DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

EXECUTIVE BOARD MEETING

SM/20/9
Correction 1

January 23, 2020

To: Members of the Executive Board

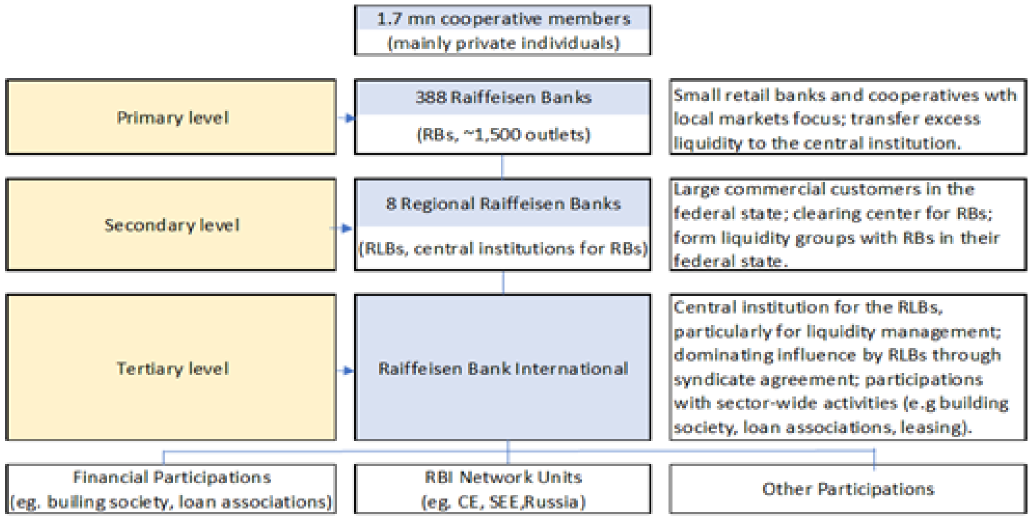
From: The Secretary

Subject: **Austria—Financial System Stability Assessment**

Board Action:	The attached corrections to SM/20/9 (1/10/20) have been provided by the staff:
Evident Ambiguity	**Page 24**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 12, 21, 27, 30**
Questions:	Ms. Melo, MCM (ext. 36485) Ms. Valderrama, MCM (ext. 37816)

While aggregate exposure to Russia represents 7 percent of CESEE assets, it is significant for the Raiffeisen segment.

Figure 2. Austria: Example of Support Mechanism – Raiffeisen Segment [1]



Source: OeNB.

1/ The Raiffeisen group (RBG) is the largest Austrian sector with over EUR 300 billion (30 percent total assets). The three-tiered structure includes 386 primary banks (RB), eight regional Landesbanken (RLB), and an internationally active bank (RBI). All RBs and their RLB are members of solidarity associations in each federal state to provide solvency support. In addition, participating members in six regional IPS (L-IPS) and a federal IPS (B-IPS) have contractual obligations to support each member and contribute to a customer protection scheme (RKO) in addition to the national DGS. RBI is the 'central institution' for the RLBs and provides liquidity management services. It holds participations with sector-wide activities in Austria (Poso, RBSK, RWBB) and is active in Central and Eastern Europe ~~(Tochter Osterr., Tochter Ausland)~~.

7. **Austrian banks have strengthened their capital levels and credit quality has improved** (Figure 6). Austrian banks have raised their capital levels from 11.6 percent common equity Tier 1 (CET1) in 2013 to 15.4 percent in 2018, supported by strong profits. However, the increase has subsided in the last two years, partly due to higher dividend payouts (as documented in Article IV reports). Despite recent improvement, banks' operating profits are dampened by a structurally high cost-to-income ratio (CTI), at around 65 percent in 2018, with Austrian SIs posting CTIs slightly below the euro area (EA) average. Credit quality has improved significantly. Nonperforming loans (NPLs) shrank from 8.6 percent in 2013 to 2.6 percent in 2018. The increase in credit quality was especially pronounced among subsidiaries in CESEE (NPLs declined from 14.0 percent in 2013 to 3.2 percent in 2018). Customer deposits at around 40 percent of liabilities underpin banking system stability.

