reason, like Vienna emotionally – whether that's because it was neutral following the postwar period or neutral ground for the secret services, I don't know. But somehow they just feel at ease here," says a Vienna lawyer.

Foreign trade between Russia and Austria is growing rapidly after a crisis-induced downturn. Austrian exports to Russia jumped by 22 per cent to €2.6bn ($3.7bn) last year, while imports rose 36 per cent to €2.3bn.

Austrian companies – particularly in the engineering, plant and equipment and automotive sectors – have found considerable success in Russia.

Although commodities still make up a large proportion of the goods flowing in the other direction, market watchers say more and more Russian companies are taking a closer look at Austria.

At least 400 mostly small Russian businesses are registered in the country, according to the Austrian Business Agency, contributing to total inward investment of €1.6bn at the end of 2009. This is far less than the €4.6bn invested by Austrian companies in Russia but not insignificant.

The highest profile Russian deal in Austria came in 2007, when Oleg Deripaska, once Russia's richest man, acquired a 25 per cent stake in Strabag, the Vienna-based construction group.

Mr Deripaska was forced to surrender his stake during the crisis but agreed to buy back a 17 per cent holding in November for €373m.

He underscored his affinity for Austria last year by hiring Siegfried Wolf, the joint chief executive of Magna International, an Austrian-Canadian car parts manufacturer in which Mr Deripaska once owned a stake. Mr Wolf joined Russian Machines, the magnate's automotive unit.

Vienna and Russia have long-standing links in the energy sector. In 1968, Vienna-based OMV, the oil and gas group, became the first European company to conclude a gas supply deal with the Soviet Union, helping Austria become a leading transit country for Russian gas.

More than 40 years later, Gazprom is to take a stake in the Vienna-based Central European Gas Hub, a gas trading platform, while Austria has signed up to South Stream, a Russian pipeline project seen by some as a rival of the European Union-backed Nabucco pipeline.

Alexander Medvedev, Gazprom's deputy chairman, is said to be particularly fond of the city, after working in Austria for several years.

Viennese financial institutions have played a big role in deepening these economic ties. Raiffeisen Bank International and UniCredit/Bank Austria are among the largest foreign-owned banks operating in Russia. Meanwhile, VTB, Russia's second-largest state-owned bank, made Vienna its centre for western European corporate banking.

"The fact that a lot of very rich private Russian individuals like coming to Vienna is of course an advantage, as this offers potential new contacts for our bank," Christian Müllner, a board member at VTB Bank (Austria) says.

Local media have speculated that Sberbank, Russia's biggest lender, is also eyeing the market via a possible tie-up with Österreichische Volksbanken, the country's fourth-biggest lender.

However, Sberbank has denied it is in negotiations to buy the Austrian bank's eastern European arm.

Visible evidence of the city's popularity with Russians, can also be found in real estate.

A luxury apartment in the central first district or a villa in the outer districts bordering the Vienna woods have become a must-have accessory.

According to Stefan Brezovich of ÖRAG Immobilien, Russians are won over by Vienna's comparative safety, historical ties, cultural attractions and, of course, the shopping.

Contrary to local legend, however, Roman Abramovich, the Russian billionaire, does not own a property on Kohlmarkt, his spokesman told the Financial Times.

The boulevard's high-end stores are probably too busy serving other wealthy Russian customers to care.

Kohlmarkt, the exclusive shopping parade: Russian is heard most weekends Corbis

Sector eyes 'catch up' potential of region

Insurance

Chris Bryant says lower spending on products in emerging neighbours presents an opportunity

In view of the devastation wreaked by recent natural disasters in Japan, Australia and New Zealand, central Europe seems a relatively benign place to run an insurance business.

Still, Vienna Insurance Group and Uniqa, two of country's leading insurance companies, have experienced their fair share of nature's destructive power in recent years.

Severe floods in Poland, the Czech Republic, Slovakia and Hungary triggered a wave of damage claims last year, while violent hailstorms have also proved costly.

"There has been a significant impact from natural catastrophes, but in other areas we have done better, so the cost side could be compensated," says Günter Geyer, VIG chief executive.

Both companies increased profits last year, even as core central European markets emerged slowly from recession and analysts remain bullish on the regional outlook for the sector.

