

Recent developments

Nonfinancial corporations and households in Austria severely hit by COVID-19

The measures adopted to contain the COVID-19 pandemic have sent Austria into the quickest and deepest recession in recent economic history. In the second quarter of 2020, Austrian GDP was down 14.3% year on year in real terms. The wide-ranging economic and social restrictions imposed to contain coronavirus abruptly changed the conditions under which businesses operate, causing a sharp drop in cash flow for many firms. Economic sectors were affected to varying degrees, with accommodation as well as the arts, entertainment and recreation having been hit hardest by the lockdown and social distancing (see Guth, M., C. Lipp, C. Pühr and M. Schneider (2020) in this publication). Falling demand, reduced capacity utilization and heightened uncertainties resulted in sharply reduced investment in the second quarter of 2020.

Beyond the COVID-19 impact, there have been risks on an international scale because of increased trade tensions between the U.S.A. and China and the uncertainties surrounding Brexit. Given the looming end of the Brexit transition period, the ongoing negotiations between the EU and the U.K. could be accompanied by increased market volatility. On a positive note, European fiscal support measures adopted in response to COVID-19 are set to boost growth. In particular, the impact of the debt financed extra-budget recovery fund (“Next Generation EU”) worth EUR 750 billion is likely to be amplified by higher than normal multipliers, as stimulus is expected to ease the particularly elevated macroeconomic uncertainty. The fund may even foster productivity when properly targeted to critical investment needs. On a negative note, the implementation of the fund and the regular long-term budget risk could be delayed since the final negotiations have been riddled with fundamental issues (rule-of-law conditionality) and require the consent of all national parliaments.

Profitability deteriorated amid the sharp contraction of economic activity. Gross value added of nonfinancial corporations fell by 19% year on year in real terms in the second quarter of 2020 and thus faster than the compensation of employees (–10%). However, due to a surge of production subsidies (by almost 900%) as a result of the various support measures (which, however, had not yet been completely disbursed in the second quarter), the gross operating surplus¹ of Austrian nonfinancial corporations increased by 3.4% year on year in real terms. This rise also supported internal financing, the most important source of funds for Austrian nonfinancial corporations. That said, it must also be noted that the current figures do not reflect problems that still lie ahead.

External financing exclusively took the form of debt in the first half of 2020. Total external financing of Austrian nonfinancial corporations increased slightly against the same period of the year before, according to preliminary financial accounts data. While equity financing – which had already been rather subdued in the two years before – was negative in net terms at EUR –0.9 billion, as foreign investors reduced their investments in resident corporations, debt financing rose by 26% to EUR 17.3 billion, the highest half-year value recorded in more than two decades. Loans by domestic banks, whose share in debt financing had already been comparatively high in recent years, accounted for almost 40% of debt financing.

¹ Including mixed income (self-employed and other nonincorporated businesses income).

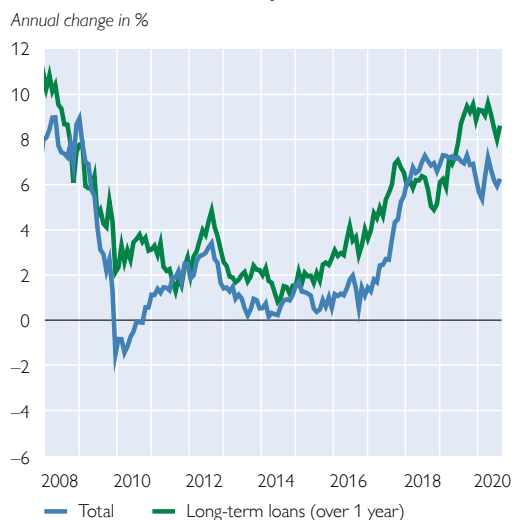
Bank loans have been a central instrument for safeguarding the liquidity of companies during the COVID-19 pandemic. Responding to firms' immediate liquidity needs, fiscal, prudential and monetary policies all aimed to uphold the flow of bank lending to the real economy. The government provided loan guarantees for bridging loans to Austrian enterprises. Prudential authorities supported the banking system in maintaining the flow of credit through several capital and operational relief measures. Moreover, the Eurosystem's monetary policy eased banks' refinancing conditions by implementing multiple instruments, including direct asset purchases (under the pandemic emergency purchase programme – PEPP) as well as lending operations, in particular targeted longer-term refinancing operations (TLTRO-III) to encourage banks to extend loans to the private sector. Thus, despite a substantial fall in corporate investment, loan growth slowed down only slightly against the high growth rates recorded in the years 2017 to 2019. In August 2020, the annual growth rate of MFI loans reached 6.3% (adjusted for securitization as well as for reclassifications, valuation changes and exchange rate effects, see left-hand panel of chart 1). In an environment of compressed cash flows, the growth in bank lending to firms was mainly driven by firms' needs for working capital as well as the need to provide for possible liquidity shortages. Moreover, bank loans were strongly supported by public guarantees and loan moratoria, with the latter reducing repayments, thereby impacting loan growth.²

Net lending surged in the first two months of the pandemic but abated in the following months. In March and April 2020, when the crisis struck and firms tried to secure short-term funding, monthly net transactions³

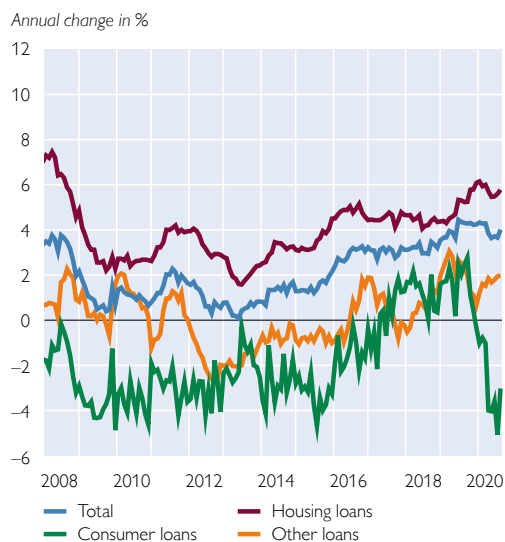
Chart 1

MFI loans to Austrian nonfinancial corporations and households

Loans to nonfinancial corporations



Loans to households



Source: OeNB.