8. **While in 2018 Austrian subsidiaries in CESEE saw above average profitability, performance has likely peaked**. Profitability increased given a favorable cycle driving down loan-loss provisions at historically low levels. Net interest margin (NIM) has been declining but remains considerably higher than in Austria. Austrian subsidiaries' CTI ratios are lower than at the consolidated level (51 percent) but have been on the rise during the last decade. After the 2012

Parliament. The government proposed, in May 2019, a reform of the supervisory framework for banking, which has been officially put on hold because the change in government (Box 1).

33. The FMSB plays a central role in terms of macroprudential oversight, benefitting from the support of OeNB's and FMA's work. The FMSB was established in 2014 to strengthen the cooperation in macroprudential supervision and to safeguard financial stability. The FMSB meets four times a year, and its members are the OeNB, the FMA, the Fiscal Advisory Council and the BMF, the latter also chairing the proceedings. The FMSB discusses facts relevant to financial market stability, and issues expert opinions, policy action recommendations and warnings about financial stability risks. The FMA is designated by law as the competent authority for applying macroprudential instruments, and it implements FMSB recommendations on a comply-or-explain basis. The OeNB is tasked with performing analysis for systemic risk identification, preparing preliminary recommendations to be voted by the FMSB, and providing the secretariat for the FMSB.

A. Macroprudential Policy Framework and Tools

34. The institutional framework for macroprudential policy is sound but could be strengthened to ensure effective and timely action. The framework encourages cooperation and coordination across different institutions. To benefit from OeNB's operational independence and the synergies offered by its role in monitoring and analyzing financial stability risks, the FMSB could be chaired by the OeNB, and its representation in the FMSB should be increased.[29] Adequate resources are needed to implement responsibilities related to European policy coordination.

35. The systemic risk monitoring framework is advanced but could be enhanced in some areas, including by closing data gaps. The analysis of real estate-related risks could be deepened and a more systematic analysis of interlinkages between different financial sector segments through common exposures is desirable. Several ongoing initiatives by the OeNB and FMA will increase the granularity of corporate and household lending data. However, data gaps remain. Authorities are encouraged to collect CRE data, gather detailed data on residential real estate exposures, enhance the granularity of CESEE exposures, and broaden the collection of NFC indicators, including on credit quality, profitability, debt and firm characteristics.

36. The expected weakening of credit demand and still negative credit-to-GDP gap justify the current countercyclical capital buffer (CCyB) of 0 percent (Figure 9). In terms of sectoral developments, growth of domestic bank credit to NFCs has picked up considerably over the last couple of years, driven primarily by real estate activities. If the strong credit growth in the NFC sector continues and credit in the real estate picks up, increasing the CCyB should be considered. Going forward, the planned introduction of *sectoral* macroprudential capital buffers to the European macroprudential framework may help address sector-specific risks stemming from credit growth.

[29] Currently OeNB and FMA are represented by two out of six voting FMSB members. The BMF, which also chairs the FMSB, has two representatives, and two members come from the Fiscal Advisory Council, which does not have a financial stability mandate.

Box 1. Institutional Reforms in Banking Oversight

In November 2018, the government announced the intention of consolidating banking supervision within the FMA. The stated aims of the reforms were to improve the efficiency of the supervisory system, reduce duplication, speed up decision making, establish clear points of contact for financial market participants, and strengthen "service orientation". Draft legislation released in April 2019 kept the main thrust of the reforms, but government changes have caused the reforms to be ~~put on hold~~reconsidered.

The FMA would assume responsibility for on-site inspections and off-site analysis from the OeNB and would become the sole point of contact on day-to-day supervision, the FMA would have sole "ownership" of content of the supervisory reporting but the OeNB would retain responsibility for data collection, processing and quality assurance.