VIG, founded in 1824, was quick to expand east after the iron curtain fell, gaining a head-start on Uniqa which was founded in 1999 after the merger of two Austrian insurers.

VIG and Uniqa have struck bank distribution agreements with Erste and Raiffeisen that helped their international expansion.

Today, the companies occupy office towers on opposite sides of Vienna's Danube Canal – Uniqa in a modern illuminated steel and glass structure built in 2004 and VIG in the so-called *Ringturm*, an imposing grey edifice dating from the 1950s.

VIG increased total premiums by 7.2 per cent to €8.6bn ($12.2bn) last year, with central and eastern Europe accounting for about 50 per cent of the total. Pre-tax profits rose by 15.1 per cent to €508m. Uniqa's presence in eastern Europe has grown rapidly but remains smaller than VIG's at about 20 per cent of premiums. Last year, premium volumes rose by 8.4 per cent to €6.2bn. Profits were about €150m.

Both groups face competition in the region from the likes of Italy's Generali, Allianz of Germany and the Polish insurance behemoth PZU. But there are still plenty of opportunities to pull in business.

In most western European countries, insurance income is between 6 and 10 per cent of GDP. But in Romania and Serbia, it is below 2 per cent.

In 2009, insurance spending per capita in Austria totalled $2,743 (€1,931), while in the Czech Republic – one of emerging Europe's most developed economies – the figure was only $723.

Christoph Schultes, analyst at Erste Group, says that insurance companies stand to benefit from the "huge catch-up potential" of the region.

The crisis did not leave Austrian insurers unscarred. Potential customers delayed car purchases, for example, leading to pressure on premium income in automotive insurance.

"Of course we had effects, with a time lag, but never of the size that was forecast. Because our type of business is very different [from banks]. We are capital reservoirs, not credit-givers," Mr Geyer says.

As the eurozone debt crisis rumbles on, European insurers are also casting a wary eye over their investment portfolios. For VIG and Uniqa the problem appears contained, as peripheral country bonds make up less than 1 per cent of their financial investments.

VIG wrote down the value of its Greek and Irish bonds by about 25 per cent in January, costing it a low double-digit million euro sum.

The current low-interest rate environment is also a potential worry for insurers, owing to pressure on investment returns.

However, they argue that the situation is manageable so long as rates do not remain low for an extended period.

In the meantime, new products are helping to boost profits. Uniqa boasts a text message service that warns clients of impending storms and a GPS service that automatically alerts the insurer in the event of a car-crash.

In spite of their optimism, neither is willing to pursue acquisitions just yet, owing to uncertainty about the regulatory environment.

Plans for a complicated risked-based capital regime governing European insurers, known as Solvency II, have unsettled the industry and prompted calls for improvements before the rules come into force in January 2013.

As well as requiring insurance companies to hold more capital, the rules are set to affect the amount of capital required to support particular asset classes. Insurers are also fretting about the introduction of a new accounting standard for insurance contracts (IFRS4).

But once the regulatory position is clarified, further opportunities may arise.

"Solvency II in my view will lead to a strategic re-evaluation of the investment map among some international firms and then [a potential acquisition] could come to market at a reasonable price," Konstantin Klien, Uniqa chief executive, says.

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Worries on exposure to east recede as growth returns

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Nor is eastern Europe immune to external shocks from the eurozone's sovereign debt crisis, rising inflation or turmoil in the Middle East.

Still, if 2009 was the year of crisis fighting and 2010 of painful adjustment, 2011 has seen Vienna's financial motor tentatively begin to refire.

The Stock Exchange can look forward to its first listing since 2007, after AMAG, an Aluminium group announced a €535m ($754m) IPO.

In February, Raiffeisen Bank International said it would acquire a majority stake in Poland's Polbank for €490m to boost its presence in central Europe's biggest economy.

Also in February, Epic, an investment firm, agreed to pay the Ukrainian government $1.3bn for Ukrtelecom, the fixed-line telecoms operator.

Vienna's supporters argue that the fundamental attractions of the region for investors – cheap, skilled labour, comparatively low public debt, ageing or absent infrastructure and underpenetration of financial products – remain undimmed.

