Austrian financial intermediaries continue to support the economy; precautionary provisioning affected banks' profits in 2020

Austrian banks have weathered the COVID-19 pandemic well so far

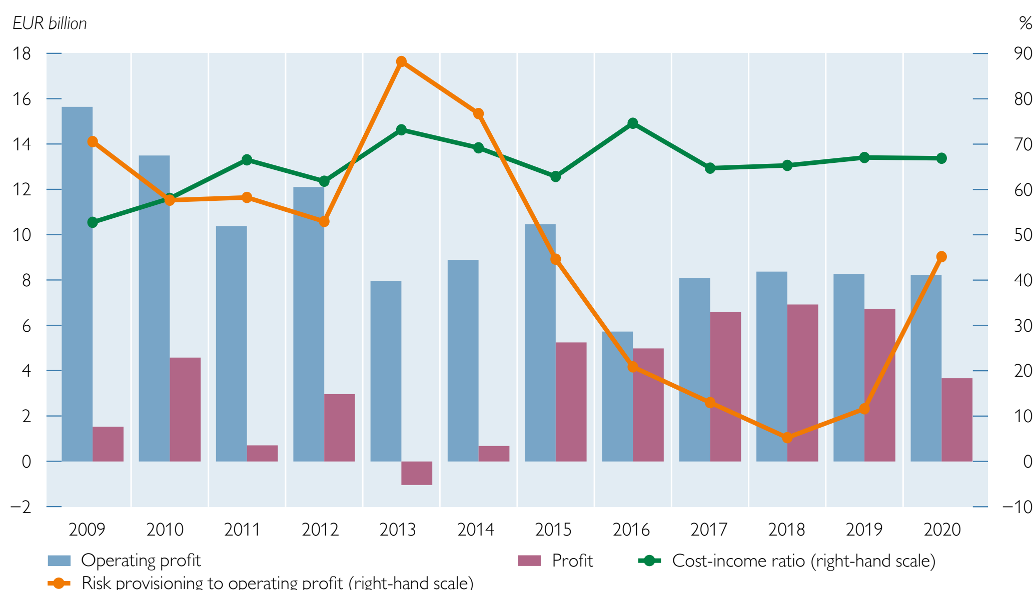
Austrian banks have weathered the COVID-19 pandemic well so far. Supporting measures have alleviated the pressure on borrowers' solvency, but risks to financial stability have increased. More than a year after the COVID-19 pandemic spread to Austria, its effects on the banking sector are still not fully assessable: credit risks are likely to rise once the cushioning impact of the supporting measures starts to fade. Until now, Austrian banks have proved to be resilient to operational challenges during several lockdowns, performed their business without major disruptions and fulfilled their economic functions vis-à-vis the real economy at all times. But the pandemic has also taken a heavy toll on banks, with their profitability burdened by precautionary provisioning in an environment of persisting uncertainty, which has also increased risks to financial stability. Nevertheless, unchanged from last year, the rating agency Moody's in April 2021 confirmed its stable outlook for the Austrian banking system. According to the outlook, banks' credit fundamentals are expected to remain broadly stable over the next 12 to 18 months.

Austrian banking sector's profit dropped by nearly half as the cost of risk soared

In a demanding operating environment, Austrian banks managed to keep their operating profits stable. With the COVID-19 pandemic raging in 2020, the main sources of Austrian banks' consolidated income remained flat. Both net interest income and fees and commissions, which together make up more than 90% of banks' income, did not budge year on year. While trading income

Chart 3.1

Profitability indicators of the Austrian banking system



Source: OeNB.

turned positive, other income declined. All in all, operating income was down by just 1%. In terms of costs, staff expenses declined by 3%, while other administrative expenses rose by 3%, so that operating costs also hardly changed year on year. Consequently, the cost-income ratio stood at an unchanged 67%, which points to a continuation of cost efficiency issues in the sector. To put it in a nutshell, the tumultuous year of 2020 barely left its mark on the overall operating profit of the Austrian banking sector.

Risk provisioning quadrupled in 2020 and led to a significant fall in profits. Although traditional credit risk indicators, such as the ratio of nonperforming loans (NPLs), continued to be favorable, Austrian banks made substantial efforts to increase their risk provisioning. This way, banks brace themselves for a potential pandemic-induced increase in credit losses over the years to come. In the consolidated profit and loss statement of the sector, this stepped-up risk provisioning caused the cost of risk to rise significantly, namely from slightly less than EUR 1 billion in 2019 to EUR 3.7 billion in 2020. This increase absorbed nearly half of the sector's operating profits (see chart 3.1). The cost of risk was the main negative driver of profit in 2020. In fact, profit contracted by EUR 3.0 billion year on year and came to just EUR 3.7 billion.[1] While such a low level had not been seen in several years, the COVID-19 impact was less severe than that of the 2007–2008 global financial crisis. The strong decline in profit also had an impact on the sector's return on assets (2020: 0.4% versus 2019: 0.7%).

With the unprecedented period of extremely low cost of risk having ended abruptly, structural issues are coming to the fore. In 2020, the onset of the COVID-19 pandemic ended the benign macroeconomic conditions, which had supported banks' profits over the past few years. Austrian banks' cost efficiency has remained low, while their cost of risk has soared, which is putting pressure on banks' medium-term profitability. Much now depends on their ability to lend at risk-adequate margins, keep costs under control and, at the same time, compete with agile market participants, such as fintechs, neobanks, but also bond markets. Masked by cyclically low cost of risk in the last years, these structural issues need to be addressed to ensure sustainable levels of profitability, which are the backbone of banks' resilience. This is crucial for banks' continued ability to provide services to the real economy, and ultimately also for financial stability both in Austria and in Austrian banks' host markets.