² For an overview of COVID-19-related moratoria and public guarantees, see the box “COVID-19-related support and relief measures for banks and their implications for financial stability.”

³ Changes in stocks adjusted for securitization as well as for reclassifications, valuation changes and exchange rate effects.

amounted to EUR 2.0 billion, against EUR 0.5 billion in the same months of the years 2018 and 2019, in which the growth of loans to nonfinancial corporations had been very buoyant. In May to August 2020, monthly net transactions fell to EUR 0.6 billion. Short-term loans (with a maturity of up to one year), which had made a large contribution to loan growth at the beginning of the COVID-19 pandemic, were repaid on a net basis from May 2020 onward. In contrast, the outstanding amount of medium- and long-term loans increased, to a large extent reflecting the scope of government guarantees given for bridging loans with medium-term maturities.

Credit standards for loans to enterprises were tightened slightly by Austrian banks in the third quarter of 2020, according to the Austrian results of the euro area bank lending survey (BLS). Yet, up to now the degree of tightening was less pronounced than during the great financial crisis of 2008–09 (GFC), which had introduced a period of relatively tight credit standards. Public loan guarantee schemes made it less risky for banks to lend to companies and compensated for deteriorating risk perception and lower risk tolerance. The share of rejected applications for loans by enterprises, which had remained stable in the first half of 2020, also increased somewhat in the third quarter, according to the survey.

Credit conditions tightened somewhat since the outbreak of the pandemic. Between March and August 2020, interest rates on new loans to nonfinancial corporations rose on average by 10 basis points, the easing monetary policy stance notwithstanding. This likely reflected higher risk premia due to the economic impact of the pandemic on firms' revenues. However, interest rates varied widely across different loan segments. While interest rates on larger loans (with a volume of more than EUR 1 million) rose, rates on smaller loans decreased. This was especially true for interest rates on loans with an interest fixation period of 1 to 5 years, which fell by 82 basis points between March and August 2020. This is typically the size and maturity bracket of guaranteed loans, for which risk considerations are less of a concern. The risk aspect was also reflected in the results of the BLS, where banks stated that in the first three quarters of 2020, interest margins on riskier loans to firms were widened to a larger extent than on loans with average risk (which had been observed already in the years before). Other terms and conditions, such as collateral requirements and loan covenants, were also tightened in the second and the third quarters, according to the survey.

Since the onset of the pandemic, nonfinancial corporations have built up substantial liquidity reserves. On top of the loans disbursed to firms, banks provided additional liquidity in the form of new credit lines. In the period from March to August 2020, the monthly average of new credit lines granted to nonfinancial corporations was 7% above the 2018–19 average. However, as firms have so far made

Chart 2

Indicators of Austrian nonfinancial corporations' liquidity



Source: OeNB.

only partial use of the credit lines granted to them, undrawn credit lines available to enterprises increased briskly in recent months, rising by 19% year on year in August 2020 (see chart 2). Additionally, firms' transferable deposits continued to rise (by 17% in August 2020), to a large extent reflecting funds raised from banks and on the bond market which have not yet been spent.

Corporate bond issuance increased substantially since the beginning of the COVID-19 pandemic. In the period from April to August 2020, Austrian nonfinancial corporations raised close to EUR 6 billion in debt securities, which is almost half more than the net amount obtained via MFI loans, after debt securities issuance had decreased in the three previous years. This increase reflected financing needs, but also benefited from the narrowing of corporate bond spreads facilitated by the enhancement of the ECB's securities purchase programmes, which include corporate bonds. In the second quarter of 2020, net corporate bond issuance was equivalent to 54% of total external financing (after having been negligible in the first quarter). However, this form of finance was only used by a small number of large firms.

COVID-19 seriously affects the debt sustainability of Austrian companies. After the GFC, nonfinancial corporations successfully reduced the debt-to-income ratio by 23 percentage points from its peak in 2013 to 2018, although in the second half of 2019, the ratio already started to rise again (see left-hand panel of chart 4).⁴ In the first half of 2020, the corporate sector's debt-to-income ratio surged by 13 percentage points to 324%, mainly as a result of rising debt. Looking ahead, while additional debt is essential to make up for lost revenues of firms, debt sustainability is bound to weaken over the medium and long term, especially in an environment of reduced corporate profits. The ensuing weakening of the corporate sector's internal financing potential will not only diminish the funds available to service outstanding debt but also impede the buildup of equity through internal finance. At the same time, raising external equity in the current situation is seriously hampered by the bleak economic outlook. Thus, it will be crucial to facilitate the buildup of equity of Austrian enterprises, especially SMEs, as they constitute the majority of domestic enterprises.⁵

The interest burden of nonfinancial corporations remained low in the first half of 2020. The ratio of interest payment obligations for (domestic) bank loans to gross operating surplus remained stable at 3%, compared to more than 9% in 2008, the sizable increase of loan volumes notwithstanding. As the majority of guaranteed loans have medium-term interest rate fixation periods, the share of variable rate loans declined by 7.4 percentage points year on year to 77.4% in the second quarter of 2020.

Insolvency numbers have fallen significantly since the start of the pandemic, but there is a risk of catch-up effects as support measures will eventually be phased out. In order to protect companies from going

⁴ This measure follows Eurostat's and the European Commission's debt measures for the macroeconomic imbalance procedure (MIP) surveillance mechanism. It excludes pension scheme liabilities, which are not very significant in Austria, and other accounts payable, such as trade credit and other items due to be paid, mostly on a short-term basis. These items essentially constitute operational debt, i.e. liabilities that a firm incurs through its primary activities. Data are presented in consolidated terms, i.e. transactions within the corporate sector are not taken into account.

⁵ First steps in that direction have been a COVID-19 start-up support fund in the amount of EUR 50 million and a company established by the City of Vienna (also with an initial funding volume of EUR 50 million) aimed at investing equity into Vienna-based companies threatened by the COVID-19 pandemic.