In Romania, only half the 21m population has a bank account, for example, and there are just over 300km of highways.

Still, there is a broad recognition that capitalising on this catch-up potential will not be as simple or as profitable as before.

Divergent growth rates and the overall higher cost of funding may mean Vienna's financial institutions are more selective about investing.

"As far as capital allocation is concerned, yes we will have a strong focus on the fast growing markets of central and eastern Europe," says Willibald Cernko, Bank Austria chief executive.

New regulatory regimes – Basel III for banks, Solvency II for insurers – may require companies to retain more of their earnings or raise fresh capital.

Tensions could emerge between the desire of national regulators to enforce high local capital and liquidity standards and the wish of cross-border banks to optimise their resources across the region.

To boost profits, financial institutions may also be forced to move beyond the bread-and-butter products of the past.

The need to reduce reliance on external funding and build local currency and capital markets, poses additional challenges but this could be an additional opportunity for companies willing to assist.

The Stock Exchange has already led the way by acquiring regional bourses and banks are determined to follow.

There is no guarantee that Austria's financial centre will be the one to profit from the region's rebound, however. It faces competition from the likes of Warsaw, Istanbul and Moscow, which all have the potential to develop further as regional financial hubs.

Moreover, as economies develop, the value Vienna can add may start to diminish.

"The risks of doing business in central and eastern Europe have fallen so much that in 10-15 years from now, nobody who wants to invest in the Czech Republic will do it via Austria," says Andreas Treichl, Erste Group chief executive.

> 'The risks of doing business in the region have fallen so much that in 10-15 years nobody who wants to invest will do it via Austria'
>
> Andreas Treichl, Chief executive, Erste Group

Although Vienna is a centre of financial expertise, it is not considered an investment banking hub and its small capital market risks marginalisation, as consolidation among global stock exchange giants gains pace.

It could also be held back by government policy.

As part of efforts to narrow the budget deficit, the ruling coalition last year introduced a €500m annual bank levy. Meanwhile, the volume of shares traded on the Vienna exchange dipped following the introduction of a tax on capital gains.

Financial companies are also alert to regulatory threats from abroad. In neighbouring Hungary where Vienna's banks, insurers and stock exchange have invested heavily, a populist government has introduced a punitive bank tax and sectoral taxes on mainly foreign-owned companies.

Rather too often for its liking, Vienna has also found itself in the headlines for the wrong reasons.

Although official rankings suggest Austria is among the world's least corrupt countries, a spate of financial scandals – not least Vienna's alleged role in channelling funds to disgraced financier Bernard Madoff – have clouded the reputation of its financial centre.

Officials argue that the current thorough investigation of these cases underlines commitment to full transparency.

Helmut Ettl, executive director of the FMA, the financial watchdog, says that while the scandals "did not enhance the image and attractiveness of Vienna as a financial centre . . . now we have to show that we [have] a zero-tolerance policy,"

Policymakers would be advised to consider ways to strengthen the reputation of its financial centre and its ability to compete.

If not, Vienna's financial workers could find themselves with more free time to kill in the city's coffee houses, while others are eating their cake.

Finance minister sticks to guns on tax moves

Interview
Josef Pröll

EU debt crisis concentrates minds, writes **Chris Bryant**

Austria's top financial official has had a difficult time recently. Josef Pröll, 42, suffered shortness of breath while skiing in the Tyrol in mid-March. After being taken by helicopter to a hospital in Innsbruck he was diagnosed with a pulmonary embolism, a potentially serious arterial blockage.

Although doctors said the finance minister would make a full recovery, he is not expected to return to work until after Easter.

When he does return, Mr Pröll will have a lot on his plate, as efforts continue to stem the sovereign debt crisis in southern fringe eurozone economies.

And as leader of the conservative Austrian People's party (ÖVP), which governs in coalition with the Social Democrats, Mr Pröll also faces domestic political problems.

Barely 48 hours after being hospitalised, he was forced to call for the resignation of Ernst Strasser, his party's leader in the European Parliament, after a lobbying scandal.

Mr Strasser denied wrongdoing but an avalanche of newspaper headlines has threatened to worsen a months-long slide in the ÖVP's poll ratings. A second MEP from the party also resigned last week over her expense claims. She denied wrongdoing.