Credit risk indicators remain favorable, but their informative value is currently weakened

After a pandemic-driven spike in lending growth in Austria in the second quarter of 2020, momentum was fading and the overall growth rate for 2020 came in at pre-pandemic levels. In the first months of 2020, propelled by the first lockdown, Austrian banks recorded a significant increase in corporate loan demand that was driven by bridging loans and refinancing. After this spike, however, demand diminished over the course of 2020, due to declining financing needs for fixed investments and increased internal financing. At the same time, lending to households in Austria remained fairly stable because of ongoing mortgage

[1] *Another noteworthy negative driver was the profit from neither fully nor partially consolidated subsidiaries (equity method of accounting) that declined by EUR 0.5 billion.*

lending that was supported by low interest rates and increased demand for home ownership. As a result, at around 4%, overall growth of loans to nonbank customers in Austria was more or less unchanged in 2020 year on year.

Continued dynamic credit growth and various support measures kept credit risk indicators at favorable levels, but the informative value of the indicators has weakened. Fiscal support and regulatory policy measures have so far helped avoid severe feedback loops between the real economy and the financial system. Such measures have included the temporary suspension of the obligation to file for insolvency, credit and other payment moratoria as well as public guarantees. The support measures also had the effect that asset quality indicators have become partly disconnected from economic realities. Under these circumstances, it becomes more challenging to gauge potential credit losses for financial institutions. Here, the international financial reporting standards (IFRS) comprise a possible forward-looking indicator which reflects the migration of loans between the three different IFRS loan stages. In 2020, Austrian banks actively started to transfer a considerable volume of loans from Stage 1 to Stage 2. In other words, they saw significantly increased credit risk for these loans since initial recognition. Banks reclassified loans either because they had analyzed individual customers' probability of default or because they sought to take precautions for loans to economic sectors that had been particularly affected by the pandemic impact.

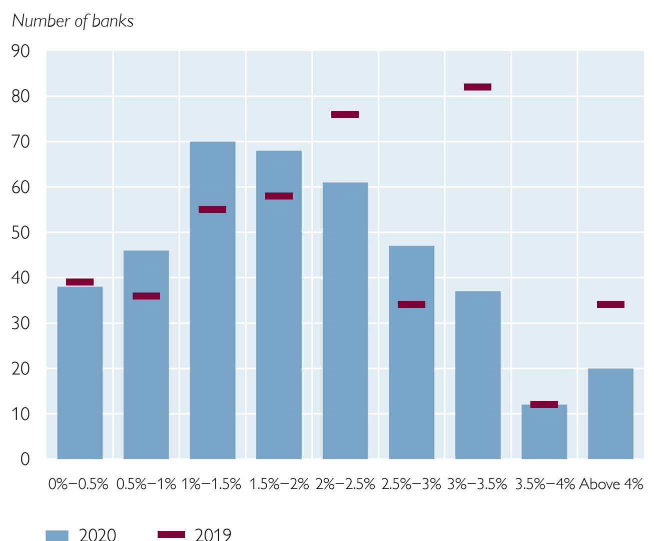
Austrian banks increased credit risk mitigating measures in 2020 as a precaution. Stepped-up provisioning did not, however, result in significantly higher loan loss provisioning ratios. Austrian banks' profitability in 2020 was burdened by a significant year-on-year increase in provisioning. The consolidated coverage ratio for all loans nevertheless remained at 49% throughout 2020. Also, the overall loan loss provisioning ratio remained stable at around 1.5% for the consolidated, and at 1.0% for the domestic, loan portfolio. The latter can

Chart 3.2

Nonperforming loans of the Austrian banking sector

Austrian banks' NPL ratios by customer group

Distribution of NPL ratios (total loan portfolio, consolidated)



Source: OeNB.

basically be attributed to two reasons. First, loan growth continued to be dynamic and, second, banks used existing provisions to write off nonperforming loans. Another risk mitigation measure was that banks strongly increased the value of collateral for corporate loans, especially for loans extended to the accommodation and food services as well as trade sectors, either by calling for additional, or by reappraising, existing collateral.

Although the average NPL ratio of Austrian banks appears low, the distribution shows that individual ratios differ considerably. The consolidated NPL ratio of Austrian banks was 2.0% at the end of 2020 (EU average: 2.6%[2]), and for domestic business it stood at 1.5%. This was a slight improvement compared to the previous year. The NPL ratios of some borrower groups had started to worsen already in the second half of 2020, however. SME loans and consumer loans – which had already had somewhat elevated NPL ratios (see the left panel of chart 3.2) – were hit in particular. The distribution of NPL ratios across Austrian banks is quite wide around the average, with some fat tails below 0.5% and above 4% (see the right panel of chart 3.2). Compared to 2019, the distribution has shifted slightly to the left.

This issue of the Financial Stability Report features studies on COVID-19-related credit risk developments in Austria. To give an in-depth view of the impact of the pandemic on the Austrian economy and its banks, two studies in this report analyze (1) the use of support measures (see page 77) and (2) the development of corporate insolvencies in Austria (see page 57). Both factors are set to drive the development of banks' NPL ratios in the course of 2021 and the years to come.

