

# Austrian financial intermediaries: bank profits reach another post-crisis high, while insurance sector results are under pressure

## Austrian banks have continued to benefit from the favorable economic environment

### Consolidation process within the banking sector continues

**Banks continue to dominate the Austrian financial sector, but their share has decreased over the last years.** In 2008, banks still had a market share in the Austrian financial sector of well over 80%. However, in the wake of the financial crisis, banks have shrunk their balance sheets and embarked on a consolidation path. At the end of 2018, banks made up three-quarters of the Austrian financial sector (see chart 3.1). At the same time, mutual funds and insurance companies have become more important, increasing their net asset value and total assets.

**In 2018, consolidation among Austrian banks continued, but their balance sheets expanded.** Compared to previous years, the pace of consolidation decelerated, with the number of banks declining by 5% to 597 at the end of the year. At the same time, banks' aggregate total assets increased by 4% to EUR 986 billion.

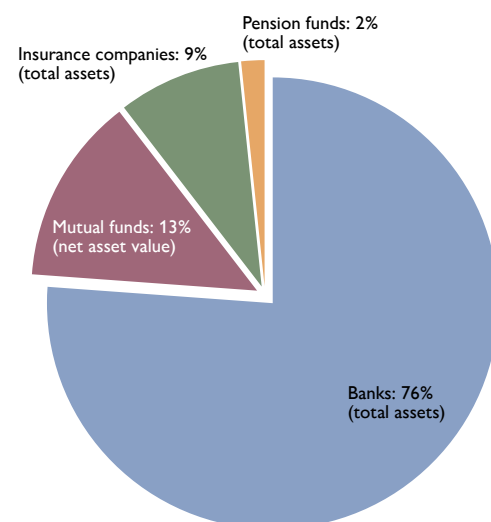
**While Austria still has a large number of banks, the sector's total assets are concentrated at just a handful of institutions.** The five biggest banks represent nearly half the sector's size in terms of total assets, and Austria's significant institutions<sup>1</sup> (i.e. those supervised by the ECB) represent nearly two-thirds.

But since the average Austrian bank has total assets of only EUR 2 billion, which is well below the European average of EUR 24 billion,<sup>2</sup> it is important to continue with the consolidation process to achieve further synergies.

**Foreign claims of Austrian banks continued to increase, driven by an expansion in neighboring countries.** As of end-2018, the Austrian banking sector's foreign exposure amounted to EUR 375 billion, which includes the assets of 55 subsidiaries, 219 branches as well as direct cross-border activities. This represented an increase by 3% compared to the previous year. Although Austrian banks expanded their activities in Germany and Switzerland in 2018, more than 60% of the sector's

Chart 3.1

### The Austrian financial sector at a glance



Source: OeNB, FMA.

Note: Data as of end-2018.

<sup>1</sup> Significant institutions including UniCredit Bank Austria, which is a subsidiary of the Italian UniCredit Group.

<sup>2</sup> Source: ECB.

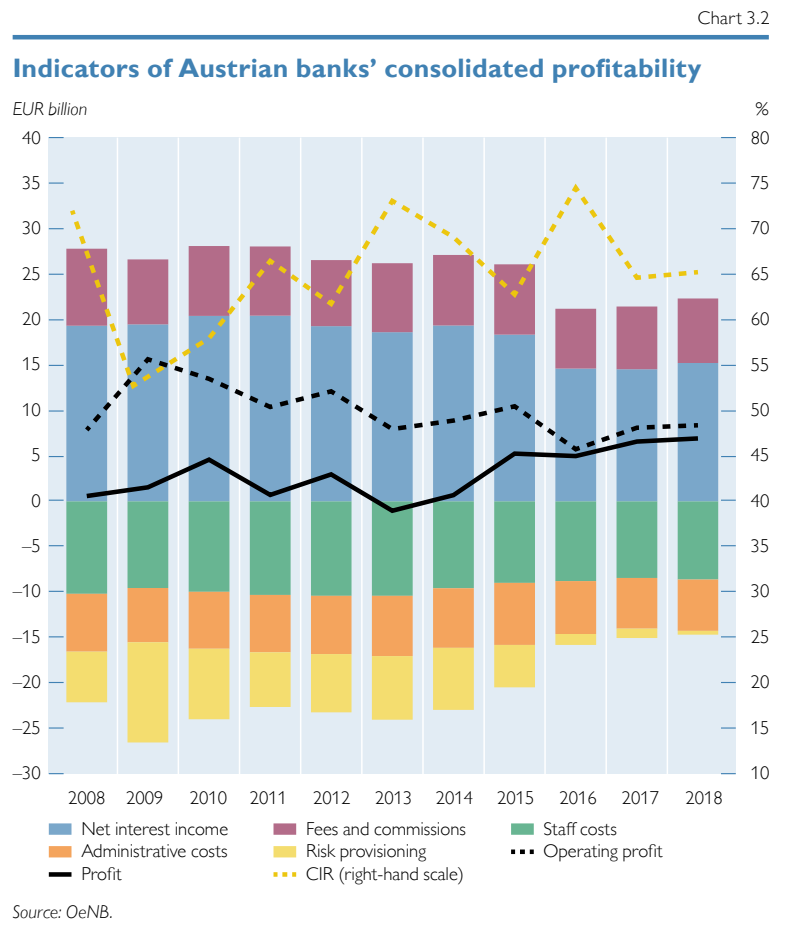
exposure were still claims on countries in CESEE. Overall, Austrian banks continued to strengthen their business focus on EU countries.

### Bank profits at a post-crisis high

**Austrian banks continued to benefit from macroeconomic tailwinds in 2018.** Their consolidated profits reached another post-crisis high at EUR 6.9 billion, which implies a substantial year-on-year increase of 5% (see chart 3.2) and a return on assets of 0.8%, with the latter being well above the average EU level of 0.4%.<sup>3</sup>

**The 5% increase in operating income to EUR 24 billion was supported by improvements in net interest income as well as fees and commissions.** These two sources of revenue, which made up more than 90% of Austrian banks' income in the last years, increased by 5% and 3%, respectively, in 2018. While fees and commissions continued their gradual expansion, net interest income rose substantially in 2018 after having been under pressure for several years. The increase in 2018 was due to both volume and price effects, given that total assets rose and that the consolidated net interest margin expanded slightly (to 1.6%). It is too early to say, however, whether these improvements mark a turning point and can be sustained in the years to come, given the macroeconomic slowdown and the prolonged low interest rate environment.

**The rise in income was outpaced by operating costs, however, and thus cost efficiency has remained weak.** Driven by increasing impairments on investments in associated companies, Austrian banks' expenses grew by 6% year on year, that is, slightly faster than revenues (both staff and administrative costs rose only moderately at 2% and 1%, respectively). Consequently, the sector's cost-income ratio (CIR) worsened, albeit only slightly, and is still at an elevated level of 65%. In an international comparison, Austrian banks' CIR corresponds to the weighted average for EU banks. This average, however, is driven by German and French banks, whose CIRs of 82% and 73%, respectively, are significantly above the average.<sup>4</sup> Given that most banking systems – especially in CESEE and the Nordic countries – display better CIRs than Austrian banks, there seems to be room for improvement and lessons to be learned from best practice examples. Taking into account total operating



<sup>3</sup> Source: EBA Risk Dashboard, data as of Q4 2018.

