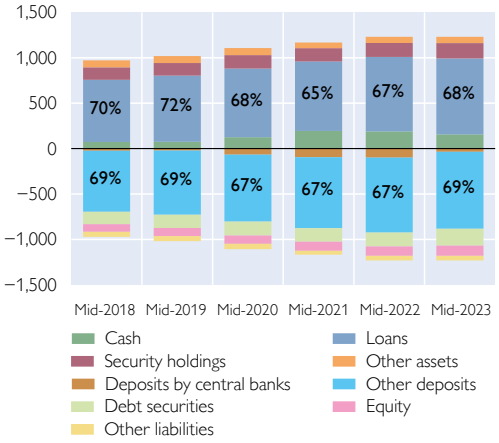
Recent developments and macroprudential policy update

The Austrian banking sector further increased its profit in the first half of 2023 despite fading momentum in loan growth

Chart 1

Consolidated balance sheet of the Austrian banking sector

Assets and liabilities, EUR billion



Source: OeNB.

Austrian banks' total assets remained at around EUR 1.2 trillion, more than 50% of which are held by the top three banking groups. Austria has around 500 banks, whose total assets equal about EUR 1.2 trillion. Nearly EUR 300 billion come from their subsidiaries in Central, Eastern and Southeastern Europe (CESEE). The consolidated balance sheet is dominated by loans and deposits (excluding central banks), which make up more than two-thirds of the sector's assets and liabilities. These shares have been stable over the last years (see chart 1). In contrast, cash balances and deposits by central banks, which had risen during the COVID-19 pandemic, started to decline recently. Despite the large number of banks, the sector is highly concentrated, with the top three banking groups accounting for more than half of total assets.

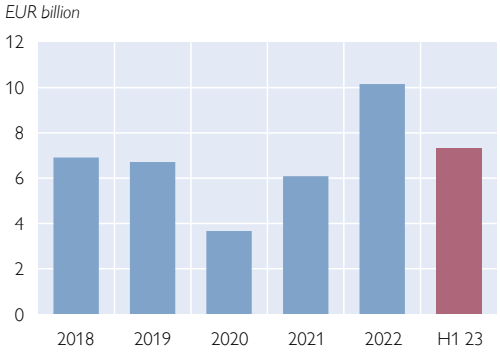
The largest banks in Austria are required to hold a capital buffer for other systemically important institutions (O-SII buffer), which reflects their role for the financial system and the wider economy. The O-SII buffer is prescribed for banks whose malfunctioning or failure may trigger a systemic risk that could entail serious negative consequences for the financial system and the real economy. Systemically important institutions in Austria are identified based on the guidelines of the European Banking Authority (EBA) by considering a bank's size and other factors such as its complexity and interconnectedness.[1] Currently, seven banks at the consolidated level and eight banks at the unconsolidated level are identified as systemically important institutions and hold an O-SII buffer between 0.5% and 1.75%. The next periodic evaluation of this buffer will take place in 2024.

The Austrian banking sector earned a record profit, mainly due to higher interest margins. Austrian banks continued to increase their profits in the first half of 2023, supported, among other things, by rising policy interest rates on deposits in riskless overnight central bank accounts. Compared to the same period last year, they more than doubled their profits to EUR 7.3 billion (see chart 2). With the net interest margin amounting to over 2%, Austrian credit institutions expanded their net interest income by more than 40% over the last 12 months. High inflation, on the other hand, also led to an increase in administrative

[1] *A detailed list of the results is published on the website of the Financial Market Stability Board (FMSB) at https://fmsg.at/en/publications/warnings-and-recommendations/2023/recommendation-fmsb-4-23.html.*

Chart 2

Net profit of the Austrian banking sector



Source: OeNB.

costs and wages in particular. Impairments on equity participations, which weighed on last year's results, no longer had a significant impact on profits, while loan loss provisioning was only marginally higher than last year.

