Austrian financial intermediaries benefited from improved environment in 2021

Austrian banks' profitability has recovered from the pandemic, but the war in Ukraine is clouding the outlook

While 2021 was marked by a strong economic recovery, which also supported the Austrian banking sector's profitability, new challenges started to emerge in early 2022. The global economic recovery from the COVID-19 pandemic that started in 2021 proved just a brief respite. The Russian invasion of Ukraine will have as yet uncertain geopolitical and macrofinancial consequences. In addition, expectations of upcoming interest rate hikes in a highly inflationary environment, remaining pandemic-related uncertainties and waning one-off effects such as monetary and pandemic support measures are contributing to a highly challenging environment for the Austrian banking sector. Against this background, a cautious approach to profit distributions will play a critical role in strengthening Austrian banks' risk-bearing capacity, which weakened somewhat in 2021 in a European comparison. Going forward, it is therefore important for the Austrian banking sector to preserve past improvements in resilience, especially given strong credit growth and uncertainties related to the war in Ukraine.

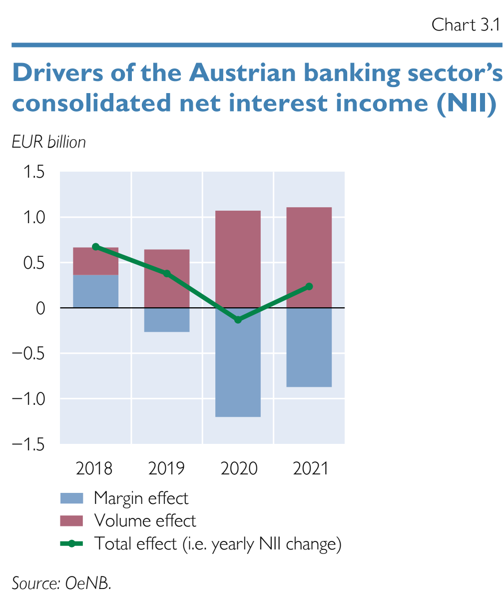
Austrian banking sector's operating business gained from accelerated lending

Net interest income made up more than 60% of the Austrian banking sector's operating income over the last few years, driven solely by the growth in loan volumes since 2019. 2018 was the last year when the consolidated net interest margin[1] expanded slightly, helping to raise banks' net interest income (see chart 3.1). Between 2018 and 2021, however, the margin fell by 23 basis points to 1.35%. This large drop was also due to monetary policy operations that inflated total business volumes. Strong margin pressure was mostly compensated for by a fast expansion of (average) total assets, a development that raises questions about the sustainability of business strategies aimed at outgrowing underlying profitability issues caused by high competition (e.g. in potentially overheating residential real estate markets).

Operating business picked up considerably in 2021, as both income and expenses contributed positively. On the income side, net interest income rose slightly, while fees and commissions gained +9% year on year. As other operating income and trading losses had little impact on the aggregate result, operating income rose by 4% to EUR 25.7 billion. Since the

Chart 3.1

Drivers of the Austrian banking sector's consolidated net interest income (NII)



Source: OeNB.

[1] *The net interest margin is defined as net interest income divided by average total assets.*

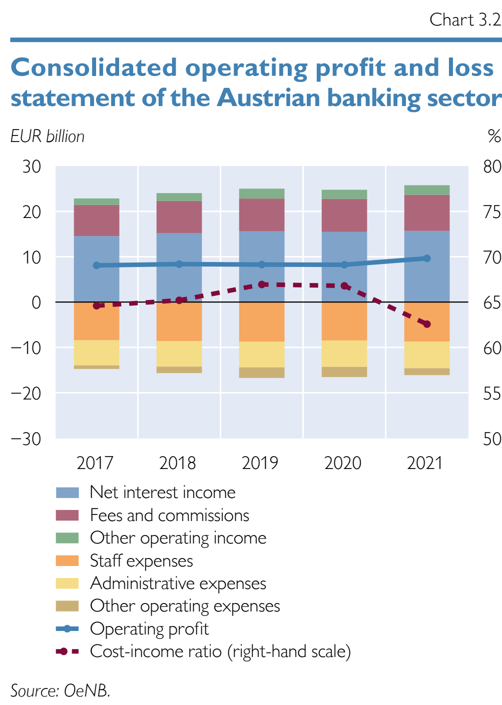
consolidation of the Austrian banking sector (including its bricks-and-mortar business) continued in 2021,[2] staff and administrative expenses were well controlled (at +2% year on year), while impairments on participations came to a virtual halt (–95%). As a result, operating expenses declined by 3% year on year. With this tailwind of positive operating jaws, the cost-income ratio came down to 63%, and the operating profit of the Austrian banking sector rose significantly by 17% (see chart 3.2).

Lower risk costs drove up profitability, but many new challenges ahead

The profit of the Austrian banking sector nearly doubled in 2021, driven by a sharp decline in risk costs. At the end of 2021, the Austrian banking sector's nonperforming loan (NPL) ratio reached a new low, so banks reduced risk provisioning by 68% year on year. Together with the strong operating performance, this propelled profits to EUR 7.2 billion (+95% year on year), the highest level since the global financial crisis that started in 2008, and 7% higher than the pre-pandemic level of 2019 (see chart 3.3). Consequently, the return on average assets reached 0.7% (2020: 0.4%).

Chart 3.2

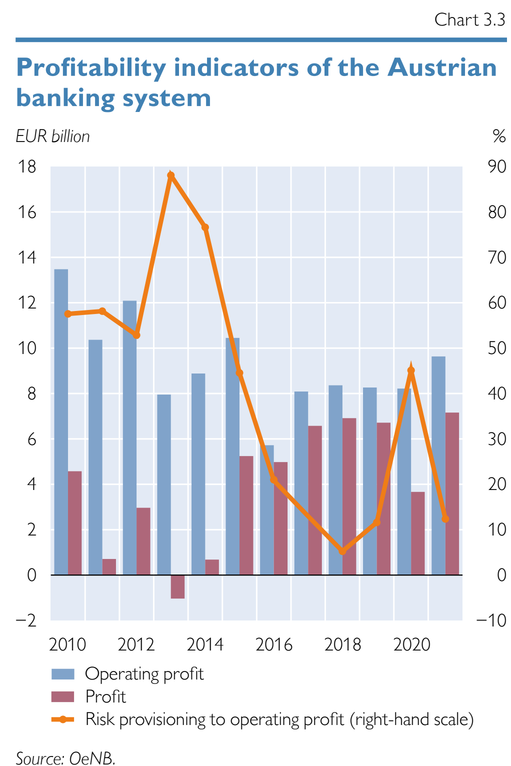
Consolidated operating profit and loss statement of the Austrian banking sector



Source: OeNB.

Chart 3.3

Profitability indicators of the Austrian banking system



Source: OeNB.

[2] *The number of banks in Austria dropped further in 2021. Moreover, Austrian banks also reduced the number of their foreign branches. However, due to the renewed setup of banking services in many post offices, the number of domestic branches rose by around 10%.*

Credit quality remains solid

Contained loan defaults together with strong lending have led to a further decline in NPL ratios. In 2021, bank lending in Austria was driven by the economic recovery after the pandemic. The demand for corporate loans continued to be strong as firms needed financing for warehousing and working capital, and demand for housing drove mortgage loan growth. NPL ratios declined further as a consequence of strong lending and pandemic-related support measures. The consolidated NPL ratio went down to 1.8%, with the corresponding figure for domestic loans coming down to 1.4%. As the right-hand panel of chart 3.4 shows, the distribution of consolidated NPL ratios has slightly shifted to the left, and the number of banks with NPL ratios above 2.5% has dropped markedly.