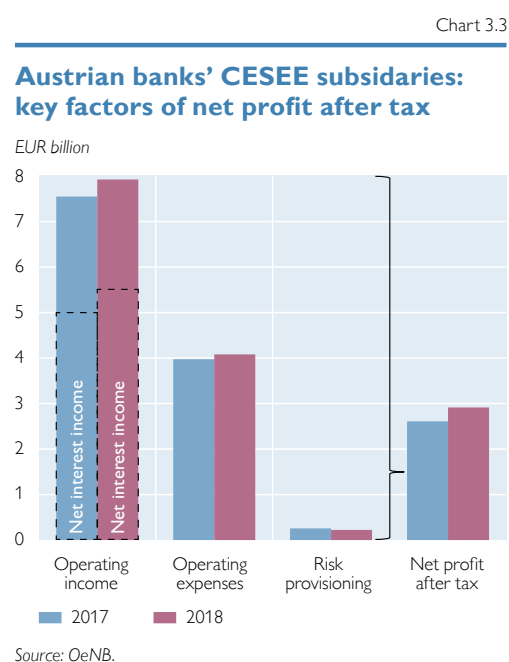
<sup>4</sup> Source: EBA Risk Dashboard, data as of Q4 2018.

income and operating costs, Austrian banks earned an operating profit of EUR 8.4 billion in 2018, up 3% on the previous year.

**Austrian banks' profits continued to be supported by falling risk provisions, which reached another historical low in 2018.** Having declined substantially since the height of the financial crisis, provisioning for (mostly credit) risk was cut by more than half – as credit quality continued to improve – and stood at EUR 0.4 billion at year-end. As chart 3.2 shows, low risk costs in a benign macro-economic environment have supported rising profits over the last years, while operating profitability remained burdened by a high CIR. Therefore, Austrian banks should continue to address structural issues to foster the sustainability of their profits and ensure that they have enough room for maneuver in a potential downturn.

**Other comprehensive income (OCI) complements a holistic profitability assessment of banks reporting under International Financial Reporting Standards (IFRS).** It provides a view on unrealized profits and losses that do not flow through banks' profit and loss statement (P&L), but are directly recognized and accumulate in shareholders' equity. Thus, analyzing OCI provides an additional profitability measure that integrates a forward-looking view on banks' operations. In 2018, Austrian IFRS banks recorded an OCI of –EUR 0.9 billion – burdened by valuation losses on debt instruments at fair value – and have accumulated OCI in their equity of –EUR 7.6 billion (e.g. due to foreign currency translations or defined benefit pension plan adjustments), of which around half could flow through the P&L in the future.

### Profitability of subsidiaries in CESEE has increased further



**Austrian banking subsidiaries' business activities in CESEE in 2018 mirrored the benign macro-economic environment in the region.** Their net profit after tax rose from EUR 2.6 billion in 2017 to EUR 2.9 billion in 2018 (see chart 3.3).<sup>5</sup> This was attributable to strong loan growth in most CESEE countries that translated into a rise in net interest income and the historically low level of risk provisions. The highest net profits after tax in 2018 came from subsidiaries in the Czech Republic, Russia, Romania and Slovakia. The highest increase in net profits was registered at subsidiaries in Romania, the Czech Republic and Croatia.

**Austrian subsidiaries in CESEE mostly lend to households.** In absolute terms, loans of Austrian

<sup>5</sup> Figures from sold units are not included for comparability reasons.

banking subsidiaries to nonbanks grew particularly strongly in the Czech Republic (+EUR 3.0 billion), Slovakia (+EUR 2.0 billion) and Romania (+EUR 1.5 billion) in 2018. Loan growth was funded by local deposits, which rose in the same manner, so that loan-to-deposit ratios stayed nearly unchanged. Overall, Austrian banking subsidiaries' credit growth in CESEE was 7% in 2018. The main driver were loans to households (in particular mortgage loans), which grew by 11% in the entire region. A breakdown by country reveals that loan growth to households was 9% in the Czech Republic, 11% in Slovakia and 12% in Romania in 2018. Loan growth to nonfinancial corporations was positive too, but far from vivid.

**Net interest income, which makes up almost 70% of Austrian subsidiaries' operating income, rose by a strong 8% in 2018, while net interest margins remained almost unchanged.** The increase in net interest income was most notable in the Czech Republic and Romania due to high credit growth and a rise in the central banks' policy rates. At the same time, the aggregate net interest margin of subsidiaries in CESEE, defined as net interest income to average total assets, stagnated at 2.7% year on year (as seen in chart 3.4). The margins at subsidiaries in Austria's neighboring countries are below this average, but their net interest income has benefited from a high volume of interest-bearing assets.

**Low risk provisioning remained a key factor for profitability for Austrian banks' CESEE subsidiaries in 2018.** In several countries, like Hungary, Ukraine, Albania or Slovenia, Austrian subsidiaries released more credit risk provisions than they built up. Furthermore, in most countries where subsidiaries' provisioning was still positive on balance, the buildup in 2018 was well below the previous year's. However, the coverage ratio of Austrian banks' CESEE subsidiaries remained high at 64% in 2018, up from 61% in 2017.<sup>6</sup>

**Loan quality has improved thanks to lower nonperforming loans and higher loan growth**

**The loan quality of the Austrian banking sector continued to improve on the back of lower**

Chart 3.4

### Austrian banks' CESEE subsidiaries: net interest margins

Net interest income in % of average total assets

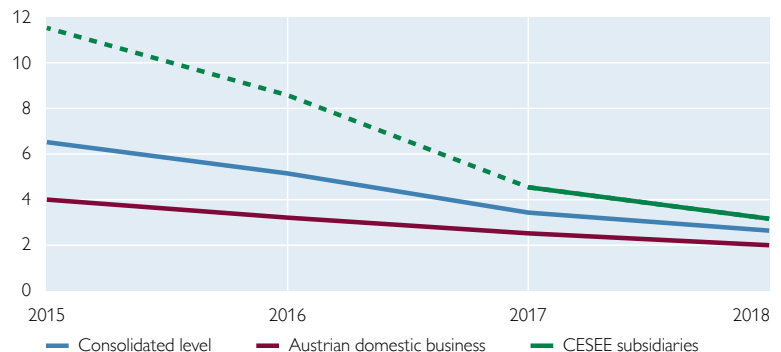


Source: OeNB.

Chart 3.5

### Credit quality of Austrian banks

Nonperforming loans in % of total loans



Source: OeNB.

Note: The ratio for CESEE subsidiaries prior to 2017 includes only loans to corporates and households.

<sup>6</sup> See the EBA Risk Dashboard for a comparison of coverage ratios in Europe.

Chart 3.6

**Growth of loans to nonbanks in Austria**

Source: OeNB.

Note: Annual growth rates adjusted for exchange rate effects, write-downs and reclassifications.

**nonperforming loans (NPLs) and higher credit growth.** The consolidated NPL ratio went down to 2.6% as of end-2018, 80 basis points below the previous year's level (see chart 3.5). A breakdown by geographical segments shows that the NPL ratio in Austria was 2.0%, while Austrian subsidiaries in CESEE reduced their NPL ratio to 3.2%.

**Reduced provisioning leads to a lower loan loss provision ratio.**

Austrian banks were able to further reduce their risk provisioning due to the still favorable economic environment, but as a result, their loan loss provision ratio declined to 1.8%, well below the historical average of 2.6%. If banks had to increase the ratio up to this average, they would have to build up new provisions of nearly EUR 5 billion (assuming

a constant loan volume). Given that this buildup would be unlikely to take place in just one year, the resulting negative impact on profits would be spread over time, however.