Improved operating efficiency pushed Austrian banks' return on assets well above the European average in the first half of 2023. Rising income and lower expenses raised operating efficiency. The consolidated cost-to-income ratio of the Austrian banking sector improved to 50% in the first half of 2023. Provided that profits stay on a similar course in the second half of the year, Austrian banks will generate a consolidated return on assets of 1.3%. The comparative figure for the European banking sector would be 0.7%.

Due to rising interest rates and banks' stricter lending conditions, bank lending is losing momentum in Austria. Companies' short-term financing needs for inventories and operating resources remained at an elevated level, but demand for investment loans has been falling. In August 2023, corporate loans grew by 4.7% year on year, i.e. only at half the rate recorded at end-2022. At the same time, loans to households contracted by 1.3%, caused by a shrinking volume of mortgage loans, as increasing interest rates made the latter less affordable. In light of this, the annual growth rate of domestic loans to nonbanks declined to 1.1% in August 2023.

The credit-to-GDP gap remained negative, warranting a countercyclical capital buffer (CCyB) of 0%. The credit-to-GDP gap, which serves as the leading indicator for activating the CCyB, remained well below the critical threshold of +2 percentage points, which implied a CCyB of 0%. However, with GDP growth having proven increasingly volatile over the last few years, the credit-to-GDP gap may have become less reliable as an indicator of the buildup of cyclical risk. Consequently, supervisory authorities closely monitor additional relevant indicators that relate, for instance, to the correct pricing of risks in the financial system, the valuation of real estate markets and the indebtedness of households and corporates.

Since the introduction of binding borrower-based measures (BBMs) in Austria in August 2022,[2] residential real estate (RRE) lending standards have improved significantly. The BBMs, which are a structural macroprudential instrument, define limits for new RRE lending with respect to the loan-to-value (LTV) ratio (90%), the debt service-to-income (DSTI) ratio (40%) and loan maturities (35 years). Since the fourth quarter of 2022, the share of sustainable lending has increased for all indicators defined in the BBMs. For the

[2] *See https://www.fma.gv.at/en/fma-issues-regulation-for-sustainable-lending-standards-for-residential-real-estate-financing-kim-v.*

Chart 3

Bank loans to domestic households

Annual growth in %

Source: ECB.

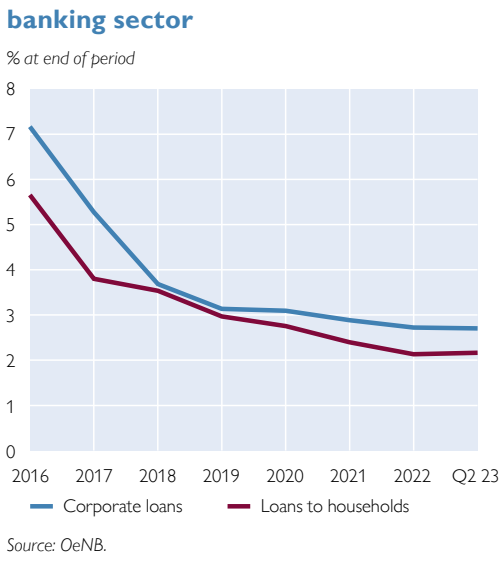
LTV ratio, the share of sustainable lending climbed from 70% to 79%. The shares of sustainable lending for the DSTI ratio and for loan maturities are even higher at 89% and 99% in the first half of 2023, which reflects an increase by 5 and 3 percentage points, respectively. Banks' flexibility increased further in 2023 due to an amendment. In addition to the exemption bucket applicable to up to 20% of the volume of new loans, bridge loans, for instance, were exempted too. According to reporting data, banks only used around two-thirds of their total exemption bucket in the first half of 2023, which suggests that the decrease in mortgage volumes is demand driven. Further evidence that BBMs were not driving the deceleration comes from a comparison with the situation in Germany, where no such measures are in place and lending growth has shown a similar downward trend (see chart 3). Against this background and considering the current environment of higher interest rates, elevated economic uncertainties and lower loan demand, a recent evaluation suggests that it is necessary to keep the BBMs in place to prevent a rise in RRE-induced systemic risk.