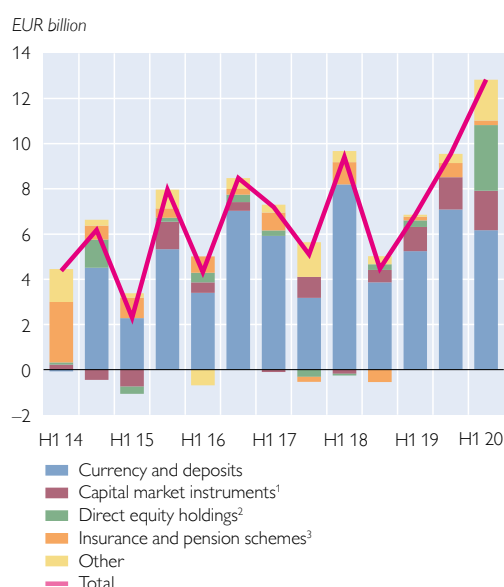
bankrupt, the obligation to file for bankruptcy due to overindebtedness was temporarily suspended. As a result, the number of insolvencies dropped by 46% in the second and third quarters of 2020, compared to the same period of the previous year. Other policy measures, such as loan guarantees and moratoria, which temporarily shielded firms from the economic effects of the pandemic have also contributed to this decline. Despite the considerable fall in the number of insolvency proceedings, total insolvency liabilities more than doubled in the second and third quarters of 2020 against the same period in 2019 to EUR 1.9 billion, reflecting a number of large bankruptcies. Yet, while COVID-19-related relief measures have so far helped mitigate liquidity shortages and thus avoid widespread bankruptcies, they have shifted insolvency risks into the future (and possibly also delayed the insolvency of unviable firms). Not only is there a danger of catch-up effects when bankruptcy relief measures will be phased out, but the deterioration of the economic environment might also touch off additional insolvencies, especially in industries hit particularly hard by the crisis. The sectors suffering the most severe output losses were the arts, entertainment and recreation as well as accommodation and food services industries, which, consequently, are expected to experience the largest increases in insolvency rates, according to the corporate insolvency model developed by the OeNB (see Guth, M., C. Lipp, C. Puhr and M. Schneider (2020) in this publication). Moreover, the increased borrowing that went along with a number of those policy measures may impair the future repayment capacity of enterprises, a situation which may be further aggravated by the fact that loans to industries that have been hit hardest by the crisis expanded most.

In the household sector, the COVID-19 pandemic has resulted in a sharp reduction of incomes.

This concerned all types of income, from property income (−48% in the first half of 2020 compared to the same period of the year before) to self-employment income⁶ (−5%) to employee compensation (−2.3%) amid a significant decrease in employment triggered by the economic downturn. Yet, government support for short-time work schemes and other government transfers had a stabilizing effect. Household consumption was affected by the lockdown in the spring more directly and to a larger extent than household income. Limited opportunities to consume and high uncertainties regarding future income increased precautionary saving. In real terms, consumption dropped by 16.1% year on year in the second quarter of 2020. Accordingly, the savings rate of

Chart 3

Net financial investment of households



Source: OeNB.

¹ Debt securities, mutual fund shares and listed shares.

² Unlisted shares and other equity.

³ Insurance contracts, pension entitlements, severance funds.

⁶ Operating surplus and mixed income.

households rose to 23% (not seasonally adjusted) in the second quarter of 2020 (compared to 15% in the same quarter of the preceding year).

Financial investment flows of households almost doubled in the first half of 2020. Mirroring the jump in the savings rate, households' financial investment flows rose by 87% year on year to EUR 12.8 billion (see chart 3). Reflecting high uncertainty, liquid assets contributed two-thirds to this rise as households increased their cash holdings by EUR 1.4 billion and overnight deposits by EUR 7.3 billion. Other bank deposits were reduced by EUR 2.5 billion as the shift from time and saving deposits to overnight deposits continued.

Households' capital market investment holdings have registered sizable valuation losses during the pandemic so far. In the first half of 2020, net financial investments in capital market instruments amounted to EUR 1.7 billion, the highest half-year value in almost a decade. Households reduced their direct holdings of debt securities but continued to invest in mutual fund shares and listed shares. Reflecting the massive price declines in national and international capital markets following the COVID-19 shock in spring 2020, households encountered (unrealized) valuation losses amounting close to EUR 15 billion in the first quarter of 2020. However, as capital markets recouped a significant share of these declines in the second quarter, financial assets recovered almost half of these losses so that the net effect on the securities portfolios of households was about EUR 8 billion, equivalent to 6.3% of the outstanding amount at the end of last year. By comparison, the cumulative effects of the GFC in 2008 had been significantly more pronounced, at EUR –19 billion. As the results of the Household Finance and Consumption Survey (HFCS) for Austria show, capital market investments are very much concentrated in the portfolios of higher-income households, which are in a better position to bear such valuation losses.⁷

After the onset of the pandemic, growth of lending to households decreased slightly. Between February and August 2020, the annual growth rate of bank loans to households slowed from 4.3% to 4.0% year on year (adjusted for reclassifications, valuation changes and exchange rate effects; see right-hand panel of chart 1). This moderation reflected uncertainties among households about the impact of the pandemic on their disposable income and employment prospects. Moreover, policy measures aimed at supporting the household sector were to a lesser extent channeled through the banking sector than support for the corporate sector; in the case of households, such measures mainly took the form of loan moratoria for persons who have suffered substantial cuts in incomes as a result of the pandemic. Like in the corporate loan segment, reduced repayments due to moratoria affected the volume of outstanding loans to households and thus growth rates. In line with the decrease in consumption of durables and the extraordinary fall in consumer confidence in the first half of 2020, consumer loans were down 3.0% year on year in August 2020. Other loans, which include loans to sole proprietors and unincorporated enterprises (which were eligible for loan guarantees), rose by 2.0%. As in past years, the main contribution to loan growth came from housing loans, not only because the latter are the most important loan category for households – accounting for more than two-thirds of the outstanding volume of

⁷ For instance, only 2.6% of households in the lowest income quintile but 18.4% in the highest income quintile own mutual fund shares. For stocks, the percentages are 1.6% and 11.3%, respectively.