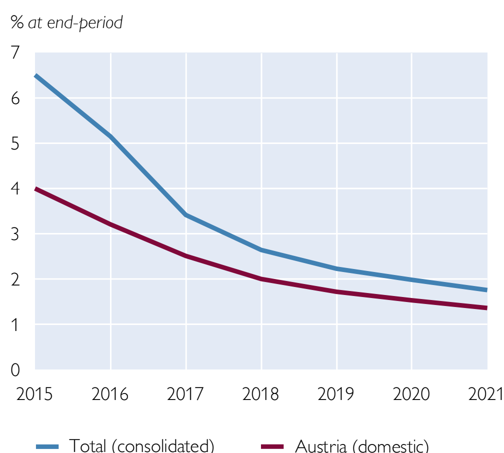
The quality of loans became more heterogeneous across economic sectors in Austria during the pandemic, reflecting the different ways in which the pandemic affected individual industries. Despite comprehensive government support schemes, an increase in loan defaults in severely affected sectors became inevitable. In particular, the NPL ratios of loans to companies in arts, entertainment, education, construction and accommodation rose between mid-2020 and end-2021, contrary to the general trend.

The share of forborne loans and loans with significantly increased credit risk (IFRS stage 2[3]) leveled off in 2021. Although overall credit quality improved in 2021, there was some deterioration in certain sectors and loan types. For example, the NPL ratio of loans with expired payment moratoria – as shown in chart 3.5 – continued to rise, reaching a level twice as high as the overall average NPL ratio at the end of the year, both for loans to households and nonfinancial corporations. The share of forborne loans in total loans of the Austrian banking sector started to increase after the outbreak of the pandemic. However, when the economic recovery took hold and large-scale defaults did not materialize, the figure

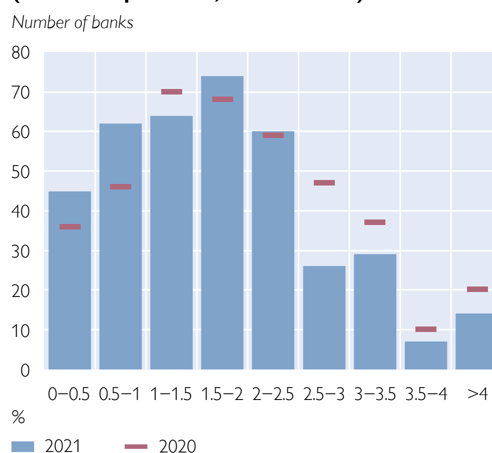
Chart 3.4

NPL ratios and NPL distribution in the Austrian banking sector

Change in NPL ratios over time



Distribution of NPL ratios (total loan portfolio, consolidated)



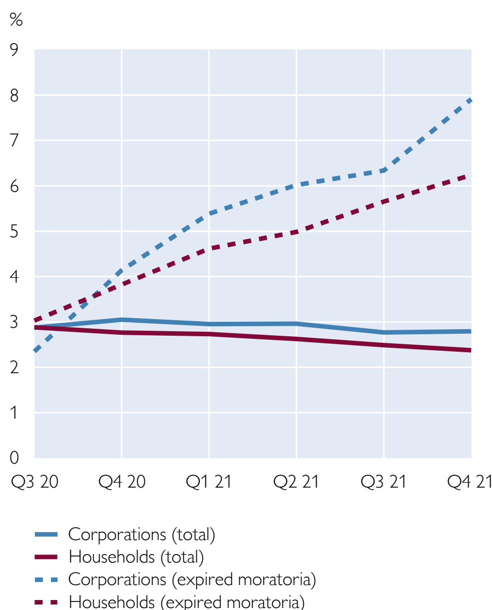
Source: OeNB.

[3] *For further details, see IFRS 9 and expected loss provisioning – Executive Summary (bis.org).*

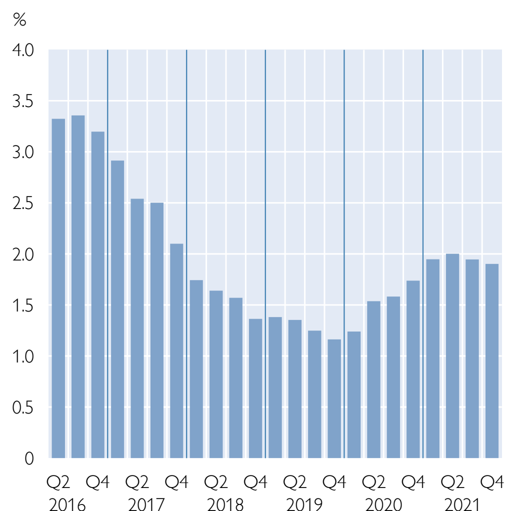
Chart 3.5

Other consolidated credit risk indicators

NPL ratios of all loans and loans with expired moratoria



Share of forborne loans in total loans



Source: OeNB.

leveled off at 2%. Similarly, the share of IFRS stage 2 loans went down 0.7 percentage points between end-2020 and end-2021, when it stood at 18.2% of all consolidated loans of Austrian banks.

Foreign currency loans in Austria have continued to decline thanks to the supervisory measures adopted previously and hence do not represent a systemic risk to the Austrian banking sector. As of end-2021, the volume of outstanding foreign currency loans to domestic households stood at EUR 10.1 billion (–17.2% year on year, exchange rate adjusted). These loans are almost entirely (97%) denominated in Swiss francs. The share of foreign currency loans in total loans to households came down from 6.6% to 5.5%. Despite the significant decline over the last decade, residual risks from foreign currency loans remain, as about three-quarters are bullet loans linked to repayment vehicles.

Austrian banking subsidiaries in CESEE continued to reduce their retail foreign currency loan portfolios. In 2021, the volume of foreign currency loans to households in CESEE dropped by 3.0% (exchange rate adjusted) to EUR 9.3 billion. The share of foreign currency loans in total retail loans dropped from 12.7% to 11.0%. Around three-quarters of these loans are denominated in euro. In the corporate segment, the outstanding amount of foreign currency loans increased by 5.0% to EUR 21.1 billion, mostly driven by the increase of euro-denominated loans (+4.6% year on year to EUR 18.5 billion).[4] Due to the stronger growth of loans denominated in local currency, the foreign currency share in the corporate loan segment fell from 38.1% to 35.9% year on year. This significantly

[4] *The increase is also partly due to mergers and acquisitions in Czechia and North Macedonia.*

higher share of foreign currency loans compared to the household segment can be partially explained by the fact that many firms have income in foreign currency (i.e. a natural hedge).

The quality of foreign currency loans has improved somewhat but remains significantly weaker than that of local currency loans. In 2021, credit quality improved for both foreign currency and local currency loans, with the former continuing to trail behind. At end-2021, the NPL ratio of foreign currency loans stood at 4.3% and that of local currency loans was 2.7% (both –0.4 percentage points year on year). The associated risk has been partly mitigated by adequate provisioning, with the coverage ratio standing at 66% and 65%, respectively.

Profits in CESEE have surged but the war in Ukraine brings new challenges

The Austrian banking sector continued to expand during the pandemic, not only in the home market but also abroad. Propelled by continued loan growth and support by monetary policy measures, Austrian banks' total assets grew by 5% in 2021 to EUR 1.2 trillion. The share of foreign exposures expanded to 39% on the back of increased business, for instance in Czechia, Germany and Hungary. At the same time, business contracted i.a. in the UK, Spain and China. The Austrian banking sector is particularly exposed to CESEE; therefore, this report focuses on business in this region and its financial stability implications for Austria.

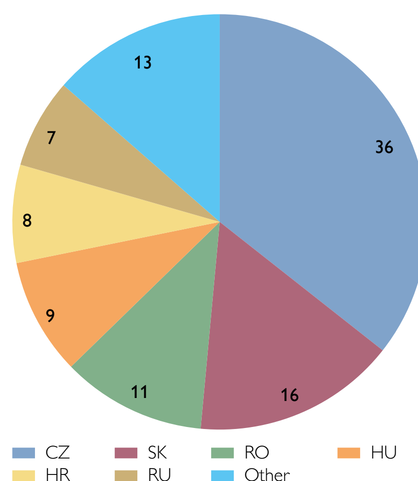
The majority of Austrian banking subsidiaries in CESEE are based in EU member states, accounting for more than four-fifths of Austrian subsidiaries' total assets in CESEE (totaling EUR 271 billion); Czechia alone hosts more than one-third, other important markets are Slovakia, Romania, Hungary and Croatia. Russia, by contrast, represents only 7% of Austrian CESEE subsidiaries' assets (see chart 3.6), and together with Ukraine and Belarus less than 10%. That said, the war in Ukraine will have adverse effects on the entire CESEE region, where Austrian banks are among the most active players. Therefore, the volatile situation will have to be closely monitored and any issues will have to be quickly addressed (see box 2).