Speaking to the Financial Times before both his illness and the lobbying furore, the jovial Mr Pröll – a former student of agricultural economics who ran the agriculture ministry before switching to the finance beat – appeared tired but determined.

In recent months, Austria has played an active role in negotiations over the contents of the eurozone's crisis-fighting armoury.

As one of only six eurozone countries with a top AAA credit rating, it may yet have to shoulder more of the burden of financing the bloc's €440bn ($620bn) temporary bail-out facility.

It has therefore taken a tough line with troubled peripheral economies, joining Finland, Germany and the Netherlands in putting fiscal rectitude at the heart of the debate.

> 'I'm optimistic that even with new taxes, we will remain very attractive for financial institutions who want to bring their headquarters to Austria'

"We are in the club of friends who have two targets: stabilise the euro and make clear that we need more discipline and competitiveness in the eurozone," Mr Pröll said.

Last month, the minister declined to grant Ireland a more lenient rate of interest for borrowing from the crisis fund without further fiscal reform.

He was also vocal in calling for Portugal to consider seeking a bail-out sooner rather than later.

To understand how far the tables have turned, recall that in 2009 some economists said that Austria could follow Iceland and Ireland into the abyss, because of its banks' exposure to ailing eastern European economies.

"I was of a different mind to many others two years ago, because I was convinced we were on the right track with our budget planning and with Austria's investments in central and eastern Europe," Mr Pröll explained "And the history of the past two years shows that this was right."

Mr Pröll was at his most effective – and popular – at the height of the financial crisis, when his swift interventions to prop up the economy won plaudits. A €100bn package to support national financial institutions coupled with timely bail-outs of struggling lenders Hypo Group Alpe Adria and Kommunalkredit helped restore confidence in the banking system.

Meanwhile, targeted stimulus measures combined with short-time working subsidies prevented widespread job cuts and a more serious downturn, ministers argue.

The economy is this year expected to grow by about 2 per cent, while the unemployment rate of 4.3 per cent is the lowest in the European Union, according to Eurostat, the EU statistics office.

But as the economic crisis has receded, critics say Mr Pröll's performance has been less convincing.

In November, he led his party into budget negotiations that many observers hoped would provide the impetus for long overdue structural reforms. But the result was instead a compromise that pleased few.

"We've done what was necessary, but less than I had hoped for – substantial structural changes just weren't possible in this coalition – that's the reality," he acknowledged.

Adding to budgetary woes, Austria was last week forced to revise upwards last year's budget deficit figure, because of changes in EU accounting standards.

In the negotiations, Mr Pröll is proud of successfully defending Austria's system of group taxation – which allows the pooling of profits and losses of resident group companies – arguing that these are a strong incentive for companies to base themselves in Vienna.

But financial institutions were in no mood to be grateful, having been hit with a €500m annual bank levy, plus a new tax on capital gains (*see article below left*).

Mr Pröll is unrepentant, however. "I'm optimistic that even with new taxes, such as the bank tax, we will remain very attractive for financial institutions who want to bring their headquarters to Austria," he said.

Josef Pröll: 'We have two targets: stabilise the euro and more discipline and competitiveness in the eurozone' Getty

The devil lies in the detail for collection of capital-gains levy

Taxation

Banks charged with effecting the measure have lodged objections, writes **Eric Frey**

The Austrian government, in search of new sources of revenue to reduce the budget deficit, last year abandoned its tradition of low capital and property taxes and introduced a 25 per cent levy on capital gains from stocks, bonds and other financial instruments.

While most experts agree with the general objective, they criticise the details of the tax, which is designed to be administered by banks and brokerage firms.

"The stated objective was a fair, easy-to-administer and widely acceptable solution for taxing capital gains, and that goal was unfortunately missed," says Stefan Walter, managing partner at the accountancy firm RSM Exacta, a Vienna-based member of RSM International, the network of independent accounting firms.

Capital losses can only be charged against gains if they occur in the same calendar year, and then only via personal income tax returns, which can delay repayment for more than a year.

The biggest complaints come from the banks, that have to invest in software and create procedures to collect the taxes.