Austrian banks' capitalization increased in 2020

Austrian banks' efforts to increase their CET1 ratios were supported by restrained dividend payments and supervisory relief measures, but the sector's leverage ratio went down. After a short-lived slump at the beginning of the year 2020, the Austrian banking sector managed to increase its capitalization in the subsequent quarters. This was also supported by temporary supervisory relief measures, such as reduced loan provisioning requirements due to postponed NPL recognition or the prolongation of transition periods for certain Basel III rules. Together with the retention of profits, this helped increase Austrian banks' CET1 ratio to 16.1% (as at end-2020, nearly +50 basis points year on year).[3] The ratio thus stood somewhat above the euro area average. However, as total assets expanded despite slightly shrinking risk-weighted assets, the leverage ratio declined from 8.3% to 7.7%.

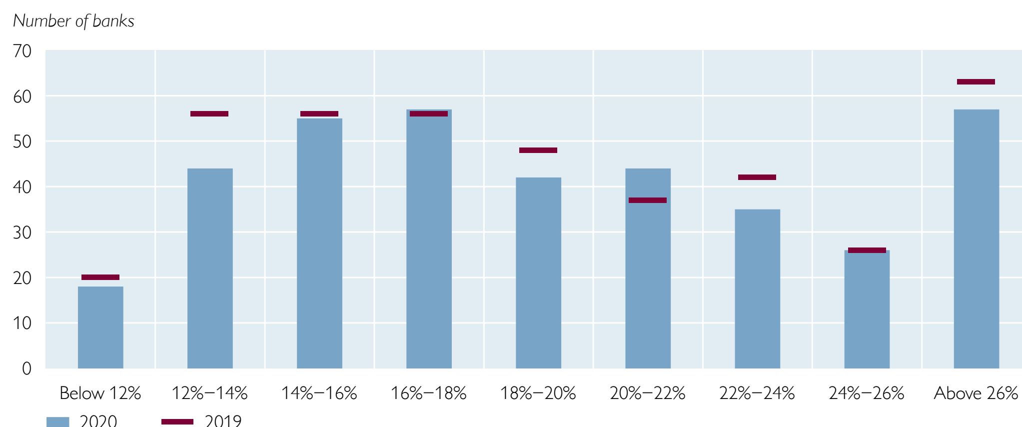
Capital ratios of Austrian banks vary markedly across the sector and their development in 2020 was heterogeneous. Chart 3.3 shows that the distribution of Austrian banks' CET1 ratios is skewed to the right, i.e. many banks' capitalization exceeds the weighted average of 16.1%. The average, which is depressed by several larger banks, does not reflect the good capitalization of most – small – institutions.

[2] *According to the EBA Risk Dashboard as at end-2020.*

[3] *Despite the increase in the Austrian banking sector's CET1 ratio in 2020, nearly half the banks experienced a decline in their respective ratio.*

Chart 3.3

Distribution of Austrian banks' CET1 ratios



Source: OeNB.

Equity capital is the most important stabilizing factor in times of crisis. The importance of internal financing should not be underestimated. After a bank's profits, equity is the second line of defense in terms of loss absorption. With a view to safeguarding financial stability in difficult times, macroprudential supervisors aim at high levels of capitalization. In 2020, Austrian banks markedly reduced their profit distributions to shareholders, which significantly helped increase their overall capital. But as uncertainty persists, careful handling of profit distributions is also warranted for 2021. The ECB recommends that, until September 30, 2021, credit institutions exercise extreme prudence when deciding on, or paying out, dividends or performing share buybacks to remunerate shareholders.[4]

The ECB's targeted review of internal models (TRIM) has been finalized: Austrian banks' internal models perform well by comparison in the Single Supervisory Mechanism (SSM). The publication of the TRIM results[5] marked the end of a comprehensive five-year project. At its core, TRIM was made up of 200 on-site model investigations across 65 significant institutions (SIs). The OeNB conducted 13 of these investigations. The project covered all market and counterparty credit risk models and more than 65% of credit risk exposures within the SSM. Austrian banks accounted for less than EUR 1.3 billion of the overall impact on risk-weighted assets, which increased by more than EUR 275 billion on account of deficiencies identified in the course of the TRIM project. Consequently, Austrian SIs that apply internal models were less affected by supervisory measures and have clearly profited from the OeNB's guidance and findings over the last 15 years. However, while the TRIM project did not have a major impact on Austrian SIs' capital requirements, it highlighted the need for banks to continue investing in internal models and the related data architecture. This is especially important as they are about to start implementing the requirements that resulted from the EBA's regulatory review of the internal ratings-based

[4] *See ECB. 2020. Recommendation on dividend distribution during the COVID-19 pandemic.*

[5] *See ECB. 2021. ECB's large-scale review boosts reliability and comparability of banks' internal models.*

(IRB) approach.[6] On top of the ongoing model maintenance, banks will moreover have to address the medium- to long-term model-related challenges of the COVID-19 pandemic.

Austrian banks are well funded

The Austrian banking system shows high levels of liquidity. LCR buffers are mostly made up of the top category of eligible high-quality liquid assets. All Austrian banks report liquidity coverage ratios (LCRs) well above the regulatory minimum. In March 2021, the system-wide LCR stood at 168% at the consolidated level, which corresponds to an increase of 26 percentage points over the last 12 months. The share of Level 1 assets, excluding high-quality covered bonds, came to 98% at end-March 2021, and the share of Level 1 central bank reserves rose to as much as 61%. While largely unchanged in absolute terms, Level 2a and Level 2b assets account for 1.1% and 0.4%. Within the classification of Level 1 assets, the most important categories are cash, central bank reserves and government bonds. The net stable funding ratio (NSFR) will be introduced for all Austrian credit institutions on June 28, 2021. The Austrian banking system seems to be adequately prepared for this new regulatory minimum requirement.