The FMA's Supervisory Board would be reduced from the ten members to six and would take on responsibilities for strategic planning and establishing priorities for supervision. Two of the members would be appointed by the OeNB, and the other four by the BMF, two of whom would be independent experts with no current affiliation with regulated entities. The two-person Executive Board would be reduced to one member, with termination of the OeNB appointee.

The FMA would also establish a Financial Market Advisory Board, composed of experts from relevant ministries, industry, academia, the stock exchange and the OeNB, to advise on matters related to financial markets, and draw up proposals on supervisory topics. The Board would be able to seek opinions and make its proposals public, including on priorities for regulation.

The reforms would increase the dependence of the FMA on government funding. Currently, the OeNB's costs for prudential supervision are largely borne by the OeNB itself; the FMA's costs are largely covered by supervisory levies. Since there is no intention to increase these levies, the increased costs incurred by the FMA from the absorption of OeNB responsibilities would need to be funded by the government budget. The FMA and the OeNB would be required to implement cost-efficiency programs, and the reforms included an increase in the OeNB's profit distribution to the government from 90 to 95 percent to help cover costs.

The OeNB would retain some involvement in supervision since the governor would continue as a member of the Governing Council of the ECB, and an OeNB representative would remain as a non-voting member on the ECB's Supervisory Board. The OeNB's responsibilities for financial market stability would be unchanged. The number of OeNB representatives on the FMSB would increase from one to two.

44. The prolonged low interest rate environment challenges the insurance sector. The duration gap between asset and liabilities is one of the highest among the European peers. The average guaranteed rates remain high, while the investment returns continue to be declining. In addition, Solvency II allows insurers to recognize expected profits in future premiums as part of their own funds, and these make up a substantial part of the own funds of the two largest insurance groups. The reliance on future profitability to meet capital requirements challenges the entities' business models over the medium term, especially that of composite insurers.[32] It is recommended that the FMA conducts more targeted stress testing on the segments/business lines for which future profitability is material. Moreover, supervisors should clearly communicate to higher risk insurers

[32] The average share of expected profits in future premiums relative to own funds is about 12 percent, which is close to the European average. While the largest Austrian insurance group' reliance on future profits reaches over 40 percent, this is not deemed to be systemic given the small size of the insurance sector.

consider amending the bankruptcy regime to explicitly provide the ability to transfer a non-systemic bank's covered deposits and its sound assets to an acquirer.

53. As noted in the EA FSAP, ensuring that a bank in resolution can maintain enough liquidity is another key challenge. The ~~OeNB's~~ provision of Emergency Liquidity ~~Framework~~ Assistance (ELA) ~~framework~~ by the OeNB could be enhanced by formulating a policy on lending to a bank prior to and within resolution, and by expanding the types of assets eligible as collateral—which could be adjusted if required once the EA framework for liquidity in resolution is completed. The BMF should take steps to be able to support funding in resolution without requiring additional legislation at the time of need.

C. Deposit Protection

54. Deposit guarantee arrangements are sound and have suitable funding, but steps can be taken to strengthen deposit protection arrangements and their integration with the overall crisis management and safety net regime. There are two DGSs. The Einlagensicherung Austria GmbH is the so-called "uniform DGS" for Austrian banks that are not members of the second DGS, the Sparkassen-Haftungs GmbH. The DGSs have the right to access the funds of the other DGS (including contingent contributions) should the available resources of the fund and the contingent contributions from its members prove insufficient in amount. As a last resort both schemes can borrow, and the BMF may guarantee such borrowing, though no *ex ante* guarantee is in place and the BMF would need to table legislation to provide for it. The DGSs do not have the power to finance the transfer of assets and liabilities in the context of bankruptcy proceedings. The BMF should secure *ex ante* standing authority to provide a guarantee for the borrowing of either DGS in case of last resort.[34]

D. Insurance Resolution

55. Austria's ongoing discussions on an insurance resolution framework are a welcome step, and going forward, FMA's powers should be substantially reinforced. The team supports the formal adoption of the overarching principle that losses must be first borne by shareholders and other creditors, before they affect policyholders' and beneficiaries' claims. FMA restructuring powers should be extended to all kinds of insurance and all types of creditors. It should also be given the power to mandate a portfolio transfer. A strong resolution framework, building on the existing Deckungsstock[35], should be supported by a combination of different funding arrangements that provide adequate private ex-ante resources for resolution purposes and benefit from the credible support of provisions for public funding.