Lending at variable interest rates remains an area of macroprudential concern. From 2022 onward, the share of new loans to households with variable interest rates rose again, reaching close to 50% in August 2023, which exposes borrowers to interest rate risks, and such risks have already started to materialize. Interestingly, this occurs at a time when interest rates for variable rate loans are higher than for fixed rate lending. This development warrants close monitoring, as variable rate loans carry an additional indirect credit risk for the banking system.

Credit quality remains high. Rising interest rates, subdued economic conditions and an increasing number of insolvencies, which are back at pre-pandemic levels, have not yet resulted in a deterioration of Austrian banks' credit quality. This is in part because the effects of rising interest rates usually take some

Chart 4

Consolidated NPL ratio of the Austrian banking sector



Source: OeNB.

time to lead to credit defaults. Furthermore, amid lower household and corporate indebtedness, the consolidated nonperforming loan (NPL) ratio[3] remained at 2.0%. In mid-2023, the NPL ratios of corporate and household loans ran to 2.7% and 2.2%, respectively, as can be seen in chart 4. Consequently, Austrian banks kept credit risk provisioning stable year on year, and the relative cost of risk[4] at 0.2%. The consolidated coverage ratio continued to fall, however, as vintage NPLs with higher provisions were replaced by newly formed, less provisioned NPLs.

The Austrian banking sector's liquidity ratios are high and comfortably above minimum requirements. The sector's liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) are high, with the median LCR amounting to 158% and the median NSFR equaling 127% in mid-2023. Austrian banks' ratios are therefore comfortably above the minimum requirements of 100%. While reducing central bank deposits, banks' repayments of amounts borrowed under the Eurosystem's targeted longer-term refinancing operations (TLTROs) freed up collateral. In terms of liquidity ratios, Austrian banks thus match or slightly outperform the European average, while their central bank reserves still account for a major part of their liquid assets.

The capitalization of the Austrian banking sector has improved, but Austrian significant institutions (SIs) continue to trail behind their competitors. Driven by retained earnings, the Austrian banking sector's common equity tier 1 (CET1) capital rose to EUR 90 billion in the first half of 2023. The corresponding CET1 ratio stood at 16.6%. At 7.9%, the consolidated leverage ratio, which offsets the weaknesses of risk-based capital requirements, was kept nearly stable. Despite the increased capitalization, Austrian SIs still trail behind both their smaller local competitors and European SIs on average.[5] Therefore, continued efforts are needed by Austrian SIs to increase their capital base. The gradual phase-in of increased structural buffer requirements until 2024 is an important step in this direction, not least because a strong capital base is crucial in times of high inflation, sharply rising interest rates, geopolitical tensions and a subdued economic outlook.[6]

[3] *NPL ratio excluding cash balances at central banks and other demand deposits.*

[4] *Defined as loan loss provisioning over total loans.*

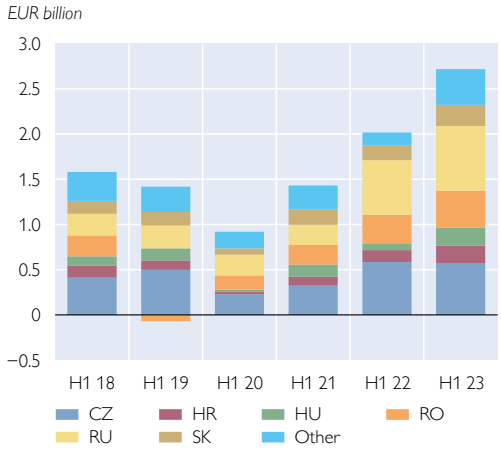
[5] *As of mid-2023, the average CET1 ratio of European SIs amounted to 15.7%, while Austrian SIs recorded an average ratio of 15.2%. See https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisorybankingstatistics_second_quarter_2023_202310~f41e7f2373.en.pdf.*

[6] *To learn more about the results of the OeNB's 2023 solvency stress test, see the box at the end of this report.*

Austrian banks' activities in CESEE are concentrated in EU member states, but Russia's profit contribution continues to be considerable. With more than 80% of assets and 60% of profits originating from inside the EU, Austrian banks' CESEE subsidiaries predominantly operate within the common European framework. Nonetheless, as highlighted by chart 5, six countries have dominated profit contributions over the last years, with Russia playing a significant role, although those profits are currently not transferable.