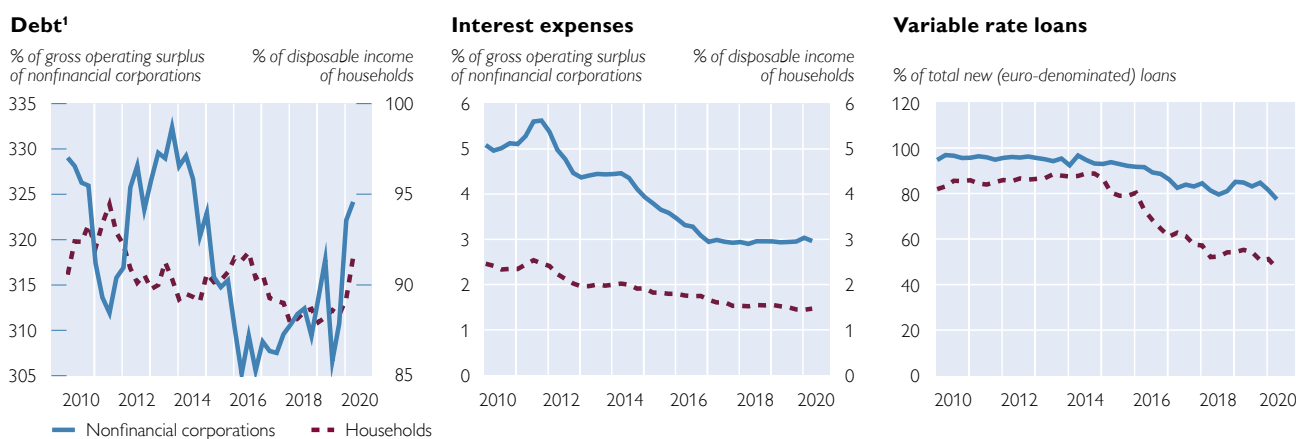
loans to households – but also because they registered the highest growth rate of all loan purposes, reaching 5.8% year on year in August 2020. According to the BLS, Austrian banks slightly tightened their credit standards for housing loans in the second and third quarters of 2020, as they had done throughout 2019, mainly because of the perception of increased risk and lower risk tolerance. At the same time, banks reported a slight increase in the demand for housing loans in the third quarter of 2020 (as in 2019 and the first quarter of this year).

The conditions for housing loans remained favorable. Interest rates on new bank loans fell by 5 basis points in the period from March to August 2020. Interest rates on housing loans fell by 16 basis points, while those on consumer loans rose by 55 basis points. BLS results show that banks' margins for riskier housing loans were tightened in each of the first three quarters of this year but those for loans with an average risk profile were tightened only in the second quarter.

Debt sustainability of households did not deteriorate noticeably in the first half of 2020. Households' debt-to-income ratio increased slightly – by 3.3 percentage points – to 91.5% against the year before, as disposable income receded while debt rose slightly. The loan moratoria for borrowers affected by COVID-19 eased the financial pressure on households that made use of this measure for the time being but might increase the burden of debt servicing once they expire. However, as is the case with financial assets, households that have taken out a loan tend to have higher incomes, according to HFCS 2017 data. About 21% of households in the lowest income quintile, but 46% of the highest income quintile had taken out a loan in 2017. Thus, a significant share of household debt is held by households that are more likely to have sufficient funds to service their loans. The share of variable rate loans (with an initial rate fixation period of up to one year) in new loans fell from 55% in the second quarter of 2019 to 47% in the second quarter of 2020 (see right-hand panel of chart 4). Foreign currency loans continued to be a risk factor despite having decreased further in the first half of 2020 to less than 8% of all outstanding loans (and to 10% of housing loans). The share of foreign currency loans in total new loans edged up from 0.8% in the first quarter to 0.9% in the second quarter of 2020.

Chart 4

Risk indicators for Austrian nonfinancial corporations and households



Residential property prices in Austria rose further in the first half of 2020. In the second quarter of 2020, prices increased by 4.1% year on year. Especially prices for single-family houses have recorded pronounced increases since the onset of COVID-19 (possibly related to increased working from home and the lockdown experience in general). Given that remote working is assumed to continue to play a bigger role in the future, it is likely that there will be a shift from office to residential space, which, as a consequence, will change the price structure in both the commercial and residential real estate markets. The OeNB fundamentals indicator for residential property prices reached 16.8% in the second quarter of 2020. This signals that residential real estate price developments continue to deviate from the changes in the explanatory factors that the indicator tracks; this warrants continued close attention.⁸

Austrian financial sector proves resilient to initial COVID-19 shock

Austrian banks' resilience, which had increased substantially since the GFC, has remained strong despite the initial COVID-19 shock. In the first half of 2020, the consolidated common equity tier 1 (CET1) ratio of the Austrian banking system remained at 15.5%, as lending by Austrian banks continued to be strong and regulatory capital relief measures proved supportive. In this respect, the OeNB recommends that banks continue to focus on a solid capital base and take a careful approach regarding the distribution of profits.

Stress test results show a well-capitalized Austrian banking sector. Aggregate results suggest that the Austrian banking system is well positioned to weather the fallout of the pandemic. Thanks to government support, many of the expected corporate defaults could be avoided, which, in turn, has limited losses in banks' equity. Even under the adverse scenario, the Austrian banking system remains well capitalized, with all significant institutions and most major less significant banks being more resilient now than during the GFC a decade ago.⁹

Traditional loan quality indicators have improved. However, as nonperforming loans (NPLs) are expected to rise, banks have started to increase provisioning. In the current situation, payment moratoria as well as fiscal and monetary measures supported a further improvement of loan quality ratios in the first half of 2020. The consolidated NPL ratio of the Austrian banking sector came down to 2.0%, nearly 20 basis points lower than at end-2019. For the domestic loan book, the NPL ratio improved to 1.5%. Those improvements were both driven by the inflow of new loans and the reduction in existing NPLs. However, the share of loans assigned to stage 2¹⁰ according to IFRS 9 increased markedly, from 10% at end-2019 to 16% in June 2020. For corporate loans, this share even increased from 10% to 22%. This signals a deterioration in credit quality and, consequently, Austrian banks increased their loan loss provisioning. The consolidated coverage ratio rose by 74 basis points to nearly 50%. Proper credit risk provisioning at an early stage remains key to mitigate risks to financial stability both in Austria and foreign host markets.