Austrian banks' CESEE subsidiaries posted a profit totaling EUR 3 billion in 2021, driven by a surge in operating profit and a substantial decline in risk costs. Net interest income rose by 5% year on year, profiting from strong loan growth and rising interest rates, while fee and commission income increased even more (+16%); operating income was thus 8% higher. Despite strong inflationary tendencies in the region, operating costs remained under control (+5%

Chart 3.6

Total assets of Austrian banking subsidiaries in CESEE

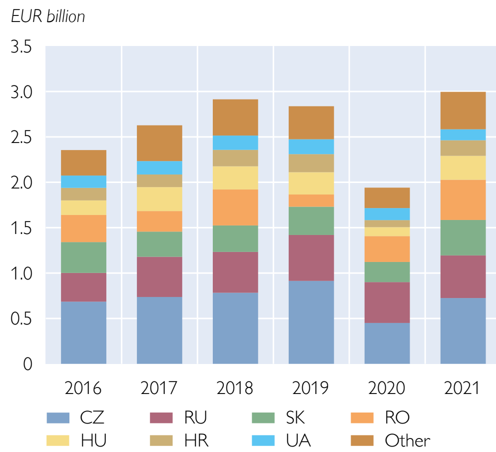
Total: EUR 271 billion; %



Source: OeNB.

Chart 3.7

Profits of Austrian banking subsidiaries in CESEE



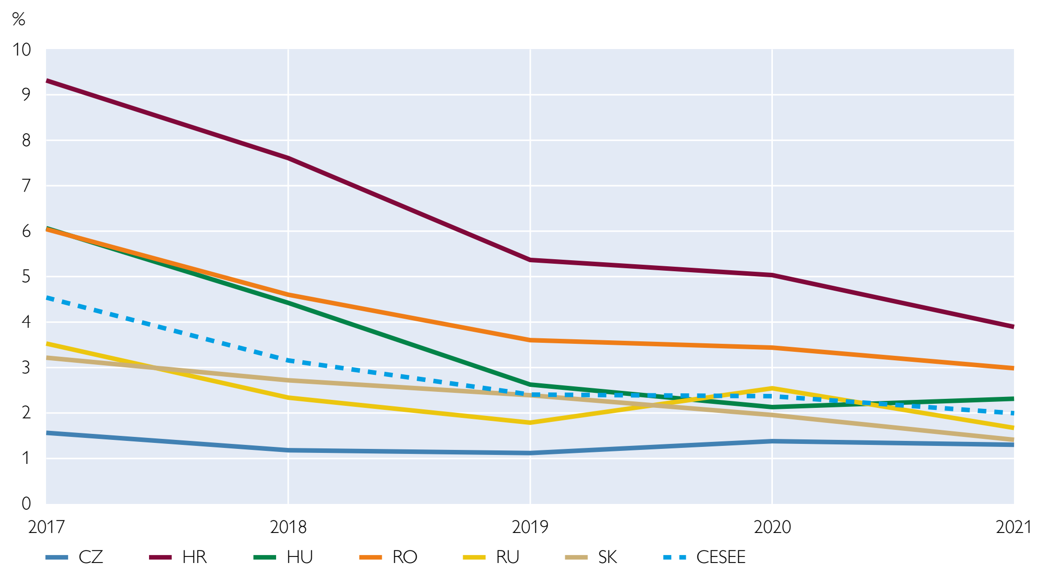
Source: OeNB.

year on year), and operating profit rose by 12% to EUR 4.3 billion (5% above the pre-pandemic 2019 result). As the pandemic-related fallout became clearer, credit risk provisioning declined by more than 70%, and consequently profit rose by more than half to EUR 3.0 billion (6% above 2019).

2021 was a bounce-back year, as the immediate impact of the pandemic slowly faded, but the war in Ukraine and strong inflationary pressure are contributing to the buildup of new challenges. The Russian invasion of Ukraine will negatively affect the nascent economic recovery in CESEE, and banks' profitability will feel the impact of increased risks. Austrian banks should benefit from their geographically diversified exposure, but Russia and – to a certain degree – Ukraine have been important profit drivers in the sector's CESEE business (see chart 3.7). Nevertheless, a potential withdrawal from Russia or losing these profits, although painful, currently appears manageable in light of solid consolidated profitability and proactive macroprudential policy measures by the Austrian authorities (see box 2).

Chart 3.8

NPL ratios of Austrian banking subsidiaries in CESEE

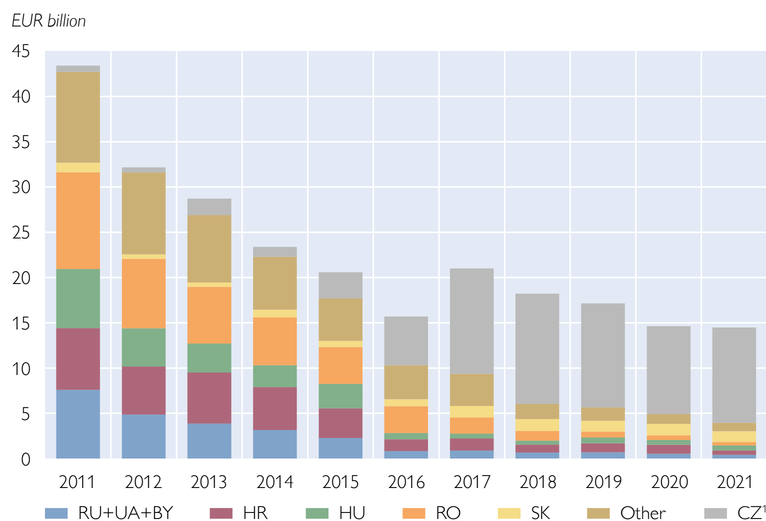


Source: OeNB.

Austrian subsidiaries in CESEE started 2022 on a strong footing: the nonperforming loan ratio was low, capitalization strong and funding balanced. With an NPL ratio of slightly below 2%, a robust coverage ratio above 64% and 85% of loans classified as IFRS stage 1 at the end of 2021, credit risk reached a historic low at Austrian banking subsidiaries in CESEE, despite the COVID-19 pandemic's initial impact (see chart 3.8). Austrian banks' and their subsidiaries' risk-bearing capacity is strong, resting on robust local profitability in 2021 (as described above) and strong capitalization, with a common equity tier 1 (CET1) ratio of 17% at the subsidiary level, and parent banks benefiting from a macroprudential systemic risk buffer. Furthermore, Austrian banks' CESEE subsidiaries are now predominantly self-funded through deposits from nonbanks, as highlighted by a loan-to-deposit ratio of 73%, which is also attributable to the timely implementation of a macroprudential measure in 2012[5]. This balanced local funding structure made it possible to reduce intragroup liquidity transfers and thus significantly decrease Austrian parent banks' exposure at risk (see chart 3.9).

Chart 3.9

Austrian banks' intragroup liquidity transfers to banks in CESEE

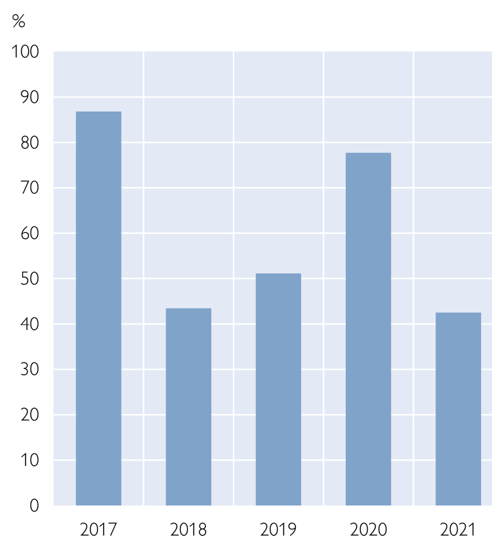


Source: OeNB.

