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City engages in struggle for regional reputation

Bank bailouts, onerous tax rates and Ukrainian crisis threaten Austrian capital's position as financial hub, write *James Shotter* and *Eric Frey*

For more than a decade from the early 1990s, Austrians looked with pride at their banks, as most of the largest and some midsized lenders embarked on a big expansion into central and south-eastern Europe.

The rapid growth in the international businesses of Raiffeisen Bank International, Erste Group and Bank Austria, which is now a unit of Italy's UniCredit, brought jobs, tax revenue and pride to Vienna. The city had enjoyed a long tradition in finance, but became a banking backwater in the years after the second world war.

Among second-tier lenders, Bawag, once a trade-union bank, ÖVAG, the clearing house of the co-operative Volksbank sector, and Hypo Alpe Adria, a regional lender, also snapped up businesses in neighbouring countries to participate in the cross-border bonanza.

With the onset of the financial crisis in 2008, the fortunes of these banks turned quickly, as their foreign exposure transformed from a boon to a burden. The three big banks managed to pare their losses in the east and, thanks to an infusion of capital from the government, weathered the crisis reasonably well. Bawag was hit by a trading scandal and sold off its foreign subsidiaries. But ÖVAG and – far more expensively and controversially – Hypo suffered huge losses (see page 4) and were bailed out with public money.

In recent months, the eastern exposure of Vienna's banks has again emerged as a cause for concern, as the stand-off between the west and Russia over the future of Ukraine has become increasingly bloody and unpredictable.

Erste sold its business in Ukraine in spring 2013. Raiffeisen still has a net exposure of €3.8bn to Ukraine through its Aval subsidiary, which is the country's fifth-biggest bank by credit volume. Bank Austria's gross exposure is €1.6bn and it has a further €11.9bn at risk in Russia.

Large as those numbers are, they are topped by Raiffeisen's gross exposure to Russia, which stands at €19.7bn. Russia has long been one of the Austrian lender's most profitable markets, and Raiffeisen's chief executive, Karl Sevelda, has stressed that his bank has no plans to withdraw from the country, citing its long-term attractiveness.

In the short term, however, Raiffeisen's and Bank Austria's Russian businesses could face a bumpy ride as the impact of the political crisis seeps into the real economy.

And even Austrian banks that are not directly involved in Russia and Ukraine are quite likely to be affected by the conflict, says Josef Christl, a consultant and former executive director of the Austrian central bank (OeNB).

"One of the problems with the situation in Ukraine and Russia is that it calls into question the whole central and eastern European story, which is so important for the Austrian financial sector," he says.

Back home, the news has not been much rosier. In March, after years of procrastinating, the government finally decided how to wind down Hypo, which has consumed €5.75bn in state aid since being nationalised in 2009.

The solution involves setting up a state-run bad bank, which will add €17.8bn to the public debt and bring the gross debt-to-gross domestic product ratio above 80 per cent.

The decision has brought a belated degree of resolution to a festering problem. But the sums involved – the economist Bernhard Felderer puts the total cost of the Hypo affair at €9bn – have outraged the public and done nothing for the broader financial sector's standing.

In an attempt to recover some of the money it spent on bailing out banks during the financial crisis, as well as to assuage public anger, Austria imposed one of the highest bank levies in the EU in 2011. This year it raised it to help cover some Hypo-related expenses.

While top bankers largely accept the government's wish to recoup some of its bailout costs, they have been infuriated by its intention to keep the bank levy in place, even as the banks start to pay into a fund established under the EU banking union.

In response, Erste Group indicated it might move its headquarters to the Czech Republic, where it has its largest foreign subsidiary. One of Raiffeisen's regional banks said that it might cross over to Germany, where bank levies are much lower.

The debate about the bank tax has fed into wider discussion about Austria's competitiveness as a business location. A growing number of businesspeople fret that unfavourable changes to individual and business tax regimes risk eroding the attractions that have made Vienna a hub for foreign businesses.

"Vienna has huge advantages: traffic links to central and eastern Europe, and openness to the region," says Mr Sevelda. "If you need a lawyer or a consultant you can easily find someone who understands the region. But we have

to be careful in tax policy, because our competitors aren't sleeping. Prague and Warsaw must be taken seriously."

Indeed, at 45.4 per cent of national output, Austria's tax take is higher than that of notoriously high-tax Sweden.

Although the government will still fail to meet the requirements of the EU fiscal pact by bringing its structural deficit below the threshold of 0.5 per cent of national output, the calls for tax cuts are getting louder.

Experts also criticise the structure of the tax code. While labour income is highly taxed, the country has some of the lowest taxes on wealth and property in the OECD. Moreover, too much of the public budget is used for pension payments and distorting subsidies. Too little flows into productivity-boosting realms such as education and research and development.

"The main problem is not how much is taxed but what for," says Karl Aiginger, head of the Wifo economic research institute. "The Austrian economy will only remain competitive if we have the necessary skills."

The other area in which Vienna has struggled of late is capital markets. The stock exchange received a welcome boost this month, when aviation components group FACC said it planned a €150m listing this year.

That would be a rare shaft of light in a gloomy sky. The stock exchange – a whirl of activity before the financial crisis – has had no initial public offerings since 2011, although it has had a number of capital raisings, notably from Erste and Raiffeisen and insurer Uniqa.

One way to improve the situation, suggests Mr Christl, would be to sell off some of the companies still fully or partly owned by the state.

"If you want to revive the capital markets, privatisations would make a lot of sense, especially at the moment, as the government could used the one-off gains to offset the one-off costs from Hypo," Mr Christl says.

For now, the government shows little interest in privatisations. Instead, its recent actions are more likely to reduce than increase activity on the Vienna stock exchange.

This month, the finance ministry was central to the brokering of a deal that will see 10 eurozone countries introduce a financial transaction tax from 2016. The move is fiercely opposed by bankers who fear it will drive transactions elsewhere. "It is a political decision, but you have to think about what it means," says Andreas Treichl, chief executive of Erste Group. "It means you are taking a deliberate decision not to have financial transactions in Europe."

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