Chart 5

Austrian banks' subsidiaries in CESEE: profit in the first half of the year

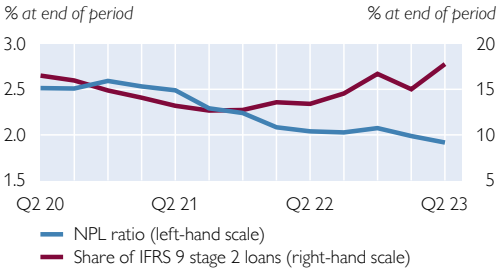


Source: OeNB.

Austrian banks' subsidiaries in CESEE earned a record EUR 2.7 billion in the first half of 2023. In a higher interest rate environment, the subsidiaries earned more than EUR 4 billion in net interest income (+16% year on year), while fees and commissions income rose by 10% to more than EUR 2 billion. Consequently, operating income amounted to EUR 6.5 billion and subsidiaries' operating profit (EUR 3.6 billion) was up by almost 20%. Very much like in Austria, credit risks have not yet materialized, despite high interest rates, a cost-of-living crisis and higher input costs for companies. The NPL ratio[7] reached a historic low of 1.9% and credit risk provisioning dropped by more than one-third year on year. The share of IFRS 9 stage 2 loans started to increase, however, which points to rising risks (see chart 6).[8] The overall positive business development is reflected in the subsidiaries' profit of EUR 2.7 billion (up more than one-third year on year) and their return on assets, which rose substantially from 1.4% in the first half of 2022 to 1.9% one year later.

Chart 6

Austrian banks' subsidiaries in CESEE: asset quality indicators



Source: OeNB.

As of mid-2023, the aggregate CET1 ratio of Austrian banks' CESEE subsidiaries stood at 18.1% (up 2 percentage points year on year). Their loan-to-deposit ratio was 71%.[9] These solid levels are a testament to past efforts by banks and supervisors to make local banking systems more resilient, by increasing the subsidiaries' risk-bearing capacity and ensuring a balanced refinancing

[7] *NPL ratio excluding cash balances at central banks and other demand deposits.*

[8] *Loans are classified in stage 2 if their "credit risk has increased significantly since initial recognition and is not considered low." For further details, see https://www.bis.org/fsi/fsisummaries/ifrs9.pdf.*

[9] *The loan-to-deposit ratio is calculated by dividing loans to nonbanks by deposits from nonbanks.*

structure.[10] The outlook for banking in CESEE remains clouded, given uncertainties related to the effects of the war in Ukraine, inflation as well as monetary policy. Hence, credit risk costs may start to rise and net interest margins might be squeezed as deposits are termed out.

The systemic risk buffer (SyRB) addresses, among other risks, the high and concentrated banking exposure to emerging economies in Europe. Disruptions in the whole or in parts of the Austrian financial system may entail severe negative consequences for the entire financial system and the real economy. The SyRB addresses structural systemic risks, inter alia the domestic banking sector's specific ownership structures and its high exposure to emerging economies in Europe. Although the SyRB is a structural buffer that is expected to stay fairly stable over time and is not affected by short-term developments, the OeNB evaluates it on a regular basis. The next evaluation will take place in 2024.