56. In the short-term, requesting pre-emptive and proportional recovery plans from selected insurers is strongly recommended. This requirement should be imposed on selected

[34] Alternatively, the BMF could be provided the power to lend directly to the schemes.

[35] The Deckungsstock is an internal pool of funds insurers must hold in a specific register monitored by a trustee. The assets may only be used for the benefit of policyholders and beneficiaries in case of bankruptcy or runoff.

Table 2. Austria: FSAP Risk Assessment Matrix (concluded)

		Supervisory assessment: Mitigating • Banking sector oversight: FMA minimum standards of the granting of FX and RPV loans (2013), revised in 2017, helped decrease default risk in mortgage loans. (**M**) • Macroprudential: 2018 FMSB~~MA~~’s guidance on sustainable lending standards in real estate financing has strengthened bank supervisory dialogue to prevent a deterioration in underwriting standards. (**M**) Crisis management: A synchronized decline in regional real estate prices could spread contagion through the DGS system. (**A**)
4. Weaker-than-expected global growth (Global)	**Medium** • Idiosyncratic factors in the U.S., Europe, China, and stressed emerging markets feed off each other to result in a synchronized and prolonged growth slowdown: • U.S.: Confidence wanes against a backdrop of a long expansion with stretched asset valuations, rising leverage, and policy uncertainty, leading to weaker investment and a more abrupt closure of the output gap. • Europe: Weak foreign demand, Brexit, or concerns about some high-debt countries makes some EA businesses delay investment, while faltering confidence reduces private consumption. Inflation expectations drift lower, and the region enters a prolonged period of anemic growth and low inflation. • China: In the near term, further escalation in trade tensions not only reduce external demand, disrupt supply chains, and depresses confidence and investment, but potentially also trigger tighter financial conditions, a sharp downturn in the property market, renewed PPI deflation, and a drop in commodity prices. In the medium term, weaker external demand, the potential reversal of globalization, and the increasing role of the state could weigh on growth prospects. Moreover, excessive policy easing—reversing progress in deleveraging and rebalancing—increases risks over time of a disruptive adjustment or a marked growth slowdown. • Large stressed emerging economies: Policy missteps, idiosyncratic shocks, and/or contagion prevent expected stabilization or recovery in stressed economies from materializing, generating negative spillovers and reducing global growth.	**Risk Assessment: Low** • A widening in Italian spreads would depress asset valuations of Italian government bonds, even though Austrian banks’ exposure to Italy is limited (1.3 percent of total foreign claims). Another channel of contagion is through funding markets as the third largest Austrian banks is a subsidiary of an Italian G-SIB. Adverse developments in Italy could lead to financial distress through higher funding costs. • Austria is a very open economy, with exports comprising more than 50 percent of GDP. Therefore, any retreat from cross-border integration, trade dispute or a deepening of geopolitical uncertainties, can pose material downside risks to Austrian output. A balance-sheet recession in Austria would depress disposable income, increase affordability risk (particularly for export-driven corporates), and lead to higher default rates. • Persistent low interest rates would erode bank margins and become a major threat for life insurance companies, given their rate-sensitive products and investments. **Supervisory assessment: Amplifying** • Insurance sector oversight: Implementation of risk rating and stress testing methodologies need clear steer. (**A**) • Macroprudential: SyRB for systemic vulnerability and O-SII buffer increase capital resilience. (**M**) • Crisis management: A unified, single resolution process for a major Austrian bank with an Italian parent (SPE) could lead to a downgrade in its credit profile. (**A**) • Banking sector oversight: A weak framework for country risk and transfer risk could add losses from events in foreign countries. (**A**)