"In terms of operational complexity, it's a nightmare," says Patrick Butler, head of investment banking at Raiffeisen Bank International.

Raiffeisen and other banks have filed a complaint at the constitutional court and are optimistic they will prevail. A decade ago, a similar scheme was struck down by the court because it imposed an unfair administrative burden on the banks.

Domestic banks may also lose business to foreign competitors because of the levy, says Roland Rief, partner for international tax services at Ernst & Young Austria, the accountancy firm.

Capital gains at foreign banks will not be taxed at source, but will need to be reported in tax returns. This will allow investors to match gains and losses and delay payment.

"Foreign banks have already started to adjust their IT systems to the new tax laws, so customers will automatically know what to report to the tax authorities," says Mr Rief.

Herta Vanas, tax lawyer at the international tax organisation Taxand, is less critical. Before, capital gains on securities held for less than a year were taxed at the marginal income tax rate, which is 50 per cent for most investors.

She says: "Short-term speculation is now more favourable than before, but most investors did not report these gains at all.

> 'Foreign banks have started to adjust their IT to the new tax laws'

"So the state receives more revenue, while individual investors will enjoy their profits more if they know that they are not evading taxes. And a 25 per cent rate is tolerable. This makes a big capital flight unlikely."

Neighbouring countries impose similar levies on capital gains. For example, starting in June, Switzerland will impose a 35 per cent source tax.

Austria's tax will also affect private foundations (*Privatstiftungen*), which have flourished in the country over the past two decades.

Virtually all tax benefits of these foundations have been eliminated in recent years, but they remain quite popular, says Mr Walter.

"I would not recommend any client to set up a foundation for tax purposes, but they are an excellent instrument for preserving family wealth," he says. "They can stop the heirs from blowing the money."

Under Austrian law, the transfer of assets into a foundation is irreversible, while the bylaws clearly define beneficiaries and disbursements.

Foundations are also attractive for foreign investors trying to protect their wealth from any political asset-grab, says Ms Vanas.

Unlike a British trust, they are non-transparent because ownership is transferred from the individual to the foundation.

"There is no reach-through possible, so there is full protection from state actions," Ms Vanas says.

And while Austria abandoned its system of anonymous bank accounts some years ago, it still has the highest level of bank secrecy anywhere in the European Union.

Mr Walter says that, as a next step, the country should offer favourable terms to domestic investors who parked their assets abroad and want to come clean.

A Swiss study estimates that Austrians hold €12bn ($16.8bn) in untaxed wealth in Swiss banks alone, and a lot of it would be repatriated if the legal risks were not excessive.

"There need not be a fully fledged tax amnesty, but it should be done without red tape and taxed at a flat rate of less than 10 per cent," Mr Walter suggests.

Such a move would bring more business to Austrian banks and offset some of the expenses of the capital gains tax, provide additional tax revenue to the state and bring in capital that could be legally invested at home.

Patrick Butler: 'In terms of operational complexity, it's a nightmare' Reuters

The largest player in the CEE region

jointforces

The Vienna Stock Exchange initiated the CEE Stock Exchange Group (CEESEG), which consists of the four stock exchanges of Budapest, Ljubljana, Prague and Vienna. The CEE Stock Exchange Group is the largest group of exchanges in the region.

Its goal is to strengthen and advance the regional capital markets of Austria, the Czech Republic, Hungary, and Slovenia. This yields many benefits for issuers, trading members, institutional investors as well as data vendors and index license customers of all member exchanges.

For further information please visit **www.ceeseg.com**

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Bourse painstakingly pursues goal to be regional hub

Stock exchanges

Integration of group trading systems has proved a challenge, says **Robert Anderson**

Amid the ructions of global stock market consolidations, the Vienna bourse has been continuing with its patient, painstaking regional integration.

While Deutsche Börse tries to merge with NYSE Euronext, and the London Stock Exchange with Toronto, Vienna last month welcomed the Belgrade exchange as the ninth member of its "data alliance", seen as a first step towards a takeover.

Vienna now owns controlling stakes in Prague, Budapest and Ljubljana, and pools data also with Bucharest, Sarajevo, Banja Luka (in Bosnia's Serb-run enclave), Skopje and Belgrade. It also has looser partnerships with the Bulgarian, Montenegrin, Croatian and Ukrainian bourses.