Recommendations by the OeNB

Fast rising interest rates boosted the banking sector's net interest margin and lifted profits to new highs in the first half of 2023. As banks used this momentum to improve their capitalization and thus their resilience to future risks, this development benefits financial stability. However, inflation is still too high and, consequently, monetary policy is set to stay tight. As geopolitical tensions also linger, multiple challenges persist for banks and the wider economy. Banks' currently outstanding profitability might not last, as interest margins can be expected to decrease. As a result, the OeNB recommends that Austrian banks further strengthen financial stability by taking the following measures:

- Continue to strengthen the capital base by exercising restraint regarding profit distributions.
- Adhere to sustainable lending standards for residential and commercial real estate financing.
- Ensure that interest rate risk management practices adequately reflect changes in the risk environment and that credit risk provisioning levels are conservative at the current juncture.
- For commercial real estate loans, be proactive in provisioning and use conservative collateral valuations.
- Maintain cost efficiency improvements to ensure structurally strong profitability.
- Further develop and implement strategies to deal with the challenges of new information technologies, increased cyber risks and climate change.

Box 1

Results of the OeNB's 2023 solvency stress test for Austrian banks

Background

The OeNB conducts annual stress tests for all Austrian banks under its dual mandate for banking supervision and financial stability. *The solvency stress test is designed to assess banks' resilience to adverse macroeconomic shocks and provides insights on both a bank-wide and a system-wide level. Conducted in a top-down fashion, it relies on the*

[10] *On the latter point and the Austrian supervisors' efforts, see https://www.oenb.at/en/financial-market/financial-stability/sustainability-of-large-austrian-banks-business-models.html.*

OeNB's well-established ARNIE stress testing framework, which is continuously improved. The stress test covers both significant and less significant institutions at the highest consolidated level. It focuses on risks relevant to the Austrian banking sector, including spillover effects among banks, which are particularly important for the decentralized sector. The most recent stress test is based on end-2022 data and covers the period from 2023 to 2025.

Scenarios

The adverse scenario assumes a severe macroeconomic downturn combined with a prolonged phase of elevated inflation and interest rates. *To be consistent with the recent EBA/ECB exercise, the OeNB employed the same baseline and adverse scenarios for its calculations. The baseline scenario projects cumulative GDP growth of 3.9% for the Austrian economy over the stress test horizon (2023–25). The adverse scenario assumes geopolitical tensions driving up commodity prices and causing supply shortfalls. Austrian inflation falls from 9.2% in 2023 to 3.9% in 2025 but remains above historical norms. Euro area real GDP contracts sharply with an overall negative cumulative growth rate of 5.9%. Austrian real GDP sees a slightly smaller negative cumulative growth rate of 5.3%. CESEE countries experience an average real GDP decline of around 6.5%, while Russian GDP shrinks by 14.8% over the same period. Driven by market expectations, the adverse scenario assumes that short-term interest rates rise to 4.4% in 2023 and drop to 3.5% by 2025, while EU long-term rates fall from 5.9% to 4.9%.*

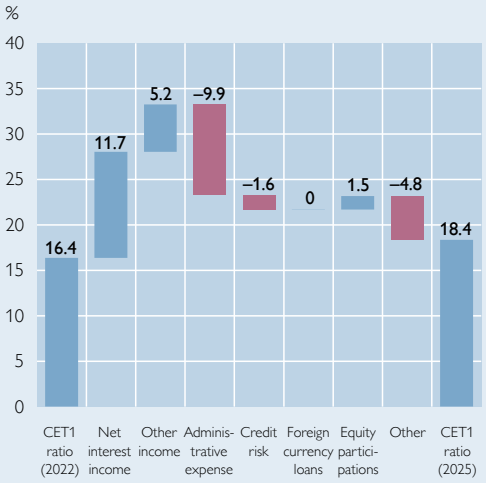
Results and risk drivers

While the aggregate CET1 ratio increases by 2 percentage points in the baseline scenario, it declines by 4.2 percentage points in the adverse scenario, landing at 12.2% at the end of 2025. *The following waterfall charts show the most important risk drivers and their contribution to capital depletion for both the baseline and the adverse scenario.*