⁸ For more information on the property market in Austria, see the latest edition of our quarterly publication "Immobilien aktuell" (available in German only) at <https://www.oenb.at/Publikationen/Volkswirtschaft/immobilien-aktuell.html>.

⁹ Detailed stress test results can be found from page 79.

¹⁰ Stage 2 loans in the context of IFRS 9 are loans whose credit quality has deteriorated significantly since initial recognition but offer no objective evidence of a credit loss event.

The impact of COVID-19 on the profitability of Austrian banks became clearly visible in the first half of 2020 as banks' operating profit plunged and risk provisioning increased significantly. Although net interest income increased slightly year on year and income from fees and commissions remained unchanged, operating income declined somewhat due to a halving of income from equity investments. At the same time, operating expenses increased markedly due to a significant increase in impairments on these investments. Consequently, operating profit declined by nearly one-quarter to EUR 3.3 billion and the cost-income ratio deteriorated to 72%. The pandemic is likely to trigger a significant deterioration in credit quality – not only in Europe, but worldwide. It is therefore crucial for banks to be transparent about their loan books' quality and to build up provisions for future loan losses. In the first half of 2020, Austrian banks raised loan loss provisioning to EUR 1.8 billion, after only EUR 1.0 billion for the entire year of 2019. Together with the decline in operating profits, this put additional pressure on banks' net profits, which fell by three-quarters year on year to EUR 0.9 billion. This marks the worst first half-year result since 2014, when geopolitical tensions and goodwill write-downs on Central, Eastern and Southeastern European (CESEE) subsidiaries burdened profitability. The return on average assets deteriorated to 0.2%, and the return on average equity plunged to 2.5%.

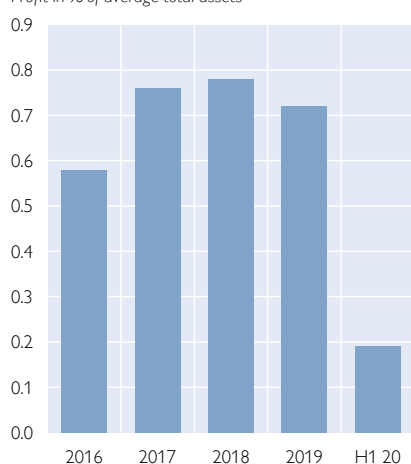
The Austrian banking system is growing despite the pandemic. Most Austrians typically also find a bank branch close to their home, even though the overall number of branches has declined further. Despite the severe impact of COVID-19 on the global and the domestic economy, Austrian banks increased the size of their balance sheets in the first half of 2020. Compared to the end of 2019, total assets increased by 7% to more than EUR 1.1 trillion due to strong lending and an expansion of liquidity. At the same time, Austrian banks continued their consolidation efforts: While the number of banks remained largely constant, the number of domestic branches declined further. The current report therefore includes an in-depth, spatial analysis of the development of the

Chart 5

Key indicators of the Austrian banking sector

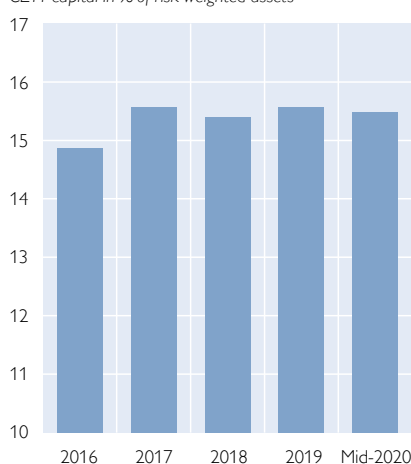
Return on assets

Profit in % of average total assets



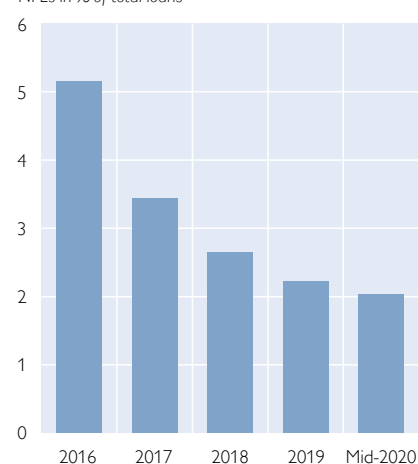
CET1 ratio

CET1 capital in % of risk-weighted assets



NPL ratio

NPLs in % of total loans



Source: OeNB.

Note: Consolidated data.

Austrian bank branch network, which shows that around a quarter of all Austrian municipalities lacked a branch at the end of 2019. On average, however, Austrian bank customers travel only 1.5 kilometers to the nearest branch.¹¹

Austrian banks' foreign exposure increased further in the first half of 2020. Total assets of Austrian banking subsidiaries in CESEE (worth EUR 231 billion) continue to be concentrated in a handful of EU host markets. The foreign exposure of the Austrian banking system increased by 6% in the first half of 2020 to EUR 425 billion.¹² Austrian banks expanded their activities for instance in the Czech Republic, Germany, Slovakia and France, and reduced business in Russia and Turkey. At the end of June 2020, the exposure to CESEE was nearly EUR 260 billion, somewhat higher than at end-2019. More than one-third of total assets in CESEE are located in the Czech Republic. Slovakia and the Czech Republic together account for more than half of all Austrian CESEE subsidiaries' assets as at mid-2020. Other important markets are Romania, Hungary and Croatia, which means that the top 5 host countries are all EU Member States (see chart 6). When it comes to absolute profits in the first half of 2020, however, it is Russia that leads the ranking (a first since 2013), just slightly ahead of the Czech Republic, and Romania trailing by some distance (see chart 7).