**Austrian banks' CESEE subsidiaries have also further improved their loan quality.** Compared to the previous year, the NPL ratio dropped from 4.5% to 3.2% in 2018. At the country level, heterogeneity is still high: The NPL ratio remained below or close to the Austrian level in, for instance, the Czech Republic and Slovakia (1.2% and 2.7%, respectively) but was still elevated – albeit improving – in Croatia, Hungary and Romania (between 4.4% and 7.6%).<sup>7</sup>

**Loan growth in Austria gained further momentum in 2018, especially in the real estate sector, leading also to improved credit quality indicators.** Loans to nonbanks increased by 4.9% year on year compared to 3% one year earlier (see chart 3.6). The expansion was driven by lending to corporates (especially in residential construction) as well as the continued growth of mortgage loans to households. Cooperative banks and savings banks were the most active lenders in 2018, while building and loan associations reduced their outstanding loans to nonbanks.

<sup>7</sup> For a comparison with average NPL ratios in CESEE markets, see chart 1.4. In general, Austrian subsidiaries in CESEE perform better than their competitors.

Box 2

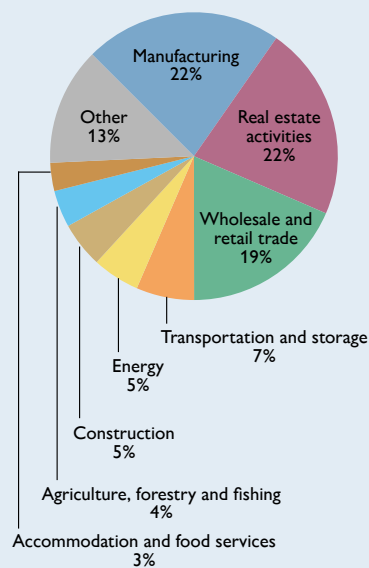
### Austrian banks' corporate loan portfolios in CESEE

**Austrian banks' corporate lending in CESEE is concentrated in eight sectors, and these loans accounted for 87% of the region's corporate loan portfolio at end-2018.**<sup>8</sup> The sectoral decomposition (see chart 3.7) also shows that the highest volumes by far were extended to the manufacturing industry, real estate activities, and the wholesale and retail trade sector. Over the last two years, smaller sectors recorded the highest growth rates, above all transportation and storage (+19%; see the bar chart of chart 3.7), but larger sectors also registered strong growth rates (wholesale and retail trade: +13%, manufacturing: +9%). Surprisingly, loans for real estate activities grew only slowly (+2%), while those to the construction industry even contracted by -10%. The latter development was mainly driven by a decline in loans in Croatia and Slovenia, partly due to portfolio adjustments and NPL sales at certain banks.

Chart 3.7

### Austrian banks' corporate loan portfolios in CESEE

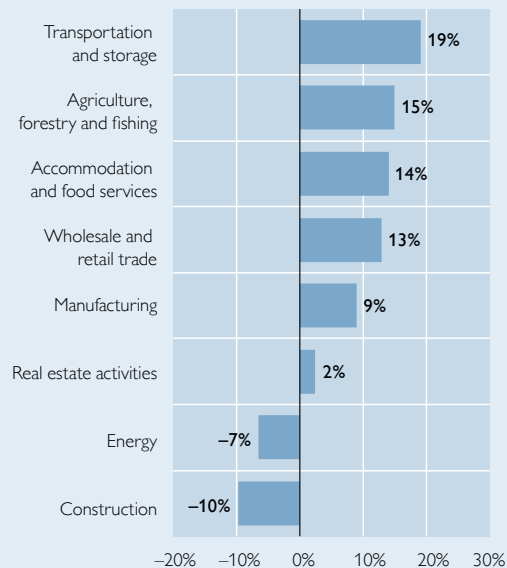
By economic sectors



Source: OeNB.

Note: Data as of end-2018.

Loan growth rates by borrower sectors from end-2016 to end-2018

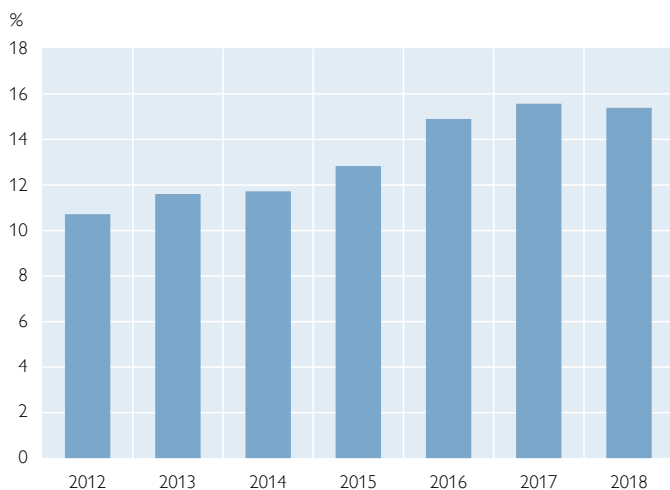


Source: OeNB.

Note: Given that the sale of Raiffeisen Polbank's core banking operations to BNP Paribas in 2018 limits comparability, the growth rates have been adjusted for this one-off effect.

<sup>8</sup> The analysis includes direct cross-border lending and lending through banking subsidiaries.

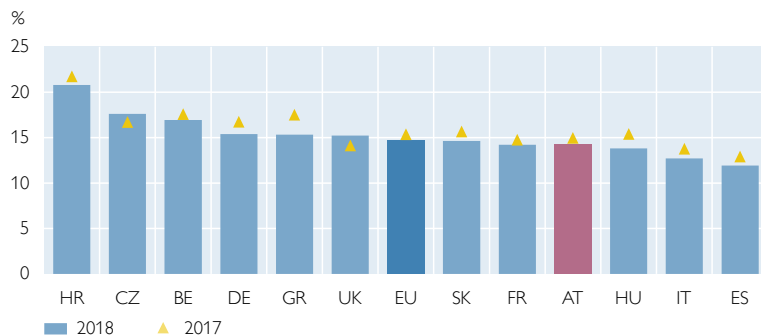
Chart 3.8

**Consolidated CET1 ratio of Austrian banks**

Source: OeNB.

Note: The ratio before 2014 is an approximation of the current Basel III regime.

Chart 3.9

**CET1 ratios in selected European countries**

Source: EBA, sample of reporting banks.

**Capitalization of Austrian banks has slightly declined**

**Austrian banks' capital ratios declined in 2018 due to a rise in risk-weighted assets and the dividend payout ratio.** The Austrian banking system's profit reached a post-crisis high in 2018 amid strong loan growth in both Austria and CESEE, but this also led to higher risk-weighted assets (+4% year on year). Furthermore, banks also chose to distribute a higher proportion of their profits to their shareholders in 2018: Compared to the previous year, Austrian banks doubled their dividend payout ratio to nearly one-third. As the increase in risk-weighted assets outpaced the increase in capital, the common equity tier 1 (CET1) ratio of Austrian banks declined and stood at 15.4% at the end of 2018 (18 basis points lower than in the previous year, see chart 3.8).

**The slight deterioration in Austrian banks' capitalization was consistent with developments in other European banking sectors.** According to data from the European Banking Authority (EBA), most European markets saw a reduction in banks' CET1 ratios in 2018. Austrian banks that report to the EBA had a CET1 ratio of 14.2% at the end of 2018 (see chart 3.9). This was below the European average of 14.7%, even though the average itself had declined. However, as an OeNB study

on the international comparability of risk weights<sup>9</sup> has shown, there are statistically significant and economically important cross-country differences in risk weights that determine CET1 ratios. Due to a higher share of risk-weighted assets in total assets, Austrian banks have a CET1 ratio that is below the EU average, but a leverage ratio that is markedly better.