The funding mix of Austrian banks continued to be concentrated on retail and corporate deposits. Mostly larger institutions tap the capital market by issuing own debt securities. Overall, retail and corporate deposits remain the primary funding source of the Austrian banking sector. The first 12 months of the COVID-19 pandemic did not trigger sudden changes in the funding structure.

Box 2

Impact of the pandemic on government bond yields in Austria

The UDRB[7] index tracks the average yield of outstanding euro-denominated Austrian government bonds, issued under Austrian law, with a fixed coupon and a residual maturity of more than one year. While it still serves as an underlying index for a small share of Austrian loan contracts, its importance has decreased over time.

The UDRB index clearly responded to the different phases of the pandemic, which was in line with comparable international indices. *Much like comparable international yields, Austrian government bond yields, represented by the UDRB, saw a strong increase, after the initial shock caused by the outbreak of COVID-19 in March 2020. However, in August, yields had returned to pre-crisis levels amid strong support from the ECB's asset purchase program. The UDRB then decreased further, to reach an all-time low of –0.47% in November. Yields remained mostly unchanged until the start of 2021, but then rose again – in light of the strong recovery in the USA, the worldwide vaccination rollout and potential reflation. Such a rise was also reflected across the board in European government bond yields. In this environment, the UDRB reached –0.22% at the end of April 2021.*

[6] *See EBA. 2019. EBA publishes report on progress made on its roadmap to repair IRB models.*

[7] *The German abbreviation stands for "umlaufgewichtete Durchschnittsrendite für Bundesanleihen," i.e. the average yield on government bonds weighted by outstanding amounts.*

The change in government bond yields had only a limited impact on Austrian banks. *Compared to other countries like Italy, Slovenia or Spain, Austrian banks' exposure to sovereign bonds issued by the national government is limited. In addition, only around 6% of all government bonds held by Austrian banks belong to the mark-to-market segment. Therefore, increasing yields (i.e. decreasing prices) have a very limited effect on banks' profit and loss accounts in the short term.*

Chart 3.4

Average government bond yields in Austria

Source: OeNB.

New oversight standards for payment instruments

In October 2020, the ECB published a draft oversight framework for electronic payment instruments, schemes and arrangements (PISA). Where this is appropriate and possible, this new framework is aligned with the principles for financial market infrastructures (PFMIs). The purpose of the PISA framework is twofold: (1) to consolidate existing oversight standards for card payment schemes, credit transfer schemes, such as SEPA, the Single Euro Payments Area, and the like into a single framework; and (2) to integrate new standards for payment innovations, e.g. instant payments, digital payment tokens, payment initiation or facilitation. In this context, PISA is intended to complement the oversight of individual payment systems and/or the microprudential supervision of payment service providers, according to the Payment Services Directive, with aspects that are relevant from a payment scheme/arrangement perspective. A public consultation on the draft PISA framework was conducted during the second half of 2020. The framework is scheduled to apply from mid-2021, with a transition period of one year.

At the national level, COVID-19 did not negatively affect the operational stability of the Austrian financial market infrastructures. ATM and POS transactions declined, however, in 2020. The OeNB's oversight function remained fully effective as it shifted from conducting on-site inspections to performing online assessments.

Foreign exposure increased despite the pandemic, but subsidiaries' profitability in CESEE deteriorated markedly

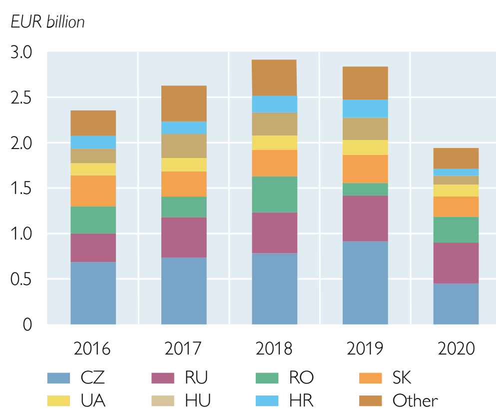
Austrian banks' total assets increased despite the pandemic, as structural transformation processes continued. The consolidated balance sheet of the Austrian banking sector increased by 10% to more than EUR 1.1 trillion in 2020. Most notably, the cash reserve on the asset side doubled and central bank liabilities increased even more strongly. Austrian banks also pressed ahead with transformation processes: the number of banks continued to go down, with the number of domestic branches declining at an even faster pace,[8] especially among joint stock and private banks. At the same time, the business volume of foreign branches remained stable, but overall foreign exposures increased slightly to EUR 412.5 billion in 2020, especially in CESEE.

The profitability of Austrian banks' subsidiaries in CESEE deteriorated markedly in 2020 on account of COVID-19-related effects taking their toll. Compared to 2019, profit after tax was down by one-third, dropping from EUR 2.8 billion to EUR 1.9 billion. Given that average assets rose by 6% year on year, the return on average assets came down from 1.3% to 0.8%. Regarding the most important host markets, it is remarkable that the fall in profits was highly heterogeneous in 2020 (see chart 3.5). Profits dropped by more than half in Croatia, Hungary and Czechia, whereas the decline amounted to only 11% in Russia.[9]

The lower profits of Austrian banking subsidiaries in CESEE were mainly due to a quintupling of credit risk provisioning. A 3% decrease in net interest income as well as in fees and commissions in 2020, which account for the lion's share of the CESEE subsidiaries' income, caused last year's operating income to shrink by 2%. Staff costs declined but other operating expenses rose by a similar amount, so operating costs remained broadly flat. Consequently, operating profit contracted by 5%. Most significantly, banks increased credit risk provisioning fivefold, to more than EUR 1.2 billion (see chart 3.6), as they were adjusting to an operating environment severely affected by the COVID-19 pandemic and its repercussions in the real economy. Altogether, subsidiaries' profit decreased by nearly EUR 900 million to EUR 1.9 billion.