[1] Transfers to banks in Czechia are exceptionally high, as banks use them to benefit from the high differential between the Czech National Bank's and the ECB's key interest rates.

Chart 3.10

Increase in Austrian banks' retained earnings in % of total profits



Source: OeNB.

Pressure on banks' capitalization increased

Improved capitalization compared to levels seen during the great financial crisis enabled Austrian banks to overcome the effects of the COVID-19 pandemic, but capital ratios have weakened slightly more recently. During the pandemic, Austrian banks benefited from a capitalization level that had doubled since the great financial crisis. Improved capital ratios helped maintain confidence in the banking sector and positively influenced

[5] *This was part of a package of measures addressing the sustainability of large Austrian banks' business models, see Sustainability of large Austrian banks' business models – Oesterreichische Nationalbank (OeNB).*

external assessments. During 2021, however, capital ratios fell slightly due to an increase in risk-weighted assets, which was driven by strong loan growth combined with the resumption of profit distributions. Chart 3.10 shows that in 2021, the increase in retained earnings (as a share of total profits) fell, especially compared to 2020, when restrictions on profit distributions were in place.

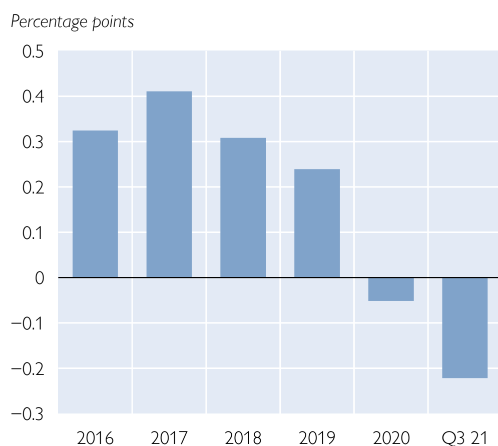
Risk-weighted assets of Austrian banks also increased in 2021 due to pandemic-related downgrades of banks' internal ratings assigned to customers. In response to the COVID-19 pandemic, banks in Austria have downgraded their ratings for nonfinancial corporate debtors, which led to an overall deterioration of the rating distribution during the first waves of the pandemic. Borrowers that had received COVID-19 support were particularly affected by the downgrades; in this group, the share of exposures in rating classes with a higher probability of default increased considerably. The study published in the special topics section of this report sheds more light on this issue.

The decline in the Austrian banking sector's capital ratio widened the gap between the domestic banking sector and the European average. Banks' capital ratios decreased broadly across Europe in 2021, but the decline was more pronounced in Austria. In order to counter the widening gap vis-à-vis the European average, Austrian banks will have to strengthen their capital ratios going forward, also taking into account their individual risk profile.

The Austrian banking system's liquidity situation was good in 2021, as it benefited from positive market perception, a sound collateral pool and the favorable terms of the ECB's targeted longer-term refinancing operations (TLTROs).[6] Over the past few years, banking systems in the euro area have benefited from the favorable terms and conditions governing the ECB's monetary policy operations, which got even more favorable in the reaction to the economic challenges arising from the COVID-19 pandemic. Austrian banks are comparatively well endowed with eligible collateral (including credit claims), which allowed them to comprehensively tap the liquidity offered via the ECB's TLTROs. Austrian banks had an average of EUR 82 billion of outstanding liabilities against the Eurosystem in the course of 2021, which carried an interest rate of –1% as the overwhelming majority of banks fulfilled the attached lending conditions. At the same time, banks increased their deposits with the OeNB by an even larger amount, which suggests that banks accessed the TLTROs not because of immediate liquidity needs but to generate additional income. In 2021, the average amount deposited by Austrian banks at

Chart 3.11

Gap between the CET1 ratio of the Austrian banking sector and the European average

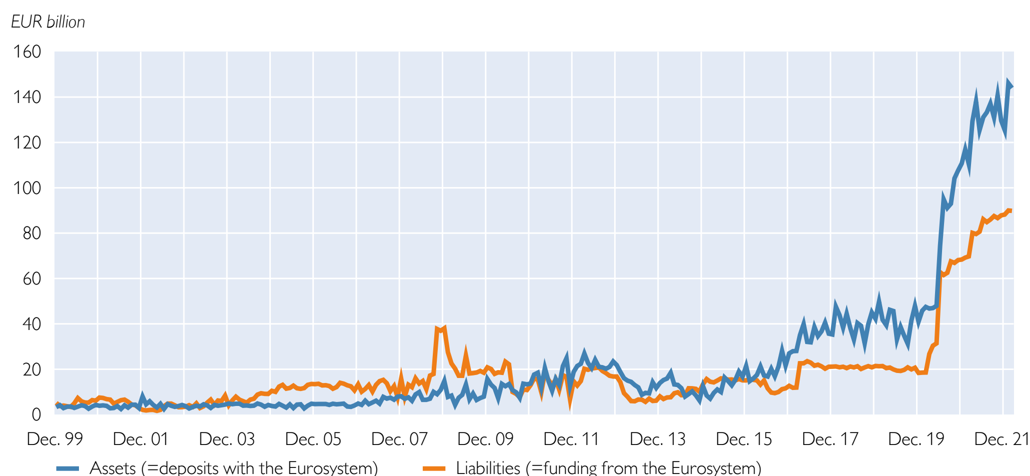


Source: OeNB, ECB.

[6] See *Targeted longer-term refinancing operations (TLTROs) (europa.eu).*

Chart 3.12

Austrian banks' assets and liabilities vis-à-vis the Eurosystem



Source: ECB.

the Eurosystem's central banks was EUR 129 billion. About a quarter carried an interest rate of 0%, the remainder –0.5%. This allowed the banking sector to generate risk-free revenues by tapping central bank operations while the costs were limited to providing sufficient collateral.

The Austrian banking system is well prepared for balanced quantitative tightening. Austrian banks currently have excess liquidity with the Eurosystem, they are well endowed with collateral, and benefit from high market confidence as measured by the ratings issued by international agencies. This allows them to issue unsecured and secured debt at competitive funding costs. While a smooth transition to steeper interest rate curves will generally be positive for banks' operative margins, challenges would arise from abrupt changes in the interest rate environment. From a financial stability perspective, a timely reaction to inflation pressures would help reduce the risk of abruptly rising rates. Nonetheless, given the more volatile interest rate environment, banks will need to manage their interest rate risks with caution. In addition, banks can ensure their continued access to funding markets by further improving the soundness of their balance sheets. Improving their capital ratios to bring them in line with their European peers will be key in this context.

New framework for electronic payments

The European legislator is intensively working on a new Regulation on Markets in Crypto-assets (MiCA) as part of the digital finance package, which will potentially alter the European electronic payment's landscape. The new legal framework envisages different kinds of crypto assets, i.a. e-money tokens that are explicitly designed for payment purposes, and asset-referenced tokens that are – up to a predetermined extent – also suitable for electronic payments. These newly regulated, possibly faster, cheaper and more efficient means of payment, augmented by related services (e.g. wallet or exchange services), have the potential to compete with existing electronic payment solutions.

The MiCA proposal implies new regulatory and technical challenges for overseers. The OeNB has the statutory mandate for payment systems oversight in Austria and is therefore closely following these developments. In a next step, the OeNB will adapt its oversight practice by integrating the Eurosystem's new oversight framework for electronic payment instruments, schemes and arrangements (PISA), which was introduced in November 2021 and covers crypto assets used within a payment scheme.