<sup>9</sup> Kerbl, S. and S. Döme. 2017. Comparability of Basel risk weights in the EU banking sector. In: *Financial Stability Report 34*. OeNB. December. 68–89. [https://www.oenb.at/dam/jcr:0b5b3df2-1579-486b-b455-1912828clf2b/fsr\\_34\\_screen.pdf](https://www.oenb.at/dam/jcr:0b5b3df2-1579-486b-b455-1912828clf2b/fsr_34_screen.pdf)



Box 3

### IMF Financial Sector Assessment Program in Austria in 2019

Austria is one of 29 countries whose financial sector the IMF deems to be systemically important, among other things because of its size and function as a regional financial hub for CESEE. Therefore, a mandatory comprehensive and in-depth assessment under the IMF's Financial Sector Assessment Program (FSAP) takes place every five years. The IMF conducted FSAPs in Austria in 2003, 2008 and 2013. The 2019 FSAP in Austria comprises three components: (1) sources, probabilities and potential impact of material risks to systemic stability in the near future; (2) the legal and regulatory financial stability framework; and (3) national institutions' capacity to deal with a financial crisis should risks materialize. It also includes an assessment of Austria's anti-money laundering and terrorist financing regulations. With respect to banking supervision, the focus of the Austrian FSAP is on the supervision of less significant institutions, as a detailed assessment of significant institutions was conducted under the euro area FSAP in 2018.

### Austrian banks' liquidity positions are solid

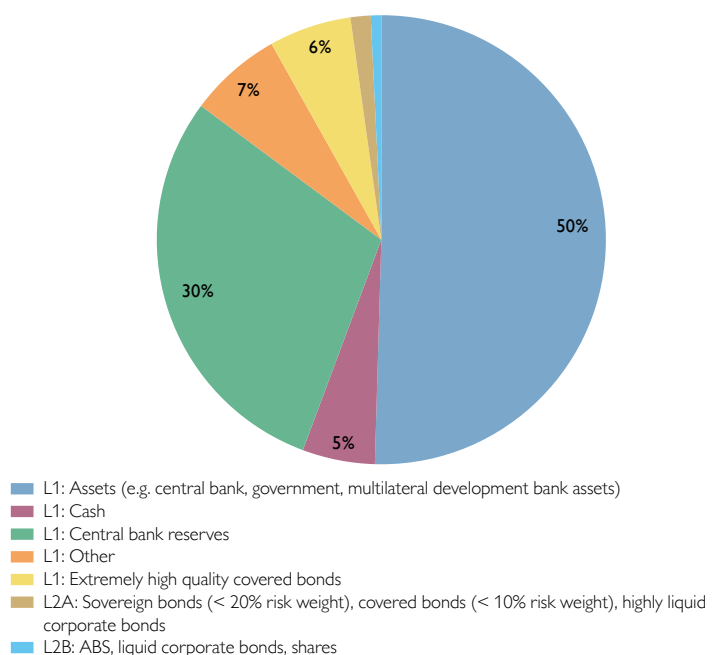
**High liquidity coverage ratios (LCRs) attest to Austrian banks' solid short-term resilience against liquidity shocks.** All Austrian banks report LCRs above the regulatory minimum. At the system level, the weighted average LCR on an aggregated currency basis stands at 145% at the unconsolidated level and at 149% at the consolidated level (as of end-2018). Over the last year, monthly LCRs have moved in a stable band between 134% and 153% without much volatility. The greatest contributors to net cash outflows in foreign currencies within the LCR for the Austrian banking system were the Czech koruna and the U.S. dollar. While the weighted average LCR in Czech koruny stood at 210%, the LCR in U.S. dollars was only 47% at the consolidated level.

**The composition of Austrian banks' liquidity buffers has remained unchanged, consisting mainly of assets belonging to the highest category of eligible level 1 (L1) assets.** In fact, the share of L1 assets (excluding high-quality covered bonds) amounted to 92%, while the share of L1 covered bonds rose slightly to 6% (see chart 3.10) at end-2018. Within the L1 assets category, cash, government bonds and central bank assets accounted for more than 88%.

**Retail and corporate deposits are the main components of Austrian banks' funding mix.** Funding in the capital market via the

Chart 3.10

Composition of Austrian banks' liquidity buffers



Source: OeNB.



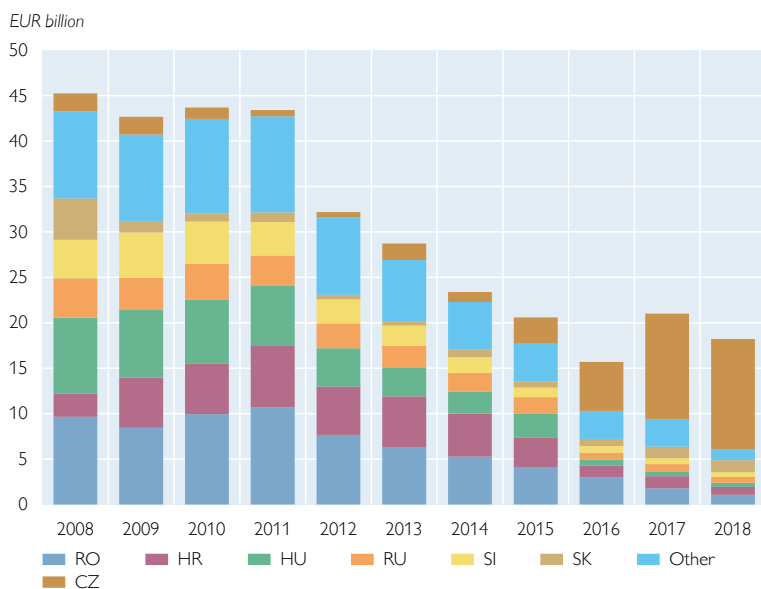
issuance of debt securities is mostly used by larger institutions. In terms of liability volumes, 60% are deposits, of which retail deposits account for the largest part, and only 14% are debt securities.

**The Austrian unsecured money market has turned from a short-term liquidity-raising into a deposit-taking market**, in which Austrian banks accept liquidity from banks operating in CESEE at a rate below the deposit facility rate.<sup>10</sup> Looking at the Austrian unsecured money market loan network (i.e. all transactions in which either the loan originator or beneficiary is an Austrian bank), a deposit-taking business model seems to be emerging, where Austrian banks pay negative interest rates significantly below the Euro OverNight Index Average (EONIA) and below the deposit facility rate. In other words, they receive interest for taking in liquidity. Since the unsecured interbank market for Austrian banks currently consists of just a few hundred interbank loans per month, it could well be described as dried up. Also, in recent months, just a handful of money market loans have been granted with maturities longer than one week. This phenomenon is also prevalent in other euro area countries and makes it more difficult to develop a reference rate that is suitable to replace the Euro InterBank Offered Rate (EURIBOR).<sup>11</sup> However, the limited reliance of Austrian banks on the potentially volatile short-term unsecured funding market could also be interpreted as a positive factor for financial stability.

**The refinancing structure of large Austrian banks' subsidiaries in CESEE remained sustainable in 2018.**

Chart 3.11

**Intra-group liquidity transfers to CESEE credit institutions**



Source: OeNB.

In line with the Austrian supervisory guidance on strengthening the sustainability of the business models of large internationally active Austrian banks (“Sustainability Package”) adopted in 2012, the supervisory authorities have been monitoring the stock and flow loan-to-local stable funding ratios (LLSFRs) of Austria’s largest banks’ foreign subsidiaries.<sup>12</sup> As of end-2018, all 22 monitored subsidiaries of Erste Group Bank and Raiffeisen Bank International had a sustainable local refinancing structure (compliant with the guidance). The aggregated stock LLSFR remained broadly stable year on year (Q4 2018: 75%), and two-thirds of all subsidiaries had a ratio below 80%, which is well below the early warning threshold of 110%. Due to the subsidiaries’ stronger

<sup>10</sup> The source for the analyzed unsecured money market data is TARGET2.