In the first half of 2020, Austrian banking subsidiaries in CESEE earned EUR 0.9 billion, one-third less than during the same period of 2019. Given that operating income remained almost flat year on year and operating costs increased by 3%, operating profits declined to 1.8 billion (–5% year on year). Credit risk provisioning, however, soared from just EUR 77 million to EUR 625 million, reflecting both very low levels of credit risk before the COVID-19 pandemic as well as its initial impact. Consequently, the total profit of Austrian banking subsidiaries in CESEE dropped to EUR 0.9 billion in the first half of 2020. Despite its substantial decrease, this profit made a vital contribution to the Austrian banking system's consolidated profitability.

At mid-2020, the NPL ratio of Austrian banking subsidiaries in CESEE was 2.3%, even slightly below the pre-COVID level of 2.4%. This decline was caused by stagnating NPL volumes in the first half of 2020, while the gross book value of loans rose by 4%. Credit quality at the subsidiaries continued to be highly heterogeneous, with subsidiaries in the Czech Republic reporting an aggregate NPL ratio of just 1.1%, while, e.g., the NPL ratio of subsidiaries in Croatia stood at 5.3%. The aggregate coverage ratio continued its upward trend and stood at 68%. However, as the pandemic has meanwhile also hit the CESEE region with full force, credit quality is expected to deteriorate markedly, which is already reflected in the large increase in credit risk provisioning.

The capitalization of Austrian banking subsidiaries in CESEE is solid and their funding situation balanced. At mid-2020, the aggregate CET1 ratio stood above 17% and the loan-to-deposit ratio at 77%. 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. Austrian banking subsidiaries in CESEE are better prepared to cope with the impact of the

¹¹ A detailed analysis can be found in Stix, H. (2020) in this publication (from p. 87).

¹² Foreign exposure is measured in terms of the ultimate risk of all Austrian banks (growth is not exchange rate adjusted).

pandemic than they were when dealing with the effects of the GFC. However, as the Austrian banking system's profits depend to a great extent on the CESEE region, the slowdown in those economies will further burden its profitability.

Austria's supervisory policy toolkit includes several macroprudential capital buffers.¹³ The systemic risk buffer (SyRB) aims at mitigating noncyclical long-term risks, which emerge in the context of capitalization, the banking sector's size, the size of foreign exposures as well as banking group's ownership and structure. The SyRB was implemented in early 2016 and has been activated for 13 Austrian banks on a consolidated level. The second macroprudential policy measure is a capital buffer for banks that are of systemic importance for Austria's financial system (O-SII buffer). Third, there is the countercyclical capital buffer (CCyB), which stood at 0% in September 2020.

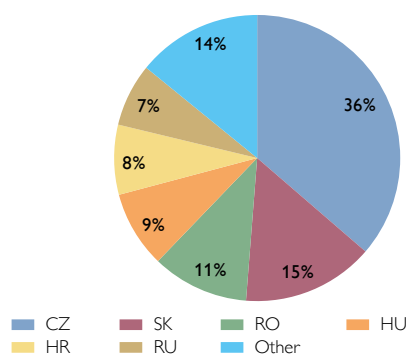
Thanks to the analytical work of the OeNB, Austria's macroprudential policy is effective in mitigating systemic risks. During the COVID-19 pandemic, Austrian banks have at their disposal EUR 19 billion of macroprudential capital buffers to be used for absorbing losses and maintaining lending. The system's resilience was increased further by retained profits as recommended by the Austrian Financial Market Authority (FMA), the OeNB and the Single Supervisory Mechanism (SSM). Macroprudential capital buffers also improve investors' and rating agencies' perception of Austrian banks, and, consequently, domestic banks benefit from better refinancing conditions compared to their peers. This will allow them to support the real economy over the next challenging quarters.

Currently, both the SyRB and the O-SII buffer are applicable and the higher of the two rates applies, but this will change by the end of 2020. The new Capital Requirements Directive V (CRD V), which is to be implemented

Chart 6

Total assets of Austrian banking subsidiaries in CESEE

Total assets: EUR 231 billion



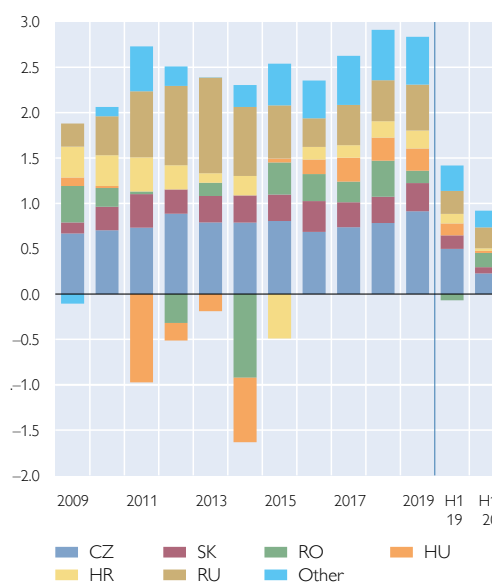
Source: OeNB.

Note: Data as of mid-2020.

Chart 7

Profit of Austrian banking subsidiaries in CESEE

EUR billion



Source: OeNB.

¹³ See <https://www.fmsg.at/en> for further details. In Austria, the countercyclical capital buffer will be maintained at 0% of risk-weighted assets in the absence of excessive credit growth. See FMSB recommendation 2/2020 (June 15, 2020).

by the end of 2020, states that the two buffers will become additive. Given that this legal change comes at a time of high economic uncertainty, the Financial Market Stability Board (FMSB) recommended – subject to the transposition of the CRD V into Austrian law – that the size of the buffers be adjusted to prevent the effective buffer requirements from increasing between end-2020 and end-2022 just because of legal changes. Ultimately, this means that the overall buffer requirements have been left largely unchanged.¹⁴

The OeNB follows a comprehensive approach in macroprudential supervision, considering both crisis prevention and crisis resolution. This ensures consistency between macroprudential regulation, the resolution regime and the deposit guarantee schemes (DGSs). The OeNB performed a systemic risk analysis of the Austrian DGSs in 2017 and identified room for improvement. Together with the FMA, it called for reforms to improve the availability of alternative funding (beyond ex ante funds and ex post contributions). In 2020, the DGSs implemented such reforms. A recent OeNB systemic risk analysis has found that the DGSs have remained resilient and credible, despite a substantially reduced volume in a fund after two deposit insurance events in the first half of 2020.