Chart 3.5

Profits of Austrian banks' subsidiaries in CESEE by country



Source: OeNB.

Credit risk provisioning at Austrian banks' subsidiaries in CESEE was of a precautionary nature in 2020, as traditional risk indicators have yet to deteriorate. While the real economy was weighed down by the COVID-19 pandemic, households and

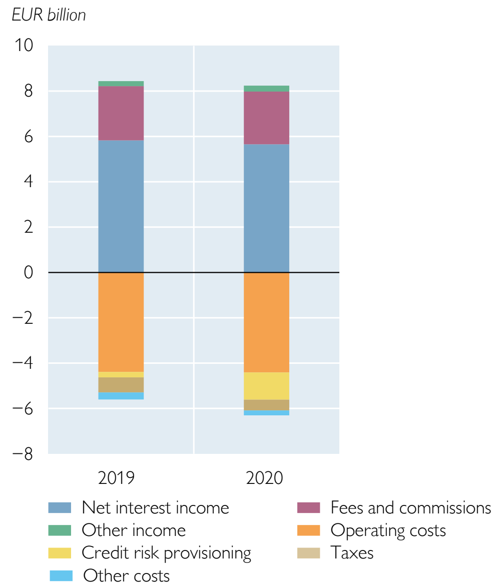
[8] *The number of banks declined by 5% year on year and the number of domestic branches even shrank by as much as 11%.*

[9] *The development in Romania, where profits more than doubled in 2020, was due to the reversal of a one-off effect; for further details, see the Financial Stability Report 39.*

nonfinancial corporations, at the same time, profited from several support measures, including debt moratoria and short-time work schemes. Indirectly, this helped keep traditional risk indicators, such as the NPL ratio, at low levels, while the coverage ratio continued to be adequate. As highlighted by chart 3.7, NPL ratios had fallen substantially over the last years and barely changed in 2020, with the ratio for all loans remaining flat, at 2.4% year on year. At a more granular level, however, corporate loans worsened slightly, household loan quality was unchanged, and the important subcategory of residential real estate loans improved further. Throughout 2020, the coverage ratio for all loans came in at a satisfactory level of above 66%. There is, however, one important caveat regarding these encouraging credit risk indicators: the share of IFRS Stage 2 loans – i.e. loans whose credit risk had increased significantly since initial recognition – was close to one-fifth at the end of 2020 (for corporate loans alone: one-quarter).[10] This points to a nonnegligible potential for future loan losses in the region, especially once current COVID-19-related support measures expire, and is the reason for banks' provisioning. In this challenging environment, it is still paramount that Austrian banks and their subsidiaries in CESEE prepare for the expiry of support measures, such as debt moratoria, and maintain a high level of transparency regarding the quality of their loan books.

Chart 3.6

The profit and loss statement of Austrian banking subsidiaries in CESEE



Source: OeNB.

Chart 3.7

Austrian banking subsidiaries in CESEE: NPL ratios (by counterparty) and coverage ratio

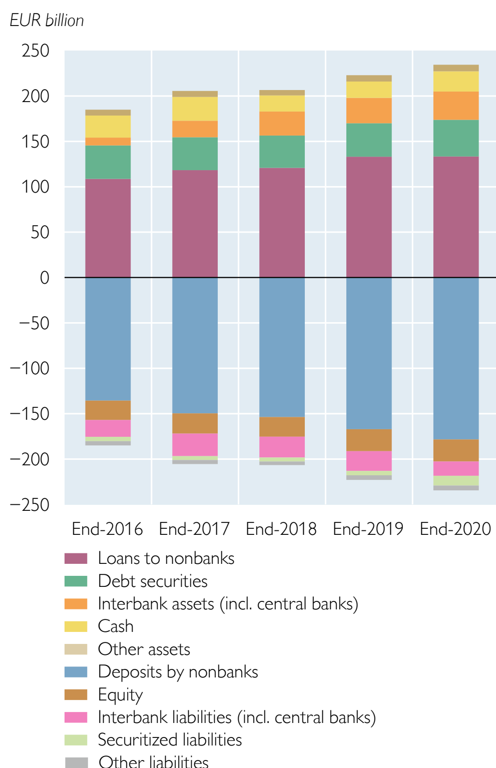
Source: OeNB.

Note: RRE stands for residential real estate.

[10] *Unfortunately, the time series for IFRS loan stages at Austrian banks' foreign subsidiaries is only available from mid-2020.*

Chart 3.8

Balance sheet of Austrian banks' subsidiaries in CESEE



Source: OeNB.

The capitalization of Austrian banking subsidiaries in CESEE remained solid and their funding situation well balanced. At the end of 2020, the aggregate CET1 ratio stood above 17% and the loan-to-deposit ratio at 75%. These solid levels bear testimony to past efforts of banks and their host and home supervisors to improve banking systems' resilience and foster financial stability. Among other initiatives, the OeNB monitors the loan-to-local stable funding ratios of the largest Austrian banks' foreign subsidiaries.[11] At the end of 2020, all 23 subsidiaries of Erste Group Bank as well as Raiffeisen Bank International had a sustainable local refinancing structure. Compared with the global financial crisis, Austrian banking subsidiaries in CESEE are therefore better prepared to cope with the impact of the COVID-19 pandemic.