Box 1

Cyber risks – a new challenge to financial stability

Cyber risks and their systemic nature arising from interconnections and interdependencies within the financial system and the operational systems serving it represent a new challenge to financial stability. *Cyber risk has long been understood as an idiosyncratic operational risk affecting internal information and communication technology (ICT) infrastructures and has therefore been on the radar of microprudential supervision. Dedicated regulatory frameworks and supervisory policies are in place and being further developed at the European level to deal with cyber risk from different angles (e.g. the Digital Operational Resilience Act, DORA[7]). Consequently, microprudential policy and vigilant supervision contribute essentially to increasing overall operational cyber resilience and reducing the risk arising from the aggregate impact of cyber risks at an individual bank's level. The financial sector's growing reliance on ICT across a broadening array of interconnected and often hardly substitutable operational systems (which perform critical functions) leads to multiple dependencies and concentrations. This, in turn, increases the risk that a cyberevent will have severe consequences for financial institutions, with potentially destabilizing effects on the financial system. Besides financial costs, a major cyberincident can lead to operational disruptions in systemically critical functions and to an erosion of confidence in the functioning of the financial system. Operational and/or financial contagion channels and the accompanying loss of confidence can amplify the initial shock and seriously impair the smooth functioning of critical financial services, with potentially severe effects on the real economy. Thus, the European Systemic Risk Board (ESRB) in 2020 identified cyber risk as a source of systemic risk to the financial system and therefore considers the issue in a system-wide (macroprudential) context.[8]*

Existing macroprudential tools may not prove effective in addressing the systemic nature of cyber risk. *The traditional macroprudential toolbox, which typically addresses cyclical or structural systemic risks to financial stability, enhances the financial sector's resilience to shocks. Thus, macroprudential tools provide relevant backstops and can also mitigate the amplification of potential financial shocks associated with a cyberincident. However, they are not specifically designed to counter cyber risk and thus have limited capability to serve as a systemic cyber risk mitigant.[9] The implementation of direct requirements for the purpose of cyber resilience (outside the macroprudential toolbox), which e.g. allow a quick restoration of operational systems, may be more efficient in mitigating systemic cyber risk.*

The calibration of potential systemic mitigants relies on a deeper understanding of systemic cyber risk-related vulnerabilities and potential contagion channels in the financial system. *Given that the discussion about systemic cyber risk is in the early stages, there is a lack of understanding of systemic cyber risk-related vulnerabilities and a need to improve analytical and monitoring capabilities. To get an all-encompassing view of cyber*

[7] *Proposal for a regulation of the European Parliament and the Council on digital operational resilience for the financial sector, see EUR-Lex — 52020PC0595 — EN — EUR-Lex (europa.eu).*

[8] *See ESRB publishes report on systemic cyberattacks (europa.eu).*

[9] *The ESRB report Mitigating systemic cyber risk (europa.eu) "Mitigating systemic cyber risk" (2022) provides a comprehensive assessment of traditional tools, see Mitigating systemic cyber risk (europa.eu).*

risks, a concurrent approach from both the micro- and the macroprudential supervisory angle is required. Special attention should be given to possible operational concentration risks and contagion channels in the financial system. The identification of systemically important nodes, which fulfill critical financial or operational services, provides a first indication of potential contagion channels and contributes to a better understanding of the network topology, interdependencies and potential risk amplifiers. Furthermore, it assists authorities in their risk assessment and formulation of potential policy action.

An "IT system operator map" for Austria provides a first promising overview of the interconnectedness of IT service providers in the Austrian financial market. *This map was the outcome of a joint project launched by the Financial Market Authority (FMA) and the OeNB in 2019. Updated and expanded in 2021,[10] it identifies and categorizes by activity the IT service providers and those appointed as subcontractors for maintaining critical business processes. Additional data provided include, e.g., information about certifications. The IT system operator map allows the FMA and the OeNB to better understand the IT landscape of the supervised entities, identify important service providers and possible concentration risks and incorporate this knowledge in their supervisory activities. Furthermore, it is a useful tool with regard to the upcoming oversight regime for critical ICT service providers envisaged by the EU regulation DORA.*

Macroprudential supervision in Austria

The Austrian Ministry of Finance (BMF), the FMA and OeNB have jointly responded to the European Commission's consultation on improving the EU's macroprudential framework for the banking sector. The consultation was open until March 2022 and focused on four key issues, notably (1) the functioning of the buffer framework, (2) missing and obsolete macroprudential instruments, (3) internal market aspects and (4) global and emerging risks. In their reply, the BMF, the FMA and the OeNB called for a more flexible use of the countercyclical capital buffer and addressed overlaps between capital buffers and minimum requirements, for example by considering a leverage ratio add-on. Overall, the Austrian response emphasized the need for stability in the framework, which had proved its effectiveness during the current pandemic. Regulatory changes should therefore be guided by the following high-level principles: (1) reducing the complexity of regulation, (2) increasing the resilience of the financial system, (3) reflecting flexibility across EU member states due to heterogenous financial cycles and (4) ensuring compliance with the Basel reforms. Ultimately, the goals of the macroprudential framework and parallel regimes need to be preserved.

Rising risks from mortgage lending are being addressed

Systemic risks from residential real estate financing have been mounting steadily in recent years. The OeNB has repeatedly voiced concerns about the buildup of risks related to residential real estate (RRE) loans. While systemic risks in this segment have been increasing in many euro area countries, developments in Austria have been extraordinary. In the first quarter of 2022, the annual growth rates of real estate prices and mortgage lending accelerated to 12.3% and 7.2%, respectively. Between end-2010 and end-2021, real estate prices doubled in

[10] *As part of the FMA's study Study on "Digitalisation of the Financial Market" - FMA Österreich (2021).*

Chart 3.13

Lending to households for house purchase

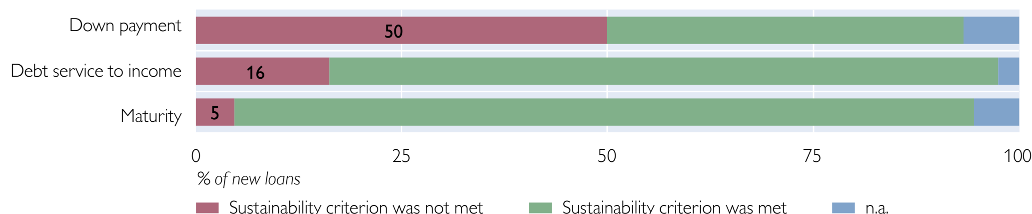
Source: OeNB, ECB.

Austria, whereas they only increased by slightly more than one-third in the euro area. These price increases go hand in hand with accelerating overvaluation. According to OeNB estimates, the overvaluation of RRE prices in Austria reached a record 34% in the first quarter of 2022; in Vienna alone, this value even climbed to an estimated 40%, according to the OeNB's fundamentals indicator for residential property prices (see chart 3.13). The rapid growth of RRE prices further reduced the affordability of housing, and households are faced with an increasing debt burden, which makes the market vulnerable to credit-driven price exuberance and future price corrections.

In Austria, market conditions continue to be driven by fierce competition and, in part, by unsustainable lending standards. A considerable share of new mortgage loans continues to be offered at elevated debt service-to-income and loan-to-value ratios. Despite record low interest rates, 16% of new lending were loans with debt service-to-income ratios exceeding 40%, leaving little room for maneuver in case of unforeseen adverse developments (e.g. a decrease in available income, increased costs of living or unemployment) or in the event of interest rate increases. At the same time, half of new loans were granted with down payments of less than 20%. Despite strong declines over the past years, the share of variable rate loans in new mortgage lending remains high, reaching 32% as of March 2022, which makes many borrowers vulnerable to increases in interest rates. One of the most important mitigating factors in this market is the fact that Austria has a well-developed rental market with a high share of nonprofit providers. Moreover, Austrian borrowers tend to have high incomes and wealth by international standards, and, finally, the Austrian banking sector is adequately capitalized thanks to the Austrian competent authorities' proactive approach to macroprudential supervision and the activation of macroprudential capital buffers.

Chart 3.14

Sustainability of new lending in the second half of 2021



Source: OeNB.

However, in times of crisis, systemic risks in this segment may jeopardize Austria's financial stability and should therefore be addressed. Housing loans are an important credit segment and source of revenue for banks. Housing loans to households account for one-third of Austrian banks' total domestic credit exposures. As lending for house purchase started to expand at high rates, real estate became an increasingly important form of collateral. As of end-2021, around 30% of banks' consolidated total assets were collateralized by some form of real estate. At the same time, the real estate sector is also economically important, which contributes to the risk of spillovers to the real economy in the event of a crisis. In 2021, construction and real estate activities contributed 18% to the total gross value added of the Austrian economy.