Recommendations by the OeNB

The Austrian financial sector has weathered the COVID-19 pandemic well so far. However, reduced economic output, nonfinancial corporations' higher debt burden as well as a rise in insolvencies are increasing medium-term risks to financial stability. Alongside persistent challenges from the low interest rate environment, deteriorating credit quality and rising provisioning needs have put downward pressure on banks' profitability. More than half a year into the COVID-19 pandemic, legal and voluntary bank measures – such as debt repayment moratoria or the suspension of the obligation to file for insolvency in case of overindebtedness – have provided strong support for the real economy, but at the same time made it more complicated for banks, investors and supervisory authorities to assess risks. In these challenging times, the OeNB recommends that banks take the following measures:

- In view of future credit risks and increased uncertainty: focus on a solid capital base, i.e. avoid share buybacks and carefully consider profit distributions (dividends, management bonuses) in accordance with European recommendations.¹⁵
- Prepare for the time when public support measures in Austria and in CESEE expire and ensure transparency regarding the credit quality of loan portfolios.
- Apply sustainable lending standards in real estate lending, both in Austria and in CESEE, and comply with the quantitative guidance issued by the Financial Market Stability Board.
- Continue efforts to improve cost efficiency and operational profitability, even under the currently difficult circumstances.
- Further develop strategies to deal with the challenges of digitalization, new technologies and cybersecurity, especially in light of the experience of the pandemic.

¹⁴ See FMSB recommendation 3/2020 (June 15, 2020).

¹⁵ Please also refer to the ECB Single Supervisory Mechanism's and the FMA's information about COVID-19 measures (<https://www.bankingsupervision.europa.eu/home/search/coronavirus/html/index.en.html> and <https://www.fma.gv.at/en/covid-19/>).

Box 1

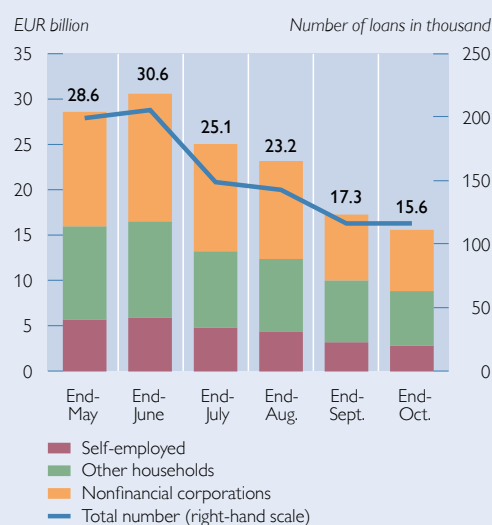
COVID-19-related support and relief measures for banks and their implications for financial stability¹⁶

Since March 2020, the Austrian government has put in place a number of measures to support the economy during the COVID-19 pandemic that also facilitate bank lending in difficult times. Parliament adopted a legislative moratorium on credit and interest payments due between April 1, 2020, and January 31, 2021, which offers household or micro-business borrowers suffering from COVID-19-related income losses the option to defer payments for a period of ten months and to extend loan tenors by the duration of the moratorium.¹⁷ Furthermore, the Austrian Financial Market Authority (FMA) notified the European Banking Authority (EBA) of a sector-wide nonlegislative moratorium, including (retrospective) deferrals in the period from March 15, 2020, to August 31, 2020. In addition, banks and their customers agreed bilaterally on voluntary individual forbearance measures. Also, the Austrian government created a COVID-19-related public guarantee scheme for newly originated loans: Eligible nonfinancial corporations can use guarantees to obtain bridge financing, thereby increasing their cash buffers.

By end-June 2020, Austrian banks had granted COVID-19-related payment extensions (including payment modifications from other countries) in the amount of EUR 46 billion on a consolidated level.¹⁸ In Austria, payment deferrals in the amount of EUR 16 billion had been granted by Austrian banks by end-October (see chart 8), which corresponded to 4.5% of total outstanding credit to households and nonfinancial corporations or 1.6% of unconsolidated total assets.¹⁹ This volume had declined from its EUR 31 billion peak in June as bank clients restarted servicing their debt and some payment extensions expired. At the same time, around 20,200 loans subject to COVID-19-related public guarantees totaling EUR 6 billion had been requested in Austria, representing around 10% of newly issued loans to nonfinancial corporations since the beginning of April.

To support the real economy and banks during these difficult times, the EBA has clarified in its guidelines²⁰ of

Volume of loans subject to COVID-19-related payment deferrals in Austria by borrowers



Source: OeNB.

Note: Payment deferrals include the legislative moratorium, the sector-wide nonlegislative moratorium and voluntary individual forbearance measures.

¹⁶ Compiled by Stephan Fidesser, Ines Ladurner, Zofia Mrazova, Vanessa Redak, Christof Schweiger, Ralph Spitzer, Daniela Widhalm and Elisabeth Woschnagg.

¹⁷ The data used in this box do not allow an assessment of households' and private companies' degree of indebtedness.

¹⁸ Based on data from regular supervisory reporting (FINREP) and the new reporting scheme defined in EBA Guideline 07/2020. Only limited data from this reporting were available at the time of writing. Please note that EBA reporting data are not directly comparable to the voluntarily reported data mentioned below due to differences in definitions, bank sample, consolidation level and observation period.

¹⁹ Austrian banks voluntarily report data to the OeNB about loans subject to the relief measures in Austria.

²⁰ EBA/GL/2020/02 (<https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-legislative-and-non-legislative-moratoria-loan-repayments-applied-light-covid-19-crisis>). The EBA phased out these guidelines by the end of September. The regulatory treatment set out in the guidelines will continue to apply to all payment holidays granted under eligible payment moratoria prior to September 30, 2020.