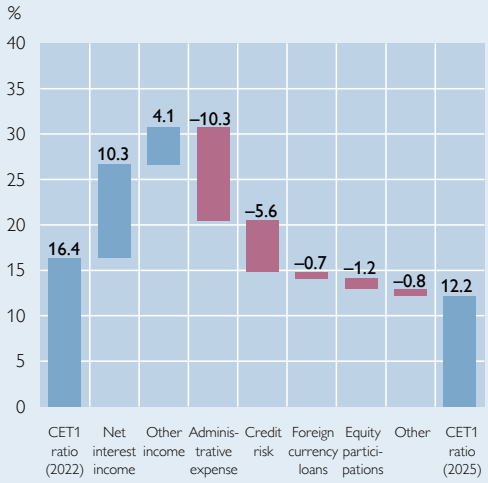
Chart 7

Austrian stress test – results and risk drivers

CET1 ratio of the Austrian banking system – baseline scenario



CET1 ratio of the Austrian banking system – adverse scenario



Source: OeNB.

Credit risk remains the main risk driver and reduces capital by 5.6 percentage points in the adverse scenario (baseline: –1.6 percentage points). Gains and losses from equity participations in nonfinancial corporations and especially other banks are significant as well. In the baseline scenario, banks participate in the profits of entities they are invested in and build up

capital (+1.5 percentage points). However, the picture reverses in the adverse scenario (–1.2 percentage points), reflecting reduced dividend income and the revaluation of equity participations. Finally, the contribution of net interest income drops from 11.7 percentage points in the baseline to 10.3 percentage points in the adverse scenario, a decline driven by a lower net interest margin. While banks profit from higher interest rates on the asset side in the adverse scenario, this effect is more than offset by higher interest costs on deposits.

The changed environment of high inflation and high interest rates results in a milder stress test impact than last year, mainly driven by higher net interest income (+2.2 percentage points) and its underlying assumptions. *In both scenarios, banks benefit from rising interest rates as assets generally reprice faster than deposits, where rates are stickier. The stress test assumes that under stressed conditions, deposit rates will rise faster than usually as customers ask for higher rates more actively. The assumptions for this pace of adjustments (the pass-through of interest rates to deposit rates, i.e. "deposit betas") are a major driver for the net interest income projections. For the stress test, the pass-through is calibrated based on OeNB research[11] and empirical observations, which indicate that household deposits show a lower pass-through than corporate deposits, while financial and other deposits reprice faster. The stress test therefore differentiates pass-through rates across scenarios, customer classes and over time. While baseline rates increase steadily over the stress test horizon, the adverse scenario assumes a steeper increase of the pass-through in the first four quarters, which overall leads to a lower net interest income compared to the baseline. Note that stress test results display a pronounced sensitivity to the underlying pass-through assumptions. The calibration of the pass-through rates taken from last year's stress test would result in a CET1 ratio of 10.2 percentage points in the adverse scenario, i.e. the impact on capital would be 2 percentage points larger.*

Conclusions

Overall, the stress test results indicate that the Austrian banking system is well placed to withstand substantial macroeconomic shocks. *The economic outlook in the baseline scenario is more optimistic than the current economic situation. In addition, higher interest rates result in a better overall performance, while the contribution of credit risk losses remains roughly unchanged. The results vary across the Austrian banking system. Banks with a larger exposure to the CESEE region experience greater losses, participation risks in the decentralized sector affect banks differently and banks with less favorable balance sheet structures benefit less from rising interest rates.*

The stress test underlines the importance of a well-capitalized banking sector. Even if capital ratios remain significantly above those observed before the great financial crisis of 2007–2008, macroeconomic uncertainty remains high. Given the speed of recent interest rate increases and the fact that many risk models were calibrated on low interest rates, potential long-term negative effects, e.g. higher credit risk losses, could still materialize. Therefore, it is important that Austrian banks act in a forward-looking and prudent manner with regard to profit distributions.

[11] *See the study by Breyer, Girsch, Hanzl, Hübler, Steininger and Wittig in this issue of the Financial Stability Report.*