Following an initiative by the OeNB and recommendations by both the ESRB and the IMF, Austria's Financial Market Stability Board (FMSB) has issued a recommendation to activate legally binding borrower-based measures in Austria. Cross-country studies have shown that borrower-based measures are effective in reducing systemic risks from real estate financing and that they are suitable to address the identified vulnerabilities in the Austrian market. A clear majority of European Economic Area economies – 24 out of 30 – have already activated borrower-based measures to address vulnerabilities in their RRE markets. The measures not only reduce banking sector losses from real estate exposures and the related risks to financial stability and the real economy, but also protect borrowers from the consequences of excessive debt. The ESRB[11] recommended on February 11, 2022, that Austria adopt legally binding borrower-based measures to mitigate vulnerabilities to financial stability that stem from the RRE sector. Similar advice has come from the OECD[12] and the IMF[13]. Supporting the reasoning put forth by these institutions, the FMSB has adopted a recommendation[14] addressed to the FMA to activate macroprudential measures as specified in Article 23h Austrian Banking Act. Specifically, the FMSB advised the FMA to adopt upper limits for loan-to-value[15] ratios (90%), debt service-to-income ratios (40%) and loan maturities (35 years) – subject to exemptions that would give credit institutions adequate operational flexibility. These new measures are envisaged to apply to all new RRE lending to households as soon as possible.

The growth rate of commercial real estate[16] (CRE) loans has remained moderate in recent years, but their share in Austrian banks' total assets is already high in an EU comparison. Still, given that both the size and the growth rates of CRE lending remain markedly below that of RRE lending to households, macroprudential measures are not deemed necessary at the

[11] *Recommendation of the European Systemic Risk Board of 2 December 2021 on medium-term vulnerabilities in the residential real estate sector in Austria (ESRB/2021/11) (europa.eu).*

[12] *OECD Economic Surveys: Austria 2021 | OECD Economic Surveys: Austria | OECD iLibrary (oecd-ilibrary.org).*

[13] *Austria: 2021 Article IV Consultation-Press Release; Staff Report; Staff Supplementary Information; and Statement by the Executive Director for Austria (imf.org).*

[14] *FMSG – Recommendation FMSB/2/2022 on applying measures to contain systemic risks from residential real estate funding.*

[15] *The loan-to-value ratio measures the total level of lending for house purchase of a borrower in relation to the mortgage collateral registered with the Austrian land registry or other CRR collateral securing the debt.*

[16] *CRE lending is defined as real estate lending to nonfinancial corporations with the purpose to fund both residential and nonresidential property or collateralized both by residential and nonresidential property.*

current stage. The share of CRE lending in Austrian banks' balance sheets is among the highest in an EU comparison, and substantial financing volumes are structurally above underlying market and collateral values. 31% of real estate lending to domestic nonfinancial corporations serves the purpose of funding residential property purchases or construction and development. This links CRE lending to private RRE loans, the systemic risks of which have made policy actions necessary. 57% of mortgage loans are used to fund commercially used property (such as office space, retail, tourism), and the remaining 12% are used for other real estate (such as infrastructure). While insurance companies and real estate funds also provide CRE funding, banks are by far the dominant suppliers of funds, which mainly take the form of mortgage loans. Banks' mortgage loans to domestic corporates amounted to a total of EUR 117 billion as of end-2021, of which EUR 51 billion were collateralized by residential real estate. In addition to that, banks have outstanding EUR 14 billion in mortgage loans to households that are collateralized by commercial property. Austrian banks' subsidiaries in CESEE had EUR 22 billion in outstanding CRE loans as of end-2021. Against the backdrop of rising input costs, supply chain disruptions and interest rate hikes, real estate developers form a particularly vulnerable sector. Austrian banks had outstanding loans in the amount of EUR 37 billion to real estate construction at the end of 2021, EUR 12 billion of which were used to fund the construction and development of residential property – a sector currently in Austria's macroprudential spotlight. Despite the improved systemic risk monitoring, with CRE price, rental and yield indices for Austria going live in 2024, the need for further initiatives to fill existing data gaps is currently being evaluated.

Capital buffers support financial stability

The implementation of binding borrower-based measures is expected to slow down bank lending, which should ease cyclical risks stemming from potentially excessive credit growth. Should this not be the case, the supervisory authorities may advise further measures (including capital-based ones). The credit-to-GDP gap, the main indicator guiding decisions on the countercyclical capital buffer (CCyB), had widened to 2.6 percentage points as of end-2021 against the backdrop of robust credit growth. In addition, other indicators relating to risk mispricing, the soundness of bank balance sheets, credit growth and property prices have not improved and continue to signal a buildup of elevated cyclical risks in the financial system. Yet, according to the relevant literature[17], there is no case for changing the CCyB mechanistically, in particular if the credit-to-GDP ratio deviates from its trend as a result of a negative business cycle. After all, annual GDP growth rebounded to 6.3% in the fourth quarter of 2021, following a sharp contraction in 2020. That said, the outlook for GDP growth remains fraught with heightened risks. To allow borrower-based measures for housing mortgages to take effect, the FMSB in May 2022 continued to recommend a CCyB of 0% for the time being in spite of the risks signaled by other CCyB-relevant indicators. At the same

[17] *Baba, C. , S. Dell'Erba, E. Detragiache, O. Harrison, A. Mineshima, A. Musayev and A. Shahmoradi. 2020. How Should Credit Gaps be Measured? An Application to European Countries. IMF Working Paper; Drehmann, M., C.E. Borio, K. Tsatsaronis. 2011. Anchoring Countercyclical Capital Buffers: the Role of Credit Aggregates. BIS Working paper; and Drehmann, M. and K. Tsatsaronis (2014). The credit-to-GDP gap and countercyclical capital buffers: questions and answers. BIS Quarterly Review.*

time, the FMSB emphasized that credit growth is still high compared with GDP growth and that the implementation period for a CCyB buffer in the future may have to be shortened, particularly if credit growth continues unabated.[18]

The structural macroprudential capital buffers implemented in Austria have supported financial stability during the recent crises. In Austria, 11 banks are currently subject to the systemic risk buffer (SyRB) and seven to the other systemically important institutions (O-SII) buffer. The SyRB addresses the systemic risks arising from the structural characteristics of the Austrian banking system, given its size, geographic concentration on emerging market economies, specific ownership structures and low structural profitability. Addressing the too-big-to-fail problem, the O-SII buffer aims to reduce the probability of large, systemically important credit institutions to malfunction or fail, as well as to limit any related damage to the financial system. Both during the COVID-19 pandemic and the shock to the financial system caused by Russia's invasion of Ukraine, these buffers contributed substantially to maintaining financial stability in Austria. By accounting for the large exposure of the Austrian banking system to the CESEE region, the SyRB specifically addresses the geopolitical risks associated with concentrated lending in emerging markets and thus prepared the banking market well for these shocks. In 2022, the OeNB is conducting the regular evaluation of the O-SII and SyRB. It takes into account the additivity of the two buffers, which was stipulated in 2019 with the introduction of the Capital Requirements Directive (CRD) V[19] but was effectively delayed by the FMSB in 2020 due to the high uncertainty caused by the pandemic.[20] The results of the evaluation will be presented to the FMSB in September.

The Austrian deposit guarantee schemes (DGSs) have proved resilient and have enjoyed high credibility during the pandemic despite four DGS payout cases since 2020. The first three DGS events only affected Austria's uniform DGS, Einlagensicherung Austria (ESA), whose ex ante funds were sufficient to cover the payouts. The latest payout was a special case in two ways: First, as the bank in question was granted a license for deposit taking within the last ten years, all three Austrian DGSs were obligated to finance the payout totaling around EUR 1 billion. Second, the bank's insolvency was averted and an orderly wind-down was ongoing in May 2022, while the funds paid out by the DGS have already been repaid in full. There are currently three different DGSs in the Austrian banking sector: (1) Einlagensicherung Austria (ESA), (2) the DGS for the savings bank sector, Sparkassen-Haftung (sHaftung), and (3) since December 2021, the DGS for the Raiffeisen sector, Österreichische Raiffeisen-Sicherungseinrichtung eGen (ÖRS). With a third DGS in place, the structural and legal complexity of the system is set to increase, as larger payouts involve more than one DGS. However, the resilience of the Austrian DGSs was substantially increased by the introduction of a reliable alternative funding arrangement for Austrian DGSs, which allows them to raise additional funding on top of the ex ante fund and ex

[18] *FMSG – 32nd meeting of Austria's Financial Market Stability Board – May 16, 2022.*

[19] *Capital requirements directive (CRD V) – concerning credit institutions – transposition status | European Commission (europa.eu).*

[20] *FMSG – Recommendation FMSB/3/2021: guidance on adjusting the other systemically important institution (O-SII) buffer.*

post contributions. Furthermore, the SyRB plays an essential role in ensuring the reliability of the alternative funding arrangements and, hence, the credibility of the Austrian DGSs.