April 2020 that payment deferrals under moratoria do not trigger a classification of these exposures as forborne or defaulted under distressed restructuring, provided the moratoria follow general principles. Importantly, it is crucial that the moratorium was launched in response to the COVID-19 pandemic and was applied before September 30, 2020. In addition, the measures taken need to be based on the applicable national law or on industry- or sector-wide private initiatives agreed and applied broadly by the relevant credit institutions. Measures meeting these principles are defined as “EBA-compliant.” EBA-compliant moratoria will interrupt day counting for the “90-days-past-due” criterion of the definition of default. However, institutions are still obliged to assess on a case-by-case basis the obligor’s unlikelihood to pay. The Austrian legislative moratorium as well as the sector-wide nonlegislative moratorium fall under the category “EBA-compliant.” Hence, banks are still in an early stage of including the impact of COVID-19 in their balance sheets.

Austrian banks are now more resilient than they were during the GFC. This is reflected in strong micro- and macroprudential capital buffers, modest levels of nonperforming loans (NPLs) and high coverage ratios. Banks can use the currently relatively favorable conditions for issuing debt instruments to further strengthen their liquidity and capital positions. In addition, Austrian banks have reduced their credit risk in recent years.²¹ Their exposure to nonfinancial corporations operating in Austrian industries most affected by the lockdowns and other containment measures represents only 6% of the total loan volume (see Guth, M., C. Lipp, C. Pühr and M. Schneider (2020) in this publication for sectoral output losses in different scenarios). Payment extensions are overrepresented²² in the sectors hotels, restaurants and health services, and underrepresented in professional services, manufacturing and construction. Public guarantees have been granted to a higher extent not only to hotels and restaurants, but also to the trade, manufacturing and construction sectors.

The COVID-19 pandemic will have negative effects on Austrian banks’ profitability, in particular when the relief measures expire. While an effect on NPL ratios is not yet visible, the share of loans assigned to stage 2 according to IFRS 9²³ increased markedly in the first half 2020.

In a hypothetical scenario in which half of the exposures currently covered by relief measures²⁴ in Austria and abroad default, NPLs would increase markedly.²⁵ However, such estimates must be interpreted with caution: First, they represent an extreme scenario, assuming that half of the borrowers currently benefiting from relief measures default. Second, an increase in the NPL stock does not directly translate into provisions, as parts of this portfolio are collateralized or have already been provisioned for. Third, it can be assumed that an increase in the NPL stock may occur not at once in 2020; instead, it may stretch over a certain period, also given the different phaseout of the support measures. In this adverse scenario, NPLs of the Austrian banking sector could potentially increase to EUR 44 billion (compared to EUR 16.4 billion currently), with an associated consolidated NPL ratio of around 6% (currently 2.1%, at a 50% coverage ratio).

Risk provisions in response to deteriorating loan quality will be burdening profitability in the upcoming months. The cost of risk²⁶ (CoR) for the consolidated Austrian banking sector increased sharply from 13 basis points at end-2019 to 46 basis points in June 2020. At the same time, the CoR is still below the average of domestic banks’ European peers

²¹ Kerbl, S. and K. Steiner. 2020. Austrian banks’ lending risk appetite in times of expansive monetary policy and tightening capital regulation. In: *Financial Stability Report 39*. OeNB. 88–109.

²² I.e. in relation to their share in the total loan volume not subject to either measure.

²³ Stage 2 loans in the context of IFRS 9 are loans that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit loss event.

²⁴ These include exposures subject to COVID-19-related payment extensions, forborne exposures not subject to COVID-19 measures and the uncollateralized exposure of loans subject to COVID-19 guarantees by end-June 2020.

²⁵ This simple scenario is not meant to substitute fully-fledged and more complex scenario analyses (see Guth, M., C. Lipp, C. Pühr and M. Schneider (2020) in this publication).

²⁶ Cost of risk is measured as annual risk provisions built up relative to gross total loans.

(55 basis points for Austrian significant institutions as compared to the SSM average of 72 basis points) and has remained at low levels in the past years (the average between 2014 and 2019 was 35 basis points). If half of the loan book subject to relief measures in Austria and abroad as of June 2020 turned nonperforming and if banks maintained their current coverage ratio, the CoR would be slightly above 200 basis points. Thus, the CoR would be higher than the 2009 peak of 130 basis points. However, such an increase is unlikely to materialize within one year; rather, it will occur over a certain period. The actual annual level would therefore be much lower. Banks have taken different approaches to dealing with COVID-19-related credit risks, with some already frontloading risk provisions in the first half of 2020 to cover an expected rise in defaults amid a rise in unemployment and corporate bankruptcies. These differences in timing can contribute to smoothing risks and the negative impact on profitability over time.

Given the sequential phaseout of public support measures, there seems to be a low probability of cliff effects in the form of high, suddenly occurring losses in the banking sector in the near future, while medium-term risks appear to be more likely. A marked deterioration in credit quality caused by the pandemic is expected in the medium term. Still, this assessment is subject to a high level of uncertainty. In the short term, there will be a double catch-up effect: First, a regular effect in insolvency filings that would take place even in the absence of a crisis but which are currently postponed due to payment deferrals as well as the partial suspension of insolvency law. Second, and in addition, there will be a crisis-induced effect, i.e. additional insolvencies due to COVID-19 (see page 73ff. for insolvency numbers and the scenario analysis in Guth, M., C. Lipp, C. Pühr and M. Schneider (2020) in this publication). In the medium-term, we see a risk of additional defaults due to the global decrease in demand, consequences of the second lockdown triggered by the second wave of infections, delayed defaults and potentially long-lasting structural changes (e.g. in tourism and transport). With a view to maintaining transparency in banks' balance sheets and allowing banks to conduct proper risk management, payment moratoria should be phased out or adjusted and replaced by more selective measures targeting specific sectors.

What remains key is adequate risk provisioning by banks at an early stage (including moving from generic risk provisioning to an approach more targeted at individual customers) as well as forward-looking action as regards the allocation of profits. Banks are expected to duly monitor their loan exposures challenged by COVID-19. Clients' short-term liquidity challenges may become long-term financial difficulties and should therefore be seen as an early warning indicator. Transparent reporting of the development of credit quality is important to be able to assess the impact of support measures on banks' balance sheets and, hence, to maintain confidence in the banking sector. In addition, profit allocation that focuses on strengthening the capital base remains key, especially as the impact of the second lockdown is difficult yet to assess.