This is the product of a strategy Vienna has pursued since its neighbours regained their independence and began to rebuild capitalist economies, of trying to draw regional exchanges into an alliance with itself as the hub.

While blue-chip companies are expected to migrate to the consolidating global exchanges, Vienna believes mid-cap and small stocks will remain on local exchanges, and that a regional alliance of bourses is the most efficient way of organising trading in these stocks, particularly if the exchanges use the same trading system and have cross-clearing and cross-membership.

"The global exchanges are playing in a different league," says Michael Buhl, joint chief executive of the Vienna bourse. "We don't compete with them."

To advance integration, the bourse runs indices for the smaller exchanges, which can help create trading appetite, and sells information from the data alliance to be used for derivatives trading.

Revenues from sales of data are now significant. They have doubled in the past five years and now represent almost 20 per cent of total income.

"Partnerships are a way of co-operating to build up trust," says Mr Buhl. "They are also viewed as a possible first step for acquisitions."

However, consolidation has so far proved frustratingly slow. The small exchanges are either owned by states, which often see them as strategic and therefore not for sale, or run by a gaggle of local banks and traders, making it difficult to establish a consensus to sell.

Mr Buhl highlights Romania and Serbia and to some extent Croatia as the most promising partnerships.

However, many exchanges still have unrealistic price expectations, he argues, despite their lower turnover after the global financial crisis.

> 'As we do not own the whole infrastructure in each country, we have to go at different speeds'

"They see themselves in terms of pre-crisis valuations," he says. "It must be a valuation that makes sense. I feel we are still far away on price."

Even when Vienna has been able to take control of an exchange, synergies have been hard to achieve because it usually does not own the clearing and settlement operation.

Integration of the exchanges trading systems alone has proved a challenge. To date, only Ljubljana uses Vienna's Xetra system (licensed from Deutsche Börse). Prague and Budapest will not adopt it until the middle of next year.

"As we do not own the whole infrastructure in each country, we have to go at different speeds," says Mr Buhl. He adds that the bourse is now focused on "technological homework" rather than acquisitions.

The larger problem is that regional integration will remain incomplete without the participation of Warsaw, and Vienna's insistence on making itself the hub has alienated its larger and livelier neighbour.

"We will not be complete without them and they will not be complete without us," says Mr Buhl, who admits Warsaw is "not interested in talking to us".

Exploiting the virtually guaranteed demand from Polish pension funds – which have strict limitations on foreign equity investments – Warsaw is pursuing a strategy of trying to attract secondary listings of central and eastern European bluechips. This threatens to suck trading volume from the stocks' primary listings on Vienna's network of local bourses.

In contrast, Vienna is not encouraging companies to list at several of its exchanges, because this would simply cannibalise trading, though a couple of Romanian companies are looking at a listing in Vienna.

Mr Buhl says it is usually better for them to stay in their local market, where they can generate publicity and liquidity.

The success of Warsaw – whose market capitalisation of €157bn ($221bn) and equity turnover almost equal Vienna's four exchanges – highlights the latter's recent failure to promote primary and secondary listings.

Adding to the gloom, monthly trading volumes (€5.4bn in February) have yet to recover to pre-crisis levels, partly because of changes to capital gains tax this year.

However, Mr Buhl says this is about to change, with a crop of initial and secondary public offerings this year as valuations pick up – the ATX index has doubled since March 2009.

He predicts two to three initial public offerings in the first half of this year (AMAG Austrian Metall, an aluminium producer, is launching the first) followed by up to three in the second half, ending a drought that has lasted since October 2007.

Judging by a recent roadshow in London, he says, interest in Austrian stocks is back to pre-crisis levels.

Austrian investors jokingly call Petrovaradin fortress their biggest project in Serbia to date – the Austrian army won it from Turkish control in 1687 and rebuilt it Dreamstime

Banking paves the way for small and medium-sized companies

Ties to ex-Yugoslav states

Austria has been the largest source of foreign investment in the region, reports **Neil MacDonald**

When Slavko Caric, Erste Bank's chief executive in Serbia, takes his monthly flight to Vienna, he hardly feels he has left home.