Austrian nonbank financial intermediaries benefited from benign environment in 2021

Austrian insurers as well as pension and investment funds saw a strong improvement in profitability in 2021 amid more benign economic conditions as well as positive movements in financial markets. Hence, the financial situation of Austrian insurance companies as well as pension and investment funds improved, supported also by an increase in the market value of their financial asset holdings. Nevertheless, the change in prevailing economic conditions as well as heightened market volatility during the past few months is expected to have repercussions for the performance of Austrian nonbank financial intermediaries.

The Austrian insurance sector's total premium volume of EUR 19.8 billion consists of EUR 11.8 billion in revenues from property and casualty insurance policies, EUR 5.4 billion from life insurance policies and EUR 2.5 billion from health insurance policies. The underwriting result increased by 38% in 2021 compared with 2020, and the financial result by 74%. Overall, the result from ordinary business activities increased to EUR 1.94 billion (compared to EUR 0.7 billion in 2020). Solvency remains solid, with more than two-thirds of all insurance undertakings holding more than the double amount of own funds required. By the end of 2021, the median solvency capital requirement ratio had increased by 9 percentage points year on year to 229%.

The Austrian insurance sector benefited from the benign financial market environment through an increase in the market value of its financial asset holdings. Debt securities accounted for 34% of the sector's total assets of EUR 145.4 billion and investment fund shares made up 28% (with mixed and fixed-income funds dominating). Shares and other equity amounted to 18%, up from 15% in the previous year. The recent increase in risk-free rates has contributed to an improvement in the insurance sector's solvency, whereas the decline in stock markets led to falling own funds and own funds requirements.

The exposure of insurance companies toward the banking sector and sovereigns could potentially become a channel of risk transmission and contagion. The sector's claims to the banking sector (domestic and foreign) via debt securities and loans continued its declining trend in 2021. At year-end, it amounted to about 10% of total assets, whereas in 2016 it had stood at 16%. Claims on domestic banks declined from 7% to 4% in the same period. The sovereign exposure came to close to 15% of total assets and remained unchanged compared to end-2016.

Austrian investment funds realized capital gains in 2021. The net asset value of Austrian investment funds was EUR 230.7 billion by the end of 2021. Driven by capital gains and net inflows, investment funds' assets increased by 13.9% or EUR 28.2 billion compared to the previous year. Net inflows accounted for EUR 15.2 billion. At the end of 2021, Austrian asset managers managed 1,131 mixed funds with assets worth EUR 105.9 billion, 434 bond funds (EUR 62.4 billion), 334 equity funds (EUR 44.1 billion), 49 short-term bond funds (EUR 6.1 billion), 38 private equity funds (EUR 0.8 billion), 39 other funds (EUR 0.4 billion)

as well as 20 real estate funds with managed assets of EUR 11 billion.[21] As the trading ban on Russian securities has led to valuation and settlement difficulties, the issuance and repurchase of fund shares of a few investment funds with significant exposure to Russian securities has temporarily been suspended.

Austrian pension funds recorded strong returns. Assets under management by Austrian pension funds increased by 5.1% (year on year) to EUR 27 billion, and the number of beneficiaries (prospective and current recipients) increased by 0.9% to just over 1 million. Currently, 12.5% of beneficiaries receive a pension under an occupational pension scheme. The largest exposure of the sector are equities (40.6% of the portfolio), followed by debt securities (32.8%), and almost all assets are invested via investment funds. In 2021, the overall return on investment of Austrian pension funds was 7.65%, compared to an average 4.97% p.a. over the past ten years.[22]

Box 2

Implications of the Russian invasion of Ukraine for financial stability in Austria

The Austrian economy in general and Austrian banks in particular have strong business ties with the CESEE region, especially with neighboring countries, but also with Russia and Ukraine. *After the fall of the Iron Curtain, Austrian companies expanded very quickly into CESEE, and Austrian banks followed their corporate customers soon thereafter. This box sheds light on the Austrian banking sector's exposure to Russia, Ukraine and Belarus and identifies potential financial stability implications of the ongoing war.*

Potential effects of the war on the Austrian real economy

The war in Ukraine is adversely affecting macroeconomic developments in Austria. *Evidently, companies with direct business relations with Russia or Ukraine are hardest hit, but those whose supply chains or sales markets are in these countries are also affected. Companies engaged in Russia may be faced with significant write-downs of Russian investments. By end-2021, the market value of Austria's outward direct investment positions in Russia totaled roughly EUR 5 billion. Yet, rising energy and commodities prices and negative confidence effects represent downside risks to domestic GDP growth, and therefore the entire Austrian corporate sector is affected. Against this backdrop, corporate profitability, which in the past two years had been propped up by pandemic-related support measures, can be expected to deteriorate, which, in turn, will diminish firms' internal financing capacities.*

Credit conditions could deteriorate. *Nominal interest rates can be expected to go up when monetary policy responds to the sharp increase in inflation. While for banks, rising interest rates in general imply an improvement in operating performance, they imply risks for companies, especially for those with variable rate loans. Additionally, lenders might demand higher risk premia, especially (but not exclusively) for loans to firms that are strongly affected by the impact of the war. Yet, even if Austrian banks' overall lending policies have, by and large, remained accommodative so far, the worsened economic outlook is likely to affect credit standards and lead to tighter terms and conditions, such as higher information and collateral requirements. The more severely companies are affected by the fallout of the war, the tighter credit standards they might face.*

Loan volumes will be affected by demand for working capital, which is expected to go up, and a likely decrease in investment activity. *On the one hand, higher input prices as well as supply chain problems, which will induce firms to stockpile*

[21] *Source: FMA Annual report on Asset management in the Austrian funds market.*

[22] *Source: FMA Quarterly Report on pension funds Q4 2021.*

inventories, will drive up (nominal) demand for working capital financing. On the other hand, a reduction or postponement of investment projects due to rising uncertainties amidst a worsening growth outlook is likely to reduce financing needs. These two effects would affect both ends of the maturity spectrum: While higher working capital financing would most likely increase the demand for short-term loans, less investment might primarily concern long-term loans. This would raise the share of short-term loans in total outstanding loans, which could increase refinancing risks. However, the large decrease in the share of short-term debt until the onset of the pandemic provides for a certain cushion in this respect. Gross indebtedness has already risen due to the pandemic. A further increase in debt – which may be subject to higher interest rates – coupled with lower profits due to the economic slowdown could impair borrowers' ability to service their debt. Still, companies' currently very high liquidity positions might provide a cushion against adverse effects.