<sup>11</sup> It has to be noted that the underlying data only show loans that have been executed and do not include loans that have been rolled over.

<sup>12</sup> For further details, refer to <https://www.oenb.at/en/financial-market/financial-stability/sustainability-of-large-austrian-banks-business-models.html>.

reliance on local funding, the (gross) intra-group liquidity transfers from all Austrian banks to credit institutions in CESEE decreased substantially over the past years. As chart 3.11 depicts, transfers have more than halved since 2011 and stood at EUR 18 billion at end-2018. Bucking the general declining trend, transfers to the Czech Republic have skyrocketed in recent years (because of the positive interest rate differential vis-à-vis the euro area). In 2018, they accounted for two-thirds of all transfers, although the affected subsidiaries' refinancing position has typically been strong.

Box 4

### **The Austrian Financial Market Stability Board at five**

**Five years ago, the Financial Market Stability Board (FMSB) was established to strengthen cooperation in macroprudential supervision and to promote financial market stability.**<sup>13</sup> Since then, the FMSB has contributed successfully to the reduction and mitigation of systemic risks identified by the OeNB in its monitoring activities. Since mid-2018, the Austrian banking sector has been ranked among the world's most stable banking systems.<sup>14</sup> Consequently, Austrian banks and the Austrian economy have been benefiting from lower funding costs. Also, a recent analysis concluded that in Austria, the benefits of macroprudential measures have outweighed their costs.<sup>15</sup>

**A strong national macroprudential framework is crucial.** Unlike in microprudential supervision, the ECB has only "top-up" powers in macroprudential supervision under the SSM; this means that the ECB can apply more stringent macroprudential measures in case of potential national inaction. So far, the ECB has never made use of these powers. Also, the European Systemic Risk Board (ESRB) monitors and assesses systemic risks in the entire EU financial system and can issue warnings and recommendations.

**Under the national macroprudential framework, the OeNB has been entrusted with the mandate of safeguarding the stability of the Austrian financial system.** In carrying out this mandate, the OeNB is responsible for identifying and assessing systemic risks in the Austrian financial sector as well as for preparing the FMSB's recommendations and risk warnings. Furthermore, it also manages the FMSB's secretariat, which is responsible for procedural matters and prepares the FMSB's meetings. Finally, the OeNB provides expert opinions to the Austrian Financial Market Authority (FMA) to underpin the latter's legal measures.

**The FMSB connects the key players in the Austrian supervisory framework.** The FMSB links the OeNB's macroprudential monitoring with the FMA's supervisory function, based on the regulatory framework defined by the Federal Ministry of Finance. In addition, the Fiscal Advisory Council is actively involved in the FMSB to ensure that the sustainability of public finances is also taken into due account. Bringing together members of these four institutions, the FMSB convenes at least four times a year.

**The OeNB has provided the input for important macroprudential measures taken by the FMSB.** Since its inaugural meeting in September 2014, the FMSB has released 24 recommendations to the FMA, one advice to the Ministry of Finance and several communications on standards for sustainable mortgage lending, including their quantification, thereby making a significant contribution to maintaining financial stability in Austria. In particular, the implementation of the systemic risk buffer (SyRB)<sup>16</sup> and the other systemically important

<sup>13</sup> [www.fmsg.at/en](http://www.fmsg.at/en)

<sup>14</sup> Standard & Poor's Banking Industry Country Risk Assessment (BICRA).

<sup>15</sup> For details see Posch, M., S. Schmitz and P. Strobl. 2018. Strengthening the euro area by addressing flawed incentives in the financial system. In: *Monetary Policy and the Economy Q2/18*. OeNB. 34–50.

<sup>16</sup> The SyRB addresses the risks to individual banks that arise in the financial system because of its intrinsic mechanisms of risk sharing.

*institutions (O-SII) buffer<sup>17</sup> were adequate measures to contain direct and indirect risk concentration, to prevent moral hazard and increase the financial system's resilience. More recently, the FMSB published a quantification of sustainable lending standards to prevent the buildup of systemic risks stemming from banks leaning toward easing their lending standards for real estate loans.*

**Macroprudential policy in Austria is guided by high standards of transparency, accountability and consistency.** *The FMSB publishes all its recommendations and press releases after each meeting on its website. It pursues its activities on the basis of a strategy that is also geared at fostering the decision-making process and communication and at demonstrating its accountability to the public. To ensure consistency, the OeNB takes into account the different aspects of systemic risk mitigation – macroprudential policy, the deposit guarantee schemes and the resolution regime – when preparing the FMSB's decisions.*

**The FMSB will continue to play a key part in safeguarding financial stability in Austria.** *It stands ready to respond swiftly to increases in systemic risks and to employ all its available tools to preserve financial stability in Austria and to contribute to financial stability in the EU.*

## The OeNB's approach to macroprudential policy

**The OeNB's approach to macroprudential supervision emphasizes consistency between crisis prevention and crisis resolution.** An efficient framework has to ensure consistency between macroprudential regulation, the resolution regime and deposit guarantee schemes (DGSs). For regulators, the interplay of measures in these areas is essential. Hence, the OeNB's approach fundamentally contributes to strengthening financial stability in Austria.

**Macroprudential buffers have been put in place in Austria.** Since 2016, the systemic risk buffer (SyRB) and the other systemically important institutions (O-SII) buffer have been activated for selected Austrian banks.<sup>18</sup> The SyRB addresses the systemic risk resulting from stress in the system for individual banks. It enables banks to absorb the repercussions of problems at individual banks which may arise from the risk-sharing mechanisms in financial systems such as deposit guarantee schemes or interbank exposures.<sup>19</sup> For this reason, the calibration of the SyRB explicitly considers the two risk channels of funding cost shocks due to stress at an Austrian bank and costs emanating from a DGS event. The SyRB works as a corrective buffer to reduce negative effects by providing for a higher risk-bearing capacity. As a preventive buffer, the O-SII reduces structural risks within the financial system. The O-SII aims at making systemic events less probable by requiring systemically important banks to hold more capital.

<sup>17</sup> *The O-SII buffer addresses the systemic risks to the financial system that arise from the potential failure of an individual bank via direct and indirect contagion.*

<sup>18</sup> <https://www.fmsg.at/en/publications/warnings-and-recommendations/2018/recommendation-fmsg-2-2018.html> and <https://www.fmsg.at/en/publications/warnings-and-recommendations/2018/recommendation-fmsg-3-2018.html>

<sup>19</sup> *The most important sources of systemic risks for the Austrian banking system are the still substantial exposures to emerging markets in Europe, weak structural profitability and banks' specific ownership structures, which do not ensure the adequate recapitalization of banks in the event of a crisis. Moreover, banks continue to be exposed to systemic risks, above all stemming from the risk-sharing mechanism in the financial system and from reputation effects (spread risk).*

**Banks whose failure might have significant negative effects on financial stability are identified during resolution planning conducted by the national resolution authority.**<sup>20</sup> The OeNB's consistent approach ensures that those banks are also identified as O-SIIs. Banks that are not considered O-SIIs can usually exit the market through regular insolvency proceedings, with the DGS effectively protecting savers' deposits. Austria has implemented the EU Directive on DGS<sup>21</sup> and also has in place a sound and strict supervisory system. In spite of this, the failure of a large bank that would require DGS payouts could have a substantial impact on financial stability. Thus, the OeNB has extended its framework for identifying O-SIIs in line with the relevant EBA guidelines. This approach includes the application of the EBA indicators relating to banks' size, importance for the economy, cross-border activities and interconnectedness. Furthermore, national supervisors draw on their expertise regarding the domestic banking sector to identify further institutions that are so relevant that they should be designated as O-SIIs. In this process, the OeNB considers the findings from resolution planning and the assessment of the DGS. Therefore, banks with a share higher than 3.5% of guaranteed deposits are identified as highly relevant for the entire system because their failure would (over)burden the DGS; this is why they are classified as O-SIIs. In contrast to the SyRB, the O-SII buffer reflects the risk of the bank to the entire system and aims at reducing the probability of a large bank's failure. Hence, the O-SII buffer reduces the likelihood that large DGS events happen at all, while the SyRB ensures that if a DGS event happens, banks will be able to handle it.