In the taxi from the airport to group headquarters, "the driver usually speaks Serbian, or else Croatian or Bosnian," Mr Caric says. "So do most of the service personnel in restaurants and even many of the staff at our bank."

Serbo-Croatian languages – although known by different names – remain mutually intelligible despite the 1990s wars. Consumer-goods producers still look at former Yugoslav countries as one "domestic" market.

Yet the Serbian capital Belgrade no longer functions as the regional hub, either politically or economically.

Instead, the Austrian capital – a similar-sized city with roughly 10 times the per capita income – exerts the greatest pull on people.

"Vienna could practically be the capital of the former Yugoslavia," says Moritz Fried, an Austrian private equity executive for New Europe Capital in Belgrade. "Anyone who's anyone in the former [Yugoslav] republics seems to have started out there, or done business there, or sent his kids there for university."

Some 200,000 Serbs live in the city of 2m, with another 100,000 elsewhere in Austria. Most work in service industries and send money home to their families.

"Vienna is actually one of the largest Serbian cities," says Andreas Haidenthaler, Austrian commercial counsellor in Belgrade. Austria, meanwhile, has been the largest source of foreign investment in the region.

Austria's net direct investment flows to former Yugoslav republics
€m

	1996-2000	2001-2005	2006	2007	2008	2009	Q1-3 2010
Bosnia and Herzegovina	25	336	244	203	231	91	72
Croatia	455	2,090	(-23)	5,205	726	301	389
Montenegro	0	0	14	14	22	17	26
Macedonia	3	12	184	4	87	33	22
Serbia	3	492	422	504	370	323	149
Slovenia*	422	1,081	204	243	374	36	46

Source: compiled data Austrian National Bank (OeNB) * EU member since 2004

"After the fall of the iron curtain, Austrian companies, and especially banks, were the first to recognise that new markets were opening," Mr Haidenthaler says.

About 40 per cent of financial services in Serbia, including insurance, are Austria-controlled. Raiffeisen and Hypo Group Alpe Adria are among the top five banks by market capitalisation.

So is Italy's UniCredit group, which took over Bank Austria and still oversees most of central and eastern Europe via Vienna.

These banks also operate in other ex-Yugoslav countries. Erste entered Serbia five years ago by taking over Novosadska Banka, an institution with roots in former Austro-Hungarian towns.

Austrian investors jokingly call Petrovaradin fortress, 70km north of Belgrade, their biggest project in Serbia to date – the Austrian army won Petrovaradin from Turkish control in 1687 and rebuilt the old fortress.

The Danube, which flows through both capitals, formed the frontier between the Austro-Hungarian and Ottoman Turkish empires. Serbia's northern province, Vojvodina, was run by Austria until the first world war, when artillery pounded old Belgrade from across the river.

"I was surprised to find that Austrians are relatively well liked here," Mr Fried says. "Austrians are much more liked here than Serbs are in Austria."

Historically, relations have been poor. But for a country struggling to recover from more recent wars and economic sanctions, Austrian investment has been welcome.

> 'Anyone who's anyone in the former [Yugoslav] republics seems to have started out in Vienna, or done business there, or sent his kids there for university'

Banking has paved the way for numerous small and medium-sized enterprises. Many Austrian manufacturers have shifted production outside the European Union to save on labour costs, or from China to cut transport time.

Anti-corruption lobbyists, however, see Vienna's role differently.

"Since the fall of communism, Austria's business and political elite have rushed to benefit from the region's weak rule of law and opaque privatisation schemes," says Natasha Srdoc, co-founder of the Adriatic Institute for Public Policy, a Croatia-US think-tank.

Viennese prosecutors are investigating 1990s money laundering at Hypo Group Alpe Adria, especially through loans in Croatia. Yet Austrian anti-corruption laws remain weak by European standards, Ms Srdoc says. Apart from questions about transparency, regional fragmentation prevents larger-scale financial mobilisation.

The Vienna Stock Exchange has tried to pull countries together with joint indices and data-sharing agreements.

Full stock market integration would be as "spectacular as joining the EU" to boost regional economies, Mr Caric at Erste says.

"But we also need to form closer ties within the Yugosphere," he adds. "Our markets, whether for consumer goods or finance, are just too small . . . for large investors to be interested."