Potential effects on the Austrian banking sector

Nearly 8% of Austrian banks' CESEE exposure is to Russia, Ukraine and Belarus. Austrian banks are among the leading foreign lenders in these countries. *By the end of 2021, the foreign on-balance exposure on an immediate-borrower basis of all Austrian banks in CESEE was EUR 296 billion, EUR 23 billion thereof to Russia, Ukraine and Belarus. According to BIS statistics, domestically owned Austrian banks are among the leading lenders in these countries (with an exposure of EUR 22 billion). Austrian subsidiaries in Russia, Ukraine and Belarus have contributed substantially to Austrian banks' total profits, accounting for 9% of total profits in 2021. In 2020, this share had been even higher, as the pandemic had already reduced profits in western Europe, while CESEE markets still performed better.*

Austrian subsidiaries in Russia, Ukraine and Belarus have been active lenders with a solid funding base, but their capitalization is below that of other Austrian subsidiaries in CESEE. *The balance sheets of Austrian banking subsidiaries in the three countries are dominated by corporate loans, mostly to borrowers in the manufacturing, trade and agricultural sectors. The subsidiaries have a solid funding base, with loan-to-deposit ratios at 80% in Russia and at around 65% in Ukraine and Belarus. This reduces the need for intragroup liquidity transfers. The balance sheets are predominantly denominated in domestic currency, making them less vulnerable to risks related to foreign currency (FX) fluctuations. However, from a consolidated view, parent banks will be affected by currency depreciations and volatility, which will test the effectiveness of their FX hedges. Overall, Austrian banking subsidiaries in CESEE are well capitalized, and those in the three analyzed countries maintain solid capitalization by local standards. However, their capital ratios are below the average of other Austrian CESEE subsidiaries.*

Supervisory measures have reduced risks and made Austrian banks more resilient. *Since the global financial crisis, the OeNB and the Austrian Financial Market Authority (FMA), together with the ECB within the SSM, have taken proactive measures that reduced the risks from CESEE activities. These measures have already proven their value in recent years and are of special importance in the current crisis. In particular, the measures are aimed at:*

- ***Funding risk:*** *The Austrian sustainability package published in 2012 aims to increase local, stable funding at foreign subsidiaries of Austrian banks. As a consequence, intragroup liquidity transfers by Austrian banks to CESEE declined by 67%, and those to Russia, Ukraine and Belarus by even 95%. The loan-to-deposit ratio declined from over 100% to 73% for all CESEE subsidiaries and to 76% in the analyzed three countries.*
- ***FX risk:*** *Austrian supervisors' guiding principles helped reduce the stock of FX loans at subsidiaries in CESEE by limiting new FX lending to borrowers with income in the loan currency. Since the end of 2010, the stock of FX loans extended by subsidiaries to both households and nonfinancial corporations in Russia, Ukraine and Belarus declined by almost 80% to EUR 3 billion.*
- ***Credit risk:*** *The volume of NPLs at Austrian banks' foreign subsidiaries fell significantly over recent years. In addition to the significant efforts of the SSM in this respect, international cooperation platforms like the Vienna Initiative helped improve risk management at the*

bank level and NPL resolution frameworks. In addition, regulation that limits large exposures helped reduce concentration risks.

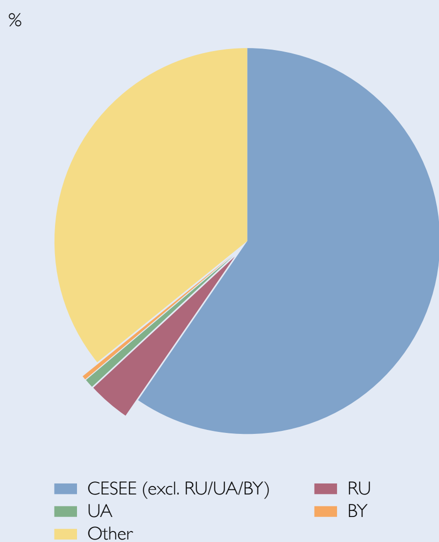
- ***Risk-bearing capacity:*** *Macroprudential capital buffers, especially the systemic risk buffer, and strong regional profits have improved the risk-bearing capacity of Austrian banks that are active in CESEE. Supported by macro- and microprudential capital measures, the Austrian banking system more than doubled its capital ratio since the global financial crisis. One of the elements relevant for the calibration of the systemic risk buffer is the banking sector's exposure to CESEE and concentration risk at certain banking groups.*

Chart 3.15

Austrian banks' activities in Russia, Ukraine and Belarus

Foreign exposure of Austrian banks

%

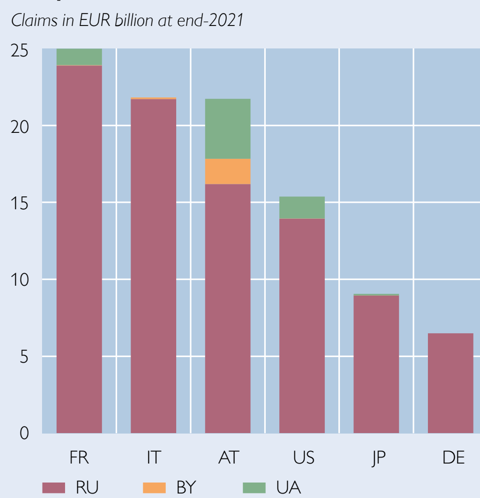


Source: OeNB.

Note: Data as of end-2021.

Austrian banks' exposure by international comparison

Claims in EUR billion at end-2021

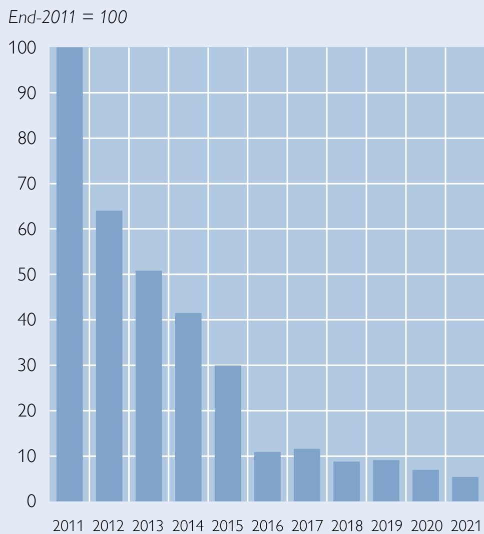


Source: BIS.

Note: Data on an immediate-borrower basis, domestic banks.

Austrian banks' intragroup liquidity transfers to banks in RU, UA and BY

End-2011 = 100

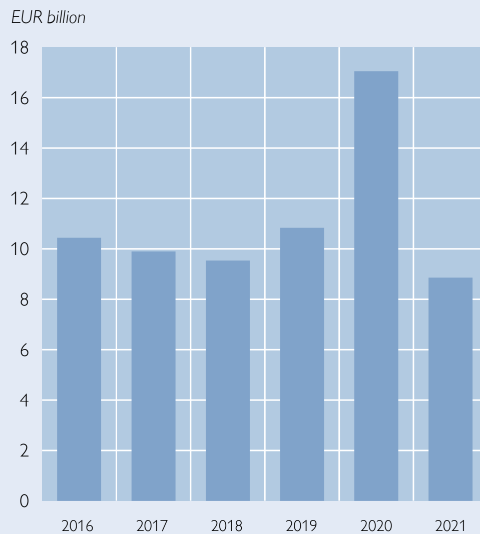


Source: OeNB.

Note: On-balance figures.

Share of profits from RU, UA and BY in Austrian banks' total profits

EUR billion



Source: OeNB.

The orderly wind-down of a Russian banking subsidiary in Austria did not jeopardize financial stability. *After the ECB had assessed in February 2022 that Sberbank Europe AG was failing or likely to fail and hence prohibited the bank from continuing business operations, in early May, the authorities announced that Sberbank's insolvency had been averted and that the funds paid out by the deposit guarantee scheme had already been repaid in full. In this difficult situation, supervisors' quick and decisive action, including the prompt payouts by the deposit guarantee schemes, made a considerable contribution toward ensuring that financial market stability and confidence in the Austrian financial market were maintained.*[23]

Conclusion: First-round effects did not have serious financial stability implications for Austria, but second- and third-round effects are as yet difficult to assess. *The Austrian banking sector has relevant banking exposures to Russia, Ukraine and Belarus and benefited from high profitability in these markets in the past. Given the worsening local economic and financial situation and potential repercussions for Austria, banks and supervisory authorities are monitoring the situation very closely and are constantly assessing the impact of the war and sanctions on banks' business models and their risk-bearing capacity. As risks had already been significantly mitigated over the past few years, first-round effects of the current crisis have been contained so far. However, second- and third-round effects, like reduced business activity together with the expected deterioration in credit quality, may pose challenges to the business outlook.*

[23] For details see press release FMA/OeNB: insolvency of Sberbank averted – all creditors able to be serviced in a timely manner – FMA Österreich.