Strong deposit growth and flat loan volumes depressed the net interest margin at Austrian banking subsidiaries in CESEE. Over the course of 2020, deposits by nonbanks rose by 7%, partly due to the lack of consumption and investment opportunities as well as increased uncertainty related to the pandemic. At the same time, loans to nonbanks remained unchanged and the subsidiaries increased their investments in cash and lower-yielding assets, such as debt securities and interbank assets (including vis-à-vis central banks; see chart 3.8). Consequently, subsidiaries' net interest margin continued its long-term decline and stood at 2.5% in 2020, compared to 2.8% in 2016. With Austrian banks' consolidated profit depending to a significant extent on their subsidiaries in CESEE, Austrian supervisory authorities continue to closely monitor profitability trends in CESEE and to foster financial stability in the region.

Macroprudential supervisory activities in Austria

At the beginning of the COVID-19 pandemic, the OeNB advised the Austrian Financial Stability Board (FMSB) to decide against buffer releases to ensure that investors continue to have confidence in the Austrian banking sector and that funding costs for the Austrian banks and the real economy remain favorable. Austrian authorities repeatedly communicated to banks that buffers can and should be used to absorb losses and maintain lending during the pandemic. Retrospectively, the FMSB's expectations

[11] *For further details, see OeNB. Sustainability of large Austrian banks' business models.*

were fulfilled given that solvency remained solid, funding costs did not go up and lending to nonfinancial corporates and for mortgages stayed dynamic. Banks did not cut back lending and continued to have a strong capital position. Capital conservation also benefited from the FMA and OeNB recommendations on dividend distributions. In line with supervisory guidance, banks suspended dividend payouts throughout 2020.

Policy proposals geared toward more releasable buffers or macroprudential space can increase systemic risk, in particular in times of financial stress. First, the economic benefits of releasing buffers are very small and, thus, substantially lower than the risks associated with a less resilient banking system, especially under stress. Second, loan growth in the euro area has been strong so far. Third, reducing capital buffers might only bring small gains for monetary transmission but result in large losses in terms of financial stability for individual countries due to heterogeneous financial cycles across member states.

Potential changes to the macroprudential framework in the EU should not dilute internationally agreed minimum standards. While the EU macroprudential framework laid down in the CRD/CRR has not been fully tested yet, empirical evidence suggests that macroprudential policies have been working as intended and the current regime is effective. Any regulatory changes should be assessed within the European Commission's macroprudential policy review in 2022. The following high-level principles should be guiding this review: (1) reducing the complexity of regulation, (2) increasing the resilience of the EU financial system, and (3) preserving the objectives enshrined in regulation so as not to dilute existing buffer and other minimum requirements. Ultimately, any changes to the macroprudential framework in the EU need to be aligned with the framework defined by the Basel Committee on Banking Supervision (BCBS).

In light of the COVID-19 pandemic's impact on the Austrian commercial real estate sector, the OeNB and the FMSB have stepped up their monitoring activities. The drivers of this intensification are first and foremost tourism- and retail-related real estate, as these segments have been hit particularly hard. Loans granted by Austrian banks to domestic nonfinancial corporates which are collateralized by commercial real estate (CRE) structurally exhibit higher NPL ratios. At the same time, real estate companies (i.e. of the NACE sectors "construction" and "real estate activities") generally have lower ratings than the overall corporate sector. An EU-wide comparison shows that CRE-backed corporate loans account for an above-average share in Austrian banks' total assets. Efforts are underway to obtain data for calculating CRE price, rental and yield indices. CRE-related risk assessments will improve significantly once these indices are available.

Increasing signs of systemic risks arising from residential real estate loans warrant heightened supervisory attention. In 2018, the FMSB followed a recommendation by the OeNB and issued public guidance on sustainable real estate financing. At that time, continued strong lending growth, rising real estate prices and record-low interest rates caused the OeNB to conclude that there were signs of rising systemic risks in real estate financing and that compliance with supervisory expectations will be crucial for safeguarding financial stability in Austria. Since then, key indicators on lending standards have revealed that the risk profile of banks' lending has not improved (see box 3), which, in combination with

a very dynamic real estate market, points toward increasing risks to financial stability. Even though the share of newly granted variable rate housing loans has decreased considerably, to below 40% in the first quarter of 2021, it is still high compared to other countries. Last year's IMF mission suggested that authorities consider further regulatory requirements. Drawing on a new reporting framework (see box 3), the OeNB will regularly provide the FMSB with its findings on systemic risks from real estate financing and on banks' compliance with sustainable lending standards.

The Austrian deposit guarantee schemes (DGSs) have proved resilient in the pandemic and enjoy high credibility despite two DGS payout cases in the first half of 2020. Both DGS payouts only affected Einlagensicherung Austria (ESA) as its ex ante fund was sufficient. To counterbalance the substantially lowered volume in the ex ante fund, ESA member banks started to pay increased contributions in 2020. Moreover, the Raiffeisen sector has submitted an application for the recognition of a new institutional protection scheme (IPS) structure, which covers the entire sector and constitutes the basis for the recognition of a separate Raiffeisen DGS. With a third DGS in place, the structural and legal complexity is set to increase, as larger payouts involve more than one DGS. Working arrangements between the different DGSs will need to reflect, and alleviate, the increased complexity.