**Macroprudential policy reduces the probability of public bailouts.** The OeNB's macroprudential policy combines a preventive approach (O-SII buffer) with a risk-mitigating approach (SyRB). This ensures the availability of a number of options to manage future banking problems without public bailouts. In addition, the combined approach intends to strengthen the shock absorption capacity of large banking groups and banking sector institutional protection schemes (IPSs). Since banks may be systemically relevant both at the consolidated and at the unconsolidated level, the SyRB and the O-SII buffer are implemented on both the consolidated and unconsolidated level.

**Macroprudential buffers have a positive impact on the Austrian banking sector.** Recent SyRB and O-SII buffer evaluations show that the activation of the buffers has yielded the intended effects. (1) Austrian banks have improved their capitalization (without scaling back lending) and (2) have made adjustments in their foreign business, which carried relatively high risks. This has led to (3) a decrease in the overall size of the Austrian banking sector. Against this background, the rating agency Standard & Poor's raised the rating of the Austrian banking system in May 2018, which puts it among the most stable banking systems worldwide.

**The countercyclical capital buffer (CCyB) remains at 0%.** The FMSB's recommendation to the FMA to leave the CCyB at 0% from July 1, 2019, was based on the finding that the main indicator – the credit-to-GDP gap – is negative and therefore does not show excess credit growth in Austria (see chart 3.12). In

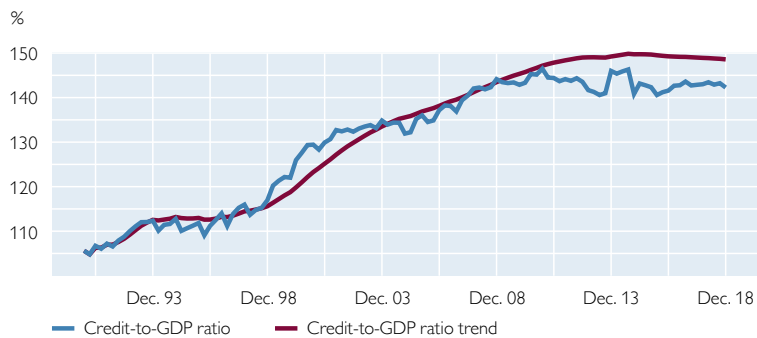
<sup>20</sup> See also Eidenberger, J., V. Redak and E. Ubl. 2019. *Who puts our financial system at risk? A methodological approach to identify banks with potential significant negative effects on financial stability.* In: *Financial Stability Report 37.* OeNB.

<sup>21</sup> Directive 2014/49/EU.

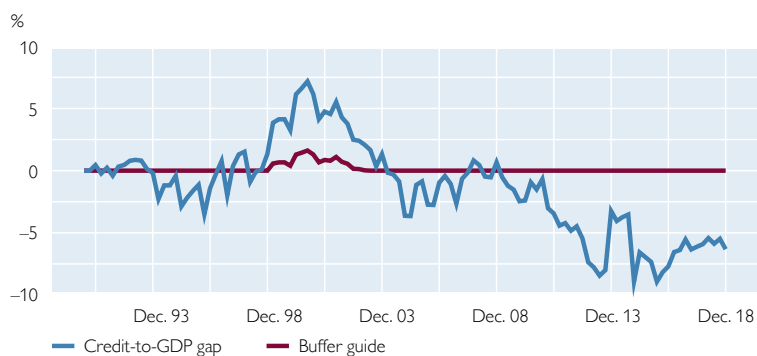
Chart 3.12

## Indicators related to the countercyclical capital buffer

### Credit-to-GDP ratio and trend



### Credit-to-GDP gap and CCyB guide



Source: OeNB.

Note: The credit-to-GDP gap (blue line, bottom panel) is defined as the difference between the credit-to-GDP ratio (blue line, top panel) and its trend (purple line, top panel). A positive gap indicates that the current credit-to-GDP ratio is higher than its trend, which, according to the methodology proposed by the Basel Committee on Banking Supervision, indicates excessive credit growth.

In addition to this indicator, the OeNB's assessment of a set of eleven variables within six risk categories feeds into the CCyB decision. These variables include banks' interest margins, a high-yield bond spread, the leverage ratio, risk-weighted assets for corporate and mortgage loans, debt-to-income ratios for households and corporates, the price-to-rent ratio and the OeNB's fundamentals indicator for property prices, and the current account balance.<sup>22</sup> Finally, the Austrian Financial Stress Indicator is also taken into account.<sup>23</sup> Currently, the FMSB considers the level of cyclical systemic risks stemming from excessive credit growth in Austria to be relatively low. However, some variables in the residential real estate sector warrant close monitoring with a view to the emergence of potential systemic risks.

**Several European countries have put in place, or are discussing, positive countercyclical capital buffers.** The most important among them, from an Austrian perspective, are France, Germany, the Czech Republic and Slovakia. France introduced a CCyB of 0.25% to be applied from July 1, 2019. This is in accordance with the

Basel methodology based on the credit-to-GDP gap, which indicates a positive CCyB for France. However, the main argument was the high degree of private sector debt recorded in 2018. In Germany, the competent authorities are discussing an increase of the CCyB above 0%, having identified three vulnerabilities: (1) an underestimation of credit risk by low risk weights, (2) an overvaluation of collateral values due to increased real estate prices and (3) high interest rate risk. Given that the German market is very similar to the Austrian market, the OeNB has been looking into whether these findings are also relevant for the domestic market. The OeNB found that, first, risk weights are considered to be higher in Austria than in Germany,<sup>24</sup> and their change over time enters the set of additional indicators for determining a CCyB rate in Austria. Second, higher real estate prices are a concern for financial stability in Austria too, but supervisory efforts have

<sup>22</sup> See Sigmund, M. and I. Stein. 2017. *What predicts Financial (In)Stability? A Bayesian Approach*. In: *Credit and Capital Markets Vol. 3*. 299–336.

<sup>23</sup> See Eidenberger, J., B. Neudorfer, M. Sigmund and I. Stein. 2013. *Quantifying Financial Stability in Austria – New Tools for Macroprudential Supervision*. In: *Financial Stability Report 26*. OeNB. 62–81.

<sup>24</sup> See Döme, S. and S. Kerbl. 2017. *Comparability of Basel risk weights in the EU banking sector*. In: *Financial Stability Report 34*. OeNB. 68–89.



been made to limit the resulting vulnerabilities. Third, a close examination of interest rate risk<sup>25</sup> presented as a special topic in this report finds elevated interest rate risks for Austrian banks. While not yet at a level that would be critical from a systemic perspective, its increasing trend warrants further monitoring. In the Czech Republic, a 1% CCyB was introduced in July 2018, which will be raised to 1.5% from July 2019, mainly because of the high risks in the mortgage loan sector, according to the central bank. In Slovakia, a rate of 1.5% will be applicable starting in August 2019, with the general credit expansion, which is also visible in the credit-to-GDP gap, being quoted as the main reason.