As the chatter on Viennese commuter trains confirms, the cultural Yugosphere has already stretched north. Fis Vitez, a Bosnian retailer and furniture maker with a showroom on Ottakringer Strasse since 2002, sells mainly to ex-Yugoslav customers.

Banks, such as Erste, can serve customers in Serbo-Croatian, primarily for international money transfers.

"We don't distinguish this as a separate customer group here at the receiving end [for remittances]," Mr Caric says. "But our colleagues in Austria do, so as to provide personalised service."

Delays to upgrade hamper efficiency

Airport

A key project to maintain competitiveness is a third runway, writes **Eric Frey**

Only a 16-minute train ride or a 20-minute drive from the city centre, the international airport is one of the main assets that make the Austrian capital an attractive business location.

Despite its relatively modest size, it offers one of the best hub systems for destinations in the central and east European region and the Middle East.

In recent years, however, the once comfortable departure halls became increasingly crowded. The last terminal expansion took place in 1996, when passenger volume, now 20m, was less than half that.

A new terminal, called Skylink, with 51 additional gates, was supposed to offer relief as early as 2008. But as costs exploded and the huge project descended into chaos, its completion date was postponed for several years.

Public uproar over costs , which doubled from the originally projected €400m ($567m) to €800m, resulted in a management shake-up last year.

In an emergency move Christoph Herbst, a prominent lawyer with no management experience became chief executive of the supervisory board, replacing Herbert Kaufmann, a former MP and labour-rights advocate, and took personal control of Skylink's construction.

When Skylink opens in mid-2012, overcrowding should ease and the comfort of passengers will improve, says Mr Herbst. Additional shops and restaurants will also boost revenues.

Mr Herbst is searching for a managing board to take over later this year. The new leadership team will need the blessing of the city of Vienna and the surrounding province of Lower Austria, which jointly hold a 40 per cent stake in the publicly traded airport operator VIE.

The new board will need to be more professional than previous managers, says Mr Herbst.

Their task will not only be to complete Skylink, but also to streamline the airport's management and cut costs to boost profitability and generate the funds for investment.

"There is increasing pressure from airlines and passengers to upgrade," Mr Herbst says.

The key project for the future is a third runway.

A sharp decline in traffic in the wake of the financial crisis and the ash cloud caused by the eruptions of Icelandic volcano Eyjafjallajökull in the spring of 2010 took away some pressure on the airport's capacity, but traffic has already fully recovered.

If passenger volume stays on its long-term growth path of 4 to 5 per cent a year, as Mr Herbst expects, another runway will be urgently needed before the end of the decade.

A strong recovery in the CEE region would make a quick start to construction even more pressing.

Growth is expected to come both from point-to-point and transfer business, and much of it will be directed to primary and secondary destinations in central, south-eastern and eastern Europe, where Vienna's airport offers particularly good connections.

Most of these flights are operated by the home carrier Austrian Airlines, which the government sold to Lufthansa in 2009, after the former had a brush with bankruptcy in the wake of the financial crisis.

There were fears that both Austrian Airlines and Vienna airport would lose part of their regional franchise to Lufthansa's main hubs in Frankfurt and Munich.

> 'There is increasing pressure from airlines and passengers to upgrade'
>
> **Christoph Herbst, Chief executive, Airport supervisory board**

But Mr Herbst is confident that will not happen.

He says: "Lufthansa is managing its subsidiaries, Swiss and Austrian, at arm's length. Nothing else would make sense.

"The parent needs to let them strengthen their long-haul destinations, because that is where money is made."

And none of the other airports in the region, Prague, Budapest or Bratislava, offers the connections that can be found in Vienna.

While the previous airport management was often at odds with Austrian over fees and some strategic issues, Mr Herbst says he wants to strengthen the co-operation between the airport and the home carrier.

Most of the transfer business, which makes up a third of passenger volume, is generated by Austrian, which has narrowed its losses under Lufthansa's tutelage but has not yet returned to profitability.

"Without the focus on the home carrier, we would lose our hub function and be reduced to point-to-point business", says Mr Herbst. "That would mean much fewer destinations and a very different strategy."