Box 3

First insights gained from Austria's new regulatory reporting framework on banks' lending standards for residential real estate financing

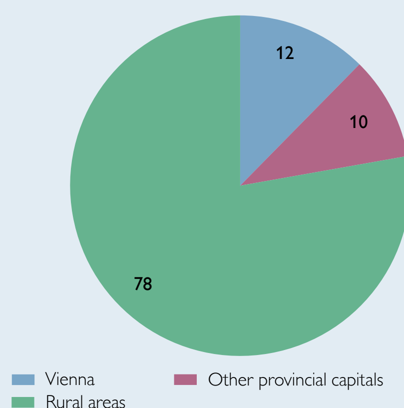
In the second half of 2020, Austrian banks issued almost EUR 15 billion worth of new residential real estate (RRE) loans, which compares with a five-year average of EUR 10 billion[12]. *The new database covers all new RRE lending by banks collateralized by immovable property as well as uncollateralized[13] RRE lending. Austrian households borrow almost exclusively to establish their households' main residence; only a minor share (7%) of new loans was granted for buy-to-let purposes[14]. This is also reflected in borrowers' age structure: almost half the new loans were granted to borrowers aged 35 years or younger. While Austria's capital Vienna is important, the bulk of new lending took place in Austria's rural areas (78%; see chart 3.9).*

Not all new lending can be considered sustainable according to the FMSB's

Chart 3.9

Residential real estate lending in the second half of 2020

Geographical breakdown in %



Source: OeNB.

[12] *Source: ECB. 2016–2020. MFI Interest Rate Statistics.*

[13] *For the purpose of this data collection, a loan is classified as "uncollateralized" in case there is no mortgage registered with the Austrian land register ("Grundbuch") securing the loan and no other funded credit protection as defined in Article 4(1)(58) CRR. These loans can, however, be secured by other forms of collateral, such as shares or registrable mortgage certificates ("eintragungsfähige Pfandurkunden – EPUs").*

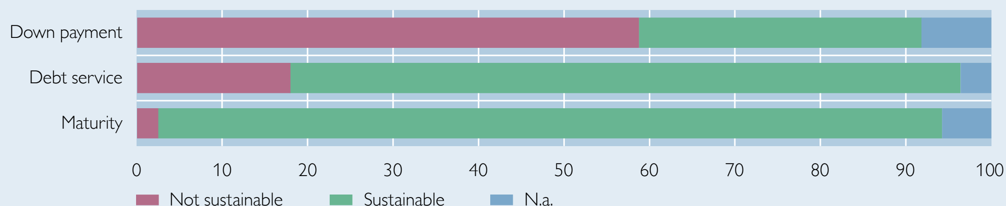
[14] *Buy-to-let lending does not include renting out or selling properties for commercial use.*

***guidelines.** In 2018, the FMSB recommended[15] that (1) borrowers contribute own financial means of no less than 20% of total financing needs ("down payment"), (2) loan maturities exceed 35 years only in exceptional cases and (3) debt service expenses do not exceed 30% to 40% of a household's net income.*

Chart 3.10

Sustainability of residential real estate lending in the second half of 2020

Share of new lending in %



Source: OeNB.

***The new data show a continuation of recent trends in key lending indicators that point toward increasing systemic risk.** One half of all borrowers' projects was financed almost entirely through credit, i.e. the down payment was less than the benchmark of 20% communicated by the FMSB (see chart 3.10). This is also reflected in high leverage ratios (loan-to-market value of property). With one-fifth of loans, debt service is not sustainable according to the FMSB's guidelines given that it exceeds 40% of borrowers' net income. Compared to five-year averages, the share of lending that is unsustainable according to both indicators has increased by approximately 5 percentage points.[16] Most housing loans were granted with maturities of 20 to 35 years, and ultralong maturities remain the exception, with their share decreasing further compared to the five-year average. In addition, the share of variable interest rate loans – although decreasing – is still high in Austria compared to other EU countries and bears interest rate risks for borrowers.*

***The OeNB stays vigilant about rising systemic risks, and compliance with sustainable lending standards remains key.** RRE lending to households has been growing at annual rates of above 5% for the past two years. The continued strong dynamics imply that unsustainable lending practices quickly feed into the stock of housing loans and impair the risk profile of banks' balance sheets across the Austrian banking system. Therefore, the OeNB urges banks to comply with sustainable lending standards in real estate financing.*

Austrian banks reduced foreign currency loans further

Foreign currency (FX) loans continue to be on the decrease in Austria. Due to supervisory measures, FX loans have declined further and do not represent a systemic risk to the Austrian banking sector. By January 2021, the volume of outstanding FX loans extended to domestic households had fallen to EUR 11.4 billion, down by 13.7% year on year and exchange rate adjusted. The lion's share (96%) of these loans is denominated in Swiss francs. The share of FX loans in total loans to households shrank by 1.5 percentage points year on year to 6.6%. Despite the significant decline over the past years, residual risks from FX loans remain, as

[15] *See FMSB. 2018. 17th meeting of the Financial Market Stability Board.*

[16] *Source: OeNB Mortgage Lending Survey, 2016–2019; OeNB VERA H reporting 2020. Only collateralized loans were included in the calculation. There are differences in coverage between sources.*

about three-quarters are bullet loans linked to repayment vehicles. Such loans may face a funding shortfall at loan maturity in case of unfavorable exchange rate movements and/or underperforming repayment vehicles. In the past few years, 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. To monitor these loans, the OeNB – in cooperation with the FMA – conducts an annual survey among a representative sample of Austrian banks. The results of this year's survey are expected to be available in summer 2021.