### Housing loans continue to be under close supervisory monitoring

**The growth of housing loans by Austrian banks to households has remained strong, as real estate prices have been increasing further.** The annual growth rate of residential real estate prices reached 7.4% in 2018 and remained strong also in the first quarter of 2019 (see chapter on corporate and household sectors in Austria). While lending for house purchases has grown more strongly than overall banks' balance sheets, its share still accounted for only 14% of Austrian banks' total balance sheet, which is below the EU average of 19%.

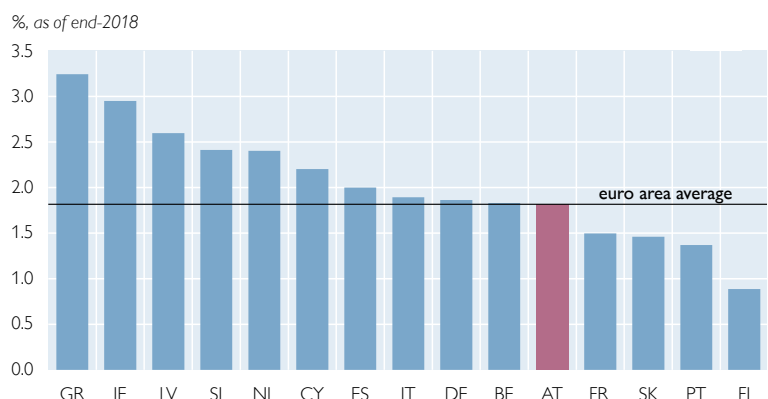
**Nonperforming mortgage loan ratios have remained low.** At the end of 2018, the NPL ratio for loans collateralized by residential real estate was 1.6% and, therefore, lower than for other types of loans to nonbanks. However, since NPL ratios are backward-looking indicators, they are suited for monitoring a buildup of systemic risks only to a limited extent.

**The interest rates on new housing loans in Austria and in the euro area have continued to decline.** Having dropped below 2% already in 2016, they averaged only 1.8% both in Austria and the euro area as of end-2018 (see chart 3.13). Over the last years, the initial fixed interest period for housing loans has increased markedly. For example, loans with rates fixed for more than ten years made up one-third of all new housing loans in 2018; until the beginning of 2016, this share had been below 10%. Still, loans with variable interest rates accounted for 44% of all new housing loans in Austria in 2018.

**The OeNB calls on Austrian banks to comply with the guidance on sustainable real estate lending issued by the FMSB in September 2018.**<sup>26</sup> Preliminary evidence from an OeNB survey is encouraging, confirming banks' efforts to reach more sustainable loan-to-value

Chart 3.13

#### Interest rates on new housing loans



Source: ECB.

<sup>25</sup> Kerbl S., B. Simunovic and A. Wolf. 2019. Quantifying interest rate risk and the effect of model assumptions behind sight deposits. In: *Financial Stability Report 37*. OeNB.

<sup>26</sup> Press release of the 17<sup>th</sup> meeting of the Financial Market Stability Board, September 2018. <https://www.fmsg.at/en/publications/press-releases/2018/17th-meeting.html>

ratios and maturities. Nevertheless, the OeNB is concerned about the comparatively high share of new mortgage loans with loan-to-value ratios above 100%, for which borrowers did not provide an adequate deposit, and about rising debt service levels in relation to borrowers' income.

**The OeNB aims at preventing the strong momentum in the Austrian real estate market from fueling a credit-price spiral.** The potential for a credit-price spiral has increased against the backdrop of continuously rising real estate prices and increasing loan volumes granted at lending standards that are not in line with the FMSB's guidance on sustainable debt service ratios. At the same time, however, some mitigating factors are still at work: a relatively low level of household indebtedness, a rising share of loans with longer interest rate fixation periods, and the above-mentioned relatively low level of mortgages in relation to bank capital.

**The OeNB will continue to closely monitor systemic risk from real estate lending.** An analysis of lending standards over time shows that new mortgage lending with conservative risk indicators has been on the decline, while potential risks have been slowly building up. In line with its financial stability mandate, the OeNB will carefully evaluate whether these developments warrant an activation of macroprudential instruments as laid down in Article 22b Austrian Banking Act. A key aspect in this regard will be the assessment of the effectiveness of the FMSB's quantitative guidance on sustainable real estate lending.

#### **New leaflet about risks of foreign currency loans**

**Foreign currency lending has continued to decline sharply in Austria.** The volume of outstanding foreign currency loans to domestic nonbanks fell by 11% (exchange rate adjusted) to EUR 20.6 billion in 2018. As a result, the share of foreign currency loans in total loans dropped to 5.7%. Given the substantial decrease seen over the past few years, foreign currency loans do not represent a systemic risk for the Austrian financial system. Yet, the risks for household borrowers remain high, since about three-quarters of foreign currency loans to households are bullet loans linked to repayment vehicles. The OeNB, in cooperation with the FMA, conducts an annual survey among a representative sample of Austrian banks to ensure the ongoing monitoring of outstanding foreign currency loans, especially those linked to repayment vehicles. The 2019 survey results showed that at the end of 2018, the shortfall between the outstanding loan amount in euro and the forecast value of the repayment vehicle upon maturity had equaled around 30% of outstanding repayment vehicle loans, or EUR 4.2 billion.

**A new information leaflet on foreign currency loans informs borrowers about related risks.** It has been published on the joint initiative of the OeNB, the FMA and the Austrian Economic Chambers with the aim of further increasing borrowers' awareness of the risks emanating from foreign currency loans.<sup>27</sup> The leaflet is available at bank branches across Austria. In addition to providing a concise overview of the relevant risks, it puts a focus on banks' information

<sup>27</sup> For more details on the new information leaflet on foreign currency loans, see [https://www.oenb.at/dam/jcr:5f7c71f7f-b0ee-49b9-9c0d-ae35eaa221d0/folder\\_fremdwahrungskredite\\_01\\_2019.pdf](https://www.oenb.at/dam/jcr:5f7c71f7f-b0ee-49b9-9c0d-ae35eaa221d0/folder_fremdwahrungskredite_01_2019.pdf) (available in German only).



obligations toward borrowers, which were substantially expanded in the revised FMA Minimum Standards published in 2017.<sup>28</sup>

**The amount of foreign currency loans issued by Austrian banks' CESEE subsidiaries has also continued to decline.** The volume of outstanding foreign currency loans to households and nonfinancial corporations fell by 5% (exchange rate adjusted) to EUR 29.8 billion in 2018, and the share of foreign currency loans in total loans came down from 27% to 25%. The euro is the most important loan currency by far, accounting for about 80% of all foreign currency loans. Loans in Swiss francs and U.S. dollars account for around 10% each. Apart from this ongoing downward trend, there are political uncertainties about legislative initiatives regarding foreign currency loans in several countries (e.g. Poland) which could increase the financial burdens on Austrian banks operating in CESEE.

**The quality of foreign currency loans has improved but is still weaker than that of local currency loans.** The NPL ratio of foreign currency loans issued by Austrian banks' CESEE subsidiaries has declined continuously over the past three years. Still, foreign currency loans continue to be of weaker credit quality than local currency loans. As of end-2018, the NPL ratio for foreign currency loans stood at 6.4% (down from 8.5% a year before), while the ratio for local currency loans was 3.9%. The associated risk has been partly mitigated by high risk provisioning, with the NPL coverage ratio standing at almost 66% for both loan portfolios. Broken down by currency, the strongest decrease of the NPL ratio can be observed for U.S. dollar-denominated loans, whose NPL ratio came down from 11.2% to 5.7% in 2018. This strong reduction was mainly due to NPL sales in Romania, Ukraine and Russia. The NPL ratio of euro- and Swiss franc-denominated loans stood at 6.4% and 7.4%, respectively.

Box.5

#### **Strengthening cyber resilience in financial market infrastructures**

**In December 2018, the ECB published cyber resilience oversight expectations (CROEs).** This new framework for oversight activities is based on the global guidance for financial market infrastructures published in 2016 by the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions (CPMI-IOSCO). The CROEs provide supervisors and financial market infrastructures with a benchmark against which they can evaluate the current level of cyber resilience, measure progression and identify areas for further improvement. The OeNB's oversight function will apply the CROEs in addition to the CPMI-IOSCO Principles for Financial Market Infrastructures. In Austria, substantial improvements in the field of cyber resilience have already been achieved for selected addressees, which include national payment systems as well as central counterparties and central securities depositories.

**Another current oversight focus lies on the implications of the revised European Payment Services Directive (PSD2).** The PSD2, which was transposed into Austrian law in 2018, aims at enabling innovation and setting higher security standards

<sup>28</sup> For more details on the revised "FMA Minimum Standards for the Risk Management and Granting of Foreign Currency Loans and Loans with Repayment Vehicles", see <https://www.fma.gv.at/download.php?d=2885>.

for payment services. National payment service providers are currently working on the development of mutually compatible interfaces in order to fulfil the requirements of common and secure communication (set by the respective regulatory technical standard, which will be applicable from September 2019).

### Prolonged period of low yields is a challenge for the life insurance sector

**Persistently low yields and the risk of a sudden interest rate rise are still posing challenges to the insurance sector, and life insurance companies in particular.** As a result, life insurance premiums have decreased sharply by 25% since their all-time high in 2010 (from EUR 7.4 billion to EUR 5.5 billion). Given that the maximum guaranteed rate on a traditional life insurance policy is unchanged at 0.5%, some life insurers continue to adapt by shifting their business mix toward products that are directly linked to market performance and whose investment risk is borne by policyholders. These developments notwithstanding, the share of traditional life insurance contracts remains stable at about two-thirds of all life insurance premiums written.

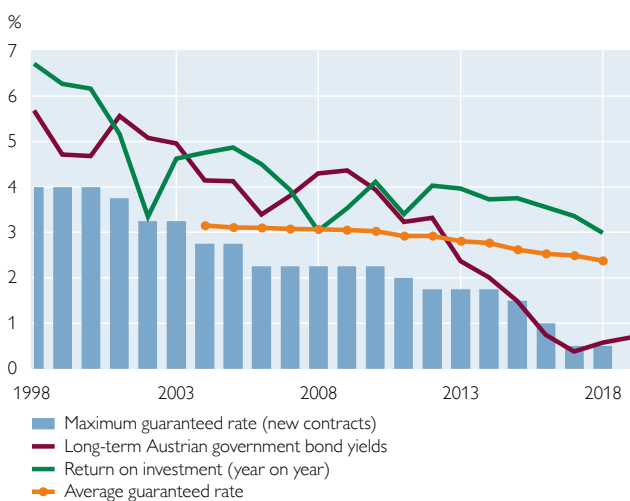
**The profitability of the life insurance sector remains higher than the guaranteed rate on existing policies.** The left-hand panel of chart 3.14 shows that despite the adversities the sector has been faced with, the investment return of Austrian life insurance companies is higher than the average guaranteed rate on the stock. The right-hand panel shows a similar result at the individual company level: for most life insurance companies, the return on their assets is still higher than the guaranteed rate of the stock.

**At the same time, the results of the entire insurance sector slumped.** The underwriting result fell by 13% in 2018, while the financial result fell by 10% to EUR 2.5 billion. This led to a decrease in the result from ordinary activities by 6%.

Chart 3.14

### Return on Austrian life insurance companies' investments compared with important benchmarks

Return on investment and guaranteed rate



Rate of return and average guaranteed rate

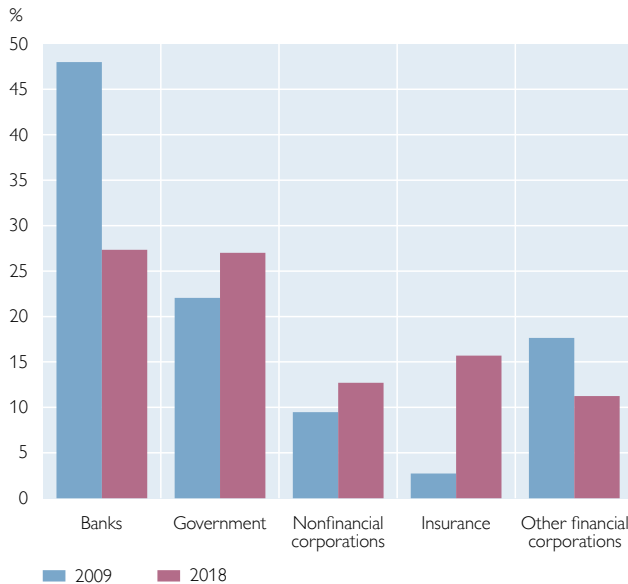


Source: FMA (Austrian Insurance Statistics).

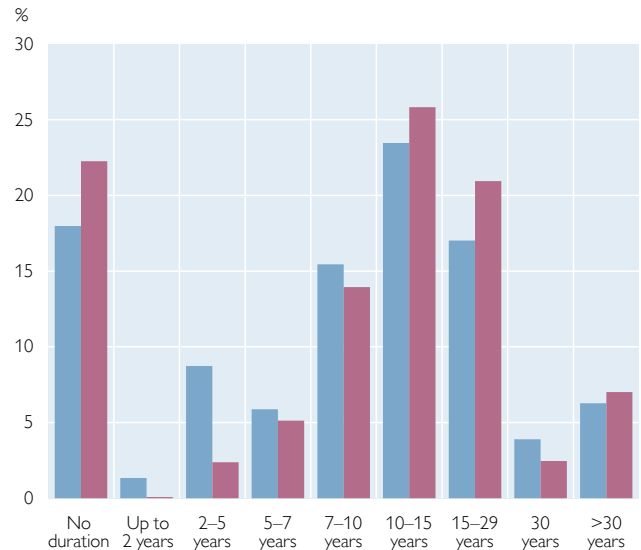
Chart 3.15

### Considerable changes in Austrian insurance companies' investment behavior

Insurers' asset allocation in securities investments



Original maturity of insurers' investments in securities



Source: OeNB.

**The Austrian insurance sector has been adjusting its investment behavior to the low interest rate environment and to regulatory changes, such as Solvency II.** From 2009 to 2018, insurers significantly reduced their exposure to bank securities (by more than 20 percentage points), while increasing investments in government bonds by 5 percentage points (see the left-hand panel of chart 3.15). However, these developments are not homogeneous in the sector, where a small number of large insurance undertakings accounts for the majority of assets (the top five undertakings account for more than 70% of total assets). Over the past decade, there has also been a shift in securities' maturities from short (2 to 5 years) toward longer maturities (10 to 29 years). This was caused by Solvency II-induced capital requirements and efforts to address the duration gap between life insurers' liabilities and assets, which makes short-term securities particularly unattractive given the long duration of insurers' liabilities (see the right-hand panel of chart 3.15). The solvency capital ratio of Austrian insurance companies stands at a comfortable median of 255%, which is higher than the ratio of most of its European peers.<sup>29</sup>

<sup>29</sup> EIOPA *Financial Stability Report December 2018* p. 30, <https://eiopa.europa.eu/Publications/Reports/EIOPA%20FSR%20December%202018.pdf>