The strong Swiss franc continues to put pressure on foreign currency borrowers. Even though the Swiss franc has depreciated somewhat against the euro since the beginning of the year and is now trading at around 1.10 per EUR (its lowest level since November 2019), its cumulative appreciation since September 2008 still amounted to around 45% in early May 2021. In other words, a borrower who took out a Swiss franc bullet loan of EUR 150,000 in September 2008 would currently have to repay EUR 217,000, in addition to the interest that also becomes due. The OeNB therefore still recommends that banks and borrowers intensify bilateral negotiations to find tailor-made solutions to mitigate risks arising from these loans.

Austrian banking subsidiaries in CESEE also continued to reduce their retail foreign currency loan portfolio. In 2020, the volume of FX loans to households dropped by 4.7% (exchange rate adjusted) to EUR 9.5 billion. This translates into a 12.7% share of FX loans in total retail loans. Around three-quarters of these loans are denominated in euro. In the nonfinancial corporation segment, the outstanding amount of FX loans increased by a slight 1.3% to EUR 19.9 billion, which was mostly driven by the increase in euro-denominated loans (+2.5% year on year, to EUR 17.7 billion). At year-end 2020, the FX share in the corporate loan segment stood at 38.1%. The significantly higher share of FX loans in the corporate loan segment can be partially explained by foreign currency income of many corporations (natural hedge) and less political attention. FX loans continued to show weaker credit quality than loans in local currency. In 2020, the NPL ratio for the two loan portfolios remained broadly stable and stood at 4.7% and 3.1%, respectively. The associated risks have been partly mitigated by satisfactory risk provisioning, with the NPL coverage ratio equaling 67% for both loan portfolios.

Austrian nonbank financial intermediaries benefited from rising market valuation

Austrian insurers have proven resilient to the COVID-19-related financial and economic shocks so far. In the near term, the ongoing economic weakness will challenge insurers' underwriting profitability, driven by weak premium growth, and contribute to rising credit risk on the asset side. Moreover, insurance companies will continue to be affected by the persistently low interest rate environment (e.g. through reinvestments at low or even negative yields, rising liabilities), which is still the fundamental longer-term concern for the sector. Hence, life insurance companies in Austria have already started moving from guaranteed-return to unit-linked business models or to lower guaranteed returns in new policies. Rising yields as seen in the first quarter of 2021, if sustainable, may help insurers only over the longer term to rebuild their deteriorated interest income.

The Austrian insurance sector's total premium volume of EUR 19.1 billion in 2020 consists of EUR 11.3 billion revenues from property and casualty insurance policies, EUR 5.4 billion from life insurance policies and EUR 2.4 billion from health insurance policies. The underwriting result declined by 10% in 2020 compared with 2019, and the financial result decreased by 43%. Overall, the result from ordinary business activities dropped to EUR 0.7 billion, down from EUR 1.55 billion in 2019. At the end of 2020, Austrian insurance companies were well capitalized, despite a year-over-year 18-percentage-point lower median solvency capital requirement ratio of 220%.

The extensive support measures taken to mitigate the impact of the COVID-19 pandemic have improved financial market conditions. Thus, they have also benefited the Austrian insurance sector by increasing the market value of its holdings of financial assets. The composition of the securities holdings of Austrian insurance companies changed only slightly in 2020. Debt securities accounted for 39% of the sector's total assets of EUR 141 billion, investment fund shares totaled another 27% (mixed and bond funds played a dominant role), and shares and other equity amounted to 15%. Over the last three years, the importance of debt securities declined by 2 percentage points, while the share of investment funds increased by more than 1 percentage point. In 2020 only, share and other equity investments increased by 9%, mainly driven by nonlisted shares.

Insurance companies' exposure to the banking sector and to sovereigns might become a channel of risk transmission and contagion to the insurance industry. The sector's average exposure (investments and sales agreements) vis-à-vis the banking sector in Austria is above the EU average, but has remained almost unchanged since 2016. Bail-inable securities issued by banks and held as assets by insurance companies continued to decline by 10% to EUR 15.4 billion[17]. The insurance sector's exposure to the domestic sovereign (debt securities and loans) amounted to less than 5% of insurers' total assets, having declined over the last three years. In this period, however, investments in debt securities issued by other euro area governments increased by 2 percentage points to 11% of total assets.

Austrian pension funds enjoyed solid returns in a rather difficult environment. Assets under management by Austrian pension funds increased by 2.8% (year on year) to EUR 25.0 billion in 2020, and the number of beneficiaries (prospective and current recipients) increased by 1.5% to 995,000. Currently, 119,000 beneficiaries receive a pension under an occupational pension scheme. The largest exposure of the sector are bonds (37% of the portfolio), followed by stocks (36%), and almost all assets are invested via investment funds. In 2020, the overall return on investment of Austrian pension funds was 2.5%, compared to an average 3.9% per year over the past ten years.

Austrian investment funds realized capital gains in 2020. The net asset value of Austrian investment funds was EUR 202.5 billion at the end of 2020. Driven by capital gains and net inflows after the COVID-19-related plunge in the first quarter, the funds' assets increased by 3.8% or EUR 7.5 billion year on year. Net inflows accounted for EUR 6.1 billion.

[17] *See FMA. 2020. Report on the State of the Insurance Industry 2020.*